

Taxation (Base Maintenance and Miscellaneous Provisions) Bill

Commentary on the Bill

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Thin capitalisation rules for foreign-owned banks

THIN CAPITALISATION RULES FOR FOREIGN-OWNED BANKS

(Clauses 39-44, 60(8),(10),(11),(14),(15),(17)-(19),(24)-(26),(28), 69-74, 80(3),(5)-(8),(10)-(12),(14)-(16),(19))

Summary of proposed amendments

The centrepiece of the bill is the introduction of rules designed to ensure that foreign-owned banks operating in New Zealand pay enough tax on their New Zealand income. As the government announced in September, the changes are expected to result in these banks paying around \$360 million more a year in New Zealand tax.

Foreign-owned banks have taken tax deductions for interest arising from excessive debt to reduce income that is subject to New Zealand tax. New thin capitalisation rules will deny foreign-owned banks interest deductions if they do not have sufficient capital in New Zealand to support their New Zealand business and their offshore investments made through New Zealand.

Application date

The amendments will apply from 1 July 2005. This means that banks will need to measure the capital they have in New Zealand at the end of the measurement period beginning 1 July 2005, which generally will be as at 30 September 2005.

Key features

The Income Tax Act 2004 is being amended as follows:

- The current thin capitalisation rules in subpart FG will be amended to include rules specifically for foreign-owned registered banks and their groups operating in New Zealand.
- A “registered bank” is defined in section OB 1 as having the same meaning as in the Reserve Bank of New Zealand Act 1989.
- An amended section FG 2(1) will determine whether the bank has sufficient foreign ownership to be covered by the thin capitalisation rules.
- Section FG 3 of the current rules will be replaced with a new section FG 3 that requires a reporting bank, as defined in section FG 8D, to calculate annual total deductions based on a calculation in section FG 8B. This annual total deduction is the deduction that the reporting bank can make after an adjustment for any interest denial as a result of the new thin capitalisation rules.
- The adjustment to the annual total deduction calculation in section FG 8B will be required when the reporting bank’s New Zealand banking group (“NZ banking group”) has less net equity supporting its New Zealand business than the net equity threshold determined under section FG 8H of the new rules. The actual net equity of the bank is determined under section FG 8G.

- The interest adjustment calculation in section FG 8B takes any shortfall between the net equity and the net equity threshold of the NZ banking group and applies an interest rate to that shortfall.
- The interest rate applied to the shortfall is determined in section FG 8B by dividing the interest expense of the banking group by the average interest-bearing debt held by the NZ banking group over the income year. Financial accounts will be the basis for the interest and debt values.
- The NZ banking group is defined in section FG 8C, and includes any registered bank and any companies or fixed establishments operating in New Zealand that would be required under New Zealand's generally accepted accounting principles to be consolidated into the ultimate foreign parent of the registered bank.
- The reporting bank has the option in section FG 8C to exclude life insurance companies and their associated groups from the NZ banking group.
- Net equity under section FG 8G and net equity threshold under section FG 8H must be calculated by the reporting bank for the NZ banking group as at the last day of each measurement period. The measurement period is defined in section FG 8E. A reporting bank can choose a quarterly, monthly or daily measurement period.
- The calculation of net equity for the NZ banking group under section FG 8G starts with accounting values of shareholder and branch equity drawn from the financial statements of the members of the group. The aggregation of equity will be done in accordance with accounting rules that apply to consolidations. Any amounts that are considered to be equity for tax rules but not for accounting purposes will be added to the aggregated accounting amount of shareholders and branch equity. Interest-free loans to the NZ banking group from non-resident associates will also be included in net equity. In calculating net equity, equity for accounting purposes that is considered debt for tax purposes is deducted under section FG 8G.
- A number of other deductions from equity are then required. These are provided for in section FG 8G. The effect of these deductions from the adjusted accounting equity described above is that the NZ banking group will be required to have sufficient equity to fully equity fund each of the assets represented by these deductions.
- The deductions in section FG 8G are:
 - capital gain amounts that arise from the sale of intangible assets to associates (from the start of the 2005 year);
 - certain intangible assets;
 - policyholder liabilities;
 - revaluation reserves;
 - future tax benefits;
 - credit enhancements;
 - capital advances to connected persons;
 - equity in the NZ banking group that is held by a life company or by a life group that has opted to be excluded from the banking group under section FG 8C;

- equity held by the banking group in any life business that has chosen the section FG 8C exclusion; and
- offshore investments.
- Offshore investments under section FG 8G will include all equity investments in non-residents except for:
 - interests in foreign investment funds (FIFs) for which the FIF income or loss is calculated using the comparative value method or the deemed rate of return method;
 - shares in a “grey list” company¹ that are listed on the official list of a recognised exchange and revenue account property.
- Offshore investments will also include any notional offshore investment amount as calculated under section FG 8G(3). This calculation will use foreign tax credits claimed by the NZ banking group against an income tax liability as the basis of calculating a notional amount that represents the offshore investment by the group that would be required to generate the foreign tax credits.
- Section FG 8G(3) allows a banking group to claim up to \$5 million of foreign tax credits before it will have a notional offshore investment amount.
- The calculation of net equity threshold for the NZ banking group is provided for under section FG 8H. This is based on 4% of the NZ banking group’s risk weighted exposures.
- “Risk-weighted exposure” is a regulatory term. Section FG 8F defines “regulatory value”, which will be relevant when determining the risk-weighted exposures for the NZ banking group. To determine a regulatory value of the risk-weighted exposures of the NZ banking group, the Capital Adequacy Framework that is issued by the Reserve Bank of New Zealand is applied to the value of the banking group’s assets and exposures.

Background

Foreign-owned banks operating in New Zealand are using interest deductions arising from an excessive level of debt to reduce the portion of their income that is subject to tax in New Zealand. The policy issues giving rise to the excessive debt can be separated into those arising as a result of the banks’ outbound investment and those arising from the banks’ level of inbound investment into New Zealand to support their New Zealand business.

On the outbound investment side, cross-border financing arrangements generate income that is effectively not subject to New Zealand tax through the use of various features of our international tax rules. As these outbound investments have generally been funded by debt, the associated interest expenses have been used to reduce the New Zealand portion of their income that is subject to New Zealand tax.

¹ A grey list company is one that is resident in a country specified in Schedule 3 of the Income Tax Act 2004. These countries – which include Australia, the United Kingdom and the United States – have tax systems that are similar to New Zealand’s.

On the inbound side, there is potential for banks to substitute debt for equity in the financing of their New Zealand businesses through the use of holding companies and bank branches. This results in their New Zealand groups being more thinly capitalised, for tax purposes, relative to their businesses worldwide.

The proposed thin capitalisation rules for banks are a systemic response to the problem of excessive debt funding by banks. The fundamental objective of this approach is to measure more accurately the income associated with the New Zealand activities of banks, ensuring that excessive debt cannot be allocated to the New Zealand operations of a multinational bank.

The new thin capitalisation rules for banks compare the equity associated with the New Zealand banking business (net of certain outbound investments) with a prescribed level of required equity based on 4% of the banks' New Zealand risk-weighted exposures, and deny interest expenses to the extent that there is a deficiency. The measurement of equity is based on accounting and regulatory concepts of equity, which allows for verifiability and minimises compliance costs. The objective of the new rules is not the regulation of the amount of equity in New Zealand per se, but the use of equity as the basis for a benchmark for achieving an appropriate allocation of interest expenses.

The effect of the proposal on outbound investment is that banks will be prevented from using the expenses associated with this income as a deduction against the New Zealand-sourced income.

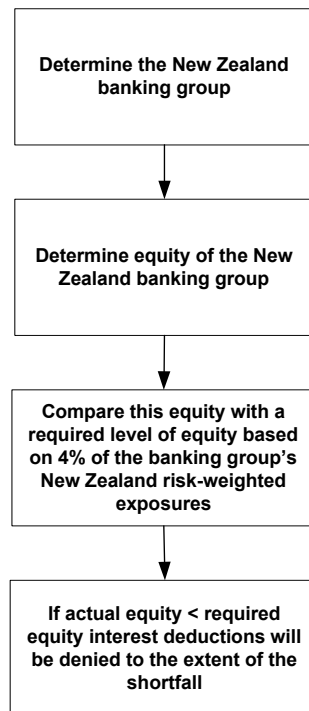
For inbound investment issues, the proposed approach requires a significant level of equity is available to support the New Zealand business. This is determined on the basis of 4% of the NZ banking group's New Zealand risk-weighted exposures.

Our current thin capitalisation rules do not effectively apply to banks, primarily because of the on-lending concession. The proposed rules will apply specifically to banks and their New Zealand groups. These thin capitalisation rules differ from the thin capitalisation rules applying to other taxpayers in three main ways. They are based on a minimum level of equity rather than a maximum level of debt, equity is measured net of offshore assets, and they require banks to have at least a 4% level of capital rather than, effectively, a 25% level of capital. A comparatively lower level of capital is appropriate for banking businesses.

Australia has applied special thin capitalisation rules to banks since July 2001, comparing the net equity of banks in Australia to a benchmark to determine if any interest deductions should be disallowed. While that approach is conceptually similar to the New Zealand proposal, there are important technical differences between the rules to take account of the different circumstances between the two countries.

The proposed thin capitalisation rules for foreign-owned banks operating in New Zealand are summarised in figure 1.

Figure 1: Thin capitalisation rules for foreign-owned banks



Detailed analysis

Application of the rules

The new rules will apply to foreign-owned registered banks. A “registered bank” is defined in section OB 1 as having the same meaning as in the Reserve Bank of New Zealand Act 1989. Section FG 2(1) will determine whether the registered bank has sufficient non-resident ownership to make it subject to the New Zealand thin capitalisation rules under new section FG 8B.

A foreign-owned registered bank will be required to determine its “NZ banking group” under section FG 8C. This group will include all resident entities and fixed establishments (generally branches) operating in New Zealand that would be required to consolidate with the ultimate foreign parent of the registered bank for financial reporting purposes.

Section FG 8C also provides an option to exclude life insurance companies from the NZ banking group. Entities that are part of a life insurance company’s group can likewise be carved out, provided that they do not have a main activity that is banking, financing or leasing and they are not holding companies of banking, financing or leasing companies.

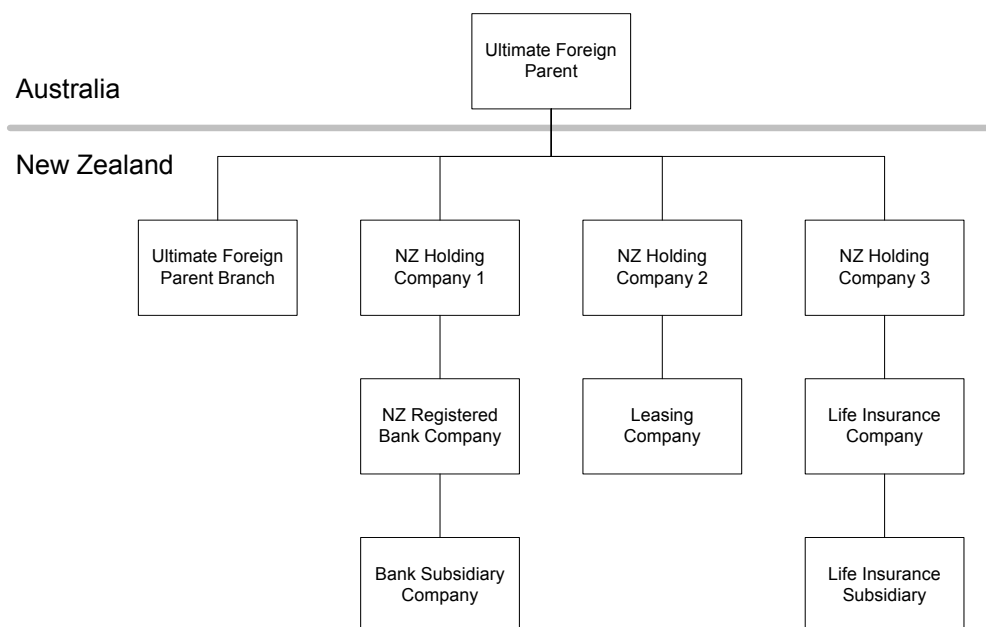
In respect of other “non-banking business” in the NZ banking group, goodwill associated with this business is not required to be taken as a deduction against the equity of the banking group (that is, it is not required to be fully equity funded) under section FG 8G. This covers goodwill acquired by a member of the banking group that is not in relation to banking, financing, leasing or life insurance businesses.

Companies carved out of the banking group will continue to be subject to the existing thin capitalisation rules in section FG 8 and interest allocation rules in section FH.

Under new section FG 3, the reporting bank will make any adjustments in its income tax return for an annual total deduction for interest based on the calculation in section FG 8B. “Reporting bank” is defined in section FG 8D. The registered bank will be referred to as the reporting bank. If there are two or more registered banks in the NZ banking group, the banks must elect a reporting bank, under section FG 8D, which will be responsible for performing the NZ banking group’s thin capitalisation calculation.

An example of a NZ banking group is shown in figure 2.

Figure 2: Example of a NZ banking group



In the example in figure 2, the NZ banking group would include:

- Ultimate Foreign Parent Branch,
- New Zealand Holding Company 1,
- New Zealand Holding Company 2,
- New Zealand Registered Bank Company,
- Bank Subsidiary Company, and
- Leasing Company.

In the example, New Zealand Holding Company 3, Life Insurance Company and Life Insurance Subsidiary have elected the carve-out option, so are not part of the NZ banking group. The reporting bank will be New Zealand Registered Bank Company.

Under section FG 8C, if the ultimate foreign parent of the registered bank does not include in an accounting consolidation any New Zealand resident entity or fixed establishment on the basis that its inclusion is not material in the context of its worldwide consolidation, that entity or fixed establishment will still be included in the NZ banking group.

Measurement of the NZ banking group's net equity

The NZ banking group's net equity is calculated under section FG 8G. The starting point will be the accounting values of shareholders' equity and branch equity included in the financial statements of the members of the NZ banking group, based on accounting consolidation principles. The consolidation of the NZ banking group may or may not actually be required for accounting purposes. If there is no requirement to consolidate the NZ banking group for financial reporting purposes a "notional" accounting consolidation of the NZ banking group for the purposes of the tax rules is effectively needed. This may be based on an aggregation of consolidations of sibling groups. This means that where two or more sibling consolidated groups are aggregated, inter-group transactions will need to be eliminated.

In the example given in figure 2, the Ultimate Foreign Parent Branch, the consolidated New Zealand Holding Company 1 group (includes New Zealand Registered Bank Company and Bank Subsidiary Company) and the consolidated New Zealand Holding Company 2 group (includes Leasing Company) would aggregate their shareholder equity and branch equity, ensuring that any inter-group transactions were eliminated.

Furthermore, accounting equity in section FG 8G will be the accounting value of items considered to be equity for tax purposes but treated as debt for accounting purposes. Interest-free debt from a parent (in the main applying to smaller branch banks) will also be considered as equity in section FG 8G when it is not of a temporary nature. Items that are treated as equity for accounting purposes, but are debt for tax purposes, will be deducted from equity in the section FG 8G calculation.

Section FG 8G also requires a number of additional deductions from the aggregated accounting equity described above. These deductions, summarised below, essentially follow the prudential deductions required by the regulator (the Reserve Bank of New Zealand). The requirement to make these deductions from equity is based on the premise that the NZ banking group must have enough equity to fully fund certain assets of the group. Deductions will be made from equity for:

- *Capital gain amounts*: the accounting value of capital gains on the sale or disposal of intangible assets made from the start of the 2005 tax year when those gains arise from transactions between members of the NZ banking group and non-members that are associated with the NZ banking group.
- *Intangibles*: the accounting value of intangible assets other than: (a) goodwill that relates to a business that is not banking, financing, leasing, or life insurance; and is acquired from a person who is not associated or relates to an entity that is acquired from an associated person [as discussed under "carve-out", above]; (b) films or film rights; and (c) property that is depreciable property or is expected to become depreciable property.

- *Policyholder liabilities*: The accounting value of policyholder benefit liabilities and policyholder retained profits that contribute to equity.
- *Revaluation reserves*: the accounting value of asset revaluation reserves included in equity.
- *Future tax benefits*: the accounting value of future tax benefits that arise from tax losses or from timing or temporary differences that would result in tax losses if the item that gave rise to the timing or temporary difference was deductible in the current year.
- *Credit enhancements*: credit enhancements (such as guarantee interests) provided to associated funds management and securitisation schemes, as defined in the Reserve Bank of New Zealand's Capital Adequacy Framework.
- *Capital advances to connected persons*: advances of a capital nature to a connected person, as defined in the Reserve Bank of New Zealand's Capital Adequacy Framework.
- *Equity in the registered bank (or banks) held by carved out life companies and their carved out group*
- *Equity in a carved out life group held by the registered bank (or banks)*
- *Offshore investments*:
 - (a) Equity investments in non-residents, except:
 - a. interests in foreign investment funds (FIF) for which the FIF income or loss is calculated using the comparative value method or the deemed rate of return method; and
 - b. shares in a grey list company that are listed on the official list of a recognised exchange and held on revenue account.
 - (b) Notional offshore investment amounts:

The deduction for offshore investments includes a calculation of the value of investments generating foreign tax credits in excess of a de minimis based on \$5 million of foreign tax credits. This de minimis allows for a reasonable level of offshore lending that would not be subject to the proposed rules, while capturing significant lending that does not result in tax payable in New Zealand. Transitional rules will cover foreign tax credits on income after 1 July 2005. Correspondingly, the de minimis applying to foreign tax credits will be pro rated for the first year the rules apply.

Measurement of net equity threshold using risk-weighted exposures

Section FG 8H provides for the measurement of net equity threshold based on 4% of the NZ banking group's risk-weighted exposures. Risk-weighted exposures, a regulatory concept, include the on and off-balance sheet assets of the NZ banking group adjusted for risk. Under section FG 8F, regulatory values are determined by applying the Reserve Bank of New Zealand's Capital Adequacy Framework, which sets out the methodology and rates for risk-weighting assets. Resident entities and fixed establishments that are members of the NZ banking group that do not currently risk-weight their assets for the regulator will need to carry out this risk-weighting exercise for the new thin capitalisation calculation.

Measurement period

The reporting bank will be required to measure the NZ banking group's (the group determined at the measurement date) net equity and net equity threshold at least four times a year. These four measurement dates will match up with the reporting bank's reporting quarters to the Reserve Bank of New Zealand.

If a bank is purchased by another bank, separate calculations will be made for any measurement periods before the acquisition, and then a joint calculation will be made for measurement periods after acquisition. Each bank will return its respective calculation pre-takeover. The joint calculation is made and returned by the bank designated to be the "reporting bank" for that latter period.

The reporting bank will have the option, under section FG 8E, to measure the NZ banking group's net equity and net equity threshold on a daily or monthly basis, rather than on the standard quarterly basis.

Interest denial on shortfall between actual and required equity

If for any quarter (or more frequent measurement date that the bank chooses) net equity is less than the net equity threshold based on 4% of risk-weighted exposures, there will be an adjustment under section FG 8B to the reporting bank's annual total deductions in respect of that measurement period. Any adjustments in respect of measurement periods will be required in the reporting bank's tax return for the income year in which the adjustments arise.

The adjustment amount will be calculated under section FG 8B, using an average cost of funds interest rate which is based on the total interest expense of the NZ banking group divided by average quarterly interest-bearing debt for the group. The interest expense and total debt amounts will be based on financial reporting amounts after consolidation and, therefore, elimination of intra-group and inter-group transactions. The accounting policies of the group must be consistent with those of the reporting bank.

Transitional arrangements

Transitional rules will be available for the first income year, to take account of part-year application of the new rules for some banks. Transitional rules will also apply when a foreign-owned company registers as a bank in New Zealand and when a company ceases to operate as a registered bank in New Zealand.

The new bank thin capitalisation rules will apply from 1 July 2005. For banks with a September financial year this will mean that the rules have application for part of their 2004-2005 income year, specifically in the last quarter of this year. This has implications, in particular, for the notional offshore investment calculation.

In the case of part-year application for the 2004-2005 income year, the rules allow for the notional offshore investment amount to be based on foreign tax credits claimed against income tax for the part year. The transitional rule in section FG 8G(3) allows for a calculation based only on the credits received in the part of the income year in which the new rules apply. The de minimis threshold of \$5 million has also been adjusted accordingly.

When there is a change in the bank treated as the reporting bank, a transitional rule also requires calculations to be made for all measurement periods since the last measurement period included by the former reporting bank in its previous income tax return. This is required when the two banks have different balance dates, which would otherwise cause a gap or an overlap.

Exclusion from thin capitalisation rules and excess interest allocation rules

Any taxpayer included in a NZ banking group will be excluded from the existing interest apportionment rule in section FG 8 as that taxpayer will now be subject to the new banking thin capitalisation rules. Members of the NZ banking group will also be excluded from the interest allocation rules currently in section FH 1. This is to ensure there is no doubling up in respect of adjustments resulting from excess debt levels.

Specific anti-avoidance provisions

The current thin capitalisation rules include a specific anti-avoidance provision in respect of temporary reductions in financial arrangements (liabilities) or increases in assets when the reduction or increase has the purpose or effect of defeating the intent of the thin capitalisation rules. Section FG 8I contains a similar rule for the specific bank thin capitalisation rules. However, given that these new rules applying to banks are based on minimum equity supporting the New Zealand assets rather than maximum debt supporting the New Zealand assets under the current rules, a different rule is applied. When there is a temporary reduction in assets or an increase in equity so as to defeat the intent and application of the new rules, that temporary reduction or increase will be excluded from the thin capitalisation calculations.

Changes to the tax depreciation rules

CHANGES TO THE TAX DEPRECIATION RULES

(Clauses 5, 19, 20, 21, 22, 24, 25, 60(21),(22),(23), 63, 93 and 94)

Summary of the proposed amendments

A number of amendments are being made to the tax depreciation rules to improve their operation. They include changes to the tax depreciation treatment of patents, the special tax depreciation rate rules, additions to the list of depreciable intangible property and extending deductibility for losses on buildings.

The changes are intended to reduce compliance costs by clarifying and improving the application of various depreciation provisions and make the special depreciation rules more accessible to taxpayers.

Application date

The amendments will apply from the 2005-06 income year.

Key features

Patents

New section EE 27B is being added to the Income Tax Act 2004. Its purpose is to better align the depreciation treatment of patents with useful life by ensuring that when a patent is granted, the first allowable depreciation deduction includes depreciation for the period from the date the patent application was lodged to the date the patent was granted.

Special tax depreciation rate rules

The operation of the special tax depreciation rules is being improved by increasing the flexibility available to the Commissioner of Inland Revenue to consider special tax depreciation rate applications. Changes are to:

- section EE 28 of the Income Tax Act 2004, to extend the special tax depreciation rules to apply to fixed-life intangible property;
- section 91AE(2) of the Tax Administration Act 1994, to clarify that the Commissioner may have regard to a range of factors in determining the estimated useful life of an asset;
- section 91AE(3), to allow the Commissioner to prescribe a special tax depreciation rate using a straight-line formula in addition to the currently legislated diminishing value formula; and
- section 91AK(2), to allow the Commissioner to prescribe a special tax depreciation rate outside the six-month time limit if the taxpayer involved agrees to this.

Plant variety rights

Schedule 17 of the Income Tax Act 2004 is being amended to add plant variety rights (granted under the Plant Variety Rights Act 1987) and the right to use plant variety rights to the list of depreciable intangible property.

Losses on buildings

Section EE 41(2) of the Income Tax Act is being amended to allow deductions for losses resulting from buildings that are destroyed or rendered useless for the purposes of deriving gross income as the result of an event that is outside the control of a taxpayer (a “qualifying event”).

Background

An officials’ issues paper released in July, *Repairs and maintenance to the tax depreciation rules*, invited consultation on how to improve the tax rules on depreciation of assets. It suggested ways of reducing possible tax biases, a matter still under consideration, and resolving practical problems with the application of the rules, the focus of the changes in this bill, which are in response to specific concerns raised by taxpayers.

Detailed analysis

Patents (Clauses 20, 21, 25 and 60(21))

Under current tax law, a patent is fixed-life intangible property, which means that depreciation of a patent is over its legal life – a period of twenty years (or 240 months). Depreciation is allowed when a patent is used or is available for use. Therefore the earliest time at which a patent can be depreciated is in the year it is granted. However, the time taken for a patent to be granted from the date a complete application is lodged with the Intellectual Property Office of New Zealand can be significant. When granted legal life a patent applies from the date of the application, which will result in its life being less than twenty years from the date of grant. The tax rules accommodate this by reducing the legal life by the time taken for a patent to be granted. This allows higher annual depreciation deductions over the remaining life of the patent than would otherwise be the case.

A more economically correct approach, which improves the net present value of the depreciation deductions, is to allow depreciation relating to the portion of a patent’s life that is expended in the period that the patent is pending to be claimed in the first income year in which depreciation is allowed. An amendment to allow this is being made via the addition of new section EE 27B of the Income Tax Act 2004. The new section contains a rule for calculating depreciation in respect of the first income year the patent is used or is available to be used. In that first year, a taxpayer will be able to claim the annual deduction for the year (calculated using the formula in section EE 27B(3)) as well as an “uplift” amount relating to the period (in months) the patent was pending. The formula for calculating the uplift is provided in section EE 27B(4)(a). In every other year, the taxpayer will be able to claim an annual deduction calculated

in accordance with the formula in section EE 27B(3). How these new rules would work in practice is outlined in example 1.

Example 1: Patent depreciation deductions when patent is granted to original applicant – current and proposed rules

A complete application for a patent is lodged on 1 April 2005. The application is granted on 1 April 2008. The legal life of the patent, once granted, begins on 1 April 2005 which means that at the time of grant the patent has a remaining legal life of 17 years under the current rules. The table outlines the deductions under the current rules and under the proposed changes:

	Year	Current (Rate = 1/17)	Proposed (Rate = 1/20)	
Application lodged	1/4/05	\$0	\$0	
	1/4/06	\$0	\$0	
	1/4/07	\$0	\$0	
Patent granted	1/4/08	\$588	\$2,000	← “Uplift” of \$1,500 for yrs 1-3 plus \$500 annual deduction for yr 4 (yr of grant)
	1/4/09	\$588	\$500	
	1/4/10	\$588	\$500	
	1/4/11	\$588	\$500	
	1/4/12	\$588	\$500	
	1/4/13	\$588	\$500	
	1/4/14	\$588	\$500	
	1/4/15	\$588	\$500	
	1/4/16	\$588	\$500	
	1/4/17	\$588	\$500	
	1/4/18	\$588	\$500	
	1/4/19	\$588	\$500	
	1/4/20	\$588	\$500	
	1/4/21	\$588	\$500	
	1/4/22	\$588	\$500	
	1/4/23	\$588	\$500	
	1/4/24	\$588	\$500	
Total cost		\$10,000	\$10,000	

Under the proposed changes there may be instances, however, when ownership of a patent application changes during the patenting process such that the patent is granted to a person other than the person who made the original application. In this circumstance, under section EE 27B(5), the amount of the uplift will be amended so that the depreciation for the period the patent is pending is limited to the date that ownership of the application changed (and not the date the application was lodged). This is the correct result as the person to whom the patent is granted will have held the

application only for a certain period of time and should, therefore, not be entitled to a depreciation uplift, in the first year, for the period the application was held by the person who originally applied for the patent. The annual depreciation deduction for such a taxpayer (the formula in section EE 27B(3)) will be based on legal life of twenty years (240 months), less the time that the patent application was held by the original applicant (again, in months). Example 2 demonstrates this.

Example 2: Patent depreciation deductions when patent is not granted to original applicant – current and proposed rules

A lodges a complete application for a patent on 1 April 2005. The application is sold to B on 1 April 2006 and the patent is granted on 1 April 2008. B is the holder of the patent. The legal life of the patent, once granted, begins on 1 April 2005. B has held the application for a period of two years prior to grant. A has held the application for one year. The life to B should, therefore, be discounted by one year (to 19 years or 228 months) when applying the formulas in section EE 27B. The depreciation uplift B will receive is 2/19 (or 24/228) of the cost. The annual deduction in each year will be 1/19 (12/228) of the cost. The table outlines the deductions under the current rules and under the proposed changes:

	Year	Current (Rate = 1/17)	Proposed (Rate = 1/19)	
Application lodged by A	1/4/05	\$0	\$0	
B acquires application	1/4/06	\$0	\$0	
	1/4/07	\$0	\$0	
Patent granted to B	1/4/08	\$588	\$1,579	← “Uplift” of \$1,053 for 2 yrs application is held by B plus \$526 annual deduction in year of grant
	1/4/09	\$588	\$526	
	1/4/10	\$588	\$526	
	1/4/11	\$588	\$526	
	1/4/12	\$588	\$526	
	1/4/13	\$588	\$526	
	1/4/14	\$588	\$526	
	1/4/15	\$588	\$526	
	1/4/16	\$588	\$526	
	1/4/17	\$588	\$526	
	1/4/18	\$588	\$526	
	1/4/19	\$588	\$526	
	1/4/20	\$588	\$526	
	1/4/21	\$588	\$526	
	1/4/22	\$588	\$526	
	1/4/23	\$588	\$526	
	1/4/24	\$588	\$526	
Total cost		\$10,000	\$10,000	

The amendments will apply only to new grants of patents in New Zealand, in the 2005-06 and later income years. The changes will not apply when, for example, a patent is acquired in the 2005-06 income year but has been used previously, because the intent of the changes is to mirror the loss of economic life during the patenting process. For those taxpayers the existing formula of depreciating over the remaining legal life (in section EE 27(2)) will continue to apply.

Special tax depreciation rate rules (Clauses 19, 22, 93 and 94)

Under the special tax depreciation rules, taxpayers can apply for depreciation rates that are higher (or lower) than those prescribed by Inland Revenue if they consider the prescribed general depreciation rate is substantially different from the rate that should apply. This may arise, for example, if depreciable property is being used in a way that is different from that considered by Inland Revenue when determining a general economic depreciation rate for the property. A special rate may also be applicable if the actual economic life of depreciable property is dependent on certain factors, such as the length of a taxpayer's income-earning process or business (and cannot be salvaged at the end of it).

At present, the basis on which the Commissioner will issue special tax depreciation rates requires taxpayers to identify, for example, the actual economic life of depreciable property with a high degree of certainty. This has led to concerns that this basis is too rigid. That is, if actual economic life cannot be clearly ascertained, a special tax depreciation rate will generally not be allowed.

The changes will allow the Commissioner greater flexibility in considering special tax depreciation rate applications if he is reasonably satisfied that, in the circumstances, the actual economic life of depreciable property differs significantly to the estimate of economic life used to prescribe the general tax depreciation rate (estimated useful life). This would include taking into account assessments of economic life based on valuers' reports and other available best estimates (for example, from different depreciation methods). However, the current legislation guiding the Commissioner on the factors that he may have regard to in this area is unclear. The changes are intended to clarify this.

At present, in section 91AE(2) of the Tax Administration Act 1994, the Commissioner is required to have regard to the formula in section EE 25(4) of the Income Tax Act 2004 and the rate of depreciation (if any) that the person uses for financial reporting purposes. How this provision is meant to be interpreted is unclear because financial reporting depreciation rates can differ significantly from tax depreciation rates, simply because of the differences in the underlying formula used or even the method – for example, diminishing value versus straight-line. In such cases the more important piece of information is likely to be the estimate of useful life and how this is calculated. To that effect, section 91AE(2) is being amended to explicitly allow the Commissioner to have regard to any factors that are relevant in determining estimated useful life. This will include, as noted above, estimates from independent valuers.

Another concern is whether, under section 91AE(3), the Commissioner can prescribe a special tax depreciation rate that is not determined using the legislated diminishing value formula (the formula in EE 25(4)). This has implications when, for example, a taxpayer requests a straight-line rate to be calculated without reference to the diminishing value formula. Changes are therefore proposed to section 91AE(3) to allow the Commissioner to prescribe special tax depreciation rates using a straight-line method from the outset, instead of setting a diminishing value rate and then prescribing a straight-line equivalent.

The Commissioner will also be allowed greater flexibility to consider special and provisional tax depreciation rates outside the current six-month time bar, if an applicant agrees to such an extension. Owing to the potentially complex nature of some special and provisional tax depreciation rate determinations, the six-month deadline can be breached. It is currently unclear whether determinations issued after the time limit has lapsed are valid under current legislation. Section 91AK(2) is being amended to enable the Commissioner, in legislation, to exceed the six-month time limit with the approval of the taxpayer concerned.

Finally, section EE 28 of the Income Tax Act 2004 is being amended to extend the special tax depreciation rules to fixed-life intangible property (property whose economic life is equated with legal life, for tax purposes) if a taxpayer is able to prove that the economic life of the property will be significantly less than its legal life. This is in response to taxpayer concerns that in the case of fixed-life intangible property such as patents, the economic life of the patent may be different from its legal life, owing to factors such as competitors finding ways to work around the patent. The proposed amendment will allow the Commissioner to consider special tax depreciation rate applications in respect of fixed-life intangible property. However, the onus will remain on the taxpayer to prove that such a determination is warranted.

The amendments will apply to applications for special tax depreciation rates that are made in the 2005-06 and subsequent income years.

Plant variety rights (Clauses 5, 60(22) and 63)

A grant of plant variety rights, under the Plant Varieties Act 1987, gives the holder the exclusive right to produce for sale and to sell propagated material of the plant variety for a period of twenty or twenty-three years, depending on the plant material. Currently, plant variety rights and the right to use plant variety rights are not listed on Schedule 17 of the Income Tax Act 2004 and are, therefore, not depreciable, even though they offer similar protection over intellectual property to a patent, which is depreciable. Therefore plant variety rights and the right to use plant variety rights are being included in Schedule 17 as depreciable intangible property. Plant variety rights will be fixed-life intangible property with depreciation over the property's legal life. The inclusion of plant variety rights as depreciable intangible property will result in any royalties from the use of such property being taxable. This is consistent with the tax treatment of other types of intangible property listed in Schedule 17. Consequently, the "royalty" definition in section CC 9(2)(a) is being amended to include a reference to plant variety rights.

The proposed amendments will apply to plant variety rights granted, and rights to use plant variety rights acquired, in the 2005-06 and subsequent income years.

Losses on buildings (Clauses 24 and 60(23))

Currently, under section EE 41(2) of the Income Tax Act 2004, if a building is destroyed, demolished or otherwise disposed of for a loss, no deduction is allowed in respect of the depreciation loss under the tax depreciation rules.

This section is being amended to allow a deduction for losses on buildings where a building has been destroyed or rendered useless for the purpose of deriving gross income owing to an event that is outside the control of a taxpayer – a “qualifying event”. A definition of “qualifying event” is to be inserted into section OB 1. The definition of “qualifying event” will encompass any unexpected event that either results in, or brings about, the destruction of a person’s building or renders it useless and where the destruction or damage is not caused by the action or failure to act of the person, or their agent, or an associated person. This will include events such as earthquakes, floods and other natural disasters.

The proposed amendments will apply to losses on buildings arising from a “qualifying event” (under the preceding definition) in the 2005-06 and subsequent income years.

The Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill, which was before Parliament when the present bill was introduced, contains amendments allowing deductibility for losses arising from the destruction of certain farming land improvements (under sections DO 4, DO 5 and DP 3) as a result of the February and July storms. At a later stage those provisions will be extended to losses arising from a qualifying event, as defined above, with application from the 2005-06 income year.

Death and asset transfers

DEATH AND ASSET TRANSFERS

(Clauses 11, 18, 23, 26, 27, 28, 29, 31, 32, 33, 34, 35, 36, 37, 45, 47, 48, 60(5) & (12), and 100)

Summary of proposed amendments

The law is being clarified by the introduction of generic rules for the income tax treatment of “in kind” or “in specie” distributions and gifts, including transfers of assets and liabilities on a taxpayer’s death. Such distributions, gifts and transfers will be treated as disposals and acquisitions at market value. The measure will have tax implications only to the extent the property is inside the tax base to start with.

The effect of the new rules on the estates of deceased individuals is that there will generally be two market value transfers: one at the time of a taxpayer’s death, and one on the subsequent distribution of the estate to beneficiaries. Exclusions will apply to estates left to spouses and close relatives of the deceased. “Roll-over” relief will also be available for forestry assets in an estate when the forest is left to a close relative.

Application date

The provisions will apply from the beginning of the 2004-05 income year. Past transactions will not be disturbed when the tax base is not at risk and the tax law is uncertain.

Key features

A new subpart FI of the Income Tax Act 2004 will provide generic rules for the tax treatment of “in kind” or “in specie” distributions and gifts, including transfers of assets following a taxpayer’s death. The core proposal is that assets and liabilities distributed or transferred will be deemed to be disposed of and acquired at market value.

Thus, unless an exception applies, there will be two valuation points in respect of each deceased individual’s estate: one on the date of death, and the other when the estate is distributed. The exceptions proposed are:

- Section FI 5 provides that when the beneficiary of an estate is the spouse or de facto partner of the deceased, assets and liabilities are transferred at the book values that they have for tax purposes. (This approach to valuation is known as roll-over relief.)
- Section FI 6 provides that for simple estates when the assets are left either to charity or to close relations of the deceased, roll-over relief will apply on the distribution of the estate. The transfer of the assets from the deceased to the administrator or executor of the estate will be the market value, unless any of the other exceptions apply.

- Section FI 7 provides roll-over relief both on the date of death and when the estate is distributed for forestry assets where the beneficiaries of the estate are close relations of the deceased.

The first two exceptions will also apply when there are specific legacies to third persons of assets that are not in the tax base.

Generally, a taxpayer's death will not, in itself, lead to an asset being brought into the tax base. While the rule applies to all assets, it has relevance only to the extent the assets are in the tax base, or enter the tax base later. A particular example of this is the treatment of land held on capital account, the proceeds of which would be assessable if the property was sold within ten years of acquisition. Special provisions will ensure that death by itself does not trigger this ten-year rule.

Unexpired accrual expenditure will not be required to be valued at market value. It can continue to be valued at cost less the amount amortised.

Use-of-money interest will not be imposed in relation to a deceased individual's tax liability in the year of death, so long as all tax due is paid by the due dates.

A savings provision will ensure that the tax treatment of past deaths and distributions from trusts and estates will not be disturbed when:

- the tax base is protected by the position that was taken, either because the tax book values of the assets and liabilities were rolled over, or because a market value exercise was done; and
- the beneficiaries of the trust or estate are limited to persons that are New Zealand-resident for taxation purposes and who are not exempt from income tax; and
- the underlying tax law was not clear.

Background

The tax law in the area of "in kind" distributions, gifts and transfers on the death of a taxpayer is currently neither clear nor consistent. Cases in recent years have highlighted this lack of clarity, and there have been repeated calls to clarify the tax treatment of assets and liabilities on the death of a taxpayer and their subsequent distribution to the beneficiaries. For example, it seems reasonably clear that a beneficiary has no depreciation cost base for assets distributed by a trust, although the trustees are required to treat the distribution of the assets as a disposal at market value. These issues were also raised by the Valabh Committee in its 1992 report, *Tax Accounting Issues*.

An officials' issues paper, *Tax Implications of Certain Asset Transfers*, was published in April 2003, and the proposals in that paper were modified as a result of submissions received.

The paper did not discuss GST issues, which are being considered in a separate policy project.

At present, a number of specific statutory rules address the tax consequences of distributions and asset transfers resulting from death but, as a group, they are not coherent or comprehensive. Some were introduced as ad hoc responses to specific base maintenance concerns.

Detailed analysis

Section FI 1 Disposals and resulting acquisitions to which subpart FI applies

To ensure comprehensive and generic rules, the new subpart will provide a disposal value and an acquisition cost price of property (defined to include liabilities) that are:

- distributions from a trustee to a beneficiary of a trust;
- “in kind” or “in specie” distributions from a company to a shareholder;
- gifts;
- transfers to an administrator or executor of a deceased estate; and
- distributions by an administrator, executor or trustee of a deceased estate to a beneficiary, including an obligation to make a payment under a credit contract.

Section FI 2 Disposal and resulting acquisition of property treated as occurring at market value

The general rule is that the disposal value and the acquisition cost price of the distributions and transfers to which subpart FI refers are at market value. The law already provides that some transfers and distributions are valued at market – for example, depreciable property distributed by a trust is a market value disposal, and extending this concept to all such transactions will provide consistency.

Section FI 3 Market value of property to recipient

The value that is used for the disposal must also be used for the acquisition.

Section FI 4 Date on which disposal and resulting acquisition treated as occurring

The date of the disposal and acquisition for tax purposes will generally be the date a person disposes of the property.

Subsection (2) provides that transfers upon death are treated as occurring immediately before to death.

Section FI 5 Disposal and resulting acquisition of property by spouse or de facto partner and others on death of person

Relief is introduced for simple estates in order to reduce compliance costs.

When the only beneficiary of an estate is the spouse or de facto partner of the deceased, the transfer of assets and liabilities to the administrator or executor and the subsequent transfer to the beneficiaries will be treated as if they were matrimonial property settlements to which subpart FF applies. In other words, the assets and liabilities will be treated as if they had belonged to the surviving spouse or de facto partner since they were acquired by the deceased taxpayer. This will have the effect of “rolling over” the property at the tax book value.

The exclusion from the market rule will continue to apply even when there are other beneficiaries, so long as they receive property that is not in the tax base.

Section FI 6 Special rules for distributions from estates of certain deceased persons

When certain conditions are met, a distribution from the administrator or executor to the beneficiaries is treated as if it were a matrimonial property settlement to which subpart FF applies. In other words, the assets and liabilities will be treated as if they had belonged to the beneficiary from the date when they were transferred at market value to the administrator or executor. This will have the effect of “rolling over” the property at the tax book value.

The conditions for this exception applying are:

- the only beneficiaries of an estate are persons related to the deceased to the second degree or are charities; and
- the estate does not establish any life interests; and
- the terms of the will or intestacy require that no property of the deceased taxpayer be held in trust; and
- in a tax year during which the property is subject to administration or executorship or in which the property is held in trust for this purpose, the net income of the estate is distributed beneficially to the maximum extent possible.

The exclusion from the market rule will continue to apply when there are other beneficiaries, so long as they receive property that is not in the tax base.

Again, the rationale for this exclusion is to reduce compliance costs.

Section FI 7 Disposal and resulting acquisition of property that is standing timber

When standing timber owned by the deceased is left either specifically or generally to a person who is related to the second degree, the transfer of the forest to the administrator or executor of an estate and the subsequent transfer to the beneficiary will be treated as if they were matrimonial property settlements to which subpart FF applies. In other words, the assets and liabilities will be treated as if they had belonged to the beneficiary since they were acquired by the deceased taxpayer. This will have the effect of “rolling over” the property at the tax book value.

This exclusion recognises that immature forests, in particular, are difficult to value.

Section FI 8 Relationship of section FI 3 to subpart CB

It is not the intention that a taxpayer's death should result in an asset being brought into the tax base merely because the ten-year period for land held on capital account has not elapsed.

Relief will apply when land owned by the deceased, which if sold would be caught by any of the subpart CB ten-year "tainting" rules (sections CB 7, CB 8, CB 9 and CB 12), is left either specifically or generally to a person who is related to the second degree. Both the transfer of assets and liabilities to the administrator or executor of an estate (section FI 1(2)(d)) and the subsequent transfer to the beneficiaries (section FI 1(2)(e)) will be treated as if they were matrimonial property settlements under subpart FF if the land is then disposed of within ten years of its acquisition by the relative in a fashion that triggers any of the ten-year tainting rules.

Section FI 9 Special rules for in kind distribution of property by company

Section FI 9 applies when a company distributes assets "in kind" or "in specie" to shareholders, whether or not by way of a dividend.

Such a distribution is treated as a disposal and acquisition on the day it occurs, at the market value on that day.

This provision is a clarification of the existing law. There is currently doubt that current law provides a tax cost base for the shareholder when assets are distributed in specie. This can, for example, cause difficulties when the asset is used by the shareholder in a business, and the shareholder wishes to claim depreciation on it.

Section FI 10 Relationship of subpart FI to unexpired prepayments

Section EA 3 provides that the unexpired portions of certain prepayments are added to income at the end of the year. The unexpired portions are allowed as deductions in the following year.

Section FI 10 provides that when the taxpayer who claimed a deduction for these types of expenditure dies, the unexpired portions do not need to be revalued at market value under sections FI 1 and FI 2. The adjustments should continue to be made on the basis of cost, less the amount amortised. The tax return of the deceased adds these amounts back as income and the estate receives a corresponding deduction. Again, the provision is inserted for compliance cost reasons.

Section FI 11-13 Death or trust distributions occurring before beginning of 2005-06 income year

Sections FI 11 to 13, when read together with the general savings rule in the Income Tax Act 2004 (section YA 3), provide that certain past tax treatments are saved. These are generally when the past treatment was uncertain and the tax base is not at risk.

Section FI 11 applies when the following criteria are met:

- The Income Tax Act does not explicitly specify a treatment for both the deceased and the executor or trustee.
- The death occurred before the beginning of the deceased's 2005-06 income year.
- The beneficiaries are New Zealand resident taxpayers.

If the same valuation method was used for both the disposal by the deceased taxpayer and the acquisition by the administrators or executors, and that valuation was either at market value or a roll-over, those valuations will be accepted as appropriate.

Section FI 12 provides the same rules for distributions from trusts when the distribution occurred before the date of introduction of this legislation.

Section FI 13 provides similar rules for the period between the date of introduction of this legislation and the beginning of the trust's 2005-06 income year, but when the Tax Act specifies a treatment by the trustees on the distribution, that treatment will also apply to beneficiaries. The particular issues here concern depreciable property, which the Tax Act specifies is disposed of at market value, but does not provide a value for the beneficiary's acquisition.

Use-of-money interest

The definition of "date interest starts" in section 120C of the Tax Administration Act 1994 is being amended to ensure that use-of-money interest will not be imposed in relation to a deceased individual's tax liability in the year of death, as long as provisional and terminal tax payments are made by due date. This is a concessionary measure which ensures that estates will not incur unexpected use-of-money interest liabilities when a taxpayer's death triggers a tax liability.

Consequential amendments

Subpart FI is a comprehensive set of rules which provide for the tax treatment of "in kind" or "in specie" distributions, including the transfers of assets upon a taxpayer's death. Accordingly, a number of specific provisions which address specific transactions are being repealed. Other sections are being amended to make them consistent with the new rules.

Sections CZ 6(3), EC 4, EE 40(7), EW 29(13), EW 36(1)(b)(i), EW 39, EW 41(1)(b)(i), EW 44, EX 55 and GD 2 are repealed. Sections EH 5(4), EH 19(2), EH 67(4), EH 50(2), FB 3 and GD 14(3)(c) are amended.

Imputation credit shopping

IMPUTATION CREDIT SHOPPING

(Clauses 6, 46, 54, 55, 56, 60, 75, 76, 77, 78 and 80)

Summary of proposed amendments

The dividend and imputation rules are being amended to ensure that, in certain circumstances, when a company is sold the benefits of any prepaid tax will stay with the original group that paid the tax and cannot be refunded. The changes have been designed as a revenue protection measure.

Although the transactions targeted by the proposed legislation arguably fall foul of the current anti-avoidance rules in the Income Tax Act, the amendments ensure that imputation credits earned by one group of companies cannot effectively be paid to a different group's shareholders. Tax policy officials have described these transactions as "imputation credit shopping".

Companies that leave wholly owned groups that have available net losses in excess of \$1 million may elect that a debit balance in their imputation credit account or an amount of prepaid tax in excess of their imputation credit account's credit balance be transferred to another New Zealand group company immediately before leaving the group.

If such an election is not made and the company then joins another wholly owned group with different ultimate shareholders, a final tax will be payable that cannot be creditable against other tax liabilities of the company or group.

Other amendments:

- modify the imputation credit anti-streaming rule;
- clarify that share splits cannot be treated as dividends; and
- as a remedial measure, clarify that all payments of income tax can create imputation credits.

Application date

The revenue base protection amendments, once enacted, will apply from the date of introduction of the bill. The remedial measure will to apply from 1 April 1995.

Key features

New section ME 9B applies to companies leaving wholly owned groups that have available net losses in excess of \$1 million at the end of the previous tax year. Immediately before leaving the group, a company may elect that a debit balance in its imputation credit account or an amount of prepaid tax, to the extent the amount exceeds the credit balance in its imputation credit account, may be transferred to another company in its original group. Alternatively, the company that leaves may

elect to pay further income tax of an amount equal to the debit balance or excess amount of prepaid tax. This further income tax will be a final tax and cannot be credited against other tax liabilities, as it can under section ME 9. The reason is that, in this case, the further income tax is to offset the tax benefit that has already been received by the leaving group's shareholders in the form of imputation credits.

New section ME 9C applies to the companies that did not elect to transfer the debit balance or excess prepaid tax and did not make a payment of further income tax.

If such a company then joins a new wholly owned group with different ultimate shareholders it will be required to make a payment of further income tax equal to the debit balance in its imputation credit account, or the amount of prepaid tax to the extent it exceeds its credit balance in its imputation credit account. Again, as in section ME 9B, further income tax will not be creditable against other tax liabilities because this further income tax is to offset the tax benefit received by the leaving group's shareholders in the form of imputation credits.

Section CD 7 is being amended to prevent share splits under section 48(b) or (c) of the Companies Act 1993 from being treated as a dividend.

Section GC 22(4)(b) is being amended to ensure that the anti-imputation credit streaming rules apply when there is an account advantage that may not also be accompanied by a tax credit advantage.

Section ME 4(1)(l) is added to include any payment to an account with Inland Revenue that has not created a credit otherwise under section ME 4. This is to include payments made to offset a debit created by the attachment of imputation credits to dividends by a company that is not a provisional taxpayer.

Background

Under the classical dividend system that applied in New Zealand until 1988, two amounts of tax were levied on company profits: first, as they were earned, by way of company tax, and again when they were distributed as dividends to the shareholders. The imputation rules have the effect of relieving this double taxation. A New Zealand company can attach imputation credits to dividends paid to shareholders representing the tax paid by it. Shareholders can use these imputation credits to alleviate the taxation obligations in respect of the dividend.

There are detailed provisions within the imputation rules to ensure that, among other things, the shareholders who were the ones at the time the tax was paid are the same shareholders who receive the imputation credits. Obviously, this is in general terms only, since it is not always practicable to track individual shareholders, particularly of widely held companies. Companies are required to maintain a record of the payments of tax and the tax passed on to shareholders through an imputation credit account.

There are also specific provisions within the imputation rules that govern tax refunds. Essentially, a refund may not be claimed unless the company concerned has an equivalent level of imputation credits.² This is to ensure the tax paid by a company is not refunded when the imputation credits created by the original payment have already been attached to dividends paid to shareholders.

The imputation rules do not prevent a company prepaying its income tax in order to create imputation credits that it can attach to its dividends. Typically, this happens when the company is in a loss situation.

Several companies have done this in the past, presumably in order to enhance the value of their shares, as dividends with imputation credits are worth more than dividends with no credits. They have also done it, presumably, in circumstances where they anticipate paying income tax in the reasonable future.

When tax has been prepaid in this fashion, use-of-money interest is not payable, on the basis that the shareholders have actually used the imputation credits to reduce their tax liability. There is no policy objection to these prepayments.

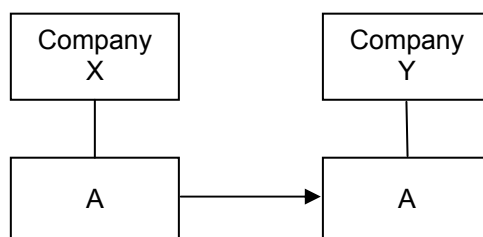
Transactions that are contrary to policy intent

It had always been the intention that a tax overpayment not matched by an equivalent credit balance in the imputation credit account would not be refunded but used to offset a tax liability of the company owned by the shareholders that had received the imputation credits.

There are two types of transactions, however, that run contrary to the underlying policy intent of the imputation rules. They involve the use of a special purpose subsidiary.

The first type involves a special purpose subsidiary with a prepaid tax amount and imputation credit account with no imputation credits. It is sold to a consolidated group with surplus imputation credits.³ The special purpose subsidiary then joins the consolidated group and as the group has imputation credits in excess of the prepaid tax amount, a refund of the tax is made.

For example, Company A, owned by Company X, has prepaid tax of \$300 and no imputation credits in its imputation credit account. Company A is sold to Company Y, which is part of a consolidated group with a credit balance of \$500. Company A joins Company Y's consolidated group.



² When a refund is made, a debit arises to the imputation credit account.

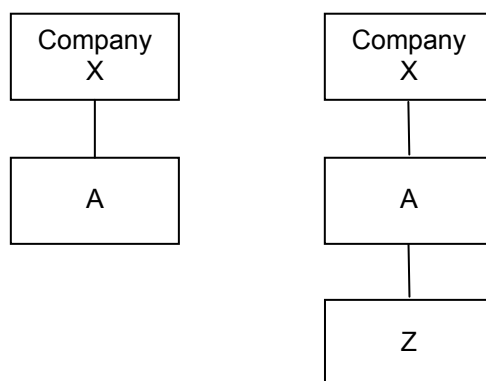
³ As there is prepaid tax and no imputation credits in the imputation credit account, this would indicate that tax prepayment was made to square up an imputation credit account. The square-up would have been necessary because imputation credits had been attached to dividends and yet no underlying tax had been paid previously.

A comparison is made between the amount of prepaid tax in Company A, \$300, with the credit balance of the imputation credit account of the consolidated group – \$500. As the credit balance exceeds the prepaid tax, a refund is released and the consolidated group’s imputation credit account debited by the amount of the refund.

A's Tax Account	Consolidated group's ICA
<div style="text-align: right; margin-bottom: 10px;">333</div> <div style="text-align: left;">Refund 333</div>	<div style="text-align: right; margin-bottom: 10px;">500</div> <div style="text-align: left;">Refund 333</div>

The second type of transaction is more complicated. Here a special purpose subsidiary of the company with a prepaid tax amount and an empty imputation credit account is created. The special purpose subsidiary pays a fully imputed taxable bonus issue in the form of a share split to its parent company. The parent company’s imputation credit account now has sufficient imputation credits so that the prepayment of tax can be refunded. While the special purpose subsidiary has an equivalent debit balance in its imputation credit account, the final step is that the company is sold to and amalgamated with a company with surplus imputation credits.

For example, Company A, with prepaid tax of \$300, no imputation credits and owned by Company X, now incorporates a special purpose subsidiary Z.

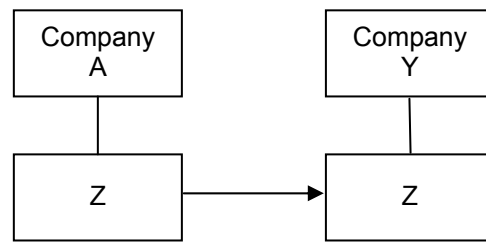


Special purpose subsidiary Z makes a share split, electing it to be a taxable bonus issue⁴ with a value of \$609 and so attaching imputation credits of \$300. This causes a debit to Z’s imputation credit account of \$300 with a corresponding credit to A’s imputation credit account.

Now that A has a credit balance of \$300 in its imputation credit account, it can receive a refund of its prepaid tax.

⁴ There is an argument, however, under current law, that a share split is not a bonus issue and therefore cannot be a taxable bonus issue.

Z, with a debit balance in its imputation credit account of \$300, is sold to Company Y, which, as before, has a credit balance of \$500 in its imputation credit account.



Company Y and Company Z then amalgamate, and Company Y, as the amalgamated company, puts its debit balance into its imputation credit account.

Detailed analysis

The amendments are aimed primarily at companies that have no immediate expectation of being liable to income tax but prepay tax to impute dividends to shareholders and then engage in transactions to have the prepaid tax refunded to them in some way.

The mechanisms, to date, have involved the sale of a company having either a debit balance in its imputation credit account or an amount of prepaid tax that exceeds the credit balance in its imputation credit account to another company that has imputation credits surplus to its immediate needs.

The end result is that, in effect, imputation credits are transferred from the shareholders of the imputation-rich company to the shareholders of the imputation-poor company. This is contrary to the intent of the imputation rules, that imputation credits should be of benefit only to the shareholders of the company that paid the tax in the first place. It is for this reason that, under present law, breaches in excess of 66% in shareholder continuity trigger losses in imputation credits.

Because of the need for an explicit buttress for the shareholder continuity rules but balanced by the concern that non-tax driven transactions should not be disturbed, the amendments are targeted at wholly owned groups that have group losses in excess of \$1 million.

Loss-making groups are the most likely to be at risk of entering into such transactions because they are more likely to impute dividends without an expectation of having taxable income.

Therefore section ME 9B is being inserted to give companies that leave wholly owned groups with accumulated losses in excess of \$1 million in the last tax year the ability to transfer immediately, before sale, any debit balance in their imputation credit account or an amount of prepaid tax in excess of their imputation credit account's credit balance to another company within the original wholly owned group.

This is to allow the original group's shareholders to retain the benefit of the amount of prepaid tax that enabled their dividends to be imputed. Similarly, with any debit balance, they retain the obligation to pay tax by 31 March, since this obligation arose because the group has utilised the imputation credits.

A "leaving company" may instead choose to pay further income tax equal to the amount of the debit balance or the excess prepaid tax. It is not expected this will be the preferred option as further income tax will be a final tax and not creditable against other tax liabilities. As the prepayment would otherwise have value to the vendor group, this is unlikely to happen in practice.

Section ME 4(1)(cb) and (cc) are being added to allow the transfer of the debit balance or the payment of further income tax to clear the debit balance to create an imputation credit to the account of the leaving company. Section ME 4(2)(bb) is also being added to make the creation of the imputation credit effective from the date the leaving company ceases to be a member of a wholly owned group in the case of a transfer or the date the payment of further income tax is made, as applicable.

To buttress section ME 9B, section ME 9C provides that imputation credit companies that leave wholly owned groups that have available net losses in excess of \$1 million and join another wholly owned group with different ultimate shareholders will be required to make a payment of further income tax equal to any debit balance in the joining company's imputation credit account or any amount of prepaid tax that exceeds the credit balance in its imputation credit account. The further income tax will not be creditable to other tax liabilities.

Given that there will be an option to transfer the debit balance or excess prepaid tax immediately before the company leaves the "former group" and joins the "new group" it is expected that a liability to further tax will arise only in exceptional cases.

Sections 101 and 140B are being amended to include sections ME 9B and ME 9C within their scope.

Tax pooling accounts

Entitlements to funds in a tax pooling account are included in the quantification of an "excess entitlement" in ME 9B (3) and ME 9C (4). This is because deposits to a tax pooling account create imputation credits in the same way as voluntary or prepayments of tax.

To prevent the imposition of further income tax, however, if any amounts of excess entitlement are held by a company that leaves a wholly owned group with \$1 million available net losses in a previous tax year and then joins a wholly owned group with different ultimate owners, a transfer in the tax pool by the leaving company will be necessary.

As the operation of tax pooling accounts are outside the direct control of Inland Revenue, this transfer will need to be initiated by the leaving company to ensure there is no liability to further income tax when joining a wholly owned group with different ultimate owners.

Clarification that a share split cannot be a dividend

In the transactions discussed in the background, a common feature is the use of a share split which, when an election is made for it to be a taxable bonus issue, can have imputation credits attached. This is because taxable bonus issues are treated as dividends for income tax purposes.

From the commentary accompanying the changes to the Income Tax Act as a result of the Companies Act 1993, it is clear that it was always envisaged that a share split be a non-taxable bonus issue.

The 1993 discussion document *Taxation Implications of Company Law Reform* commented on the amendment of the “bonus issue” definition:

With the elimination of company law distinctions between capital reserves and retained earnings, there is no need to maintain a tax distinction between share splits and non-taxable bonus issues. Therefore, Income Tax Act references to non-taxable bonus issues will also be applicable to share splits.⁵

Further, the discussion document states that:

The definition of “non-taxable bonus issue” will be retained, but will in future be synonymous with a share split.⁶

Thus it appears that it was not anticipated that a share split should be treated as a taxable bonus issue and, therefore, a dividend to which imputation credits could be attached. Instead it appears that share splits were intended to be a non-taxable bonus issue, which are not treated as dividends.

Contrary to the original intention, it appears that there is at least an arguable case that a share split can be a bonus issue which, on election, can become a taxable bonus issue and then can have imputation credits attached.

For this reason, section CD 7(1) is being amended to ensure that share splits under section 48(b) or (c) of the Companies Act 1993, or similar subdivision of shares by companies not registered under the Companies Act 1993, such as foreign companies or unit trusts, cannot be treated as dividends.

Strengthening the anti-imputation credit streaming rule

It appears that the current anti-imputation credit streaming rule may not apply to imputation credit shopping transactions. The rules appear not to envisage a situation where an arrangement could create an advantage to an imputation credit account – an “account advantage” – without also creating a credit for use against an income tax liability – a “tax credit advantage”.

⁵ Part 1 – para 4.2.4

⁶ Part 2 – Explanatory Notes to section 3(1) of the Income Tax Act 1976

In the transactions discussed earlier in the background, the taxable bonus issue to which imputation credits are attached is paid to a wholly owned group member and is therefore exempt from income tax. As there is no tax credit advantage, the anti-streaming rules appear not to apply, even though there is an account advantage.

To buttress the other proposed amendments, section GC 22(4)(b) is being amended to apply where there is an account advantage, regardless of whether there is also a tax credit advantage.

Clarification that all payments of income tax create imputation credits

A subsidiary issue that has arisen during the review of these transactions is that the legislation may not allow all payments of income tax to create imputation credits. In particular, according to the current provisional tax rules, tax payments made by companies that are not provisional taxpayers are not considered payments of provisional tax. Therefore, under the current provisions, no equivalent imputation credit arises.

The companies most likely to be affected by this would be ones that have no tax liability because of accumulated losses, but impute dividends to shareholders. The voluntary prepayments of tax are made with the expectation that this would square up the imputation credit account after attaching imputation credits to dividends. In other words, the prepaid tax amount is intended to pay for the tax benefit the shareholders receive.

It appears, however, that this is not the case and that voluntary payments of tax do not create imputation credits, contrary to the original policy intent.

Section ME 4(1)(l) and ME 4(2)(j) are therefore being added to ensure that all payments of income tax made can create imputation credits, regardless of whether the company was a provisional taxpayer or not. The date of the credit to arise is the date the payment is made to Inland Revenue.

Such amendments are retrospective in application to 1 April 1995, to ensure that no imputation credits can be disallowed, contrary to the original policy intent.

Privilege – right of non-disclosure
for tax advice

PRIVILEGE – RIGHT OF NON-DISCLOSURE FOR TAX ADVICE

(Clauses 82, 83, 84 and 89)

Summary of proposed amendments

A statutory “privilege” or a right not to disclose certain documents, will apply for tax advice provided by tax advisors. It will apply to communications between advisors and their clients for the main purpose of providing or receiving tax advice.

The non-disclosure right will be subject to a number of exclusions such as for factual information, debt collection advice, accounting and tax work papers and matters of fraud. Tax advice is not expected to include such matters as valuation and investment advice. The amendments do not affect legal professional privilege.

Application date

The new non-disclosure right will apply to requests for information made after the date of enactment.

Key features

New section 20B of the Tax Administration Act 1994 introduces a non-disclosure right for certain communications between tax advisors and their clients. Such communications (referred to as “tax advice documents”) will be privileged if they are brought into existence for the main purpose of giving or receiving advice on tax laws. A document that is created for the purpose of committing or promoting an illegal or wrongful act will not qualify for the privilege.

The right of non-disclosure will belong to the affected taxpayer. This means that taxpayers may withdraw the non-disclosure claim if they choose to provide the relevant advice to Inland Revenue. When tax advice is given to more than one person, a non-disclosure claim will apply only for the taxpayer in respect of whom the claim is made.

To qualify for the right, the taxpayer’s advisor will need to be a member of an organisation, or group of persons (an approved advisor group), that has been approved by Inland Revenue and meets certain other criteria.

New section 20D sets out the rules for claiming the right of non-disclosure. It must be claimed in writing and must include a brief description of the document, the name of the author and the date the document was created. The taxpayer (or the tax advisor on the taxpayer’s behalf) will need to make the claim and a statutory declaration will need to be provided by the tax advisor within a specific time (generally within 28 days of a request for information having been made under section 17 of the Tax Administration Act).

New section 20F provides that certain information (“tax contextual information”) must be disclosed, even if it is contained in a tax advice document. Examples of tax contextual information are:

- factual information relating to transactions entered into by the taxpayer, including information about the purpose of the transaction;
- accounting and tax work papers that contain information which supports the financial statements and/or the tax return;
- matters concerning debt recovery.

This information will need to be disclosed by way of a statutory declaration by the tax advisor in a form prescribed by Inland Revenue.

A number of existing remedies are available if the progress of an investigation is deliberately impeded through abuse of the privilege rules. If a tax advisor is convicted of any of these offences, a court may order that the advisor be barred from making statutory declarations of tax contextual information.

The secrecy provisions are being amended to allow Inland Revenue to advise the approved advisor group if a recognised tax agent breaches the rules relating to non-disclosure – for example, by making a false statutory declaration.

Background

Under the Tax Administration Act 1994, professional privilege is available to lawyers in respect of confidential communications with their clients in relation to tax matters. This means that information that is subject to privilege is not required to be disclosed to Inland Revenue. The same right of non-disclosure is not currently available to chartered accountants and other tax advisors who have a similar tax advice function to that of lawyers. There are administrative protocols that govern the means by which Inland Revenue should seek to gain access to information held by tax agents but no statutory right of non-disclosure.

Inland Revenue needs to be able to access sufficient information to be able to administer the Revenue Acts properly. Much relevant and useful documentation about taxpayers’ affairs is held by accountants because of the role that they play in preparing financial statements and tax returns. They are the largest single group of tax agents and advisors and are responsible for a very large percentage of the tax returns filed with Inland Revenue. Because of this central role in the administration of the tax system, a blanket extension of legal professional privilege to accountants is not appropriate.

Accountants should, however, also be able to give candid and independent advice to their clients, as lawyers do, without the need to disclose that advice to Inland Revenue. The benefit of enabling this to occur is that the advice can promote voluntary compliance by taxpayers with the tax system and give rise to a consequent reduction in compliance and administrative costs.

In May 2002 a government discussion document, *Tax and Privilege: a proposed new structure*, was released for public consultation, but there was significant resistance to the proposals it set out. The amendments included in the bill, while aiming to achieve the same objectives, differ from the earlier proposals.

Detailed analysis

The non-disclosure right is introduced in new sections 20B to 20F of the Tax Administration Act:

- Section 20B states the circumstances in which tax advice documents are not required to be disclosed.
- Section 20C provides for the status of the document after an Inland Revenue request for information is made.
- Section 20D contains the requirements for making a claim for the non-disclosure right.
- Section 20E deals with attachments to tax advice documents.
- Section 20F defines “tax contextual information” in a tax advice document that must be disclosed by way of a statutory declaration.

Section 20B – No requirement to disclose tax advice document

This section introduces a non-disclosure right for certain communications between tax advisors and their clients.

If a valid claim of non-disclosure is made, a “tax advice document” is not required to be disclosed under Inland Revenue’s information gathering provisions (sections 16 to 19 of the Tax Administration Act).

Under subsection (2) a document is eligible to be a “tax advice document” if it is created:

- by a person for the main purpose of instructing a tax advisor who is a member of an approved advisor group; and
- by a tax advisor who is a member of an approved advisor group, if the document was brought into existence for the main purpose of giving tax advice on tax laws to a taxpayer about the taxpayer’s own affairs.

Advice given for the furtherance of illegal or wrongful acts, or in relation to impending or future illegal or wrongful acts, is specifically excluded from the non-disclosure right by section 20B(2)(b)(ii). This will include fraud.

The term “tax advisor” is defined in subsection (4) as a natural person who is part of an approved advisor group, has a significant function of giving tax advice, and is subject to the code of conduct and disciplinary procedures of the approved advisor group. The approved advisor group must be approved by the Commissioner of Inland Revenue for the purpose of the non-disclosure right.

Section 20C – Treatment of document

Documents that may be eligible for the non-disclosure right will be treated as tax advice documents from the time a request for information is made. If no claim for the right is made, this status will cease when the taxpayer informs Inland Revenue that no claim is to be made, or on the date the information is required to be supplied.

If a claim is made for the non-disclosure right, the status as a tax advice document will cease when:

- a court or the Taxation Review Authority rules that the document is not a tax advice document; or
- the taxpayer agrees in writing that the document is not a tax advice document; or
- the taxpayer withdraws the claim; or
- the approved advisor group advises that the tax advisor was not a member of the approved advisor group at the relevant time.

While a document is treated as a tax advice document, it must be held by the tax advisor in a secure place.

Section 20D – Claim that document is a tax advice document

Consistent with the fact that the non-disclosure right belongs to the taxpayer, a claim for the right must be made by the taxpayer or the tax advisor on the taxpayer's behalf. If the tax advisor makes the claim it must be accompanied by written confirmation from the taxpayer that the tax advisor is authorised to act on his or her behalf, and a statutory declaration by the tax advisor that he or she is authorised to act on behalf of the taxpayer.

If the tax advice document was prepared by the taxpayer for the main purpose of instructing the tax advisor to provide tax advice, the claim for the right must include a brief description of the form and contents of the document, the name of the tax advisor and the date of the document.

If the tax advice document was prepared by the tax advisor for the purpose of providing advice to the taxpayer, the claim must include a brief description of the form and content of the document, the name of the tax advisor, the name of the approved advisor group, the areas of law to which the advice relates, and the date of the document.

A claim relating to information that is requested under section 16 (Commissioner may access premises to obtain information) or section 16B (Power to remove and copy documents) must be made by the day on which Inland Revenue exercises the right of inspection or removal, or a later date that has been agreed.

If the information is requested under section 17 (Information to be furnished on request of Commissioner) the claim must be made by the later of the date when the information is required to be provided, or 28 days after the request for information is made.

If the information is requested under section 17A (Court orders for production of information or return), section 18 (Inquiry before a District Court Judge) or section 19 (Inquiry by Commissioner) the claim for the non-disclosure right must be made by the date when the information is required to be produced.

Section 20E – Document or part of document included in tax advice document

Attachments that exist independently of the privileged document (created for a different purpose than the privileged tax advice) will not be privileged, unless they qualify for privilege in their own right. For example, a sale and purchase agreement attached to a privileged document would not be privileged. However, attachments that form part of the privileged advice (and do not have separate existence) will themselves be privileged. This will include “wiring” diagrams, although Inland Revenue will be able to prescribe that factual information contained in a diagram be provided in a diagrammatic form.

Section 20F – Person must disclose tax contextual information from tax advice document

Even though the tax advice document is protected from disclosure, tax contextual information included in such a document will need to be disclosed by way of a statutory declaration.

Disclosure of this information must be made by the date when the claim for the non-disclosure right is required. Therefore if the information is requested under section 16 (Commissioner may access premises to obtain information) or section 16B (Power to remove and copy documents) the disclosure must be made by the date determined by the Commissioner.

If the information is requested under section 17 (Information to be furnished on request of Commissioner) the disclosure must be made by the later of the date when the information is required to be provided, or 28 days after the request for information is made.

If the information is requested under section 17A (Court orders for production of information or return), section 18 (Inquiry before a District Court Judge) or section 19 (Inquiry by Commissioner) the disclosure must be made by the date when the information is required to be produced.

“Tax contextual information” means:

- facts or assumptions which are provided to a taxpayer in contemplation of an actual transaction entered into by the taxpayer, or a similar transaction being investigated by Inland Revenue;
- steps involved in the performance of a transaction actually entered into by the taxpayer, or a similar transaction being investigated by Inland Revenue;
- advice that does not concern the operation and effect of tax laws (for example, valuation and investment advice);
- advice on recovery of tax debts;
- facts or assumptions relating to non-tax advice; and

- accounting and tax work papers that contain information which supports the financial statements and/or a tax return of a taxpayer.

The statutory declaration must be made by a tax advisor who has authority to act on behalf of the taxpayer, and has not been barred from making statutory declarations. A court could bar the advisor if he or she is convicted of an offence under:

- section 111 of the Crimes Act 1961 (false statements or declarations);
- section 143(1)(b) of the Tax Administration Act 1994 (not supplying information when required to do so by a tax law);
- section 143A(1)(b) or (c) of the Tax Administration Act 1994 (knowingly not supplying information when required to do so by a tax law, or providing altered, false, incomplete or misleading information);
- section 143B(1)(b) or (c) of the Tax Administration Act 1994 (knowingly not supplying information for the purpose of evading tax, or providing altered, false, incomplete or misleading information);
- section 143H of the Tax Administration Act 1994 (obstruction).

Secrecy

New section 81B provides that Inland Revenue may divulge information to an approved advisor group about a member who breaches the non-disclosure rules. This will allow disciplinary action to be taken, if appropriate.

Consequential amendments

Section 17A, which relates to court orders for production of information or returns, is being amended. Currently, under subsection (7), a court may order that information should be produced and reviewed in order to determine whether an order should be made for the information to be provided to Inland Revenue, and whether the information is subject to legal professional privilege. Subsection (7) is being amended to provide a similar rule in relation to the accountant's non-disclosure right.

Other policy matters

TAX EXEMPTION FOR PETROLEUM EXPLORATION AND DEVELOPMENT

(Clauses 8 and 66)

Summary of proposed amendment

Income earned from drilling exploratory or development wells and from undertaking seismic survey work relating to petroleum exploration in New Zealand will be exempted for a period of six years. The activities must be carried out by non-resident companies and confined to offshore petroleum fields.

The measure is intended to remove a tax obstacle to gas exploration in New Zealand, as part of a package of measures to boost gas exploration over the next five years.

Application date

The amendment will apply to income from drilling activities and seismic survey activities in New Zealand from 1 January 2004 to 31 December 2009.

Key features

The exemption is contained in a new section CW 45B of the Income Tax Act 2004 (CB 16 of the 1994 Act), and further definitions have been included in section OB 1 of both Acts.

The exemption will apply to certain income of non-resident rig operators – specifically, income from the drilling of wells to explore or develop offshore petroleum fields in New Zealand. It will also apply to income of non-residents from ships providing seismic survey readings in order to identify petroleum in New Zealand.

The exemption will apply for six years.

Background

Current domestic rules tax non-resident drilling rig operators and seismic ship operators from the first day of their presence in New Zealand. Under some of our double tax agreements, however, New Zealand may tax a non-resident rig or seismic ship operator only if the period of presence in New Zealand is longer than 183 days. When it is, the non-resident will generally be taxed from the first day of its presence in New Zealand.

This rule creates an incentive for seismic ship operators and drilling rig operators to leave New Zealand before 183 days have elapsed to avoid any New Zealand tax liability. Drilling rigs and seismic ships are large pieces of equipment and moving them to and from New Zealand is very expensive. In addition to this cost, other costs caused by delays in drilling operations result from the rigs or ships leaving New Zealand and different rigs or ships taking their place.

Taxes are inefficient if they bias firms or individuals into more costly activities. The most obvious problem is when taxes lead to more costly activities being undertaken without raising revenue. The exemption from tax for seismic ships and drilling rigs is aimed at removing this inefficiency. The government announced in August that it would introduce legislation to remove a tax obstacle to gas exploration by temporarily lifting the “183-day rule” for offshore rig operators. In September the government announced it would extend the measure to cover drilling rigs to cover gas field development work and to seismic survey ships involved in gas exploration. The period of application of the exemption is set to coincide with other measures in the government’s gas exploration package announced on 14 June.

COOK ISLAND NATIONAL SUPERANNUATION FUND

(Clauses 9 and 65)

Summary of proposed amendments

The Cook Island National Superannuation Fund is a compulsory national superannuation fund established by Cook Islands legislation. The Fund is governed by a trust deed, and New Zealand's Public Trust has been appointed as trustee. Under New Zealand's tax law, therefore, the Fund may be treated as a New Zealand-resident for tax purposes and therefore subject to New Zealand tax on its worldwide income. An amendment will treat the Fund as a non-resident for New Zealand tax purposes and it will be liable for New Zealand tax only on New Zealand-sourced investments. This is consistent with how other non-resident entities are taxed.

Application date

The amendment will apply from 1 July 2001, the date on which the Fund started.

Key features

New section CW 49B of the Income Tax Act 2004 provides that the Cook Island National Superannuation Fund is exempt from income tax on its foreign-sourced income. A similar amendment will be made to the Income Tax Act 1994 and apply retrospectively, from 1 July 2001.

Background

In November 2000 the Cook Islands Parliament passed an Act to establish a fund to provide all employees and self-employed people with a pension in retirement. Contributions to the Fund are compulsory for employers and employees unless contributions are made to a New Zealand superannuation fund.

The current governance structure of the Fund, with the Public Trust being trustee, may give rise to unintended consequences under New Zealand's tax legislation. It is likely that the Fund will be deemed to be a New Zealand resident company and, therefore, subject to New Zealand tax on its worldwide income. Consequently, the Fund has sought a legislative solution to deal with the unintended tax effect.

TAX DEDUCTIONS FOR BUSINESS ENVIRONMENTAL EXPENDITURE

(Clauses 4, 10, 13-17, 30, 68, 86 and 95)

Summary of proposed amendments

The rules covering tax deductions for business environmental expenditure to avoid, remedy or mitigate the discharge of contaminants in section DB 37 of the Income Tax Act 2004 (section DJ 10 of the 1994 Act) will be clarified and expanded by:

- specifying categories of qualifying environmental expenditure and default amortisation rates;
- giving the Commissioner of the Inland Revenue the power to issue amortisation rates for other categories of environmental expenditure;
- removing the current distinction between industrial and non-industrial waste; and
- introducing a matching mechanism so that site restoration and monitoring costs can be matched against prior business income.

These changes are being made to ensure that all business operating costs, including those for dealing with environmental issues, are taken into consideration in calculating taxable income, and that the timing of such deductions is appropriate.

Application date

The proposed amendments to section DB 37 of the Income Tax Act 2004 (section DJ 10 of the 1994 Act) will apply for income years beginning and environmental expenditure incurred after the date the amending legislation is enacted. The removal of the distinction between industrial and non-industrial waste will be retrospective, to protect taxpayers who have taken a wide interpretation of the term “industrial waste”, either in filing their tax returns or in raising a dispute with Inland Revenue. Taxpayers who have not taken a wide interpretation of the legislation will not be able to take advantage of the retrospective change.

Key features

Section DB 37 is being revised so that it sets out categories of deductible environmental expenditure and the rate at which an amortisation deduction is available to business taxpayers when no other tax deduction is available. The default categories of expenditure and amortisation rates will be as follows:

Expenditure categories and amortisation rates

General description of expenditure	Amortisation rate
<i>Testing and feasibility expenditure</i> – Expenditure incurred in testing and determining the feasibility of different options for avoiding, remedying or mitigating the discharge of contaminants until the time the taxpayer commits to one particular option.	100%
<i>Construction/improvement expenditure</i> – Expenditure incurred constructing in New Zealand, an improvement for the purposes of avoiding or mitigating the discharge of a contaminant, including riparian or screen planting.	A default amortisation rate based on the lesser of 35 years (1/35) or the length of the applicable resource consent granted (1/life of resource consent).
<i>Restoration expenditure</i> – Expenditure incurred in remedying the effects of contaminants.	100%
<i>Monitoring expenditure</i> – Expenditure incurred in monitoring the effects of contaminants.	100%

The Commissioner of Inland Revenue will also be able to set amortisation rates for individual categories of construction/improvement expenditure. In determining the appropriate amortisation rate, the Commissioner will have regard to the fact that for environmental expenditure, estimated useful life for tax purposes may be less than physical life. Estimated useful life may also be less than the life of the applicable resource consent.

A matching mechanism will be introduced so that site restoration and monitoring costs can be matched against prior business income. Taxpayers will be able to choose to establish a restoration account with Inland Revenue. Over the life of a business, if the discharge of contaminants results from operations, a cash deposit equivalent to the tax effect of the accounting restoration provision can be made into the account. This deposit will give rise to a tax deduction so that the taxpayer's cash position is unchanged. Interest will be paid on deposits at 3% per annum. Business taxpayers will be able to obtain a refund from the account if they incur restoration and monitoring expenditure or if the anticipated liability for restoration (as evidenced by their audited financial statements) decreases. This refund will give rise to taxable income which will be offset by tax deductions for restoration and monitoring expenditure. This is consistent with the objective of matching restoration and monitoring costs against prior business income.

If a taxpayer transfers liability for site restoration/monitoring to another taxpayer (for example, on the sale of a site) or to the government (on death, liquidation or bankruptcy), the balance of the restoration account will be transferred to the new taxpayer/Ministry for the Environment to be used for future site restoration.

Finally, section DJ 10 of the 1994 Act will be amended retrospectively to remove the word "industrial". This will eliminate the current distinction between industrial and non-industrial waste.

Background

At present, there is uncertainty regarding the existing scope of tax deductions available for environmental expenditure, and it appears that some environmental costs may not be deductible. This results in the incorrect calculation and taxation of income from business activities.

Business taxpayers are currently able to claim a tax deduction for environmental expenditure in three ways:⁷

- a deduction for normal operating (revenue) expenditure;
- a deduction under the depreciation rules for certain types of capital expenditure, such as tanks, reservoirs, pipes, pumping machinery and screens; and
- a deduction under section DB 37 (DJ 10) for other capital environmental expenditure.

Section DJ 10 was introduced to permit business taxpayers a deduction for expenditure incurred for the purpose of treating industrial waste when no other allowance might otherwise be possible. It allows business taxpayers to claim a deduction for the cost of constructing on land in New Zealand any earthworks, ponds, settling tanks, or other similar improvements primarily for the purpose of treating industrial waste in order to prevent or combat pollution of the environment. When a deduction is available, it must be spread evenly over five years, beginning with the year in which the expenditure was incurred.

Despite the existence of a specific section to provide for environmental costs, there are certain expenses which may not be deductible. Section DJ 10 pre-dates the Resource Management Act 1991, so does not provide a deduction for costs incurred in complying with new health and environmental standards, such as site restoration. It is also unclear as to what is covered by the term “industrial waste”. The inability to claim tax deductions for site restoration and uncertainty around the meaning of “industrial waste” result in the incorrect calculation and taxation of income from business activities. This has led to taxpayer submissions calling for a change to the rules, including allowing environmental costs, particularly in relation to site restoration, to be matched against related business income.

⁷ Excluding industry-specific provisions (such as for mineral and petroleum mining).

TAX RECOVERY PROVISION: APPLICATION TO CIVIL PENALTIES AND INTEREST

(Clause 49)

Summary of proposed amendment

An amendment will clarify that the tax recovery provision in the Income Tax Act 2004 – section HK 11 – applies to civil penalties and use-of-money interest.

Application date

The amendment will apply from the date of enactment.

Key features

The tax recovery provision in the Income Tax Act 2004 – section HK 11 – makes the directors and shareholders of a company liable in certain circumstances for income tax payable by the company if it is left with insufficient assets to meet its liability. This provision also applies to a company's GST liabilities.

A clarifying amendment is being made to section HK 11 to ensure that it applies to civil penalties and use-of-money interest. This clarifying amendment is in line with the policy intent of the tax recovery provision.

Background

Section HK 11 is directed at arrangements which deplete a company's assets so that it is unable to meet its tax liabilities. The company itself is often liquidated as part of the arrangement, or simply because the company serves no useful purpose after a transaction is completed.

Under section HK 11, the directors and shareholders of a company can be made liable, in certain circumstances, for the unsatisfied income tax and GST liabilities of the company. Broadly, these circumstances are when:

- an arrangement has been entered into by the company which has the effect of leaving it unable to meet its income tax liability;
- a director making reasonable enquiries would have been aware of this effect; and
- a purpose of the arrangement was to have that effect.

It is the policy intent of section HK 11 that it should apply to allow Inland Revenue to collect unpaid civil penalties and use-of-money interest imposed on companies from their directors and shareholders if the requirements of that provision are satisfied. However, there is some uncertainty that the current law achieves this policy intent. A clarifying amendment is therefore desirable to remove this uncertainty.

EXCESS IMPUTATION CREDITS OF INDIVIDUALS

(Clauses 50, 51, 85 and 104)

Summary of proposed amendments

New rules will require excess imputation credits received by individuals (natural persons) and unincorporated bodies to be carried forward instead of being converted into a net loss. This will ensure that the benefit of the credits is equal to the tax paid.

Application date

The provision will apply from the 2005-06 tax year.

Key features

Excess imputation credits received by an individual will be carried forward to the next tax year, rather than converted to a deemed net loss, as provided in section LB 2 of the Income Tax Act 1994 and the Income Tax Act 2004. The change is intended to apply to taxpayers who would currently convert excess imputation credits to a deemed net loss at a rate of 1/0.21, so it will also apply to, for example, an unincorporated society.

Taxpayers with excess imputation credits will be required to file a tax return to ensure that Inland Revenue has an accurate record of these credits.

The Commissioner will extinguish excess credits if writing off an outstanding amount of tax. If both a net loss and excess credits carried forward are available, the Commissioner will determine the order in which they are extinguished. In determining this apportionment, the Commissioner must consider any preference of the taxpayer that the Commissioner is aware of.

Background

Conversion of excess imputation credits to a net loss

All imputation credits received by taxpayers in excess of those required to meet their tax liability for the tax year are currently converted to a deemed net loss. Taxpayers may carry forward this net loss to the next tax year. Companies also have the option of using the net loss to offset income derived by another company in the same group in the year the credits are received.

The rate of conversion depends on the type of taxpayer. For example, a company divides the number of excess credits by 33% (the company tax rate) to determine its deemed net loss. Individuals and unincorporated bodies divide the number of excess credits by 21%.

The rate of conversion is intended to ensure that the benefit of the net loss is equal to the value of the imputation credit. A single rate of conversion achieves this for taxpayers such as companies, who always have the same tax rate.

For taxpayers such as individuals, whose marginal tax rate can vary, no single rate of conversion to a deemed net loss can achieve the desired policy outcome. Any rate of conversion will benefit taxpayers differently, relative to the value of their excess credits, according to their income in the year the loss is applied. Currently, individual taxpayers with excess imputation credits are obtaining an average benefit from deemed net losses in excess of the value of the excess credits.

The current conversion rate for these taxpayers is a compromise. It was originally based on what was considered a “middle” effective marginal tax rate of 28%. The position of this rate relative to the bottom of the personal tax scale is now occupied by the 21% rate, and the top marginal tax rate has increased from 33% to 39%. This has increased the disparity between the original value of imputation credits and their potential value if converted to a deemed net loss. The proposed amendment will ensure that the benefit of excess imputation credits equals the tax paid.

Extinguishing of carried-forward imputation credits

Currently, when writing off an amount of outstanding tax, the Commissioner is required to extinguish any net loss of the taxpayer based on the amount of the tax written off, divided by 33%. A similar (but “dollar-for-dollar”) requirement is proposed in relation to excess imputation credits carried forward, which are currently converted to a net loss.

PAID PARENTAL LEAVE – INFORMATION EXCHANGE BETWEEN INLAND REVENUE AND THE DEPARTMENT OF LABOUR

(Clauses 88, 90, 91 and 112)

Summary of proposed amendments

Amendments to the secrecy provisions will allow Inland Revenue to use taxpayer-specific information to identify applicants who may be ineligible to receive paid parental leave (PPL) or a parental tax credit, or may have received an overpayment.

The amendments will also allow Inland Revenue to communicate taxpayer-specific information to the Department of Labour so any discrepancies can be investigated and resolved.

Application date

The amendments will apply from the date of enactment.

Key features

New section 85H of the Tax Administration Act 1994 will allow Inland Revenue to compare taxpayer-specific information with information provided by an applicant, to identify applicants who may be ineligible to receive PPL or may have received an overpayment. When these checks reveal a possible discrepancy, Inland Revenue can communicate taxpayer-specific information relating to the applicant to the Department of Labour for further investigation.

New section 85I will allow Inland Revenue to compare taxpayer-specific information with information provided by an applicant, to identify applicants who have applied for the parental tax credit and PPL in respect of the same child. When someone has applied for both payments, Inland Revenue will decline the application for either PPL or the parental tax credit.

New section 81(4)(q) of the Tax Administration Act 1994 provides a specific exemption from the requirement that Inland Revenue maintain the secrecy of taxpayer information, for the purposes of section 85H of the Act.

Background

As part of the implementation of the PPL scheme in 2002, certain validation checks were developed using information collected as part of the administration of the tax system, to ensure that the scheme was not subject to misuse. The checks were designed to indicate whether:

- an employment relationship exists between the PPL applicant and the employer from whom the applicant claims to be taking leave;
- an applicant returned to work for the employer from whom she claimed to be taking leave during the PPL payment period;
- an applicant claimed, or made an application for, both PPL and the parental tax credit in respect of the same child.

It transpired that Inland Revenue does not have the legislative authority to use information collected or obtained as part of the administration of the Revenue Acts, for PPL purposes. The Parental Leave and Employment Protection Act 1987, which provides for the payment of PPL, is not a Revenue Act, and Inland Revenue acts as the payment agency under a delegation in this Act.

PUBLICATION OF TAX OFFENDERS' NAMES

(Clause 103)

Summary of proposed amendment

The requirement for the Commissioner of Inland Revenue to publish the names of serious tax offenders is being removed.

The current name publishing rules are inflexible, excessively harsh on some taxpayers, and potentially ineffective, and are therefore being removed. Name publication will still occur through the Commissioner seeking publicity, when appropriate, after court imposed sanctions.

Application date

The amendment will apply retrospectively to taxpayers whose names are currently due for publication, but have not yet been published.

Key features

An amendment is being made repealing section 146 of the Tax Administration Act 1994.

Background

The current name publishing rules were intended to act as a deterrent to tax offending, thereby improving taxpayer compliance. Empirical evidence, however, is inconclusive about the effectiveness of such rules.

The rules also tend to be excessively harsh on some taxpayers – for example, those who evade for small sums, or one-off offenders. This is as a result of the inflexibility of the rules in both their scope and application. Name publication has only one level of punishment, irrespective of the magnitude of the offence, and it applies to various offences with potentially differing levels of culpability. As a result, there is no ability to tailor the punishment to either the type or the magnitude of the offence.

Nevertheless, some benefits are still seen in publishing names of offenders. These benefits are the greatest in cases where a court has imposed a sanction. As such, the Commissioner will, when appropriate, seek publicity after court imposed sanctions. Having an independent body determine a taxpayer's wrongdoing adds to the credibility of the process, while creating a threshold to ensure that the punishment is not disproportionate to the offence.

GST AND THE FIRE SERVICE LEVY

(Clause 106)

Summary of proposed amendment

An amendment clarifies that GST is payable on amounts paid to the New Zealand Fire Service Commission by way of the fire service levy.

Application date

The amendment will apply from 1 October 1986, the date that GST first applied to the supply of goods and services in New Zealand.

Key features

The amendment to section 5 of the Goods and Services Tax Act 1985 confirms that payment of the fire service levy is consideration for a supply of goods and services by the New Zealand Fire Service Commission.

To prevent any possible risk of backdated claims for refunds of overpaid GST relating to earlier taxable periods, the amendment applies retrospectively to 1 October 1986, the date that GST first applied to the supply of goods and services in New Zealand.

Background

GST is designed to tax the consumption of goods and services by final consumers. This is achieved by applying GST to the widest possible range of goods and services supplied in New Zealand, so that consumer patterns are not affected. To ensure that only final consumers face the full burden of the GST, businesses receive a credit to offset the tax paid on purchases that are used to make supplies on which GST is imposed.

Under the GST Act and relevant case law, GST is imposed according to whether there is a sufficient connection between a payment and any supply of goods and services made in return for the payment. This creates a boundary that makes it difficult at times to determine whether certain payments should or should not be classified as being for taxable goods and services and hence subject to GST.

The fire service levy is payable on all contracts of fire insurance covering New Zealand property and is used to fund the Fire Service Commission. The Commission has been collecting the levy since 1 July 1986.

Although the levy is used to fund the activities of the Fire Service Commission, it is unclear whether the levy is a premium for a contract of insurance. It is also unclear to what extent the provision of services by the Fire Service is the result of a statutory obligation rather than a contractual one.

When Parliament gives an entity the right to collect amounts from the public (other than as a fine or interest penalty) in order to fund its activities, GST should apply. The amendment is consistent with this policy intent and clarifies that the New Zealand Fire Service Commission provides goods and services to both the Crown and the general public in consideration for amounts received by way of the fire service levy.

GST DEREGISTRATION FOR NON-RESIDENTS

(Clause 110)

Summary of proposed amendment

The amendment will give the Commissioner of Inland Revenue a discretion to deregister non-residents who do not carry on a taxable activity in New Zealand, to prevent the inappropriate refund of GST on their purchases in New Zealand.

Application date

The amendment will apply to persons who register for GST on or after the date of enactment.

Key features

The Commissioner of Inland Revenue, under section 52 of the Goods and Services Tax Act 1985, will be able to cancel the registration of a non-resident who does not carry on a taxable activity in New Zealand. The effect of this deregistration is that the non-resident will not be able to claim back the GST incurred on the goods and services it purchases in New Zealand.

Consistent with existing deregistration provisions, this deregistration could have effect back to the date on which the non-resident was registered for GST in New Zealand if a taxable activity was never carried on in New Zealand from that date.

The amendment is directed at non-residents who have only a passing or temporary connection with New Zealand and who should be treated as final consumers of the goods and services they purchase in New Zealand and, therefore, not entitled to a GST refund.

The Commissioner will prepare guidelines explaining the circumstances when the discretion to deregister a non-resident will be exercised and when it will not. For example, the discretion will be exercised to prevent non-residents who are temporarily in New Zealand and who do not carry on or intend to carry on any taxable activity in New Zealand, and whose only supplies in New Zealand are made for nil consideration, from having the GST on their purchases in New Zealand refunded. The discretion will not be exercised if the non-resident intends to carry on a taxable activity in New Zealand and registers before beginning operations in New Zealand.

Background

The GST Act allows non-residents to register in New Zealand for GST purposes without carrying on any taxable activity in New Zealand if they carry on a taxable activity overseas. They do this so they can get input tax credits for their expenditure in New Zealand, which may be an appropriate treatment. For example, when a person intends to carry on a business activity in New Zealand in the next 12 months, but is in the process of getting ready for that activity, GST refunds should be allowed.

When non-residents have only a passing or temporary presence in New Zealand, however, it is not desirable, from a policy perspective, to allow them a refund of the GST on their purchases in New Zealand. An example of this kind of situation is when an entity not resident in New Zealand performs services in New Zealand for which it charges nil consideration. The entity carries on no “taxable activity” in New Zealand, but can register for GST purposes in New Zealand because it is carrying on a “taxable activity” overseas.

It is problematic that a non-resident can make supplies in New Zealand for which it does not charge anyone, but it can still claim a GST refund for making those supplies. The entity’s profile is the same as a final consumer, yet, for GST it is treated as a business and can currently claim back the GST on its purchases – often of an entertainment or accommodation nature – in New Zealand. The amendment will give the Commissioner of Inland Revenue the discretion to deregister the taxpayer in these cases.

New Zealand already collects GST from non-resident businesses that have only a passing connection with New Zealand. The proposed amendment will buttress this power as it will discourage non-residents who are in New Zealand temporarily and have no intention to carry on a taxable activity in New Zealand from registering for GST for the sole purpose of claiming the GST back on their purchases in New Zealand.

Remedial amendments

MISCELLANEOUS REMEDIAL AMENDMENTS

A number of miscellaneous technical amendments are being made to the tax Acts.

Income Tax Act 1994 and Income Tax Act 2004

Disclosure provision for premiums paid to non-resident insurers (Clause 38)

The double tax agreement between New Zealand and the Netherlands was recently amended to close a tax avoidance opportunity involving the payment of cross-border insurance premiums. A special disclosure provision in section FC 17 of the Income Tax Act 2004 requiring the disclosure to the Commissioner of premiums paid to residents of the Netherlands is now unnecessary. This provision will therefore be repealed with effect from 1 April 2005, the same application date as the related amendment to the double tax agreement.

Redundant foreign tax credit provision (Clause 52)

The dividends Article in the double tax agreement between New Zealand and the United Kingdom was recently replaced with application from the 2005-06 income year. Section LC 15 of the Income Tax Act 2004, which relates to the claiming of foreign tax credits from the United Kingdom, is relevant only for the purposes of the previous dividends Article. Section LC 15 is therefore redundant and will be repealed with application from the commencement of the Income Tax Act 2004.

Redundant provisional tax provisions (Clause 53)

Section MB 2(1)(aa) and (ab) of the Income Tax Act 2004, which relate to provisional tax payments, are redundant and will be repealed with application from the commencement of the Income Tax Act 2004. These provisions were originally enacted in 1998 with application to provisional tax payments for the 1998-99 income year only, and should not have been re-enacted as part of the Income Tax Act 2004.

Dividend withholding payment credit cross-references (Clauses 55 and 57)

Sections ME 5(1)(h) and MG 5(1)(e) of the Income Tax Act 2004, which relate to debiting imputation credit and dividend withholding payment accounts, contain an incorrect cross-reference. The reference to “section LD 8(1)(a)” will be replaced with “section LD 8(1)(c)”, with application from the commencement of the Income Tax Act 2004.

Resident withholding tax exemption for community trusts (Clauses 58 and 79)

An income tax exemption for trustees of community trusts – section CB 4(1)(m) of the Income Tax Act 1994 – was enacted by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 with application from the 2004-05 income year. An amendment allowing a resident withholding tax exemption certificate to be issued to a trustee of a community trust will be made to the Income Tax Act 1994 to match this income tax exemption. This amendment will apply from the 2004-05 income year. An equivalent amendment will also be made to the Income Tax Act 2004.

Late payment penalty cross-reference (Clause 59)

Section NH 3(4) of the Income Tax Act 2004, relating to the disallowance by the Commissioner of an election by a company to satisfy a dividend withholding payment liability by reducing a net loss, contains a reference to an additional tax penalty imposed under section 150 of the Tax Administration Act 1994. This reference is redundant and will be replaced by a reference to late payment penalty imposed under section 139B of the Tax Administration Act 1994, with application from the commencement of the Income Tax Act 2004.

Definition of “net loss” (Clauses 60 and 80)

The definition of “net loss” in section OB 1 of the Income Tax Act 2004 contains two drafting errors. First, the cross-reference to “section 177C(4)” of the Tax Administration Act is incorrect and will be replaced with “section 177C(5)”. Second, the reference to the amount “written off” by the Commissioner will be replaced by a reference to the amount “extinguished” by the Commissioner, in order to align the definition with the correct terminology used in section 177C. These amendments will apply from the commencement of the Income Tax Act 2004. An equivalent amendment to this second amendment will be made to the definition of “net loss” in section OB 1 of the Income Tax Act 1994, with application from 1 July 2002.

Superannuation fund expense transfers (Clause 67)

A master superannuation fund will be allowed to elect in which year (2000-01 or 2001-02) it will deduct certain expenses of a member fund. The amendment deals with a timing anomaly that arose from an amendment to section DI 3 in 2001. Master funds previously deducted the expenses on the day they were incurred but, after the change, deducted the expenses in the income year in which they were incurred. Master funds could not deduct 2000-01 member fund expenditure incurred after the master fund's 2000-01 balance date.

Tax Administration Act 1994

Small claims jurisdiction of Taxation Review Authority (Clause 92)

Section 89E allows taxpayers to elect in their notice of proposed adjustment (NOPA) to have their dispute heard in the small claims jurisdiction of the Taxation Review Authority in certain circumstances. Section 89E refers to a NOPA issued under section 89D (a taxpayer NOPA to a Commissioner assessment) but not section 89DA (a taxpayer NOPA to their self-assessment). Section 89E will therefore be amended to include a cross-reference to section 89DA to ensure that taxpayers can elect to use the small claims jurisdiction of the Taxation Review Authority in self-assessment situations. This amendment will apply to disputes that are begun under Part 4A of the Tax Administration Act on or after 1 April 2005.

Redundant binding rulings provision (Clause 96)

Section 91E(6) contains a definition of “assessment” for the purposes of the Commissioner making a private ruling. This definition is redundant, because of the general definition of “assessment” in section 3 of the Tax Administration Act, and will therefore be repealed with application from the date of enactment.

Non-filing taxpayers (Clauses 97 and 99)

Sections 92(4) and 108(1B) were enacted as part of the self-assessment amendments in 2001 and were intended to ensure that the tax position of a non-filing taxpayer for an income year becomes certain and final in the same way as for filing taxpayers. These provisions will become unnecessary under section BC 1(1) of the Income Tax Act 2004, which provides that the income tax liability of a non-filing taxpayer is the total tax withheld in respect of the taxpayer; this ensures that the tax position of a non-filing taxpayer becomes certain and final. Accordingly, sections 92(4) and 108(1B) will be repealed, with application from the 2005-06 income year.

Updating unacceptable tax position provisions (Clause 102)

Section 141B is concerned with the imposition of shortfall penalties in relation to unacceptable tax positions. Before 1 April 2003 the provision was concerned with unacceptable interpretations of tax laws. Section 141B(5) and (6) should be updated to take into account this change of approach in section 141B from unacceptable interpretation to unacceptable tax position. These amendments will apply from the date of enactment.

Goods and Services Tax Act 1985

GST on imports (Clause 107)

Section 12, which relates to the imposition of GST on imports, requires a minor clarifying amendment to be made to it. This involves making the input tax terminology in section 12(4)(d)(ii) consistent with the approach used in section 12(4)(c) by referring to an input tax deduction under section 20(3). This amendment will apply from the date of enactment.

Adjustment provision (Clause 108)

Section 25(2)(a) refers to “tax charged by the supplier”, which is incorrect because it is the GST Act itself that charges tax on supplies. A clarifying amendment will be made to correct this by adopting the approach used in section 25(4), with application from the date of enactment.

Factored debts provision (Clause 109)

Section 26A requires registered persons who account for GST on a payments basis to pay GST on the remaining book value of a debt when it is factored. This provision will be restructured to integrate it with the calculation of tax payable in section 20 of the GST Act, with application from the date of enactment.

Taxation Review Authorities Act 1994

Meaning of “precedent” (Clause 111)

A definition of “precedent” is being included in the Taxation Review Authorities Regulations 1998 to clarify that a “precedent” case is one that has wider implications for other taxpayers. For consistency a similar amendment will be included in the Taxation Review Authorities Act 1994 where “precedent” is referred to in section 13B(1)(b). This amendment will apply to disputes that are commenced on or after 1 April 2005.