Taxation (Relief, Refunds and Miscellaneous Provisions) Bill

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

15 April 2002

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

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Taxpayer financial relief

OVERVIEW OF SUBMISSIONS

Amendments to the Tax Administration Act 1994 give effect to the debt and hardship proposals outlined in the discussion document *Taxpayer compliance, standards and penalties: a review*, released in August 2001. The amendments aim to correct deficiencies in the current rules and to provide guidance to both taxpayers and Inland Revenue on the appropriate treatment of a person in debt. The rules outlined in the bill provide a framework. Inland Revenue is preparing more prescriptive administrative guidelines that will provide the necessary balance needed to ensure that each taxpayer's circumstances are taken into account.

Five submissions on the bill contained comments on the new taxpayer financial relief rules. The submissions were generally very supportive of the new rules, considering that they provide more guidance to taxpayers and Inland Revenue. Officials agree with many of the submissioners' proposals, including extending the period for taxpayers to respond to requests from Inland Revenue from ten working days to 20 working days, removing the definition of "dependent" from the definition of "serious hardship", to allow Inland Revenue to determine on a case-by-case basis whether a person is a dependent of the taxpayer, and removing two of the criteria available to the Commissioner to decline to enter an instalment arrangement.

Officials have also proposed changes to ensure that the rules work more efficiently.

GENERAL

Issue: Administration of proposals

Submission
(*4W – BusinessNZ*)

Better Inland Revenue debt management procedures, combined with better relief from penalty rules for taxpayers that have obviously been complying with tax laws over the years would assist taxpayers before they get into the situation when it is necessary to contact Inland Revenue regarding debt write-offs.

Comment

Officials agree with the sentiments expressed in the submission. Inland Revenue has recently adopted a compliance strategy which is aimed at increasing flexibility, helping those trying to comply and ensuring that firm action is taken against those who do not.

The taxpayer financial relief rules provide a framework for Inland Revenue to consider how best to provide relief for taxpayers in financial difficulties. Administrative guidelines are being prepared and will provide the necessary balance needed to ensure that taxpayers have their specific circumstances taken into account. These guidelines are being prepared in consultation with the Institute of Chartered Accountants of New Zealand and various budgetary advisors.

A taxpayer's previous compliance is a factor that is taken into account when imposing penalties. For example, the initial late payment penalty was amended to be imposed in two stages: 1 percent the day after the due date and 4 percent a week later. This amendment is aimed at reducing the penalty on taxpayers whose payment is only a few days late.

The submission raises administrative issues that are outside the legislation and therefore officials recommend that the submission be declined.

Recommendation

That the submission be declined.

Issue: Application of the new taxpayer financial relief rules to existing debts

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

On the request of either Inland Revenue or the taxpayer, existing instalment arrangements that would not comply with the new criteria should be able to be brought within the new rules.

Comment

Recent changes to the Tax Administration Act mean that from 1 April 2002 taxpayers who are a party to an instalment arrangement do not have incremental late payment penalties imposed for any month that the taxpayer has met all of the terms of their instalment arrangement. Therefore there is no benefit for an existing instalment arrangement to be brought automatically within the new rules.

Recommendation

That the submission be declined.

Issue: Application of the new rules to existing "parked" debts

Clause 78

Submission
(Institute of Chartered Accountants of New Zealand)

Any debt subjected to "write-off" under the current rules should be automatically deemed to be fully written off pursuant to the new rules.

Comment

Tax debts that have been written off under the old rules may have been written off for reasons that do not exist under the new rules. For example, under the current rules if a taxpayer is overseas a debt may be written off, whereas under the new rules the debt would continue to accumulate use-of-money interest and late payment penalties.

Officials are also concerned that automatically deeming the debts to be fully written off could be seen as unfair by those taxpayers who have got into financial difficulties and repaid their debt.

Officials see merit in applying the new rules to debts that have been written off when those debts are reinstated after 1 July 2002. The reinstatement of the "written-off" debt is done manually, and officials consider that when the debt is reinstated Inland Revenue should then consider what, if any, financial relief should be given.

Recommendation

That the submission be accepted in part in that the new rules apply to reinstated "written off" debts.

Issue: Maximising the amount recovered

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

The correct approach should be as follows:

Income
less committed and appropriate expenses, including all current and ongoing tax and liabilities
= funds available for repayment of (all) outstanding debt.

Decision as to:

- write-off, instalment arrangement or suspension for up to (say) three years (or a combination of the latter); or
- bankruptcy/liquidation

is then based on that data.

The focus should then be, as proposed, to maximise the amount collected over time.

This analysis will take into account the implications of (for example) business continuity vs liquidation.

Comment

Broadly, this is what will happen in practice. The legislation will make clear the broad principle, with the administrative guidelines providing detail. Officials consider legislating for issues such as "committed and appropriate expenses" is likely to lead to disputes between taxpayers and Inland Revenue as to what meets this definition. Officials are also concerned that the approach proposed by the Institute does not cover the fact that the taxpayer has assets that can be sold.

The only substantive area of difference between the submission and the intention of the legislation is that, under the legislation, the Commissioner's role is clearly to maximise the collection of the outstanding tax. The submission places greater emphasis on business continuity. Officials still consider that the emphasis should be placed on the Commissioner maximising the collection of outstanding tax. Nevertheless, the rules provide Inland Revenue considerable flexibility. The outcome of early discussion is more likely to be positive, with reduced stress and cost for taxpayers. The need for other approaches to debt recovery and measures of last resort such as bankruptcy, will reduce.

Recommendation

That the submission be declined but that the submission be considered as part of the administrative guidelines.

Issue: Response period

Clause 78

Submission

(7 – PricewaterhouseCoopers, 9W – National Council of Women of New Zealand (Inc.), 12 – Institute of Chartered Accountants of New Zealand)

The legislation should specify:

- a response period for Inland Revenue; and
- a response period for taxpayers of no less than 20 days. *(PricewaterhouseCoopers)*

The bill proposes ten working days for a taxpayer to provide information sought or to respond to a counter-offer. The bill does not impose the same ten days on the Commissioner to respond. Ten days is insufficient time if there are postal delays or the taxpayer needs to communicate or visit their accountant. One month is more appropriate, and the same time limit should be imposed on the Commissioner. *(National Council of Women of New Zealand (Inc.))*

Inland Revenue should be required within 20 days of receiving a request to advise the taxpayer of the following:

- when the request was received; and
- who the officer will be who will be handling the request.

If Inland Revenue has not responded within 20 working days, use-of-money interest stops (to equate with incentives on the taxpayer).

The taxpayer should have a minimum of 20 working days to respond. *(Institute of Chartered Accountants of New Zealand)*

Comment

The discussion document proposed that when Inland Revenue requests information, or makes a counter-offer, the legislation will provide that the taxpayer should be given at least ten working days, from the date of Inland Revenue's request or counter-offer, to respond. On reflection, officials agree with submissioners that taxpayers should be given 20 days to respond to requests for information or for responding to counter-offers.

In respect of the legislation specifying a response period for Inland Revenue, officials consider that there are already sufficient incentives for Inland Revenue to respond in a timely manner to a taxpayer's request. Stopping the imposition of use-of-money interest is contrary to the policy underlying the use-of-money interest rules in that the Crown is not being compensated for not having the use of its money. These taxpayers have not met a fundamental tax obligation to pay tax on time. Officials remain of the view that the best way to ensure a timely response from the department is to establish appropriate standards as part of Inland Revenue's annual reporting process.

Officials agree with the Institute's submission that taxpayers be advised when the request was received and who the officer will be who will be handling the request. We recommend, however, that this proposal be included in the administrative guidelines and that there be no time limit imposed on the Commissioner for providing this information.

Recommendation

That:

- the submission be accepted to the extent that the response period for taxpayers be extended to 20 days; and
- the administrative guidelines require the Commissioner to respond to taxpayer requests as quickly as possible, but that this be achieved through reporting requirements.

Issue: Information provided by the taxpayer outside the timeframe allowed for in section 177(3)

Clause 78

Submission
(Matter raised by officials)

The legislation should provide specific rules to clarify how the legislation will apply in cases where the information requested by Inland Revenue is provided outside the response period provided for in section 177(3).

Comment

Section 177(3) of the bill provides that the taxpayer has ten working days, or a longer period allowed by Inland Revenue, to provide the information sought by Inland Revenue or to respond to a counter-offer. As noted previously, officials recommend that this time period be extended to 20 working days.

Inland Revenue has a discretion to allow the taxpayer further time to respond. If taxpayers were unable to respond because of circumstances beyond their control, that discretion would be exercised.

If the delay was the result of taxpayers inaction the legislation does not provide clear rules as to what should happen.

Officials recommend that the legislation provide that if the taxpayer responds after the expiry of the response period provision of the required information should be treated as a new request for an instalment arrangement.

Recommendation

That the submission be accepted.

Issue: Definition of "outstanding tax"

Clause 61

Submission
(Matter raised by officials)

A definition of "outstanding tax" should be inserted.

Comment

The taxpayer financial relief rules apply to "outstanding tax". It has been suggested by the people working on the administrative guidelines that for tax to be outstanding then the due date for the payment of the tax must have passed. However, the legislation refers to taxpayers contacting Inland Revenue seeking financial relief before the due date. It was always intended that the provisions apply to amounts owing to Inland Revenue before or after the due date, and that the amount can include core tax (except child support or student loans), interest or civil penalties.

Officials recommend that, in order to remove any doubt, a definition of "outstanding tax" be inserted.

Recommendation

That the submission be accepted.

Issue: Legal entities and hardship

Submission
(7 – PricewaterhouseCoopers)

Criteria should be introduced that allow Inland Revenue to consider the financial impact of debt collection on a company in determining whether to enter into an instalment arrangement.

Comment

Officials disagree with the submission. The role of Inland Revenue should simply be that of maximising the amount of debt recovered as this maximises the efficiency and equity of the tax system. Not collecting debt from taxpayers who threaten bankruptcy or liquidation as a consequence of recovery action is equivalent to providing a tax subsidy. Officials note that, under the proposals, consideration of serious hardship is considered in relation to principal shareholders.

Recommendation

That the submission be declined.

Issue: Look-through

Clause 78

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

On application by the taxpayer, Inland Revenue should be obliged to look through to the effect on all shareholders.

Comment

Officials disagree that Inland Revenue should be obliged to look through to the effect on all shareholders. This would be administratively unfeasible and also raises the issue that debt recovery from a company may cease simply because of the impact of that recovery on one shareholder. For example, if a shareholder has invested his or her life savings in a public company, the tax recovery, in this case, should not be influenced by the impact of the recovery on that one taxpayer.

During consultation with the Institute of Chartered Accountants of New Zealand, officials were asked to consider whether the provision could be extended to apply also to shareholder-employees. We agree with the Institute that extending the look-through rule to shareholder-employees has merit. This type of taxpayer typically works for the company and reinvests any earnings in the company. The definition of "shareholder-employee" in the Income Tax Act refers to "close company".

There are basically two definitions of "close company": the first refers to a company which has five or fewer natural persons whose voting interests or market value interests exceed 50 percent, and the second refers to a company with 25 or fewer shareholders. Officials consider that the look-through rule should apply to shareholder-employees of close companies that fall within the first part of the definition. We are concerned that if the rule also applied to companies of 25 or fewer shareholders then the rule could be open to manipulation. That is, if any one of the 25 shareholders faced serious hardship because Inland Revenue was collecting a tax debt from the company then the tax debt may end up being written off.

Recommendation

That the submission be accepted but limited to shareholder-employees of close companies where the close company has five or fewer natural persons whose voting interests or market value interests exceed 50 percent.

Issue: Drafting of section 177A(1)(b)

Clause 78

Submission
(7 – PricewaterhouseCoopers)

Section 177A(1)(b) is not well worded. The exclusion should reflect that the taxpayer should not put their tax debt last, then decide that they in a difficult position and look to the Inland Revenue Department for help.

Comment

The proposal in the submission is harsher than the current wording in the bill. For example, a taxpayer owes Inland Revenue money and also has other debts some of which relate to basic community standards, say, a fridge on hire purchase. If the legislation provided that serious hardship did not include "financial difficulties that arise solely because the taxpayer is obligated to pay tax" then the taxpayer's obligations under the hire purchase agreement would not be taken into account, which may result in the fridge being repossessed.

During the hearing of evidence concern was also expressed in relation to business debts, in that taxpayers may pay suppliers ahead of Inland Revenue in order to maintain their business. Officials acknowledge that this does happen but note that this submission relates to the definition of serious hardship, which applies to natural persons and at the Commissioner's discretion to principal shareholders. To determine whether taxpayers are facing serious hardship, their total financial position should be considered and each taxpayer considered on a case-by-case basis.

Recommendation

That the submission be declined.

Issue: Definition of "serious hardship" and expensive education

Submission
(9W – National Council of Women of New Zealand (Inc.))

An additional circumstance should be included where the provision of expensive education for the taxpayer or their dependents should not be a consideration when determining if serious financial difficulties would arise if tax liabilities were met.

Comment

Officials consider that expensive education would be excluded under paragraph (b)(iv) of the "serious hardship" definition, which states "the taxpayer is unable to afford goods or services that are expensive or of a high quality or standard according to normal community standards".

The definition of "serious hardship" gives the Commissioner flexibility to consider the specific circumstances of the taxpayer. For example, if the taxpayer had a child who is hearing impaired and who required special schooling then the cost of that schooling would be considered appropriate under the definition.

The administrative guidelines will provide more guidance on this issue.

Recommendation

That the submission be declined.

Issue: Definition of "serious hardship"

Clause 78

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

Child support and other non-discretionary obligations should be taken into account in determining resources available to repay debt.

The effect on a family (as opposed to just the taxpayer) should be explicitly considered.

It will be difficult to define and measure “normal community standards”.

Consistency committees should be set up to review Inland Revenue’s decisions.

Comment

In practice, the administrative guidelines will consider “child support and other non-discretionary obligations” in determining the resources available to repay debt.

In relation to the submission that the effect on the family as opposed to just the taxpayer should be considered, the definition of “serious hardship” generally applies to the “taxpayer or their dependent”. “Dependent” has been defined in section 177A(2) as being “a person within one degree of relationship”. Officials are concerned that this definition may be too narrow and recommend that the definition be repealed and that whether a person is a taxpayer’s dependent be determined on a case-by-case basis.

In relation to defining and measuring “normal community standards”, the legislation provides a framework for Inland Revenue to consider how best to provide relief for taxpayers in financial difficulties. Administrative guidelines are being proposed, which will provide the necessary balance needed to ensure specific circumstances are taken into account.

Inland Revenue will set up consistency committees.

Recommendation

That the submission be accepted in part in that the definition of “dependent” in section 177A(2) be removed.

Issue: Serious hardship applies only to natural persons

Clause 78

Submission
(Matter raised by officials)

The legislation should be clarified to make it clear that only natural persons can suffer serious hardship.

Comment

As the legislation is currently drafted, it could be argued that legal entities, for example companies, partnerships or trusts, could suffer serious hardship. This was never the intention of the legislation. Legal entities cannot suffer hardship. Officials recommend that the legislation be clarified to provide that only natural persons can suffer serious hardship.

Recommendation

That the submission be accepted.

INSTALMENT ARRANGEMENTS

Issue: Criteria for declining to enter an instalment arrangement

Clause 78

Submission

(7 – PricewaterhouseCoopers, 9W – National Council of Women of New Zealand (Inc.), 12 – Institute of Chartered Accountants of New Zealand)

Inland Revenue should not be able to decline requests to enter an instalment arrangement if either:

- the taxpayer is requesting an instalment arrangement to stop the Commissioner taking action to recover tax; or
- the taxpayer has previously made a request to enter into an instalment arrangement and the request has been declined. *(PricewaterhouseCoopers)*

While requests for instalment arrangements should not be used as a device in reducing penalties, taxpayers should not be limited to only one application for an instalment arrangement. Personal circumstances often change and it is reasonable for taxpayers to be able to request instalment arrangements on more than one occasion. It may be that a time period (say, within six months) be inserted if the Committee is concerned that this clause will be abused. *(National Council of Women of New Zealand (Inc.))*

As the purpose is impossible to determine and being declined or not complying in the past is irrelevant, the following three criteria should be removed:

- the purpose of the request for an instalment arrangement is simply to stop recovery action;
- the taxpayer has not complied with a previous instalment arrangement; and
- the taxpayer has previously made a request to enter an instalment arrangement and the request has been declined. *(Institute of Chartered Accountants of New Zealand)*

Comment

Section 177B(2) sets out the circumstances where the Commissioner may decline to enter an instalment arrangement.

The fourth criterion is where "the taxpayer is requesting an instalment arrangement to stop the Commissioner taking action to recover the outstanding tax". The discussion document *Taxpayer compliance, standards and penalties: a review* proposed that when taxpayers contacted Inland Revenue seeking financial relief then Inland Revenue would "suspend any late payment penalties and recovery action currently underway". In drafting the legislation officials overlooked the recommendation to suspend recovery action. On reflection, officials consider that any recovery action underway should continue. The administrative and compliance costs of suspending the action would be great, and would outweigh any benefit of suspending the action. As recovery action will not be suspended a taxpayer could not request an instalment arrangement in order that recovery action be suspended. Officials therefore agree with submissioners that this criterion should be removed.

In relation to the fifth criterion that "the taxpayer has not complied with a previous instalment arrangement", officials disagree with submissioners. We consider that previous non-compliance is a good indicator as to whether a taxpayer will comply. We also note that all of the criteria for declining to enter an instalment arrangement are discretionary. If, for example, the taxpayer had not complied with a previous arrangement and that non-compliance was some time ago and the taxpayer had complied with all of their other tax obligations, Inland Revenue would probably enter an instalment arrangement. The administrative guidelines will provide more guidance on this issue.

The Institute of Chartered Accountants also recommended that the sixth criterion where "the taxpayer has previously made a request to enter an instalment arrangement and the request has been declined" be removed. Officials agree with the submissioner. Officials were concerned that taxpayers who had their requests for an instalment arrangement declined could repeatedly request an instalment arrangement in relation to the same debt. Officials consider that if the taxpayer asks for an instalment arrangement in relation to the same debt and the taxpayer's circumstances have not materially changed then the reason given for declining the arrangement the first time will remain relevant and the arrangement can be declined for that reason.

In relation to the submission from the National Council of Woman that taxpayers not be limited to only one application for an instalment arrangement, officials agree. If the taxpayer requests relief, it is not granted, the taxpayer's circumstances worsen and another request is made for relief, relief may be granted. As noted above, all of the criteria are discretionary, allowing the taxpayer's specific circumstances to be taken into account.

It was never intended that the taxpayer could be a party only to one instalment arrangement at a time. If the taxpayer had a tax debt and entered an arrangement, and then got into difficulties in relation to a new tax debt the taxpayer could request financial relief in relation to that second debt. That relief could be in the form of write-off, or the taxpayer may have their first arrangement varied to include the second debt or the taxpayer and Inland Revenue could enter a second arrangement. As with all of the taxpayer financial relief rules, the outcome will be determined on a case-by-case basis taking the circumstances of the taxpayer into account.

Recommendation

That the submission be accepted in part in that paragraphs (d) and (f) of section 177B(2) be removed.

Issue: Renegotiation of instalment arrangements

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

The Institute agrees with the renegotiation of instalment arrangement proposals, except for Inland Revenue's proposed power to decline an instalment arrangement when a previous arrangement has not been adhered to.

Comment

Officials disagree with this submission. If the taxpayer has a past history of non-compliance, officials consider that such behaviour could indicate that the taxpayer would not comply with the requested arrangement. The power to decline to enter an instalment arrangement is a discretion that allows the taxpayer's specific circumstances to be taken into account.

For example, if the taxpayer's circumstances worsen, the taxpayer misses a few instalments and the taxpayer then requests that the arrangement be renegotiated, a new arrangement may be entered into. On the other hand, if the taxpayer did not notify Inland Revenue for a year, say, renegotiation of the arrangement might be declined on the basis that the previous arrangement was not complied with.

As noted previously, administrative guidelines will be issued on this matter and will be publicly consulted on.

Recommendation

That the submission be declined and that Inland Revenue continue to look at the taxpayer's past compliance when determining whether to enter an instalment arrangement or not.

Issue: Use-of-money interest

Submission
(7 – PricewaterhouseCoopers, 12 – Institute of Chartered Accountants of New Zealand)

During the course of an instalment arrangement either:

- no use-of-money interest; or
- a reduced level of use-of-money interest, equivalent to the secured mortgage lending rate

should apply to the debt. *(PricewaterhouseCoopers)*

The legislation should be amended so that no interest will apply. Imposing use-of-money interest does not assist the recovery of more tax. *(Institute of Chartered Accountants of New Zealand)*

Comment

Use-of-money interest compensates the recipient for not having the use of their money. Rather than not charging use-of-money interest during the term of an instalment arrangement, officials consider that a better approach, with very likely the same outcome, is for Inland Revenue to determine the amount the taxpayer can afford to repay, including use-of-money interest, and write off the balance. Charging use-of-money interest provides taxpayers with an incentive to repay their debt as soon as possible. This is specifically important in cases where a taxpayer's circumstances change. It also enables taxpayers to see the consequences of delaying payment – the interest they are incurring for not paying their tax on time.

Not charging use-of-money interest during the term of an instalment arrangement or charging interest at a lower rate would encourage all taxpayers to contact Inland Revenue stating that they cannot pay their debts on the due date and requesting to enter instalment arrangements instead. The norm would become one of requesting an instalment arrangement in the hope that use-of-money interest and penalties will not apply.

In addition, not charging use-of-money interest undermines the policy underlying the use-of-money interest rules, that is, that the Crown is not being compensated for not having the use of its money.

Recommendation

That the submission be declined.

Issue: Taxpayers defaulting on instalment arrangements

Clause 78

Submission
(Matter raised by officials)

If taxpayers default on instalment arrangements Inland Revenue may cancel the instalment arrangement.

Comment

If taxpayers do not comply with their repayment obligations under instalment arrangements, late payment penalties will be imposed. Officials are concerned that taxpayers may enter instalment arrangements and not comply with their obligations, and because the legislation does not allow Inland Revenue to renegotiate arrangements for a two-year period, the department has entered an arrangement that cannot be overturned.

Officials therefore recommend that if a taxpayer is not adhering to the arrangement Inland Revenue should have the power to cancel the arrangement and take the necessary action to recover the outstanding debt. The administrative guidelines will set out how this proposal will work in practice.

This provision is in no way aimed at providing Inland Revenue with the opportunity to renegotiate instalment arrangements within the two-year time period. It is designed to ensure that where a taxpayer is not adhering to an arrangement, action can be taken to recover the outstanding tax. If a taxpayer's financial situation worsens, the taxpayer always has the option of renegotiating their arrangement with Inland Revenue.

Recommendation

That the submission be accepted.

Issue: Bankruptcy/liquidation of taxpayers who are party to an instalment arrangement

Clause 78

Submission
(Matter raised by officials)

The legislation should state that if a taxpayer who is a party to an instalment arrangement is bankrupted or liquidated, the amount outstanding under the arrangement and any other amounts outstanding are included in the department's proof of debt.

Comment

Officials consider that the legislation should clearly state that if the taxpayer is bankrupted or liquidated then any proof of debt should be for the entire amount owing to Inland Revenue, including any amount subject to an instalment arrangement. Officials are concerned that if an amount is subject to an instalment arrangement and the taxpayer is complying with the arrangement there may be an opportunity for the amount owing under the arrangement to be omitted form the proof of debt. This was never the intention of the legislation and officials recommend that the legislation be clarified to ensure that the proof of debt is for the entire amount owing.

Recommendation

That the submission be accepted.

Issue: Rate for extinguishing tax losses

Submission
(*9W – National Council of Women of New Zealand (Inc)*)

In subclause (4) the extinguishing of a taxpayer's net loss should be at the taxpayer's marginal tax rate, not 33 percent. If the taxpayer were to use the tax loss against current taxable income it would start at 19.5 percent, not 33 percent. The use of tax losses against outstanding tax is advantageous to taxpayers not just for financial reasons but for physiological [sic] reasons in that it lessens the financial pressure felt by owing Inland Revenue, which can be greater than owing other people.

Comment

The point being made is understandable. However, we have opted to use a simple rate which will generally either be accurate or taxpayer-friendly.

Recommendation

That the submission be declined.

Issue: Section 177C(4)

Clause 78

Submission
(Matter raised by officials)

The drafting in section 177C(4) is not clear.

Comment

Officials consider that the drafting in section 177C(4) is unclear. The section does not set out clearly that the amount the taxpayer's net loss should be reduced by is the amount of the outstanding tax written off, divided by 33 percent. We recommend that the bill be amended to make this clear.

Recommendation

That the submission be accepted.

Issue: Section 177C(6)

Clause 78

Submission
(Matter raised by officials)

Section 177C(6) should apply to both bankruptcies and liquidations, and the section should apply regardless of who took the action to bankrupt or liquidate the taxpayer.

Comment

Under the new section 177C(6), Inland Revenue will be able to reinstate a written-off debt if within a year of the debt being written off the taxpayer becomes bankrupt. This section is in response to a submission received on the discussion document *Taxpayer compliance, standards and penalties: a review*. The submissioner was concerned that the taxpayer's other creditors could encourage the taxpayer to have an amount owing to Inland Revenue written off so that when the taxpayer is subsequently bankrupted the dividend paid to those other creditors is greater. On reflection, officials are concerned that such a scenario could also occur when a taxpayer is liquidated. Officials therefore recommend that the section be amended to apply also to liquidations.

As drafted, the reversal of the write-off occurs only if the taxpayer declares bankruptcy. Officials consider that the write-off should be reversed if the taxpayer or any creditor takes bankruptcy action.

Recommendation

That the submission be accepted.

Issue: Abusive tax position and evasion

Clause 78

Submission
(Matter raised by officials)

Section 177C(3) should refer to shortfall penalties for abusive tax position or evasion or similar act, and it should be made clear that that amount that cannot be written off includes the shortfall penalty.

Comment

Under the new section 177C(3), Inland Revenue cannot write off outstanding tax if the taxpayer was liable to pay in relation to the outstanding tax a shortfall penalty for an abusive tax position or evasion or similar act. This section is aimed at ensuring those taxpayers who take such tax positions face the entire consequences of their actions.

However, the taxpayer financial relief rules restate the definition of “abusive tax position”. As the shortfall penalty is imposed under sections 141D or 141E, officials consider that there is no need to restate the definition.

As the section is currently drafted, it could be argued that the amount that cannot be written off excludes the shortfall penalty itself. To remove any doubt, officials consider that the section be clarified to ensure that the amount that cannot be written off includes the shortfall penalty.

Recommendation

That the submission be accepted.

Issue: Imposition of penalties when an amount written off is reinstated because false or misleading information was provided

Clause 78

Submission
(Matter raised by officials)

If an instalment arrangement is cancelled because Inland Revenue entered the arrangement based on false or misleading information provided by the taxpayer, any late payment penalties not imposed should be imposed when the arrangement is cancelled.

Comment

Under the new section 177B(6), Inland Revenue will be able to cancel an instalment arrangement if Inland Revenue entered the arrangement based on false or misleading information provided by the taxpayer. Officials consider that as Inland Revenue would not have entered the arrangement had the false or misleading information not be provided, those late payment penalties that were suspended because the taxpayer was a party to an instalment arrangement should be imposed when the arrangement is cancelled.

Recommendation

That the submission be accepted.

Issue: Remove cross-reference to section 176(2) in section 177C(1)

Clause 78

Submission
(Matter raised by officials)

Section 177C(1) should be amended to allow write-off of debt in cases other than serious hardship and inefficient use of Inland Revenue's resources.

Comment

The taxpayer financial relief rules make it clear that the Commissioner's role is to maximise the amount of debt recovered. In order to fulfil this role, Inland Revenue should be given the discretion to write off amounts when the amount cannot be collected, and not just when the taxpayer faces serious hardship or it is an inefficient use of the Commissioner's resources. Officials therefore recommend that the reference to section 176(2) in section 177C(1) be removed

Recommendation

That the submission be accepted.

Issue: Reinstatement of amounts that should not have been written off

Clause 78

Submission
(Matter raised by officials)

The legislation should provide that if an amount is written off under section 177C(2) it can be reinstated if a further dividend or distribution is made.

Comment

Section 177C(2) provides that the Commissioner must write off outstanding tax that cannot be recovered if the taxpayer is made bankrupt or liquidated or the taxpayer's estate has been distributed. The legislation does not provide rules for reinstating the amount written off when a previously unknown asset is identified later. For example, after a taxpayer's estate has been distributed a bank account is identified as the taxpayer's, officials consider that the amount written off should be reversed to the extent of the department's share in the newly identified asset. We are concerned that because the debt has been written off, Inland Revenue would not be in a position to claim any portion of the newly identified asset.

Officials recommend that an amendment be made to ensure that if a new asset is identified after an amount has been written off that the amount written off may be reversed.

Recommendation

That the submission be accepted.

Issue: Imposition of the 4 percent initial late payment penalty

Clause 75

Submission
(Matter raised by officials)

If a taxpayer enters an instalment arrangement on or after 1 April 2002 and then defaults on the arrangement the 4 percent late payment penalty should not be imposed.

Comment

The late payment penalty legislation was recently amended to impose the initial late payment penalty in two stages. One of the changes made at the same time relates to the imposition of late payment penalties when the taxpayer enters an instalment arrangement. From 1 April 2002, if a taxpayer enters an arrangement before the due date the 1 percent initial late payment penalty is imposed. If the taxpayer defaults on the arrangement, the 4 percent late payment penalty is imposed at the time of the default.

Under the taxpayer financial relief rules, if a taxpayer enters an arrangement before the due date the 1 percent initial late payment penalty is imposed, but if the taxpayer defaults the 4 percent initial late payment penalty is not imposed.

Officials consider that the provisions should be consistent. We recommend that the legislation be amended so that from 1 April 2002 the 4 percent initial late payment penalty is not imposed if the taxpayer defaults on the arrangement.

Recommendation

That the submission be accepted.

Transfers of excess tax

OVERVIEW OF SUBMISSIONS

Clause 77 of the bill inserts into the Tax Administration Act 1994 a comprehensive set of rules governing the transfer of tax that has been overpaid.

The general principle underlying the transfer rules is that a taxpayer who has overpaid tax is entitled to a refund. In some cases, the taxpayer might ask Inland Revenue to transfer that overpayment to another period or type of tax of the same taxpayer, or to another taxpayer, rather than issue a refund cheque. The proposed new rules authorise Inland Revenue to do this.

The rules therefore allow excess tax to be transferred to any other taxpayer as at a date that is a proxy for the date on which the tax would be refunded. The proxy is the later of the date after the return is filed and the date of the transfer request. This recognises that, once the return is filed, the taxpayer has no control over the length of time it takes to process the return.

The new rules also allow transfers to a limited category of taxpayers to be effective at the date the tax is overpaid. Such transfers are allowed when the transfer is made:

- to another period or tax type of that taxpayer;
- between taxpayers who are, or consider themselves to be, one economic entity; and
- between taxpayers who share an income stream where the income is allocated after the end of an income year.

Six submissions have been received on the proposals (from the Institute of Chartered Accountants of New Zealand, PricewaterhouseCoopers, KPMG, the Whyte Group, Business New Zealand and the Retail Association). All submissions welcome the proposed new rules. They are seen as providing certainty where the existing rules are not clear and have been inconsistently applied. They are also in many respects more generous than existing rules.

There are two key issues arising out of submissions – the effective date of transfer, and the application date of the new rules.

Effective date of transfer

The effective date of transfer is a critical issue because of the differential use-of-money interest rates. Credit use-of-money interest on overpayments of tax is currently 4.83%, while the rate for underpayments is 11.93%. We have reported to you separately on how these rates are calculated.

The ability to transfer excess tax as at the date of overpayment enables the transferor to forgo any credit use-of-money interest that would otherwise be payable on the overpayment in order to relieve the transferee of late payment penalties and a higher rate of interest on an underpayment. As long as the right amount of tax has in aggregate been paid, the transfer can be arranged so that there is no interest or late payment penalty charged.

As noted earlier, tax that is transferred to the same taxpayer or between certain associates may be transferred as at the date of overpayment. These transfers are referred to in submissions and this report as "backdated" transfers – that is, the transfer can be backdated to the date of overpayment of the tax. If, in aggregate, the same taxpayer or two associates pay the correct amount of tax, there are no late payment penalties or use-of-money interest. One submission argues for all transfers to be backdatable, while most argue for some extension of the list of taxpayers who may backdate a transfer to the date of overpayment.

Application date of the new rules

Broadly, the new rules apply to tax that is overpaid in the 2002-2003 year, and tax overpaid in earlier years that is assessed after enactment of the proposed legislation. The Institute of Chartered Accountants strongly recommends retrospective application of the new rules.

APPLICATION DATE

Clause 77(2)

Submission
(12, 12B and 12C – Institute of Chartered Accountants of New Zealand)

The new rules relating to transfers of overpaid tax must have retrospective application. This is because taxpayers should not be paying use-of-money interest at a high rate on underpayments of tax while simultaneously they (or an associate) are receiving use-of-money interest at a lower rate on overpayments of tax. The bill removes that problem prospectively for taxpayers associated as set out in the bill, but for credits arising before the 2002-03 year the problem remains.

In particular, in relation to transfers requested from 21 April 2001 until the application date of the new legislation, taxpayers are disadvantaged, being charged simultaneous debit and credit interest from payment date until the first day of the next income year.

Instead of the proposals applying from the date of enactment, the proposals should be applied to:

- transfer requests documented in writing before 21 April 2001; and
- transfers of tax credits arising in statements issued after 21 February 2001.

These application dates are the same as those applying to an amendment made to the transfer rules last year.

Comment

Broadly, the new rules apply to tax paid in the 2002-2003 year and to excess tax arising on assessments made after enactment. One feature of the new rules that is welcomed by taxpayers is that provisional tax that is overpaid can be transferred as at provisional tax dates (instead of the first day of the next income year).

The essence of the Institute's submission is that it wants transfers at provisional tax dates to apply retrospectively because it ensures that a taxpayer will not be receiving use-of-money interest on overpaid provisional tax at a low rate while it or an associate is paying use-of-money interest at a higher rate on underpayments of provisional tax or another tax type.

Under Inland Revenue guidelines issued in 1994, excess provisional tax can be transferred no earlier than the date after balance date, once tax has been assessed for the year. The Institute argues that before 1998, this was not enforced so taxpayers in practice could transfer at provisional tax dates. It also argues that, in developing administrative guidelines in relation to an amendment to the transfer provisions last year, the department has allowed such transfers if taxpayers had requested them before 21 April 2001. The Institute is therefore mostly concerned about the inability to transfer at provisional tax dates between 21 April 2001 and the date of enactment of the proposed legislation.

Officials' response

Officials strongly oppose the retrospective application of the new rules. Legislation should have retrospective application only in exceptional circumstances, and we do not consider that it is warranted in this case.

First, while we agree that there is considerable uncertainty about aspects of the existing rules, and inconsistent application of them, it is clear in the guidelines that transfers of provisional tax may only be made on the day after balance date once tax is assessed. It may well be true that some taxpayers have obtained transfers at provisional tax dates in contravention of the guidelines, but Inland Revenue's administrative policy is clear in this respect. We consider that, as current policy is clear in relation to transfers of provisional tax, retrospective application to permit taxpayers to transfer provisional tax at an earlier date is wrong in principle. Inland Revenue does not agree that it has administratively authorised transfers at provisional tax dates if requests are made in writing before 21 April 2001. If this were the case there would be no need for retrospective application to apply to these cases, as the Institute proposes.

Secondly, retrospective application would involve high administrative and compliance costs and add to the confusion over the existing rules. Under the Institute's proposal, for example, transfers requested in writing as far back as 1994 would be dealt with under rules that have not yet been decided. Previous transfers would need to be unwound, use-of-money interest and late payment penalties adjusted, and amounts refunded. To action such requests represents an inefficient use of Inland Revenue's resources.

Thirdly, the effective date of transfer under the proposed new rules may be later than the date on which the transfer was made under existing practice. For example, under the new rules, the transfer of an excess to a taxpayer that is not included in the list of close associates is effective at the later of the day after filing the return and the day of the request. Under the current rules, taxpayers may have had the excess transferred earlier than this. For example, a transfer between unrelated taxpayers, or taxpayers not included in the list of close associates, may have been made at the day after balance date under the existing rules. In that case, retrospective application of the new rules would disadvantage the taxpayer.

The Institute has argued for the new rules to be applied retrospectively in the same way as the amendment last year to the transfer rules. That amendment ensured that transfers of excess tax could be made to a period in which there was no outstanding liability for tax. This was a minimal amendment intended to create some certainty in relation to one aspect of the rules that had been particularly problematical. It was much more limited in scope, and was deliberately silent on the effective date of transfer. The transfer provisions in this bill create a new set of comprehensive rules. In our view, the analogy between the two sets of amendments is not appropriate.

Administrative issues raised in supplementary submission

The Institute also states in its supplementary submission 12B that one of the Inland Revenue service centres had provided incorrect training to staff on the effective date of transfer under existing rules. Inland Revenue agrees that this occurred but notes that, as soon as the department found out about the problem, it was rectified. The Institute has acknowledged this in its subsequent letter to you on 21 March 2002 (submission 12C). Submission 12B added that it appeared that the Inland Revenue head office did not have adequate control over service and call centres. Its letter of 21 March clarifies that the Institute is not inferring that the incident is evidence of lack of control. It states that this is not the case, and was not the intended message.

Inland Revenue agrees that because of the uncertainty over existing rules, there has been inconsistent application of them. Mistakes will be made, as is only to be expected in an organisation as large and diverse as Inland Revenue. To put the criticism into perspective, Inland Revenue has actioned in excess of 103,000 transfers for clients of agents since 1 January 2002. However, over the last 12 months the organisation has worked very closely with the Institute representatives to find both legislative and operational solutions to issues relating to transfers of excess tax.

Recommendation

That the submission be declined.

EXTENSION OF PROPOSED RULES TO OTHER TAX TYPES

Clauses 61(7)(a), 77

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

Income tax credits should be able to be offset retrospectively against other tax obligations, and vice versa, at the original payment date. At a minimum, this should apply to transfers within a taxpayer's account.

Comment

The transfer provisions in the bill generally already allow transfers between tax types at the original payment date for transfers within the same taxpayer's account and to certain close associates. However, student loan and child support obligations are not "tax" as that term is defined in the Tax Administration Act 1994. The provisions should be extended to apply to transfers of excess tax to student loan and child support obligations, and transfers of overpaid student loan obligations to other tax types.

Recommendation

That the submission be accepted in that the transfer provisions should be extended to apply to transfers of excess tax to student loan and child support obligations, and transfers of overpaid student loan obligations to other tax types.

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

Under the bill, taxpayers are only able to transfer "tax", which specifically excludes use-of-money interest paid under Part VII of the Tax Administration Act 1994. The new rules should provide for the transfer of credit use-of-money interest. Under existing practice, taxpayers are able to transfer credit use-of-money interest to offset against other tax liabilities. Taxpayers should be able to transfer use-of-money interest at the same date as the core tax to which it relates.

Comment

We agree that credit use-of-money interest should be able to be transferred. However, we do not agree with the Institute that the interest should be transferable on the same day as the core tax to which it relates. For policy and administrative reasons, it should be transferable only on the day on which it would otherwise be paid out to the taxpayer.

Under the bill, core tax that is overpaid may be transferred to the same taxpayer or listed associates as at the date of overpayment. Broadly, this is so that taxpayers that are, or consider themselves to be, one economic entity, and that in aggregate have paid the right amount of tax, are not receiving use-of-money interest at one rate on overpayments and paying late payment penalties and a higher use-of-money interest rate on underpayments. These arguments apply in relation to core tax, not use-of-money interest.

Interest should not be transferred as at the same date as core tax because when use-of-money interest is transferred, it converts to core tax in the hands of the transferee. This has two consequences. First, use-of-money interest could be payable to the transferee on the use-of-money interest transferred, thereby avoiding the rule that no use-of-money interest is payable on use-of-money interest. Second, interest could also be transferred back and forth between associated taxpayers' accounts, each time converting interest into core tax and compounding the core tax on which interest is payable. The Institute accepts that this is possible but considers that taxpayers would not bother doing this unless there are large amounts at stake and the compliance cost of doing so is outweighed by the benefit.

Transfers could, from a policy perspective, be transferable at the date applicable to transfers to unrelated taxpayers – the later of the day after the return is filed and the day of the transfer request (which often coincide). However, currently Inland Revenue can transfer interest only at "process date" – that is, the date on which the interest would be paid out to the taxpayer following assessment of the return for the period to which it relates. The system for calculating credit interest is discussed below.

Credit use-of-money interest is payable on tax that is overpaid by the taxpayer. It is most frequently applied in relation to overpaid provisional tax. The interest owing in relation such tax is first calculated only after an assessment of the tax owing in that year, and is recalculated to take account of any subsequent adjustments in that year (such as transfers). Interest that has accrued up to the process date is then paid out to taxpayers or transferred at their request. It is not administratively feasible to change this in the short term. We understand that such a change, even if feasible in the longer term, would require the complete redesign of the interest calculation process.

We therefore recommend that credit use-of-money interest continue to be transferred on the day on which the use-of-money interest would be paid out to the taxpayer in the absence of a transfer request.

Recommendation

That the submission be accepted in part, so that the new rules be amended to permit transfers of credit use-of-money interest but that the effective date be the date on which the use-of-money interest would be paid out to the taxpayer in the absence of a transfer request.

EFFECTIVE DATE OF TRANSFER – TECHNICAL ISSUES

Issue: Specific rules required for determining when tax is overpaid

Submission
(17W – KPMG)

A key issue to the success of the rules is determining when an overpayment exists. It is fundamental that the date an overpayment of tax arises is clearly set out in legislation and the rules permit a transfer of any excess from that time. Taxpayers should be entitled to transfer amounts to another year or another taxpayer in a manner consistent with the new two-way use-of-money interest rules.

Comment

Excess tax that is paid directly to Inland Revenue can be transferred within a taxpayer's own account, and to certain associates, as at the date of overpayment of the tax. In many cases, it will be clear when tax is overpaid – for example, when a duty or GST or terminal tax is paid. However, there are options for determining when provisional tax is overpaid, and we agree that the legislation should set out in detail how much provisional tax is "excess" and when this can be transferred to the same taxpayer or a listed associate.

The rules are in two parts – transfers before and after assessment of the transferor's tax liability for the year. Before assessment, the relevant excess that can be transferred is the amount paid in excess of provisional tax liability. After assessment, the relevant excess that can be transferred is the amount paid by way of provisional tax that exceeds the residual income tax liability for the year. The discussion below sets out the formulae for calculating at what date the excess is transferable in each case.

1. Transfer of excess over provisional tax liability before assessment

(a) Basic rule

Taxpayers should be able to transfer at any time before assessment an amount of provisional tax paid that exceeds their provisional tax liability. Such a payment was not required under the provisional tax rules – it is refundable and should be transferable.

Essentially, the excess that is transferable as at a date is the net provisional tax paid by that date less the provisional tax owing by that date. This is expressed in the formula below, which calculates the excess that is available for transfer as at a particular date ("date x") as "a – b – c – d" where

a = the provisional tax paid by date x (including voluntary payments made under section MB 6 of the Income Tax Act 1994 and tax transferred to the taxpayer)
b = refunds paid out up to date x (including transfers out[1])
c = the provisional tax liability payable by date x
d = when the taxpayer has, on a date ("date y") in the year that is after date x, either
(i) paid less tax on date y than the provisional tax due on that date or
(ii) received a refund of provisional tax paid in the year

and there is no offsetting excess of tax paid arising before date y and after date x

(iii) the provisional tax liability due on date y less the amount of tax paid on that date where (i) applies and
(iv) the amount of the refund where (ii) applies.

In a situation in which item d applies, the Commissioner will allow the amount calculated under item d to be transferred at or after date x provided that it is transferred back to the taxpayer in time to prevent late payment penalties applying in relation to the taxpayer's payments of provisional tax for that year.

Item d prevents taxpayers transferring an excess at a date that would trigger late payment penalties in relation to a subsequent underpayment of a provisional tax liability. However, temporary transfers of overpaid provisional tax are allowed to reduce late payment penalties or use-of-money interest in relation to other unpaid tax liabilities provided this does not result in late payment penalties for underpaid provisional tax.

Example 1

A estimates provisional tax at $150,000 ($50,000 at each provisional tax payment date) but pays $75,000 at each provisional tax instalment date. A requests a transfer of excess provisional tax on 31 March. The formula calculates when the excess is available for transfer.

	P1	P2	P3
Amount paid	$75k	$75k	$75k
PT liability	$50k	$50k	$50k
a =	$75k	$150k	$225k
b =	$0k	$25k	$50k
c =	$50k	$100k	$150k
d =	$0k	$0k	$0k
Tax overpaid	$25k	$25k	$25k

[1] by the taxpayer or by the Commissioner under the offset provisions

$25,000 is transferable at P1. A transfers it at this date (which is reflected in item b at P2). (If nothing is transferred before P2, $50,000 would be transferable at P2.)

$25,000 is transferable at P2. A transfers it at this date (which is reflected in item b at P3). The remaining $25,000 is transferable at P3.

Example 2 – taxpayer pays excess provisional tax at P1 and misses payments on P2 and P3

A pays provisional tax on the uplift basis and is required to pay $50,000 at each instalment. She pays $150,000 at P1, nothing on P2 and nothing on P3. If A's request for a transfer is made after P3, there is no transferable excess.

	P1	P2	P3
Amount paid	$150k	$0k	$0k
PT liability	$50k	$50k	$50k
a =	$150k	$150k	$150k
b =	$0k	$0k	$0k
c =	$50k	$100k	$150k
d =	$100k	$50k	$0k
Tax overpaid	$0k	$0k	$0k

(b) Where taxpayers revise their estimated provisional tax, or estimate after paying on the uplift basis

Taxpayers can revise their provisional tax liabilities up to and on the third provisional tax instalment date. Where the amount of provisional tax payable by a provisional taxpayer is reduced, under section MB 8 of the Income Tax Act 1994 the taxpayer can apply for a refund of the difference between the provisional tax paid and the amount that would have been payable had the reduced amount of provisional tax applied at all earlier provisional tax instalment dates.

Section MB 8 could apply when:

- taxpayers who pay provisional tax based on an estimate of their tax liability, re-estimate their liability at the second or third provisional tax payment dates;
- taxpayers who pay provisional tax on the uplift basis for the first, or first two, provisional tax instalment dates estimate for the remaining instalment date/s; and
- taxpayers who have paid the first instalment, or first two instalments, of provisional tax on the basis of 110% of their residual income tax liability for the year-before-last pay the remaining instalments on the basis of 105% of their residual income tax liability for the previous year.

We propose a transfer rule that would apply in the first two situations, but not the third. The rule would allow taxpayers who have paid more provisional tax than their estimate or revised estimate to transfer the excess. The formula for calculating how much excess may be transferred at a particular date is essentially the same as that applying to transfers after assessment discussed in the next section. However, item c of the formula would refer to the estimated residual income tax liability of the taxpayer rather than actual residual income tax liability.

There are two reasons for excluding the third category of taxpayers from this rule.

- First, we are concerned that small, unsophisticated taxpayers, for whom in any year the uplift method may be quite inaccurate, will transfer an "excess" based on a change in uplift basis and expose themselves to late payment penalties if the tax liability turns out to be higher than the revised provisional tax. Those who estimate at the third instalment date may also be subject to late payment penalties if they transfer at provisional tax dates based on a revised estimate and their tax liability is higher than that estimate. However, they will have turned their minds to the likely amount of the tax liability in the current year and the estimation at P3 (3 weeks away from year-end) could be expected to be more accurate than a third provisional tax instalment based on last year's residual income tax. Taxpayers who pay all three instalments on the uplift basis can still transfer any excess above residual income tax at a provisional tax payment date, but they must wait to do so until after assessment.
- Second, most taxpayers who pay provisional tax on the uplift basis are not subject to use-of-money interest. Taxpayers who are not subject to use-of-money interest, and whose income fluctuates, would be able to take advantage of those fluctuations by transferring out excesses (and earning interest elsewhere on them) in years where provisional tax was reduced as a result of changing the base of the uplift from one year to another.

2. Transfer of excess provisional tax after assessment

We propose that the total excess that may be transferred is the net provisional tax paid for the year less the residual income tax (RIT) for the year. Net provisional tax is tax paid (including voluntary payments made under section MB 6 and tax transferred to the taxpayer) less refunds of that tax (including tax transferred out by the taxpayer) paid out prior to assessment.

The formula below calculates the amount that may be transferred as at a particular date. Essentially, the amount that is transferable as at a date is the difference between the net provisional tax paid by that date and the tax that would be due by that date for the purposes of the use-of-money interest rules in the Tax Administration Act 1994 (calculated as if there was no safe-harbour[2] provision in those rules). However, under item "d" that amount is reduced when there is a subsequent underpayment of tax relative to what would be due for the purposes of calculating use-of-money interest. Item d prevents taxpayers transferring an amount when that would trigger late payment penalties or use-of-money interest at a subsequent date. However, temporary transfers that do not have this effect are permitted.

Formula for calculating when excess tax is paid

The excess available for transfer as at a particular date ("date x") is

a – b – c – d where

a = the amount of tax paid up to and including date x[3]
b = refunds of that tax paid out up to and including date x[4]
c = the RIT that would be due and payable by date x for the purposes of calculating use-of-money interest under section 120K of the Tax Administration Act 1994 calculated as if section 120K(4) did not apply
d = when the taxpayer has, on a date ("date y") in the year that is after date x, either
(i) paid less tax on date y than the amount of RIT due on date y under section 120K[5] or
(ii) received a refund[6], prior to assessment of RIT, of provisional tax paid in the year

and there is no offsetting excess of tax paid arising before date y and after date x,

(iii) the RIT due on date y less the amount of tax paid on date y where (i) applies and
(iv) the amount of the refund where (ii) applies.

In a situation in which item d applies, the Commissioner will allow the amount calculated under item d to be transferred on or after date x provided it is transferred back to the taxpayer in time to prevent use-of-money interest or late payment penalties applying in relation to the taxpayer's payments of provisional tax for that year.

[2] The safe harbour rules in section 120K(4) of the Tax Administration Act 1994 provide that natural person taxpayers with an RIT of under $30,000 are not subject to use-of-money interest on under- and over-payments of provisional tax from provisional tax instalment dates. In such cases RIT is not spread over the provisional tax payment dates for the purposes of calculating use-of-money interest. However, to accurately calculate excess tax transferable at a date, the RIT should be spread over provisional tax payment dates in all cases.
[3] This includes transfers in which are deemed to be tax paid.
[4] This includes transfers out which are deemed to be refunds.
[5] Also calculated as if section 120K(4) did not apply.
[6] Includes transfers out.

Example 3 – taxpayer pays provisional tax liability at all instalments and incurs loss

A Co pays $20,000 provisional tax at each of P1, P2, P3 on the uplift or estimation basis. A Co is assessed as having a loss for the year. The total credit available for transfer is $60,000, being the difference between the provisional tax paid ($60,000) and the residual income tax ($0).

The amount that may be transferred at the first, second and third provisional tax dates is calculated as follows. (Item b at P2 and P3 assumes that the excess tax is transferred as soon as it is available.)

	P1	P2	P3
Amount paid	$20k	$20k	$20k
RIT due	$0k	$0k	$0k
a =	20k	$40k	$60k
b =	$0k	$20k	$40k
c =	$0k	$0k	$0k
d =	$0k	$0k	$0k
Tax overpaid	$20k	$20k	$20k

$20,000 is transferable at each of P1, P2 and P3. If amounts are not transferred at those dates, they can be transferred at subsequent dates.

Example 4 – taxpayer misses provisional tax instalment

A pays provisional tax on the uplift basis, but he is subject to use-of-money interest. He paid his liability of $20,000 on P1, missed the payment due on P2, and paid $20,000 on P3. His RIT is $15,000.

The total excess that may be transferred is $25,000 (being tax paid of $40,000 less the residual income tax of $15,000).

	P1	P2	P3
Amount paid	$20k	$0k	$20k
RIT due	$5k	$5k	$5k
a =	$20k	$20k	$40k
b =	$0k	$10k	$10k
c =	$5k	$10k	$15k
d =	$5k	$0k	$0k
Tax overpaid	$10k	$0k	$15k

A can transfer $10,000 on or after P1 and in this example transfers the $10,000 at P1 (which is reflected in item b at P2). A can transfer the balance of $15,000 on or after P3. A could also transfer at P1 the $5,000 calculated under item d at that date provided he transferred that amount back in by P2. This would enable him to reduce late payment penalties and use-of-money interest in relation to other tax liabilities paid late during this period.

Recommendation

That the submission be accepted and the legislation be amended to include the rules set out above that specify the amount of excess provisional tax that may be transferred and the date at which it can be transferred.

Issue: Transfer should be effective when tax is paid

Clause 77, section 173L(2)(c)

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

Proposed section 173L(2)(c) provides that a taxpayer may elect a transfer date that is after the date the excess tax is paid. This should be amended to a date that occurs **on or** after the date the excess tax is paid.

Comment

Officials agree that excess tax should be transferable on the date that the excess was paid.

Recommendation

That the submission be accepted.

EFFECTIVE DATE OF TRANSFER – TRANSFERS AT DATE OF OVERPAYMENT

Clause 77

Issue: Should all transfers be backdatable?

Submission 1
(12 – Institute of Chartered Accountants of New Zealand)

The proposed rules allow a transfer to be backdated to the date of overpayment when the transfer is to the same taxpayer or between associates listed in the legislation. This ensures that taxpayers within this group who have paid the correct amount of tax in aggregate will not be paying interest at a high rate on underpayments at the same time as they receive interest at a lower rate on overpayments.

There is no need for any limitation on the parties to whom a backdated transfer may be made. The purpose of the use-of-money interest rules is to compensate the Crown for the loss of the use of funds from taxpayers paying too little tax, to compensate taxpayers for the loss of use of funds through paying too much tax and to encourage taxpayers to pay the correct amount of tax on time. If tax is paid at the relevant dates, the Crown has not lost the use of funds and it should allow transfers between taxpayers to minimise use-of-money interest.

Submission 2
(12 – Institute of Chartered Accountants of New Zealand)

If the primary submission is not accepted, a taxpayer should be permitted to make a backdated transfer to any taxpayer to cover a shortfall that has been voluntarily disclosed within, say, two months or one return period.

Comment

Submission 1

Officials disagree with submission 1 for the following reasons.

Administration costs

First, allowing all transfers to be backdated to the date of overpayment would significantly increase the administrative workload of Inland Revenue as it would have to field transfer requests and recalculate late payment penalties and debit use-of-money interest on underpayments of provisional tax, or other tax types, often several years after the tax is overpaid. The proposed new rules require the Commissioner to do this for certain associates, but to do it for any two taxpayers would significantly increase administrative costs. The unwinding of late payment penalties and debit use-of-money interest also increases the complexity of the tax system.

The Institute considers that allowing backdated transfers to all taxpayers will not result in imposing high administrative costs on Inland Revenue because taxpayers will only make transfer requests if the interest (and presumably late payment penalty) impact exceeds the compliance cost to the taxpayer. It also argues that Inland Revenue costs should be less than those facing the taxpayer. We agree that there will be compliance costs for a taxpayer in making the request and monitoring Inland Revenue's actioning of the retrospective transfers to ensure that the consequences of the transfer are correct. We do not agree that Inland Revenue's costs will be less than that facing the taxpayer. If all transfers can be retrospective there will be a sufficient number of taxpayers requesting such a transfer to increase significantly Inland Revenue's administrative workload.

The Government is currently considering a pooling proposal which would go a significant way to addressing the Institute's concern over the difference in use-of-money rates for underpayments and overpayments of tax. In effect, it would allow the transfer of overpayments of one taxpayer to satisfy underpayments of another through an intermediary or "pool". Taxpayers who had overpaid tax would, through this mechanism, receive an interest rate higher than the statutory credit use-of-money interest rate, and taxpayers who had underpaid could "buy" overpaid tax at an interest rate lower than the statutory debit use-of-money interest rate. The proposal, set out in a Government discussion document in 2001, is designed in such a way as to minimise administration costs to Inland Revenue.

Cancellation of late payment penalties

Secondly, transfers of excess tax to satisfy a tax liability of the same taxpayer, or a close associate, not only minimise use-of-money interest but can result in the cancellation of late payment penalties incurred by the transferee. This is appropriate when tax is transferred within a taxpayer's account – if taxpayers have paid the right amount of tax in aggregate, they should not be subject to late payment penalties. By extension, it is also justifiable when taxpayers are the same economic entity, or see themselves as one economic entity, or where taxpayers share in an income stream and do not allocate income between themselves until year end. To allow a taxpayer to "buy" excess tax from an unrelated taxpayer so as to cancel late payment penalties reduces the incentive for taxpayers to pay the right amount of tax on time and undermines the integrity of the tax system.

Manipulation of backdated transfers

The ability to backdate a transfer can be manipulated to enable use-of-money interest to be payable where it is intended that none should. Allowing backdated transfers to all would expand this opportunity.

Submission 2

Officials also do not support submission 2. The Institute argues that a backdated transfer should be allowed to anyone to cover a shortfall that has been voluntarily disclosed within, say, two months or one return period by the transferee. It suggests that this would allow voluntary disclosure with no penalty, but prevent careless or deliberate shortfalls. The Institute subsequently noted that shortfall penalties may still apply, but consider that the transfer should be allowed to prevent any late payment penalties and use-of-money interest applying. The Institute proposes a backdated transfer be permitted to recognise that taxpayers who voluntarily disclose shortfalls are less culpable than those who do not.

The rules in relation to shortfall penalties already recognise and deal with this, as shortfall penalties are reduced by 75% if the shortfall is voluntarily disclosed before audit.

Recommendation

That the submissions be declined.

Issue: Transfers to taxpayers within one degree

Submission
(Matter raised by officials)

The transfer provisions allow excess tax to be transferred to taxpayers within one degree of relationship as at the date of overpayment. The concept of "degrees of relationship" is used elsewhere in the Revenue Acts, and where this occurs the concept is clarified so that it is clear that this means a person connected with another by blood relationship, marriage, a relationship in the nature of marriage, or adoption. We propose that a similar provision be included in the transfer rules and that it be clear that "taxpayers within one degree" includes a spouse, de facto spouse and same sex partner.

Recommendation

That the transfer provisions be amended to clarify that a person is related to another when they are connected by blood relationship, marriage, a relationship in the nature of marriage, or adoption and that "taxpayers within one degree" therefore includes a spouse, de facto spouse and same sex partner.

Issue: Extension of list of taxpayers eligible for retrospective transfers

Submission 1

The list of those associates to whom backdated transfers can be made should be extended to include transfers between:

- shareholder/employees *(12 – Institute of Chartered Accountants of New Zealand)*;
- family members to within two degrees to cover normal family dealings *(7 – PricewaterhouseCoopers)*;

- family members to within three degrees (for example, uncle/nephew) *(12 – Institute of Chartered Accountants of New Zealand)*;
- taxpayers with common control as described in section 2A(1)(i) of the GST Act 1985 *(12 – Institute of Chartered Accountants of New Zealand)*;
- taxpayers who are commonly managed, such as superannuation funds and unit trusts *(12 – Institute of Chartered Accountants of New Zealand)*;
- superannuation funds, group investment funds and unit trusts that are commercially or practically connected *(7 – PricewaterhouseCoopers)*;
- a trust and a company where the trust runs its trading through the company and the trust owns at least 66% of the shares in the company *(7 – Pricewaterhouse Coopers)*;
- family trusts *(7 – Pricewaterhouse Coopers)*;
- associated persons as defined in section 2A of the GST Act 1985 *(12 – Institute of Chartered Accountants of New Zealand).*

Submission 2
(2 – Retail Merchants Association)

The class of associated persons that may make backdated transfers should be broadened.

Comment

Framework for determining who may make backdated transfers

As with the Income Tax Act generally, the late payment penalty provisions apply on taxpayer-by-taxpayer basis to encourage the taxpayer to pay the right amount of tax on time. Therefore an individual taxpayer who has paid the right amount overall should be able to transfer overpayments to offset underpayments as at the date the excess is paid so that there is no late payment penalty. They also should not be receiving interest on overpayments at one rate and paying interest on underpayments at a higher rate.

This rationale can be extended to those who are one economic entity – for example, companies that are 100% commonly owned. Beyond this, there is an element of pragmatism – if the list is too restrictive and there is no other means to avoid the difference in use-of-money interest rates, taxpayers will consider the use-of-money interest rules unfair and they may not be sustainable in the long run. Balanced against this are the costs of extending this category of taxpayers in terms of administration and complexity, reducing the incentive for an individual taxpayer to pay the right amount of tax on time, and increasing opportunities to manipulate transfers to obtain use-of-money interest where none would otherwise be payable.

Balancing these factors, the right to operate on an aggregate basis for the purpose of the transfer rules is extended to include taxpayers who consider themselves to be one economic entity and taxpayers who share in an income stream and, for commercial reasons, do not allocate income between themselves until after the end of the income year.

The list of taxpayers who can operate on an aggregate basis was compiled using these criteria. The bill therefore allows backdated transfers between:

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

Submissions seek the extension of that list to include transfers between the following categories of taxpayers. PricewaterhouseCoopers does not take issue with the framework but argues that the list is narrower than the framework would suggest – that is, it argues that the entities they propose fit within the framework.

Shareholder/employees

Backdated transfers may be made between a shareholder/employee and a company because frequently it is not clear how much income will be distributed by the company to the shareholder/employee and in what form (for example, as salary or dividends). This income is often allocated after the end of the year. If backdated transfers can be made between these two, it is not necessary during the year to determine who will derive the income and in what form for the purpose of accurately calculating provisional tax instalments.

Two shareholder/employees in the same company are not one economic entity, and, as between themselves, they do not share in an income stream – they each share in an income stream with the company.

Family members

PricewaterhouseCoopers seeks to allow backdated transfers for family members within two degrees to cover normal family dealings. The Institute seeks an extension for family members within three degrees. Examples of relationships within two and three degrees are:

a person and his or her grandparent/grandchild) within two degrees
a person and his or her brother/sister)
a person and his or her parent-in-law)

a person and his or her aunt/uncle (parent's sibling))
a person and his or her niece/nephew) within three degrees
a person and his or her spouse's grandparent/grandchild)

In our view, neither set of taxpayers are the same economic entity or share in an income stream simply on the basis of their degree of relationship. (If they happen to be partners in the same partnership, they can make backdated transfers in that capacity.)

Taxpayers with common control as described in section 2A(i) GST Act 1985

Section 2A(i) of the GST Act defines as associated persons A and B if they are each associated with C under the various other tests of association in the definition. The definition is very wide because it is an anti-avoidance provision – for example, a company and the brother of a shareholder with a 25% interest in a company are associated under this test. Such associates are not one economic entity, and do not share in an income stream.

Taxpayers who are commonly managed – such as superannuation funds and unit trusts – and superannuation funds, group investment funds and unit trusts that are commercially or practically connected

These taxpayers are not one economic entity, nor would they consider themselves one economic entity. They are simply "customers" of the same manager. They also do not share in an income stream. Transfers between them should not be backdated.

A trust and a company where the trust runs its trading through the company and the trust owns at least 66% of the shares in the company

As noted above, backdated transfers of excess tax can be made between companies in the same group (that is, companies with 66% common shareholding). PricewaterhouseCoopers argues that if a trust trades through and owns 66% of a company, the trust and company should be able to make backdated transfers between themselves.

Trading trusts and companies can be substitutable investment vehicles. Therefore, on the face of this, allowing a trading trust and a company in which it owns 66% of the shares to make backdated transfers appears consistent with allowing group companies to make backdated transfers. However, there is no definition of "trading trust" in the Income Tax Act and the concept of "trading through a company" is too vague to be a requirement – arguably all shareholders run their trading through companies. We do not support their inclusion in the list.

Family trusts

PricewaterhouseCoopers argues that family trusts should be able to transfer excess credits between them in the way that companies in the same group can. They acknowledge that this would require developing a set of deemed ownership rules for trusts, but consider that this should be possible.

The rules for determining when companies are owned by the same shareholders and therefore are in the same group are complex, and developing such rules for trusts is likely to be even more complex. This is because discretionary trusts can be set up to potentially benefit a wide range of family members but distributions may be made to a narrow group of those beneficiaries.

We therefore do not agree with the submission.

Taxpayers who are associated persons within the meaning of section 2A GST Act

As noted earlier, the list of taxpayers who are associated under section 2A of the GST Act is wide, and includes companies that are 50% commonly owned, a shareholder owning 25% of a company, and trustees and settlors of a trust.

Associated persons tests are used in both the Income Tax Act and GST Act and are broadly drafted because they generally have an anti-avoidance focus.

This is not an appropriate basis on which to allow backdated transfers. It includes relationships where the parties are not one economic entity and do not share in an income stream allocated after the end of the year.

Recommendation

That the submissions be declined.

Issue: Backdated transfers between taxpayers to be in both directions

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

It should be specifically confirmed that the transfers in the bill that may be backdated are effective in both directions – for example, if a transfer from a company to a shareholder/employee may be backdated, then a transfer from a shareholder/employee to a company should be able to be backdated.

Comment

It is intended that transfers that may be backdated are effective in both directions. This is not clear in all cases.

Recommendation

That the submission be accepted.

EFFECTIVE DATE – TRANSFERS THAT MAY NOT BE BACKDATED

Clause 77

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

The earliest effective date for transfers other than those to the same taxpayer and listed close associates is the later of the day after the relevant return is filed and the date of the transfer request. The commentary on the bill states that this is broadly a proxy for the date of processing the transfer request. The date of request is in no way a proxy for the date of processing.

Comment

The submission notes that processing may take place weeks or even months after a return is filed. The Institute adds that, when the policy was being developed, officials initially considered that the effective date for transfers to taxpayers other than the listed associates should be the date of processing the return – that is, the date on which the refund would otherwise be paid out.

This was changed to the later of the date of the request and the date after filing the return in response to the point made by the Institute that the processing date could be some time after filing, and that this was in the control of Inland Revenue, not the taxpayer. The Institute considers the date of request is an improvement but is not a proxy for the date of processing.

The submission is a comment on a comment and proposes no specific legislative change.

Recommendation

No recommendation is required.

EFFECTIVE DATE OF TRANSFER – DEFAULT DATES

Submission
(Matter raised by officials)

The transfer provisions state that taxpayers may choose to transfer excess tax rather than having it refunded, and the date of transfer is a date that they choose provided it is no earlier than a specified date. There are no default dates for processing transfer requests when the taxpayer does not request a date. They are likely not to specify a date if, for example:

- they request a transfer on the 2001-2002 income tax return by ticking the relevant box (the new rules apply to 2002 assessments after enactment of the bill);
- they are indifferent to the date the transfer is made (because, for example, they are not subject to use-of-money interest) or they do not know what date to choose and rely upon Inland Revenue to transfer at an appropriate date.

Default dates are required to enable Inland Revenue to process these requests efficiently. However, taxpayers would be able to contact the department subsequent to the transfer at a default date, and elect a different transfer date that is within the terms of the transfer provisions. We envisage that once the rules are enacted, tax agents would generally specify a date, so that processing at a default date can be reduced to a minimum.

We propose a legislative amendment that would allow Inland Revenue to transfer excess tax at a date the Commissioner considers appropriate, when a taxpayer has elected a transfer but not specified a date. This provides Inland Revenue with as much flexibility as possible to set default dates that minimise subsequent manual adjustments. In order to achieve this, the dates would be those that generally maximise credit use-of-money interest, or minimise differential use-of-money interest, for taxpayers within the constraints of the new rules. The default dates would be discussed with the Institute and published in administrative guidelines.

We have discussed this proposal with the Institute, who agrees that default dates are required provided they can be overridden by the taxpayer. However, given the previous debates over transfers with Inland Revenue, the Institute is wary about providing Inland Revenue with flexibility as to the default date. We consider that it is not feasible or desirable to be prescriptive in legislation about which default dates will apply in which circumstances. The protection for taxpayers is that they can override the default date (within the legislative framework).

Recommendation

That the submission be accepted.

EFFECTIVE DATE OF TRANSFER – CHARITABLE DONATIONS/CHILDCARE REBATES

Issue: Date of transfer

Clause 77

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

It is proposed that a rebate for childcare or charitable donations can be transferred only at the later of the date of the request for the transfer and the date after which the taxpayer applies for the refund (generally these dates will coincide). A taxpayer that has incurred an expense and is entitled to a childcare or charitable donation rebate should be able to retrospectively offset the refund against income tax obligations from the same year. This should apply to related taxpayers as set out in section 173L, but at a minimum to a transfer to the same taxpayer's account.

Comment

When the filing of tax returns for many wage and salary earners became optional in 2000, the process for claiming childcare and charitable donations rebates changed. They are no longer claimed in the income tax return, and no longer offset income tax obligations for the year. Instead, taxpayers who are eligible for the rebate file a separate rebate claim form and the rebate is refunded.

Broadly, the bill provides that the earliest effective date of transfer of the rebate is the day after filing the claim form[7]. This is because there is no use-of-money interest payable on the rebate, and transfers at an earlier date could be made to an associate in order to avoid this restriction and collect use-of-money interest on the rebate.

The Institute argues that these rebates should be retrospectively transferable so as to offset income tax obligations for the year in which the childcare expenses and donations are made. For transfers within the same taxpayer's account and to listed associates, overpaid tax may be backdated to the date of overpayment of the tax. The problem with applying a similar rule to childcare and charitable donations rebates is that the rebate would be transferable on the date the donations were made or the childcare expenses paid. These amounts may be paid out by the taxpayer numerous times during the year. It is therefore not administratively feasible to allow transfers to be made at each date.

The only feasible means of achieving the Institute objective is to reintegrate the rebate claim form into the tax return for those filling in a tax return. This is contrary to Government policy, which is that the claiming of rebates should be a separate, simple process.

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[7] This is intended to occur after the end of the income year – the officials' submission on the following page proposes the correction of a defect in the Act that allows the form to be filed earlier than this.

Recommendation

That the submission be declined.

Issue: Remedial amendment

Submission
(Matter raised by officials)

The changes made as part of the Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001 to remove the six-month deadline for claiming rebates inadvertently repealed the rule that, unless there are special circumstances, taxpayers can claim their refunds only from the year following the one in which they incurred rebatable expenditure.

A remedial amendment is required to section 41A of the Tax Administration Act 1994 to reinstate the correct rule that:

- standard and early balance date taxpayers can apply for a refund for an income year from 1 April next following the end of the taxpayer's income year; and
- late balance date taxpayers can apply for a refund for an income year from the first day of the taxpayer's next accounting year.

Recommendation

That the submission be accepted.

EFFECTIVE DATE – EXCESS TAX APPLIED TO MEET LIABILITY

Submission
(Matter raised by officials)

The Commissioner has the right under the Revenue Acts to apply excess tax of a taxpayer to satisfy an unpaid liability of the taxpayer. These provisions have priority over the proposed transfer legislation because excess tax paid by one taxpayer should not be transferred to another taxpayer when the first taxpayer has a tax debt owing.

However, the provisions in the Revenue Act do not specify at what effective date the excess tax is transferred to satisfy the liability. We propose that the same dates as apply to requested transfers apply also to transfers that are automatically made by the Commissioner to satisfy arrears.

This issue was raised by the Institute in discussions with officials.

Recommendation

That the submission be accepted.

TRANSFER NOT COUNTED FOR SHORTFALL PENALTY PURPOSES

Clause 77

Submission
(7 – PricewaterhouseCoopers)

Excess tax that is transferred should be treated as tax paid by the transferee on the date of the transfer for the purposes of imposing a shortfall penalty under Part IX of the Tax Administration Act 1994.

Comment

The bill proposes that overpaid tax that is transferred to a taxpayer is "tax paid" by the taxpayer for all purposes except the shortfall penalty rules. This is because the shortfall penalty rules are intended to penalise taxpayers who fail to take sufficient care in calculating their tax, who take an abusive tax position or who evade tax. This activity should be penalised regardless of whether the taxpayer can arrange a transfer to cover a shortfall from a person who has overpaid their tax.

PricewaterhouseCoopers argues that there are a number of situations where short payments would occur on the expectation that a transfer from another taxpayer will soon be forthcoming. It argues that, where this proves to be the case, shortfall penalties should not be imposed.

Shortfall penalties can apply only when there is a difference between what the taxpayers calculate as their liability and what their liability is. Therefore if they have correctly calculated their liability, but are relying on a transfer for payment, no shortfall penalty will arise.

If transferred tax could eliminate shortfall penalties, taxpayers could undercalculate their liability and rely on a transfer to cover the shortfall in the event that their calculation was shown to be wrong.

Recommendation

That the submission be declined.

DRAFTING ISSUES: EARLY BALANCE DATE TAXPAYERS

Clause 77

Submission
(7 – PricewaterhouseCoopers)

Proposed section 173L(3) states that when excess tax is deducted on behalf of an early balance date taxpayer, the taxpayer may transfer the tax on a day after the end of the year in which the deduction occurred. This provision is not necessary because subsection (2) adequately conveys what is intended. If clarification is required, then it should occur within subsection (2)(b) itself, dispensing with the need for subsection (3).

Comment

The policy intent of proposed section 173L(2) and (3) is that if too much tax is deducted on the taxpayer's behalf – for example, PAYE – the first day that the credit is available for transfer is generally the day after balance date. So, for taxpayers with a standard balance date (31 March) this is 1 April. However, if a taxpayer has an early balance date (say November 30), because the taxpayer also has business income, salary earned up until 31 March is included in the return to the previous November 30. In this case, deductions may not be made until 31 March. Therefore a taxpayer with an early balance date should also not be able to transfer the excess before 1 April.

In subsection 173L(2)(b) "income year" means the year from 1 April – 31 March. This provision should refer to a taxpayer's accounting year, which will include non-standard balance dates. Subsection (3) is therefore required.

Recommendation

That the submission be declined but that subsection 173L(2)(b) be amended to refer to a taxpayer's accounting year, not income year.

TRANSFER OF EXCESS TAX RETAINED BECAUSE OF INSUFFICIENT IMPUTATION CREDITS

Clause 48(4)

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

Clarification is sought that proposed new section MD 2(5A) will permit transfers when there is a terminal tax shortfall, not merely when a taxpayer has underpaid the tax due at a provisional tax instalment on, for example, the uplift method.

Comment

Clause 48 inserts a new section MD 2(5A) into the Income Tax Act as an adjunct to the amendments relating to transfers of excess tax at the request of a taxpayer. The amendment expands the scope of section MD 2(5), which applies when overpaid income tax is not refunded to a corporate taxpayer because its imputation credit account has insufficient credits. (This means that it has already passed on credit for the tax to its shareholders.) Instead, the overpaid tax is retained and applied in payment of tax that is payable by the company. It is not clear that the excess can be applied as at a date on which there is no liability to pay provisional tax but from which use-of-money interest applies in relation to underpaid residual income tax. The amendment clarifies that the excess can be credited as at a provisional tax date to eliminate use-of-money interest on underpaid residual income tax.

The proposed amendment already does exactly what the Institute proposes. We have advised them of this.

Recommendation

That the submission be declined.

EXTENSION OF BILL TO ALLOW "POOLING" THROUGH INTERMEDIARIES

Clause 77

Submission
(4W – Business NZ)

The bill should be widened to permit the pooling arrangements discussed in *More Time for Business*. While the measures in this bill and the proposed pooling options are endorsed, a better solution is a reduction in the margin between the two use-of-money interest rates.

Comment

We have reported to you separately on how the use-of-money interest rates for overpayment and underpayment of tax are set.

The Government is considering the pooling proposals discussed in *More Time for Business*.

Recommendation

That the submission be declined.

EXTENSION OF CIRCUMSTANCES IN WHICH TAX CAN BE REFUNDED (AND TRANSFERRED)

Clause 77

Submission
(10 – Whyte Group)

The bill should be amended to allow taxpayers to estimate their tax liability after the third provisional tax instalment date and before filing a return, and obtain a refund or transfer of the excess tax paid based on that estimate.

Comment

The submissioner is correct in stating that the law currently does not allow a taxpayer to file an estimate of the taxpayer's terminal tax liability after the third provisional tax instalment and obtain a refund of any overpaid tax based on that estimate. After the third instalment date has passed, the taxpayer must wait until the tax return is filed and tax for the year is assessed. Only then is a refund payable.

The Whyte Group proposes a significant change to the Income Tax Act. It seeks to change the circumstances in which a refund can be paid, so that a taxpayer would be entitled to a refund based on its estimated tax liability rather than wait until a return is filed and tax is assessed. This goes beyond the transfer provisions in the bill, which apply only to the extent that an amount is already refundable under the current law. Such a change would require considerable analysis and consultation.

The submission is outside the scope of the bill.

Recommendation

That the submission be declined.

Further tax simplification measures

OVERVIEW OF SUBMISSIONS

The bill introduces a number of initiatives to reduce compliance costs for taxpayers, including:

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

Six submissions were received on the proposals and they were generally supportive of efforts to further simplify the tax system, although some submissions commented that the proposals did not go far enough. Clearly, any tax simplification and compliance cost reduction initiative must be measured against its impact on other objectives, including the efficiency of the tax system and revenue requirements.

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

Clauses 63(2) and 63(5)

Submission
(7 – PricewaterhouseCoopers, 9 – National Council of Women)

The non-withholding income threshold under which a return does not have to be filed is too low and should be increased to a more realistic level such as $2,500 per annum. *(National Council of Women)*

The structure of the amendment is not consistent with the style of the existing legislative provisions and should be clarified so that the description of the type of the income and the threshold match the existing treatment. *(PricewaterhouseCoopers)*

Comment

The $200 non-withholding income threshold mirrors the non-filing provision currently in place for withholding income from which tax has not been deducted correctly. Like the withholding income threshold, it is aimed at removing the compliance cost burden for taxpayers who earn small amounts of income during the year from having to return this income. It also removes the risk for these taxpayers of sanctions applying for not filing a return and remitting the appropriate tax deduction. Increasing the threshold to, say, $2,500 would result in a significant risk to the revenue, one that would exceed the compliance cost savings from such a measure.

Submissions have also proposed that the amendment in clause 63(2) of the bill be split so that the description of the type of income and the threshold match the treatment for withholding income in sections 33A(1)(a) and 33A(1)(b) of the Tax Administration Act 1994. Officials consider that the current drafting style reflects the fact that the proposed threshold for non-withholding income is separate from the $200 threshold for withholding income. That is, if in a year a person has withholding income of $150 from which tax has not been correctly withheld and non-withholding income of $180, the relevant non-filing provisions can be applied in respect of both income types. If the amendment were drafted as suggested by the submissions, however, the non-filing provisions would apply only if the person earned $200 or less in total of both withholding and non-withholding income. Here, in respect of the earlier example, the non-filing provisions would not apply as the person has earned in excess of $200 ($330) from all sources.

Recommendation

That the submissions be declined.

ADJUSTMENTS REQUIRED FOR FAMILY ASSISTANCE PURPOSES TO BE REMOVED

Clause 41

Submission

(12 – Institute of Chartered Accountants of New Zealand)

Minor mechanical changes are required in relation to the proposal.

Comment

The submission proposed that in relation to the treatment of depreciation on buildings and income (and adverse event income) equalisation account deposits for family assistance purposes, clause 41(2) of the bill be removed as it could give rise to a double deduction. Subclause (2) allows depreciation on buildings and income equalisation account deposits to be claimed as a deduction for family assistance purposes from the 2003-04 income year. Currently, these items are not allowable deductions for family assistance purposes but they are for income tax purposes.

Officials agree with the submission, that clause 41(2) is unnecessary and could give rise to a double deduction as the family assistance rules are applied on taxable income (that is, income determined after the income tax rules have been applied).

The submission also proposed that clauses 41(4) and 41(7) of the Bill be clarified to ensure that deposits to income (and adverse event income) equalisation accounts relate to a specific income year. The submission commented that without such an amendment, an adjustment would need to made for income equalisation account deposits made during or after the 2003-04 income year that relate to years prior to the 2003-04 income year. The submission suggested inserting the words “for a year” before the words “before the 2003-04” in subclauses (4) and (7). Officials agree with the intent of this submission but consider that it would be more meaningful to change the current wording of subclauses (4) and (7) so that any income equalisation account deposit relating to the 2002-03 or a previous income year that is refunded in the 2003-04 or a subsequent income year is not income for the purposes of determining family assistance.

Recommendation

That the submission be accepted subject to officials’ comments.

REMOVAL OF INTERIM IMPUTATION RETURN REQUIREMENTS

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

Issue: Proposed section MD 2(1A)

Submission
(17 – KPMG)

The proposed section MD 2(1A) need only act as a proviso to section MD 2(1)(a) of the Income Tax Act 1994, and there should be a link in the proposed section to extension of time arrangements.

Comment

Officials agree that the proposed amendment only has use as a proviso to section MD 2(1)(a) and can only be applied by companies that have extensions of time for filing their tax returns. The suggested changes should clarify the application of the new provision.

Recommendation

That the submission be accepted.

Issue: Requirement to disclose changes in imputation ratios

Submission
(7 – PricewaterhouseCoopers)

The requirement for taxpayers to disclose in their annual imputation return if two imputation ratios have increased or decreased by more than 20 percent from the preceding income year should be removed, as well as the requirement to explain the change.

Comment

The submission has commented that the requirement to disclose the ratios be removed owing to widespread non-compliance. This submission is beyond the scope of the current bill, but will be addressed in the taxation bill scheduled for introduction in May.

Recommendation

That the submission be declined in respect of the Taxpayer (Relief, Refunds and Miscellaneous Provisions) Bill.

GREATER FLEXIBILITY IN COMMUNICATING RESIDENT WITHHOLDING TAX INFORMATION

Clauses 62 and 65

Submission
(7 – PricewaterhouseCoopers, 9 – National Council of Women)

The proposal should require the interest payer to advise what withholding tax rates have been applied to interest income. *(PricewaterhouseCoopers)*

The gross withholding income threshold for communicating resident withholding tax information to interest earners should not be increased. *(National Council of Women)*

Comment

Submissions have requested that clause 62 be amended so that the resident withholding tax rate applied to interest income is disclosed by the interest payer when communicating resident withholding tax information to interest earners. Submissions have commented that this is a quick and easy way for interest earners to determine whether or not the interest payer has deducted withholding tax at the correct rate and is especially useful when taxpayers have multiple bank accounts or have provided their tax number part way through the year.

The requirement for interest payers to communicate the amount of withholding income earned and the resident withholding tax deducted should ensure that taxpayers are able to calculate the withholding rate applied with relative ease. However, officials take the point that this may be more difficult when a tax number is provided mid-year (resulting in resident withholding tax being deducted at the non-declaration rate for some of the year) or if interest earners have a number of different accounts or derive withholding income from multiple sources. In these instances, having information relating to the withholding tax rate may reduce compliance costs associated with determining a taxpayer's tax obligations.

A consequential amendment to clause 65(1) has also been requested, in relation to the information the Commissioner of Inland Revenue can require interest payers to provide.

In relation to the threshold for communicating resident withholding tax information to interest earners, submissions have commented that this information should be available to all interest earners regardless of the amount of interest and tax deducted at source. For most interest earners, this information is already likely to be provided in other forms, such as a bank statement. The threshold recognises that there are compliance costs for interest payers in providing a separate resident withholding tax deduction certificate to interest earners and these costs are particularly likely to be an issue for small interest payers.

Recommendation

That:

- an amendment be made to clause 62 to include the requirement for interest payers to disclose the resident withholding tax rate applied to withholding income when communicating resident withholding tax information to interest earners.
- a consequential amendment be made to clause 65 to require interest payers to also furnish the withholding tax rate to the Commissioner.

RAISING THE USE-OF-MONEY INTEREST THRESHOLD

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

Issue: Application date and threshold amount

Submission
(7 – PricewaterhouseCoopers, 12 – Institute of Chartered Accountants of New Zealand)

The proposal should apply from the start of the 2002-03 income year as this date allows Inland Revenue plenty of time to become operationally prepared. *(PricewaterhouseCoopers)*

The residual income tax threshold under which a provisional taxpayer is not subject to the use-of-money interest rules should be increased to $50,000. *(Institute of Chartered Accountants of New Zealand)*

Comment

Submissions have commented that because the use-of-money interest calculation is not performed until the end of an income year and after an income tax return for that year has been filed, a 2002-03 income year application date is viable. That is, Inland Revenue will have ample lead time (the period spanning the income year end, the due date for filing and the time taken to process the return) to implement the amendment.

A 2003-04 income year application date was recommended on the basis that Inland Revenue would need time to have the processes in place to properly inform taxpayers of the higher threshold. This application date ensures that all taxpayers, including those with early balance dates, have uniform access to the amendment.

The Institute has commented that the tax threshold, under which certain taxpayers are removed from the use-of-money interest rules, has remained unchanged for eight years and inflation would lift it to between $40,000 to $45,000. Concurrently, the 39% tax rate has dropped the level of income at which the $30,000 threshold is reached. It has further submitted that the administration of the use-of-money interest regime has caused huge compliance costs for both taxpayers and Inland Revenue.

The amendment will allow eligible taxpayers to earn up to $12,820 in extra income each year before the use-of-money interest rules apply. Increasing the tax threshold to $50,000, as suggested by the Institute, would mean that an extra $51,282 in income would be allowed. Such a threshold would present a significant risk of deferral of tax, one that would exceed any compliance cost savings or reduction in risk for taxpayers. Officials also consider that use-of-money interest issues can be better dealt with through other initiatives. For example, a number of options for removing and reducing use-of-money interest risk have been outlined in the Government discussion document on tax simplification, *More time for business*. Officials are currently considering the viability of these proposals.

Recommendation

That the submissions be declined.

Issue: Drafting error

Submission
(Matter raised by officials)

A drafting error in clause 55(25) of the bill should be corrected.

Comment

Clause 55(17) of the bill raises the threshold commensurately in respect of the definition of a "new provisional taxpayer". Subclause (25), however, applies subclause (17) from the date of Royal assent. Officials submit that this is incorrect and subclause (25) should be amended to remove the reference in it to subclause (17). Clause 55(29) of the bill provides the correct application date for the amendment

Recommendation

That the matter raised by officials be accepted.

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

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

Submission

(2, 2A – Retail Merchants Association of New Zealand, 7 – PricewaterhouseCoopers, 9 – National Council of Women, 12 – Institute of Chartered Accountants of New Zealand)

The trading stock threshold under which valuation is not required should be increased to $50,000. *(Retail Merchants Association of New Zealand)*

The proposal should be amended to ensure that taxpayers who are not required to register for GST are entitled to apply the proposal. *(PricewaterhouseCoopers)*

The trading stock threshold should be increased to $20,000 or, if this submission is not accepted, the threshold should not be based on taxable supplies for GST purposes. *(Institute of Chartered Accountants of New Zealand)*

The $1.3 million threshold is fairly high. *(National Council of Women)*

Comment

Submissions have commented that very few retailers would have trading stock below the proposed $5,000 threshold for application of the amendment, and given that it is only the movement in stock balances that creates any tax consequences the proposed threshold seems unnecessarily low.

Most businesses are likely to value their closing stock as a matter of course for accounting purposes. When taxpayers are not required to do so, generally because the amount of residual stock is negligible, the tax system creates extra work. Consequently, many small businesses do not accurately measure their closing stock and therefore run the risk of sanctions being applied if caught. The relevant amendment is aimed at alleviating this risk and reducing the compliance costs for small businesses from having to account for changes in the value of what is essentially small amounts of trading stock.

Officials consider that a significantly higher trading stock threshold would impose a large fiscal cost on the government. For example, under a $50,000 threshold for valuing trading stock, taxpayers with closing stock of $5,000 at the end of year one would not have to value the stock at the end of year two if they are able to reasonably ascertain that the value of stock has not exceeded $50,000. If the actual value of stock at the end of year two were $45,000, the trading stock adjustment (that is, “income” of $40,000 that would otherwise be taxable) would now effectively be deferred. A higher threshold would also make it difficult to ensure that taxpayers are making reasonable estimations about the value of their trading stock.

In its supplementary submission, the New Zealand Retailers Association proposed that the threshold amount could be increased to $50,000 with the inclusion of a second criterion that taxpayers be required to value their trading stock if they reasonably estimated that the closing value of the trading stock was at least 50 percent greater than the opening value. As noted in that submission, officials consider that it unlikely that concerns about the Association's proposal can be resolved in time to support an amendment to the current bill. We will, however, further consult on this issue with the Association.

Submissions have also commented that the trading stock threshold should not be based on taxable supplies for GST purposes. They have suggested that this will preclude the smallest taxpayers – that is, those taxpayers that are so small that they are not required to be GST-registered or who make exempt supplies – from being able to apply the amendment. Officials concur with this assessment and recommend that the associated recommendation be accepted. The amendment was intended to apply to all taxpayers with turnover not exceeding $1.3 million in an income year.

In relation to the submission by the National Council of Women, officials consider that reducing the $1.3 million turnover threshold would limit the number of taxpayers with trading stock of $5,000 or less at income year-end who are able to apply the proposal.

Recommendation

That an amendment be made to the relevant clauses in the bill to ensure that taxpayers who are not registered for GST purposes are able to apply the proposal.

Issue: New rules for taxpayers with low gross income

Submission
(17 – KPMG)

The introduction of the proposal should be deferred until such time as a proper review of some substantive provisions for taxpayers with low gross income can be established.

Comment

The submission has commented that while the proposal is supported in principle, a full review of the Income Tax Act should be undertaken and consideration given to developing a set of rules that reduce the burden on taxpayers with gross income below a certain threshold. A review of the Income Tax Act, as suggested by the submission, is beyond the scope of this bill. Officials also consider that the proposal's introduction is warranted on the basis that this will significantly reduce the compliance burden and the associated risks for taxpayers with small amounts of residual stock.

Recommendation

That the submission be declined.

Transfers of holiday pay

OVERVIEW OF SUBMISSIONS

Clauses 9 and 18

The eight submissions on the proposals were unanimous in their support for proceeding with the proposal and divided on the method of doing so.

The following is a very simplified summary of what is quite a complex issue.

Typically, a net deduction is available for monetary remuneration (such as wages and holiday pay) when it is paid to employees.

The law is not clear as to which party, if either, obtains a deduction when employees, and the provisions for monetary remuneration (such as holiday pay) associated with those employees, are transferred from one person (the first employer) to another (the second employer). These transfers usually take place as part of the sale of a business but could, as is pointed out by a submissioner, also occur with the transfer of an employee, typically within a group of companies. When both employers are subject to income tax it is clear that one or the other should obtain a deduction.

The second employer, who assumes the employee obligations, is reimbursed, at least in an economic sense, for assuming the employee obligations, by the first employer.

A recent Privy Council case made it very clear that under current law the second employer does not obtain a deduction in respect of the provisions assumed. The current scheme of the Income Tax Act makes it difficult, but not impossible, for the first employer to obtain a deduction. Even then there is some uncertainty and compliance costs are incurred.

The core proposal in the bill is to clarify current law by ensuring the first employer obtains the deduction. Both parties have to have agreed on the amount transferred for the first employer to get the deduction. There is a special rule for associated parties to ensure that associated persons do not restructure to accelerate the timing of the deduction.

As the second employer will need to separate these payments from other monetary remuneration payments, this means the second employer will need to continue to track the amounts transferred, thus continuing to incur compliance costs.

An alternative would be to structurally change the law so that the second employer obtains the deduction. While this would further reduce compliance costs, it is inappropriate from a fiscal and conceptual perspective. Another alternative that would further reduce compliance costs is possible, but did not find favour during consultation.

Submissions were divided on whether the first employer or the second employer should obtain the deduction.

There are a number of ancillary matters that also need to be addressed.

WHICH PARTY OBTAINS THE DEDUCTION

Clause 18

Submission

(4W – Business New Zealand, 17W- KPMG, 12 – Institute of Chartered Accountants of New Zealand, 15 – New Zealand Law Society)

The proposal should be changed so that the second employer obtains the deduction.

Comment

All submissions on this issue agree that certainty is needed, although there are mixed views on which party should obtain the deduction. The Corporate Taxpayer Group, PricewaterhouseCoopers and the Retail Merchants support first employer deduction, whereas the submissioners above support second employer deduction.

The National Council of Women argued that both parties should obtain a deduction, without reconciling the apparent double deduction.

The reasons proffered for second employer deduction are:

- It is simpler.
- It lowers compliance costs.
- It aligns the main rule and the associated persons rule.
- It means there is no acceleration of the deduction.
- It puts both parties in the same position as if the transfer had never happened.
- Normal accounting practice provides this.

A number of these points are interrelated.

There are, however, stronger reasons why the first employer should get the deduction:

- It means the deduction follows the expense. The first employer is the one that bears the cost of these provisions as an expense. This is consistent with general accepted accounting practice and, as the Institute acknowledges, is conceptually correct. It is not usual tax practice to give one person a deduction for expenditure that, at least in an economic sense, another person has suffered.
- There are potential fiscal implications. The point was made during the limited consultation that occurred on this proposal that vendors may not be able to use the deductions because they are in a loss situation or have insufficient other income against which to offset the deduction. Allowing the second employer a deduction in such circumstances is akin to the transfer of (some portion of) a loss without being subject to the usual limitations that apply on the transfer of losses. Government policy is that losses may not be transferred to non-group companies, and we see no reason to change that policy in this case.

- It correctly treats transfers across the tax exempt/taxpayer boundary and vice versa.

Turning to the points raised in the submissions:

Simplicity and compliance costs

Overall, the proposal will reduce compliance costs. This is because the first employer ends up being offered total certainty. These compliance costs are the costs of structuring in order to get the deductions.

However, it is true that compliance costs could be further reduced if the deduction was generally made available to the second employer. Some submissions correctly recognise that the proposal will not reduce the second employer's present compliance costs, while others argued, incorrectly, that they will increase them.

The compliance cost issue relates to the acquirer having to separate the payments made in respect of monetary remuneration provisions assumed from the first employer from those made to any other employees the second employer might have. This happens under current law and will still continue under the proposal in the bill. PricewaterhouseCoopers, in its verbal submission, suggested that, so long as there were some appropriate rules to enable these provisions to be tracked, its view was that these costs generally should not be material. This is dealt with below.

While it is true that giving the deduction to the second employer would reduce these costs, we consider that the advantages of the first employer getting the deduction outweigh the further compliance savings.

Alignment of main rule and associated person rule, no acceleration of deduction and parties in the same position as if the transfer had not taken place

We agree that alignment of the rules would be useful. However, it is common to have a general rule and an associated persons rule that ensure the tax base is maintained.

While we understand the point being made regarding the acceleration of the deduction, we note it is somewhat unusual for taxpayers to disagree with proposals that accelerate the timing of deductions. In other words, the submissioners' proposals, on the face of it, are taxpayer-unfriendly.

The suggestion that second employer deduction leaves the parties in the same position that they would be if the transfer had not taken place is only partially correct. It is correct from a timing perspective. However, it is incorrect to say the second employer would obtain the deduction as if the transfer had not taken place.

Normal accounting

Generally accepted accounting practice requires the recognition of expenditure and its accrual as it is incurred. The proposed approach of first employer deduction is consistent with this practice. The change, therefore, is only aligning the tax rules with accounting practice, which has happened in a number of instances over the past few years.

It appears that the point being made is the simplicity and compliance cost point made above, that the usual taxation treatment of monetary remuneration is that it is effectively only deductible when it is paid to the employee.

Recommendation

That the submission be declined.

Issue: Limit transfers from tax exempt entities

Clause 18

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

If the submission that the second employer obtains the deduction is accepted, there need to be special rules where the first employer was tax exempt or the monetary remuneration provisions would not otherwise have been deductible to the first employer.

Comment

The submission correctly recognises that when the first employer would not obtain a deduction for monetary remuneration the second employer also should not obtain such a deduction.

However, if the principle submission that the second employer should not obtain the deduction is not accepted, this submission falls away.

Recommendation

That the submission be declined.

Issue: The amendment should be retrospective

Clause 18

Submission
(14 – Corporate Taxpayer Group (CTG))

The amendment should be backdated to apply from the introduction of the Core Provision changes (the 1997-98 income year).

(15 – New Zealand Law Society)
The second employer should get the deduction and this amendment should be backdated.

Comment

Allowing the second employer a deduction is a fundamental change in law which is covered in the submission above. In any case, making it retrospective, as suggested by the NZ Law Society, would lead to the possibility of double deductions if the first employer has already claimed a deduction. Therefore retrospective legislation would also be needed to deny any deductions previously claimed by the first employer. We believe that this would be unacceptable.

It was proposed that the application date be the date of enactment. While retrospective changes should generally be avoided, we can see some merit in the CTG submission to backdate the proposal in the bill to clarify the law that the first employer gets the deduction. In particular, in theory someone should get the deduction. Under current law that person can only be the first employer, even though this person’s entitlement is not totally clear. Therefore allowing some retrospectivity would achieve the right policy result and prevent inappropriate disputes.

Officials recommend that to the extent the first employer has claimed a deduction in the 1997-98 or subsequent income years in a filed tax return which relates to a period before the general application date, that deduction should be grandparented if it qualifies under these rules.

Recommendation

That the submissions be accepted in part.

Issue: Extension of associated parties rule to restructurings

Clause 18

Submission
(4W – Business NZ)

Associated persons should not be treated differently so as not to impede restructuring for commercial reasons.

Comment

Business NZ argues that it does not seem right that businesses that restructure for commercial reasons, such as to improve the efficiency of their New Zealand operations, should face a different outcome than if they had sold their business to someone else.

Our conclusion is that applying the core proposal to associated persons is only likely to encourage tax-driven restructuring to accelerate the timing of the deduction. Under the proposal in the bill, restructuring within a corporate group will result in the deduction being timed exactly the same as if the restructuring had not occurred.

Recommendation

That the submission be declined.

Issue: Extend change to other provisions

Clause 18

Submission
(7 – PricewaterhouseCoopers)

The proposed amendment solves the problem only in respect of wage-related provisions. A more inclusive solution is required in respect of other provisions that transfer.

Comment

The submission correctly points out that other provisions can transfer between taxpayers. Examples would be provisions for bad debts or repairs. Officials agree that similar issues seem to arise.

However, it is not appropriate to consider this wider issue at this stage in the progress of the bill. Officials suggest that the issue be added to their work programme so that it can be advanced as appropriate.

Recommendation

That the submission be declined.

Issue: Compliance costs of the second employer tracking the provisions

Clause 18

Submission
(Verbal submission – PricewaterhouseCoopers)

The second employer should be offered a simplified mechanism for tracking the non-deductible amounts.

Comment

Under current law there is a lack of clarity as to how the second employer tracks the non-deductible provisions assumed. This could be on an employee-by-employee basis or on some sort of more global basis.

Officials agree that clarification would be helpful. The second employer should be allowed to calculate the amounts, on a first-in-first-out basis on either a per employee or per group of employees basis, so long as once the employer chooses a basis, they cannot change it.

Recommendation

That the submission be accepted.

Issue: Section CH 4 not appropriate place

Clause 9

Submission
(17W – KPMG)

Part CH is not the appropriate place to include the provision relating to adjustments in business income.

Comment

Under the new section CH 4, if the amount actually paid out by the acquirer as monetary remuneration is less than the amount transferred, the difference is income to the acquirer. KPMG correctly argues that this deals with business income rather than employment-related income, which is the focus of subpart CH. Subpart CD seems more appropriate for this provision.

Recommendation

That the submission be accepted.

Issue: Clarifying timing rule interrelationships

Clause 9 and 18

Submission
(7 – PricewaterhouseCoopers)

The current wording of the proposed section DF 10(4) relating to associated party transfers requires amendment to incorporate a timing rule for associated purchasers. Preferably, this would be achieved by a link to section EF 1.

Comment

We agree that the rule for associated persons needs to link back to section EF 1 to ensure that the purchaser can use that timing rule for the deduction. Additional words in section DF 10(4) along the lines that "for the purposes of section EF 1, the amount is deemed to be monetary remuneration incurred by the purchaser" provide an appropriate result.

Recommendation

That the submission be accepted.

Submission
(15 – New Zealand Law Society)

The legislation should make it clear that the proposed specific timing rules should be excluded from the scope of section EF 1.

Comment

Officials agree that there is potential for confusion when comparing the words of these proposals and the existing section EF 1.

In fact the submission highlights a structural problem with the proposals. The *incurred* liabilities are already deductible under the core provisions of the Income Tax Act, but the effective deduction is deferred under section EF 1 until such time as they are paid (and there is some uncertainty about the exact mechanism). Thus, contrary to what is proposed in the bill as introduced, there is no need to provide that these incurred provisions are deductible; rather, there is a need to release these provisions through section EF 1 so there is an effective deduction. This second point is the submissioner's point.

However, there is a need to ensure that the *contingent* liabilities are deductible as is currently proposed. Depending on how this is done, they too may need to be released through section EF 1.

Recommendation

That the submission be accepted.

Issue: New section DF 10 linkage to sale price

Clause 18

Submission
(7 – PricewaterhouseCoopers, 9 – National Council of Women)

PricewaterhouseCoopers submitted that new section DF 10(2) needs to link the amount parties can agree between themselves for tax purposes to the actual sale price, inclusive of the actual provisions transferred, to avoid potential distortions. Both submissions suggested that the agreement should be reduced to writing.

Comment

Under section DF 10, the taxpayer can deduct the provisions for monetary remuneration transferred to the purchaser in respect of employees transferred if the taxpayer and the purchaser agree on the transferable amount. There is a subsequent wash-up calculation designed to ensure that differences between the amounts transferred and the actual amounts paid are brought to tax. The submission argues that section DF 10, as it stands, could cause some uncertainty between the parties.

We agree that to avoid doubt over what has been agreed, the agreement between the two parties should be in writing. That amount may not be included directly in the sale price but could arise through a side agreement. The key point to ensure certainty is that the amount should be reflected in the consideration that the two parties exchange.

Recommendation

That the submissions be accepted.

Issue: Cross-references between section DF 5 and DF 10

Clause 18

Submission
(7 – PricewaterhouseCoopers)

The new subsection DF 5(3) should be amended to include a reference to the new section DF 10 so that the relationship between the two sections is explicit rather than implicit.

Comment

The proposed subsection DF 5(3) refers to lump sum payments made by taxpayers who take on liabilities as part of the purchase of a business. It therefore implicitly refers to the situations contemplated by the proposed section DF 10. We agree that more explicit cross-referencing may be helpful to the reader.

Recommendation

That the submission be accepted.

Issue: Extension of associated person rule to transferred employees

Clause 9 and 18

Submission
(7 – PricewaterhouseCoopers)

The treatment of associated persons should be extended to cover employees transferred between associated persons.

Comment

Under the proposed legislation, if a sale of a business is between associated persons, the first employer will not qualify for a deduction but the second employer will be able to claim deductions for amounts that would have been deductible had the business not been sold.

Transfers of employees between associated parties need not involve the sale of the business. The employees may simply be transferred, along with their leave entitlements. The legislation should cover this situation, which is a normal intra-group activity. We therefore recommend that the proposal concerning a transfer of a business between associated persons be widened to cover the transfer of employees between associated companies if no sale of the business occurs.

Recommendation

That the submission be accepted.

Unit trusts and Category A group investment funds

OVERVIEW OF SUBMISSIONS

The bill contains a number of proposed changes to the taxation of unit trusts and "Category A" group investment funds. They deal with:

- an over-taxation problem for the funds by introducing a new system to address the negative dividend issue so that funds can preserve available subscribed capital (ASC) previously lost on redemptions of units;
- a base maintenance amendment to ensure unit trust managers do not receive excess imputation credits on redemptions; and
- a remedial amendment to correct a double debit to the imputation credit account.

Four organisations made submissions on the proposed legislation for unit trusts and Category A group investment funds: PricewaterhouseCoopers, Investment Savings and Insurance Association of NZ Inc, KPMG and the Institute of Chartered Accountants of New Zealand.

All welcomed the changes relating to the negative dividend issue. There were a number of suggested technical amendments to ensure these rules worked appropriately. To a large extent, officials have recommended that they be accepted.

Submissions proposed allowing a refund of income tax paid in advance if there was a credit balance in the new supplementary ASC account. This proposal takes the original proposal a lot further and officials believe it will need further consideration. Officials will continue to work with industry representatives on this issue. For the purposes of this bill, we recommend that the proposals contained in the bill are maintained.

A further submission on negative dividends was that Inland Revenue issue detailed guidelines on the calculation of an opening balance for the supplementary ASC account. Inland Revenue is working on developing these guidelines and plans to include them in the *Tax Information Bulletin* covering the enacted legislation.

OVER-TAXATION OF QUALIFYING UNIT TRUSTS AND CATEGORY A GROUP INVESTMENT FUNDS

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

Issue: Operation of the supplementary available subscribed capital account

Clause 51 inserts a new subpart MJ into the Income Tax Act 1994, which provides for the establishment and operation of a supplementary ASC account. This account will record amounts of ASC contributed by unit-holders and members of qualifying unit trusts and Category A group investment funds but not returned to them on redemption of their units. The supplementary ASC account balance can then be converted to imputation credits and transferred to the qualifying unit trust's, or group investment fund's, imputation credit account at the end of an imputation year or when the qualifying unit trust or group investment fund ceases to operate an imputation credit account. Only a supplementary ASC account balance sufficient to meet the debit balance in the qualifying unit trust's or group investment fund's imputation credit account can be converted and transferred.

Submission

(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

As the proposed section MJ 1(1) is currently drafted, there is potential for confusion over whether "start date" is the date of assent or the date from which the trust decides to maintain a supplementary ASC account. The start date should be the date from which the trust decides to maintain an account and the wording should be altered to reflect this.

Comment

Officials agree that the start date should be the date from which the trust decides to maintain a supplementary ASC account. A trust can choose to start to operate this account on any date on or after the enactment of this legislation. The legislation should be clarified to reflect this intention.

Recommendation

That the submission be accepted.

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

The proposed section MJ 1(2) is not necessary. Any trust wanting to apply section MJ 4(1) would presumably decide to establish and maintain its supplementary ASC account on and after a particular date in that period which they will choose, and by virtue of section MJ 1(1) that will be its start date.

Comment

The proposed section MJ 1(2) is necessary but should be clarified. Under proposed section MJ 4(1) a qualifying unit trust or Category A group investment fund can choose to calculate an opening balance for its supplementary ASC account. This allows for past transactions that gave rise to the negative dividend issue to be taken into account under the new rules. This calculation must be done as at a date anywhere between the date the legislation is enacted and 31 March 2003. This date can be referred to as the effective date. The legislation should be clear that the start date of the supplementary ASC account in this case is the day following the effective date, and not the day after the calculation is actually performed. The legislation should be clarified in this regard.

Recommendation

That the submission to remove section MJ 1(2) be declined but the legislation be clarified for the start date for a fund that calculates an opening balance.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

The proposed section MJ 3(2) should be amended to clarify that the “first imputation year” refers to the income year in which the “start date” for the supplementary available subscribed capital account occurs.

Comment

It was intended that the “first imputation year” referred to in the new section MJ 3(2) is the imputation year in which the “start date” falls. Officials agree that the legislation should be clarified to reflect this.

Recommendation

That the submission be accepted.

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

The proposed section MJ 4(2)(a) should be reworded to insert the word “realised” after “total amount”.

Comment

The submission states that “the new present tense language can be confusing” and that it would be preferable to clarify that the calculation is of ASC forfeited on previous realisations. Section MJ 4(2)(a) provides an opening balance calculation for the supplementary ASC account. The MJ 4(2)(a) calculation requires the fund to determine the ASC previously lost based on actual redemptions. Officials are concerned that referring to the amount realised may cause confusion. Realisation is likely to be a concept that is more relevant to the unit-holder or member and not the fund. Officials recommend, therefore, that this change is not made as it could result in additional confusion. However, for purposes of clarity, the reference to “available subscribed capital per share” could be changed to “available subscribed capital per share redeemed”.

Recommendation

That the submission be declined but additional clarity can be made to legislation by referring to “available subscribed capital per share redeemed”.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

The proposed section MJ 4(2)(a) should be redrafted to ensure that it aggregates all the “lost” ASC from redemptions, and that the affected trust is able to aggregate the lost ASC from only some redemptions if it chooses (for example, if records do not allow the requisite calculation for redemptions before a certain date). The section should also exclude “lost” ASC from redemptions which occurred prior to the unit trust/GIF establishing an imputation credit account.

Comment

It was always intended that if a unit trust or group investment fund chose to calculate the opening balance of its supplementary ASC account by reference to actual redemptions, it could choose to take into account redemptions in some years and not in others. This situation can arise if the fund has inadequate records for some years and so is unable to determine the actual redemptions in those years. The legislation should be clear that this is allowed.

We agree with the submission that when using actual transactions only redemptions after the establishment of an imputation credit account should be included. Under the notional liquidation calculation only redemptions following the introduction of the imputation credit account are effectively taken into account.

Recommendation

That both parts of the submission be accepted.

Submission

(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

The definition of "further tax on liquidation" in proposed section MJ 4(2)(b) should be replaced with "further income tax on liquidation". This definition should refer explicitly to further income tax payable (under section ME 9) as a result of a debit balance in the imputation credit account following the notional wind-up calculation.

Comment

Officials agree that the legislation should clarify that it is income tax that is payable under section ME 9. Section ME 9 of the Income Tax Act 1994 provides for the payment of further income tax when there is an end of year debit balance in a company's imputation credit account or a company ceases to operate an imputation credit account. This is the relevant amount of income tax for the purposes of the notional liquidation calculation.

Recommendation

That the submission be accepted.

Submission

(13 – Investment Savings and Insurance Association of NZ Inc, 17W – KPMG)

The definition of "tax not available to impute dividends" in proposed section MJ 4(2)(b) needs amendment to ensure that this amount arises only to the extent that the structural features have increased the further income tax to pay.

Comment

Officials agree clarification is necessary. We suggest that to achieve this clarification MJ 4 (2)(b) should refer to section MJ 4(4), which sets out the features of the tax system that will give rise to amounts that do not have tax payable on them. Consequently, credit for income tax paid on them is not allowed under the notional liquidation calculation.

Recommendation

That the submission be accepted.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 17W – KPMG)

The definition of "maximum imputation ratio" in section MJ 4(2)(b) should be defined as being the "ratio calculated in accordance with the formula".

Comment

The suggestion provides further clarification.

Recommendation

That the submission be accepted.

Submission
(17W – KPMG)

The proposed formula for calculating the opening balance of the supplementary ASC account in section MJ 4(2)(b) needs to clarify whether tax payments made to clear imputation credit account debit balances arising from negative dividends can be included in the calculation of "further tax on liquidation". Under the current legislation these tax overpayments cannot be recognised as an asset owing to insufficient imputation credits. Therefore, they are not distributed in a notional liquidation and ultimately do not give rise to "further tax on liquidation".

Comment

This situation may arise, in particular, when a fund is liquidating and it has prepaid tax that it will not be able to use in the future because liquidation means it has no future tax liability. However, the fund will not be entitled to a refund of this prepaid tax because it has already provided the imputation credits gained from the payment of that tax to shareholders. The attachment of these imputation credits may have arisen out of the negative dividend issue. However, the imputation credits may also have been attached to dividends paid out of capital profits or foreign income for which there are no New Zealand tax credits.

If it can be shown on liquidation that the prepaid tax was as a result of the negative dividend issue rather than for the other reasons, the refund of the tax should be available on liquidation. Consequently, we recommend that the legislation provides that on liquidation to the extent there is a credit in the supplementary ASC account, and assuming a nil balance in the imputation credit account, the fund can receive a refund of the prepaid tax.

In terms of the opening balance calculation, only actual redemptions will be determinative of the supplementary ASC account credits in such a case referred to above.

Recommendation

That the submission be declined but an amendment be made to allow for a refund of the tax to the extent that there is a credit in the supplementary ASC account on liquidation and a nil balance in the imputation credit account.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

The list of structural features of the taxation and imputation systems referred to in the definition of "tax not available to impute dividends" in proposed section MJ 4(2)(b) should be made a finite list, rather than an inclusive list.

In the alternative, if the list is to remain inclusive the structural features of the taxation and imputation systems should be defined in a generic way (with the existing list constituting examples).

Suggested wording:

> "....features by virtue of which a company which does not issue shares on terms subject to section CF 3(1)(b)(iv) would not normally be expected to be able to fully impute a distribution made on liquidation of that company…."

Comment

Officials are concerned that a finite list could be potentially restrictive and therefore prefer the alternative submission. The suggested wording should be modified, however, to refer to a "New Zealand resident company" and to remove the reference to "normally".

Recommendation

That the alternative submission be accepted and the generic wording, as modified, be included in section MJ4 (4).

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 17W – KPMG)

Proposed section MJ 5(1) should be clarified to apply "in respect of any share redeemed or otherwise cancelled in that imputation year". In addition, the word "provided" should be used rather than "if".

Comment

Officials agree with the first suggestion to make reference to "otherwise cancelled" as well as "redemption". However, we are of the view that it is better drafting to continue to use "if" rather than replace it with "provided".

Recommendation

That the submission be accepted in respect of extending the redemptions to other cancellations, but declined regarding a change from “if” to “provided”.

Submission

(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

The proposed section MJ 5(3) should be amended to apply to redemptions that occur on or after the start date.

Comment

Section MJ 5(3), as drafted, appears to ignore redemptions made on the start date when calculating credits to the supplementary ASC account. This was not intended.

Recommendation

That the submission be accepted.

Submission

(13 – Investment Savings and Insurance Association of NZ Inc)

Another methodology should be available as an alternative to the need to track “lost” ASC each time a redemption arises. This sub-section could include, as an alternative, a simple annual adjustment to the ASC account at 31 March, using the notional liquidation calculation in accordance with the proposed section MJ 4(2). Alternatively, this could be refined by allowing the taxpayer to complete a notional liquidation calculation as at the time a debit balance arises in the imputation credit account. Each calculation would be replacement for the last notional liquidation calculation.

If this were not considered possible, a second-best approach would be to allow the taxpayer to complete the proposed section MJ 4(2) calculation on liquidation.

Comment

Officials do not accept the first-best approach set out in the submission. This seems to fundamentally change the basis for determining credits to the supplementary ASC account by moving from recording actual redemptions to determine the lost ASC to redemptions with reference to a regular notional liquidation calculation. While we understand that funds may as a matter of course perform these calculations regularly, it is our preference to continue with the proposal to use actual redemptions to determine lost ASC going forward. This basis also appears to have a lower administrative cost.

Officials consider that the second-best approach is a better alternative for funds that do not wish to maintain a supplementary ASC account.

Recommendation

That the submission on the second-best approach be accepted and the first-best approach declined.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 17W – KPMG)

The election referred to in section MJ 6 should be cross-referenced as the election under section MJ 7(1).

Comment

As a matter of drafting it is preferred that the cross-reference is not included. This does not appear to give rise to confusion as there is only one possible election this can refer to.

Recommendation

That the submission be declined.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 17W – KPMG)

Proposed section MJ 7 should be amended to allow an election at any time of the year for the transfer of a credit balance in the supplementary available subscribed credit account at that time. If this amendment is made, a consequential change will be needed to section MJ 6 to keep it consistent with section MJ 7.

Comment

This does not appear to cause any problems or tax planning opportunities and therefore officials agree to the change.

Recommendation

That the submission be accepted.

Submission
(17W – KPMG)

The wording of section MJ 7 needs to be amended so that a transfer of a credit balance in the supplementary ASC account can occur to provide a sufficient level of imputation credits to allow for a refund of tax overpayments arising because of negative dividends.

Comment

Section MJ 7 allows for the transfer of a credit balance in the supplementary ASC account where there is a debit in the imputation credit account. In the described situation in the submission there is no debit in the imputation credit account, as the tax cannot be refunded unless there are sufficient credits in the imputation credit account to make the refund.

The refundability of tax paid in advance in order to cover a debit in the imputation credit account was not part of the original proposal for solving the negative dividend issue. This solution was developed by officials and industry representatives. If this refundability is to be included, further thought needs to be given as to the need for a supplementary ASC account. Officials recommend that the proposed legislation be enacted and the issue of refundability be given further thought by officials and the industry.

Recommendation

That the submission be declined.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

An amendment should be made to section MD 2(1A) in clause 48 to allow a refund of tax where the refund is not more than the aggregate of the balance of the imputation credit account and the imputation credit value of the balance of the supplementary ASC account.

Comment

This refund potential would allow the release of tax that has been prepaid in the past because of the negative dividend problem. The refund will create a debit balance in the imputation account which will be able to be "made good" by the transfer of part or all of the balance of the supplementary ASC account.

This issue is different from the previous refundability issue in that it relates to prepaid tax arising out of ASC lost prior to the introduction of the supplementary ASC account. Once again, this refundability issue was not included as part of the original solution. As with the previous issue, we recommend that the proposed legislation be enacted, with the recommended amendments, and further thought be given to the appropriateness of refundability. We note that officials are recommending that a refund of prepaid tax is made on liquidation to the extent that it can be shown there is lost ASC.

Recommendation

That the submission be declined.

Submission
(13 – Investment Savings and Insurance Association of NZ Inc, 7 – Pricewaterhouse Coopers, 17W – KPMG)

Inland Revenue should issue guidelines on the calculation of an opening balance for the supplementary ASC account using the notional liquidation method.

Comment

Inland Revenue is working with the industry on developing these guidelines. It is intended that these will be included in the *Tax Information Bulletin* covering the enacted legislation.

Recommendation

That the submission be accepted.

Clause 5

The proposed section CF 7A ensures that when a unit trust manager redeems units with a unit trust in the ordinary course of its business, to the extent that the dividend constitutes a recovery of the purchase price, the manager (and any persons nominated by the manager) will not be able to utilise the imputation credits received.

Issue: Excess imputation credits received by managers of qualifying unit trusts

Submission
(17W –KPMG)

The following words in the proposed section CF 7A(2) should be removed.

> "to the extent that the dividend, exclusive of the imputation credit, recovers the price paid by the unit trust manager, the trustee or the person nominated by the manager or trustee to acquire the units."

Comment

The submission appears to raise concerns with the reference to the recovery of "purchase" price and tries to further define the concept of price. The submission preferred alternative wording. Officials are concerned that this wording may apply more widely than intended.

Recommendation

That the submission be declined.

Submission
(Matter raised by officials)

The new provision should also cover group investment funds that derive Category A income.

Comment

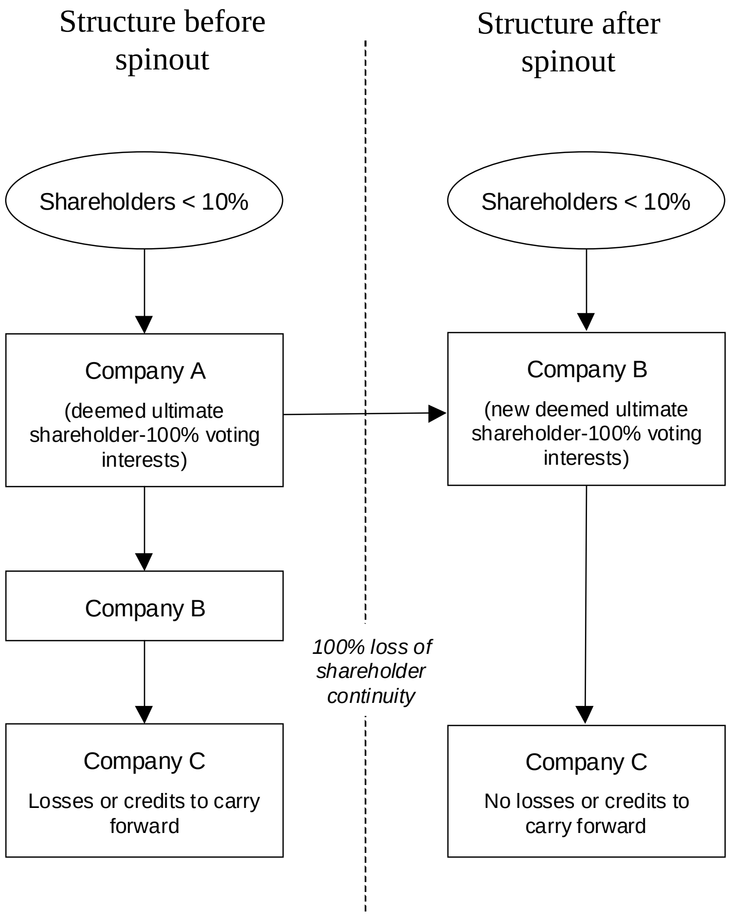
The base maintenance issue arising for unit trust managers also arises in respect of group investment fund managers in the same circumstances regarding redemptions. It was intended that the amendment apply to these manager redemptions.

Recommendation

That the submission be accepted.

Carry forward of losses and credits after a spinout

Clause 56 provides for tax losses and credits of a subsidiary company to be preserved on the "spinout" of that company by a parent company. A spinout occurs when the parent company sells its interest in a subsidiary to its own shareholders. The diagram below illustrates the effect of a spinout in the absence of the provisions in the bill.



In the diagram, company A spins out its interests in company B and company C – that is, company A sells its shares in company B to its own shareholders. Before the spinout, company A holds all voting interests in company C on behalf of its small shareholders under the concessional ownership tracing rule in section OD 5(6)(b) of the Income Tax Act 1994. After the spinout, company B holds these same interests in company C.

From an economic perspective, there is no change in the ownership of company C as a result of the spinout. However, if company B wishes to apply section OD 5(6)(b) after the spinout, there will be a 100% change of ownership interests in company C, and company C's losses or credits would be cancelled.

The bill preserves the losses by treating company B as holding the ownership interests in company C that were, before the spinout, deemed to be held by company A on behalf of the small shareholders. The rule applies only to the extent that the shareholders in company A and company B are the same immediately after the spinout.

Submissions

Three submissions have been received on the spinout provisions in clause 56 – from the NZ Law Society, Chapman Tripp and the Institute of Chartered Accountants. They propose extensions and minor amendments to the provisions.

MINOR DRAFTING CHANGE

Clause 55(18)

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

The bill provides that the definition of "nominee" in section OB 1 applies for the purpose of section OD 5(6A). As the term "nominee" is also used in section OD 5(6F), the definition of nominee also should apply for that purpose.

Comment

We agree with the submission.

Recommendation

That the submission be accepted.

SIMILAR RULE SHOULD APPLY WHEN THE CONCESSIONARY TRACING RULE IN SECTION OD 5(5) IS USED

Clause 56

Submission
(15 – New Zealand Law Society)

The proposed new rule applies only when a breach in continuity would be caused by a change in the person deemed to hold shares under one of the concessionary rules for measuring continuity of ownership (section OD 5(6)(b)). However, there are other concessionary rules for tracing ownership interests in a company. A similar rule to that proposed in the bill should apply where continuity is measured using the concessionary rule set out in section OD 5(5). That provision enables direct interests of shareholders in a company such as company A who hold less than 10% to be grouped together and classified as a "notional single person".

Comment

We agree with the submissioner that a similar rule to that in the bill may be appropriate when shareholders in the parent company are a "notional single person". However, this requires more detailed analysis – for example, a consideration of the circumstances in which companies will be using that concessionary rule, and whether having two companies (the holding company and the spun out company) owned by the same notional single person fits with the scheme of the concessionary tracing rules.

The analysis, and any resulting legislation, is likely to be complex. It is therefore best dealt with as a separate policy issue which progresses through the normal tax policy process.

Recommendation

That the submission be declined but that the issue be noted for consideration at a later date.

TWO-STEP SPINOUT

Clause 56

Submission
(15 – New Zealand Law Society)

The proposed legislation should be extended to apply where:

- company A holds a less than 10% interest in company C; and
- company B holds no interest in company C; and
- as part of the spinout restructuring process, company A wishes to transfer its interest in company C to company B prior to transferring company B to its shareholders.

Comment

The submission argues that the proposed new rules should be extended so that tax losses and credits are preserved in certain circumstances when corporate restructuring occurs before a spinout. The NZ Law Society refers to the example on the following page.

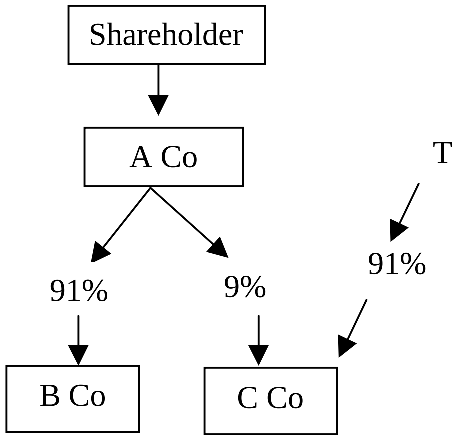
The NZ Law Society considers that a breach of continuity may occur, and therefore any losses or credits may be lost, when the restructuring occurs before the spinout. It points out that this is despite the fact that there is, in substance, no change in economic ownership of C Co on the restructuring.

We do not agree that the proposed rules in the bill should be extended to cover corporate restructurings prior to a spinout. Preservation of losses and credits on a corporate restructuring when there is no change in economic ownership is a discrete issue that should be considered separately.

Recommendation

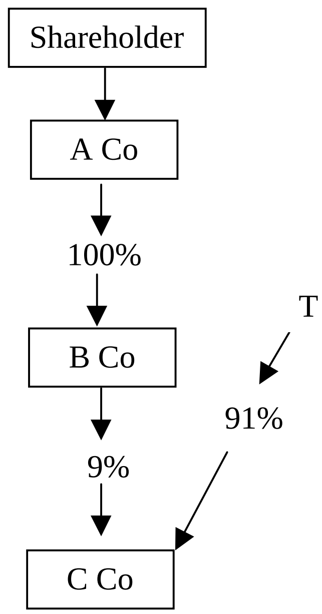
That the submission be declined.

I. Position before restructuring and spinout



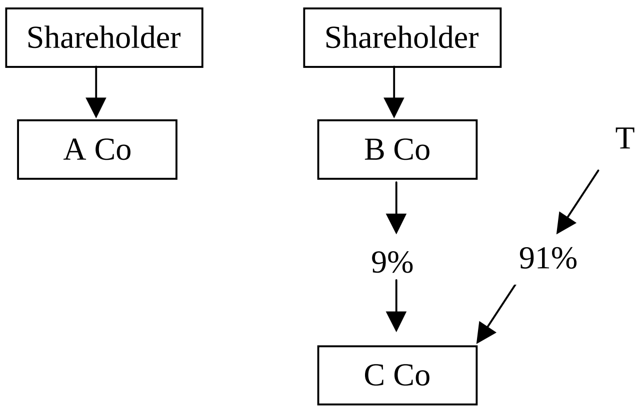
II. Restructuring

A Co sells its interest in C Co to B Co



III. Spinout

A Co sells its shares in B Co to its own shareholders



INTERESTS HELD BY PARENT COMPANY IN LOSS COMPANY PRIOR TO SPINOUT

Clause 56

Submission 1
(15 – New Zealand Law Society)

It is clear from subsection (6A) that the new provisions are intended to apply to prevent a breach of continuity when the holding company (company A) has measured its ownership in the loss company (company C) using the concessional tracing rule in section OD 5(6)(b). It should be made clear in the operative subsection (6B) that the only interests in Company C previously held by company A that will be treated as interests of the spinout company (company B) are those treated as interests of company A under section OD 5(6)(b).

Comment

We agree that company B should be treated as holding only those interests of company A that are held under section OD 5(6)(b) prior to the spinout. However, a corresponding amendment is required to ensure that taxpayers are not penalised where company A holds indirect interests in company C that are not held under section OD 5(6)(b). The problem arises where there is a significant shareholder in company A who is not receiving shares in the spinout company B. In order to avoid double counting that change in shareholding, commonality should be measured only in relation to the shares held under section OD 5(6)(b) by company A and company B immediately after the spinout. Currently, commonality is measured in relation to all shares in company A and company B immediately after the spinout.

So, for example, assume Company A is owned by E (20%) and small shareholders holding less than 10% (80%). Company A is treated as holding 80% of the shares in company C under section OD 5(6)(b). E holds the other 20% of the shares. E is not receiving shares in the spun out company B. Paragraph (6B) should treat company B as holding the 80% interest held by company A in company C under section OD 5(6)(b) prior to the spinout. However, because all the small shareholders in company A also hold shares in the same proportion in company B immediately after the spinout, there should be 100% commonality. (The current provision would allow only 80% commonality).

We have discussed this with the submissioner, and two practitioners whose clients are contemplating a spinout in a situation in which there is a significant shareholding in the parent company A. They agree with the proposed amendment.

Recommendation

That the submission be accepted and that commonality be measured only relation to shares held by company A and company B under section OD 5(6)(b) immediately after the spinout.

Submission 2
(15 – New Zealand Law Society)

It should be made clear (at least for the avoidance of doubt) that, for the purpose of applying the tax loss and credit continuity provisions on and after the spinout, the original holding company (company A) is deemed not to have held the relevant interests in the loss company (company C) prior to the spinout.

Comment

For the purposes of applying the continuity provisions after the spinout, the new rules deem the spun out company (company B) to have held the relevant interests in the loss company (company C) for relevant periods before the spinout. By deduction, therefore, company A does not hold the relevant interests in the loss company during those periods.

We are concerned about the complexity of the provision, and clarifying this point in legislation adds to that complexity. We therefore propose that, for the avoidance of doubt, this point should be clarified in the *Tax Information Bulletin* that covers enactment of the legislation.

Recommendation

That the submission be declined but that the *Tax Information Bulletin* covering enactment of the legislation state that, to the extent that interests are treated as being held by the spun out company B, they are not simultaneously held by company A.

REQUIREMENT THAT HOLDING COMPANY IS A LIMITED ATTRIBUTION COMPANY

Clause 56

Submission
(15 – New Zealand Law Society)

The new rules require that the parent company A holding the interests in the loss company C prior to the spinout be a limited attribution company from the time the loss is incurred until the spinout. This fails to take account of a situation in which company A becomes a limited attribution company (for example, by listing) subsequent to a loss being incurred. It does not appear logical to exclude this situation from the proposed amendments.

Comment

Broadly, a limited attribution company is a widely held or listed company. There is a requirement in the spinout provisions that the parent company A be a limited attribution company for the period between the incurring of the loss and the spinout to minimise fiscal risk.

However, we accept the point raised in the submission that company A may be widely held at the time of the spinout but not at the time the loss was incurred. It should be sufficient if company A is a limited attribution company at the time of the spinout.

Recommendation

That the submission be accepted so that it is sufficient if company A is a limited attribution company at the time of the spinout.

DRAFTING OF DEFINITIONS IN SUBSECTION (6E)

Clause 56

Submission
(15 – New Zealand Law Society)

The definitions of “common market value interest” and “common voting interest” that apply for the purposes of this provision are worded slightly differently from the definitions of the same expressions in section IG 1(5) of the Act. The wording of the definitions is perhaps clearer in the provisions in the bill. It may be prudent to amend the definitions in section IG 1(5) so as to remove any suggestion that the different wording results in an unintended difference in meaning.

Comment

The definitions of “common market value interest” and common voting interest” in the bill may change to reflect a proposed amendment to the spinout provisions recommended in this report. If this is the case, the submission is no longer relevant.

If the definitions are retained in the bill in their current form, we do not favour amending the definitions in section IG 1(5). That section contains definitions of “common voting interest” and “common market value interest” that apply generally for the purposes of calculating a common interest in two companies.

The spinout provisions contain their own definitions of those terms for the purposes of measuring the common interest of a shareholder in both the parent company and the company that is spun out. Losses and credits are preserved to the extent of the common interest in both companies.

The terms are specifically defined for the purposes of the spinout rules in order to better link the definitions with the substantive provisions. However, the specific definitions have the same effect as the general definitions, and the wording is otherwise almost identical.

We do not favour an amendment to the general definitions without the opportunity for general consultation. The rewrite of the Income Tax Act will address issues of inconsistency between provisions and definitions that are intended to have the same effect. The consultative process associated with this will allow an opportunity for others to comment on a proposed redraft of the general definitions.

Recommendation

That the submission be declined.

SHAREHOLDERS WHO INTEND TO SELL SHARES IN THE SPUN OUT COMPANY

Clause 56

Submission
(18 – Chapman Tripp)

A minor amendment to the spinout provisions is desirable to accommodate the possibility of a parent company that is spinning out a subsidiary, retaining shares in the subsidiary on behalf of one or more of the shareholders of the parent company and selling the shares on behalf of those shareholders.

Comment

As the submission points out, the proposed new section OD 5(6A) already accommodates the possibility that shares in the subsidiary company B may be transferred to a sale agent acting on behalf of shareholders who wish to dispose of their shares in the subsidiary company immediately after the spinout. (The new provisions apply if shares in the subsidiary to be spun out "are transferred to a nominee of a shareholder" of the parent company.)

The shares in the spun out company that are held by the nominee are treated as being owned by the shareholder who wishes to sell the share. Because that shareholder will own shares in the parent company A and in the spun out company B, any change in continuity of the spun out company will therefore occur not on the spinout but on the subsequent sale of the share by the nominee.

The submission argues that, instead of a separate nominee being appointed as sale agent, the parent company may act as the nominee. If this is the case, the shares will be retained by the parent company, although the capacity in which it holds the shares will change from beneficial owner to nominee on behalf of its own shareholder.

We agree with the suggested amendment to the provisions.

Recommendation

That the submission be accepted.

LOSS OF SHAREHOLDER CONTINUITY ON CORPORATE CONVERSION

Clause 56

Submission
(Matter raised by officials)

A new provision should be included in the Income Tax Act 1994 to ensure that shareholder continuity is not broken in circumstances where a company of proprietors that is established by statute converts to a limited liability company.

Comment

Officials have been made aware of a potential tax problem for New Zealand companies owned by an overseas company that is to be converted from an unincorporated company of proprietors into a limited liability company. The issue relates to the measurement of shareholder continuity in the New Zealand companies following the conversion of its overseas parent. It is possible that as a consequence of the conversion there will be a technical breach of the shareholder continuity rules for the New Zealand companies, resulting in these companies losing their imputation credits and tax losses at the date of conversion. This is contrary to the policy behind the shareholder continuity rules in the Income Tax Act 1994 because there has been no change to the underlying beneficial ownership of the New Zealand companies as a result of the conversion.

The Income Tax Act 1994 should be amended so that it is clear that there is no change in the shareholding as a result of the conversion and therefore no breach of the shareholder continuity rules.

Recommendation

That the submission be accepted.

GST treatment of warranty payments from non-registered offshore warrantors

OVERVIEW OF SUBMISSIONS

Clauses 80A, 82, 84

The proposed changes relieve non-registered offshore warrantors of a GST impost on payments made under a warranty agreement that has been included in the purchase price of an imported good.

A potential double impost of GST occurs when GST is paid by the final consumer on the value of anticipated warranty repairs that is included in the purchase price of the good as a warranty agreement, and an irrecoverable GST impost is also paid by a non-registered offshore warrantor on the actual cost of warranted repairs.

The provisions will remove the potential double impost by zero-rating supplies of goods and services made under a warranty agreement when:

- the warranty agreement was included in the purchase price of goods which attracted GST on importation into New Zealand; and
- consideration for the supply is paid by the non-registered offshore warrantor.

The bill proposes applying these changes from the date of enactment.

Seven submissioners commented on the bill's provisions to zero-rate services in respect of warranty payments made by non-residents. All submissioners supported the policy to ensure that potential double taxation does not arise in relation to goods imported with warranties. All submissioners also commented on the application date, all recommending that the proposals apply retrospectively.

Four submissioners made various recommendations of a technical nature.

SCOPE OF THE ZERO-RATING PROVISIONS

Submission
(16 – Motor Industry Association)

An alternative argument in the Suzuki case was that, rather than there being a supply to the non-resident warrantor, the importer supplies a service to the customer for which the non-resident warrantor pays consideration. If this interpretation were taken, the zero-rating provision would not apply to the payment by the non-resident warrantor because one of the requisites for zero-rating under the proposed amendments is that a supply is made to the non-resident warrantor.

Submission
(7 – PricewaterhouseCoopers)

Clarification should be given as to why in clause 82, the zero-rated supply of repair services is deemed to be the only supply for the consideration given by the non-resident.

Comment

Following the Suzuki decision, it is clear that when the importer provides a service of remedying a defect under warranty to the non-resident warrantor, payment from the non-resident warrantor is consideration for that service. The proposed amendments seek to zero-rate this supply. Clause 82 is intended to ensure that, where this supply occurs, the payment from the non-resident warrantor cannot be treated as consideration for any other supply (such as a supply of services from the importer to the customer). In this way, based on the Suzuki scenario, the proposed amendments remove any argument that there is another supply not covered by the proposed zero-rating provision.

However, if the warranty scenario is varied slightly so that, for example, the non-resident warrantor makes payment directly to a third-party repairer as consideration for services supplied by the repairer to the customer, the zero-rating provisions would not apply. In the same way as in the Suzuki scenario, an effective double impost also occurs in this situation as GST is imposed on the value of the warranty embedded in the purchase price of the good and also on the services provided under the warranty.

The proposed amendments are intended to remove the effective double tax impost on warranty payments. The identifying feature of the supplies causing this double impost is that consideration for the supply of services provided under the warranty agreement is given by a non-resident warrantor to a registered business, with the non-resident unable to recover any GST cost associated with the consideration. Officials therefore consider that the proposed amendments should be broadened to ensure that when there is no supply of services to the non-resident warrantor, a payment by the non-resident warrantor to a repairer as consideration for repair services provided under the warranty agreement, is also zero-rated. We recommend that the issue of the deemed single supply be clarified in the *Tax Information Bulletin* that covers the new legislation.

Recommendation

That the submissions be accepted and that the operation of the deemed single supply in clause 82 be illustrated in a *Tax Information Bulletin*.

INCLUSION OF GOODS

Submission
(16 – Motor Industry Association, 12 – Institute of Chartered Accountants of New Zealand, 11W – Deloitte Touche Tohmatsu)

The legislation should be clarified to ensure that the provision of goods under a warranty agreement is zero-rated.

Comment

The proposed amendments apply to the service of remedying the defect covered by the warranty agreement. Remedying the defect may involve a variety of activities, from repairing a part of the good to replacing the whole good.

Submissioners are concerned that because the proposed legislation refers only to services it could be interpreted to mean that only the labour content of repair services, and not the provision of replacement parts and goods, is zero-rated.

Officials agree that it is desirable to clarify the proposed amendments so that, whether or not replacement parts are included in the supply, provided it meets the other legislative requirements, the supply will be zero-rated.

Recommendation

The submission be accepted.

DEFINITION OF "WARRANTY"

Submission
(16 – Motor Industry Association)

Replacement of and compensation for defective goods should be included in the definition of "warranty".

Comment

GST is imposed on supplies of goods and services made in the course of a taxable activity. Compensation is not consideration for a supply. In the absence of a supply to the non-resident warrantor, the issue of a double tax impost does not arise.

When the replacement of the good is required to remedy a defect that is covered by a warranty agreement to which the amendment applies, the supply of the replacement will also come within the provisions, provided the other conditions are met. If the replacement is not covered by the warranty, the cost of the replacement cannot be considered to have been factored into the cost of the warranty. The cost of replacement would not therefore have attracted a GST impost by being included in the good when it was sold. Thus there would be no double impost of GST.

Recommendation

That the submission be declined.

Submission
(16 – Motor Industry Association)

The reference to the "supply agreement" in the definition of "warranty" should be deleted.

Comment

This term is used in the legislation to distinguish between different warranty arrangements. When the value of the warranty is embedded in the purchase price of the good, GST is paid on that value as part of the GST impost on the total purchase price. However, when a warranty agreement is given separately from the goods and the value is readily identifiable the warranty may not be subject to GST. Alternatively, in the case of a registered purchaser, the warranty may be subject to GST, for which an input tax credit may be claimed. Therefore, repair services performed under such an agreement should not be zero-rated. Officials consider that the term "supply agreement" best describes an agreement that includes a warranty given for the good supplied but may be, for example, contained in various documents other than the sale and purchase agreement. Officials consider it would be beneficial to advise in a *Tax Information Bulletin* item that "supply agreement" refers to the sale and purchase agreement and other agreements such as the importation and warranty agreements that are interdependent with the sale and purchase agreement.

Recommendation

That the submission be declined but that what can be regarded as a "supply agreement" be described in the *Tax Information Bulletin.*

Submission
(11W – Deloitte Touche Tohmatsu)

The reference to the warranty being "given under the supply agreement" should be replaced with "given together with the supply agreement" to include warranty agreements that are given by a separate entity in the supplier group but not separately charged for.

Comment

The proposed wording would open a potential loophole in relation to offshore warranty agreements that are given with the good but not included in the purchase price of the good and, therefore, do not attract GST. When an offshore warrantor gives a warranty separately from the good both the provision of the warranty and any payment under that warranty will be outside New Zealand's GST base and, therefore, not subject to GST. As clause 84(1)(ma) requires only that the goods have been subject to tax, the proposed wording would allow zero-rating of repair services performed under warranties which have not been subject to a GST impost.

Recommendation

That the submission be declined.

Submission
(16 – Motor Industry Association)

Product recalls should be included in the definition of "warranty".

Comment

The Motor Industry Association has advised that, in many instances, the cost of product recalls is factored into the price of goods and covered by a warranty agreement included in that price. In that case, the proposed amendment would already apply to the cost of product recalls. Supplies that result from a product recall but are not provided under warranty are, however, outside the scope of the proposed amendments, which are directed at ameliorating the taxation effect of the Suzuki decision on warranties. Officials note that the cost of product recalls may also be provided for in other ways, such as such as under a general insurance contract, and may therefore not attract an effective double tax impost.

Recommendation

That the submission be declined.

Submission
(16 – Motor Industry Association, 12 – Institute of Chartered Accountants of New Zealand, 7 – PricewaterhouseCoopers, 11W – Deloitte Touche Tohmatsu)

The phrase “without further cost to the recipient” should be deleted.

Comment

Many warranty arrangements provide for some cost to be met by the warranty holder. This portion of the services should not be zero-rated because it is in addition to the purchase price of the goods and has not therefore attracted a prior GST impost. However, officials agree that a contribution to the cost of warranty repairs by the warranty holder should not preclude the portion of warranty repairs that is met by the warrantor from being zero-rated when that portion has been anticipated in the purchase price and therefore charged with GST. This intention is already met by the phrase “to the extent that”, which contemplates the apportionment of supplies when consideration is paid by more than one person.

Recommendation

That the submission be accepted.

Submission
(16 – Motor Industry Association)

In the definition of “warranty” for the purpose of the zero-rating provisions, the phrase “during a certain period of time after the goods are supplied or before a certain level of usage is reached” should be replaced with “during a specified amount of time, distance or other measure of use”.

Comment

The term “specified” raises the issue of what would constitute valid specification and would therefore add complexity to the legislation. The primary concern is that the terms of the warranty arrangement are identified and agreed. This intention is met by requiring that the terms be “certain”.

It is also important to ensure that only defects that become apparent after the good has been supplied, and are therefore not reflected in a discounted purchase price, be included in the zero-rating provisions. The submissioners proposed wording does not distinguish between defects that are apparent at the time of sale and defects that become apparent after sale.

In addition, the use of distance as an example of measured use is redundant and may colour the interpretation in a manner inconsistent with the wide range of products and use that may be covered by warranties.

Recommendation

That the submission be declined.

Submission
(16 – Motor Industry Association)

The definition of “warranty” should be included in section 2 of the GST Act, the interpretation section.

Comment

If a definition relates only to a specific section it may be inappropriate to include the definition in a general interpretation section. However, if a term is used in more than one section of the Act it is usual to place the definition in the general interpretation section to ensure it is accessible.

In response to submissions discussed above, officials recommend amending the proposed legislation by inserting the term “warranty” into section 5 as well as section 11A. The proposed definition is intended to apply only to these two amendments, and the term is not used anywhere else in the Act. The definition can therefore be moved to section 2, the general interpretation section, without it applying more broadly than intended.

Recommendation

That the submission be accepted.

DEFINITION OF "WARRANTOR"

Submission
(16 – Motor Industry Association)

To ensure clarity, the term "warrantor" should be defined as a person providing a warranty.

Comment

Often the supplier, who is providing the warranty with the supply of the good, will not be the same person who is liable under the warranty. The person liable under the warranty agreement is also providing the warranty. A definition of warrantor would add complexity and may restrict the application of the section unnecessarily.

Recommendation

That the submission be declined.

APPLICATION DATE OF AMENDMENT

Submission
(16 – Motor Industry Association, 12 – Institute of Chartered Accountants of New Zealand, 7 – PricewaterhouseCoopers, 11W – Deloitte Touche Tohmatsu, 17W – KPMG, 4W –Business NZ, 8W – CablePrice)

The amendment should apply from the introduction of GST, 1 October 1986, for the following reasons:

Integrity of the tax system

The current legal position on warranty payments is not ideal as evidenced by the proposed amendment and it is unfair to leave taxpayers exposed to an effective double impost for periods prior to the amendment of the enactment. Failure to remedy this unfairness will undermine the integrity of the tax system and, in particular, taxpayer perceptions of that integrity, to the detriment of compliance.

Clear expectation

Taxpayers had a clear expectation from the introduction of GST, based on a shared interpretation in the motor industry, that warranty payments were not subject to GST. This interpretation is validated by the proposed amendment and supported by the fact that GST is not generally payable in respect of warranty payments in the UK, Canada or Australia.

The Government has legislated retrospectively at other times to validate taxpayers' interpretation where it was inconsistent with the law but consistent with the correct policy outcome. The recent amendments in relation to inbound tourists are an example of where taxpayers' understanding of the policy was confirmed. To be consistent, the Government should amend the legislation to comply with taxpayer expectations.

Fiscal cost

The fiscal impact of retrospectivity, estimated by officials to be up to $10 million in GST that would be refunded and a further amount of up to $25 million that would otherwise be collected, is not material from the Government's perspective, but is material to the affected taxpayers. Further, the fiscal cost of the amendment is likely to be less than that anticipated by officials.

Compliance cost

The prospective application of the amendment gives rise to significant compliance cost concerns because of the considerable amount of detail required to respond to the Inland Revenue's audit activity in this area.

Comment

Officials agree that the correct policy result is not to impose GST in these cases. The issue is whether GST relief should be retrospective or prospective.

The underlying presumption in law-making is that legislation should operate on a prospective basis. Prospective application ensures that taxpayers can make decisions on the basis of laws that are not unexpectedly altered. That is constitutionally proper, fair, and allows for rational economic decision-making.

This does not mean that legislation should never be applied retrospectively. Rather, it sets a norm that legislation should be prospective in application unless specific circumstances warrant a departure.

When the issue of retrospective legislation has previously been considered by this Committee, officials have argued that retrospective legislation is justified when it restores or at least does not contravene the rational and legitimate expectation of all parties. This principle does not justify retrospective changes in the law to produce an appropriate policy outcome that, had it been considered at the time, would have been reflected in the legislation.

Incorrect policy outcomes arising from faults in the legislation should in general be corrected prospectively. Hence, elsewhere in this bill it is proposed to correct expense deductions for petroleum mining on a prospective basis even though no one suggests that this is anything other then the correct policy outcome.

Applying a rational and legitimate expectation test

Parallels have been drawn in the submissions with the government's decision to introduce retrospective legislation in relation to the issue concerning GST refunds to inbound tourist operators and educational institutions.

In that instance, however, there was wide consultation and full debate from the introduction of GST regarding the correct policy and tax treatment of inbound tourism. Both taxpayers and the government understood that the effect of the law was, as intended, that inbound tourism was subject to GST. This was seen as justifying a retrospective change in the law but not to the extent that taxpayers had filed returns on the basis that no GST was payable. Taxpayers who had not paid GST on inbound tourist operations were deliberately not subject to retrospective law change on the basis that they evidenced an expectation that this was the correct legal position.

There was no detailed policy consideration of GST on warranties when GST was introduced. The issue was considered by the Taxation Review Authority in 1996, and it concluded that GST is payable. This was confirmed by decisions of the High Court (in 2000) and the Court of Appeal (in 2001). This requires the Inland Revenue Department to review past GST assessments in appropriate cases but, under Inland Revenue's interpretation of the law, it can only increase an assessment as far back as four years (from now to 1998).

Any retrospective legislation would need to reverse the prior judgement of the Court of Appeal as it affected parties to that litigation. While taxpayers may have interpreted the law as being that GST on warranty payments was not payable, and while this may be the correct policy outcome, it is difficult to conclude that this was other than an interpretation of the law that was proved to be incorrect.

To see this as of itself a justification for retrospective application would create a new and expanded precedent for retrospective tax changes, both for and against taxpayers, creating considerable uncertainty as to the future stability of our tax laws.

Fiscal cost

Officials disagree with the suggestion that the amount of money in question, up to $35 million, is not significant. While the exact amount in issue has been difficult to determine, this figure is officials' best estimate of tax that would be refunded or not collected through audit activity by Inland Revenue in relation to both the motor vehicle industry and other industries with similar arrangements.

Officials can find no basis for the submission that the fiscal costs would be less than the $35 million estimated by officials.

Compliance costs

While taxpayers may incur some cost as a result of audit activity in this area, it is not anticipated that any cost in addition to that normally incurred in the course of audit activity would arise.

Recommendation

That the submission be declined.

Other policy changes

Issue: PAYE and ACC levies

Clauses 13 and 16

Submission
(7 – PricewaterhouseCoopers, 12 – Institute of Chartered Accountants of New Zealand)

The submissions support the proposal to clarify that partners in a partnership can deduct pensions paid to former partners.

However, to alleviate compliance costs, PricewaterhouseCoopers also proposes that pensions paid under the proposed section DF 8A should be subject to PAYE. This change would apply prospectively to allow pension payers time to modify their systems accordingly. This change could be achieved by an addition to the definition of "salary and wages" in the Income Tax Act 1994.

PricewaterhouseCoopers recommends that such pensions should not be subject to ACC premiums.

Comment

Applying PAYE to pensions will mean that pensioners, if they have no other income or have other income that is withheld at the correct rate, will not be required to:

- file an income tax return since tax will have already been deducted at source; and
- comply with the provisional tax rules in respect of tax payable on the pensions.

The point made by PricewaterhouseCoopers is valid in terms of reducing the compliance costs associated with paying these types of pension.

However, as the submissions correctly point out, changing the definition of "salary and wages" would result in the pensions being subject to ACC levies. We also note that similar pension payments made by employers to former employees are also subject to ACC levies, which appears to be an inappropriate outcome. We therefore conclude that this area needs wider consideration rather than the separate changes suggested by the submission.

Recommendation

That the submissions in regard to PAYE and ACC be accepted in principle, but that further work be done on the ACC problem for pensions paid by both employers and by partnerships and that these measures be applied contemporaneously.

Issue: Use of section DF 1 for partnership pensions

Clause 13

Submission
(17W – KPMG)

The submission argues that section DF 1 is not the appropriate section to amend as it relates to employee expenditure and, therefore, a new section DF 1A would be more appropriate.

Comment

Section DF 1 lists certain expenditures that are not allowed as deductions unless there is a specific deduction rule for them in the Income Tax Act. The proposed change merely adds pensions paid to former partners to that list, with the relevant deduction rule being added through the new section DF 8A. The appropriate grouping of these various provisions is an issue that is being addressed as part of the rewrite of the Act. In the meantime, we consider it appropriate to include the change in section DF 1.

Recommendation

That the submission be declined.

Issue: Reference to spouse remarrying in new section DF 8A

Clause 16

Submission
(17W – KPMG)

The submission proposes that new section DF 8A(1)(c) be amended to exclude the reference to a spouse remarrying.

Comment

The submission argues that such a rule is outdated.

Officials note, however, that the inclusion of the reference to remarrying extends the criteria under which pensions are deductible and is, accordingly, taxpayer-friendly. The point is that if the deed under which the pension is payable limits the pension until remarriage, the Tax Act should follow suit.

The Income Tax Act 1994 is currently being reviewed for consistency with the Human Rights Act 1993. The terms “spouse” and “remarriage”, which also occur in tax law detailing the payment of employee pensions on which these provisions are based, will be considered as part of that review.

Recommendation

That the submission be declined.

Issue: Two-person partnerships

Clause 16

Submission
(Matter raised by officials)

The legislation should allow deductions to sole traders if they pay pensions to former partners.

Comment

The draft legislation relates to a continuing partnership, but it is possible that a two-person partnership may be wound up on the retirement of one of the two partners and for the remaining partner, as a sole trader, to pay the retiring partner a pension.

While we acknowledge this could happen in practice, we believe it would be unlikely. However, on balance, we agree the legislation should allow deductions to sole traders if they pay pensions to former partners.

Recommendation

That the submission be accepted.

TAX DEDUCTIONS FOR BRIBES

Clause 19

Submission
(12 – Institute of Chartered Accountants of New Zealand,
7 – PricewaterhouseCoopers)

Tax deductions should be allowed for payments to foreign public officials that are not considered illegal under the Crimes Act 1961.

The definitions cross-referenced to the Crimes Act 1961 should be repeated in the tax legislation, and several words in the proposed section DJ 22(1) are redundant and should be removed.

Comment

An amendment in the Crimes Amendment Act 2001 ensured that bribes made to foreign public officials are criminal offences according to the Crimes Act 1961. Payments to foreign public officials are not illegal under the Crimes Act if these payments are legal in foreign public officials' jurisdictions. This amendment was made in accordance with New Zealand's obligations under the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

The proposed amendment to the Income Tax Act 1994 would deny deductions for payments made to foreign public officials that are illegal under the Crimes Act. This amendment would also deny deductions for payments that would not be unlawful acts under the Crimes Act because they were legal in foreign public officials' jurisdictions. Both submissions suggested it was inappropriate to take a stronger stance than the Crimes Act and that payments to foreign public officials that are legal should be deductible. The Institute of Chartered Accountants also queried whether the draft amendment is consistent with the approach taken in other countries and suggested that differences in the treatment of bribes for tax and criminal purposes could result in greater compliance costs for taxpayers.

Officials agree that the amendment should be more closely aligned to the Crimes Act so that payments to foreign public officials that are legal in the foreign country are deductible. Officials note that aligning the criteria for deductibility of payments to foreign public officials more closely with the criteria used to determine illegality in the Crimes Act would be consistent with the approach undertaken by Australia. To claim these deductions, taxpayers must ensure payments made to foreign public officials are not offences under the laws of the officials' countries.

The Institute suggested that the definitions of terms that are cross-referenced to the Crimes Act 1961 should be included. Officials believe that including terms that are cross-referenced would result in unnecessary duplication. Referring directly to the Crimes Act would prevent the need for corresponding legislative amendments to be made to the Income Tax Act should any further amendments be made to the Crimes Act.

Officials agree that the words “offers” and “agrees to give” can be removed from the amendment as offering or agreeing to give a bribe would not be sufficient to create an entitlement to a tax deduction. However, officials consider that use of the words “corruptly” and “improper” should be retained as they assist in conveying the nature of payments that would be non-deductible. Removing these terms would also be inconsistent with the wording used in the Crimes Act.

Recommendation

That the submissions to allow deductions for payments that are not criminal offences under New Zealand law, and to remove words describing the offering of bribes from the proposed section be accepted.

That the submission to include terms that are cross-referenced to the Crimes Act 1961 and to remove the words “corruptly” and “improper” be declined.

PETROLEUM MINING DEDUCTIONS

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

Issue: Transitional provisions

Submission
(12 – Institute of Chartered Accountants of New Zealand, 15 – New Zealand Law Society, 7 – PricewaterhouseCoopers)

The new provisions should apply to contracts entered into on or after 3 December 2001.

Comment

We agree that transitional provisions should be introduced for clauses 10, 20, 55(5) and 57(1). This will mean that the new provisions apply generally only to contracts entered into on or after 3 December 2001.

These transitional provisions will ensure that any petroleum miner that entered into a contract before 3 December 2001 to dispose of a controlled petroleum mining entity will obtain a deduction for the cost of shares or trust interests in that entity.

Clause 11 should not have transitional provisions. It removes a drafting error that could provide a petroleum miner with a deduction on disposing of a controlled petroleum mining entity *in addition to* the deduction for the cost of shares or trust interests in that entity.

Recommendation

That the submission be accepted in relation to clauses 10, 20, 55(5) and 57(1).

Issue: Clause 11 (Section CJ 7)

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

Section CJ 7 is no longer required.

Comment

Officials agree that section CJ 7 is no longer required.

Recommendation

That the submission be accepted.

Issue: Resettlements of trusts

Clauses 25 and 27

Submission
(7 – PricewaterhouseCoopers)

The proposed new sections EH 5(2A) and EH 52(2A) should be amended to clarify:

- the point in time at which the trust receiving the resettlement distribution must satisfy the tests in sections EH 5(1)(b) and EH 52(1)(b);
- that, for the purposes of satisfying these tests, the resettlement distribution should be treated as if it were itself a forgiveness of debt by the creditor.

Comment

The policy rationale underlying new sections EH 5(2A) and EH 52(2A) is to ensure that a trust that has qualified for the "natural love and affection" concession in relation to past debt forgiveness and resettles its assets on a second trust will not automatically trigger the rules that claw back this concession. The intention is that this claw-back will not occur if the second trust, like the original trust, is established to benefit charities or beneficiaries for whom the creditor had "natural love and affection".

We agree that, under the current drafting, this result is not achieved as clearly as it could be. The problem stems from the fact that the tests for whether the second trust meets the relevant criteria are contained in sections EH 5(1)(b) and EH 52(1)(b). The criteria in these sections do not concern the distribution of assets under a resettlement but, rather, the forgiveness of debt by a creditor. The current wording does not recognise this and provides simply that the claw-back will not apply if the second trust satisfies the criteria in sections EH 5(1)(b) and EH 52(1)(b).

This gives rise to the issue of when the second trust is required to satisfy these criteria. As it stands, the drafting is unclear on this point. It could be:

- the time the second trust was established; or
- the time the debt was forgiven to the first trust; or
- the time of distribution.

The intention is for the criteria to apply at the time of distribution.

Therefore, as the submission notes, the draft provisions should be amended to provide that, upon resettlement, an assessment is required to ensure that the criteria in sections EH 5(1)(b) and EH 52(1)(b) would be met.

Recommendation

That the submission be accepted.

Issue: Distributions not taxed twice

Clauses 25 and 27

Submission
(7 – PricewaterhouseCoopers)

The proposed sections EH 5(3A) and EH 52 (3A) should be amended so that their application is limited to gross income arising by application of sections EH 5(3) and or EH 52(3).

Comment

The proposed sections EH 5(3A) and EH 52(3A) are intended to clarify that distributions that are treated as gross income of the trustee under the claw-back rules cannot give rise to a second layer of tax as beneficiary income. As the submission correctly points out, the current drafting is potentially wider than this and could be read to include all gross income derived by the trustee rather than simply income derived by virtue of the claw-back rules.

Recommendation

That the submission be accepted.

BLOODSTOCK DEPRECIATION RATES

Clause 28

Submission
(Matter raised by officials)

A drafting error in clause 28 should be corrected.

Comment

Officials have discovered an error in the current drafting of the amendment in clause 28 of the bill. This error precludes broodmare owners with "late balance dates" (for example, 31 July) from applying the amendment in respect of broodmares purchased between 1 April 2001 and that balance date, in respect of the 2001 year (31 July 2001). The Government and officials have previously represented to the bloodstock industry that the amendment will apply in respect of all broodmares either first depreciated or purchased on or after 1 April 2001, irrespective of the balance date of the relevant bloodstock owner.

Recommendation

That the submission be accepted.

Submission
(19 – New Zealand Thoroughbred Breeders' Association)

An immediate 100 percent specified write-down (depreciation) rate should be allowed for stallions. Similarly, broodmares aged 12 or older ("old broodmares") should be allowed to be written off in the year of purchase.

Comment

The submission is beyond the scope of the current bill. Officials have, however, conducted analyses on the depreciation rates for stallions and old broodmares and the results suggest that the current depreciation rates are broadly correct. The relevant data supporting officials' conclusions was provided to both the Finance and Expenditure Committee and the submissioner at the Committee's request.

Recommendation

That the submission be declined.

GST – NON PROFIT BODIES

Clause 81

Submission
(9W – National Council of Women of New Zealand Incorporated,
12 – Institute of Chartered Accountants of New Zealand)

Submissioners agree with the proposed amendment to clarify that non-profit bodies are entitled to claim input tax credits for GST paid in relation to all their activities except the making of exempt supplies.

Comment

The Government announced in the discussion document *Tax and Charities* (released June 2001) proposals to clarify the legislative basis for registered non-profit bodies to claim deductions of input tax by allowing deductions in relation to all activities except the making of exempt supplies. The amendment therefore confirms that non-profit bodies are, for example, able to claim input tax credits in respect of the activity of collecting donations. This change will provide greater certainty for charities and other non-profit bodies in relation to their GST obligations and will reduce compliance costs.

Recommendation

That the submissions be noted.

Remedial amendments

EXCLUSIONS FROM TERM "DIVIDENDS"

Clause 4

Submission
(3W – Minter Ellison Rudd Watts)

The submission agrees with the proposed change, but argues that it should be retrospective.

Comment

Given that the amendment corrects an historical anomaly, there is no reason why it should not be backdated to, say, the application date of the current Income Tax Act 1994. It is officials' judgement that taxpayers will always have interpreted the law as it is now being amended, so retrospectivity provides absolute certainty.

Recommendation

That the submission be accepted.

REFERENCES TO "GENERALLY ACCEPTED ACCOUNTING PRINCIPLES"

Clauses 6, 8, 23, 24, 30 to 32, 45, 55

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

The bill replaces references to "generally accepted accounting principles" with references to "generally accepted accounting practice". There should be an exclusion for non-resident reporting entities that report using generally accepted accounting principles.

Comment

The term "generally accepted accounting practice" is defined in the Financial Reporting Act 1993 and encompasses all standards approved by the Accounting Standards Board and those that have authoritative support in New Zealand. This amendment is to clarify the law and is not intended to impose more rigorous standards than those imposed currently. Officials will explain the intention of the amendment in a *Tax Information Bulletin* once the legislation is enacted.

Recommendation

That the submission be declined.

EXEMPTION FROM SUPERANNUATION FUND WITHDRAWAL TAX

Clause 12

Submission
(12 – Institute of Chartered Accountants of New Zealand, 17 – KPMG)

The application date of the amendment should be altered to apply to withdrawals made on or after the date of Royal assent.

Comment

The amendment was intended to apply in respect of superannuation fund withdrawals made on or after the date of enactment of the fund withdrawal tax legislation.

Recommendation

That the submissions be accepted.

Issue: Consequential amendments to correct cross-referencing errors

Clause 17

Submission
(Submission – 17W KPMG)

Several consequential amendments are required to section ED 4 of the Income Tax Act 1994 following the enactment of the Taxation (GST and Miscellaneous Provisions) Act 2000. Specifically, the reference to section 21(3) contained in section ED 4(3)(a) should refer to section 21I(1) – (3).

Comment

Section ED 4 of the Income Tax Act 1994 set out the rules for taking into account GST when calculating taxable income. In general, GST does not factor in determining gross income or in respect of claiming deductions. However, section ED 4(3) allows GST to be included in deductions for items for which a change in use adjustment is required under the Goods and Services Tax Act 1985.

The amendments proposed by the submissioner were enacted by the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

Officials note, however, that further clarification is required in respect of the reference to section 21(1) contained in section ED 4(3)(a) and ED 4(4)(b). The reference should be corrected to read section 21. As part of the reforms enacted by the Taxation (GST and Miscellaneous Provisions) Act 2000, section 21(1) was re-written and expanded to the present section 21(1) – (5). A reference to section 21 will include these new subsections. The amendments should apply from 10 October 2000, the date that the Taxation (GST and Miscellaneous Provisions) Act 2000 was enacted.

Recommendation

Note that amendments proposed by the submissioner have already been enacted in the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

Officials recommend that the reference to section 21(1) in sections ED 4(3)(a) and ED 4(4)(b) be corrected to refer to section 21.

The amendments should apply from 10 October 2000 the date that the Taxation (GST and Miscellaneous Provisions) Act 2000 was enacted.

Issue: Deductibility of GST on fringe benefits

Clause 17

Submission
(4 – Business NZ, 17 – KPMG, 12 – Institute of Chartered Accountants of New Zealand)

Clause 17 should be withdrawn from the bill. It would deny an income tax deduction for the GST payable on the taxable value of fringe benefits.

Comment

It was not intended to deny a deduction for this item of GST. The change underlying clause 17 is the recharacterisation of this GST as fringe benefit tax for the purposes of administration so that it can be paid with fringe benefit tax rather than as a separate item in the GST return.

Initially there was concern that the recharacterisation had the potential to create the confusing result that the GST is deductible twice, once as fringe benefit tax under section ED 2 of the Income Tax Act 1994 and again as GST under section ED 4(3). However, officials now consider that this is not the case and agree that clause 17 should be removed.

Recommendation

That the submissions be accepted.

ABSOLUTE ASSIGNMENT OF A FINANCIAL ARRANGEMENT WITH DEFERRED CONSIDERATION

Clause 26

Submission
(Matter raised by officials)

The proposed change to ensure that absolute assignments of financial arrangements with deferred consideration will not terminate the financial arrangements should also be applied to legal defeasances with deferred consideration.

Comment

In substance, legal defeasances with deferred consideration have the same effect as absolute assignments with deferred consideration. Therefore terminating financial arrangements when there are legal defeasances with deferred consideration could result in potential double taxation, as it could for absolute assignments with deferred consideration. Double taxation could occur because legal defeasances with deferred consideration create new financial arrangements that will be taxed on an accrual basis consistent with the accrual rules. However, terminating financial arrangements could lead to deferred consideration being taxed under the base price adjustment rule. This is not an intended policy result.

Therefore officials consider that this amendment should be extended to legal defeasances with deferred consideration.

Recommendation

That the submission be accepted.

THE MINOR BENEFICIARY RULE – CLARIFICATION OF SECTION HH 3D(1)(c)

Clause 33

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

Clause 33 is intended to clarify that the $1,000 threshold for application of the minor beneficiary rule relates to the value of the loan(s) provided to the trust, not to the value of the interest forgone on the loan(s). The Institute supports the policy objective of the proposal but considers that clause 33(1) does not clarify the meaning of section HH 3D(1)(c) as intended. It recommends that the wording of clause 33(1) be reconsidered.

Comment

Officials agree that the proposed amendment to section HH 3D(1)(c) may still leave some uncertainty as to whether the $1,000 value relates to the settlement on the trust (the interest forgone on the loan), or whether it relates to the value of the loan itself. Officials therefore recommend that this provision be clarified by adding an express reference to the loan having a total value of not more than $1,000.

Recommendation

That the submission be accepted.

NON-STANDARD INCOME YEAR PROVISIONAL TAXPAYERS

Clause 46

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

Taxpayers that were prevented from electing to be provisional taxpayers because of an unintended result of a previous amendment should be allowed to make this election retrospectively.

Comment

An amendment to section MB 2A in the Taxation (Annual Rates, GST and Miscellaneous Provisions) Act 2000 had the unintended result of preventing certain taxpayers from electing to become provisional taxpayers. The amendment applied from the 1998-1999 income year.

The proposed amendment corrects the unintended result of the previous amendment and allows non-standard balance date taxpayers to elect to be provisional taxpayers when they first furnish a tax return. Although the proposed amendment would apply from the 1998-1999 income year, some non-standard balance date taxpayers that would have otherwise elected to be provisional taxpayers have already furnished returns and, in accordance with the current law, not elected to be provisional taxpayers. Officials agree with the Institute submission that those taxpayers that have already furnished a tax return and were prevented from making this election should be allowed to make it retrospectively.

Recommendation

That the submission be accepted.

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

Issue: Compliance costs

Clause 52

Submission
(4W – Business New Zealand)

Business New Zealand does not oppose the amendment in the bill but wishes to note its concerns with the greater compliance cost of FBT, which have occurred following the introduction of the top personal rate of 39%.

The complexity of the new multi-rate rules means that in certain cases it is uneconomic for businesses to take advantage of paying the lower FBT rates. The compliance costs in collecting FBT are very high in comparison to the total revenue raised from FBT. Business New Zealand asks the Committee to endorse the recommendation of the Ministerial Panel on Business Compliance costs for a first principles review of FBT.

Comment

The amendment to fringe benefit tax legislation in clause 52 is of a minor nature and ensures that employers are not required to ascertain an employee's tax residence in calculating the tax on the employee's cash remuneration.

The multi-rate FBT rules allow employers to choose FBT rates that better correspond to the remuneration they provide to the employee receiving the fringe benefit. Employers can either pay 64% on all fringe benefits or use the multi-rate calculation. Their choice of method is a trade-off between compliance costs and accuracy.

The multi-rate method of calculating FBT was introduced to ensure that middle and low-income employers were not overtaxed on the value of fringe benefit provided to them.

The Government, as part of its tax policy work programme, has announced that a review of the FBT rules will begin later this year. One of the key areas of this review will be to look at options to simplify the administration of FBT and reduce compliance costs.

Recommendation

Note that Government intends to begin a review of the FBT rules later this year.

Issue: Remedial amendment of clause

Submission

(Matter raised by officials)

Clause 52, amending section ND 5(1) of the Income Tax Act 1994, should apply on or after 1 April 2000 for employers paying FBT on quarterly or annual basis.

Comment

In clause 52 the definition of "tax on cash remuneration" is being amended to ensure that the full low-income rebate applies in the multi-rate calculation, irrespective of the employee's tax residence.

The Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001, enacted early last year, included an equivalent amendment to section ND 5(2) of the Income Tax Act. However, as a result of an oversight, section ND 5(1) was not amended at the same time. Amending clause 52 corrects this oversight.

The amendment as drafted has an incorrect application date from 1 April 2001. The correct application should be from 1 April 2000 to coincide with the amendment to section ND 5(2)

Recommendation

That clause 52 applies to fringe benefits provided:

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

Issue: Non-filing taxpayers

Clause 55(19)

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

The proposed reference to section 33A of the Tax Administration Act 1994 in the definition of "non-filing taxpayer" in section OB 1 of the Income Tax Act 1994 should be replaced with a reference to section 33A(1). This change should be done because section 33A includes references to individuals required to file returns and, therefore, referring to the whole of section 33A may have unintended consequences.

Comment

The reference to section 33A of the Tax Administration Act was included in clause 55(19) of the bill to ensure that the exclusions listed in section 33A(2) were imported into section 33A(1), which lists the natural persons who are not required to furnish a return of income for an income year and will not receive an income statement.

There would be a risk that the exclusions in section 33A(2) would not be imported into section 33A(1) if the definition of "non-filing taxpayer" simply referred to section 33A(1). Officials agree, however, that referring to the whole of section 33A in the definition of "non-filing taxpayer" may unintentionally be interpreted as including a reference to natural persons who are required to file returns because some provisions in section 33A refer to filing taxpayers.

Officials therefore consider that the reference to section 33A in clause 55(19) of the bill should be changed so that it refers to natural persons to whom section 33A(1) applies after the application of section 33A(2).

Recommendation

That the submission be accepted to the extent outlined above.

Issue: Minor remedial amendment to incremental late payment penalties

Clause 75

Submission
(Matter raised by officials)

Legislation introduced in the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001 to reduce the impact of late payment penalties for those who pay just a few days late had two unintended consequences. It:

- removes the mechanism for cancelling penalties on a debt if before 1 April 2002 the taxpayer entered into an instalment arrangement or compulsory deduction action started; and
- prevents incremental late payment penalties from applying if the initial late payment penalty or incremental late payment penalties were imposed before 1 April 2002.

Officials recommend that:

- the effect of the former section 183B of the Tax Administration Act 1994 be reinstated in cases where instalment arrangements or compulsory deduction action started before 1 April 2002; and
- section 139B of the Tax Administration Act 1994 be amended so that incremental late payment penalties can be imposed regardless of whether earlier penalties were imposed under the current or previous penalty legislation.

Recommendation

That the submission be accepted.

GST – PENALTY INTEREST

Clause 85

Submission
(11W – Deloitte Touche Tohmatsu)

The proposed change to extend the exempt treatment of penalty interest to charges imposed under statute is supported. However, if the word "interest" is given a narrow interpretation the amendment will not apply to other penalty charges that may arise, particularly late payment charges not in the form of interest. This raises doubts as to whether the amendment achieves its policy intent.

Comment

The amendment extends the application of section 14(3) of the Goods and Services Tax Act 1985, which treats the payment of interest arising from late payment as consideration for an exempt supply. At present, the legislation applies to interest charged under a contract. The amendment extends this treatment to interest charged by a public or local authority under statute. The question raised by the submissioner concerns where the boundary between exempt and taxable supplies should be drawn.

As outlined in the government discussion document *GST: A Review* (March 1999), and as enacted in the Taxation (GST and Miscellaneous Provisions) Act 2000, penalty interest should not, in principle, be subject to GST. The change was largely a simplification measure to remove the uncertainty about the treatment of such payments. In most cases penalty interest is equivalent to the payment of interest on the outstanding balance of the purchase price. The charge therefore compensates for the time value of money, and is comparable to other exempt supplies included in the section 3 definition of "financial service".

The submissioner argues that the term "late payment charge" would better reflect the intent of the amendment and avoid concerns that the term "interest" would be read too narrowly. As noted above, the intention of the amendment is to remove payments which compensate for the time value of money from the scope of the tax. However, late payment charges can be used to recover costs in addition to the time value of money, such as the ongoing use of a good or service or administrative costs. To extend the scope of the amendment as suggested would not therefore necessarily be consistent with the original policy intent and would create inconsistencies between penalties charged under contract and those imposed under statute. Drawing the boundary to include supplies beyond "interest" confuses the intent of the legislation and potentially exempts other supplies that should be subject to GST.

Officials note, however, that the term interest could be read narrowly and possibly exclude payments in the nature of interest. Officials recommend that clause 85 be amended to include charges, either under statute or contract, that compensate for the time value of money but might not be specifically labelled as interest. An example of this arises under the Rating Powers Act which authorises the imposition of an additional 10 percent levy if payment is not made by the due date.

Recommendation

That the submission be declined but that clause 85 be amended to include charges in the nature of interest.

GST – CHANGE-IN-USE ADJUSTMENTS

Clause 87

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

It would be tidier if the amendment was incorporated as new paragraph 23G(1)(c) rather than the proposed new subsection 21G(1A) of the GST Act.

Comment

The amendment improves the interpretation of law as it relates to making adjustments for changes in use. Specifically, the amendment changes the placement of the rule allowing one-off adjustments for assets with a value of less than $18,000, to better reflect that the adjustment can indeed only be made once and is not applicable on a period by period basis.

Section 21G(1) provides a general rule in respect of the timing of adjustments allowed under section 21F. The general rule requires that adjustments for changes in use be made either on a taxable period by taxable period basis or annually. Consistent with the current drafting style of tax bills, the concession to allow a one-off adjustment for assets with a value of less than $18,000 is separate from the general timing rule and it is appropriate that it is included in a separate section.

Recommendation

That the submission be declined.

ERRORS OR OMISSIONS BY THE COMMISSIONER

Submission
(5W – Maurice Halligan, 6W – Maurice Marshall)

If the Commissioner or his staff makes an error or omission the Commissioner should be required to refer such an omission after a period of twelve months to an ombudsman for settlement, thus ensuring the matter will reach a finality. (Maurice Halligan)

The Commissioner should be required to process all returns, say, within fifteen months, with any failure to be reported back to the Finance and Expenditure Committee for action, by the taxpayer, or for there to be an ombudsman to whom such problems could be referred.

Comment

In relation to the submission from Mr Marshall, officials have discussed the issues raised.

In relation to both of the submissions which proposed that issues be settled by an ombudsman, taxpayers have the right to take any issue they have to the Ombudsman for consideration

Recommendation

That the submission be declined but that officials note that taxpayers may go to the Ombudsman at any time they wish.