

Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Bill

Commentary on the Bill

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Major policy changes

GST AND FINANCIAL SERVICES: ZERO-RATING SUPPLIES

(Clauses 104(2), 109(2), 111, 113(2), (3) & (5), 114, 115, 116(1) and 119)

Summary of proposed amendments

The amendments to the Goods and Service Tax Act 1985 (the GST Act) provide that the supply of financial services by a registered person to another registered person that has a predominant activity of making taxable supplies may be zero-rated. The proposed amendments give effect to reforms outlined in the government discussion document *GST and financial services*, which was released in October 2002.

Registered persons that do not want to incur the compliance costs associated with the new amendments may elect to treat the supply of financial services as exempt.

Application date

The amendments will apply from a date to be set by Order in Council which will be no earlier than 12 months after the enactment of the legislation introduced in the bill. This will allow sufficient time for implementation of the changes.

Key features

- Section 11A(1)(q) allows financial service providers that are registered for GST to zero-rate supplies of financial services to customers that are registered for GST if the level of taxable supplies made by the customer,¹ in a given 12-month period, is equal to or exceeds 75 percent their total supplies for the period.
- Section 11A(1)(r) allows zero-rating of financial services that are supplied by financial service providers to customers that may not meet the 75 percent threshold but are part of a group that does meet the threshold in a given 12 month period – for example, the treasury or finance function of a group of companies.
- Financial services supplied to customers that have a significant activity of making exempt supplies (more than 25 percent of their total supplies) or supplied to customers that are not registered for GST will not be able to be zero-rated.
- Section 11D allows taxpayers to zero-rate supplies of financial services under sections 11A(1)(q) and/or (r) based on either actual figures for their customers' levels of taxable supplies or by estimating their customers' level of taxable supplies using a method approved by the Commissioner.
- New section 11C allows registered persons to elect to treat supplies of financial services as exempt if they give written notice of their election to the Commissioner.

¹ Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

- Section 20C allows for an additional deduction from output tax for supplies of financial services made by a financial service provider to another financial service provider, which in turn makes supplies to a business that qualifies to receive zero-rated financial services. The amount that the first financial service provider can deduct will be determined by the ratio of taxable to non-taxable supplies made by the recipient financial services provider.
- Section 26B will require adjustments to input tax or output tax if there is an error in determining whether a customer is eligible to receive zero-rated financial services.
- Sections 21G and 21H are amended to disallow one-off input tax adjustments for assets that are applied principally for the purpose of making taxable supplies as a result of the new zero-rating rules.
- Section 3A(2)(c) is amended to disallow second-hand goods input tax credits for goods purchased to make supplies which are zero-rated under either section 11A(1)(q) and/or (r).

Background

The term “financial services” covers a wide range of transactions including the provision of loans, the taking of deposits, trading in financial securities such as shares and debentures, the provision of life insurance and charging interest on goods sold on credit. Businesses involved in the supply of financial services are also varied and include banking institutions, credit unions, financiers, life insurers, and, to a lesser degree, retailers and other businesses that sell goods on credit.

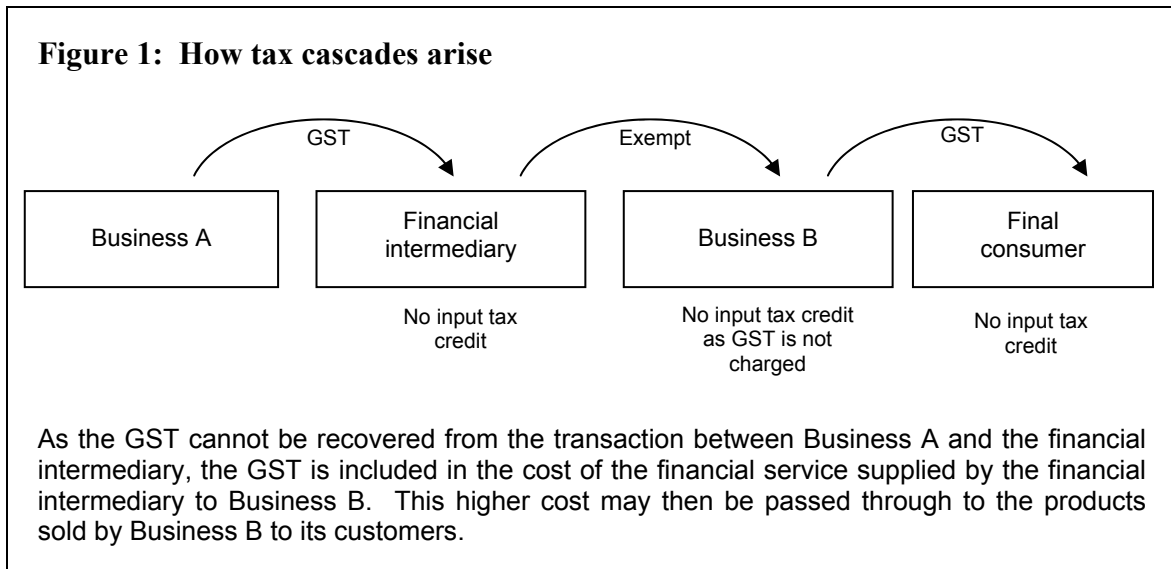
For GST purposes the term “financial services” is broadly defined by section 3 of the GST Act. It is this definition, without any further amendment, that will apply for the purposes of the zero-rating proposals.

Since 1 October 1986, the date that GST first applied to goods and services supplied in New Zealand, supplies of financial services have been exempt from GST.² This means that GST is not charged on the supply of financial services and the supplier is unable to recover any GST paid on purchases used in making the supply. Exemption is used in a GST system as a substitute for taxing supplies of goods and services when the usual method for taxing those goods and services is impractical. Instead of directly taxing the supply of financial services, tax is collected when a financial service provider purchases goods and services to produce financial services.

This departs from the usual operation of GST, which ensures that each time tax is paid in the supply chain businesses receive a credit (input tax credit) to offset the tax. Input tax credits allow GST to roll forward until the goods and services are purchased by a consumer that is unable to recover the GST. As it is the financial services provider that bears the GST cost instead of the private consumer, exemption creates the following problems:

² Financial services that are supplied to non-residents that are outside New Zealand at the time of supply are treated as exports and are eligible for zero-rating.

- *Tax cascades*: When a supplier of financial services cannot recover the GST paid on purchased goods and services, the irrecoverable GST forms part of the cost of production. The financial service provider faces a choice: raise the price of the services or absorb the GST cost. If it passes the cost on to businesses through higher prices, those businesses face the same choice: pass on or absorb the tax cost. The result of these choices along the supply chain to the final consumer may be increased prices or reduced profits. This effect is known as “tax cascading” and is illustrated in figure 1.



- *Self-supply bias*: Rather than make the decision to absorb or pass on the cost of GST, the financial services provider may attempt to minimise the impact of GST by “self-supplying” essential activities rather than acquiring those same goods and services from third parties (which would be subject to GST).

These identified problems could be removed by taxing all financial services. This, however, has proven to be problematic as overseas studies, such as that undertaken in the European Union in relation to cash flow taxation, have shown. This is because financial services can either be charged for directly (for example, through bank fees) or indirectly through the inclusion of the intermediation costs of the service in the suppliers’ margins (for example, in the interest rate margin). In the case of interest rate margins, the value of the financial intermediation fee is difficult to determine. If the policy decision were made just to tax fee-based income, a high degree of substitutability between direct and indirect charges would remain and would undermine the ability to apply GST successfully to financial services.

Given this constraint, the government outlined in the discussion document *GST and financial services*, released in October 2002, proposals to zero-rate financial services supplied between financial services providers and other businesses. Zero-rating business-to-business supplies has the advantage of removing the potential for tax cascades to arise while dealing with the valuation and identification problems that make the application of GST to financial transactions difficult. It also means that financial supplies to businesses will be treated in much the same way for GST purposes as non-financial transactions, as illustrated in figure 2. The treatment of

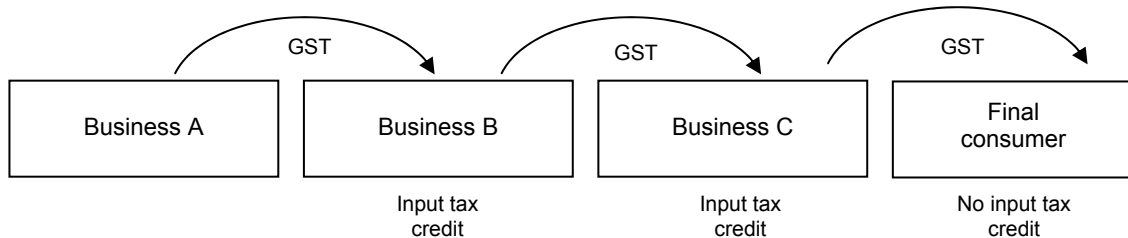
financial services supplied to final consumers will remain unchanged in that such supplies will remain exempt from GST.

Zero-rating means that GST at the rate of zero-percent is charged rather than the standard rate of 12.5 percent. By charging GST, albeit at the rate of zero-percent, the supply of financial services will be treated as a taxable supply (rather than as an exempt supply, as is currently the case) and the supplier will be able to claim back GST paid on purchases used in supplying the financial services.

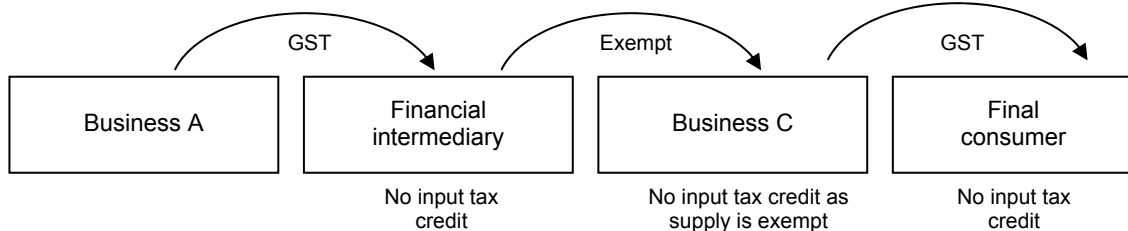
Figure 2: Comparison of the treatment of taxable supplies and exempt supplies under current and proposed legislation

Current treatment

1. Supply of taxable goods and services by Business B

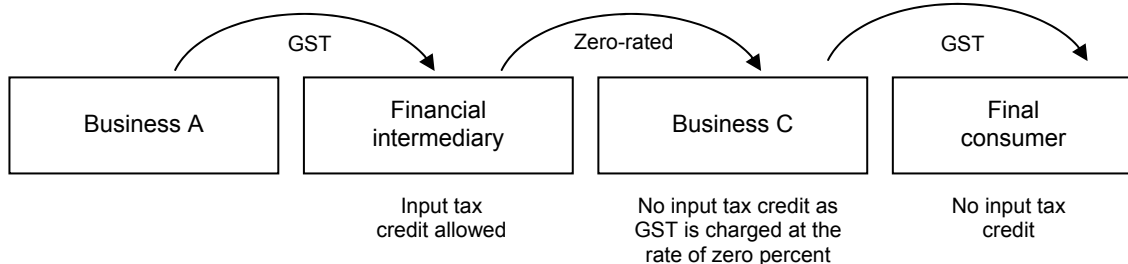


2. Supply of financial services by financial intermediary



Proposed treatment

3. Supply of financial services by financial intermediary



Under the proposal, the supply of financial services by the financial intermediary to Business C is equivalent to a supply of standard-rated goods and services.

Detailed analysis

Overview

The purpose of the proposed amendments is therefore to address concerns with the current exempt treatment of financial services. The potential for overtaxation in the business sector has led to the proposal to zero-rate business-to-business supplies. The aim, however, is not to remove the problems caused by exemption entirely, as exemption plays an important role in ensuring that the consumption of financial services by final consumers is at least taxed in part, even if indirectly by not allowing financial services providers full recovery of their GST costs.

The proposed amendments are directed at setting out the general conditions under which supplies of financial services may be zero-rated. The GST Act provides comprehensive rules for the deduction of input tax. In conjunction with administrative guidelines these are considered adequate to address how input tax may be recovered from zero-rating financial services.

General application

New section 11A(1)(q) provides that the supply of financial services from financial services providers to business customers may be zero-rated if the customer is a GST-registered person who has an activity of making taxable supplies³ that equal or exceed 75 percent of their total supplies in a 12-month period.

Financial services will not be zero-rated if:

- The services are supplied to businesses that have more than an incidental activity of making exempt supplies of financial services and other non-financial exempt supplies, that is, exempt supplies exceed 25 percent of total supplies; or
- The services are supplied to non-registered persons (or final consumers).

When determining whether a supply of financial services may be zero-rated the financial services provider will need to know whether the customer is GST registered and the customer's ratio of taxable supplies to total supplies.

The determination of the taxable status of a customer will be made by the financial services provider. New section 11D will allow registered persons to zero-rate supplies of financial services based on either actual figures for their customers' levels of taxable supplies or on estimations of their customers' total level of taxable supplies that are obtained using a method approved by the Commissioner.

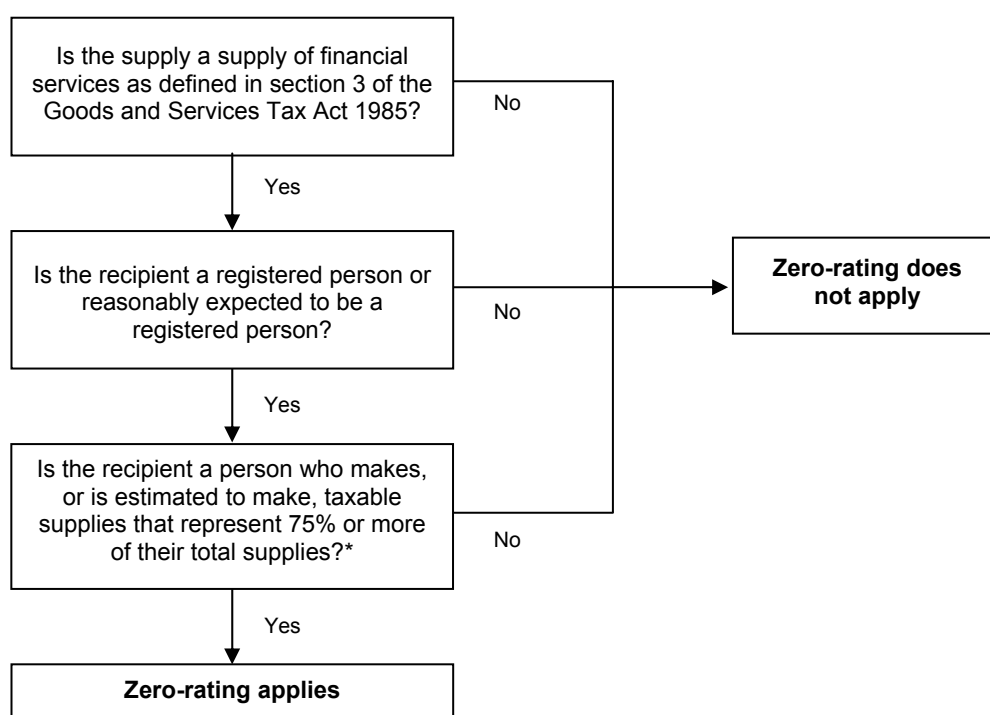
The reason for this is that the difference between zero-rating and exemption can generally be described as the respective ability or inability of financial services providers to claim input tax credits. The deduction of input tax credits is a matter for the financial services provider to determine – not the recipient. As far as the recipient of a financial service is concerned, GST does not currently apply to the receipt of financial services, and this position will remain with zero-rating.

³ Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

New section 11C allows registered persons to elect to treat supplies of financial services as exempt if they give written notice of their election to the Commissioner. This allows financial services providers to assess, in less straightforward situations, the trade-off between the benefits of zero-rating and the compliance costs associated with identifying the customer and determining the customer's mix of taxable and non-taxable supplies.

Figure 3 illustrates the questions that should be considered when determining whether a supply of financial services should be zero-rated. Guidelines are being prepared by Inland Revenue to assist taxpayers in determining when supplies of financial services may be zero-rated.

Figure 3: Applying the proposed zero-rating of domestic business-to-business supplies of financial services



* Administrative rules are being developed by Inland Revenue to assist in determining whether customers are appropriately categorised as businesses that are entitled to receive zero-rated financial supplies. The main determinant should be the nature of the customer's business. Thus:

- A customer that is a financial intermediary or a supplier of residential accommodation would not generally be categorised as entitled to receive zero-rated supplies as it is reasonable to expect that the volume of exempt supplies and zero-rated financial services would exceed 25 percent of its total turnover.
- Most manufacturers, primary producers and retailers, on the other hand, would be expected to be entitled to receive zero-rated supplies.
- Businesses that make a mixture of taxable and exempt supplies such as general and life insurers will need to be categorised on a case-by-case basis.

Supplies of financial services to special purpose vehicles or group finance operations

The application of new section 11A(1)(q) could mean that some financial services supplied to businesses would not be zero-rated because they are received by:

- an entity that is not registered for GST but is part of a group of which some or all of the members are GST registered; or
- an entity of this nature that is primarily concerned with the financial activities of the group.

In either case, the entity itself may not be entitled to receive zero-rated supplies but might be if the total activities of the group were taken into account.

To address this issue new section 11A(1)(r) allows a registered person to “look through” the entity that contractually receives the financial services to the wider group. Provided that the wider group is a group for the purposes of section IG 1 of the Income Tax Act 1994 and meets the 75 percent test, the supply of financial services to the recipient entity may be treated as zero-rated.

Treatment of supplies of financial services between financial institutions

Financial services supplied by a financial institution to another financial institution would not be zero-rated under new section 11A(1)(q) as it is expected that most financial institutions will not satisfy the requirement that 75 percent of their supplies are taxable supplies. However, it is recognised that denying the benefits of zero-rating in this situation will mean that the objective of removing the overtaxation of businesses is not met in the instance of the second financial institution supplying financial services to a business customer. To address this, new sections 20(3)(h) and 20C provide an additional deduction to the first financial institution to the extent that the second financial institution makes supplies to taxable businesses.

This level of relief will be calculated according to the formula:

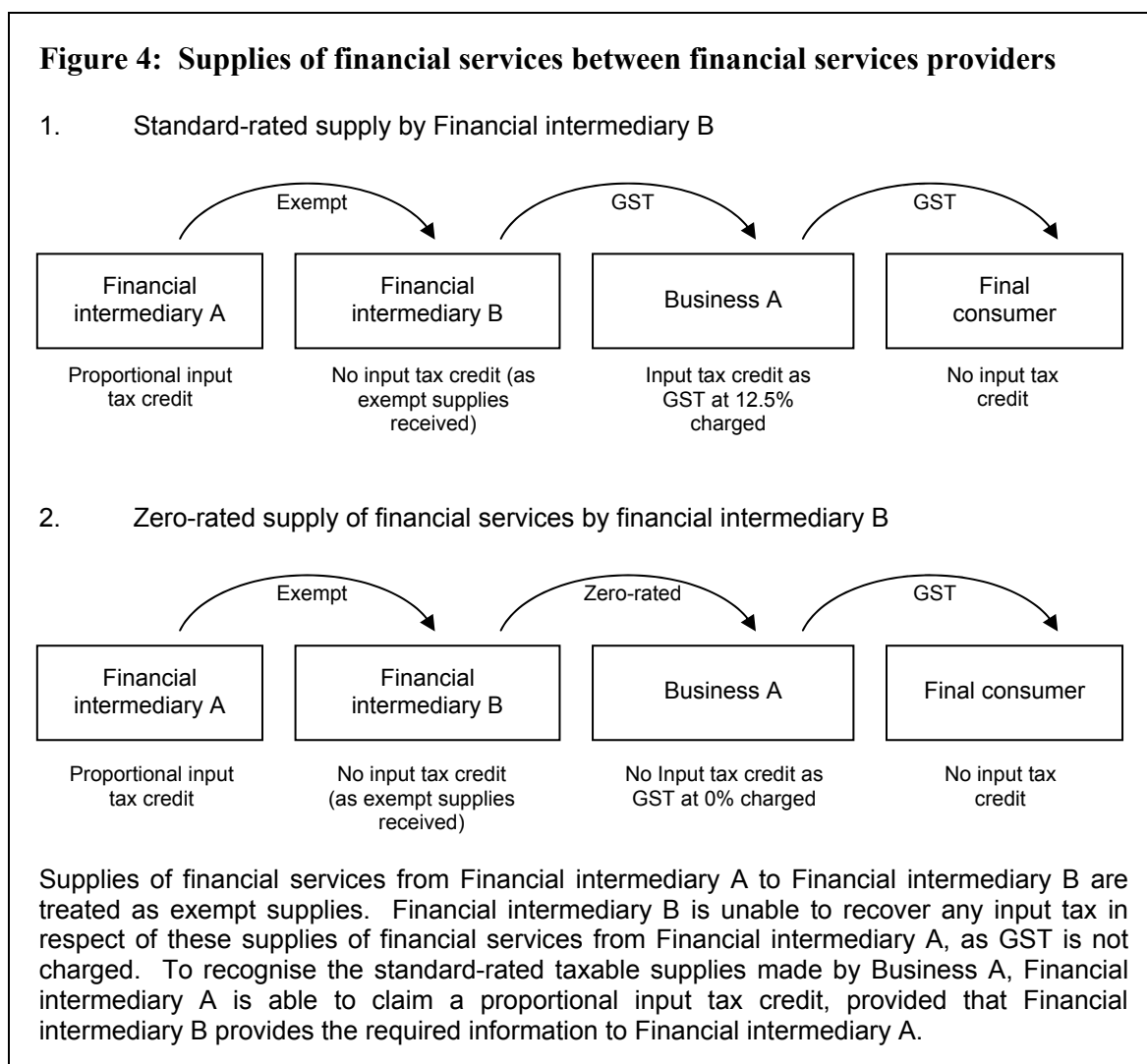
$$a \quad \times \quad \frac{b}{c} \quad \times \quad \frac{d}{e}$$

where—

- a. is the total input tax that the registered person would be able to deduct, other than under new section 20(3)(h), in respect of the taxable period if all supplies of financial services by the registered person were taxable supplies;
- b. is the total value of exempt supplies of financial services by the registered person to the recipient financial services provider in respect of the taxable period;
- c. is the total value of supplies by the registered person in respect of the taxable period;
- d. is the total value of taxable supplies the recipient financial services provider in respect of the taxable period;
- e. is the total value of supplies by the direct supplier in respect of the taxable period.

The formula provides a deduction that is proportional to the total deduction that would be allowed if all supplies of financial services were taxable supplies. The proportion is found by multiplying two fractions. The first fraction is the proportion of the total value of supplies made by the registered person that consists of exempt supplies of financial services to a recipient financial services provider. The second fraction is the proportion of the total value of supplies made by the recipient financial services provider that consists of taxable supplies.

For practical reasons, the formula is limited to the activities of the second financial services provider. Consideration was given as to whether the formula should be extended for financial services provided to taxable businesses further down the chain. As a result of consultation, however, it was considered that any analysis of the potential tax cascade that would arise in these circumstances would be too difficult and would very likely in any event give rise to substantial compliance costs for limited benefit. The proposed treatment of supplies of financial services between financial intermediaries is illustrated in figure 4.



Deduction of input tax and apportionment

The main tax effect of the proposed zero-rating of financial services supplied to businesses will be an increased recovery of input tax for financial service providers.

The current section 21A sets out the methods of allocating input tax credits to making taxable and other (including exempt) supplies.

Actual use: This method of allocation requires the taxpayer to directly attribute the use of the goods and services to the extent that those goods and services are used for a purpose of making taxable supplies.

Turnover method: This method is used in cases where the actual use method it is too difficult to apply – for example, in the case of overhead expenses. The formula as shown in the legislation, is:

$$\frac{\text{Total value of exempt supplies for taxable period}}{\text{Total value of all supplies for taxable period}}$$

An alternative (or special) method: This method is available, provided that the Commissioner approves it, if its use results in allocated amounts that are fair and reasonable in comparison with actual use.

In all cases, section 21A requires that the method of allocation used must result in a fair and reasonable allocation of input tax credits between taxable and other supplies.

To address specific issues with apportioning input tax credits, Inland Revenue is working on guidelines to assist with the implementation of the proposed legislation.

Adjustments

It is expected that differences will arise in the level of input tax recovery that is claimed for a given period based on the registered person's determination of its customer base and the level of recovery that should actually have been made for the period.

New section 26B addresses this by requiring an adjustment to be made if a registered person has made a return based on an amount relating to supplies made by another person and an inaccuracy in the figure for the amount has affected the accuracy of the return. If this has resulted in an excessive input tax credit recovery output tax is payable in respect of the excess. If the result is an under-recovery of input tax credits then further input tax credits are allowed.

The Commissioner can relieve the taxpayer from making an adjustment if satisfied that the taxpayer's estimated result gives an overall result for zero-rated supplies under sections 11A(1)(q) and/or (r) and/or deductions under section 20C that is not significantly greater than the result that would arise if actual rather than estimated figures were used.

New section 26B requires the adjustment to be made either in the taxable period in which the inaccuracy becomes apparent or in a later period that is acceptable to the Commissioner. It is expected that Inland Revenue is preparing guidelines for what later period or periods are acceptable.

Other matters

Exported financial services

The proposals do not affect the current treatment of exported financial services.

One-off change in use adjustments

Remedial changes are proposed to sections 21G and 21H to preclude one-off changes in the use of assets held at the time that sections 11A(1)(q) and 11A(1)(r) take effect. These changes in use must instead be made on a period-by-period basis, even if there has been a change in the principal purpose from one of making non-taxable supplies to one of making taxable supplies. This is intended to mitigate the revenue loss of the proposals.

Second-hand goods input tax credits

Changes are proposed to the definition of “input tax” in section 3A(1)(c) to preclude second-hand goods input tax credits being claimed for purchases of goods which are used to make zero-rated supplies of financial services under sections 11A(1)(q) and (r). This is intended to mitigate the revenue loss of the proposals.

Tax invoices

For the purposes of zero-rating supplies of financial services it will not be necessary to issue a tax invoice. The purpose of the tax invoice is to provide verification that tax has been charged on a supply of goods and services received by the recipient especially in the case when a supply is charged with GST at the standard rate of 12.5% and the recipient would be entitled to claim an input tax credit. For a supply of financial services the amount of input tax that could be claimed by a recipient is nil, whether the supply is treated as exempt or zero-rated. To require financial services providers to issue a tax invoice under these conditions would needlessly increase compliance costs.

GST ON IMPORTED SERVICES: INTRODUCING A REVERSE CHARGE

(Clauses 101, 102, 104(1), 105, 106, 107, 108, 109(1), (3) & (4), 110, 113(1)-(4) & (6), 117, 118, 121, 122, 123 and 124)

Summary of proposed amendments

The amendments to the Goods and Services Tax Act 1985 (the GST Act) will introduce a “reverse charge” mechanism to tax certain imports of services.

The reverse charge will require GST registered recipients of supplies of imported services to self-assess GST on the value of the services if:

- the services are not acquired by a person who makes taxable supplies that represent 95 percent or more of total supplies; and
- the supply of those services, if made in New Zealand by a registered person, would be a taxable supply.

This means that if a registered person acquires services that would be subject to GST if supplied in New Zealand and for which the recipient would not have received a full,⁴ or any, input tax credit, the recipient will be required to add GST to the price of the services and return the GST to Inland Revenue.

The recipient of a supply of imported services will be treated as the person who made the supply for the purpose of imposing and enforcing the reverse charge and for determining whether the GST registration threshold is exceeded. For all other purposes in the GST Act the recipient of a supply of imported services will remain the recipient, rather than the supplier, of the services.

Amendments are also being made for the purpose of applying the reverse charge to related party internal charges. Such charges will exclude amounts relating to salaries and interest.

Application date

The amendments introducing the reverse charge will apply from a date to be set by Order in Council. It is expected that the amendments will come into effect no earlier than 12 months after the enactment of the legislation introduced in the bill, to allow sufficient time for implementation of the changes.

⁴ I.e. An input tax credit is received and no adjustments are required for non-taxable use under sections 21 – 21D.

Key features

The approach adopted in the legislation is based on treating certain imported services as being supplied in New Zealand and deeming the recipient of those services to be their supplier rather than on a separate code for imported services.

The two key provisions are:

Section 8(4B): This contains a new place of supply rule for imported services. It provides that there will be a supply of services in New Zealand if:

- services are supplied by a non-resident supplier to a recipient who is a New Zealand resident;
- the services are acquired by a person who, in a 12-month period which includes the date the services are supplied, makes supplies of which less than 95 percent in total value are taxable supplies; and
- the supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

Section 5B: This treats the supply of imported services to which section 8(4B) applies as having been made by the recipient of those services for the purposes of certain sections. It also treats the services as having been supplied by the recipient in the course or furtherance of a taxable activity carried on by the recipient. Therefore the value of imported services supplied to a person will be included in the total value of supplies made by that person for the purposes of determining liability to register for GST under section 51.

Although businesses making exempt supplies in New Zealand will usually be registered for GST in any event, the reverse charge may require others to register – in particular, any person importing services exceeding \$40,000 in value in a 12-month period as a private consumer.

In addition to these key sections, other features of the legislation are:

- Section 55(7A), which, for the purposes of supplies subject to section 8(4B), disregards the GST effects of grouping (overriding section 55(7)) for supplies made by a non-resident member of a group to a New Zealand resident member of a group.
- Section 56B, which, for the purposes of supplies subject to section 8(4B) and in relation to a person deems the following:
 - a branch or division outside New Zealand to be a separate person and a non-resident;
 - activities carried on by that non-resident person to be carried on independently by that person;
 - a branch or division inside New Zealand to be a separate person and resident in New Zealand;
 - activities carried on by that person resident in New Zealand to be carried on independently by that person; and

- a head office to be a branch or division.
- Section 9(2)(a)(iv), which ensures that the time of supply for a supply of services between associated parties which is subject to section 8(4B) will be the earliest of:
 - when an invoice is issued;
 - when payment is made in respect of the supply; or
 - the end of the taxable period that includes the date which is two months after the recipient's balance date for the year the service was performed.
- Section 10(2A), which provides that, for the purpose of a supply to which section 8(4B) applies, the value of the supply is equal to the consideration for the supply. This amendment ensures that section 8(1) charges GST on the amount of the consideration for the supply, meaning the consideration for the supply is GST-exclusive in the same way as for imported goods.
- Section 10(3B), which provides that, for the purposes of a supply between associated parties to which section 8(4B) applies, the recipient does not value supplies at market value when the payment for those services is an allowable deduction to the recipient. This is similar to section GD 13 of the Income Tax Act 1994.
- Sections 10(15C), which provides that the value of related party internal charges that are to be subject to the reverse charge under section 8(4B) is reduced by the value of any salary or interest component in the internal charge.

Background

The current GST treatment of imported services

Unlike imported goods, most services imported into New Zealand are not subject to GST. When GST was introduced in 1986 it was decided that the tax would not apply to imports of services, even though both imports of goods and services are generally included in the GST base.

This treatment was adopted as most services were consumed in the jurisdictions in which they were produced. Legal and technological constraints either prevented international trade in services altogether or made it uneconomic. The volume of services imported into New Zealand at the time was low, and the exclusion of imported services from the GST base was therefore seen to be relatively non-distortionary. The compliance and administration costs associated with imposing GST on imported services at the time outweighed the revenue gain and the benefits from removing the distortions that non-taxation would create.

The need for reform

The review of the GST treatment of imported services was included in the government's tax policy work programme for 2001-2002, prompted by increased volumes of imported services. Deregulation of the telecommunications and financial services markets in New Zealand, coupled with the rapid advances in communication and computer technology driving electronic commerce, have increased the ability to

consume in New Zealand at a reduced cost a wide range of services that have been produced offshore.

The government's electronic commerce strategy, as set out in the strategy paper *E-Commerce: Building the Strategy for New Zealand*, also identified addressing the GST treatment of imported services as a key part of ensuring that New Zealand's regulatory environment takes into account electronic commerce.⁵

The growth in the volume of imported services exacerbates the distortions caused by the non-taxation of imported services and undermines the competitiveness of New Zealand service industries. It also has the potential to undermine the GST base.

The competitive distortions arise because New Zealand service providers making supplies in New Zealand are required to charge GST, while non-resident service providers in the same situation are not. New Zealand service providers are therefore currently at a disadvantage compared to non-resident service providers. The price differential that the differing tax treatment causes may distort consumption decisions.

The majority of other countries with a GST/VAT system have a tax on imported services. There are benefits to be gained from having a tax treatment of cross-border supplies of goods and services similar to that of our trading partners. By not taxing imports of services the New Zealand GST system allows those services to avoid any impost of consumption tax, as such supplies would not have been taxed when exported from the jurisdiction in which they originated.

The increasing mobility of the supply of services and advances in electronic commerce mean that purchasing services supplied offshore will become more common. Although the tax base is not threatened at present by the fact that GST is not applied to imported services, a significant revenue risk may arise in the future.⁶

Discussion document – GST and imported services: a challenge in an electronic commerce environment

On 27 June 2001 the Government released a tax policy discussion document addressing the GST treatment of imported services – *GST and imported services: a challenge in an electronic commerce environment*. This document proposed the introduction of a “reverse charge” mechanism to tax imports of services by businesses. The reverse charge would require businesses acquiring services from offshore to self-assess and return GST on the value of supplies they have received. To minimise compliance and administrative costs for businesses, the reverse charge would apply only to those businesses which acquire services for other than taxable purposes (mainly financial institutions).

The reverse charge is intended to alleviate the current distortion in favour of imported services created by the non-taxation of imported services compared to the taxation of domestically supplied services. It also aligns New Zealand's GST system with that of

⁵ *E-Commerce: Building the Strategy for New Zealand*, November 2000, page 15.

⁶ For example, globally, electronic commerce is predicted to reach approximately US\$ 600 billion in trade by 2004-05, or roughly eight percent of all global trade (OECD Presentation: Electronic Commerce - Answering the Taxation Challenges, Tokyo OECD / Pacific Island Forum Conference, February 2001).

most other countries with a VAT or GST system and the treatment of services with that of goods.

Detailed analysis

The place of supply rule

General scheme

The proposed imported services legislation has been integrated as far as possible with the general GST provisions. The approach is based on treating certain imported services as being supplied in New Zealand and deeming the recipient of those services to be their supplier. This is in contrast to introducing a separate code, which would require far more detailed legislation as many existing provisions of the Act would need to be replicated.

The key provisions of the proposed legislation are new section 8(4B), containing the place of supply rule for imported services, and new section 5B, which treats the supply of imported services to which new section 8(4B) applies as having been made by the natural recipient of those services for the purposes of certain sections.

This commentary uses the terms “natural supplier”, “natural recipient” and “deemed supplier”: the first term refers to the non-resident supplier and the second and third terms refer to the New Zealand resident recipient of the imported services, who is required to apply the reverse charge.

Application of section 8(4B)

Section 8(4B) treats a supply as being made in New Zealand if:

- the services are supplied by a non-resident supplier to a recipient who is a resident;
- the services are not acquired by a person who makes taxable supplies that, in a 12-month period that includes the date the supply is made, represent 95 percent or more of total supplies; and
- the supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

Therefore supplies of services that would be exempt supplies if made in New Zealand will not be subject to the reverse charge.

It is important to note that, as explained below, section 8(4B) refers to the natural supplier and recipient of services, not the deemed supplier. Section 8(1), which imposes the liability to GST does, however, refer to the deemed supplier so that the liability to return GST is imposed on the New Zealand resident natural recipient of the supply.

Application of section 5B

Section 5B deems the natural recipient of services to be the deemed supplier of those services in certain circumstances. For the purposes of certain listed sections in the GST Act, section 5B treats a supply of services to which section 8(4B) applies as having been made by the recipient of those services in the course or furtherance of a taxable activity carried on by the recipient. Therefore the value of imported services supplied to a person will be included in the total value of supplies made by that person for the purposes of determining liability to register for GST. A person who makes no other taxable supplies in New Zealand may be required to register as a result of importing in excess of \$40,000 of services in a 12-month period.

For the purposes of sections not listed in section 5B, a supply of services to which section 8(4B) applies continues to be treated as having been made by the natural supplier of those services. It is therefore important to note that for the purposes of the sections not listed in new section 5B, references to “supplier” (and a supply being made by a person) and “recipient” will refer only to the natural supplier and natural recipient.

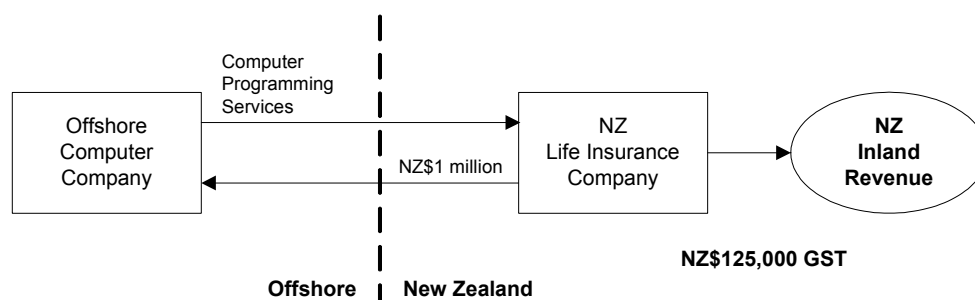
The most important provisions when the supplier (and recipient) references are to the natural supplier (and natural recipient) are sections 9 and 10. The time and value of supply provisions would not work if the supplier references did not refer to the natural supplier because, even though there may be a deemed supplier for the purposes of certain provisions, there is still only the one supply of imported services.

The sections for which section 5B applies to treat the natural recipient as the deemed supplier are:

Section	Topic
8(1)	Imposition of tax.
15	Taxable periods.
15A	Change in registered person’s taxable period.
19A	Requirements for accounting on payments basis.
20(4)	Calculation of tax payable: output tax.
20B	Allocation of taxable supplies following investigation by Commissioner.
25AA	Adjustments if contract for supply of imported services changed.
51	Persons making supplies in course of taxable activity to be registered.
52	Cancellation of registration.
57	Unincorporated bodies.
75	Keeping of records.
76(6)	Avoidance: 12-month period.
78	Effect of imposition or alteration of tax.
78B	Adjustments to tax payable for persons furnishing returns on payments basis following change in rate of tax.
78BA	Adjustments to tax payable in relation to credit and debit notes following change in rate of tax.
78C	Change in accounting basis coinciding with or occurring after change in rate of tax.

Most provisions do not require any amendment to cater for the reverse charge. For example, Parts VI and VII of the GST Act, dealing with recovery of tax and refunds and relief from tax, are not based on the concept of a supply and therefore can be applied unchanged to the reverse charge.

Figure 1: Example of the operation of the reverse charge



Example 1: The application of sections 8(4B) and 5B

An offshore computer company makes a supply of programming services to a NZ life insurance company (see diagram 1 above). NZ life insurance company makes solely exempt supplies of services. The NZ life insurance company is charged \$1 million for the services, which it pays on receipt of the services. An invoice is provided after payment is made. The two companies are not associated persons.

Applying sections 8(4B) and 5B to the simple example in figure 1:

- The services are supplied by a non-resident supplier to a resident recipient.
- The services are not acquired by a person making taxable supplies amounting to 95 percent or more of total supplies.
- The supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

Therefore section 8(4B) treats the supply as having been made in New Zealand, and section 8(1), in conjunction with section 5B, treats the natural recipient as the deemed supplier of the services. This requires the New Zealand life insurer to add GST to the value of the supply and return the GST to Inland Revenue. The value of the supply is \$1 million (the consideration for the supply), so GST of \$125,000 must be returned to Inland Revenue.

The operation of the reverse charge will not allow the life insurer in example 1 an input tax credit under section 3A, as it has imported services for a principal purpose other than that of making taxable supplies. Even though the imported services are a taxable supply with the life insurer as their deemed supplier, the services have still not been acquired by the life insurer as natural recipient for the principal purpose of making taxable supplies, as the application of sections 3A and 5B require.

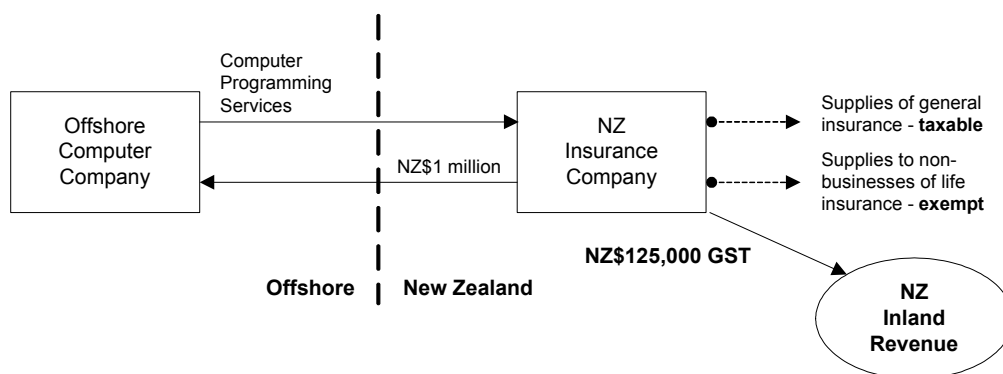
Mixed-use acquisitions

In some circumstances, a recipient of services subject to the reverse charge will be able to claim either an input tax credit under section 3A or change in use adjustments. This will occur when the services are not acquired by a solely non-taxable entity.

For example, if a New Zealand company which principally (say, 70 percent), but not solely, makes exempt supplies, acquires services, the input tax credit adjustment provisions in section 21E would apply. Section 21E(1)(a) would be applicable because the New Zealand company acquires the imported services for the principal purpose other than that of making taxable supplies. Although the company is treated as the supplier under section 8(1), the company as the natural recipient has still acquired the services and section 5B does not apply.

Section 21E(2)(a) would be applicable because tax has been charged under section 8(1) (as a result of the application of the reverse charge under sections 8(4B) and 5B) on the supply of services made to the company. Although the company is treated as the supplier under section 8(1), the supply has still been made to the company as the natural recipient and section 5B does not apply. Therefore section 21F would allow a deduction under section 20(3). A similar analysis would allow the company an input tax credit under section 3A(1)(a) if it has acquired imported services for the principal purpose of making taxable supplies.

Figure 2: Application of the adjustment provisions



Example 2: Mixed-use acquisition – principally exempt

An offshore computer company provides software to a New Zealand life insurance company for \$1 million (see figure 2). Using a turnover approach, the software is used 70 percent for making exempt supplies of life insurance, and 30 percent for making taxable supplies of general insurance. Under the reverse charge, the life insurance company would, therefore, add GST to the \$1 million, giving a figure of \$1.125 million, and include the GST of \$125,000 imposed under the reverse charge in its GST return.

Because the life insurance company uses the software 30 percent for making taxable supplies, it is entitled to an input tax credit adjustment, and will be able to make a period-by-period deduction from its output tax liability.

The life insurance company would not, however, include the \$1.125 million as a supply it has made for the purposes of making the adjustment based on turnover.

Example 3: Mixed-use acquisition – principally (but not 95 percent) taxable

An offshore computer company provides software to a New Zealand life insurance company for \$1 million (see figure 2). Using a turnover approach, the software is used 70 percent for making taxable supplies and 30 percent in making exempt supplies. The reverse charge will apply, as the software is not acquired by a company which makes taxable supplies amounting to 95 percent or more of total supplies. Under the reverse charge, the life insurance company would, therefore, add GST to the \$1 million, giving a figure of \$1.125 million, and include the GST of \$125,000 imposed under the reverse charge in its GST return.

The company will, however, be entitled to a full input tax credit of \$125,000 on the importation of the services under section 3A, as they are acquired for the principal purpose of making taxable supplies. It would then be required to make an adjustment on a period-by-period basis for exempt supplies made using the software.

Time of supply rules

The normal time of supply rules will generally apply for the purposes of the reverse charge. This will mean the time of supply for the reverse charge would be the earlier of when an invoice is issued or payment is made in respect of a supply, or when the services are performed if a supply is between associated persons and an invoice has not been issued, or payment received, before the relevant GST return is filed.

A time of supply rule based on the performance of services may in some instances be problematic since the recipient may not be aware of the time the services are performed, especially when the services are performed on an ongoing basis or charged for at year's end. For ongoing services this issue should be removed by adopting a test based on the time of payment in a similar manner to section 9(3), relating to agreements to hire. It is also proposed for the purposes of the reverse charge to ensure

that the reference to the time of performance in section 9(2)(a) will apply only if the issue of an invoice or making of payment have not occurred by the end of a given period – the taxable period that includes the date which is two months after the recipient’s balance date.

This will mean that the time of supply for a supply of services between associated parties which is subject to section 8(4B) will be the earliest of:

- when an invoice is issued;
- when payment is made in respect of the supply; or
- the end of the taxable period that includes the date which is two months after the recipient’s balance date for the year the services were performed.

Example 4: Time of supply

A (offshore parent company) and B (NZ subsidiary) are parts of a multinational group. Throughout a year (monthly) A supplies B with administrative and accounting services. B is registered for GST, accounts for GST on a two-monthly taxable period basis and makes solely exempt supplies. B is not charged for these services until after the end of each year, when a lump sum is charged for administrative and accounting services provided by the parent company to all members of the multinational group.

The supply of services will be subject to the reverse charge as it is a supply that would be taxable in New Zealand and it is acquired by a business which makes taxable supplies amounting to less than 95 percent of total supplies. B’s balance date is 30 June, and the end of the taxable period that includes the date that is 2 months after B’s balance date is 31 August.

The time of supply for the services could either be:

Invoice: if A provides B with invoices/an invoice for the services provided before either payment is made or 31 August, the time of supply for the service/services will be when the invoice is issued.

Payment: if B makes payment for the services before either the issue of invoices/an invoice for the supply/supplies or 31 August, the time of supply will be when the payment/payments are made.

Taxable period following balance date: if neither an invoice is issued, nor payment made, before 31 August, then the time of supply will be 31 August. The supply will therefore be included in B’s GST return due on 30 September.

Value of supply

The normal rules for determining the value of a supply will apply for the purposes of the reverse charge other than, in some circumstances, the rules for transactions between associated persons. Applying the normal rules would mean that the value of the supply would be either the actual consideration or the open market value of the supply if it is between associated persons and the actual consideration is less than the open market value of the supply.

The use of the open market value rule for supplies between associated persons, however, could lead to an increase in compliance costs and potentially to a revenue loss if tax deductions resulting from the deemed value of supply were taken into account. The valuation of services for which there is no charge could, in particular, involve substantial compliance costs.

To minimise any compliance costs and revenue loss, under new section 10(3B) the cost basis for supplies between associated parties will be required to be used if the consideration for the supply would be an allowable deduction to the New Zealand recipient under the Income Tax Act.

Example 5: Value of supply

As part of an international advertising campaign for a multinational group C (an offshore parent company) supplies D (a NZ subsidiary that makes only exempt supplies) with advertising services. As the advertising services are for a multinational group and most of the costs are absorbed and incurred in other countries in which the company operates, the New Zealand branch is not charged for the services, either explicitly or by way of a cost allocation from the head office.

The supply of services will be subject to the reverse charge as it is a supply that would be taxable in New Zealand and it is acquired other than for solely taxable purposes. Prima facie, as C and D are associated persons, D would have to calculate the market value of the services it has received. However, section 10(3B) would apply so that an uplift in the value of supply to market value is not required, as the cost of the advertising services would have been a deduction for company D under the Income Tax Act 1994. The value of the supply would therefore be zero, and GST at 12.5% on this would result in a zero amount.

Related party transactions

General position

In many instances, charges for services from an associated overseas business will be incorporated into a larger sum. This may be the case, for example, within a group of companies or single multi-national company, where the parent company or head office may allocate a proportion of its costs to the various parts of the enterprise or charge a management fee (referred to as “internal charges”).

The treatment of internal charges aims to achieve a balance between:

- the objective of imposing the tax on services that, if not taxed, would give rise to distortions;
- the need to ensure that the revenue base is maintained; and
- the objective of minimising compliance and administration costs, limiting the extent to which the various components of the charge must be identified.

The amendments aim to achieve this balance in part by excluding the salary and interest components of an internal charge so that only the remainder of the charge is subject to the reverse charge.

A related issue is whether a New Zealand entity should be treated as distinct from its offshore parent or head office. This is problematic with branches, as a New Zealand branch, for example, is not a separate legal entity from its head office. The general approach proposed is to treat the New Zealand entity or presence as separate, but only in relation to supplies of services that would be taxable supplies if made in New Zealand by a registered person.

This has required changes to the treatment of cross-border transactions between head offices and branches or members of groups of companies, as these are not usually treated as supplies for GST purposes. The proposals will ensure that New Zealand branches and subsidiaries are taxed in a similar manner.

The treatment of related party transactions can therefore be summarised as follows:

- (i) Start from the principle that the reverse charge should apply to services which would be subject to GST if supplied in New Zealand by a GST registered person.
- (ii) Treat a New Zealand entity or presence as separate from its offshore presence in relation to the services described in (i). This requires:
 - treating a New Zealand branch of a non-resident company as a separate entity; and
 - not disregarding supplies within a group of companies.
- (iii) Calculate the amount of an internal charge that is to be subject to the reverse charge by taking the internal charge and identifying component supplies or values that are excluded from the ambit of the reverse charge – these include salaries, interest and also any other exempt supplies.

Separating entities

In respect of branches and head offices, new section 56B deems the following for the purposes of supplies subject to section 8(4B) in relation to a person:

- a branch or division outside New Zealand to be a separate person and a non-resident;
- activities carried on by that non-resident person as being carried on independently by that person;

- a branch or division inside New Zealand to be a separate person and resident in New Zealand;
- activities carried on by that person resident in New Zealand as being carried on independently by that person; and
- a head office to be a branch or division.

In respect of groups of companies, section 55(7A) disregards the GST effects of grouping (overriding section 55(7)(a) and (c) to (dc)) for supplies made by a non-resident member of a group to a New Zealand resident member of a group for the purposes of supplies subject to section 8(4B).

Related party charges

Section 10(15C) provides that the value of related party services that are to be subject to the reverse charge under section 8(4B) is reduced by the value of any salary or interest charges from any member of a non-resident company's wholly owned group under section IG 1 of the Income Tax Act 1994 that form a part of an internal management services charge. Other exempt components will be excluded from the reverse charge more generally under section 8(4B)(c)(i).

Example 6: Related party transaction

E is the offshore head office of a multinational company. F is the New Zealand branch of the multinational company. The multinational company supplies financial services. E provides administrative, accounting and management services to F and to other branches in other countries. E recovers the cost of providing these services by making a cost allocation to each branch every year.

F is debited with a cost allocation of \$10 million, which covers administrative and management costs. Within the \$10 million of administrative and management costs, there are the following cost components:

Staff salaries:	\$5 million
Financing (interest) costs:	\$1 million
Administration costs:	\$1.5 million
Management costs:	\$2.5 million
Total cost allocation	\$10 million

Supplies of administrative, accounting and management services are taxable supplies if made in New Zealand. F makes taxable supplies amounting to less than 95 percent of total supplies. Section 56B treats E and F as separate entities carrying on activities so, prima facie, the \$10 million cost allocation is subject to the reverse charge. Under section 10(15C), however, components of a cost allocation that are attributable to salaries and interest incurred by E are excluded from the value of the cost allocation subject to the reverse charge. Therefore only \$4 million of the cost allocation is subject to the reverse charge.

Example 6: Related party transaction – continued

Therefore the amount subject to the reverse charge is:

Staff salaries:	0	excluded
Financing (interest) costs:	0	excluded
Administration costs:	\$1.5 million	
Management costs:	\$2.5 million	
Total subject to reverse charge:	\$4 million	
<i>GST at 12.5%</i>		
Total GST to be returned:	\$500,000	

Documentation requirements

In the absence of invoices, alternative supporting documentation, such as a supply contract or record of payments made, will be allowed to substantiate the valuations adopted for the purposes of the reverse charge. New section 20(2)(d) allows input tax credits to be claimed on supplies subject to the reverse charge if sufficient records are kept as required by new section 24B. The section is also required so it can be ascertained whether output tax has been charged on the correct amount, particularly in relation to amounts excluded from the reverse charge under section 10(15C).

Section 24B requires any recipient of a supply of services subject to section 8(4B) to maintain sufficient records of the supply to enable the following to be ascertained:

- the name and address of the supplier;
- the date on which, or the period during which, the supply was received;
- a description of the services supplied;
- the consideration for the supply;
- the time by which payment of the consideration for the supply is due; and
- the amount of the consideration for a supply that the taxpayer is excluding from the value of the supply under section 10(15C)(a) and (b).

Digitised services

The definition of “goods” will be amended so that supplies of imported digitised products, such as software provided over the Internet, will be treated as supplies of services and thus potentially subject to the reverse charge. This change will not affect persons who import no more than \$40,000 of services in a 12-month period.

Other minor changes

The following changes to introduce the reverse charge are also being made to the GST Act:

- New section 25AA is inserted, as an equivalent to section 25 (credit/debit notes and adjustments relating to them) for the purposes of supplies subject to section 8(4B).
- New section 11A(5), which excludes supplies subject to section 8(4B) from zero-rating under section 11A, is inserted.
- New section 2A(1)(bb), which treats branches or divisions treated as separate persons under section 56B as associated persons, is inserted.
- A definition of “non-resident” (a person who is not resident) is included for purposes of drafting style, and makes no substantive change to the law. All references to “not resident in New Zealand” in the GST Act are replaced by a reference to “non-resident”.

TRANS-TASMAN IMPUTATION

(Clauses 9, 15, 39, 41-45, 47-50, 64, 66, 70, 77, 80-83, 93 and 96)

Summary of proposed amendments

Australia and New Zealand are reforming their imputation laws to reduce a longstanding problem of the double taxation, of certain trans-Tasman investments, known as “triangular tax”. This reflects the commitment of both governments to the continued strengthening of the Closer Economic Relations agreement and promoting trans-Tasman business by reducing the taxation impediments to operating in both countries.

Australian and New Zealand shareholders of trans-Tasman companies that choose to take up these reforms will be allocated imputation credits representing New Zealand tax paid and franking credits representing Australian tax paid, in proportion to their ownership of the company. However, each country’s credits can be claimed only by its residents.

New Zealand is introducing legislation incorporating Australian companies that wish to join New Zealand’s imputation rules as part of the joint Australia/New Zealand initiative. Similarly, on 29 May 2003 Australia introduced the Taxation Laws Amendment Bill (No. 6) 2003, which proposes legislation to incorporate New Zealand companies that wish to join Australia’s imputation rules.

New Zealand is also introducing a new form of grouping for imputation purposes only which Australian companies may also join. This is an attempt to mitigate the problem that imputation credits cannot pass through companies resident in neither Australia nor New Zealand.

Imputation grouping will enable any Australian or New Zealand company within a wholly owned group to pay an imputed dividend if tax has been paid, or imputation credits received from companies outside the group, by any Australian or New Zealand company within the group. It will not, therefore, be necessary to pay a dividend up the chain of companies for the top company to access imputation credits created further down the chain.

Application dates

The amendments enabling Australian companies to elect to maintain an imputation credit account apply from 1 April 2003 but the amendments allowing Australian companies to pay imputed dividends will apply from 1 October 2003. The imputation grouping rules also come in from 1 April 2003.

Key features

New section ME 1B of the Income Tax Act 1994 is being inserted to allow Australian companies to elect to maintain an imputation credit account.

New subpart FDB and a new definition in section OB1 are being added to set up the new concept known as “imputation grouping”. The rules are the same as currently apply for imputation of consolidated groups in sections ME 10 to ME 14.

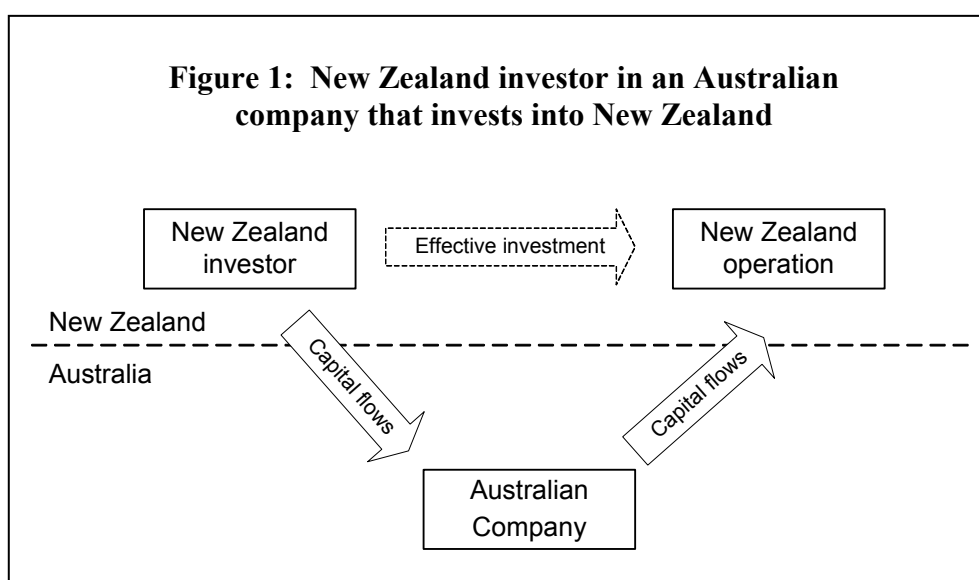
A new term, “consolidated imputation group”, is being added to incorporate imputation groups as well as existing consolidated groups that do not also join a imputation group.

Background

On 19 February 2003, the Australian Treasurer, Hon Peter Costello, and the New Zealand Minister of Finance and Revenue, Hon Dr Michael Cullen, announced that both countries had decided to adopt the pro rata allocation method to solve the longstanding “triangular tax” problem.

This was after consultation on both sides of the Tasman following the joint release of the discussion document *Trans-Tasman triangular tax* on 6 March 2003.

Within Australia and New Zealand, “triangular tax” arises when investors make equity investment in their own country through a company resident in the other country. Figure 1 sets out an example of a New Zealand investor in an Australian company which in turn invests into New Zealand.



‘Triangular tax’ is a consequence of Australia’s and New Zealand’s policies of allowing only:⁷

- tax paid in their country to generate imputation credits; and
- resident companies to pass on imputation credits to their shareholders.

In the 1980s, when imputation rules were introduced in both Australia and New Zealand, these policies did not cause concern as Australians primarily invested into Australian companies and New Zealanders primarily invested into New Zealand companies. Since then, with the development of globalisation, generally, and Closer Economic Relations (CER), in particular, there has been a greater level of cross-investment between the two countries. This increased level of trans-Tasman cross-investment highlights the issue that Australia and New Zealand are respectively imposing two layers of tax upon the same underlying income.

A pro rata allocation solution was chosen by both governments as it is the only method that apportions the tax benefits on the basis of the shareholders’ ownership, consistent with both countries’ current policy on imputation. Shareholders have the right to a proportion of the total income of a company rather than to a specific income source derived by the company. It seems appropriate, therefore, that the credit allocation rules continue to require a company paying a dividend to attach the same proportion of each type of credit to each dividend that it pays.

Relief from “triangular tax” based on a pro rata allocation of imputation credits would see dividends paid by an Australian or New Zealand company have both an Australian and a New Zealand imputation credit attached. Subject to the respective countries’ rules on the maximum allocation of credits (maximum ratio), the imputation credits would be allocated to shareholders in proportion to their shareholding in the company.

In New Zealand, the pro rata allocation method is being put into practice by allowing Australian companies to elect into the existing New Zealand imputation rules. This will allow Australian companies that elect to maintain an imputation credit account and pay New Zealand tax, to pass on that tax in the form of imputation credits on a pro rata basis to their shareholders.

Australia has also introduced a bill containing similar legislation, to allow New Zealand companies to elect into the existing Australian imputation rules.

Detailed analysis

IMPUTATION RULES TO INCLUDE AUSTRALIAN COMPANIES

Election to maintain an imputation credit account – section ME 1B

An election by an Australian company to join the New Zealand imputation rules will be conditional upon:

⁷ Australia’s and New Zealand’s current imputation models are not alone in this feature. It is common international practice.

- its Australian residence being determined by a new provision in section OB1 which is based on the current Australian rules for determining the Australian residence of a company in section 6(1) of Australia's Income Tax Assessment Act 1936; and
- neither an Australian nor a New Zealand double tax agreement treating the company as not resident of either Australia or New Zealand.

30 days' notice of election required

The Australian company must give 30 days' notice to the New Zealand Commissioner of Inland Revenue that it elects to maintain an imputation credit account. An imputed dividend can be paid only after the notice period has passed, or 1 October 2003, whichever is later. For all other purposes, the start date is retrospective to the beginning of the imputation year that applies to the date when the notice period has passed.

For example, on 30 March 2004 an Australian company notifies the Commissioner that it elects to maintain an imputation credit account. This is effective for the purposes of paying an imputed dividend from 29 April 2004, but the company may maintain an imputation credit account from 1 April 2004.

On 1 August 2003 an Australian company notifies the Commissioner that it elects to maintain an imputation credit account. This is effective for the purposes of paying an imputed dividend from 1 October 2003, but the company may maintain an imputation credit account from 1 April 2003.

Revocation of election or cessation of eligibility

Such an election may later be either revoked by the company at any time or lapse if the company ceases to be eligible to maintain an imputation credit account but is effective, for all purposes other than paying imputed dividends, until the end of that imputation year. Either a revocation or a cessation of eligibility will mean that the Australian company will cease to be an imputation credit account company. The effect is that under existing section ME 5(1)(k), a debit will arise in the account to the extent there is a credit balance – meaning that on revocation or cessation of eligibility, the company will lose its existing imputation credits. Such credits cannot be reinstated if it re-elects to maintain an imputation credit account or its eligibility is restored and a re-election can be made.

Imputed dividends cannot be paid either from the date the Commissioner receives the revocation or from the date that eligibility ceases. Neither the revocation nor the lapse in eligibility will affect the obligations of the Australian company that arose while the company was maintaining an imputation credit account.

The Commissioner has the discretion to revoke a company's election in the event of an actual or potential breach in the imputation rules, including:

- neither paying further income tax, penalties and interest on time nor entering into an arrangement with Inland Revenue to remedy the default;

- non-filing of imputation returns; or
- the Commissioner has reasonable grounds to believe the Australian company will incur and default on a liability to further income tax, penalties and interest.

The Commissioner also has a discretion not to accept the re-election of any company whose election has been revoked previously if the company cannot satisfy the Commissioner that the reasons for revocation will not occur again. A revocation by the Commissioner is also effective immediately for the purposes of paying imputed dividends, but for all other purposes it is effective from the end of that imputation year.

Such discretions are necessary given the difficulties the Commissioner would have in collecting tax arrears in a country other than New Zealand.

Joint and several liability

For the same reason, all companies that are in the same wholly owned group as the Australian company that has elected to maintain an imputation credit account will be jointly and severally liable for any further income tax, penalties and interest as the company that incurred the liability. Such joint and several liability will generally be invoked only in the event of a default by the Australian company.

The exception is when the companies within the wholly owned group are prohibited by an independent regulator from having such a joint and several liability with the company maintaining an imputation account.

Consequential amendments

Such companies that have a valid election will be defined as “Australian imputation credit account companies” in section OB 1. The definition of “imputation credit account” in section OB 1 is being expanded to include accounts maintained under section ME 1B. The definition of “imputation credit account company” is also being expanded to include companies that are required to maintain an imputation credit account under section ME 1B.

Additional credits and debits to an Australian company’s imputation credit account

As well as the existing provisions in sections ME 4, 5, 11 and 12 new subsections ME 4(1C), ME 5(1C), ME 11(1C), and ME 12(1C) are added to enable the following tax payments by the Australian company to create an imputation credit, and any refunds to create an imputation debit:

- non-resident withholding tax on interest, dividends or royalties;
- non-resident contractors’ withholding tax;
- non-resident shippers’ tax;
- non-resident film renters’ tax; and
- non-resident insurers’ tax.

These payments also represent tax paid in New Zealand by an Australian company, so it is appropriate that they also create imputation credits in the same way as payments of income tax or the receipt of imputation credits.

New subsections ME 4(2C), ME 5(2C), ME 11(2C), and ME 12(2C) are being added to clarify that the date the imputation credit or debit arises is the date the tax is paid or refunded respectively.

New subsections ME 4(1D) and ME 11(1D) are being added to ensure that these new provisions, when combined with the original provisions for creating imputation credits, do not create imputation credits that exceed the amount of tax originally paid.

Payment of dividend in Australian dollars

New section CF 5B is being added to allow Australian companies, when paying an Australian dollar dividend, to use the New Zealand dollar equivalent at the time of declaring the dividend for all purposes of the imputation rules. This concession is dependant on there being no more than three months between the declaration and the payment of the dividend.

Dividend withholding payment

Item c in the formula in section NH 2(1) is being amended to allow imputation credits attached to a dividend to reduce a dividend withholding payment liability when no underlying foreign tax credits are available.

Further income tax

New subsection ME 9(5E) allows an Australian company that pays further income tax under section ME 9 but does not have a New Zealand income tax liability to gross up the tax paid into a loss, and transfer the loss to another group company.

The reason for grossing up the tax into a loss is that if the further income tax payment were simply transferred to another group company, the group company could have the tax payment refunded if it had sufficient imputation credits to comply with section MD 2.

Compliance requirements

New subsection 29(1B) is being added to the Tax Administration Act 1994 to require an Australian company paying a dividend with an imputation credit attached to specifically use the term “New Zealand imputation credit” on the shareholder dividend statement. This is because the term “imputation credit” is also used in Australia with respect to Australian credits of company tax attached to dividends.

For Australian readers

Shareholder dividend statement – section 29 Tax Administration Act 1994

Every time a company pays a dividend, it must provide to the shareholder receiving the dividend a shareholder dividend statement which includes the amount of the dividend, the amount of any imputation credits attached and the amount of any withholding taxes deducted.

New subsection 69(1B) is being added to require an Australian company that maintains an imputation credit account but does not have to file a return of income to file its annual imputation return by 31 July following the end of an imputation year.

Sections 139(A) and 142(1)(d) are being amended to impose a late filing penalty of \$250 on Australian companies that do not file their annual imputation account returns on time.

Subsections 43A(4) and (5), which can exclude companies from filing annual returns, is being amended to apply to New Zealand companies only.

For Australian readers

Annual imputation return – section 69 Tax Administration Act 1994

An imputation return must be filed annually regardless of the balance of the account at the end of the year.

Imputation year – section OB 1 Income Tax Act 1994

Regardless of a company's balance date, for the purposes of income tax, all companies in New Zealand's imputation system have a balance date of 1 April to 31 March for the purposes of imputation. This is known as the imputation year.

New subsection 67(1)(eb) is being added to require that Australian companies that pay dividends in Australian dollars include the exchange rate used on the company dividend statement when calculating the imputation ratio.

For Australian readers

Company dividend statement – section 67 Tax Administration Act 1994

Every time a dividend is declared a company dividend statement is required. It provides a summary of information that includes:

- the number of shares that received a dividend or bonus issue;
- the date the dividend is declared and the date paid;
- the total amount of imputation credits attached; and
- the imputation ratio.

Imputation rules

The definition of “imputation rules” in section OZ 1 (1) of the Income Tax Act 1994 is being amended to include new sections CF 5B; the definition of “dividend” for Australian companies paying Australian dollar dividends; new subpart FDB, which introduces the imputation grouping rules; and sections ME 10 to ME 14, which govern the rules for maintaining a consolidated imputation credit account.

For Australian readers

Further income tax is payable to the extent a company has a debit balance in its imputation credit account at 31 March. It is payable by 20 June following.

Imputation penalty tax is an additional penalty of 10% of the further income tax due.

Other imputation rules

The imputation rules also include the following sections of the Income Tax Act 1994:

- CF 6(1) and (2) – defines dividend for some purposes;
- FC 12 – applicable to investors in Category A Group Investment funds;
- GC 21 to GC 23 – anti streaming rules;
- LB 1 and 2 – determines the amount of imputation credit that can be applied by shareholders;
- MD 2 – limit on refunds of tax for companies with imputation credit accounts;
- ME 1 to ME 14 – rules governing the operation of imputation credit accounts;
- ME 30 to ME 40 – rules governing the operation of imputation credit accounts for statutory producer boards (producer boards governed by a New Zealand statute);
- OB 6(1)(d) – income tax excludes penalties or interest charged under the Tax Administration Act 1994;
- Part MZ – terminating imputation provisions (provisions that have a limited life and will terminate at a particular date).

As well, they include the following sections of the Tax Administration Act 1994, which set out the requirements for furnishing:

- 29 – a shareholder dividend statement;
- 64 – a co-operative company to provide particulars of deemed dividend;
- 67 – a company dividend statement when an imputation credit account company declares a dividend;
- 69 – an annual imputation return;
- 70 – a return when required by the Commissioner or when a company ceases to maintain an imputation credit account;

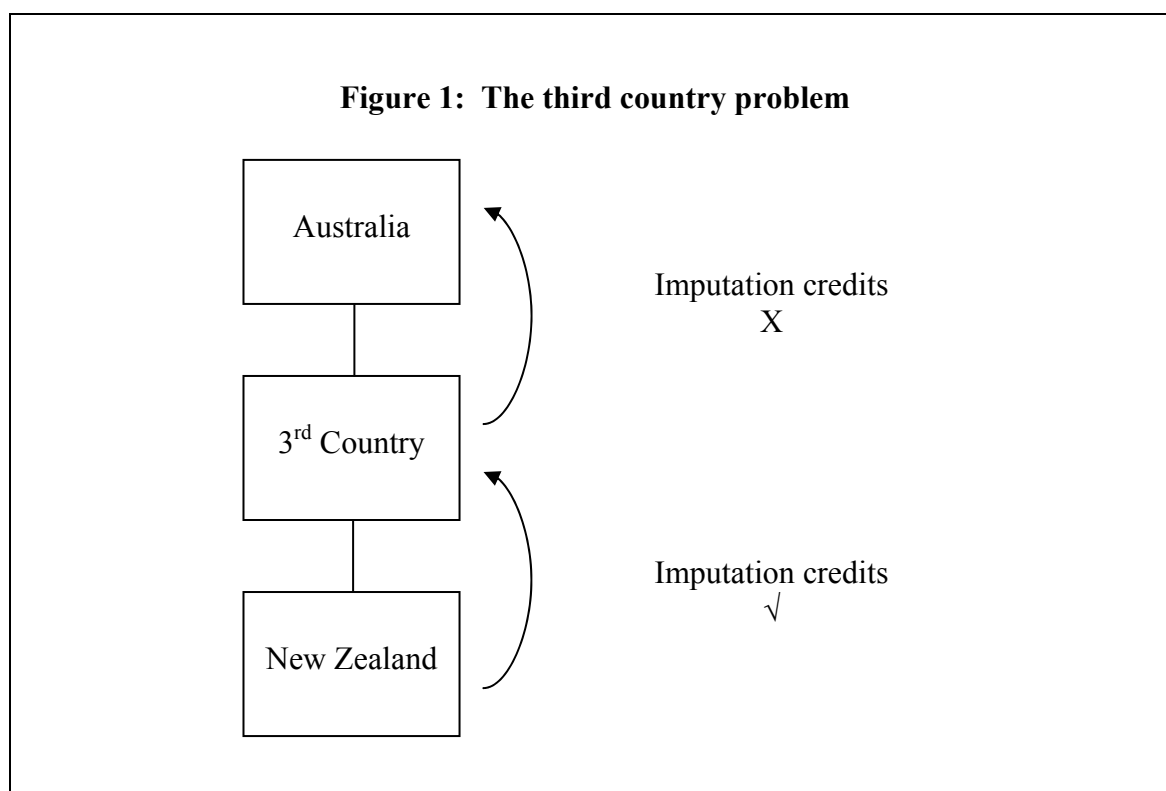
and the assessment of:

- 97 – imputation penalty tax;
- 101 – further income tax;
- 139B – late payment penalty;
- 140B – imputation penalty tax if company has an end of year debit balance in its imputation credit account;
- 140D (1) and (2) – interaction of imputation penalty tax with income tax; and
- 180 – grounds for remissions and refunds of imputation penalty tax.

IMPUTATION GROUPING

Third country issue

Imputation grouping is being introduced as part of the reform in an attempt to mitigate what has become known as the “third country issue”, illustrated in figure 1. Consistent with current Australian and New Zealand imputation rules, the earlier discussion document had proposed that imputation credits would not flow through companies resident in neither Australia nor New Zealand – a third country.

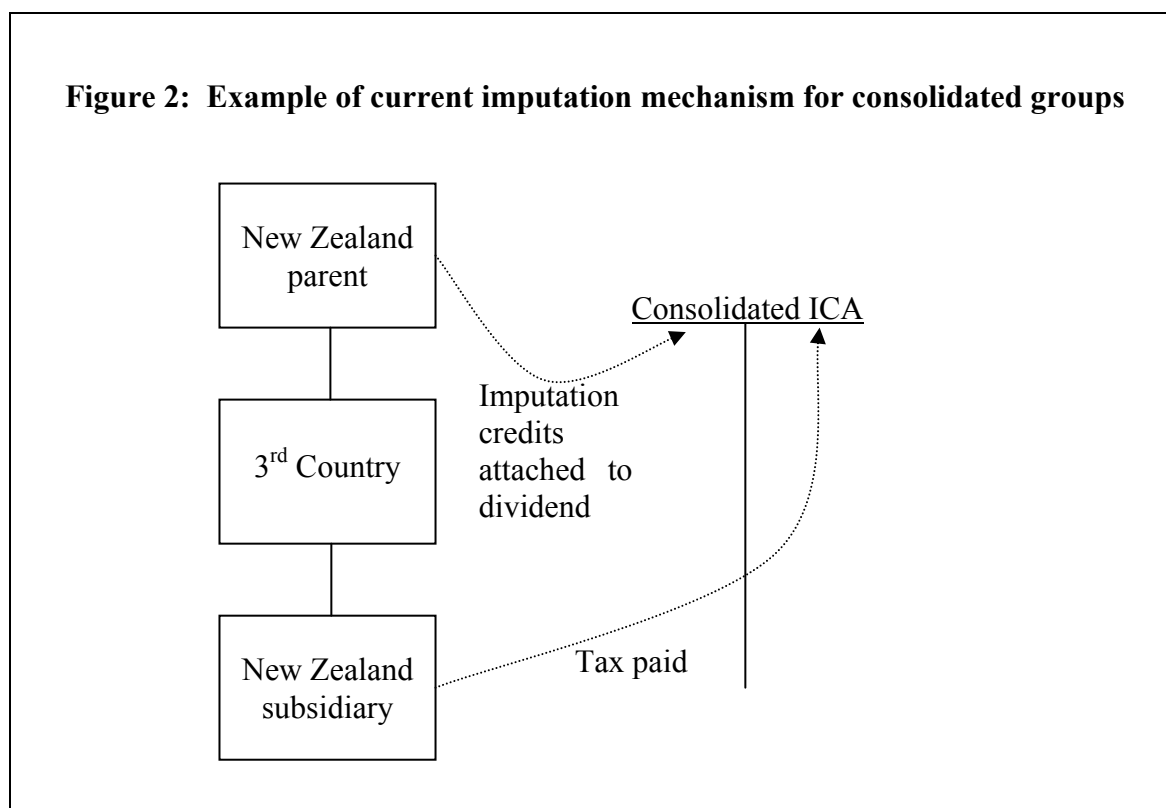


A number of submissions disagreed with this aspect of the reform, arguing that it was not uncommon for trans-Tasman subsidiaries to be owned by a holding company in a third country. Although not wishing to treat trans-Tasman group structures involving a company resident in a third country more favourably than similar New Zealand group structures, the Australian and New Zealand governments have attempted to lessen this problem.

Current consolidation provisions for imputation

To treat trans-Tasman and New Zealand structures alike, the option chosen by the New Zealand government is one based on that which is currently available to New Zealand groups under the consolidation rules. Under these rules, there is no requirement that the chain of wholly owned companies be New Zealand resident; the requirement is simply that the companies which consolidate are New Zealand resident.

This means that tax paid by any of the New Zealand consolidated companies can go to a single consolidated imputation account which any consolidated company can use to impute a dividend.



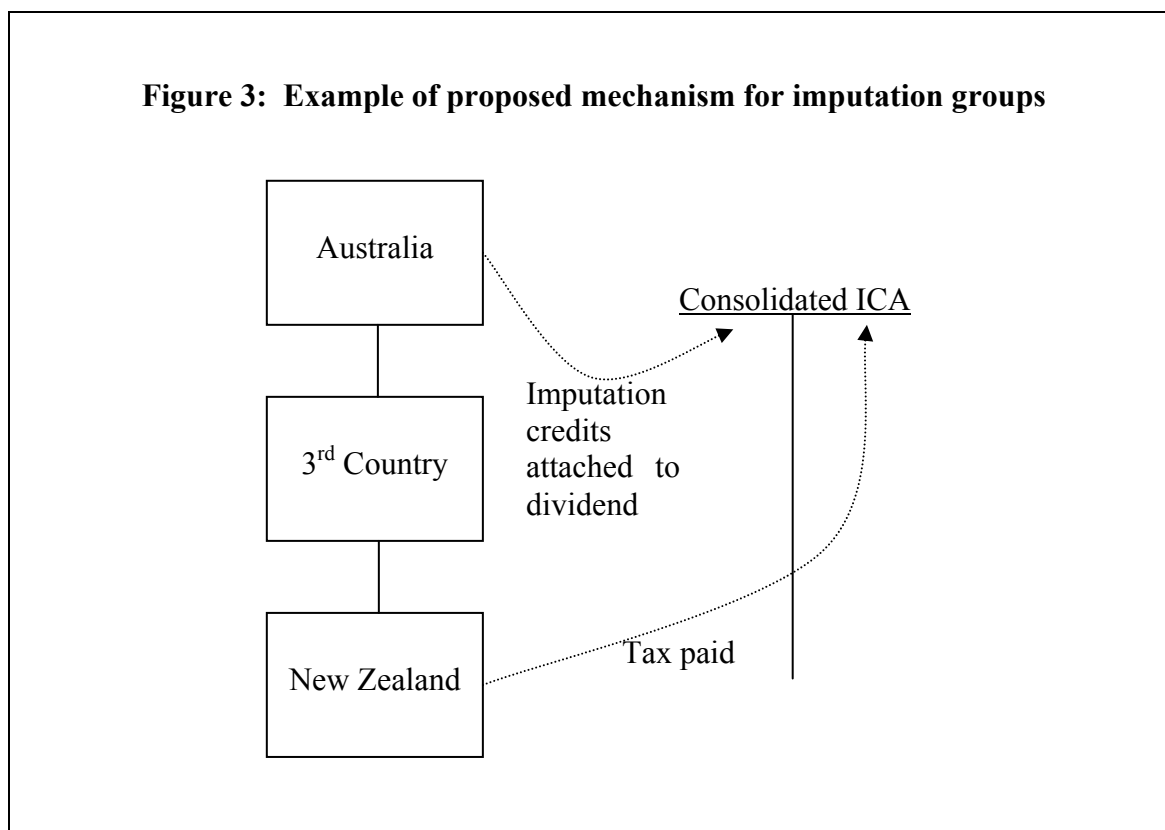
It is very important, however, to note that, even under consolidation, if a dividend is to be paid from the New Zealand subsidiary to the third country company, and the third country company is to receive a supplementary dividend, imputation credits must be attached. The attachment of imputation credits causes a debit to the consolidated imputation credit account, but as the third country company is not a member of the consolidated group, the imputation credits it receives cannot form a credit to the consolidated account. This is appropriate because the loss of imputation credits as the dividend leaves New Zealand ensures that New Zealand tax is always paid on the underlying income.

This will continue to be a feature in the rules relating to imputation groups. To pay a supplementary dividend to the third country company, imputation credits must be attached and an imputation debit made to the consolidated imputation credit account. There will be no credit to the consolidated imputation account when the dividend is received by the 3rd country company.

Summary of proposed amendments

New subpart FDB is being added to incorporate the concept of imputation grouping within the Income Tax Act 1994. The effect will be that any company in the imputation group can attach imputation credits if tax has been paid by another group member.

Figure 3: Example of proposed mechanism for imputation groups



Eligibility is similar to eligibility for consolidation generally and is based on those rules. The main differences are:

- The grouping is for imputation purposes only – section OB 1 definition of consolidated imputation group and application of ME 10 to ME 14.
- Australian companies that have elected to maintain an imputation credit account are also eligible to group – section FDB 1(a)(ii).
- Existing members of a consolidated group may also form part of an imputation group so long as all members of the consolidated group join the imputation group – section FDB 1(e).
- Imputation groups with Australian and New Zealand members, known as trans-Tasman imputation groups, must also form a resident imputation subgroup consisting of the New Zealand members of the trans-Tasman group section FDB 3(1) and section OB 1 definition of “resident imputation subgroup” and “consolidated imputation group”.

An imputation group does not need to have Australian members – it is quite possible for it to consist only of New Zealand companies.

Other important points to note are:

- Sections ME 10 to ME 14 are being amended to include imputation groups and resident imputation subgroups within their scope. These sections now apply to “consolidated imputation groups”, which is defined in section OB 1 as consisting of imputation groups, resident imputation subgroups and

consolidated groups of which no member is also a member of an imputation group.

- Although two or more companies are eligible to form an imputation group (section FDB 2(1)), it may continue to exist if the group is reduced to one member (section FDB 3(2)) and member is itself the nominated company (section FDB 5(3)).
- All members of the imputation group are jointly and severally liable for further income tax, penalties and interest incurred by any member of the imputation group (section FDB 4).
- The nominated company must be a member of the imputation group, and if the imputation group is also a trans-Tasman imputation group, the nominated company must be a New Zealand company, and the same company must also be the nominated company of the associated resident imputation subgroup (section FDB 5(2)(b)).
- If a New Zealand member leaves an imputation group, that is a trans-Tasman imputation group, it will also leave the resident imputation subgroup. This is because when the New Zealand member leaves the trans-Tasman imputation group, it will no longer be included within the definition of “resident imputation subgroup” in section OB 1, as it is no longer a member of the trans-Tasman imputation group.

Trans-Tasman imputation groups and resident imputation subgroups

Imputation groups that have both Australian and New Zealand group members are to be known as trans-Tasman imputation groups (new definition in section OB1).

To ensure that New Zealand tax is paid on all dividends paid offshore, imputation groups having both Australian *and* New Zealand members (trans-Tasman imputation groups) will also be required to maintain a resident imputation subgroup, consisting of the New Zealand members only, as a subset of, and additional to, the trans-Tasman imputation group.

Without a resident imputation subgroup operating alongside a trans-Tasman imputation group, it would be possible for income to leave New Zealand without any tax being paid in New Zealand.

This could occur with a trans-Tasman imputation group that had never paid any New Zealand tax. Without the requirement for a resident imputation subgroup, it could pay a dividend to Australia, attaching imputation credits⁸ and debiting the consolidated imputation credit account accordingly. When the dividend was received by the Australian company, it would then credit the consolidated imputation credit account with the attached imputation credits⁹, bringing the account back into balance. Thus untaxed New Zealand income could leave New Zealand without any New Zealand tax being paid at all.

⁸ to pay a supplementary dividend

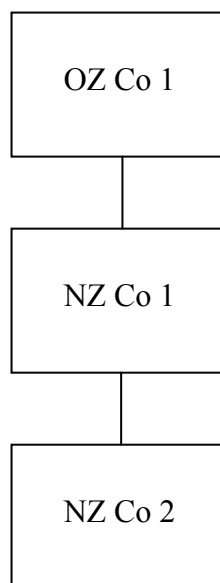
⁹ and the non-resident withholding tax deducted

By having a resident imputation subgroup, consisting of the New Zealand members of the trans-Tasman imputation group operating as a subset of, and additional to a trans-Tasman imputation group, this problem is prevented. If no New Zealand tax has been paid by the trans-Tasman imputation group, when a New Zealand company pays a fully imputed dividend to Australia both the trans-Tasman imputation group's imputation account and the resident imputation subgroup's imputation account are debited with the amount of imputation credits attached. When the dividend is received by the Australian company, the attached imputation credits are credited to the trans-Tasman imputation group's imputation credit account only.

Should that debit balance remain in the resident imputation subgroup's consolidated imputation credit account by 31 March, further income tax will be payable. When the further income tax is paid, both the trans-Tasman imputation group's consolidated imputation credit account and the resident imputation subgroup's consolidated imputation credit account will be credited with this payment.

Example of how a trans-Tasman imputation group and a resident imputation subgroup will work

OZ Co 1, NZ Co 1 and NZ Co 2 are all part of a wholly owned group of companies and wish to form a trans-Tasman imputation group.



As the group contains Australian and New Zealand members, it is a trans-Tasman imputation group and the New Zealand members, NZ Co 1 and NZ Co 2, must also form a resident imputation subgroup.

Both groups start the imputation year with a zero balance in their respective consolidated imputation credit accounts. NZ Co 1 then pays to OZ Co 1 a:

- \$67 dividend and
- a \$11.82 supplementary dividend.

with:

- \$11.82 of non-resident withholding tax deducted and
- imputation credits of \$21.18 attached.

On paying the supplementary dividend, NZ Co 1 receives a foreign investor tax credit of \$11.82.

Looking first at the dividend coming from the New Zealand company, the imputation credits attached and the foreign investor tax credit create debits to both the trans-Tasman imputation group consolidated imputation credit account and the resident imputation subgroup's consolidated imputation credit account.

Payment of dividend from NZ Co 1 – imputation entries

	Trans-Tasman imputation group <u>Consolidated ICA</u>	Resident imputation subgroup <u>Consolidated ICA</u>
Imputation credits attached	21.18	21.18
Foreign investor tax credit	11.82	11.82

Secondly, regarding the receipt of the dividend by OZ Co 1 with \$11.82 non-resident withholding tax deducted and \$21.12 imputation credits attached. Credits are made only to the trans-Tasman imputation group consolidated imputation credit account as the receipt of the dividend relates only to the Australian company OZ Co 1.

Receipt of dividend by OZ Co 1 – imputation entries

	Trans-Tasman imputation group <u>Consolidated ICA</u>	Resident imputation subgroup <u>Consolidated ICA</u>
	21.12	21.12
	11.82	11.82
Imputation credits received	21.12	
NEWT deducted	11.82	

No other transactions take place throughout the imputation year. At the end of the year the resident imputation subgroup's consolidated imputation credit account has a debit balance of \$33, so further income tax of \$33 is payable. When the further income tax is paid, a credit arises to both consolidated imputation credit accounts.

The trans-Tasman imputation group consolidated imputation credit account now has a credit balance of \$33 which can be distributed to the ultimate shareholders. This is the right result as \$33 of New Zealand tax has been paid.

Payment of further income tax by the resident imputation subgroup – imputation entries

	Trans-Tasman imputation group <u>Consolidated ICA</u>	Resident imputation subgroup <u>Consolidated ICA</u>
	21.18	21.18
	11.82	11.82
	21.18	
	11.82	
Further income tax paid	33.00	33.00

Consolidated imputation groups

A new definition, “consolidated imputation group”, is being added to section OB1. This includes imputation groups, resident imputation subgroups and consolidated groups of which no member is also a member of an imputation group. Trans-Tasman imputation groups are a type of imputation group, and so are also indirectly included.

Sections ME 10 to ME 14, which currently apply to consolidated groups will be amended to apply now to consolidated imputation groups. This means that these sections will now apply to all imputation groups and resident imputation subgroups, as well as existing consolidated groups.

The effect of these provisions on imputation groups, trans-Tasman imputation groups, resident imputation subgroups and existing consolidated groups are set out below:

- *An existing consolidated group does not wish to form an imputation group.*

Other than the change in terminology in sections ME 10 onward, there are no changes to existing consolidated groups for imputation. They are now a consolidated imputation group as no members of the consolidated group are also in an imputation group. They continue to apply the existing provisions in

sections ME 10 onward that have been renamed as applying to consolidated imputation groups.

- *New Zealand members of a wholly owned trans-Tasman group of companies that have not consolidated now wish to consolidate for imputation purposes only.*

The New Zealand members of the trans-Tasman group can form an imputation group under subpart FDB and apply the provisions in sections ME 10 onward relating to consolidated imputation groups. There is no requirement to form a resident imputation subgroup as well, as this imputation group does not include both New Zealand and Australian members, so it is not a trans-Tasman imputation group.

- *Australian members only of a wholly owned trans-Tasman group of companies wish to consolidate for imputation purposes.*

Australian members of a trans-Tasman group can form a trans-Tasman imputation group under subpart FDB and apply the provisions in sections ME 10 onward relating to consolidated imputation groups. There is no requirement to form a resident imputation subgroup as well, as this imputation group does not include both New Zealand and Australian members, so it is not a trans-Tasman imputation group.

- *The Australian and New Zealand members of a wholly owned trans-Tasman imputation group wish to consolidate for imputation purposes. The New Zealand members are not part of an existing consolidated group.*

The New Zealand and Australian members, who have elected to maintain an imputation credit account under section ME 1B, of the trans-Tasman group can form an imputation group under subpart FDB. As this imputation group includes both New Zealand and Australian members, it is a trans-Tasman imputation group, and the New Zealand members must also form a resident imputation subgroup

Both the trans-Tasman imputation group and the resident imputation subgroup are consolidated imputation groups, so they both must comply with the provisions in sections ME 10 onward that apply to consolidated imputation groups.

- *An existing consolidated group wishes some members of its consolidated group together with some Australian wholly owned group members to consolidate for imputation only.*

This is not allowed as an imputation group must include either no members of an existing consolidated group or all the members of an existing consolidated group (section FDB1(e)). It will prevent a wholly owned group of companies having access to two imputation credits for one payment of tax, through an imputation group and a consolidated group's imputation account.

- *An existing consolidated group wishes to add Australian members and another New Zealand wholly owned member for imputation purposes only.*

All the members, including the ones that have already consolidated for income tax purposes, of the wholly owned group that wish to consolidate for imputation must form an imputation group under the provisions of subpart FDB. As this imputation group has Australian and New Zealand members, it is a trans-Tasman imputation group, and the New Zealand members must also form a resident imputation subgroup.

As an existing consolidated group is the basis of the new imputation group, new subsection ME 10(1B) applies. It requires that the imputation credit account used by the consolidated group continue to be maintained as the imputation group's consolidated imputation credit account.

New Australian and New Zealand non-consolidated members are treated the same as new companies joining an existing consolidated group. In this case:

- The existing consolidated imputation account will remain and become the trans-Tasman imputation groups' consolidated imputation credit account (new subsection ME 10 (1B)).
- All the debits and credits of the new Australian members, the new New Zealand members and the existing members of the consolidated group will go to the trans-Tasman imputation group's consolidated imputation credit account once the imputation group has formed (existing subsections ME 11 and ME 12).
- The pre-grouping balance of the account of the new New Zealand member and, to the extent there are any, the Australian members' individual imputation credit accounts are not transferred to the trans-Tasman imputation group's consolidated imputation credit account, but remain separate until such time as the consolidated imputation credit account has a debit to its account which it cannot offset by an existing credit. In such a case, and subject to shareholder continuity being maintained, a credit may be transferred from one of the new members individual imputation credit account to the trans-Tasman consolidated imputation account, to the extent of the consolidated imputation credit account's debit balance (existing subsections ME 13(2) to (4)).

A similar process applies to the resident imputation subgroup:

- The existing consolidated imputation account remains and becomes the resident imputation subgroups' consolidated imputation credit account (new subsection ME 10 (1D)).
- All the debits and credits of the new New Zealand member and the existing members of the consolidated group go to the resident imputation subgroup's consolidated imputation credit account once the subgroup has formed (existing subsections ME 11 and ME 12).
- The pre-grouping balance of the new New Zealand member is not transferred to the resident imputation subgroup's consolidated imputation credit account but remains separate until such time as the consolidated

imputation credit has a debit to its account which it cannot offset by an existing credit. In such a case, and subject to shareholder continuity being maintained, a credit may be transferred from the new member's individual imputation credit account to the trans-Tasman consolidated imputation account, to the extent of the consolidated imputation credit account's debit balance (existing subsections ME 13(2) to (4)).

New section ME 10(1C) provides that if an imputation group consisting of New Zealand members only subsequently consolidates for income tax purposes and no longer wishes to be an imputation group, the consolidated imputation account used by the imputation group will continue and become the consolidated imputation group of the consolidated group.

Otherwise, sections ME 10-14, which previously applied to consolidated groups, will apply to consolidated imputation groups, except as amended for payments of:

- non-resident withholding tax on interest, dividends or royalties;
- non-resident contractors' withholding tax;
- non-resident shippers' tax;
- non-resident film renters' tax; and
- non-resident insurers' tax.

Other amendments relating to imputation groups

Refunds

The effect of section MD 2, modified by section ME 14(5) for consolidated groups, is that companies cannot receive a refund if that refund would cause its imputation credit account to go into debit. This will still apply to imputation groups but on a self-assessment basis.

These sections, however, envisage that for every company or consolidated group there will be an imputation return. With imputation groups this is no longer the case, while the individual companies will still have an individual income tax liability, only one imputation return will be required for the group.

Section ME 14(6) has been added to allow the effect of MD 2 to still apply but on a self assessment basis, that is with the imputation group monitoring its compliance with section MD 2 rather than the Commissioner as is currently envisaged by the section.

Companies within an imputation group can only request a refund if section MD 2 would have been complied with should references to the company's imputation account be references to the imputation group's imputation account.

Should a company within an imputation group receive a refund without requesting it, the usual procedure will apply: the company has the choice of either returning it to Inland Revenue or filing an updated imputation credit account, one that complies with section MD 2, under section 70(3) of the Tax Administration Act.

Filing of consolidated imputation credit accounts

Section 74 of the Tax Administration Act is being amended to apply to consolidated imputation groups generally rather than just consolidated groups, as at present. There is an exception, however, for resident imputation subgroups. While they must still prepare an annual imputation return, they will be required to file it only if they have a further income tax liability under section ME 14(3).

DEFERRED DEDUCTION RULE

(Clauses 13, 14 and 66(14), (17), (18) & (21))

Summary of proposed amendments

The deferred deduction rule introduced in this bill is aimed at aggressive tax arrangements, many of which are mass-marketed, that result in investors receiving more tax deductions than the money they invest in the arrangement. Typically, the tax benefit of these deductions occurs regardless of the success of the arrangement.

The rule will apply to situations where the investor is not at real risk of having to repay loans in respect of an arrangement. However, a number of criteria are used to target the rule to minimise its impact on everyday commercial activities. Where the rule applies, deductions will be deferred to the extent the loans are outstanding and the investor continues not to be at real risk of having to repay them.

The valuation of assets used in the arrangements in question is the most problematic feature of these arrangements, so it should ideally have been the target of any legislative response. Targeting valuation, however, would be very difficult because the forecasts of income that underpin valuation of the assets involved are inherently difficult to determine and are very subjective. Instead, the rule focuses on situations where investors do not have to pay for the assets they acquire as a proxy for dealing with valuation directly.

Section DK 1 (limitation of deduction for certain film expenditure to amount at risk) is being repealed because it will no longer be necessary once the deferred deduction rule is implemented.

Application date

The rule will apply to deductions claimed for the 2004-2005 and subsequent income years.

It will apply to existing arrangements only when 70 percent of the deductions claimed arise in respect of fixed life intangible property or software, or it can reasonably be expected that there are ten or more investors. This limitation is intended to ensure that the rule does not affect existing arrangements that are not targeted.

Key features

The rule will defer tax deductions on targeted loans provided the criteria set out in new sections ES 1 to ES 3 of the Income Tax Act 1994 are met. In commercially unsuccessful arrangements this deferral could be permanent.

The criteria are designed to minimise the possibility of genuine commercial investments being affected. The criteria are:

- The arrangement has a promoter.
- The arrangement must produce losses in the first three years.
- The money that is not at risk must constitute 50 percent or more of the net arrangement assets of the investor and associated persons.
- The arrangement's net assets consist of less than 70 percent of tangible property that is comprised of land, buildings, or major plant or machinery.

The definition of "money that is not at risk" and the 70 percent of tangible property test are central to the targeting of the rule. "Money that is not at risk" is defined as:

- loans that are explicitly or economically limited or non-recourse;
- loans where material payments are not required for ten years;
- other loans which have the same effect.

A loan is explicitly a limited recourse or non-recourse loan when its terms so state. A loan is economically a limited recourse loan when it is made to an arrangement specific entity (typically a company or a partnership whose partners are not natural persons) and is not secured other than perhaps over the assets or shares of the company.

Loans are excluded, however, from the definition of "money that is not at risk" if the terms are on an arm's length basis, the lender regularly lends money on arm's length terms and carries on business in New Zealand. Such loans can be part of commercial arrangements even though they also lend themselves to aggressive tax arrangements.

The 70 percent of tangible property test takes out assets which are easy to value and therefore do not need to fall within the rule. The rule has been carefully targeted so that it should not apply to financing arrangements for projects relating to tangible assets, vendor finance arrangements and other commercial activities.

Background

The deferred deduction rule was designed to target aggressive tax arrangements that provide tax deductions from which tax savings in early years exceed the amount of the investors' own money put into the arrangement. In these arrangements the investor makes a cash return regardless of whether the arrangement is a commercial success or not.

The arrangements usually have some of the following features:

- They involve participation in a high-risk activity with apparently optimistic or unrealistic future sales projections.

- They include a transfer of property, including intangible and intellectual property that is difficult to value with precision. Transfer at an excessive price magnifies the available tax deductions, which are usually, but not always, by way of depreciation deduction.
- Their finance is arranged so that the investor is not at real risk of ever having to repay the loans. This can create inflated interest deductions and/or provide support for a higher transfer price.
- Their projected income is well into the future and may or may not materialise.

How the aggressive tax arrangements work

The arrangements in question are generally similar in structure and usually vary only in detail. Typically, investors put a relatively small amount of money into a joint venture or partnership. This can be by way of arrangement-specific, loss attributing qualifying companies or it can be direct.

The joint venture or partnership undertakes an activity. Most of the money provided by the investor goes into the activity, with the balance going to the promoter. The promoter arranges for investors to have access to loan money. The loan money is used to purchase purportedly high-value assets that diminish in value, at least for tax-purposes, over time. The higher the purchase value, the greater the tax deductions.

The investors are not at risk of having to repay the loan even if the arrangement is commercially unsuccessful. A variety of mechanisms are used to ensure this. They range from the loan being provided on explicit limited or non-recourse terms, to it being lent to an arrangement-specific company and only secured over the assets and, perhaps, the shares of the company.

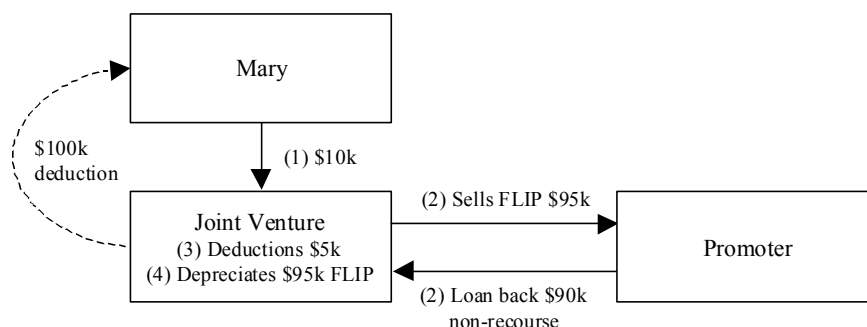
Example 1: Excessive tax savings

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

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

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

The cash flows and loss transfers are as follows:



Approach taken to target the arrangements

The valuation of assets used in the arrangements in question is the most problematic feature, so it should ideally have been the target of any legislative response. Targeting valuation, however, would be very difficult because the forecasts of income that underpin valuation of the assets involved are inherently difficult to determine and are very subjective.

Therefore the approach adopted to address these arrangements focuses on whether investors have used their own money or put their own assets at risk in the arrangement. Some of the arrangements to which the deferred deduction rule will apply are clearly of a tax avoidance nature, although this is not necessarily true of all.

Detailed analysis

New *Subpart ES – Arrangements involving money not at risk*, is inserted comprising new sections ES 1 to ES 3.

Definitions – section ES 2

Relevant definitions include:

“Loan”

A loan is a financial arrangement under which a person provides money to another person, but does not include an excepted financial arrangement.

“Promoter”

A person who:

- is a party to, or is significantly involved in formulating a plan or programme from which an arrangement is offered; or

- is aware of material and relevant aspects of the arrangement and who sells, issues or promotes the selling or issuing of the arrangement, whether or not for remuneration.

A “promoter” does not include:

- a person whose involvement with the arrangement is limited to providing legal, accounting, clerical or secretarial services to the promoter.
- a person whose role is limited to sourcing finance for an arrangement in the normal course of their business.

No numerical requirement is attached to the definition of “promoter” only for the purposes of the deferred deduction rule. Although promoter penalties apply only if there are at least ten investors in an arrangement, the deferred deduction rule will apply to future arrangements if there is only one investor per arrangement.

“Money that is not at risk”

Any outstanding obligation under:

- an arrangement-specific loan, the terms of which have the effect of relieving the borrower from the obligation to repay all or some of the loan, whether the relief is contingent or not (explicitly limited recourse);
- an arrangement-specific loan to an arrangement-specific person (typically, a company) that is unsecured or, in substance, is secured only over assets that are employed in the arrangement (economically limited recourse);
- an arrangement-specific loan, the terms of which have the effect of relieving the borrower from the obligation to make any material payments in respect of the loan for a period of ten or more years from the date the loan is made; or
- other loans which have the same effect.

Loans, however, are excluded from the definition of “money that is not at risk” if the terms are on an arm’s length basis, and the lender regularly lends money on arm’s length terms and carries on business in New Zealand. Thus loans from New Zealand financiers are automatically not “money that is not at risk”. This exclusion was limited to New Zealand financiers because Inland Revenue is able to seek information from them.

Intra-family or intra-group loans are also generally excluded.

Application of the definition of “money that is not at risk”

Three examples are presented of how the deferred deduction rule will apply in practice. In the first two examples the rule applies to the arrangements involved. The third example is of a structure to which the rule will not apply, even though it incorporates arrangement-specific finance.

Example 2: Explicit limited recourse loan

Bill puts \$10,000 of his own money into a joint venture (JV). The JV uses this for a computer development activity that produces deductions of \$10,000 in the first year.

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

In this example, the limited recourse loan would satisfy the criteria of "money that is not at risk" (section ES 2(2)(a) refers).

Example 3: Economic limited recourse loan

Kay puts \$20,000 of her own money into an arrangement-specific loss attributing qualifying company which in turn invests into a partnership of loss attributing qualifying companies. The partnership uses this money to make a film and obtains a deduction for it in year one.

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

The promoter will arrange finance. This finance is secured over the assets of and shares in the loss attributing qualifying companies, with the result that investors are not actually at risk of having to repay this finance from their non-arrangement assets. In economic terms, the loan is limited recourse against the arrangement's assets and income and would satisfy the definition of "money that is not at risk" (section ES 2(2)(c) refers).

Example 4: Arm's-length test satisfied

John puts \$10,000 of his own money into an arrangement-specific loss attributing qualifying company which in turn invests into a partnership of loss attributing qualifying companies. The partnership uses \$8,000 of this to plant a pine forest and obtains a deduction for it in year one. The balance is used as part payment for the land on which the trees are grown.

The arrangement provides that the promoter will sell to the partnership land on which to grow trees. This land will cost \$42,000 per partner.

Because the partnership cannot afford to pay for the land in full, the promoter arranges a loan of \$40,000 per partner from a New Zealand bank. The finance is secured by mortgage over the land. This results in the investors actually not being at risk of having to repay this finance from their non-arrangement assets. In economic terms, the loan is limited recourse against the arrangement's assets and income.

As the loan is from a New Zealand bank and is at arm's length on fully commercial terms and conditions, it is not "money that is not at risk" – refer section ES 2(3)(b).

Because there is no "money that is not at risk", the deferred deduction rule does not apply. John receives, via the loss attributing qualifying company, tax deductions of \$8,000 plus interest.

When the deferred deduction rule applies – section ES 1

The subpart can apply only when all of the following conditions are in place.

- There must be an arrangement that has a promoter.
- The arrangement must produce losses in the first year of the arrangement, or cumulatively in years one and two, or cumulatively in years one, two and three (the loss period).
- At the end of any of the period(s) referred to in the previous bullet point, the money that is not at risk must constitute 50 percent or more of the total cost of the arrangement assets of the investor and associated persons.
- At the end of any of the period(s) referred to in the previous bullet point the arrangement's net assets consist of less than 70 percent of tangible property that consists of land, buildings, or major plant or machinery.

For many arrangements, the conditions will not be met, so the subpart can be ignored.

For the purpose of determining whether a loss has been incurred in the loss period, section ES 1(2) provides that the investor and any affected associated persons are treated as if they have no other allowable deductions or gross income. A loss attributed to the shareholder of a loss attributing qualifying company is ignored, to prevent double counting, and the calculations are made as if no losses have been deferred in earlier years. In this respect, intra-group tax loss offsets do not yield deductions and can therefore be ignored.

The total cost of the property held by the investor and any affected associated persons is calculated on a consolidated basis for elimination of intra-group assets, liabilities and equity, equivalent to that used for consolidated companies under generally accepted accounting practice.

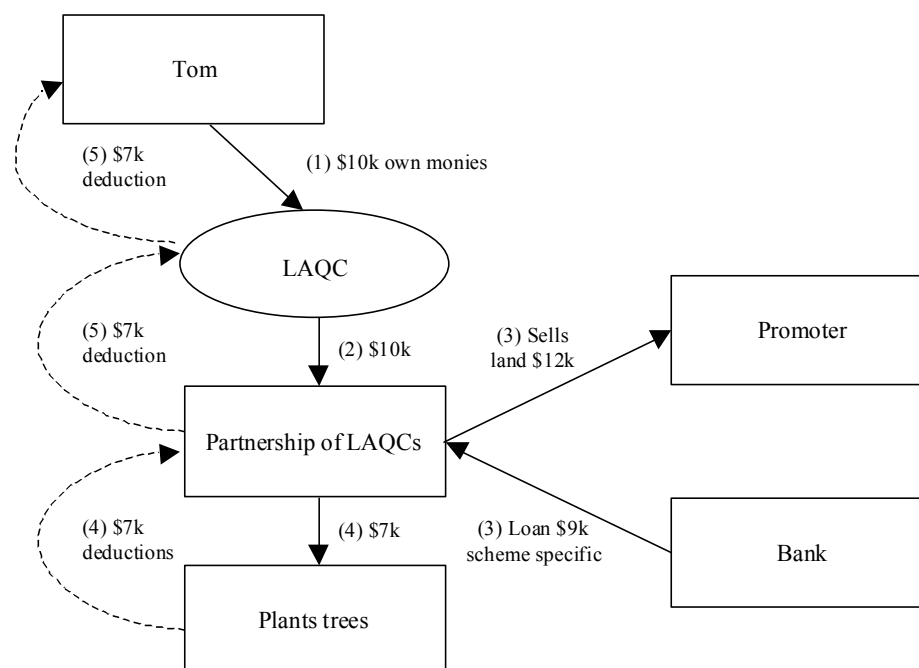
Example 5: Determining whether the rule applies

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

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

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

The cash flows and tax deductions, ignoring interest, are summarised below.



Excess allowable deductions – section ES 1(1)(b)

Section ES 1(1)(b) requires the allowable deductions of the investor and affected associated persons to be considered together. In the example, the loss attributing qualifying company, and the partnership of such companies are affected associated persons. The partnership of loss attributing qualifying companies does not have allowable deductions because section HD 1(1)(b) provides that there is no joint assessment for partnerships. Each partner takes into account their share of the allowable deductions incurred by the partnership. Allowable deductions claimed by Tom and the company are:

Tom:	\$7,000
Loss attributing qualifying company:	\$7,000
Total:	\$14,000

However, section ES 1(2) provides that a loss arising under section HG 16(1) is ignored to the extent necessary to prevent double counting. The deduction claimed by Tom is attributed to him by the company, and is ignored to prevent double counting. Therefore, in the first year that Tom acquired an interest in the arrangement, the arrangement's allowable deduction is \$7,000. Gross income from the arrangement is nil, so the arrangement satisfies section ES 1(1)(b).

Tangible property test – section ES 1(1)(c)

The rule applies only if less than 70 percent of the property that is subject to the arrangement is tangible property that is land, buildings or major plant and machinery. “Land” means the surface of the ground, and anything attached to it.

For the purposes of determining whether the property of the arrangement is tangible property:

- the property is measured at cost (refer to section ES 1(3)(a));
- the investor and any affected associated persons are considered together as a group (refer to section ES 1(3)(b)); and
- the cost of the property is calculated on a consolidated basis for elimination of intra-group balances, equivalent to that used for companies under generally accepted accounting practice in New Zealand (refer to section ES 1(3)(c)).

The investor and affected associated persons who are considered as a group are:

- Tom;
- the loss attributing qualifying company; and
- the partnership of loss attributing qualifying companies.

Tom owns the shares in the loss attributing qualifying company which is a partner in the partnership of like companies. The partnership owns land (including trees).

Under consolidation principles, the \$10,000 capital Tom holds in the loss attributing qualifying company needs to be eliminated. Likewise any capital or advances from the company to the partnership need to be eliminated.

After consolidation, all of the property of the arrangement consists of land (including trees), so the deferred deduction rule does not apply.

How the deferred deduction rule works – section ES 3

Broadly, section ES 3(1) and (5) provide that the deferred deduction rule applies in any year if:

- section ES 1 is satisfied;
- excess deductions are incurred in that year; and
- at the end of that year, the arrangement involves “money that is not at risk”.

Section ES 3(2) provides that any losses that are to be deferred are treated as gross income, and section ES 3(3) determines how the gross income should be allocated between the investor and any affected associated persons. Section ES 3(4) provides that amounts treated as gross income are allowed as deductions in the following income year.

Detailed provisions

Under section ES 3(1), the deferred deduction rule will apply in any year when:

- an arrangement satisfies the criteria in section ES 1;
- the arrangement produces losses (excess deductions) in that income year, calculated as if there was no other gross income or allowable deductions, for the investor and affected associated persons combined:
 - ignoring losses that have been attributed to shareholders of loss attributing qualifying companies; and
 - ignoring any amount that is required to be added back as gross income under section ES 3(2); but
 - allowing any allowable deductions provided for by section ES 3(4) (amounts treated as gross income under the deferred deduction rule in the previous year that is allowed as a deduction at the start of the current income year);
- the arrangement involves “money that is not at risk” at the end of the income year. For the purpose of determining whether there is “money that is not at risk” at the end of the income year:
 - amounts repaid as a result of transaction involving the use of put and call options or a contract of insurance or guarantee are disregarded if the put or call option or the contract of insurance or guarantee is part of the arrangement; and
 - the transaction does not give rise to gross income.

Section ES 3(2) provides that the investor and any affected associated persons are jointly treated as deriving gross income equal to the lesser of:

- the amount of the excess deductions calculated under section ES 3(1)(b) – that is, the excess deductions in that income year, calculated as if there were no other gross income or allowable deductions, for the investor and affected associated persons combined:
 - ignoring losses that have been attributed to shareholders of loss attributing qualifying companies; and
 - ignoring any amount that is required to be added back as gross income under section ES 3(2); but
 - allowing any allowable deductions provided for by section ES 3(4) (amounts treated as gross income under the deferred deduction rule in the previous year that is allowed as a deduction at the start of the current income year); and
- the amount of “money that is not at risk”, at the end of the income year, as determined under section ES 3(5).

Section ES 3(5) provides that for the purpose of determining whether there is “money that is not at risk” at the end of the income year under section ES 3(1)(c):

- amounts repaid as a result of transactions involving the use of put and call options or a contract of insurance or guarantee are disregarded if the put or call option or the contract of insurance or guarantee is part of the arrangement; and
- the transaction does not give rise to gross income.

This has the effect, illustrated in example 6, of deferring any deductions associated with the investor’s capital contribution until such time as total deductions exceed the amount of money that is not at risk.

Section ES 3(3) provides that when an amount is treated as gross income, the amount is allocated between the investor and the affected associated person(s) on the basis of their respective excess allowable deduction.

Section ES 3(4) provides that when an amount is deemed to be gross income, that amount is allowed as a deduction in the following income year.

Section ES 3(5) provides that some amounts may be treated as being “money that is not at risk” although they have purportedly been repaid.

Example 6: Application of the deferred deduction rule

Jan puts \$10,000 of her own money into a Joint Venture (JV). The promoter arranges a limited recourse loan of \$40,000 for her to purchase fixed life intangible property (FLIP) from the promoter for \$50,000 in total.

Jan is able to claim depreciation on the FLIP of \$25,000 in each of the 2004-2005 and 2005-2006 income years. No income is derived from the arrangement in either of those years.

2004-2005 year

The deferred deduction rule will apply (see section ES 3(1)) because:

- the criteria in section ES 1 have been satisfied;
- deductions of \$25,000 claimed by Jan exceed gross income (nil); and
- at the end of the year the arrangement involved “money that is not at risk” (\$40,000)

Under section ES 3(2) Jan is required to treat as gross income the lesser of:

- excess allowable deductions (\$25,000); or
- the amount of money that is not at risk (\$40,000).

Therefore \$25,000 is treated as gross income for 2004-2005.

2005-2006 year

Under section ES 3(4), Jan will be allowed a deduction of \$25,000 in respect of the amount deemed to be gross income in 2004-05. She will also have current year depreciation deductions of \$25,000. Thus she has total allowable deductions in the 2005-06 year of \$50,000.

Again, the deferred deduction rule will apply (see section ES 3(1)) because:

- the criteria in section ES 1 have been satisfied;
- deductions claimed by Jan total \$50,000 and exceed gross income (nil); and
- at the end of the year the arrangement involved “money that is not at risk” (\$40,000).

Therefore, \$40,000 (the lesser of \$50,000 or \$40,000) is treated as gross income for 2005-2006. This provides an effective deduction for Jan’s \$10,000 capital contribution in the second year.

2006-07 year

In year three it is agreed that the arrangement will not succeed commercially (in fact, no income has been derived from sales) and the loan is expressly written off by the financier.

Under section ES 3(4), Jan will be allowed a deduction of \$40,000 in respect of the amount deemed to be gross income in the previous year.

She also has \$40,000 gross income from the accrual rules remittance of the \$40,000 loan.

The income and expenditure offset each other in this year.

Over the life of the project, Jan has put in \$10,000 capital and, in this case, enjoyed the tax benefits from a \$10,000 deduction.

Repeal of section DK 1

Section DK 1 provides for deductions for film expenditure to be reduced when the expenditure is funded from a limited recourse loan. As the deferred deduction rule will generally apply to such arrangements, section DK 1 is no longer required and is being repealed.

Other policy changes

INCOME TAX EXEMPTION FOR COMMUNITY TRUSTS

(Clauses 5, 17 and 66(5))

Summary of proposed amendments

Community trusts established under the Trustee Banks Restructuring Act 1988 will become exempt from income tax from the beginning of the 2004-2005 income tax year. Distributions from these trusts will, however, continue to attract income tax. This means that tax-exempt beneficiaries of community trusts will still pay no tax on their distributions, while tax-paying beneficiaries will pay tax on the distributions they receive at their own tax rate. This should not alter the after-tax amount they currently receive from these distributions. The changes are being made to reduce compliance costs on these community trusts.

Application date

The income tax exemption for community trusts will be available from the beginning of the 2004-2005 income tax year.

Key features

An amendment to section CB 4(1) of the Income Tax Act 1994 provides that community trusts established under the Trustee Banks Restructuring Act 1988 will be exempt from income tax from the beginning of the 2004-2005 income year. Distributions of income from these community trusts will be subject to tax in the beneficiaries' hands, effectively, at the same rate they have been subject to tax in the community trusts before this amendment. This means that distributions to tax-exempt entities would still be taxed at 0%. Distributions to taxable beneficiaries will be taxed at the beneficiaries' own tax rate. This has the effect of requiring the beneficiary, rather than the community trust, to account for the tax on the income. Until now community trusts have paid tax on the income and distributed tax-paid income to tax-paying beneficiaries.

This amendment effectively means that all distributions by community trusts will be beneficiary income. Beneficiary income under current tax rules is taxed at a beneficiary's own tax rate.

For reasons of reducing compliance costs it is not proposed that this beneficiary income be subject to a withholding tax in the community trust based on individual beneficiaries' tax liability.

Similarly, imputation credits received by the community trusts will not be available for attaching to the distribution of beneficiary income.

Community trusts can continue to distribute the corpus of the trust – the capital sums settled on the trust and capital gains made by the trust – without a tax impost. Community trusts, as a result of the proposed amendment, can also distribute the tax-paid retained earnings of the trust without a tax impost.

Background

Community trusts established under the Trustee Banks Restructuring Act 1988 sought an income tax exemption to reduce compliance costs currently incurred by them in making tax-free distributions to mostly tax-exempt entities.

Community trusts are not currently exempt from income tax. They do not generally qualify for the charitable income tax exemption under the Income Tax Act 1994 because their purposes are wider than those of charities. However, most of the distributions made by community trusts are to tax-exempt entities. These entities include charitable entities and other organisations (such as amateur sports promoters) that receive a specific tax exemption under the Income Tax Act.

Community trusts currently ensure that distributions made to tax-exempt entities are not subject to income tax and those made to taxable beneficiaries are covered by tax credits (such as imputation credits) received by the trusts. In order to do this, they incur compliance costs.

Under current tax law, if a community trust pays beneficiary income to a tax-exempt entity, that income will not be liable for income tax in the hands of the trust or the beneficiary. This is because beneficiary income is taxed at a beneficiary's tax rate, which in the case of a tax-exempt entity is 0%. In a number of cases, community trusts have established charitable subsidiary companies or sub-trusts. Consequently, a community trust can distribute any income it is not able to distribute in a particular income year to its charitable entity as beneficiary income. In future years, distributions can be made to charitable beneficiaries out of the community trust's charitable entity. This ensures that beneficiary income paid to tax-exempt charitable entities is not subject to tax.

When a community trust makes a distribution to a taxable entity, it will generally make this out of trustee income, which is subject to tax at 33%. Analysis of the financial statements of community trusts indicates that any trustee income tax liability is covered by imputation credits received by community trusts on dividend income or, alternatively, is covered from tax losses, foreign tax credits and resident withholding tax credits. When the trustee income tax liability is covered by credits received by the community trusts, there is no further income tax liability for the trust.

Thus community trusts incur compliance costs relating to the calculation of their own taxable income, the operation of a separate charitable entity and the determination of whether the beneficiaries they distribute to are tax-exempt or taxable entities. There may also be compliance costs for beneficiaries in determining their tax status in order to be able to advise the trust.

Consequently, community trusts have sought an income tax exemption so that they can continue to make untaxed distributions to tax-exempt entities without incurring compliance costs. Under current tax rules, community trusts, in effect, pay income tax only on dividend income they receive with imputation credits.

REPEAL OF INCOME TAX EXEMPTION FOR SICK, ACCIDENT OR DEATH BENEFIT FUNDS

(Clauses 6, 10, 11 and 62(2))

Summary of proposed amendments

The income tax exemption for the investments earnings of sick, accident or death benefit funds is being repealed. The related resident withholding tax exemption is also being repealed. A closely targeted exemption is being created for the investment earnings of funds established solely for the purpose of paying for the funeral expenses of employees and their dependants.

Application date

The repeal of the income tax exemption will apply to income derived after the date of enactment.

Key features

The income tax exemption for the investment earnings of sick, accident or death benefit funds in section CB 5(1)(i) of the Income Tax Act 1994 will be repealed. The corresponding resident withholding tax exemption in section NF 9(1)(i) of the Income Tax Act 1994 is also being repealed.

The income tax exemption is being removed because it is anomalous in terms of current tax policy. As discussed below, the exemption is inconsistent with the current policy for both the taxation of savings and insurance policies. The current exemption also raises tax base maintenance concerns.

New section CB 5(1)(ib) will contain a closely targeted exemption for the investment earnings (interest and dividends) of funds established solely for the purpose of paying for the funeral expenses of the employees of an employer and the spouses and dependants of employees. The exemption will be limited to funds established by an employer for ten or more employees who have equal eligibility to benefits from the fund. All contributions to these funds will have to be made by either employers (and subject to fringe benefit tax) or employee beneficiaries of the fund. In addition, any such funeral expense fund would need to be approved by the Commissioner of Inland Revenue.

Background

Income derived by a trustee of a sick, accident or death benefit fund (other than business income) is currently exempt from income tax under section CB 5(1)(i) of the Income Tax Act 1994. A sick, accident or death benefit fund is defined in section CB 5(2) as a fund established for the benefit of the employees of any employer, or the members of an incorporated society, and the surviving spouses and dependants of any

such employees and members. The fund is required to be approved by the Commissioner of Inland Revenue. The income tax exemption for these funds was first enacted in 1940.

The Committee of Experts on Tax Compliance (1998) considered that the income tax exemption for the funds was anomalous in terms of current tax policy and that there was no public policy justification for its continuance. Accordingly, the Committee recommended the repeal of the tax exemption.

The income tax exemption for the investment earnings of these funds is inconsistent with the current policy for the taxation of savings. Because of the open-ended nature of the definition of sick, accident or death benefit funds, such funds can be used as savings vehicles. The exemption effectively allows earnings on personal savings to be exempt from income tax. The exemption therefore provides concessionary treatment that is not available to other forms of savings.

The income tax exemption is also inconsistent with the treatment of insurance policies entered into for protection against sickness, accident or death. The earnings on contributions or premiums paid on such policies are generally taxable.

The income tax exemption also raises tax base maintenance concerns. In particular, schemes with very aggressive features which exploit this exemption have been marketed to high-income individuals to reduce the tax they pay. This problem is increased by the open-ended nature of the current fund tax exemption, as there is no requirement that a fund be established only for protection against sickness, accident or death.

CHARITABLE DONEE STATUS

(Clause 22)

Summary of proposed amendment

Books for Africa, the Bright Hope International Trust, the Cheboche Area Trust Inc, the Greater Mekong Subregion Tertiary Education Consortium Trust, the Help a Child Foundation New Zealand, Plan New Zealand, the Sampoerna Foundation Limited, Surf Aid International Incorporated and The Sir Edmund Hillary Trust are to be given charitable donee status. This will enable donors to obtain tax relief on their donations.

Application date

The amendments will apply from the 2003-04 income year.

Key features

The following organisations are being added to section KC 5(1) of the Income Tax Act 1994, which lists the organisations that qualify for charitable donee status:

- Books for Africa;
- Bright Hope International Trust;
- Cheboche Area Trust Inc;
- Greater Mekong Subregion Tertiary Education Consortium Trust;
- Help a Child Foundation New Zealand;
- Plan New Zealand;
- Sampoerna Foundation Limited;
- Surf Aid International Incorporated; and
- The Sir Edmund Hillary Trust.

Background

Donations to qualifying organisations entitle individual taxpayers to a rebate of 33 1/3 percent of the amount donated, to a maximum of \$630 a year. Donations by non-closely held companies, and closely held companies which are listed on a recognised stock exchange, qualify for a deduction to a maximum of 5 percent of their net income.

Books for Africa

This organisation collects donated books and ships them to Africa for free distribution to poor and needy people in Africa. Their fundraising is to cover the costs of shipping the books.

Bright Hope International Trust

The main focus of this Trust is providing education and medical care for AIDS orphans. This organisation has a United States base and is working with the poor in 50 countries.

Cheboche Area Trust Inc

The stated aims of this Trust are to develop improved health and education services for the people of Cheboche, in Nepal.

Greater Mekong Subregion Tertiary Education Consortium Trust

This Trust is to promote higher tertiary educational standards in the Mekong region. The Greater Mekong Subregion comprises Cambodia, Lao PDR, Myanmar, Vietnam, Thailand and the Yunnan province of China. The consortium is comprised of tertiary institutions from the Greater Mekong Subregion, Australia and New Zealand.

Help a Child Foundation New Zealand

The current focus of this organisation is needy children in Africa and India. It has set up schools and children's homes, provides day care and helps parents who cannot provide for their children. It works mainly through child sponsorship.

Plan New Zealand

Plan New Zealand is the New Zealand branch of an international child-focused aid organisation which was established approximately 65 years ago and operates in developing countries. It will initially concentrate on raising funds for child sponsorship. Moneys raised through child sponsorship will benefit whole communities, not just individual children.

Sampoerna Foundation Limited

The stated aims of this company are to provide funding for the education of Indonesian students.

Surf Aid International Incorporated

This organisation has been established to provide medical aid and related education programmes to communities adjacent to surfing locations and their neighbouring communities. They are currently operating in the Mentawai Islands in Indonesia to improve the health of the local population. To carry out its work it seeks support from the global surfing community

The Sir Edmund Hillary Trust

This Trust has been established for the purpose of marking the 50th anniversary of Sir Edmund Hillary's ascent of Mt Everest. It has been established to further charitable purposes in both New Zealand and Nepal. (In the case of Nepal, the advancement of religion has been excluded from the activities the Trust may engage in.)

FAMILY ASSISTANCE – INCREASES TO FAMILY SUPPORT, CHILD TAX CREDIT AND PARENTAL TAX CREDIT INCOME THRESHOLDS

(Clauses 23 and 25)

Summary of proposed amendments

Family assistance legislation is being amended to allow an increase in income thresholds for family support, the child tax credit and the parental tax credit from 1 April 2004. Income thresholds are to be increased by 1.78% to provide an adjustment for inflation in line with the estimated increase in the Consumer Price Index for the year ended September 2003. This will have the effect of increasing the income thresholds for family support, the child tax credit and the parental tax credit from \$20,000 to \$20,356 and from \$27,000 to \$27,481.

Application date

The amendment will apply from 1 April 2004.

Key features

Section KD 2(6) of the Income Tax Act 1994, which explains how the abatement of entitlement is calculated, will be amended to include the adjusted income thresholds. The \$20,000 threshold, at which abatement begins, will become \$20,356. The \$27,000 threshold, at which the rate of abatement changes from 18% to 30%, will become \$27,481.

Similar and consequential changes will also be made to the rules for calculating interim instalments, in section KD 5B(5) and Schedule 12.

Background

Income thresholds are the points at which family assistance entitlement starts to be abated as family income rises. At the current threshold levels, family assistance abates by 18 cents for every extra dollar of family income above \$20,000 a year and 30 cents for every extra dollar of family income above \$27,000. The proposed increase in income thresholds will mean that low-income and middle-income families with income above \$20,000 will receive more family assistance.

FAMILY ASSISTANCE DEBT – WRITING OFF OVERPAYMENTS ASSOCIATED WITH ADDITIONAL PAYDAYS

(Clauses 23, 24 and 26)

Summary of proposed amendments

Family assistance legislation is being amended to write off overpayments of family assistance that arise when there is an extra payday in the year. Under the new legislation, where eligible recipients paid by Inland Revenue or the Ministry of Social Development receive an additional payment and incur an overpayment at the end-of-year square-up, an adjustment will be made so that the overpayment attributable to the extra payday is not collected from recipients.

Application date

The amendment will apply from the 2003-04 year.

Key features

Section KD 4 of the Income Tax Act 1994, which relates to the annual square-up of payments and entitlement, will be amended so as to reduce a claimant's overpayment subject to the satisfaction of certain criteria.

Claimants paid by Inland Revenue will have their overpayment reduced by an amount which is the lesser of the last instalment payment received and the amount of their overpayment if they:

- receive 27 fortnightly instalments of family assistance from Inland Revenue in 2003-04; and
- incur an overpayment at end-of-year square-up.

Claimants paid by Ministry of Social Development will have a similar reduction in their overpayment if they:

- receive at least one instalment of family assistance from the Ministry of Social Development in 2003-04 or 2004-05; and
- do not received a fortnightly instalment from Inland Revenue in the same income year; and
- incur an overpayment at end-of-year square-up.

Background

Because a year is slightly longer than 52 weeks, claimants who receive interim payments throughout the year (rather than at the end in a lump sum) sometimes receive one more payment than usual.

In 2003-04 for example, there will be 27 fortnightly paydays for claimants paid by Inland Revenue, instead of the usual 26, and 53 rather than 52 paydays for Ministry of Social Development claimants paid weekly on Tuesdays and Wednesdays. In 2004-05 there will be 53 paydays for Ministry of Social Development claimants paid weekly on Thursdays.

As fortnightly or weekly entitlement is calculated based upon a standard year comprised of 26 or 52 payment periods, claimants who would otherwise have balanced at the end-of-year square-up will be overpaid in years with additional paydays. Claimants who would have been overpaid for some other reason will have their overpayment magnified by the extra payday.

Overpayments associated with additional payment periods may contribute to the creation of family assistance debt for some claimants. Evidence suggests that some families choose not to receive family assistance payments during the income year as a result of having previously incurred a debt, and apply for an end-of-year lump sum instead, which means they no longer receive payments throughout the year to assist with day-to-day living expenses. Debt also reduces the apparent return from employment and may act as a disincentive for low-income families to move out of benefit and into work.

TAX POOLING

(Clauses 32-34, 40-42, 46-49, 60 and 66(21))

Summary of proposed amendments

Four amendments are being proposed to the recently enacted tax pooling provisions to remove a disincentive for companies to participate in tax pools. The most significant amendments are changes to the imputation provisions to allow taxpayers who, through an intermediary, deposit an amount in a tax pooling account with Inland Revenue to receive an imputation credit for the amount deposited. Imputation debits would arise for deposits refunded and for tax transferred within the pooling account to another taxpayer. Consequential amendments are being made which broadly are designed to ensure that taxpayers participating in a pool and receiving imputation credits when deposits are made are in no worse or better a position than the standard imputation treatment affords.

More minor amendments provide that no resident withholding tax is to be deducted on use-of-money interest paid to a pooling intermediary by the Commissioner, and that amounts paid and received by pool participants in substitution for use-of-money interest is “interest” for the purpose of withholding tax and income provisions. Finally, a change is proposed to the requirement for an intermediary to notify a pool participant that payment to the intermediary does not satisfy a taxpayer’s obligations to the Commissioner. It is sufficient for an intermediary to give a pool participant general notice of this, rather than giving notice on receipt of every payment from the pool participant.

Application date

The amendments will apply from 1 April 2003, the date on which the tax pooling provisions came into effect.

Key features

Imputation

- Section MBB 6(8), which sets out the time at which imputation credits arise for tax paid through a pooling account, is being replaced with a set of imputation provisions applicable to pool participants. Broadly, companies will receive a credit in their imputation credit account when a payment they have forwarded to an intermediary is deposited in a tax pooling account with the Commissioner (proposed new sections ME 4(1)(ad) and ME 4(1B)(a)). Debits to the imputation credit account will arise in relation to refunds from the pooling account to the company and sales of the amount deposited to another taxpayer (sections ME 5(1)(eb) and (ec) and ME 5(1B)(a) and (b)). Such debits are required so that a company still ultimately only receives imputation credits for tax paid by it, and deposits in a tax pooling account are not “tax paid” by the company for the purposes of the Act until deposits are transferred to the company’s income tax account. The new rules, which are explained in detail

later, are intended to ensure that taxpayers are neither advantaged nor disadvantaged by paying tax through a pooling account.

Other remedial amendments

- Section MBB 4(3) is being amended so that an intermediary can give general notice to a pool participant that payment to the intermediary does not satisfy the participant's obligations to the Commissioner.
- Section MBB 9, which deals solely with the deductibility of payments made between an intermediary and client that are substitutes for use-of-money interest, is being replaced with a provision that is broader in scope. Proposed new section MBB 9 clarifies that such payments are "interest", which was assumed in the tax pooling provisions as enacted. Such payments are treated as interest income to the recipient, and expenditure incurred in deriving gross income to the payer. They are also treated as interest for the purposes of the resident and non-resident withholding tax provisions (though resident withholding tax is still not deductible on interest paid to an intermediary by a client under section NF 1(2)(a)(ix)).
- Under proposed new section NF 1(2)(a)(x), the Commissioner would not deduct resident withholding tax from payments of use-of-money interest paid to a tax pooling intermediary.

Background

Under existing section MBB 6(8), taxpayers who pay tax through a pooling account get a credit in their imputation credit account (ICA) for the amount of funds transferred to their income tax account. The credit arises at the time that the Commissioner receives a request from the intermediary to transfer the funds (generally after the end of the income year when the tax liability is known). This is a disincentive to taxpayers paying tax through a pooling account because it is penal relative to the imputation treatment of those who pay tax directly to the Commissioner.

Taxpayers who pay provisional tax directly to the Commissioner receive a credit in their ICA when tax is paid and they can attach these credits to dividends paid out in that imputation year. Taxpayers who instead pay provisional tax through a pooling account receive a credit only after the end of the imputation year, when tax is allocated from the pool to their income tax account. Credits are therefore not available for distribution in the year the provisional tax is paid.

Even if the standard imputation treatment were to apply to pool participants, problems would arise. Under that treatment, companies would not get any credit in their ICAs until after the end of the income year, when their tax liability is established and tax is allocated from the pooling account to their income tax account. However, unlike the existing treatment under section MBB 6(8), the credits would arise retrospectively, as at the date the tax was paid (generally provisional tax dates in the previous imputation year). If the company wanted to pay out imputation credits in that year for tax it expected to have retrospectively credited to its ICA, it would still have an imputation

debit at 31 March, which requires payments of further income tax and penalty tax by 21 June. The various options to deal with this (such as ignoring the further income tax obligation, or paying the further income tax and obtaining a refund when the credits have retrospectively arisen, or transferring sufficient funds from the pool to the income tax account at 31 March to cover credits distributed) are all unsatisfactory.

A new set of imputation provisions has therefore been designed to apply to pool participants. The new rules are not intended to confer an advantage on pool participants, but are intended to remove the disincentive discussed earlier and match, so far as possible, the imputation treatment afforded to companies that pay tax directly to the Commissioner.

Detailed analysis

Companies will receive a credit in their ICA when funds they forward to an intermediary are deposited into a tax pooling account. Companies that are cautious and pay more into the pooling account than their tax liability can be penalised by this treatment if there is a breach of continuity. On the breach, they could lose more credits than they would have lost if credits had only arisen for tax paid. There are therefore two sets of rules – a basic set for those companies that do not expect a breach of continuity or that pay out their imputation credits to shareholders before any such breach. There is a second optional set of provisions for companies that would generally pay funds into the pool in excess of their tax liability and that are concerned about losing all those credits on a breach. Companies that elect to apply these provisions are, under section ME 3B, “pooling credit recorders”. These two sets of rules are discussed separately below.

Basic rules – companies that are not “pooling credit recorders”

Credits for deposits into pooling account

A company that is not a pooling credit recorder receives a credit in its imputation credit account for amounts that it has paid to an intermediary and that are deposited in a tax pooling account with the Commissioner (section ME 4(1)(ad)). The credit arises on the date the funds are paid into the tax pooling account (section ME 4(2)(ad)). The intermediary will notify the taxpayer of that date.

No imputation credit arises if and when those funds deposited into the tax pooling account are transferred to the company’s income tax account (section ME 4(1)(a)(x)).

Refunds from pooling account

If all or part of those funds in the tax pooling account are refunded to the intermediary instead of being transferred to the company’s income tax account, a debit arises to the ICA equal to the amount of the refund (section ME 5(1)(eb)).

The time at which the debit arises depends on the balance in the company’s ICA (section ME 5(2)(eb)). If the amount of the refund is less than or equal to the balance in the ICA at the date of the refund or at the end of the previous imputation year, the debit arises on the date of the refund. If the refund exceeds the balance at those dates, the debit arises at the end of the previous imputation year.

This timing rule is intended to achieve the same purpose as the restrictions on refunds of tax under section MD 2. That section prevents companies obtaining refunds of tax when they have already distributed imputation credits for that tax to their shareholders. In the case of refunds of amounts held in pooling accounts for which companies have received an imputation credit, it is not feasible for the Commissioner to withhold the refund as he does not know to whom the refund relates. (The funds could have been transferred from the original contributor to another taxpayer.) Instead, the timing rule is intended to act as a disincentive for taxpayers to pay funds into a pooling account, distribute the credits to shareholders and then seek a refund of that amount from the pooling account. A debit arising as at the previous 31 March will trigger further income tax and imputation penalty tax obligations. *It is therefore critical for taxpayers seeking refunds from the pool that they check the balance in their ICA at the relevant dates.*

Note that, when there are insufficient funds in the ICA at the relevant dates, a debit will arise of the whole amount of the refund on the previous 31 March. There is no apportionment of the debit between the date of refund and the previous 31 March because such apportionment does not work (for example, where there is a \$30,000 refund and only \$20,000 in the ICA at the relevant dates).

When the company obtaining the refund is a qualifying company, the date on which the debit arises is always the date of the refund. This is because the restrictions in section MD 2 do not generally apply to qualifying companies (section MD 2(7)).

Transfers to other taxpayers

If a taxpayer does not require funds that are held for its benefit in the tax pooling account and sells the funds to the intermediary for on-sale to another taxpayer, a debit will arise in its ICA (section ME 5(1)(ec)). As with refunds from the pooling account, the timing of the debit depends on the balance in the ICA on the date on which the transfer is made in the books of the intermediary (that is, the date on which the funds are sold) and the balance as at the previous 31 March (section ME 5(2)(eb)). Refunds and transfers to another taxpayer are treated in the same way and the discussion above in relation to the timing of debits for refunds applies equally to transfers. *It is critical to check the ICA balance at the relevant dates when transferring funds held in a pooling account to another taxpayer.*

For the purchaser of such funds who is also not a pooling credit recorder, a credit equal to the funds transferred will arise in the ICA under section ME 4(1)(ae). The credit arises on the date on which the transfer is made in the intermediary's books (ME 4(2)(ae)).

Breach of continuity

On a breach of shareholder continuity, the credits that have arisen in the ICA from deposits in a pooling account are lost under the general rule in section ME 5(1)(i).

Consolidated groups

The imputation treatment described earlier applies in the same way to payments made by a consolidated group into a pooling account. Equivalent amendments are being made to sections ME 10-ME 13.

Examples

Examples 1 to 5 illustrate the operation of the provisions for taxpayers who are not pooling credit recorders.

Examples 1-5: Companies that are not pooling credit recorders

Example 1 – standard case

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Credit arises to A Co's ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 7/11/03 Ditto
- 7/3/04 Ditto
- 31/8/04 After year end, A Co's residual income tax (RIT) is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co's ICA on this transfer – (ME 4(1)(a)(x)).
- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the \$30k – it ceases to be held for A Co and is held for B Co. A debit of \$30k arises to A Co's ICA (ME 5(1)(ec)). As the amount of the \$30k transfer does not exceed the credits in A Co's ICA at the end of the previous imputation year (31/3/04), the debit arises on 1/9/04 (ME 5(2)(eb)(i)). A credit for \$30k arises to B Co's ICA on 1/9/04 (ME 4(1)(ae) and ME 4(2)(ae)).

A Co's ICA			
	Cr	Dr	Bal
7/7/03	\$50k		\$50k
7/11/03	\$50k		\$100k
7/3/04	\$50k		\$150k
31/3/04			\$150k
1/9/04		\$30k	\$120k

Example 2 – insufficient credits in A Co’s ICA at end of previous imputation year

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Credit arises to A Co’s ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 7/11/03 Ditto
- 7/3/04 Ditto
- 20/3/04 A Co attaches \$150k credits to dividends paid to shareholders.
- 7/7/04 A Co pays \$40k to the intermediary, who deposits it into the tax pooling account. Credit arises to A Co’s ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 31/8/04 After year end, A Co’s RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co’s tax account as at 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co’s ICA for these transfers – ME 4(1)(a)(x)).
- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary’s books of the \$30k – it ceases to be held for A Co and is held for B Co. A debit of \$30k arises to A Co’s ICA (ME 5(1)(ec)). The amount of the \$30k transfer exceeds the credits in A Co’s ICA at the end of the previous imputation year (31/3/04), but A Co’s credit balance at 1/9/04 is \$40k. Since there are sufficient credits at that date, the debit arises on 1/9/04 (ME 5(2)(eb)(i)). A credit for \$30k arises to B Co’s ICA on 1/9/04 (ME 4(1)(ae) and ME 4(2)(ae)).

A Co’s ICA			
	Cr	Dr	Bal
7/7/03	\$50k		\$50k
7/11/03	\$50k		\$100k
7/3/04	\$50k		\$150k
20/3/04		\$150k	
31/3/04			\$0k
7/7/04	\$40k		\$40k
1/9/04		\$30k	\$10k

Example 3 – insufficient credits in A Co’s ICA at end of previous imputation year and date of transfer to another taxpayer

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Credit arises to A Co’s ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 7/11/03 Ditto
- 7/3/04 Ditto
- 20/3/04 A Co attaches \$150k credits to dividends paid to shareholders.
- 7/7/04 A Co pays \$20k to the intermediary, who deposits it into the pooling account. Credits arise to A Co’s ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 31/8/04 After year end, A Co’s RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co’s tax account as at each of 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co’s ICA for these transfers (ME 4(1)(a)(x)).
- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary’s books of the \$30k – it ceases to be held for A Co and is held for B Co. A debit of \$30k arises to A Co’s ICA (ME 5(1)(ec)). The amount of the \$30k transfer exceeds the credits in A Co’s ICA at the end of the previous imputation year (balance = \$0), and at the date of the transfer (balance = \$20k). A debit of \$30k therefore arises as at the previous 31 March (ME 5(2)(eb)(ii)). This will trigger imputation penalties and a requirement to pay further income tax. A credit for \$30k arises to B Co’s ICA on 1/9/04 (ME 4(1)(ae) and ME 4(2)(ae)).

A Co’s ICA			
	Cr	Dr	Bal
7/7/03	\$50k		\$50k
7/11/03	\$50k		\$100k
7/3/04	\$50k		\$150k
20/3/04		\$150k	
31/3/04			\$0k
<i>31/3/04 [retro adjustment] \$30k</i>			<i>-\$30k</i>
7/7/04	\$20k		-\$10k

Example 4 – standard case with breach of continuity debit

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Credit arises to A Co's ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 7/11/03 Ditto
- 15/12/03 Breach of shareholder continuity – debit to ICA of \$100k (existing ME 5(1)(i)).
- 7/3/04 A Co pays \$50k to intermediary. Credit arises in ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 31/8/04 After year end, A Co's RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co's ICA for these transfers (ME 4(1)(a)(x)).
- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the \$30k – it ceases to be held for A Co and is held for B Co. A debit of \$30k arises to A Co's ICA (ME 5(1)(ec)). As the amount of the \$30k transfer does not exceed the credits in A Co's ICA at the end of the previous imputation year (balance = \$50k), the debit arises on 1/9/04 (ME 5(2)(eb)(i)). A credit for \$30k arises to B Co's ICA on 1/9/04 (ME 4(1)(ae) and ME 4(2)(ae)).

The problem with this outcome is that, if A Co had paid the \$100k pre-breach tax directly to the Commissioner, rather than through a pool, it would (as a result of sections ME 5(1)(i) and ME 5(1)(e)(iii)) have, in substance, lost only \$80k in ICA credits on the breach. (It would receive a refund of \$30k, giving rise to an imputation debit of only \$10k which leaves \$40k to be passed on to shareholders.) Because A Co has paid tax through the pool and not elected to be a pool account recorder, it has only \$20k ICA credits, rather than \$40k, to pass on to shareholders.

A Co can avoid this outcome by electing to be a pooling credit recorder (see examples 6 to 12).

A Co's ICA			
	Cr	Dr	Bal
7/7/03	\$50k		\$50k
7/11/03	\$50k		\$100k
15/12/03		\$100k	\$0
7/3/04	\$50k		\$50k
31/3/04			\$50k
1/9/04		\$30k	\$20k

Example 5 – standard case with clear-out of ICA before breach of continuity debit

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Credit arises to A Co's ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 7/11/03 Ditto
- 14/12/03 Imputation credit balance of \$100k attached to dividends.
- 15/12/03 Breach of shareholder continuity – no debit arises.
- 7/3/04 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Credit arises in ICA (ME 4(1)(ad) and ME 4(2)(ad)).
- 31/8/04 After year end, A Co's RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co's ICA for these transfers (ME 4(1)(a)(x)).
- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the \$30k – it ceases to be held for A Co and is held for B Co. A debit of \$30k arises to A Co's ICA (ME 5(1)(ec)). As the amount of the \$30k transfer does not exceed the credits in A Co's ICA at the end of the previous imputation year (balance = \$50k), the debit arises on 1/9/04 (ME 5(2)(eb)(i)). A credit for \$30k arises to B Co's ICA on 1/9/04 (ME 4(1)(ae) and ME 4(2)(ae)).

A Co's ICA			
	Cr	Dr	Bal
7/7/03	\$50k		\$50k
7/11/03	\$50k		\$100k
14/12/03		\$100k	\$0k
7/3/04	\$50k		\$50k
31/3/04			\$50k
1/9/04		\$30k	\$20k

In this example, shareholders have access to credits for all \$120k of tax paid by the company. If a company was sufficiently certain that there was no likelihood of breach of shareholder continuity, or that imputation credits could be paid out before any breach, it could elect not to differentiate between pooling imputation credits and ordinary credits.

When the tax liability of a company exceeds the funds contributed by the company into a pooling account and the company purchases tax from another taxpayer, and there is a breach of continuity before the purchase, the company will, of course, retain the benefit of credits for the funds purchased (because those credits arise on the date on which the funds are purchased).

Companies that are pooling credit recorders

Companies that tend to pay more funds into the pool than their tax liability, and that may have a breach of continuity without paying out all the credits to shareholders before the breach, may wish to elect into rules that are intended to better reflect the existing imputation rules applying on breach of continuity while still allowing credits to arise on deposits into a tax pooling account. Under those rules, undistributed credits for tax paid before the breach will be lost.

The rules distinguish between credits and debits that relate to funds in a pooling account with the Commissioner (“pooling imputation credits” and “pooling imputation debits”) and other types of credits and debits. Pooling imputation credits can be treated in exactly the same way as ordinary credits – for example, they can be distributed to shareholders. The only difference is that they are not lost on a breach of continuity. (See the proposed amendment to section ME 5(1)(i).) Instead, pooling credits are converted into ordinary credits when tax is allocated from the pooling account to the company’s income tax account. This ensures that only credits relating to tax paid before the breach are lost.

A company that wishes to apply these rules, and distinguish between pooling debits and credits and other debits and credits, is known as a “pooling credit recorder” (section ME 3B).

Credits for deposits into pooling account

A pooling credit recorder receives an imputation credit for funds paid to an intermediary that are deposited into a tax pooling account with the Commissioner (section ME 4(1B)(a)). The credit arises on the date the funds are paid by the intermediary into the tax pooling account (section ME (2B)(a)).

Transfer from pooling account to company’s income tax account

When a company (through the intermediary) arranges for the transfer of an amount from the tax pooling account to its income tax account, offsetting ordinary credits and pooling imputation debits for the amount of the transfer arise to its ICA. An ordinary credit will arise for the amount transferred (section ME 4(1)(ac)) on the effective date of the transfer (section ME 4(2)(ac)), and a pooling imputation debit will arise for the amount transferred (section ME 5(1B)(c)) on the effective date of the transfer (section ME 5(2B)(b)).

Refunds from the pooling account

If all or part of the funds in the tax pooling account that were contributed by the company are refunded to the intermediary instead of being transferred to the company’s income tax account, a pooling debit arises to the ICA equal to the amount of the refund (ME 5(1B)(a)). The timing of the debit is determined under section ME 5(2B)(a) and depends on the balance in the ICA as at the date of the refund or the end of the last imputation year. Section ME 5(2B)(a) is in the same terms as the equivalent provision applying to non-pooling credit recorders (section ME 5(2)(eb)), and therefore the discussion on the timing of the debit for refunds for non-pooling credit recorders applies equally to pooling credit recorders.

Transfers to other taxpayers

If a taxpayer does not require funds that are held for its benefit in the tax pooling account and sells the funds to the intermediary for on-sale to another taxpayer, a debit will arise in its ICA (section ME 5(1B)(b)). As with refunds from the pooling account, the timing of the debit depends on the balance in the ICA on the date on which the transfer is made in the books of the intermediary (that is, the date on which the funds are sold) and the balance as at the previous 31 March (section ME 5(2B)(a)). Transfers to another taxpayer are treated in the same way as refunds, so the discussion earlier on the timing of debits for refunds applies equally to transfers.

For the purchaser of such funds who is a pooling credit recorder, a credit equal to the funds transferred will arise in the ICA under section ME 4(1B)(b). The credit arises on the date on which the transfer is made in the intermediary's books (that is, the date on which the funds are purchased) under section ME 4(2B)(b).

Consolidated groups

Consolidated groups can also elect to be pooling imputation credit recorders. Equivalent amendments to those previously discussed have been inserted into sections ME 10 to ME 13.

Examples

Examples 6 to 12 illustrate the operation of the provisions for pooling credit recorders.

Examples 6 to 12: Pooling credit recorders

Example 6 – standard case

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Pooling imputation credit arises to A Co's ICA (ME 4 (1B)(a), ME 4 (2B)(a)).
- 7/11/03 Ditto
- 7/3/04 Ditto

A Co's ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03		\$50k			\$50k
7/11/03		\$50k			\$100k
7/3/04		\$50k			\$150k
31/3/04					\$150k

- 31/8/04 After year end, A Co's RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. Credits arise to A Co's ICA of \$40k (ME 4(1)(ac)) on each of 7/7, 7/11, 7/3 (ME 4(2)(ac)). Pooling imputation debits of \$40k arise to A Co's ICA (ME 5(1B)(c)) as at the effective dates 7/7, 7/11 and 7/3 (ME 5(2B)(b)).

- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the \$30k – it ceases to be held for A Co and is held for B Co. A pooling imputation debit of \$30k arises to A Co's ICA (ME 5(1B)(b)). As the amount of the \$30k transfer does not exceed the credits in A Co's ICA at the end of the previous imputation year (balance = \$150k), the debit arises on 1/9/04 (ME 5(2B)(a)(i)). A credit for \$30k arises to B Co's ICA (ME 4(1B)(b)) on 1/9/04 (ME 4(2B)(b)).

A Co's Adjusted ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03	\$40k	\$50k		\$40k	\$50k
7/11/03	\$40k	\$50k		\$40k	\$100k
7/3/04	\$40k	\$50k		\$40k	\$150k
31/3/04					\$150k
1/9/04				\$30k	\$120k

Example 7 – insufficient credits in A Co’s ICA at end of previous imputation year

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Pooling imputation credit arises to A Co’s ICA (ME 4(1B)(a), ME 4(2B)(a)).
- 7/11/03 Ditto
- 7/3/04 Ditto
- 20/3/04 A Co attaches \$150k credits to dividends paid to shareholders (debit to ICA).
- 7/7/04 A Co pays \$40k to the intermediary, who deposits it into the pooling account. A pooling imputation credit arises to A Co’s ICA (ME 4(1B)(a), ME 4(2B)(a))

A Co’s ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03		\$50k			\$50k
7/11/03		\$50k			\$100k
7/3/04		\$50k			\$150k
20/3/04			\$150k		\$0k
31/3/04					\$0k
7/7/04		\$40k			\$40k

- 31/8/04 After year end, A Co’s RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co’s tax account as at 7/7/03, 7/11/03 and 7/3/04. A credit arises to A Co’s ICA of \$40k (ME 4(1)(ac)) on each of 7/7, 7/11, 7/3 (ME 4(2)(ac)). A pooling imputation debit arises to A Co’s ICA (ME 5(1B)(c)) as at the effective dates 7/7, 7/11 and 7/3 (ME 5(2B)(b)).

- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary’s books of the \$30k – it ceases to be held for A Co and is held for B Co. A pooling imputation debit of \$30k arises to A Co’s ICA (ME 5(1B)(b)). The amount of the \$30k transfer exceeds the credits in A Co’s ICA at the end of the previous imputation year (31/3/04), but A Co’s credit balance at 1/9/04 is \$40k. Since there are sufficient credits at that date, the debit arises on 1/9/04 (ME 5(2B)(a)(i)). A credit for \$30k arises to B Co’s ICA (ME 4(1B)(b)) on 1/9/04 (ME 4(2B)(b)).

A Co’s Adjusted ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03	\$40k	\$50k		\$40k	\$50k
7/11/03	\$40k	\$50k		\$40k	\$100k
7/3/04	\$40k	\$50k		\$40k	\$150k
20/3/04			\$150k		\$0
31/3/04					\$0k
7/7/04		\$40k			\$40k
1/9/04				\$30k	\$10k

Example 8 – insufficient credits in A Co’s ICA at end of previous imputation year and date of transfer to another taxpayer

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. A pooling imputation credit arises to A Co’s ICA (ME 4(1B)(a), ME 4(2B)(a)).
- 7/11/03 Ditto
- 7/3/04 Ditto
- 20/3/04 A Co attaches \$150k credits to dividends paid to shareholders (debit to ICA under existing rules).
- 7/7/04 A Co pays \$20k to the intermediary, who deposits it into the pooling account. A pooling imputation credit arises to A Co’s ICA (ME 4(1B)(a), ME 4(2B)(a)).

A Co’s ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03		\$50k			\$50k
7/11/03		\$50k			\$100k
7/3/04		\$50k			\$150k
20/3/04			\$150k		\$0k
31/3/04					\$0k
7/7/04		\$20k			\$20k

- 31/8/04 After year end, A Co’s RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co’s tax account as at each of 7/7/03, 7/11/03 and 7/3/04. A credit arises to A Co’s ICA of \$40k (ME 4(1)(ac)) on each of 7/7, 7/11, 7/3 (ME 4(2)(ac)). Pooling imputation debits arise to A Co’s ICA (ME 5(1B)(c)) as at the effective dates 7/7, 7/11, 7/3 (ME 5(2B)(b)).

- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary’s books of the \$30k – it ceases to be held for A Co and is held for B Co. A pooling imputation debit of \$30k arises to A Co’s ICA (ME 5(1B)(b)). The amount of the \$30k transfer exceeds the credits in A Co’s ICA at the end of the previous imputation year (balance = \$0) and at the date of the transfer (balance = \$20k). A pooling imputation debit of \$30k arises at the previous 31 March, triggering imputation penalties and a requirement for payment of further income tax. A pooling imputation credit for \$30k arises to B Co’s ICA (ME 4(1B)(b)) on 1/9/04 (ME 4(2B)(b)).

A Co’s Adjusted ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03	\$40k	\$50k		\$40k	\$50k
7/11/03	\$40k	\$50k		\$40k	\$100k
7/3/04	\$40k	\$50k		\$40k	\$150k
20/3/04			\$150k		
31/3/04					\$0k
31/3/04	[retrospective adjustment – transfer]			\$30k	-\$30k
7/7/04		\$20k			-\$10k

Example 9 – standard case with breach of continuity debit – no offsetting debit before breach

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. Pooling imputation credit arises to A Co’s ICA (ME 4(1B)(a), ME 4(2B)(a)).
- 7/11/03 Ditto
- 15/12/03 Breach of shareholder continuity – A Co does not lose pooling imputation credits (new exclusion from ME 5(1)(i)).
- 7/3/04 A Co pays \$50k to the intermediary, who deposits it into the pooling account. Pooling imputation credit arises in ICA (ME 4(1B)(a) and ME 4(2B)(a)).

A Co ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03		\$50k			\$50k
7/11/03		\$50k			\$100k
7/3/04		\$50k			\$150k

- 31/8/04 After year end, A Co’s RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co’s tax account as at 7/7/03, 7/11/03 and 7/3/04.

A pooling imputation debit of \$40k, and offsetting credit, arise on 7/7/03, 7/11/03 and 7/3/04 (ME 5(1B)(c) and ME 5(2B)(b); ME 4(1)(ac) and ME 4(2)(ac)). This means that the \$80k in ordinary credits are lost on 15/12 on the breach – a retrospective debit arises to the ICA of \$80k on 15/12 (existing ME 5(1)(i)).

- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary’s books of the \$30k – it ceases to be held for A Co and is held for B Co. A pooling imputation debit of \$30k arises to A Co’s ICA (ME 5(1B)(b)). As the amount of the \$30k transfer does not exceed the credits in A Co’s ICA at the end of the previous imputation year (balance = \$70k), the imputation debit arises on 1/9/04 (ME 5(2B)(a)). A pooling imputation credit for \$30k arises to B Co’s ICA on 1/9/04 (ME 4(1B)(b) and (2B)(b)).

A Co’s ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03	\$40k	\$50k		\$40k	\$50k
7/11/03	\$40k	\$50k		\$40k	\$100k
15/12/03			80k		\$20k
7/3/04	\$40k	\$50k		\$40k	\$70k
31/3/04					\$70k
1/9/04				\$30k	\$40k

The outcome is that A Co loses only \$80k on breach of continuity and has credits of \$40k, being “tax paid” after the breach, to pass on to shareholders. The amount lost on breach of continuity is the same as that that would have applied if the taxpayer had paid the correct amount of tax directly to the Commissioner.

Example 10 – standard case with partial clear-out of ICA before breach of continuity debit

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. A pooling imputation credit arises to A Co's ICA (ME 4(1B)(a) and ME 4(2B)(a)).
- 7/11/03 Ditto
- 14/12/03 Imputation credits of \$70k are attached to dividends.
- 15/12/03 Breach of shareholder continuity – as all credits are pooling credits, no debit arises.
- 7/3/04 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. A pooling credit arises in ICA.

A Co's ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03		\$50k			\$50k
7/11/03		\$50k			\$100k
14/12/03			\$70k		\$30k
7/3/04		\$50k			\$80k

- 31/8/04 After year end, A Co's RIT is \$120,000, so the intermediary requests IRD to transfer \$40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. Pooling debits and offsetting credits for \$40k arise on 7/7, 7/11 and 7/3/04 (ME 5(1B)(c) and ME 5(2B)(b); ME 4(1)(ac) and ME 4(2)(ac)). This results in the loss of \$10k credits on breach of continuity. An amendment to section ME 5(1)(i) ensures that the offsetting pooling debits of \$40k arising as at each of 7/7 and 7/11 do not cancel out those credits.

- 1/9/04 The intermediary purchases the \$30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the \$30k – it ceases to be held for A Co and is held for B Co. A pooling imputation debit of \$30k arises to A Co's ICA. As the amount of the \$30k transfer does not exceed the credits in A Co's ICA at the end of the previous imputation year (balance = \$70k), the debit arises on 1/9/04. A credit for \$30k arises to B Co's ICA on 1/9/04.

A Co's Adjusted ICA					
	Cr	Pcr	Dr	Pdr	Bal
7/7/03	\$40k	\$50k		\$40k	\$50k
7/11/03	\$40k	\$50k		\$40k	\$100k
14/12/03			\$70k		\$30k
15/12/03			\$10k		\$20k
7/3/04	\$40k	\$50k		\$40k	\$70k
31/3/04					\$70k
1/9/04				\$30k	\$40k

This is the correct outcome. If A Co had paid the right amount of tax (\$40k at each provisional tax date) directly to the Commissioner, it would have lost \$10k on breach and would have \$110k to pay out to shareholders. In this example, it paid out \$70k of credits on 14/12 and has a balance of \$40k left to pay out.

Example 11 – A Co buys tax from intermediary to satisfy underpayment

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. A pooling imputation credit arises to A Co's ICA (ME 4(1B)(a) and ME 4(2B)(a)).
- 7/11/03 Ditto
- 14/12/03 Imputation credits of \$70k are attached to dividends.
- 7/3/04 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. A pooling credit arises in ICA.

A Co's ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03		\$50k			\$50k
7/11/03		\$50k			\$100k
14/12/03			\$70k		\$30k
7/3/04		\$50k			\$100k

- 31/8/04 After year end, A Co's RIT is \$180,000. The intermediary requests IRD to transfer \$50,000 from the pooling account to A Co's tax account as at each of 7/7/03, 7/11/03 and 7/3/04. Pooling debits, and corresponding credits, arise as at those dates (ME 5(1B)(c) and ME 5(2B)(b); ME 4(1)(ac) and ME 4(2)(ac)).
- 1/9/04 A Co purchases from the intermediary \$10k that was deposited into the pool at each of 7/7/03, 7/11/03 and 7/3/04 (\$30k is transferred in the intermediary's records to A Co's name on 1/9/04). A pooling credit of \$30k arises as at 1/9/04 in A Co's ICA (ME 4(1B)(b) and (2B)(b)). The \$10k is transferred as at each of 7/7/03, 7/11/03 and 7/3/04. Pooling imputation debits and credits arise to the ICA as at each of those dates (ME 5(1B)(c) and ME 5(2B)(b); ME 4(1)(ac) and ME 4(2)(ac)).

A Co's Adjusted ICA					
	Cr	Pcr	Dr	Pdr	Bal
7/7/03	50k+ 10k	\$50k		\$50k + 10k	\$50k
7/11/03	\$50k+10k	\$50k		\$50k + 10k	\$100k
14/12/03			\$70k		\$30k
7/3/04	\$50k + 10k	\$50k		\$50k + \$10k	\$80k
31/3/04					\$80k
1/9/04		\$30k			\$110k

If there were to be a breach of continuity on 2/9/04, A Co would lose the \$110k credits (being tax paid before the breach of \$180k less \$70k credits paid out to shareholders).

Example 12 – A Co buys tax from intermediary to satisfy underpayment and partially pays out credit balance in ICA before breach of continuity

- 7/7/03 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. A pooling imputation credit arises to A Co's ICA (ME 4(1B)(a) and ME 4(2B)(a)).
- 7/11/03 Ditto
- 14/12/03 Imputation credits of \$70k are attached to dividends.
- 15/12/03 Breach of continuity – no debit arises because credits are pooling credits.
- 7/3/04 A Co pays \$50k to the intermediary, who deposits it into the tax pooling account. A pooling credit arises in ICA.

A Co's ICA					
	Cr	PCr	Dr	PDr	Bal
7/7/03		\$50k			\$50k
7/11/03		\$50k			\$100k
14/12/03			\$70k		\$30k
7/3/04		\$50k			\$80k

- 31/8/04 After year end, A Co's RIT is \$180,000. The intermediary requests IRD to transfer \$50,000 from the pooling account to A Co's tax account as at each of 7/7/03, 7/11/03 and 7/3/04. Credits and pooling debits arise for \$50k at each of the transfer dates. This means that \$30k is lost on breach of continuity.

A Co's Adjusted ICA					
	Cr	Pcr	Dr	Pdr	Bal
7/7/03	\$50k	\$50k		\$50k	\$50k
7/11/03	\$50k	\$50k		\$50k	\$100k
14/12/03			\$70k		\$30k
15/12/03			\$30k		\$0k
7/3/03	\$50k	\$50k		\$50k	
31/3/03					\$50k

- 1/9/04 A Co purchases from the intermediary \$10k that was deposited into the pool at each of 7/7/03, 7/11/03 and 7/3/04. (\$30k is transferred in the intermediary's records to A Co's name on 1/9/04.) A pooling credit of \$30k arises as at 1/9/04 in A Co's ICA (ME 4(1B)(b) and (2B)(b)).

\$10k is transferred from the pooling account to A Co's income tax account as at each of 7/7/03, 7/11/03 and 7/3/04. Credits and pooling debits for \$10k arise as at these dates. This gives rise to a further debit of \$20k on breach of continuity, which leaves the ICA in debit at that date (see below).

A Co's Readjusted ICA					
	Cr	Pcr	Dr	Pdr	Bal
7/7/03	\$50k + \$10k	\$50k		\$50k + \$10k	\$50k
7/11/03	\$50k + \$10k	\$50k		\$50k + \$10k	\$100k
14/12/03			\$70k		\$30k
15/12/03			\$30k + \$20k		\$-20k
7/3/04	\$50k + \$10k	\$50k		\$50k + \$10k	
31/3/04					\$30k
1/9/04		\$30k			\$60k

This is the intended result. A Co has paid tax of \$180k – \$120k before the breach and \$60k after the breach. It paid out \$70k in credits before the breach. Therefore it loses \$50k on the breach, and retains the \$60k to pay out after the breach.

FURTHER INCOME TAX

(Clauses 31, 36, 43 and 99)

Summary of proposed amendments

Amendments provide relief from double taxation and extra penalties in relation to further income tax liabilities which arise when imputation credit accounts are over-drawn.

In certain circumstance payments of further income tax may be used to offset income tax liabilities, and income tax payments may be used to offset further income tax liabilities. Relief from use-of-money interest and late payment penalties will be available where further income tax and income tax liabilities are outstanding at the same time.

Application date

The amendments will apply from the date of enactment, but a window of two calendar months from enactment is being allowed for taxpayers to request retrospective adjustments to further income tax liabilities incurred since the 1998-99 income year.

Key features

Section ME 9(5) of the Income Tax Act 1994 is being replaced by two new subsections, MB 9(5B) and (5C). New subsection (5B) provides that payments of further income tax may be credited to an income liability (including provisional tax) that arises at any time when the company is an imputation credit account company.

Likewise, new subsection (5C) provides that payments of income tax may be credited against the further income tax liability, as long as the payment was made after 31 March in the year when the imputation credit account debit caused the further income tax liability.

In both cases a company will need to specify the amount to be credited.

Offsetting further income tax liabilities and income tax liabilities in this way will make the tax system fairer and ensure that a taxpayer is not penalised twice for what can effectively be one default in payment.

New section 181B of the Tax Administration Act 1994 provides for the remission of use-of-money interest and late payment penalties on further income tax liabilities when income tax liabilities are outstanding at the same time. The remission will apply to the extent that the amount of further income tax charged is equal to or less than the amount of the unpaid income tax liability.

An amendment to section MB 9 ensures that set-offs of overpaid tax between companies in a wholly owned group will be subject to section MD 2. That is, such setoffs will not be allowed if they create a debit balance in a company's imputation credit account. This is consistent with the new transfer rules in Subpart XB of the Tax Administration Act because the rules apply only if excess tax is refundable. The amendment to section MB 9 is necessary to ensure that group company set-offs do not have inappropriate results under the remission provisions.

Background

Further income tax is charged when a company has a debit in its imputation credit account at 31 March in any year. The amount charged is equal to the debit balance in the imputation credit account and is due and payable on 20 June. Currently, section ME 9(5) of the Income Tax Act 1994 provides that any payments of further income tax can be credited to an income tax liability, as well as further income tax, but only to an income tax liability that arose after the date of payment. This can produce inappropriate results, as shown in examples 1 and 2.

Example 1

Company Z pays first and second instalments of provisional tax for the 2003 income year of \$110,000 each (total amount paid: \$220,000).

In December 2002 it declares a dividend and, in anticipation of a third instalment of provisional tax of \$110,000 (making total provisional tax payments of \$330,000), allocates imputation credits of \$330,000.

However, the third instalment of provisional tax due on 7 March 2003 is overlooked and is not paid until 7 April 2003. As a result, Company Z's imputation credit account has a debit balance of \$110,000 at 31 March 2003.

This triggers a liability for further income tax of \$110,000 plus imputation penalty tax due on 20 June 2003, despite the fact that the imputation credit account was balanced on 7 April 2003 by the late payment of \$110,000. Alternatively, if that payment had been designated to further income tax, the effect of section ME 9(5) would have been that it would not have been available to meet the outstanding provisional tax instalment.

Although Company Z has paid the third instalment, and the imputation credit account is now clear, it still owes further income tax of \$110,000 plus interest and penalties. This effectively amounts to double taxation because Company Z's only default was in respect to the provisional tax payment.

Detailed analysis

Under the new rules, Company Z in example 1 will be able to specify that the payment of \$110,000 made on 7 April 2003 is also credited to the further income tax liability due on 20 June 2003. This will extinguish the further income tax liability, but not the imputation penalty tax, which will need to be paid separately. As no further income tax is outstanding at 20 June 2003, there is no need to apply the new section 181B of the Tax Administration Act.

Example 2 shows how the relief provisions will operate in relation to use-of-money interest and late payment penalties.

Example 2

Company A pays first and second instalments of provisional tax for the 2003 income year of \$10,000 each (total amount paid: \$20,000).

In December 2002 it declares a dividend and, in anticipation of a third instalment of provisional tax of \$10,000 (making total provisional tax payments of \$30,000), allocates imputation credits of \$30,000.

However, the third instalment of provisional tax due on 7 March 2003 is overlooked and is not paid until 7 July 2003. As a result, Company A's imputation credit account has a debit balance of \$10,000 at 31 March 2003.

This triggers a liability for further income tax of \$10,000 due on 20 June 2003.

Under section ME 9(5B), Company A in example 2 will be able to specify that the payment made on 7 July 2003 should be credited to the further income tax liability (as well as the third instalment of 2003 provisional tax). This will extinguish the further income tax liability, but not the use-of-money interest and late payment penalties relating to further income tax for the period from 20 June 2003 to 7 July 2003, nor the imputation penalty tax.

As at 20 June 2003, Company A was liable to pay further income tax under section ME 9(1) and was also subject to late payment penalties in relation to the third instalment of 2003 provisional tax that was paid late. The use-of-money interest and late payment penalties effectively apply to the same default, the late payment of the third instalment of provisional tax. Therefore section 181B of the Tax Administration Act provides relief. Company A can apply for relief from use-of-money interest and late payment penalties charged on the further income tax. Imputation penalty tax will still need to be paid.

As far as late payment penalties are concerned, Company A incurred late payment penalties on outstanding income tax (the third provisional tax instalment) as follows:

8 March 2003 (1% initial penalty)	\$100
14 March 2003 (4% initial penalty)	\$404
8 April 2003 (1% incremental penalty)	\$105

and so on until it was paid.

In relation to the further income tax liability, Company A incurred late payment penalties of:

21 June 2003 (1% initial penalty)	\$100
27 June 2003 (4% initial penalty)	\$404

As the late payment penalty on the outstanding income tax liability is greater than that charged on the outstanding further income tax liability, the late payment penalty on the further income tax can be remitted in full.

Similar analysis applies to the interest running on both accounts.

BRANCH EQUIVALENT TAX ACCOUNTS AND FOREIGN LOSSES

(Clauses 51-54)

Summary of proposed amendments

The branch equivalent tax account rules are being amended to clarify that attributed foreign losses and foreign investment fund losses cannot create branch equivalent tax account credits. This is a revenue protection measure intended to prevent the inappropriate generation of tax credits.

Application dates

The amendments will apply from 1 April 1995 except when a taxpayer has a filed an income tax return based on the current law before the date of introduction of the bill, when it shall apply from that date.

Key features

Sections MF 4(1)(b) and MF 8(2)(b) of the Income Tax Act 1994 are being amended to ensure that the term “available net losses” excludes attributed foreign net losses and foreign investment fund net losses.

Background

The branch equivalent tax account rules aim to prevent double taxation of foreign income that is subject to income tax under controlled foreign company or foreign investment fund rules, as well as subject to foreign dividend withholding payment on foreign dividends received. The intention is that regardless of which income stream occurs first, tax will only be paid once.

The branch equivalent tax account mechanism provides that if income tax has been paid first, a branch equivalent tax account credit arises which offsets the liability to foreign dividend withholding payment. Alternatively, if a dividend had been paid in advance of the income being earned in the controlled foreign company, with foreign dividend withholding payment being paid first, a branch equivalent tax account debit arises which offsets the liability to income tax.

A branch equivalent tax account credit can also be created when losses from New Zealand sources have been offset against attributed foreign income, so no liability to income tax arises.

The intention was always that only losses from New Zealand sources could create branch equivalent tax account credits. However the re-ordering of the Income Tax Act in 1994 and the subsequent changes, made with the introduction of the Act’s new core provisions in 1997, have made that unclear.

Upon reordering of the Act all losses, both New Zealand and foreign, were grouped together under Part I. As a branch equivalent tax account credit could be created when “any loss” offset a company’s attributed foreign income of the company, this regrouping of losses made it less clear that branch equivalent tax account credits could only be created with New Zealand losses. The changes also apply to the Act as it was before the introduction of the new core provisions and clarify that any loss other than attributed foreign losses or foreign investment fund losses can create a branch equivalent tax account credit.

The changes under core provisions allowed “available net losses” to create branch equivalent tax account credits. “Available net losses” are defined under section OB 1 as losses offset under part I which include attributed foreign net losses and foreign investment fund net losses. As allowing attributed foreign net losses and foreign investment fund net losses to create branch equivalent tax account credits is contrary to the original policy intent, amendments are being made to exclude them with effect from the introduction of the core provisions.

APPLICATION DATE OF NEW TAX CODES

(Clause 55(3))

Summary of proposed amendment

An amendment clarifies that a new tax code should apply from the start of the pay period in which it is received by an employer, instead of the succeeding one. This rule would apply only where the new tax code was received by the employer before the payroll preparation date for that pay period. The amendment will reduce compliance costs and increase the accuracy of the PAYE system.

Application date

The amendment will apply to pay periods ending on or after 1 April 2004.

Key features

Section NC 8(4) of the Income Tax Act is being amended to provide that a new tax code can apply for the current pay period where the code is delivered prior to the cut off point for the preparation of the pay.

Background

The amount of tax deducted from salary and wages depends upon the tax code that the employee supplies to the employer. When employees' circumstances change – for example, when they become liable for student loan repayments or take on a second job, they can elect a new tax deduction code.

At present, a new tax code applies from the start of the pay period after the one in which it is provided to the employer. This can cause confusion as many employers are actually applying new tax codes to the current period in which they are received. Applying new tax codes in this way increases the accuracy of the PAYE deduction system.

The amendment will reduce compliance costs for employers in that they will not have to remember to apply the new code with effect from the following pay period. The amendment also improves the accuracy of the PAYE deduction system and therefore requires fewer salary and wage earners to file returns or request income statements.

PROGRESSIVE RATES OF SPECIFIED SUPERANNUATION CONTRIBUTION WITHHOLDING TAX

(Clauses 57, 58 and 59)

Summary of proposed amendments

The bill introduces progressive rates for SSCWT (specified superannuation contribution withholding tax) that will allow for the appropriate taxation of employer contributions to employer-based superannuation funds for employees earning \$38,000 or less. If an employer chooses to use the progressive rate system, the rate of SSCWT on behalf of each employee will be based on the sum of annual salary or wages and superannuation contribution received by the employee in the previous year. The SSCWT rate for contributions on behalf of employees with salary or wages and superannuation contributions totalling \$38,000 or less will be 21%, and for employees with salary or wages and superannuation contributions totalling more than \$38,000 it will be 33%.

The measure is intended to reduce the over-taxation of the retirement savings of low-income people.

Application date

The amendments will apply to employer contributions made after 1 April 2004.

Key features

A new section NE 2AB of the Income Tax Act 1994 will be introduced to allow for the application of progressive rates of SSCWT.

The 21% rate will be voluntary and at the discretion of employers. If employers choose not to offer it, a flat rate of 33% will be applied.

For employers who choose to use the rates, a rate will be determined for each employee at the beginning of the standard tax year, which is 1 April. The rate will be set by the employer or fund manager (depending on the administrative features of the fund) with reference to the employee's annual salary/wages and superannuation contributions in the previous standard tax year (1 April to 31 March). When employees have not worked for the previous year, an annualised estimate based on the salary or wages and superannuation contributions they have received or will receive will be used.

The progressive SSCWT rate will apply for the full year, and no adjustment will be required if salary or wages and/or contributions change during the income year to which the rate applies. However, if an employee's salary or wages and superannuation contributions do change, a new rate will be set the following year based on this change.

For example, if an employer elected to use the progressive SSCWT rates, the employer or fund manager would determine the progressive SSCWT rate on the combined salary or wages and employer's superannuation contributions paid to the employee in the previous tax year. If the combined total was over \$38,000 the rate would be 33% and if under this threshold the rate would be 21%. Therefore, if an employee's annual salary was \$32,000 and superannuation contributions were \$2,000, the marginal income rate on salary of \$34,000 is 21%, so the rate of SSCWT on the contributions would be 21%.

Background

Contributions by employers to superannuation funds on behalf of their employees are generally subject to SSCWT at a flat rate of 33 percent. The 33% rate over-taxes employees earning less than \$38,000 and under-taxes those earning more than \$60,000.

In last year's Budget the government announced that it intended to introduce, by 1 April 2004, legislation to deal with the over-taxation of employer contributions for employees earning under \$38,000. Officials then consulted with sector representatives and employers on three options, receiving a number of written and oral submissions. The main concerns arising from consultation were compliance costs and potential for salary re-characterisation.

Although the chosen option could be said to be marginally more complex than others consulted on, and impose additional compliance cost as a result of including the employee's superannuation contribution as part of the rate calculation, it provides a basis for the SSCWT rate calculation that is less likely to be manipulated and therefore avoids the re-characterisation problem.

INCOME TAX RATES

(Clause 3)

Summary of proposed amendments

The bill confirms the annual income tax rates that will apply for the 2003-2004 income year.

The annual rates to be confirmed are the same rates that applied for the 2002-2003 income year.

Application date

The amendment will apply for the 2003-2004 income year.

Key features

The rates listed in Schedule 1 of the Income Tax Act 1994 will be confirmed for the 2003-2004 income year.

Background

The Income Tax Act 1994 provides for the rates of income tax specified in the First Schedule of the Act to be confirmed each year.

EXTENDING NON-FILING OF INCOME TAX RETURNS

(Clauses 78(6), 78(9) and 84)

Summary of proposed amendment

An amendment removes the requirement for most IR 56 taxpayers, which include private domestic workers, staff of foreign consulates and embassies, New Zealand based representatives of foreign companies and Operation Deep Freeze personnel, to file end-of-year income tax returns. They will instead be issued with an income statement for the year.

Application date

The amendment will apply from the 2003-04 income year.

Key features

Section 33A(2)(h) of the Tax Administration Act 1994 is being repealed and section 80D(1) amended to remove the requirement for most IR 56 taxpayers to file IR 3 returns.

Background

Private domestic workers (such as home helpers, attendant caregivers, nannies and gardeners) and other IR 56 taxpayers are required to return tax on income from employment, under the PAYE rules, as if they were the employer. They are also required to file an end-of-year income tax return (an IR 3) to reconcile the PAYE deductions made throughout the year (as well as any other income and tax paid).

The requirement for IR 56 taxpayers to file an IR 3 return is based largely on past ACC obligations, when levies payable were calculated on the return. From the 2002 income year, however, the calculation of ACC levies is administered by the Accident Compensation Corporation. Consequently, this key reason for requiring most IR 56 taxpayers to file an end-of-year return is no longer valid. An income statement (or personal tax summary) is sufficient for these taxpayers. IR 56 taxpayers will still be required to file a return only if they have income, in a year, other than from employment (and interest or dividends).

HOME-BASED SERVICES

(Clauses 7, 66(26), 66(28), 74, 79 and 86)

Summary of proposed amendments

Provisions are being introduced to empower the Commissioner of Inland Revenue to determine standard costs for services such as home-based childcare. The Commissioner will also be able to exempt from income tax specified taxpayers in recognition of the need for practicality and the minimisation of compliance costs, while providing a consistent framework for taxation in the industry.

This measure is aimed at helping taxpayers providing services such as home-based childcare, whose tax obligations are often disproportionate to the level of net tax paid. This amendment is intended to reduce or remove these compliance costs, depending on the disparity involved.

Application date

The amendment will apply from the date of enactment.

Key features

A new section, 91AA, is being inserted into the Tax Administration Act 1994, and consequential amendments are being made to both that Act and the Income Tax Act 1994 as follows:

- Section 91AA(1) and (2) of the Tax Administration Act 1994 allows the Commissioner to determine standard costs for specified home-based services.
- Section 91AA(3) of the Tax Administration Act 1994 allows individuals to use these standard costs in lieu of actual costs, thus significantly reducing industry compliance costs.
- New section 33B of the Tax Administration Act 1994 removes the requirement to file a return for those who have income below the standard costs, removing all compliance costs. However, the right to file an income tax return is retained, if desired, in which case either actual costs or the standard costs can be used. Under section ID 1(2) of the Income Tax Act 1994, no losses are allowed if standard costs are used.
- Sections 91AA(2)(a) of the Tax Administration Act 1994 and CB 9(h) of the Income Tax Act 1994 allow the Commissioner to determine that income earned by certain taxpayers providing home based services is not taxable on the basis that the compliance costs of calculating and paying any tax owed exceed the benefits of the tax payment.

Background

The current treatment of taxpayers who provide services based on the use of their home, such as the home-based childcare industry, or those providing board can result in some taxpayers with relatively low income incurring high compliance costs. This measure addresses the concern by allowing the Commissioner to exempt income in certain circumstances, and taxpayers to use standard costs in others.

SHORTFALL PENALTIES AND LOSS ATTRIBUTING QUALIFYING COMPANIES

(Clause 95)

Summary of proposed amendment

An amendment provides relief when a loss attributing qualifying company's net loss has been overstated, causing a tax shortfall to both the company and its shareholders. Under current law, both the company and its shareholders can be subject to shortfall penalties in these circumstances.

Application date

The amendment will apply retrospectively to shortfall penalties imposed since 1 April 1998, in accordance with the four-year time bar for reassessments.

Key features

New section 141FC of the Tax Administration Act 1994 deals with the situation where, as a consequence of the attribution of a net loss by a loss attributing qualifying company and the subsequent disallowance of deductions to the company and, therefore, the shareholders as well, shortfall penalties are charged to both the company and the shareholders. In these circumstances the shareholder will be able to apply for a reduction in the penalty when the shortfall penalty charged to the company has been paid in full.

The reduction will be limited to the shareholder's pro rata proportion of the company's shortfall penalty. For the purposes of the apportionment, the shareholder's shares will be limited to those owned by the shareholder during the whole period from the start of the year of the offence to the date the penalty was imposed.

Example

LAQC Ltd is charged a shortfall penalty of \$20,000, which it pays in full.

A owns 20 of the 100 shares in LAQC Ltd (20%) for the whole of the period from the year of offence to the date the penalty was imposed. A is charged a shortfall penalty of \$800.

A seeks an offset. The equivalent of A's share of LAQC Ltd's shortfall penalty is \$4,000 ($\$20,000 \times 20\%$). As the penalty charged to A is less than \$4,000, and A owned the shares for the whole of the period from the start of the year of the offence to the date the penalty was imposed, A's shortfall penalty will be offset.

Background

Net losses of loss attributing qualifying companies are attributed to shareholders. The High Court (*Chapman v CIR* (HC M402-SD02)) has recently held that where a loss has been overstated, causing a tax shortfall to both the company and the shareholders, shortfall penalties can be imposed on both the company and shareholders because they have taken separate tax positions. This decision is under appeal.

Conceptually, only one penalty is appropriate in these circumstances. By providing relief to the shareholder, the offset mechanism recognises that penalties can be difficult to collect from a company that may no longer be a qualifying company, or is insolvent.

The design of the offset mechanism also ensures that the amendment will not affect the arguments the Court of Appeal will be asked to decide in the *Chapman* case.

STUDENT LOAN REPAYMENT DEDUCTIONS

(Clauses 55(1) & (5), 126, 127, 128, 129 and 130(2) & (4))

Summary of proposed amendment

An amendment allows Inland Revenue to instruct an employer to make the correct student loan repayment deductions from a borrower's salary or wages.

Application date

The amendment will apply from pay periods ending on and after the date of enactment.

Key features

Currently, Inland Revenue has the power to instruct an employer to change an employee's income tax code to ensure that the correct amount of tax is deducted. This amendment creates a similar power in relation to student loan repayment deductions. Sections 2, 17, 18 and 25 of the Student Loan Scheme Act 1992 are being amended accordingly.

Background

Student loan borrowers whose income is from salary or wages, and whose primary income exceeds the repayment threshold, are required to advise their employer of their student loan liability. Repayment deductions, which are incorporated into the PAYE deductions, are then made by the employer. If the correct deductions are made, most salary and wage earners will have little, or no, end-of-year liability. However, despite being reminded of their obligations, some borrowers fail to fulfil this requirement.

Remedial amendments

JUDGES' ALLOWANCES

(Clauses 66(10), (25) & (27) and 67)

Summary of proposed amendments

In 1998 the Income Tax Act was amended to ensure that remuneration and expenses paid to judges would receive the same tax treatment as similar payments made to employees. The bill contains remedial amendments that ensure the legislation reflects this policy.

Application date

The amendments will apply from 1 April 2003.

Key features

The changes amend the definitions of “salary or wages” and “employment” contained in section OB 1 of the Income Tax Act 1994. The definition of salary or wages has been extended to include payment of salary or allowances paid to judges under a determination of the Remuneration Authority. The definition of “employment” has been extended to include the activities of the office of a judge which give rise to an entitlement to the receipt of a source deduction payment. A consequential amendment repeals the definition of “specified office holder” in section OB 1, and also repeals the reference to income of a specified office holder in the definition of “source deduction payment” in section OB 2(1).

The effect of these changes is to make the remuneration of judges fit more clearly within the tax treatment that applies to employees.

Background

In 1998 the Income Tax Act was amended to ensure that judges would receive the same tax treatment as employees in respect of the income they derive from their office as a judge. However, it has since been found that those amendments may not have been sufficient to achieve that objective. This is because judges are not, in fact, in an employment relationship, and some provisions of the Act assume that such a relationship exists for employees. It is therefore necessary to add the remuneration of judges to the definition of “salary or wages”, and include the activities for which that remuneration is paid in the definition of “employment”.

GROUP INVESTMENT FUNDS

(Clauses 8, 12, 16, 18 and 66(15))

Summary of amendments

A deduction provision for management fees charged by trustee companies to investors of group investment funds is being repealed because it is no longer required.

Application date

The amendment will apply from the start of the 2004-2005 income year so that group investment funds and trustee companies have time to make any required changes to their business practices and systems.

Key features

Section DI 3A of the Income Tax Act 1994, which allows group investment funds to claim a deduction for management fees charged by trustee companies to investors in a fund, is being repealed because it is no longer required. Section CF 3(1)(ga), which provides that any amount distributed to a trustee company on behalf of an investor is not a dividend, is also repealed, along with a number of cross-references to section DI 3A.

Background

Section DI 3A was introduced to ensure that group investment funds could claim a deduction for management fees charged by trustee companies to investors in a group investment fund. Under the Trustee Companies Act 1967, trustee companies were prohibited from charging management fees to group investment funds. To get around this prohibition, trustee companies charged management fees to investors and group investment funds deducted those fees and paid them to the trustee companies instead.

Section DI 3A, however, was an interim measure. The intention was that it would be repealed as soon as the Trustee Companies Act could be amended to provide for group investment funds to pay management fees to trustee companies.

The Trustee Companies Amendment Act 2002 removed the prohibition. Management fees paid by group investment funds to trustee companies are deductible under normal tax rules, so section DI 3A and section CF 3(1)(ga), which was a consequential amendment introduced at the same time as section DI 3A, are no longer required.

IMPUTATION AND DIVIDEND WITHHOLDING PAYMENT CREDITS

(Clauses 37 and 38)

Summary of proposed amendment

When a refund would create a debit balance in a company's imputation credit account or dividend withholding payment account, no debit or credit to those accounts will result from crediting the overpaid amount to another income tax or dividend withholding payment liability. The amendment is intended to align the relevant legislation with the comprehensive transfer rules enacted in 2002.

Application date

The amendment will apply from 1 April 2003.

Key features

Section MD 4, which denies a credit to an imputation credit account or dividend withholding payment account in some circumstances, is being repealed because it is no longer appropriate.

New section MD 5 provides that no debit or credit will arise to the imputation credit account when:

- overpaid tax that cannot be refunded under section MD 2 is credited to an income tax or provisional tax liability under section MD 2(5);
- overpaid dividend withholding payments that cannot be refunded under section NH 4(2)(a) is credited to a dividend withholding payment payable under section NH 4(2)(b); and
- overpaid dividend withholding payments that cannot be refunded under section NH 5(5) is credited to a dividend withholding payment payable under section NH 5(5)(b).

Background

Comprehensive transfer rules (Part XB of the Tax Administration Act 1994) were enacted in the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002. Under Part XB, transfers of tax are treated as a refund and repayment of the relevant amount of tax. Section MD 4, which denies a credit to the imputation credit account in certain circumstances, is not consistent with this approach, and is therefore being repealed.

Part XB applies to the extent that excess tax is refundable. This means it does not apply when the company's imputation credit account or dividend withholding payment account has insufficient credits and an amount is credited under sections MD 2(5), NH 4(2)(b) or NH 5(5)(b).

Therefore a special rule is required to deal with these situations. Amounts credited under those provisions should have no effect on the balance of the imputation credit account or the dividend withholding payment account, therefore they should not result in a debit or credit to those accounts.

PROCEDURE FOR ISSUING NOTICES

(Clause 76)

Summary of proposed amendments

Amendments clarify that the Commissioner of Inland Revenue may send notices to an address nominated by a taxpayer or by the taxpayer's agent, whether it is a physical address or a post box. These amendments remove uncertainties with the procedure for issuing notices to taxpayers and ensure that notices posted in this manner by the Commissioner are valid.

Application date

The amendments apply from 1 April 1995, the date the Tax Administration Act 1994 came into force.

Key features

The amendments make two insertions in section 14(1) of the Tax Administration Act 1994 to clarify that the Commissioner may give valid notice by:

- posting the notice to an address nominated by the taxpayer; or
- posting the notice to an address nominated by the taxpayer's agent.

Background

The Tax Administration Act 1994 does not explicitly allow for Inland Revenue notices to be posted to post boxes. However, the High Court recently decided in *Hieber v CIR*¹⁰ that in some circumstances valid notice could be given via a post box.

The decision causes some uncertainty for Inland Revenue as well as taxpayers and tax agents who are not covered by the decision but choose to receive correspondence through post box addresses.

Taxpayers commonly use post boxes to provide security and ease of communication. Often the street address of a taxpayer (particularly business taxpayers and tax agents) is not equipped to receive mail. These amendments validate existing policy and practice, ensuring that all taxpayers can continue to receive notices from the Commissioner in a manner that provides certainty of delivery without causing disruption to their normal business practices.

The amendments are backdated to provide certainty for taxpayers and Inland Revenue regarding notices that have already been issued to post boxes and other addresses nominated by taxpayers or their agents.

¹⁰ (2002) 20 NZTC 17,774.

CHARGES OVER PROPERTY

(Clause 98)

Summary of proposed amendment

The Tax Administration Act 1994 is being amended to ensure that it reflects the policy outcome intended when the Personal Property Securities Act 1999 was enacted: that Inland Revenue should be able to register charges over the property of persons who default in the payment of tax deductions and ACC earner premium.

Application date

The amendments apply from the date of enactment.

Key features

Charges that are created under section 169 of the Tax Administration Act (Unpaid tax deductions, etc., to constitute charge on employer's property) may be registered on the Personal Property Securities Register.

Background

Inland Revenue has the ability to create charges over the property of a person who defaults in payment of tax deductions and ACC earner premium. Until recently, such charges were registered under registers including those created by:

- the Chattels Transfer Act 1924
- Part VI of the Companies Act 1955.

Registers for charges over personal property created by these Acts were discontinued when the Personal Property Securities Register was established by the Personal Property Securities Act 1999 on its commencement on 1 May 2002. The intention when that Act was introduced was that the status quo should be maintained in relation to the tax provisions that were affected by the Act. Therefore charges over personal property that previously could be registered under the two Acts listed above should now be registered in the current register.

There is doubt about whether legislative changes made to section 169 at the time the Personal Property Securities Act was enacted achieve this. The amendment in this bill ensures that the Personal Property Securities Act will operate in the same way, in relation to section 169 charges, as the registers that preceded it.

The amendment also replaces incorrect references to the Land Transfer Act 1952 and the Deeds Registration Act 1908 with a reference to the Statutory Land Charges Registration Act 1928.

EMPLOYER OBLIGATIONS FOR STUDENT LOAN DEDUCTIONS

(Clauses 70(2) & (4) and 130(1), (3) & (4))

Summary of proposed amendment

An amendment ensures that offences by employers relating to student loan deductions are penalised in the same way as offences relating to PAYE.

Application date

The amendment will apply from the 1997-98 income year, when the compliance and penalties legislation came into effect.

Key features

Amendments are being made to the definition of “NRWT rules”, “PAYE rules”, “RWT rules” and “SSCWT rules” in the Income Tax Act 1994 to omit unnecessary references to sections contained in Part IX. The Student Loans Scheme Act is also being amended to ensure that part IX applies as far as it is applicable to repayment deductions.

Background

The Student Loans Scheme Act 1992 originally contained its own offences and related penalties. In 1996 those relating to employer deductions were repealed. The intention was that student loan offences by employers in relation to repayment deductions would come within the provisions of the penalty rules introduced in Part IX of the Tax Administration Act.

However, the amendment made to the Student Loans Scheme Act at that time excludes section 143A(1)(d) and (e) and 143B(1)(d), and Part IX (except section 146). The original amendment should have applied to sections 143A, 143B and 146 as far as they are applicable to repayment deductions. This outcome is achieved by amending the definition of the PAYE rules in section OZ 1 of the Income Tax Act, and by amending section 25 of the Student Loan Scheme Act to ensure that the penalty provisions in the Tax Administration Act apply.

MINOR TECHNICAL AMENDMENTS

A number of minor technical amendments are being made to the tax Acts. Unless otherwise stated, the amendments will apply from the date of enactment.

Income Tax Act 1994

Definition of “dual resident company” (Clause 21)

The definition of “dual resident company” in section IG 2(11), which is part of the group loss offset provisions, refers incorrectly in two places to “an agreement”. This reference will be replaced with “double tax agreement”.

Underlying foreign tax credits (Clause 29)

Section LF 1(1), which deals with the purpose of the underlying foreign tax credit provisions, is intended to apply to New Zealand resident companies. The provision, however, refers only to a “New Zealand company”, which is defined in section OB 1 as a company incorporated in New Zealand, which is a narrower definition than that for New Zealand resident companies. Accordingly, the two references to “New Zealand company” will be replaced with a reference to a “New Zealand resident company”. The amendment will apply from the 1995-96 income year.

Electing the appropriate tax rate on extra emoluments (Clause 55(2))

Section NC 8(1A) allows employees to provide a tax code declaration to an employer electing the appropriate tax rate on extra emoluments (with the rates set in clause 8 of schedule 19 to the Income Tax Act 1994). While the present wording of section NC 8(1A) allows an employee that has an annual taxable income in excess of \$60,000 to elect to have any extra emoluments taxed at the 39% rate, it also allows them to elect the 33% tax rate. An amendment is being made to require employees to elect the appropriate tax rate on extra emoluments (that is, the 33% tax rate on extra emoluments only if total income in a year is \$60,000 or less). The amendment will apply from 1 April 2004.

Resident withholding tax exemption certificates (Clause 62(1))

Section NF 9(1)(c), which relates to resident withholding tax exemption certificates, refers to the Trustee Banks Restructuring Act 1988. This reference is redundant because that Act has been repealed. Accordingly, section NF 9(1)(c) will be repealed.

Redundant references to “additional tax” (Clauses 62(3), 65 and 89)

There are several redundant references in the Income Tax Act 1994 and the Tax Administration Act 1994 to “additional tax”. These redundant references should be replaced with references to “late payment penalty”. The affected provisions are sections NF 9(11) and NH 3(7) of the Income Tax Act 1994 and section 94(2) of the Tax Administration Act 1994. These amendments will apply to late payment penalties arising from the 1997-98 income year.

Definition of “commercial bill” (Clause 66(4))

The list of provisions to which the definition of “commercial bill” in section OB 1 applies is incomplete. This list will be amended by adding references to section DJ 16 (expenditure incurred on acquiring commercial bills) and section GC 14A (an anti-avoidance provision relating to commercial bills).

Definition of “determination” (Clause 66(8))

The definition of “determination” in section OB 1 cross-refers to the definition in section LC 7(2). Section LC 7(2) has been repealed and, accordingly, the cross-referencing definition of “determination” in section OB 1 will also be repealed.

Definition of “emergency call” (Clause 66(9))

The definition of “emergency call” in section OB 1 was amended by the self-assessment amendments enacted in 2001. As a result, paragraph (c) of the definition contains an incorrect cross-reference. Accordingly, the reference in that paragraph to “paragraph (a)(iii)” will be replaced with a reference to “paragraph (a)(iv)”, with application from the 2003-03 income year.

Definition of “resident in New Zealand” (Clause 66(24))

The definition of “New Zealand resident” in section OB 1 refers to a person resident in New Zealand under sections OE 1, OE 2 or OE 3. However, the corresponding section OB 1 definition of “resident in New Zealand” does not also contain a reference to section OE 3, which refers to a non-resident life insurer who elects to be treated as resident in New Zealand. Accordingly, a reference to section OE 3 will be included in the section OB 1 definition of “resident in New Zealand”.

Measurement of voting and market value interests (Clause 68)

Section OD 5(3), which relates to the measurement of voting and market value interests, refers to two types of trustee companies. A minor clarification to the terminology will be made to ensure that it is clear which type of trustee company is being referred to in the provision.

Basic rates of income tax (Clause 71(2))

Part A of Schedule 1 lists the basic rates of income tax. Clauses 1 to 8 list the basic rates of income tax for specific types of taxpayers or income. Clause 9 provides for the determination of the basic rate for all other taxpayers or income types (mainly individuals). Clause 9 contains a cross-referencing error as it refers to clauses 1 to 10 instead of clauses 1 to 8. This error was made when Schedule 1 was replaced by the core provision amendments, which apply from the 1997-98 income year. Clause 9 will be corrected by replacing the reference to “clauses 1 to 10” with a reference to “clauses 1 to 8”, with application from the 1997-98 income year.

Tax Administration Act 1994

Requisition of information held by offshore entities (Clause 76)

Section 17(1B) was recently enacted by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 to ensure that Inland Revenue can requisition from New Zealand residents information or documents held by offshore entities controlled by the New Zealand residents. A clarifying amendment will be made to section 17(1B) to ensure that the effect of this provision is carried through to the relevant offence provisions, which was always the legislative intention.

Non-filing of returns (Clauses 78(4), 78(5) and 78(8))

The Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002 extended the non-filing of tax returns to taxpayers with income totalling \$200 or less, in an income year, from which tax was not deducted. This was achieved by the addition of section 33A(1)(a)(iv) of the Tax Administration Act 1994. However, section 33A(2)(d), (e) and (g) requires recipients of withholding payments, interest or dividends that do not have a New Zealand source and from which withholding tax is not deducted at source, and beneficiary income, respectively, to file end-of-year income tax returns, irrespective of the total amount of the income involved. An amendment is being made to provide that taxpayers with income from these sources are required to file returns only if the total amount, in an income year, is more than \$200. The amendment will apply from the 2002-03 income year.

Redundant notice of assessment reference (Clause 85)

Section 80H(2) provides that if any income statement is treated as an assessment then the requirement in section 111 for the Commissioner to give notice to a taxpayer of an assessment does not apply. Following the self-assessment amendments enacted in 2001, section 80H treats an income statement as an assessment made by a taxpayer rather than the Commissioner and the notice requirements in section 111 apply only to assessments made by the Commissioner. Section 80H(2) is therefore redundant and will be repealed.

Accounting terminology (Clauses 87 and 88)

Two references in sections 91E(4)(j) and 91F(4)(h) to “generally accepted accounting principles” will be changed to “generally accepted accounting practice” to ensure that the use of accounting terminology is consistent between the Income Tax Act 1994 and the Tax Administration Act 1994. The Income Tax Act 1994 was previously inconsistent in its use of these two terms (which have the same meaning), and it was amended in 2002 to provide for consistent use of “generally accepted accounting practice”, which is the terminology employed in the Financial Reporting Act 1993. The amendments will apply from 17 October 2002.

Redundant objection procedure reference (Clause 90)

In section 100, relating to the assessment of non-resident withholding tax, there is a redundant reference to the former objection procedures. This reference will be replaced with the reference to the new challenge procedures. The amendment will apply from 1 October 1996.

Assessment made by Commissioner following incorrect income statement (Clause 91)

Section 106(1B) relates to the payment of tax under an assessment made by the Commissioner following an incorrect income statement. This provision will be amended to correct internal subsection references, with application from the same income years the original cross-referenced provisions applied from.

Definition of “interest period” (Clause 92)

The definition of “interest period” in section 120C(1) is being amended to reflect the effect of the Income Tax (Refund of Excess Tax) Order 2003. The Order raises from \$50 to \$200 the threshold under which a taxpayer who is issued with an income statement and is owed a refund does not have to confirm that the refund is correct. Under the section 120C(1) definition of “interest period”, where a taxpayer has been issued an income statement and has overpaid tax, use of money interest applies from the date of issue of the income statement to the earlier of the date on which the tax is refunded, or the date on which the taxpayer is able to claim the refund (in the case of overpaid tax of \$50 or more). The reference to “\$50” in paragraph (b)(iii) of the definition is being changed to reflect the higher threshold under the Income Tax (Refund of Excess Tax) Order 2003. The amendment will apply in respect of overpaid tax from the 2002-03 income year.

Gross carelessness penalty (Clause 94)

Section 141C will be amended to make it clear that when a taxpayer makes a mistake, and the mistake is of such magnitude that the taxpayer breaches the gross carelessness standard, that shortfall penalty should be imposed. This is consistent with the new section 141A(4) inserted by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003.

The amendment will apply from the start of the 2004-2005 income year for income tax and from 1 April 2004 for other tax types.

Goods and Services Tax Act 1985

Definition of flat-owning or office-owning company (Clause 103)

The reference to “flat-owning or office-owning company” in section 3(3)(c) cross-refers to the definition in section 2(1) of the Companies Amendment Act 1964. This Act, however, was repealed in 1993, and the definition of “flat-owning or office-owning company” is now contained in section 121A of the Land Transfer Act 1952. Accordingly, the reference in section 3(3)(c) of the GST Act to “section 2(1) of the Companies Amendment Act 1964” will be replaced with a reference to “section 121A of the Land Transfer Act 1952”. The amendment will apply from 1 July 1994.

Supply not in New Zealand if recipient is entitled to an input tax credit (Clause 106(5))

Section 8(8) ensures that unless the supplier and the recipient agree otherwise, a supply of telecommunications services from a non-resident to a registered person in New Zealand for which the New Zealand recipient would be entitled to an input tax credit is not subject to GST. It refers to supplies by “telecommunications suppliers”, which may unduly limit the scope of the exclusion, as telecommunications services may be supplied by companies which do not fall within the definition of a “telecommunications supplier”. The reference to “telecommunications supplier” will therefore be removed.

GST returns (Clause 112)

Section 18, which relates to other returns that are required to be made in addition to ordinary returns, contains a reference to section 19. Section 19 has been previously reorganised into several sections and the part of former section 19 that related to returns is now contained in section 19B. Accordingly, the reference in section 18 to section 19 should be updated by replacing it with a reference to section 19B.

Single change-in-use deductions (Clause 116(2))

Section 21H(3)(d), which relates to the making of a single deduction for a change-in-use of a good or service, refers to the former section 21, which governed both output tax and input tax change-in-use adjustments. Given that section 21H(3)(d) is meant to refer to single output tax adjustments, the reference in it to “section 21” will be replaced with “section 21(1)”. The amendment will apply from 10 October 2000.

Student Loan Scheme Act 1992

Student loan scheme – remedial amendment (Clause 131)

Minor drafting errors in the student loan underestimation penalty provisions (section 44A) are being corrected. The provisions currently refer to “repayment obligation” whereas the references should be to “residual repayment obligation” or “interim repayment obligation” as appropriate.

Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002

Transfers of overpaid tax (Clauses 30, 35, 61, 63 and 120)

New rules relating to the transfer of overpaid tax were recently enacted by the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002. These rules allow Inland Revenue, at the request of a taxpayer, to transfer tax that is overpaid by the taxpayer to another period or type of tax or to another taxpayer.

New section 173T provides that when excess tax is used to offset an outstanding tax liability of a taxpayer, the taxpayer can request that the offsetting occurs at a date allowed by the new transfer rules. Consequential references to section 173T were inserted in the offsetting rules in sections MB 8(1) and (2), MD 1(3), NF 7(5) and NG 16(4) of the Income Tax Act 1994 and section 46(6) of the Goods and Services Tax Act 1985.

A minor clarifying amendment will be made to these offset rules to ensure that the Commissioner's offsetting powers are not reduced by the inclusion of references in the offsetting provisions to section 173T of the Tax Administration Act. However, a taxpayer may request that the Commissioner apply the offset from any date that is allowed by the transfer rules. This clarifying amendment to the offsetting provisions will have the same application date as the relevant amendments enacted by the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002.