Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill

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

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

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Venture capital

VENTURE CAPITAL

Clause 4

The venture capital proposals in the bill remove a tax barrier to unlisted New Zealand companies gaining access to offshore venture capital. The main change is to provide an exemption from income tax for certain non-residents that sell shares in unlisted New Zealand companies. Profits from the sale of such shares may currently be taxable if a non-resident has purchased them with the purpose of resale or the proceeds from the shares are a part of the non-resident's business income.

Non-residents will generally be eligible for the exemption if they are resident in a country with which New Zealand has a double tax agreement and would not be eligible for a tax credit in their home jurisdiction for any New Zealand tax paid if the income were taxable in New Zealand. These criteria will generally be met by residents that are tax-exempt in their own jurisdiction. The new rules also provide that certain foreign funds of funds (FFOFs) will qualify as eligible investors. In a venture capital context, a FFOF pools funds on behalf of a number of international investors and invests the capital in local venture capital funds.

The changes will also see the repeal of section HC 1 of the Income Tax Act 1994. This section currently prohibits partners of special partnerships from offsetting special partnership tax losses against their other income.

Issue: Widening the concept of eligible investment to include assets other than shares

Submission
(15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts)

Under the current proposal, the rules will exempt gains from the sale of shares in an eligible New Zealand company.

PWC note that, for a number of commercial considerations, an investor may want to invest in instruments that have equity characteristics but are not shares. Examples of such instruments are options and profit-linked interest bearing debentures. For this reason PWC suggest that the exemption should apply to gains derived from the disposal of equity and debt.

MERW considers that the form of an investment should not determine whether the tax exemption should apply. It is suggested that the proposed exemption should be extended to include the sale of New Zealand business assets.

Comment

The purpose of the proposed changes is to remove tax barriers to venture capital investment. A key characteristic of venture capital investment is that the venture capital investor's return is connected directly with the performance of the company into which the investment is made. Therefore a venture capital investment is generally an equity rather than a debt investment. This explains why the current proposals are limited to an investment in shares.

The current definition of "share" in section OB 1(a) encompasses investments that have both debt and equity characteristics. That is, in subparagraph (ii) of section OB 1(a) a debenture to which section FC 1 applies is included in the definition of "share". A debenture of this type is one where the interest payable is determined by reference to the dividends payable or the company's profits. As the return from such a debenture is linked directly to the performance of the company, it is appropriate that such an investment is included in the ambit of the proposed rules. Therefore the definition of "share" that should apply for the purposes of the new rules is that contained in paragraph (a) of the definition of "share" in section OB 1.

This definition would not encompass a share option because a share option is not a direct "interest in the capital of a company". However, the economic substance of a share option (the option to purchase shares in a company at a given price at some time in the future) is clearly akin to an equity interest in that company. Therefore officials consider that an option to purchase shares in a company at a given price at some time in the future should be encompassed as an eligible investment in the new rules.

Under the proposed change, an interest in a company in the form of a convertible note that is converted into shares before the sale of those shares would not qualify as an eligible investment. However, officials consider that it is appropriate that where an interest in a company is held in the form of a convertible note and converted into shares before the sale of that interest, that interest should qualify as an eligible investment if the interest has been held for at least 12 months. This is consistent with the Australian approach and provides further flexibility when investing in venture capital.

Officials do not consider that the exemption should be extended to include the sale of New Zealand business assets. The proposals are aimed at venture capital investments. The return from a venture capital investment is typically the profit on the sale of shares rather than the sale of the underlying assets of a business.

Recommendation

That the proposed venture capital exemption encompasses the sale of shares (as per the definition of "share" in paragraph (a) of section OB 1) and share options. The exemption should also be extended to accommodate interests purchased as convertible notes where the interest has been held for at least 12 months and which are converted to shares before sale.

Issue: Extending the exemption to cover dividends

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

The current proposal would not amend the tax treatment of any dividends that the foreign investor derived from the investment in the New Zealand company. Generally, such dividends would be subject to non-resident withholding tax of 15%.

The same logic that exempts non-residents that are tax-exempt in their own country from New Zealand tax on their revenue account capital gains, applies equally to any tax that New Zealand may levy on dividends. That is, their tax exempt status in their home country will mean that they are unable to claim a tax credit for any tax that New Zealand may levy on dividends. Therefore the exemption should be extended to cover dividends.

Comment

Officials do not consider that the exemption should be extended to cover dividends. This would go further than the aim of the proposals, which is to facilitate typical venture capital investments. Consultation revealed that venture capital investors would expect to gain the vast majority of their return from an increase in the value of the underlying share rather than a distribution of dividends. This was confirmed by representatives of the venture capital industry.

In addition, the approach of excluding dividends from the ambit of the proposed regime is consistent with the Australian approach.

Recommendation

That the submission be declined.

Issue: Exemption for manager's carried interest

Submission
(16 – New Zealand Venture Capital Association)

The proposed rules should provide an exemption for the fund manager's "carried interest". Such an exemption would mean that New Zealand's rules would be competitive with those in Australia.

Comment

In certain venture capital fund manager structures it is common for a portion of the venture capital fund manager's fee to be linked directly with the performance of the underlying investments. This portion of the manager's fee (referred to as the "carried interest") is often structured as a given percentage of the profits when the shares are eventually realised. The purpose of such fee structures is to provide the manager with an additional incentive to perform. The Australian rules provide a tax concession for the carried interest by deeming it to be a capital return. By treating it as a capital return, the tax rate that applies is halved.

Officials do not consider that the New Zealand rules should provide a similar tax concession for the manager's carried interest. The carried interest portion of the manager's fee is akin to a performance bonus and should be taxed as such. In addition, a rule that deemed the carried interest to be a capital return for tax purposes would have the effect of rendering the manager's return tax-free. This is because, unlike Australia, New Zealand does not have a general capital gains tax.

Recommendation

That the submission be declined.

Issue: Property development, royalties and lease payments as excluded activities

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The prohibited activities in the proposed section CB 2(1)(g)(iii) should be amended. "Property development" in sub-sub-paragraph (A) should be amended so that it refers to "land development" and the references to "royalties" and "lease payments" in sub-sub-paragraph (H) should be removed.

Comment

Officials agree that the reference to "property development" on the list of main activities which are excluded from the rules in CB 2(1)(g)(iii) is too wide because the property referred to could include intellectual property and other property which is not land. This is not the intention as the exclusion is aimed at land development.

Many venture capital-funded companies will derive income in the form of royalties from licensing intellectual property or leasing technology. Therefore to include this type of income on the list of excluded activities would be unnecessarily restrictive and possibly disqualify a large portion of potential investee companies. Therefore officials agree with the submissions and recommend that the reference to "royalties" in section CB 2(1)(g)(iii)(H) be removed.

The reference to "lease payments" could include also include a "royalty". This is not the intention. Therefore it is recommended that the term "lease payments" remain in section CB 2(1)(g)(iii)(H) but with an exclusion for a lease payment that is also a "royalty".

Recommendation

That the submission be accepted.

Issue: Holding companies – ownership requirement of subsidiaries

Submission
(15 – PricewaterhouseCoopers)

The requirement in the proposed section CB 2(1)(h)(iii) that companies which receive funding from a holding company must be part of the same wholly owned group should be removed.

Comment

In the venture capital industry it is common for an investor to acquire a company in which the founding or existing shareholders retain an equity interest in the company. This is a common scenario because the investor may want to grow the company but retain the skills of the current management and shareholders. Equity participation is also often a factor in attracting senior management.

Under the current proposal, however, an investment in a holding company can qualify as an eligible investment only if the companies into which it invests are 100 percent owned by it. This excludes the scenario described above, because the existing shareholder will own the equity of some part of the company. This may inhibit the operation of the new rules.

Officials therefore agree with the submission and recommend that there be no requirement that the holding company and the companies into which the investments are made are part of the same wholly-owned group.

Recommendation

That the submission be accepted.

Issue: Residence of holding company subsidiaries

Submission
(15 – PricewaterhouseCoopers)

The requirement in section CB 2(1)(h)(iii) for all subsidiaries of a holding company to be resident in New Zealand should be removed.

Comment

Officials do not agree with this interpretation of the proposed section CB 2(1)(h)(iii). The proposed rule requires only that a holding company have a "main activity" of investing in eligible companies. Therefore a holding company may have non-New Zealand subsidiaries and be an eligible investment as long as its main activity is not investing in non-New Zealand companies.

Officials agree that the provision should be extended further so that eligible holding companies can have a have "main activity" of investing in non-New Zealand resident companies. The current requirement that the main activity of the holding company is investing in New Zealand resident companies could provide a barrier to New Zealand companies expanding into offshore markets. However, the requirement in the bill that the New Zealand companies that the holding company invests into (as part of its main activity) are all eligible investments should remain. This will ensure that the provisions are properly targeted at venture capital.

In addition, the recommended removal of the requirement for investments to be made into companies that were all part of the same wholly owned group (as discussed in the previous submission) should add some additional flexibility in this area.

Generally, the intention of this proposed provision is to ensure that venture capital funds which are invested in New Zealand and qualify for the tax exemption are used to fund New Zealand venture capital companies. However, officials are comfortable that there is no mischief in allowing foreign investors in unlisted holding companies which invest in foreign companies to be exempt from the gain on the sale of their interest in that holding company. The portion of the gain that relates to the non-resident company is effectively non-New Zealand sourced income of a non-resident and is currently subject to New Zealand tax only in a limited number of circumstances.

Recommendation

That the submission be accepted.

Issue: Redrafting the 12-month rule

Submission
(19 – Minter Ellison Rudd Watts)

The drafting of the proposed rules in section CB 2(1)(g)(i) and section CB 2(1)(h)(i) result in unnecessary complexity.

Comment

The proposed rules in section CB 2(1)(g)(i) and section CB 2(1)(h)(i) provide that, for an investment to qualify for exemption, the shares must be held for at least 12 months before they are sold. The proposed provisions achieve this through a requirement that "…the share is purchased…on a day that is 12 months or more before the day of the sale…"

Officials do not consider that this drafting is particularly complex and, therefore, do not consider that an amendment is required.

Recommendation

That the submission be declined.

Issue: Redrafting the listing requirement

Submission

(26 – Institute of Chartered Accountants of New Zealand, 15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts)

The proposed rules in section CB 2(1)(g)(ii) and section CB 2(1)(h)(ii) are complex and should be clarified.

Comment

The proposed rules in sections CB 2(1)(g)(ii) and CB 2(1)(h)(ii) specify for what periods the shares that are purchased cannot be quoted on the official list of a recognised exchange. The intention of the provisions is to provide that:

- if the shares are listed when they are purchased they must be de-listed within 12 months; and
- if shares that were listed when they are purchased are de-listed within 12 months they cannot be listed again within the next 12 months

Officials agree that the current drafting of these rules is complex and consider that they should be redrafted. Officials also recognise that the requirement that a de-listed company cannot be re-listed for 12 months is inflexible and may not accommodate all genuine venture capital investment strategies. Therefore officials propose that the listing requirements for eligible venture capital investments are simply that the company is either unlisted at the time the shares are purchased or, if it is listed at the time of purchase, that the company is de-listed within 12 months. This will make the listing requirements more flexible and enable the simplified drafting of these requirements.

Recommendation

That the submission be accepted.

Issue: Definition of “recognised exchange”

Submission
(Matter raised by officials)

The definition of “recognised exchange” in section OB 1 should be amended so that it applies for the purposes of section CB 2(1)(g) and section CB 2(1)(h).

Comment

The proposed section CB 2(1)(g) and section CB 2(1)(h) refer to “recognised exchange”. Section OB 1 contains a definition of “recognised exchange”. Section OB 1 should be amended so that it applies for the purposes of CB 2(1)(g) and section CB 2(1)(h).

Recommendation

That the submission be accepted.

Issue: Expanding the list of preferred countries for FFOFs

Submission

(26 – Institute of Chartered Accountants of New Zealand (ICANZ), 15 – PricewaterhouseCoopers (PWC), 19 – Minter Ellison Rudd Watts (MERW))

Under the current proposals, foreign funds of funds (FFOFs) qualify for the venture capital tax exemption only if they are established in one of eight countries (the United States, the United Kingdom, Australia, Canada, Singapore, France, Germany and Japan). A number of submissions have suggested that the number of eligible countries should be increased.

ICANZ notes that the equivalent Australian tax rules have been criticised for being too restrictive in including countries on the FFOF eligible list. They suggest that, in order to attract investment, the New Zealand rules should be as flexible as possible. ICANZ submits that the New Zealand rules should include as an eligible country all countries with which we have an exchange-of-information agreement.

PWC are also concerned that the current list of countries is unduly restrictive and, as a result, will not attract substantial investment from FFOFs. It is noted that commercial considerations often mean that FFOFs are established in internationally recognised fund management centres such as Luxembourg and Belgium – not eligible countries under the current proposal.

MERW note that, under the current proposals, an FFOF that is established in a tax haven will not qualify as an eligible investor. They suggest, however, that such FFOFs are likely to be the greatest source of potential venture capital investment. They suggest that FFOFs established in such countries should be made eligible investors to the extent that the investors in the FFOF would have been eligible if they had invested directly (rather than through the FFOF).

Comment

The key aim of the venture capital proposals is to remove New Zealand tax for foreign investors if the foreign investor cannot benefit from a credit in their home country for the New Zealand tax levied. This inability to benefit from a tax credit will generally arise from the fact that foreign investors are tax-exempt in their own jurisdiction.

However, for Inland Revenue to be able to administer these rules effectively, it was also considered necessary to allow the exemption to such investors only if they were resident in a country with which New Zealand has a double tax agreement (DTA). The exchange-of-information Article in DTAs (with the exception of the DTA with Switzerland) allows Inland Revenue to request relevant tax information from the competent authority in the DTA country.

The aim of targeting tax-exempt foreign investors, and the need for Inland Revenue to monitor the rules effectively, explains why the current proposals would allow non-residents that cannot benefit from a tax credit in their own jurisdiction to qualify, provided they are resident in a DTA country (with the exception of Switzerland).

Extending the rules to exempt certain FFOFs did not accord entirely with the key aim of targeting tax-exempt foreign investors. To meet this aim, in respect of FFOFs, it would have been strictly necessary to look through the FFOF for tax purposes and exempt the ultimate investors in the FFOF if those investors would not benefit from a tax credit for any New Zealand tax levied and they were resident in a DTA country (with the exception of Switzerland). Investors in the FFOF that did not meet these two tests would not gain the benefit of the automatic exemption and could face tax if the shares were held on revenue account. However, it was considered that this "pure" approach would give rise to compliance costs for FFOFs and their investors (that would ultimately reduce the likelihood of receiving any such investment) and administrative costs for Inland Revenue.

It was therefore considered appropriate to provide the exemption to the FFOF itself, provided that there was a reasonable likelihood that the majority of the ultimate investors in the FFOF would not benefit from a tax credit in their home jurisdiction and were resident in a DTA country.

Given that the FFOF rules compromised the policy aim of targeting non-residents that would not benefit from a tax credit, it was considered appropriate to limit the countries where eligible FFOFs could be established not only to DTA countries, but also those countries where there was a reasonable prospect of investment from FFOFs. This explains the current list of eight countries.

The submissions suggest that investment from FFOFs is likely to arise in countries that are not included on our current list of eight. These include countries that could be considered tax havens, as well as countries with which we currently have a DTA.

While we agree with these submissions, we still consider that it is necessary that an exchange of information agreement exist between New Zealand and the FFOF's country of establishment. This would allow Inland Revenue to administer the rules effectively.

Therefore we consider that it is appropriate for the list of eligible countries where an FFOF can be established to be the same as that which applies for direct investors under the proposed section CB 2(4)(a). Under this proposal, there would be one list of eligible countries for all categories of investors and it would comprise those countries with which New Zealand has a DTA (with the exception of Switzerland).

Recommendation

That the list of eligible countries where an FFOF can be established be the same as that which applies for the proposed section CB 2(4)(a).

Issue: Targeting of non-residents that would not receive a credit for any New Zealand tax imposed

Submission

(26 – Institute of Chartered Accountants of New Zealand, 15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts)

Under the current proposal, the exemption is targeted at venture capital investors that would in no circumstances be able to receive a tax credit in their home country for the imposition of any New Zealand tax that would, in the absence of the proposed exemption, be imposed on the sale of the share.

A number of submissions have expressed concern that the proposed approach of targeting the availability of tax credits would be difficult to apply in certain circumstances and may give rise to an incorrect result. It is noted that investors may not be eligible to benefit from the provision of a tax credit for New Zealand tax paid in a situation where they can offset income in their home country with losses that are carried forward.

It is also suggested that the change may apply more widely than intended as it would exempt foreign investors that would not benefit from a tax credit for New Zealand tax paid because their home country has a rule that does not tax income of this nature if the income arises from a preferred country such as New Zealand. One submission suggests that, given the proposals are intended to target tax exempt investors, the drafting should simply use words along the lines of "tax exempt or effectively tax exempt".

Comment

The target of the proposed exemption is non-resident investors that are sensitive to the imposition of New Zealand tax on profits from the sale of private equity. The reason such investors may be sensitive to New Zealand tax is the fact that often they are exempt from tax in their home country (for example, United States pension funds). This is because investors that are tax-exempt in their own jurisdiction will not be able to claim a credit in their own country for the New Zealand tax imposed.

As one submission suggests, one option for targeting the category of investors that are likely to be sensitive to the New Zealand tax is simply for the rules to refer to "exempt or effectively exempt". The problem with this approach is that there would be some uncertainty as to whether certain investors would qualify for the exemption. For example, certain investors may at the outset be taxed in their home country on the profits, but can later receive a refund of the tax that was initially levied. In such a case it could be difficult to maintain that the investor was "exempt" or even "effectively exempt" from tax.

Australia uses the words "exempt or effectively exempt" to target tax-sensitive non-resident venture capital investors. However, Australia has a registration board (the Pooled Development Fund (PDF) Board) that registers eligible investors and investments and administers the rules. The PDF Board can consider on a case-by-case basis whether an investor is "exempt or effectively exempt" and, if it is satisfied, it can provide certainty to the investor through registration. The New Zealand rules

would operate through self-assessment rather than a registration system. Therefore it is important that investors can themselves determine with a degree of certainty whether they qualify.

Therefore officials still consider that the approach of targeting the new rules to investors that would not, essentially, receive a financial benefit from tax that would otherwise be levied in New Zealand is the correct approach.

In addition, officials consider that foreign investors that would not receive a financial benefit from the imposition of New Zealand tax because, for example, their home country does not tax such investments if they arise in a preferred country (such as New Zealand) should qualify for the exemption under the new rules. Given that their home country does not tax the amount, the foreign investors are sensitive to the imposition of New Zealand tax.

On the other hand, officials do not consider that the exemption should be available to investors that cannot receive a financial benefit from the imposition of New Zealand tax simply because of personal circumstances, such as the availability of tax losses. This is the reason why the words "…in no circumstances…" is included in the proposed section CB 2(4)(a)(iii) and the words "…in any circumstances…" are included in the proposed section CB 2(4)(b)(vi)(B) and the proposed section CB 2(4)(c)(vi)(B).

Recommendation

That the submission be declined.

Issue: Timing requirements

Submission
(15 – PricewaterhouseCoopers)

There is currently no guidance in the proposed provisions as to when, and for what periods, a "qualifying foreign equity investor" must satisfy the required tests. In addition, the current proposals do not clarify adequately when, and for what period, a relevant New Zealand company must qualify under the new rules.

An amendment is required that provides clarity on this issue.

Comment

Officials agree that the proposed rules should be clarified. The policy underlying the proposals is that the foreign investor should satisfy the definition of QFEI at all times during the period of the investment – that is, from the time that the share is purchased until the time that it is disposed of. The proposed new section CB 2(1)(g) should be amended to clarify this.

In addition, the bill should be amended to clarify that the company into which an investment is made cannot have a main activity that is one of the listed prohibited activities for the period of the investment – that is, from the time that the share is purchased until the time that it is disposed of. The proposed new section CB 2(1)(g) should be amended to clarify this.

Recommendation

That the submission be accepted.

Issue: Exemption should apply to all non-residents

Submission
(4 – New Zealand Venture Investment Fund (NZVIF), 16 – New Zealand Venture Capital Association (NZVCA))

The proposed exemption should apply to all non-residents, regardless of their domestic tax status.

Comment

Officials do not agree with these submissions. The exemption is aimed at non-residents that are likely to be sensitive to the imposition of New Zealand tax. Extending the exemption to all non-residents would mean that investors that were taxable in their home jurisdiction would qualify for the exemption. These investors are not likely to be sensitive to New Zealand tax as they would be able to offset the tax in their home jurisdiction with a credit for the New Zealand tax paid.

Recommendation

That the submission be declined.

Issue: Accommodating foreign funds of funds that are structured as limited liability partnerships that have separate legal entity status

Submission
(15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts)

The proposed definition of QFEI in section CB 2(4)(b) should be widened to include FFOFs that are structured as limited liability partnerships but also have separate legal entity status. This should be done by deleting the proposed section CB 2(4)(b)(viii).

Comment

Officials agree that section CB 2(4)(b)(viii) should be deleted. Currently, the bill requires that to be a QFEI under section CB 2(4)(b), an investor must be structured as a limited partnership that is legally equivalent to a New Zealand special partnership (section CB 2(4)(b)(viii)). This is likely to give rise to a significant degree of uncertainty as the limited partnership rules in various jurisdictions can differ significantly from New Zealand's special partnership rules.

However, limited liability partnerships that are separate legal entities will be dealt with under section CB 2(4)(c), which deals with incorporated bodies, rather than widening section CB 2(4)(b). Section CB 2(4)(b) will cover only limited liability partnerships which, like New Zealand special partnerships, do not have separate legal entity status but there will no longer be a requirement that they are legally equivalent to New Zealand special partnerships.

Recommendation

That the submission be accepted and that the proposed section CB 2(4)(b)(viii) is deleted from the bill.

Issue: Accommodating foreign funds of funds that are structured as limited liability companies

Submission
(19 – Minter Ellison Rudd Watts, 26 – Institute of Chartered Accountants of New Zealand)

The definition of QFEI under section CB 2(4)(c) should be amended so that FFOFs that are structured as separate legal entities (such as United States limited liability companies (LLCs)) can make allocations of income to members that are not in proportion to the members' interest in the capital.

Comment

Currently, the proposed section CB 2(4)(c) requires that for a FFOF that is structured as a separate legal entity to meet the QFEI definition it must, among other things, have members who are entitled to shares of the income of the entity that are in proportion to their capital interest in the entity (section CB 2(4)(c)(ii)). This provision is designed to accommodate entities such as LLCs by describing their common features. However, LLCs may, in certain circumstances, be permitted to make disproportionate allocations of income to their members. The ability to make such disproportionate allocations may, therefore, disqualify such LLCs from the proposed rules. This is not appropriate.

Therefore officials consider that the proposed section CB 2(4)(c) should be amended to remove the requirement that members of the entity must be entitled to income in proportion to their capital interest in the entity.

Recommendation

That the submission be accepted.

Issue: Disqualification of FFOFs

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

There is no reason why the ineligibility of one of the partners or members of a FFOF should disqualify the whole fund from qualifying as a QFEI.

Comment

A FFOF may currently not have any member or partner who owns more than ten percent of the fund and is not resident in a listed country. The new rules are targeted at tax-exempt investors. These investors often invest through foreign funds of funds. The proposed legislation is not trying to target taxable investors who may be indifferent to the imposition of New Zealand tax.

Therefore funds that include large investments from taxable investors will not qualify. If the presence of one ineligible investor did not disqualify the entire fund, Inland Revenue would be in a position of providing the exemption to the extent that the fund consisted of investors who met the criteria. This would involve Inland Revenue having to "look through" the fund to determine the tax status and ownership interest of every investor. Officials believe that such a measure would be impractical and would impose large administrative costs.

Officials accept that FFOFs will contain a mix of tax-exempt and non-tax-exempt investors. However, the information we have received has led us to believe that many of the big FFOFs are made up of predominantly tax-exempt investors and that the ten percent limit on taxable interests in an eligible fund of fund will not disqualify from the rules many of these types of investors.

Recommendation

That the submission be declined.

Issue: Targeting investors with a 10% or less tax rate

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

The regime should be aimed not only at those who are effectively tax exempt or have a 0% tax rate but also those who effectively have a tax rate of 10% or less.

Comment

The proposal is aimed at foreign investors who are sensitive to the imposition of New Zealand tax. This is generally non-residents that are tax-exempt in their own jurisdiction, as such investors would be unable to benefit from a credit (or other compensation from their domestic tax authority) for any tax that they may pay in New Zealand.

The targeting of such tax-sensitive investors will be achieved in the new rule by focussing on whether non-residents are able to gain a financial benefit in their own country from the imposition of New Zealand tax (see sections CB 2(4)(a)(iii); CB 2(4)(b)(vi)(B); CB 2(4)(c)(vi)(B)). Such financial benefit would normally be in the form of a tax credit for the New Zealand tax paid.

If the submission's suggestion were to be applied it would be necessary to amend the rules that seek to ascertain whether the investor will gain a financial benefit from the imposition of New Zealand tax, to provide the exemption if the financial benefit arising from the imposition of New Zealand tax was not significant. Officials consider that a formulation along these lines would give rise to uncertainty and, therefore, should not be adopted.

Recommendation

That the submission be declined.

Issue: Residence of QFEI in a DTA country

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The residence requirement in CB 2(4)(a)(i) should be amended so it applies to tax-exempt entities, and the residence requirement in CB 2(4)(c) should be removed. The only requirement for qualifying foreign equity investors in subsections (b) and (c) should be that the investor is established (rather than resident) in a DTA country.

Comment

To be a qualifying equity investor under CB 2(4)(a)(i), a person must be resident in a territory under a DTA between New Zealand and that territory (excluding Switzerland). This provision is targeted at investors that cannot benefit from a tax credit in their home jurisdiction for New Zealand tax paid – generally tax-exempts. However, under many of New Zealand's DTAs a person can only be resident of a country if they are "liable to tax" in that country. The issue therefore arises whether a tax exempt investor is "liable to tax" and, therefore, a resident under the DTA.

The better interpretation of "liable to tax" is that entities that are tax exempt under their country's tax laws are "liable to tax". The fact that a country provides an entity with an exemption does not mean that the entity is not liable to that country's tax laws. Therefore no amendment is needed.

There is also a residence requirement in section CB 2(4)(c). Paragraph (c) targets FFOFs that are structured as entities that are flow-through for tax purposes but use a company form. However, there is currently some uncertainty about the ability of such an entity to be tax-resident under many of New Zealand's DTAs because a flow-through entity is transparent and, therefore, not subject to the country's tax laws. Therefore the presence of a residency requirement would mean that a FFOF could generally not qualify as a QFEI. The rule should, therefore, be amended to remove the requirement that the FFOF be resident in a particular country.

A residence requirement is, however, required to disqualify FFOFs that do become resident in a country that treats them as an entity and taxes them as such. The reason for this is that such FFOFs are unlikely to be sensitive to the imposition of New Zealand tax as they will generally be able to claim a credit for New Zealand tax paid in their home jurisdiction.

Recommendation

That the submission be partially accepted. The residence requirement in the proposed section CB 2(4)(c) should be amended to remove the requirement for the FFOF to be resident in a particular country. A residence test should be added that disqualifies FFOFs that are resident in a country and that country taxes the FFOF as an entity.

Issue: Exempt investors in a foreign fund of a fund structured as a partnership

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

The exemption provided in section CB 2(4)(b) should be provided to the individual partners of the unincorporated body (the limited partnership) rather than the partnership itself.

Comment

A limited partnership is flow-through for tax purposes. In cases where New Zealand recognises a foreign limited partnership as a partnership and treats it as flow-through for tax purposes, any New Zealand tax will be imposed on the partners rather than the partnership itself.

However, the proposed section CB 2(4)(b) provides the exemption to the partnership itself. This will have no effect as the partnership is effectively ignored for tax purposes. Therefore the proposed section CB 2(4)(b) should be amended to provide the exemption to the partners of the foreign limited partnership, provided that the partnership itself qualifies under the other requirements.

Recommendation

That the submission be accepted.

Issue: Introduction of eligible investment vehicles and a registration system

Submission
(4 – New Zealand Venture Investment Fund)

The regime should be available only to those investing through eligible investment vehicles and who are approved through a registration process, similar to that which operates in Australia.

Comment

The New Zealand Venture Investment Fund (VIF) suggests that the rules around the eligibility of foreign investors are overly restrictive and should be relaxed, but does, however, acknowledge that some restrictions are necessary. The necessary rules are best administered, it suggests, by defining eligible investment vehicles and approving investors through a registration process, similar to Australia's.

Officials consider that a system (like that in Australia) that registered eligible investors and eligible investments would be overly restrictive and bureaucratic. Such a system would impose compliance costs for investors and administrative costs for Inland Revenue. Officials consider that the proposed rules are sufficiently robust to prevent abuse of the regime and provide the opportunity for Inland Revenue to access sufficient information so that any suspected abuse can be investigated appropriately.

Recommendation

That the submission be declined.

Issue: Countries in which a direct QFEI can be resident

Submission
(4 – New Zealand Venture Investment Fund)

In relation to the proposed section CB 2(4)(a)(i), the list of countries in which an investor can be resident should be widened, at least on a case by case basis.

Comment

The reason that investors must be resident in certain countries (DTA countries with the exception of Switzerland) is to provide Inland Revenue with the opportunity to exchange information. This is necessary in order to administer the proposed rules. However, officials recognise that effective information exchange agreements may be negotiated in the future outside the context of a full DTA. If this occurs there may be some scope to extend the list of eligible countries outside those where there is a DTA.

Recommendation

That where an effective exchange-of-information agreement is negotiated with a country (outside the context of a full DTA), consideration be given to making the country eligible under the proposed venture capital rules.

Issue: Redrafting of CB 2(4)(a)(iii)

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

The words "would in no circumstances be entitled to" in section CB 2(4)(a)(iii) should be replaced with the words "is not entitled to" for the purposes of clarity.

Comment

ICANZ have submitted that the words "in no circumstances" are unnecessary and add doubt as to when the section applies. This wording is designed to catch only those investors who are tax-exempt or in a similar position from a tax perspective. As mentioned earlier, officials consider the current words are necessary to exclude investors who are not tax-exempt, or in a similar position to a tax-exempt investor, but are unable to receive a financial benefit from the government because of a temporary feature of their current circumstances, such as being in a tax loss position. There is a risk that the wording suggested by the ICANZ submission would not exclude investors in such a position.

Recommendation

That the submission be declined.

Issue: The scope of the associated persons test

Submission
(15 – PricewaterhouseCoopers)

The associated persons test used in section CB 2(4)(b)(v)(A) and (vi)(A) and CB 2(4)(c)(v)(A) and (vi)(A) is too wide because it could associate all partners in a FFOF.

Comment

The test referred to in these sections is the test laid down in OD 8(3) of the Income Tax Act 1994. However, this test is too wide and could result in all the partners of a FFOF, structured as a partnership, being associated. This would mean that if a fund had one taxable investor or an investor not resident in a DTA country, the FFOF would not be an eligible investor because this investor would taint every investor in the fund by association. The PWC submission has suggested using section OD 7 of the Income Tax Act 1994 in place of OD 8(3).

Officials agree that OD 8(3) is too wide and note that it is not the intended effect of this test to associate all of the investors in a FFOF. However, officials consider that the test in OD 7 is deficient because it does not cover trusts. Therefore officials are of the opinion that OD 8(1) should be the associated persons test used for the purpose of the sections in question. This test avoids the problems with OD 8(3) but is wide enough in scope to cover certain situations involving trusts.

Recommendation

That the submission be partially accepted and the associated persons test in sections CB 2(4)(b)(v)(A) and (vi)(A) and CB 2(4)(c)(v)(A) and (vi)(A) be changed from the test provided in section OD 8(3) to that in OD 8(1) of the Income Tax Act.

Issue: FFOFs established under State laws

Submission
(Matter raised by officials)

FFOFs should be allowed to qualify as QFEIs under section CB 2(4)(b) and section CB 2(4)(c) even if they are established under the state laws of a jurisdiction.

Comment

Under the proposed section CB 2(4)(b) and section CB 2(4)(c), an FFOF can qualify as a QFEI if it "…is established under the laws of a territory". A territory in this context refers to the foreign country. FFOFs are typically limited partnerships or foreign hybrids that are established under the state laws of a particular jurisdiction. There is some doubt whether the current drafting of the proposed section CB 2(4)(b) and section CB 2(4)(c) would extend to cover FFOFs established under a country's

state laws. It is therefore recommended that these provisions be amended to clarify that a limited partnership or foreign hybrid established under the state laws of a particular country can qualify under the new rules.

Recommendation

That the submission be accepted.

MISCELLANEOUS ITEMS

Issue: Extending the removal of the loss ring-fencing to release losses accumulated under the old rules

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

Under the current tax rules, partners of special partnerships cannot offset special partnership tax losses against their other income. These losses must be carried forward and offset against future special partnership income (section HC 1 refers). The proposal in the bill would remove this restriction for losses incurred from 1 April 2004.

The restriction should also be removed for special partnership losses incurred before 1 April 2004 and carried forward because the deferred deduction rules address any concerns about the quality of the accumulated losses.

Comment

Officials do not agree with the suggested approach. Removing the loss ring-fencing rules for special partnership losses incurred before 1 April 2004 and applying the deferred deduction rules to these losses could result in uncertainty as to whether the deferred deduction rule should apply to suspend such losses. The application of the deferred deduction criteria to transactions that were entered into in past years could in many cases be very difficult.

Recommendation

That the submission is not accepted.

Issue: Tax position of investors not subject to the regime

Submission
(15 – PricewaterhouseCoopers)

The provision of an exemption from tax on particular revenue account capital gains of certain non-residents may imply that similar capital gains of investors that do not qualify under the new rules are subject to tax. This could be addressed by including a provision in the bill to the effect that the new rules do not alter the tax position of investors who do not qualify under the regime.

Comment

Officials do not agree that the new exemption will give rise to an adverse inference that similar investments not covered by the exemption are automatically taxable. Under the current tax rules, profits from the sale of shares will only be taxable if, broadly, the shares were purchased with the dominant purpose of resale or the profits form part of the investor's business income. The new exemption is designed to remove a risk that certain foreign investors could be caught by these rules. Officials acknowledge that, in many cases, the automatic exemption afforded by the new rules would not be necessary.

While it is not considered that an amendment is required to clarify the position of non-qualifying investors, officials understand the concern raised by PWC. It is suggested, therefore, that the *Tax Information Bulletin* that is published covering the enactment of the new legislation should make it clear that the intention of the new rules is not to affect the tax position of non-qualifying investors.

Recommendation

That the submission be declined but that the relevant *Tax Information Bulletin* make it clear that the intention of the new rules is not to affect the tax position of investors that are not covered by the new rules.

Issue: Mutual recognition of regimes between Australia and New Zealand

Submission
(4 – New Zealand Venture Investment Fund)

There should be mutual recognition in Australia and New Zealand of the other country's venture capital tax regimes. This would mean that foreign venture capital investors would see Australia and New Zealand as a single venture capital market.

Comment

Officials consider that this proposal has merit and should be pursued with Australia. Currently, the Australian venture capital tax concessions apply only if the venture capital investment is made into an Australian resident company. Similarly, under the proposed New Zealand rules, the tax exemption would only apply if the investment was made into a New Zealand resident company. There is some merit in both countries considering whether their respective exemptions could be extended to apply to an investment made into the other country. The advantage of this approach would be that a non-resident venture capital investor could access New Zealand and Australian venture capital opportunities without being required to make separate investments into New Zealand and Australia.

Officials are in discussion with their Australian counterparts on this issue and it is hoped some progress can be made in the medium term.

Recommendation

It should be noted that New Zealand officials are in discussion with their Australian counterparts on this issue.

Issue: Introduction of an internationally recognised limited partnership regime and the tax treatment of foreign hybrid entities

Submission
(4 – New Zealand Venture Investment Fund, 19 – Minter Ellison Rudd Watts, 16 – New Zealand Venture Capital Association)

New Zealand should introduce an internationally recognised limited liability partnership regime which includes the following features:

- It is simple and familiar to international investors.
- The entities should be re-named "limited liability partnerships".
- It provides certainty in relation to limitation of liability and tax flow through treatment – including separate legal entity status.

The current bill should complement and accommodate the introduction of such an entity. In addition, the proposed reform should include a clarification of the tax treatment of foreign hybrid entities.

Comment

International venture capital investors prefer to invest through limited liability partnerships. The absence of such a vehicle is perceived as a barrier to attracting venture capital to New Zealand. While New Zealand has a form of limited liability partnerships (called special partnerships), these vehicles lack some of the standard features that many consider are required for venture capital investing and may have outdated and inappropriate administrative requirements.

The creation of an internationally recognised limited liability partnership regime in New Zealand is largely a regulatory issue and is currently being considered by the Ministry of Economic Development. The main features of such a vehicle are limited liability status for limited partners, unlimited liability for general partners, flow-through tax treatment and separate legal entity status. Separate legal entity status is seen as important to ensure that the limited liability of limited partners is recognised in cross-jurisdictional transactions.

Under current tax law, however, an entity with separate legal entity status will be taxed as a company and, therefore, will not be flow-through for tax purposes. The issue of separate legal entity status was an issue that was raised with Inland Revenue late in the consultation process. Inland Revenue and Treasury officials are now aware of this issue and are in the process of reviewing whether the provision of tax flow-through status to an entity with separate legal entity status is appropriate. However, this is a complex issue and the review will take some time to complete. Officials are unlikely to be in a position to recommend a course of action on this issue until November 2004.

Therefore, it is likely that changes to the regulatory regime for special partnerships will not occur until after the tax issues associated with the provision of separate legal entity status are settled.

The clarification of the tax treatment of entities known as foreign hybrids (foreign entities which look like companies but are taxed on a flow-through basis) is also an issue that Inland Revenue and Treasury tax officials are currently working on. Officials are currently bilaterally addressing, with the United States, the issue of the status of foreign hybrids under our double tax agreement. Measures to address the issues around New Zealand residents investing in foreign hybrids are due to be introduced in the first taxation bill of 2005.

Recommendation

That the introduction of an internationally recognised limited liability partnership regime and the clarification of the treatment of foreign hybrid entities cannot be achieved as part of this bill.

Issue: Drafting in CB 2(4)(b)(iv) and (c)(v)

Submission

(26 – Institute of Chartered Accountants of New Zealand)

Sections CB 2(4)(b)(iv) and (c)(v) contain double negatives and should be removed.

Comment

These sections contain requirements that a FFOF contain no member or general partner that is not resident of an approved country. In the context of the bill, officials consider that this is the clearest way to draft this particular concept.

Recommendation

That the submission be declined.

Issue: The description of flow through tax treatment

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

The phrase "as not being subject to tax on income other than as a body that handles the income of its members" in CB 2(4)(b)(vii) and (c)(iii) is difficult to interpret and should be clarified.

Comment

This phrase is designed to describe a person that has flow through tax treatment. In the absence of any legal term for a person of this nature, officials are of the opinion that in the context of this bill, the description is the appropriate way to describe this concept.

Recommendation

That the submission be declined.

Issue: Redrafting of CB 2(6)

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

Subsections (a) and (b) of section CB 2(6) need to be clarified as it is unclear what they mean.

Comment

Officials consider that this drafting achieves the correct result and that it is not unclear and, therefore, do not consider that an amendment is required.

Recommendation

That the submission be declined.

Issue: Redrafting of cross-referencing

Submission
(Matter raised by officials)

The cross-reference in section CB 2(1)(h)(iv) needs to be redrafted to avoid confusion.

Comment

The current wording of this cross-reference could lead to some confusion because the subsection refers to companies "other than the resident company", while the cross-referenced subsections are based on the "resident company" meeting the criteria they set out. Therefore the cross-reference does not work as it was intended and needs to be changed.

Recommendation

That the submission be accepted.

Issue: General partners of a special partnership – section HC 1

Submission
(Matter raised by officials)

Clause 24 should be amended so that the repeal of section HC 1 applies to special partnership losses of general partners and special partners of special partnerships.

Comment

The effect of the current drafting of clause 24(2) is that the special partnership losses of general partners of the special partnership that are incurred after 1 April 2004 would still be subject to the loss ring-fencing rules in section HC 1. The intention of the proposed clause 24(2) is that the losses of general partners of special partnerships would not be subject to section HC 1. It is therefore recommended that clause 24(2) be amended so that section HC 1 is repealed for general partners of special partnerships in respect of special partnership losses incurred after 1 April 2004.

Recommendation

That the submission be accepted.

Issue: Section 57 of the Partnership Act

Submission
(Matter raised by officials)

Clause 145, repealing section 57 of the Partnership Act 1908, should be removed from the bill.

Comment

Clause 145 removes section 57 of the Partnership Act 1908. This section states that a special partnership cannot be formed for a period longer than seven years, at which point in time it may be renewed. The objective behind this change was to update the legislation to reflect the normal life of venture capital funds (which generally exist for 10 to 15 years). However, the Ministry of Economic Development has advised that it believes this clause should be removed from the bill.

This is because the removal of the whole of section 57 would create some ambiguity and would require the courts to infer (on reading section 58, which talks about certificates of renewal) that the government intended to retain the right to renew the partnership. There are also other references to time limits, registration and dissolution, such as sections 51(f), 54 and 62, which would need to be amended or removed to ensure the government's intention to remove any time restrictions on the duration of special partnerships was clear. As section 48 prevents any of Part 1 applying to Part 2 unless specifically stated in Part 2, general provisions detailing circumstances for dissolution of the partnership will not apply to special partnerships.

The Ministry of Economic Development will reconsider the best way to achieve the government's intent as part of its review of special partnerships and will make the required changes in its bill.

Recommendation

That the submission be accepted.

Disputes resolution

OVERVIEW

Clauses 9, 34, 70, 76, 77, 78, 79, 80, 81, 82, 83, 84, 95, 97, 99, 102, 104, 129, 134, 141, 143 and 144

The main objective of the disputes process is to have legislation and administrative practices which encourage disputes to be dealt with fairly, efficiently and quickly, before they get to court.

As part of the generic tax policy process, a post-implementation review of the disputes process was undertaken, resulting in the July 2003 discussion document *Resolving tax disputes: a legislative review*. Following the review, the amendments proposed in the bill seek to further improve the framework within which tax disputes are resolved, to ensure that the process is meeting its objectives. This includes ensuring that legislated time-frames provide a balance between the government's and taxpayers' interests.

The early resolution of a dispute is intended to be achieved through a series of steps prescribed in legislation, the main elements of which are:

- A notice of proposed adjustment (NOPA). This is a notice by either the Commissioner or a taxpayer to the other that an adjustment is sought in relation to the taxpayer's self-assessment.
- A notice of response (NOR). The NOR is a notice of response issued by the party receiving the NOPA if they disagree with the NOPA.
- A disclosure notice and statement of position (SOP). A disclosure notice triggers the issue of an SOP. An SOP contains the detailed facts and legal arguments to support the position taken and again is issued by both parties. It is an important document because it limits the parties to their respective facts and arguments if the case goes to court – this limitation is referred to as the "evidence exclusion rule".

The prescribed documents are intended to encourage an all "cards on the table" approach to dispute resolution that ensures that all the relevant evidence, facts and legal arguments are canvassed before a case goes to court. There are also two administrative phases in the process – the conference and adjudication phases. The conference is a relatively formal meeting between Inland Revenue and the taxpayer which aims to clarify and, if possible, resolve the issues. Adjudication involves the independent consideration of the dispute by Inland Revenue and is the final phase in the process before the taxpayer's assessment is amended.

The process is set out in the diagrams on pages 38 and 39.

Key features of the proposed amendments

Completing the process

Proposed amendments which ensure that the various steps required to facilitate the resolution of a dispute are completed as the legislation intended include:

- clarifying that the Commissioner must, other than in prescribed circumstances, apply all the legislated steps of a dispute (proposed new section 89N, Tax Administration Act 1994 (TAA));
- replacing the current six-month period within which the parties may agree to extend the time available for a dispute with a 12-month period (section 108B); and
- expanding the circumstances in which a document that is provided late by the taxpayer will be accepted by the Commissioner (amending section 89K).

Ensuring the process is efficient and cost-effective

To ensure that the disputes resolution process is accessible to taxpayers, the costs incurred in preparing the various documents should be no greater than is necessary for each particular case. Amendments aimed at achieving this objective include:

- simplifying the documentation required by both parties to progress a dispute (amended sections 89F and 89G);
- requiring a more detailed document where a NOPA is issued by a taxpayer;
- extending the time for taxpayers to initiate a dispute to their self-assessment from two months to four months (amendment to the definition of "response period" in the TAA);
- introducing an accessible small claims process which includes raising the threshold for such cases from $15,000 to $30,000 and clarifying that a "precedent" case is one that has wider implications for other taxpayers (sections 13B of the Taxation Review Authorities Act 1994, 89E of the TAA and regulation 18 of the Taxation Review Authorities Regulations 1998); and
- allowing the disputes process to be stayed pending the outcome of a test case if both parties agree (proposed new section 89O).

Providing time-frames which balance government's and taxpayers' interests

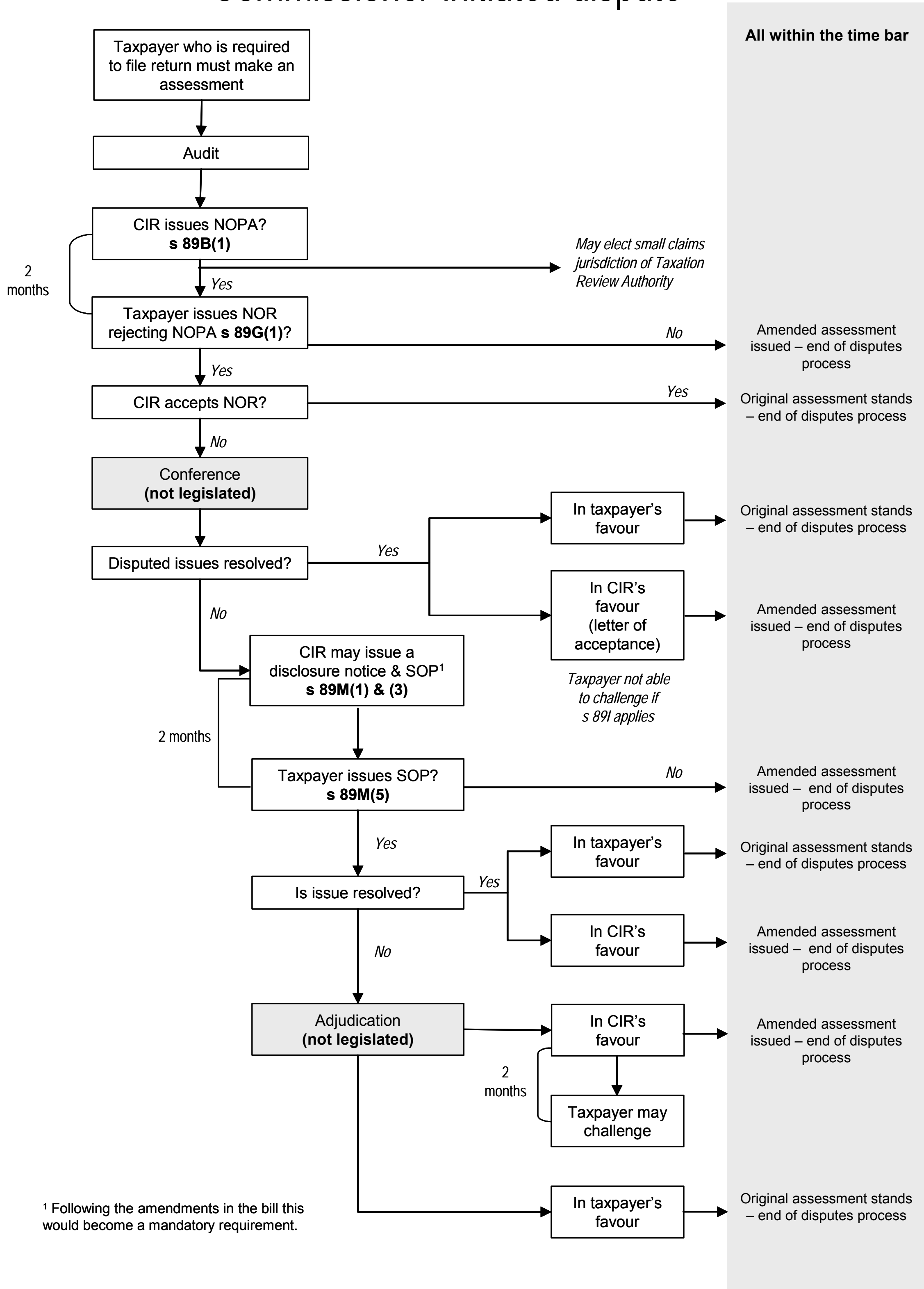
The provision of time-frames is necessary to balance the government's need to manage revenue risk and the taxpayers need to ensure that their tax is correctly paid. To achieve this, the time-frames within which tax refunds are allowed (sections MD 1(1)and MD 1(2) of the Income Tax Act 1994 and section 45 of the GST Act) are being amended to provide for a four-year rather than an eight-year refund period, unless the taxpayer has made a clear mistake or simple oversight, where the period will remain eight years.

If a taxpayer is retrospectively claiming a GST input tax deduction in circumstances where the issue may be more complex and/or disputable – for example, one arising from new case law or a new interpretation that the taxpayer had not previously considered – a period of two years will be allowed. A taxpayer's currently unlimited ability to claim an input tax credit in a current period return relating to a past transaction will be retained for straightforward cases, such as those involving a clear mistake or simple oversight.

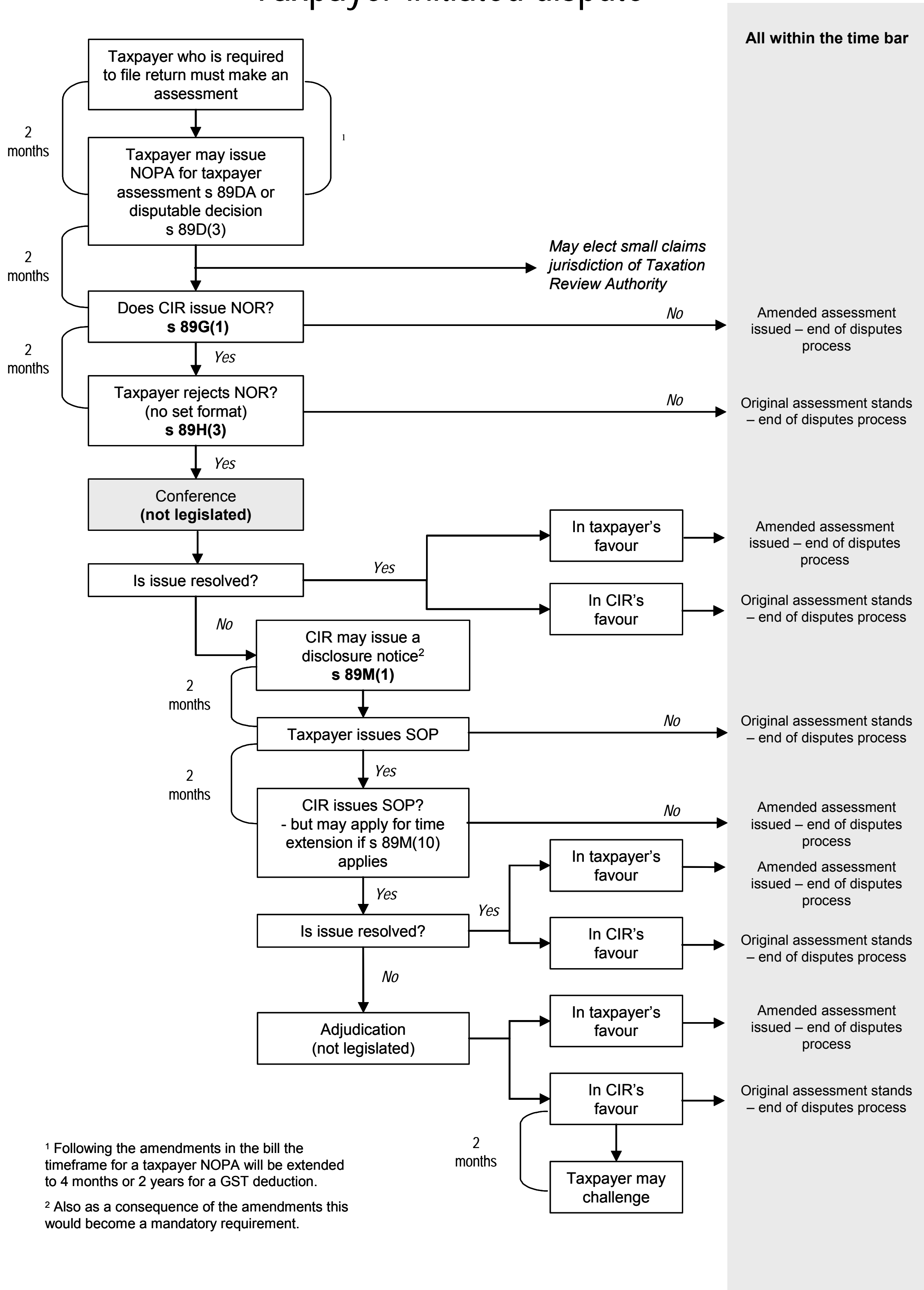
Submissions

Twelve submissions were made on the various clauses in the bill relating to the review of the disputes process. Five submissions supported the improvements made to the disputes process but considered that the amendments did not go far enough. Five submissions noted that the amendments did not address taxpayers' concerns and that the proposals weighed heavily in favour of Inland Revenue rather than taxpayers. One commented generally on the disputes resolution process, and the rest of the submissions made specific recommendations to further improve the amendments.

Commissioner-initiated dispute



[1] Following the amendments in the bill this would become a mandatory requirement.



[1] Following the amendments in the bill the timeframe for a taxpayer NOPA will be extended to 4 months or 2 years for a GST deduction.

[2] Also as a consequence of the amendments this would become a mandatory requirement.

COMPLETING THE PROCESS

Clause 84

Issue: The legislation should be clarified to ensure that "completing the process" means consideration of the taxpayer's SOP

Submissions

(13 – Jeff Owens & Company, 15 – PricewaterhouseCoopers, 21 – New Zealand Law Society, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

The section needs to be clarified to ensure the reference to "completing the process" includes Inland Revenue waiting for the taxpayer's SOP and then considering whether it agrees with the taxpayer's SOP. Under proposed section 89N what is meant is that the issue of the Commissioner's SOP and taxpayer's SOP plus consideration of the taxpayer's SOP will occur. This is not clear in the legislation.

Comment

The Commissioner is generally limited to a four-year period within which to amend a taxpayer's assessment following an investigation or in certain other circumstances. In the case of a dispute the assessment is amended following the process for resolving disputes. The intention at the time the legislation was introduced was that the various steps involved in the process would be undertaken within the four-year period.

Owing to the manner in which it has been possible to apply the disputes process, the various steps in the process have not been completed as the legislation intended in all cases.

To address this, the Commissioner of Inland Revenue will be required to follow the legislated steps of the disputes process, other than in specific circumstances. The policy intent is that both the taxpayer and Commissioner SOPs should be issued and considered within the four-year period and this is what is meant by "completing the process".

Submissions note that it is not clear whether completing the disputes process includes the consideration by the Commissioner of the taxpayer's SOP, issued in response to the Commissioner's SOP. Officials agree that this should be clarified in the legislation.

Recommendation

That the submissions be accepted.

Issue: Lack of time-frames on the Commissioner

Submissions

(13 – Jeff Owens & Company, 15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 19 – Minter Ellison Rudd Watts, 27 – KPMG)

Submissions state that the objectives of the disputes process will never be achieved while Inland Revenue has unlimited time in which to deliver on its own objectives. A fundamental fault with the disputes regime is that the legislation imposes deadlines on taxpayers at every stage of the process, but there is no deadline on the Commissioner to issue a disclosure notice in a taxpayer-initiated dispute or to issue a SOP in a Commissioner-initiated dispute.

The justification for the lack of time-frames ignores important points:

- Disputes can, and do, drag on for years.
- The main reason taxpayers would like a legislated time-frame is not to gain assurance as to progress, it is to have disputes resolved in a timely manner.
- Administrative methods of progress are ineffectual.
- It would be a measure of good faith on the part of Inland Revenue if they showed some willingness to be subject to the same, or similar, time-frames.

Inland Revenue has assured taxpayers that administrative improvements and guidelines will effectively mean the Inland Revenue will be working to set time limits internally. The submitters are not convinced that administrative time limits will work.

Submissions request that both Inland Revenue Policy and Operations provide the select committee with reasons why such statutory time-frames are unacceptable and advise how Inland Revenue proposes to improve its administration of tax disputes. There is concern that without a legislative requirement, such promised improvements will either never be made or will not be maintained.

Comment

The main reason that the legislation does not prescribe a time-frame for SOPs initiated by the Commissioner is that there needs to be adequate time allowed to determine whether the issue is able to be resolved before litigation. This includes allowing sufficient time for the conference phase, which is an important administrative part of the disputes process.

In an efficiently managed case, excessively rigid time-frames may signal to the taxpayer that Inland Revenue is focused on meeting the statutory phases of the dispute rather than on taking the time to actually resolve it.

Although introducing more time limits at the SOP stage would provide taxpayers with more assurance as to how their dispute is progressing, this can also be achieved administratively through greater contact with the taxpayer and the provision of guidelines as to likely time-frames. This is the current practice adopted by Inland Revenue in its standard practice statement (INV-170).

Further, the proposal requiring the Commissioner to complete the disputes process means that the SOP phase must be completed within four years from the return filing date. This in itself ensures that disputes are managed in a timely manner, and that audits are started and completed earlier. The ability to agree to a time bar waiver for 12 months then provides for the dispute to go through the adjudication phase, if this has not been completed within the four years. These changes already aim to enhance the timeliness of disputes and Inland Revenue will need time to adapt to these changes. For this reason alone, officials do not recommend legislating a time-frame for SOPs, even if that were an appropriate policy outcome.

Operational processes are continually being improved to ensure disputes are administered efficiently. Changes to internal processes have been implemented or are in the process of being developed, to address issues raised in the Office of the Controller and Auditor General's report on the performance of taxpayer audit (July 2003). For example, Inland Revenue is currently reviewing its case management requirements, with the aim of introducing a new case management system across the organisation. Taxpayer audit is one of the first areas of focus. This will improve the management of disputes. Note that Inland Revenue has to meet external performance standards agreed to with the government, of which timely completion of the disputes process is one.

Recommendation

That the submissions be declined.

Alternative proposal: There should be a statutory time limit requiring Inland Revenue to start and complete audits within a time-frame to ensure that the disputes process is completed

Submissions
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

Inland Revenue takes too long to start and then complete audits, which affects the department's ability to complete the disputes process within the required four-year period. Legislative amendments that impose statutory time limits requiring Inland Revenue to start and complete audits faster and more efficiently would be the preferred approach.

Comment

Officials consider that the proposal that disputes reach the SOP phase, except in certain specified circumstances, before the four-year time bar, in effect ensures that audits are started and completed earlier in the process. An additional requirement may not be able to be managed administratively without causing a revenue risk – for example, through Inland Revenue being unable to investigate a complex issue across a wide range of taxpayers within the available time-frame.

Recommendation

That the submissions be declined.

Issue: Reference to adjudication should be inserted into the legislation

Submissions
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 21 – New Zealand Law Society)

The proposed amendments do not achieve the objective of ensuring that the disputes process be completed. This is because there is no requirement to complete the adjudication phase. These requirements must be in the legislation. A simple reference in new section 89N(2) to "including adjudication phase as carried out by the Commissioner" should be sufficient.

Comment

When the current disputes process was introduced it was envisaged that the adjudication function would be separate from Inland Revenue's audit function and would have as its purpose "…the provision of an impartial application of tax law and a greater application of technical expertise to the affairs of taxpayers prior to the issue of an assessment."[1]

Submissions view the present adjudication function as a beneficial and positive aspect of the disputes process. They therefore consider that the Commissioner should ensure that disputes have the opportunity to proceed to adjudication. Officials agree with this view. However, legislating a requirement for adjudication is only one option for ensuring this. Another option, as proposed in the bill, is to provide a framework to ensure that there is sufficient time for referral to adjudication to occur administratively.

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[1] *Organisational Review of the Inland Revenue Department; Report to the Minister of Revenue (and on tax policy, also to the Minister of Finance)* from the Organisational Review Committee, April 1994, p 67.

The adjudication follows the issue of SOPs in the disputes process. It is proposed that the SOP phase must be completed before an assessment is able to be issued (except in certain prescribed circumstances). The time-frame for the Commissioner to amend an assessment is four years from the date the return is filed. Inland Revenue will need to ensure that the adjudication process is able to be completed within the four-year period. However, the legislative requirement to follow the process to the SOP phase will in some cases place more pressure on the time for the adjudication phase. Hence an extension to the time bar waiver has been recommended.

The current time bar waiver allows the parties to agree, if the four-year period for issuing an assessment is about to expire, to extend the four-year period by six months. The period proposed is 12 months. This should ensure that there is sufficient time for disputes to proceed to adjudication, if adjudication has not been completed in time.

This alternative approach effectively achieves the same result but removes difficulties which officials consider are likely to arise from the submissions' approach such as:

- The adjudication function will need to be defined. Even if this is done broadly there will need to be reference to such terms as "impartial" or "independent" which will in themselves give rise to disputes.
- Even at a broad level the functions of adjudication will need to be set out and this will need some consideration – for example, would the function be a final decision-making one and, if so, in what form would the final decision be conveyed?
- Presumably, time-frames for completing an adjudication would need to be considered. Given the complexity of many of the cases that are currently referred to adjudication, it would be important to ensure that a revenue risk did not arise because insufficient time was available to complete the adjudication. As noted above, officials' view is that the time needed to ensure this is the four-year period for assessments and a further 12-month waiver period. That would suggest that, if the adjudication function were legislated, the time bar on the Commissioner would need to be extended to five years. A change of this nature would require analysis and consultation beyond the scope of this bill.

Recommendation

That the submissions be declined.

Issue: Adjudication should be legislatively provided for and a time limit placed on the issue of the adjudication report

Submissions
(13 – Jeff Owens & Company)

The adjudication unit in Inland Revenue should be required to issue a ruling within two months. Adjudication takes too long despite the *Taxation Information Bulletin* Vol 8, No 3, August 1996 stating that an "adjudicator's decision will be made within 4-6 weeks, this could be longer, or shorter depending on how complex the case is."

Such time-frames should be put on hold during any period in which Inland Revenue has made a reasonable request for information from the taxpayer and is waiting for a response.

Comment

Adjudication's role is to consider the correct application of the law and determine whether the facts of the case meet the requirements of the legislation. Adjudication brings an impartial fresh perspective to the dispute and is independent of Inland Revenue's audit function.

The adjudicator considers carefully every argument put forward before reaching a conclusion. Therefore it is difficult to place a time limit on the production of the adjudicator's report, as this can be affected by factors such as the complexity of the case and the amount of information contained in the files sent to adjudication. As reflected in the comments on the previous submission, to ensure that the adjudication was able to be completed within a set time-frame a period of 12 months would be required.

However, in order to place a time-frame on adjudication it would be necessary to first define adjudication legislatively and, for the reasons given, officials do not support this.

Recommendation

That the submission be declined.

Issue: Other parts of the disputes process must be completed at least six months prior to the four-year time bar to allow for adjudication

Submission
(21 – New Zealand Law Society)

Alternatively, if the legislative provision of adjudication is not accepted there should be provision that the other parts of the disputes process must be completed at least six months prior to the time bar. This would allow time for Inland Revenue's administrative requirements to be completed.

Comment

The proposed section 89N, states that the Commissioner must complete the disputes process – except in certain circumstances – before an assessment is issued. This places an onus on Inland Revenue to ensure that there is enough time to complete the disputes process. As noted in the previous comments, the new 12-month time bar waiver period aims to ensure that the adjudication process is also completed.

Recommendation

That the submission be declined.

Issue: New section 89N – what constitutes a "failure to provide information requested"

Clause 84

Submission
(15 – PricewaterhouseCoopers 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

Clarification is required in proposed section 89N(1)(c)(vi) – one of the exceptions to the requirement to follow the full legislated process – as to what constitutes a failure to provide information. This limb should be invoked only where the taxpayer has failed to comply within a reasonable time-frame that the taxpayer has accepted in writing.

If no clarification is provided, Inland Revenue will be empowered to determine subjectively whether or not a taxpayer has complied with a request. There is a risk that an investigator may incorrectly claim that information is being withheld.

Comment

In order to encourage an "all cards on the table" approach to dispute resolution that ensures that all the relevant evidence, facts, and legal arguments are canvassed, Inland Revenue requires information from the taxpayer.

Generally, information is provided voluntarily to Inland Revenue. However, in situations where this does not occur a statutory power (usually in the form of a notice under section 17 of the TAA) will be invoked in order to obtain the information. The formal request will generally set out the time within which the information must be provided.

Draft paragraph (vi) is intended to address a failure to comply with this type of request for information in circumstances where the specified time limit has not been met. Therefore the paragraph should be clarified to ensure that it applies only in this situation. This should address the submissions' concern.

Recommendation

That the submissions be accepted.

Issue: New section 89N – what constitutes a "request under a statute for information"?

Clause 84

Submissions

(15 – PricewaterhouseCoopers 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

Clarification is required in section 89N(1)(c)(vi) as to what constitutes "a request under a statute for information" as the current wording appears to provide an extremely wide exception to the full disputes process requirement. It is unclear whether any information requested by Inland Revenue will arguably be pursuant to delegated authority and therefore a request under a statute.

Comment

A request under a statute by the Commissioner refers to any section under the Revenue Acts administered by the Commissioner which provides the ability to request that information be provided. The proposed wording is not excessively wide as it is naturally limited to a statutory provision such as section 17 that allows the Commissioner to request information. The request is also limited to information that relates to the dispute. It is therefore unnecessary to list particular sections.

Recommendation

That the submissions be declined.

Issue: New section 89N – the ability to apply to the High Court should be removed

Clause 84

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

There is no need for the clause allowing the Commissioner to go to the High Court as an exception to the requirement to follow the full legislated process. The section should be deleted.

Comment

The section is necessary to cater for situations where the Commissioner considers that there are reasonable grounds, other than those specifically prescribed, for not following the full statutory process. It is envisaged that the exception will be used only in exceptional circumstances.

Recommendation

That the submissions be declined.

Issue: New section 89N – in what circumstances can the Commissioner apply to the High Court for an order to either issue an assessment, or complete the process?

Clause 84

Submissions
(15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society, 26 – Institute of Chartered Accountants of New Zealand)

Clarification is needed as to the circumstances in which the Commissioner can apply under section 89N(3) to the High Court. It should also be clarified that taxpayers will have a right to appear in such hearings and appeal in any such proceedings.

The TAA should prescribe the circumstances in which Inland Revenue may exercise this power. This course of action should only be available in very exceptional circumstances.

In considering an application under proposed section 89N(3), regard should be had to the provisions of sections 89A and 89N, the conduct of the parties to the dispute and the purpose of the time bar in section 108 of the TAA.

Comment

It is envisaged that the exception to apply to the High Court for an order to issue an assessment or to allow further time to complete the process will be used only in exceptional circumstances. It is intended that the section will cover broadly similar situations already listed in the proposed new section which provide a schematic constraint to its application.

The High Court in *Sweetline Distributors Ltd & Ors v CIR*, High Court Wellington, CIV 2001-485-712, CP 107/01 confirmed that an assessment issued without completing the disputes process is valid and necessary in order to discharge the Commissioner's duty to ensure that the highest net revenue is collected in the public interest. This decision provides some guidance for Inland Revenue and taxpayers as to when it will be appropriate for Inland Revenue to approach the High Court for an order.

The process of applying to the High Court for an order is governed by the High Court Rules, not the disputes legislation and normal appeal rights exist, including the ability of the other party to appear at the hearing.

Therefore officials do not agree that the circumstances in which the provision will be used needs to be detailed in the legislation. Officials do consider, however, that some guidance on the point should be provided in a *Tax Information Bulletin* or Standard Practice Statement.

Recommendation

That the submissions be declined.

Issue: New section 89N(3) – the time bar should be suspended when the Commissioner applies to the High Court for an order to either issue an assessment, or complete the process

Clause 84

Submission
(Matter raised by officials)

Section 89N(3) provides for the ability for the Commissioner to apply to the High Court for an order to issue an assessment or to complete the process. In situations where the Commissioner must act quickly and the time bar is imminent, it is necessary to suspend the 4-year time bar if an application is made under this section to ensure the court has the time to act accordingly.

Comment

Officials consider that when an application is made the 4-year time bar should be suspended until such time as the assessment is issued, the process is completed (as directed by the court), or the dispute is otherwise resolved.

Recommendation

That the submission be accepted.

Issue: New section 89N – incorrect reference to associated person provision

Clause 84

Submission
(21 – New Zealand Law Society)

The exception that refers to the associated persons provision is inappropriate. The proposal refers to section OD 8(3). This is a wide section. In a domestic context section OD 7 provides an appropriate test for associated persons.

Comment

Officials consider that section OD 7 is not an appropriate associated persons provision to use in this context as it has a number of shortcomings, including not having a test for the trustee and beneficiary relationship; the definition in OD 8(3) includes this test. There are many examples of the section OD 8(3) associated persons definition being used in a domestic context – for example, in all the depreciation provisions. Current drafting practice is to refer to section OD 8(3) rather than section OD 7 until such time as the associated person definitions are reviewed as a separate project.

Therefore officials consider that the use of the section OD 8(3) definition is appropriate.

Recommendation

That the submission be declined.

Issue: New section 89N – reference to "criminal matter" should be defined

Clause 84

Submission
(27 – KPMG)

Allegations of a "criminal matter" in section 89N(1)(c)(i) – one of the exceptions to the requirement to follow the full legislated disputes process – should be defined. It is unclear what this means. The dispute could involve allegations of a criminal nature simply because the taxpayer was being assessed for the proceeds of crime.

Comment

The exception applies where the Commissioner may need to act quickly to issue an assessment where criminal activities are alleged.

Therefore officials agree that the application of the section should be clarified.

Recommendation

That the submission be accepted.

Issue: New section 89N – judicial review proceedings

Clause 84

Submission
(19 – Minter Ellison Rudd Watts, 15 PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

It is inappropriate that Inland Revenue is not required to complete the full disputes process where a taxpayer has chosen to bring judicial review proceedings.

As suggested in the discussion document, the exception for judicial review should not apply to judicial review proceedings initiated in relation to the time-bar.

Comment

The exception relating to judicial review proceedings reflects that the parties' resources may be directed away from progressing the dispute through the disputes process towards addressing the facts and issues in the judicial review application. The exception applies to all judicial review proceedings brought against the Commissioner.

Officials consider that this is an appropriate reason to issue an assessment without completing the full disputes process.

Recommendation

That the submissions be declined.

Issue: New section 89N – the word "delay" should be removed

Clause 84

Submission
(27 – KPMG)

The word "delay" should be removed from 89N(1)(c)(ii) and (iii). These paragraphs provide for the ability to issue an assessment without following the full legislated process if the Commissioner considers the taxpayer or an associated person of the taxpayer has taken steps as to the existence of the taxpayer's assets to avoid or delay the payment of tax. The exception is reasonable if the intent is to avoid paying tax. It is unnecessary to also include the word "delay". It is not clear what it means.

Comment

The purpose of the provision is to address situations where a taxpayer or associated person of the taxpayer seeks to dispose of assets which may be required to meet an outstanding tax liability, and the issue of an assessment becomes urgent.

Officials consider that the meaning of the word "delay" can be determined by reference to its context in the proposed provision.

To provide that the taxpayer has taken steps to avoid or delay means that it is not necessary that Inland Revenue prove that the taxpayer acted to ensure that the tax was never paid. This would often be very difficult to determine. It is therefore appropriate that the provision apply if the taxpayer sought to avoid or delay the payment of tax by taking steps in relation to the existence or location of the taxpayer's assets.

Recommendation

That the submission be declined.

Issue: Provision should be made to allow taxpayers to unilaterally opt out of the disputes process

Submission
(21 – New Zealand Law Society)

Taxpayers should be able to unilaterally opt out of the disputes process and go directly to court. Otherwise they may be required to invest a considerable amount of resource in the NOPA/SOP phase, with the taxpayer receiving no benefit.

Comment

One of the reasons the Organisational Review recommended that Inland Revenue needed a new comprehensive approach to resolving tax disputes was because many disputes went to court that could and should have been settled by discussion and full disclosure of the factual basis for argument.[2] The current disputes process therefore aims to ensure that all the relevant evidence, facts, and legal arguments are canvassed before a case goes to court.

Officials consider that giving taxpayers the ability to opt out of the disputes process unilaterally would defeat the purpose of the disputes process. In practical terms it would mean deferring the costs of a dispute to the litigation stage and potentially adding to the time and costs involved in a court hearing. There could be further additional costs if the court had to refer the case back to the parties – for example, to agree on the facts.[3]

Officials do consider, however, that the disputes process needs to cater for all taxpayers and that there should therefore be an appropriate balance between ensuring the process is completed as was intended and that the costs of the process do not outweigh the amount of money in dispute.

The bill therefore proposes two exceptions to completing the disputes process in smaller or more straightforward cases. First, the Commissioner and the taxpayer can agree to opt out of the process for any dispute. This would occur – for example, if the compliance and administrative costs that the parties might incur in completing the full disputes process would be excessive relative to the amount in dispute. Secondly, the taxpayer may elect, instead of having the full process, to have the dispute heard by the Taxation Review Authority acting in its small claims jurisdiction. The threshold for small claims has been increased from $15,000 to $30,000.

Recommendation

That the submission be declined.

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[2] *Organisational Review of the Inland Revenue Department, Report to the Minister of Revenue (and on tax policy, also to the Minister of Finance*) from the Organisational Review Committee, April 1994. P 67.
[3] See, for example, *Alpe v CIR* (2001) 20 NZTC 17,372.

THE DOCUMENTATION REQUIRED AS PART OF THE DISPUTES PROCESS

Issue: The amount of detail required in the taxpayer NOPA should not be more than the detail required in a Commissioner NOPA

Clause 80

Submission

(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society)

There should not be a difference in the standards of detail required between taxpayer-initiated NOPAs and Inland Revenue-initiated NOPAs, as contained in proposed section 89F. The level of detail in a taxpayer-initiated NOPA should be self-policing as the taxpayer knows sufficient information needs to be provided. To have a legislative difference in levels of detail risks taxpayers being accused of providing invalid NOPAs when the focus should be on the substantive merits of the taxpayer's NOPA.

Comment

Officials do not consider that a comparison between the detail required in a Commissioner NOPA and that required in a taxpayer NOPA is necessarily helpful since the two documents have quite separate functions. In general terms, less information should be required in a Commissioner NOPA because the taxpayer will know the background to the issued raised. In comparison, a taxpayer NOPA will very often contain the only information available to the Commissioner in respect of the issue raised.

One of the main reasons taxpayers may choose to initiate a NOPA is to eliminate their exposure to shortfall penalties. At present, a taxpayer can file a return on a conservative basis and then raise a potentially more arguable issue arising from their return separately by way of a taxpayer NOPA. As penalties are calculated by reference to the tax position taken in a return (or self-assessment), rather than in a NOPA, the risk of shortfall penalties applying is removed.

The purpose of requiring the taxpayer to provide more information in their NOPA is essentially to treat the document as if it were an investigation by the taxpayer of their own return. This will ensure that the taxpayer has fully considered an issue before raising it in a NOPA. It will also reduce administrative and compliance costs since, because of the greater level of detail that will be required, potential disputes may be able to be resolved at an earlier stage (ideally without the need for further investigation).

The growing use of the taxpayer-initiated NOPA may place pressure on Inland Revenue's resources, particularly given the constraints of the two-month period to issue a notice of response. Therefore it is important that this process be managed as efficiently as possible. Compliance costs will also be reduced for taxpayers if Inland Revenue does not need to continuously seek further information from them.

Officials note that, because of the potentially greater level of information that will be required in a taxpayer NOPA, taxpayers will be given four months, instead of the current two months, to provide the NOPA.

Recommendation

That the submissions be declined.

Issue: Detailed amendments to taxpayer NOPA if preceding submission not addressed

Clause 80

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

Section 89F(3)(a) should only refer to "a clear statement of the facts" rather than "clear and detailed…". The reference to "detailed" risks being seen as requiring unnecessary levels of detail and will simply increase compliance costs on taxpayers.

Comment

The objective of the NOPA and NOR documents is to ensure that, where possible, enough information is provided to resolve a dispute at an early stage. The taxpayer should therefore provide enough information to ensure that the Commissioner is either able to respond to the NOPA or to agree to the adjustment. However, taxpayers should not incur unnecessary costs in doing so.

Officials agree that the requirement that the statement of the facts and law be "detailed" should be removed. However, to ensure that disputes are resolved as quickly as possible, officials recommend that the taxpayer provide a "clear and complete statement of the facts and law that the taxpayer considers make the adjustment necessary". This would reduce the submissions' concerns with compliance costs but at the same time provide the information necessary for the Commissioner to consider the taxpayer NOPA.

Recommendation

That the submission be accepted, in that the word "detailed" be removed from proposed section 89F(3)(a) and replaced with the word "complete" or a similar term.

Issue: To provide all material documentary evidence in a taxpayer NOPA is unnecessary

Clause 80

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

There should not be a requirement for a taxpayer to attach all material documentary evidence to a taxpayer-initiated NOPA.

Comment

The requirement that a taxpayer attach all material documentary evidence to a taxpayer NOPA ensures that the Commissioner has all the information necessary to respond to the NOPA. If the information is adequate to support the adjustment then it is less likely that the Commissioner will need to investigate the adjustment further. This will facilitate a speedy resolution to the dispute.

However, officials acknowledge that there are compliance costs associated with taxpayers ensuring they provide all the material documentary evidence. In response to this concern, new section 89F should be amended to state that the taxpayer is required to supply the "key" (or similar) documentary evidence materially relevant to the issues arising between the Commissioner and the taxpayer, rather than all documentary evidence.

Recommendation

That the submission be accepted.

Issue: Clarify that a taxpayer NOPA must identify the adjustment or adjustments made to a disputable decision

Clause 80

Submission
(Matter raised by officials)

Proposed section 89F(3) setting out the content of a taxpayer NOPA should contain a requirement to ensure the taxpayer identifies the adjustment or adjustments proposed to be made to a disputable decision.

Comment

A NOPA issued by the Commissioner must identify the adjustment or adjustments that must be made to the assessment. The proposed new section does not clearly provide that taxpayers must identify the adjustment in their NOPAs. Officials recommend that a similar reference be included in the requirements for a taxpayer NOPA.

Recommendation

That the submission be accepted.

Issue: Detailed amendment to NOR

Clause 81

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

Section 89G(2)(e) requires that the issuer of the NOR indicate by how much the figure referred to in the NOPA is incorrect. The current wording assumes that the quantitative adjustments will be easy to calculate. "Likely to result" should be inserted to introduce a degree of flexibility.

Comment

One of the requirements of the NOR is that the taxpayer and the Commissioner must state concisely an adjustment to any figure referred to in the NOPA that results from the facts and legal arguments relied on by the issuer of the NOR. This proposal ensures that the NOR is a meaningful document that responds fully to the NOPA. There is no requirement that the amount referred to be final. One of the objectives of the steps in the process – especially the NOPA and NOR phase – is to achieve a level of disclosure of relevant information and discussion between the Commissioner and the taxpayer.

As the dispute progresses, the amount in dispute may be altered reflecting the outcome of, for example, a conference or other discussions between the parties. The quantitative adjustment requirement merely establishes, in the issuer of the NOR's opinion, by how much the adjustment in the NOPA is incorrect. Officials consider that the remaining steps in the disputes process in themselves provide the flexibility for this quantification to change.

Recommendation

That the submissions be declined.

THE FOUR-MONTH TAXPAYER NOPA PERIOD

Issue: Support for proposal

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

Clause 70

The proposed four-month period within which a taxpayer can issue a NOPA is better than the current two months and should be welcomed by taxpayers.

Comment

In recognition of concerns raised in submissions to the discussion document that more time is needed for taxpayers to issue NOPAs and the requirement on taxpayers to provide detailed information to the Commissioner when they initiate a dispute, it is proposed that the definition of "response period" in the TAA be amended to give taxpayers four months, instead of the current two months, to initiate a dispute to their self-assessment.

Recommendation

That the submissions be noted.

Issue: Four-month NOPA period not long enough

Clause 70

Submission
(10W – Business New Zealand, 19 – Minter Ellison Rudd Watts, 15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

Four months is not long enough. Submissions prefer a 12-month period. Taxpayers do not generally undertake reviews of their tax returns within four months of the filing of the return. Errors are usually identified 12 months after the filing of a return.

Comment

In recognition of submissions on the discussion document that more time is needed for taxpayer-initiated disputes and the proposed requirement on taxpayers to provide complete information in the taxpayer NOPA, it is proposed to extend the current two month period to issue a taxpayer NOPA to four months.

However, any further time allowed in which to issue a taxpayer NOPA – for example, 12 months – greatly reduces Inland Revenue's ability to manage the dispute through all the steps of the disputes process, within the four-year time bar. Therefore if the taxpayer NOPA period were extended to 12 months, the four-year time bar would need to be extended by a similar amount of time, which could significantly delay the issue of an assessment or resolution of the dispute. Extending the four-year time bar to five years would be inconsistent with the objective of attaining finality to an assessment within a reasonable period and would require full consultation beyond the scope of this bill.

Recommendation

That the submissions be declined.

Issue: Ensure that the self-assessment date is clear

Clause 92

Submission

(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

Consideration needs to be given how the concept of "received at an office of the department" under section 92 and the time-frame for a taxpayer NOPA will work in practice.

To ensure the date is known to taxpayers, the Commissioner should be required to print the date on the statement of account issued to the taxpayer that acknowledges the taxpayer's assessment.

Comment

Inland Revenue practice is that on the date of receipt of the taxpayer's assessment, the return is date stamped – electronically or manually – and it is this date that is entered into Inland Revenue's FIRST system. Once this date is entered into the FIRST system, a return acknowledgment form is generated and sent to the taxpayer. Therefore the taxpayer will have a record of the date of receipt, and the date of self-assessment will be clear.

Recommendation

That the submissions be accepted.

Issue: Agreement must be in writing

Clause 97

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The waiver under which the Commissioner and the taxpayer can agree to allow more time (up to 12 months) for a dispute to be resolved should be in writing.

Comment

The existing time bar waiver period of six months is problematic because in some cases six months is insufficient to complete the process.

The proposal extends this six month waiver period to 12 months to provide sufficient time to complete the disputes process in cases where this extra time is needed.

The proposal does not replace existing section 108B(2), which already provides that the waiver must be in the prescribed form and in writing. Therefore no further change is required as the submissions' concerns are already addressed.

Recommendation

That the submissions be noted.

Issue: Clarify that the Commissioner must not raise new issues in the waiver period

Clause 97

Submission
(18 – Corporate Taxpayer Group, 19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society)

The wording of the amendment (that the Commissioner cannot raise new issues during the period of the waiver) in proposed section 108B(1B) needs to be explicit and state unequivocally that the Commissioner cannot raise any new issues during the period of the extension.

The wording should be amended to make it clear that the issues that Inland Revenue is limited to investigating are those that are currently the subject of dispute and are known to Inland Revenue and the taxpayer and also formally identified by both parties, prior to the waiver being granted.

Comment

The proposal to extend the waiver period to 12 months also provides that the Commissioner will not be able to raise new issues during the waiver period that are not identified and known to both parties before the start of the waiver period. This is intended to address concerns by both taxpayers and Inland Revenue that taxpayers have in the past been reluctant to grant the waiver because of the risk that Inland Revenue could raise new issues in the waiver period.

Submissions consider that this requirement needs to be more clearly expressed in the draft legislation.

Officials agree that some clarification is required to ensure that issues not already known and identified by both parties and to which the waiver applies are raised during the waiver period.

Recommendation

That the submission be accepted.

Issue: The taxpayer should be able to further extend the waiver period

Clause 97

Submission
(27 – KPMG)

The taxpayer should be able to agree to further extend the waiver period if that is desired. The rules should allow further extensions in blocks of six months if agreement is reached.

Comment

Officials consider that the taxpayer should be able to extend the proposed 12-month time bar waiver by a further six month period. While Inland Revenue considers that this additional time would rarely, if ever, be required, taxpayers may, for example, want more certainty that if a case has gone to adjudication and the time (including the additional 12 months) expires the adjudication can still be finalised. The additional waiver period would not need to be agreed with Inland Revenue.

However, allowing ongoing six-month extension periods would be inconsistent with the objective of resolving disputes promptly. Therefore a further extension should be limited to a single six-month period.

Recommendation

That the submission be accepted in part by allowing taxpayers to extend the proposed time bar waiver by a further six months.

EXCEPTIONS TO THE FOUR-YEAR STATUTORY TIME BAR

Clause 95

Submission

(10W – Business New Zealand, 15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 18 – Corporate Taxpayer Group, 19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society, 27 – KPMG)

It is strongly recommended that the proposed changes to section 108(2) relating to the exception to the four-year time bar for the Commissioner to issue an amended assessment be removed from the bill.

The existence of a period within which a citizen or taxpayer is at risk of inquiry and/or interference by the state is a fundamental constitutional issue. The length of the period in which the Commissioner can reopen an assessment and the grounds entitling him to do so must reflect the seriousness of the breach by the taxpayer.

The proposed extension of the time bar override provisions to instances where the taxpayer materially overstates the amount of an allowable deduction is of a fundamentally different context to the earlier exceptions. There is no suggestion of the presence of any impropriety by the taxpayer (which arguably underlies the other exceptions to the time bar rules), merely the requirement that there exists an adjustable error in the filed tax return. This means the Commissioner could theoretically re-open a previously statute-barred return as a result of a court decision on the deductibility of a particular expenditure item that is decided many years later in the Commissioner's favour.

In all cases, Inland Revenue should have the ability to re-open a tax return only after the expiry of the four year statute bar where there has been misconduct on the part of the taxpayer.

In addition, interpretation of the term "material" is likely to be problematic.

Comment

An assessment can currently be amended at any time if the return provided by the taxpayer is:

- fraudulent or wilfully misleading; or
- does not mention gross income which is of a particular nature or was derived from a particular source.

On a literal interpretation, the assessment could be amended in the second situation regardless of whether or not it was the taxpayer's intention to omit gross income. However, as has been suggested by the courts, the section will operate effectively only if Inland Revenue applies it having regard to the behaviour of the taxpayer and the amount of tax at stake.

While the current legislation refers to omission of income, it does not address a range of other aspects inherent in the calculation of a taxpayer's tax liability, such as the overstatement of deductions.

The proposed amendment is intended to overcome both these deficiencies.

Regarding the issues raised in submissions, officials note that omitting income of a particular nature or source is not necessarily worse in terms of intent than materially overstating deductions. Under the current legislation if a taxpayer materially omits income from a return, the time bar exception will apply. But if a taxpayer materially overstates an expense claim or tax deduction in a tax return, the exception to the four-year period may not apply, even though the overstatement is material and might, in certain situations, be classed as tax avoidance. This inconsistency needs to be addressed.

Nevertheless, officials note the concern that the amendments extending the circumstances in which the statute bar can be overridden may be too broad and that there may be uncertainty about how the materiality test would be applied.

Therefore officials consider that the amendments should be removed from the bill for further consultation at a later date.

Recommendation

That the submissions be accepted by removing the amendments from the bill for further consideration at a later date.

TIME-FRAMES FOR REFUNDS OF EXCESS TAX

Clauses 34 and 134

Submission
(3 – National Council of Women, 15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society, 26 – Institute of Chartered Accountants of New Zealand)

The amendments to sections MD 1(1) and MD 1(2) of the Income Tax Act 1994 and section 45 of the GST Act (the refund provisions) represent a fundamental diminution in taxpayers' rights to claim refunds of overpaid tax since:

- if taxpayers have overpaid their tax they should be entitled to a refund; and
- the Inland Revenue, as administrator of the tax laws, must fulfil its obligations within a reasonable time-frame in order to provide certainty.

The legislative presumption should be to allow taxpayers an adjustment for overpaid tax as of right unless there is a good reason for its denial. The passage of time does not constitute sufficiently solid grounds to deny a refund.

The proposal is grossly inequitable and contrary to the spirit of the disputes process. Taxpayers should be entitled to a refund of overpaid tax as a fundamental right, and reducing the refund window is tantamount to a tax increase.

Therefore the amendments should be removed.

Comment

Officials consider that there should be no difference between the time-frame within which the Commissioner can increase a taxpayer's assessment, and the time taxpayers have to decrease their assessments. The rationale for the time limit is the same – to provide certainty for the taxpayer and the government.

However, for historical reasons, taxpayers have eight years to claim a refund. The long period for refunds was established in the 1950s, in an era when the administrative environment was based on assessments made by the Commissioner.

The eight-year refund period is too long in the current tax environment, which aims to achieve certainty for taxpayers and the government at the earliest practicable stage. By comparison, for Inland Revenue, the longest period generally allowed for any issue to be identified and resolved is four years from the end of the income year in which the taxpayer's return is filed. This is anomalous.

The eight-year period creates an unquantifiable revenue risk from backdated claims for overpaid taxes. This is not a significant concern in cases where the taxpayer has a clear entitlement to the refund. However, where the claim arises because of new case law or a new interpretation, substantial claims and a consequent revenue loss could result. The objective of the proposals is to protect the revenue base from large, unexpected tax refund claims and to ensure that time-frames provide the certainty for taxpayers and the government that is consistent with the objectives of administrative efficiency and equity.

Therefore the refund provisions are being amended to limit the eight-year refund period to four years, with the Commissioner being able, in the case of clear mistakes and simple oversights, and for rebate claims, to extend the period to eight years. Retaining the eight-year period in these cases protects the taxpayer's ability to claim refunds in clear cases.

Officials note that restrictive time limits on claiming GST refunds have been introduced in overseas jurisdictions. Canada reduced the four-year time limit to claim a GST refund to two years in 1997. The United Kingdom reduced the six-year GST refund period to three years also in 1997. In comparison, a four-year limit in which to claim a GST refund applies in Australia. Further, the United Kingdom and Australia have an "unjust enrichment" provision which means if it is unlikely that the GST refund will be passed on to the recipient, the refund will be denied on the basis that it will result in a windfall gain to the supplier.

Recommendation

That the submissions be declined.

Alternative submission: The amendments should refer to "mistake or oversight"

Clauses 34 and 134

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

If the previous submission is not accepted, the refund provisions should be amended to refer to "mistake or oversight", not "clear mistake or simple oversight." The words "clear" and "simple" create subjective uncertainty. If these words are retained, Inland Revenue would need to give adequate examples and clarification in a Standard Practice Statement on Inland Revenue's view of these words.

Comment

Officials consider that the words "clear mistake or simple oversight" should remain in the legislation. The objective of the wording is to distinguish between inadvertent miscalculation, and actively seeking to minimise tax liability, for example, as a result of a beneficial new interpretation or favourable new case law.

However, officials agree that a Standard Practice Statement to guide taxpayers and Inland Revenue as to the correct interpretation of the terms should be issued. Examples of what could constitute "clear mistake or simple oversight" would include arithmetical errors, or inadvertently including in gross income the same item twice.

Recommendation

That the submissions be noted.

Issue: The refund section needs to clarify that a refund claimed, but not received, before the end of the period can be issued to the taxpayer

Clauses 34 and 134

Submission
(15 – PricewaterhouseCoopers, 27 – Institute of Chartered Accountants of New Zealand)

The proposals to amend the refund provisions need to ensure that the time limitation does not apply if a refund is requested or the formal dispute mechanism has been invoked prior to the end of the refund period.

Submissions are concerned that Inland Revenue will be able to enter the disputes resolution process with no prospect of having to refund monies incorrectly collected where the outcome of the dispute favours the taxpayer and the refund period has elapsed.

Comment

The refund provisions currently state that no refund may be made after eight years, unless written application for the refund is made by or on behalf of the taxpayer before the expiration of the period.

Officials agree that there needs to be a reference in the proposed amendments similar to the existing wording referring to application for the refund before the expiration of the time bar. This ensures that in situations where a dispute which results in a refund is resolved close to the time bar payment can still be made after the time bar period if application of the refund was made before the expiration of the four-year time bar.

Proposed section 89N states that the disputes process must be completed within the four-year time bar, before an amended assessment can be issued. This, in effect, ensures that the Commissioner cannot invoke the disputes process prior to the end of the refund period in order to ensure that a taxpayer does not receive a refund.

If the taxpayer challenges the amended assessment by going to court, section 138I(3) states that the Commissioner must, after the date of determination of final liability, refund the tax to the disputant if the challenge is successful. The four-year time bar to amend an assessment does not apply to a determination or assessment made by a court. Therefore the concern raised in submissions relates only to the Commissioner's determination of an issue, not a determination by a court.

Recommendation

That the submission be accepted.

CLAIMING GST INPUT TAX CREDITS

Clauses 78 and 129

Issue: The status quo should remain

(3 – National Council of Women, 9W (11W & 12W) – Toovey Eaton & McDonald, 15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts, 26 – Institute of Chartered Accountants of New Zealand, 18 – Corporate Taxpayer Group, 21 – New Zealand Law Society, 27 – KPMG)

The status quo (that is, the unlimited time for claiming input tax credits for past periods in a current period return) should remain because taxpayers are entitled to rely on the principle that, if they are a registered person, they will receive an input tax credit in respect of GST costs they incur.

The proposed amendment does not take into account time delays. While this process commonly takes days, rather than weeks, it is a significant issue for large, geographically spread organisations.

Unless the taxpayer can demonstrate that the delay in claiming the input tax credit was due to clear mistake or simple oversight, the taxpayer cannot claim the credit in the current period return. In this respect the proposal erodes taxpayers' rights and is contrary to the philosophy of GST, which is intended to be an agency tax borne by the final consumer. The changes as proposed are likely to affect taxpayer perceptions as to the integrity of the tax system. This will result in the taxpayer having to incur potentially significant compliance costs because the taxpayer will have to issue a NOPA. This is an unsatisfactory outcome.

Comment

Under the present legislation, taxpayers are able to claim in a current period return GST input tax credits which have not been previously deducted. The time within which these claims may be made is unspecified, but may be practically limited by the seven-year statutory period for which business records must be retained.

Allowing adjustments to be made in the current period return prevents the compliance costs that taxpayers might otherwise face if they continually had to amend past returns. The proposal is to limit the circumstances in which a GST input tax credit can be claimed in the current period return to those situations where a tax invoice has not been able to be obtained or where there has been a clear mistake or simple oversight.

If there is a more disputable GST input credit claim – for example, a claim based on arguments following favourable new case law or a beneficial new interpretation of the law, a two-year period within which the taxpayer must initiate a dispute to the GST return is proposed.

Retaining the unspecified period for claiming an input tax credit is not appropriate because the government is exposed to a significant but unquantifiable revenue risk from large, backdated refund claims on more complex issues where the legislation may not be clear. Also, the unspecified time period does not provide certainty for taxpayers and the government that is consistent with a modern tax administration.

Therefore officials do not agree that the status quo should remain.

Recommendation

That the submissions be declined.

Alternative proposal: Provide for a two-year period for claiming an input tax credit with restrictions placed after that period

Clauses 78 and 129

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, matter raised by officials)

There should be an unqualified two-year period to claim an input tax credit from a prior GST period. Outside of that two-year period, an unlimited time period should be included where adjustments are required as a result of delay as well as clear mistake or simple oversight.

Submissions also raise the concern that if a failure to claim an input tax credit is caused by a dispute over the supply itself (and consequent non-payment) the exceptions to the two-year period would not apply.

Comment

The proposals in the bill continue to allow an unlimited period to claim an input tax credit but only where the inability to claim the input tax credit has arisen owing to a clear mistake or simple oversight or the inability to obtain a tax invoice. Other situations are catered for through the ability to issue a taxpayer NOPA, the period for which is currently proposed to be extended to two years for GST input tax credit claims.

The important issue raised by submissions is whether the two-year period should apply to current period returns or, as proposed, require the issue of a taxpayer NOPA. The latter approach is clearly more compliance-cost intensive.

Officials consider that an unqualified two-year period to claim an input tax credit in a current period return should be provided for in place of the proposal for a two-year NOPA period. This would address the concern raised in submissions that invoices may not be processed and approved until many months after their receipt.

One submission noted that, especially for large, geographically spread organisations, it is common for invoices to be at least two or more months old before being processed and paid. In most of these cases, it is not oversight or mistake that has caused the delay and, under the proposal, the taxpayer would not be able to claim the invoice in a current period return.

While officials consider that the situations raised by submissions should be addressed by a general two-year time-frame for current period adjustment, an unlimited period to claim input tax credits in situations caused by a delay for any reason is not warranted. Taxpayers would still be able to make claims after expiry of the two years which officials now propose –not just in a current period return.

However, outside of this unqualified two-year period, an unlimited period to claim an input tax credit should (in addition to the situations involving clear mistake, simple oversight or the inability to obtain an invoice) be allowed if the failure to claim the refund has arisen because the taxpayer did not accept a liability to pay for a supply. But at a later date – for example, because a court decided the dispute in favour of the supplier – it was determined that the taxpayer did have a liability to pay.

Officials therefore recommend that the proviso to section 20(3) be amended to allow for an unqualified two-year period to claim an input tax credit in a current period return, with an unlimited time for the specific situations mentioned above. The two-year period would apply from the time an invoice is issued (or payment if earlier).

An unqualified two-year period to make adjustments in a current period return would also apply for more contentious claims. However, as taxpayers currently have the ability to make current year adjustments at any time, this does not give rise to any new revenue risk.

The proposal contained in new section 89DA(1B) to provide for a two-year period in which to dispute a GST return will be replaced with the general four-month period for taxpayer NOPAs.

Officials note that overseas jurisdictions have introduced strict time limits on the ability to claim input tax credits. Introducing time limits has been motivated by the fiscal risk of allowing large backdated refund claims that could result from the ability to claim an input tax credit at any time. Canada reduced the four-year time limit to claim an input tax credit to two years in 1997. The United Kingdom allows three years to claim an input tax credit in a current period return. In comparison, a four-year limit in which to claim an input tax credit applies in Australia.

Recommendation

That the submissions be accepted in part by allowing an unqualified two-year period to make a current period input tax credit claim with an unlimited time for specific situations outside of that two-year period.

Alternative proposal: Ability to claim input tax credit outside of the two-year period

Clause 129

Submission
(Matter raised by the adviser to the Committee)

A failure to claim an input tax credit could also arise outside of the two-year period if a supply, following an elapse of time, is found to be taxable and the related input tax credit has not been claimed.

Comment

As noted in the response to the preceding submissions the ability to claim an input tax credit outside of the proposed two-year period will be restricted to situations involving clear mistake, simple oversight, the inability to obtain an invoice or the resolution of a dispute. A further situation that should be included is where it is found – for example, by Inland Revenue following an audit – that a supply previously considered by the taxpayer to be exempt was taxable and, on the basis of the taxpayer's earlier view, input tax credits relating to the GST costs incurred in making the supply had not been claimed.

Officials consider that an unlimited time to claim an input tax credit in this specific situation should also be allowed.

Recommendation

That the adviser's submission be accepted.

Alternative proposals: 12-month time period to claim input tax credit or specify when a credit cannot be claimed

Clauses 78 and 129

Submission
(9W (11W & 12W) – Toovey Eaton & McDonald, 15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The existing proviso should be amended to allow claims for, say, 12 months after the invoice date. *(Toovey Eaton & McDonald)*

Rather than requiring taxpayers to prove their entitlement to an input tax claim relating to a prior period, the rules should allow taxpayers an input tax deduction except in certain circumstances specifically tailored to address the fiscal risk. *(PricewaterhouseCoopers, Institute of Chartered Accountants of New Zealand)*

Comment

Officials consider that a 12-month period in which to claim an input tax credit may not be long enough in many situations. Legislating for situations where an input tax deduction would not be allowed would require excessive detail in the legislation.

Therefore a two-year period, as discussed in the response to the submissions above, with the appropriate qualifications in place after that period, is more appropriate to address the concerns raised in submissions.

Recommendation

That the submissions be declined.

THE APPLICATION OF THE COMMISSIONER'S DISCRETION TO AMEND ASSESSMENTS – SECTION 113

Issue: Practical application of section 113 of the TAA

Clause 99

Submission
(10W – Business New Zealand, 15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts, 27 – KPMG)

Assuming Inland Revenue agrees with the technical position in relation to correctness of the proposed adjustment for tax overpayments, Inland Revenue should reassess and correct the tax overpayments as well as the underpayments under section 113.

While the proposed amendments in the bill do not directly change the legal position under this scenario, there is a concern that some Inland Revenue operations staff are unwilling to reassess in the case of tax overpayments but do not hesitate to reassess for underpayments.

The select committee should request that Inland Revenue reconsider its policy regarding the application of section 113.

The circumstances when a taxpayer can request an amended assessment under section 113 should be broadened to circumstances where:

- The taxpayer has made a genuine and clear error in a tax return they have filed with Inland Revenue; and
- Their request for an amended assessment under section 113 is made within the four year time bar.

Section 113 should be amended to remove the Commissioner's discretion to reopen an assessment if a taxpayer is able to show that the assessment imposes an income tax obligation above an amount correctly determined in accordance with the Revenue Acts.

Comment

Many provisions in the Revenue Acts reserve powers to the Commissioner. These powers are generally in the form of discretions allowing the Commissioner to carry out administrative duties, and make decisions regarding the affairs of individual taxpayers.

The Commissioner's function of administering the tax laws requires him to operate efficiently within prescribed time-frames so that, as far as it is practicable to achieve, taxpayers pay the correct amount of tax. For this purpose the Commissioner must be able to use a discretion to amend assessments and to make default assessments whether or not those assessments favour the revenue or the taxpayer. Therefore the discretion to amend assessments under section 113 should remain.

Note, however, that section 113 is being amended to provide that the discretion be subject to section 89N in cases involving a dispute.

Officials note that Standard Practice Statement INV 510 sets out the circumstances when the Commissioner may exercise the discretion to amend assessments to ensure correctness. The statement was issued in August 2002, following external consultation throughout its development. The statement provides guidance for situations where genuine errors have been made and there is an agreed adjustment.

Inland Revenue is undertaking a general review of its practices, in part to address concerns raised in the Office of the Controller and Auditor General's report on the performance of taxpayer audit. The issue raised by submissions should therefore be considered as part of that review.

Recommendation

That the submission requesting legislative change be declined. That the submission requesting an operational review of section 113 be noted by Inland Revenue.

Issue: If the preceding submission is not accepted, section 89D(5) should be amended to accept a late NOPA

Submission
(27 – KPMG)

Section 89D(5) of the TAA provides that a NOPA issued by the taxpayer must be issued within the response period – currently two months. The rule in section 89D(5) of the TAA should be amended to allow the Commissioner to accept a NOPA outside of the response period.

Comment

The definition of "response period" is being amended to give taxpayers four months, instead of the current two months, to initiate a dispute to their self-assessment.

Section 89K of the TAA gives the Commissioner a discretion to accept a late document where exceptional circumstances have prevented the taxpayer from providing the document on time. Section 89K is being amended to give the Commissioner the discretion to accept a late document outside of the applicable response period if the lateness is minimal – for example, if the document is filed one or two days late or the document is late owing to one or more statutory holidays falling within the response period.

Officials do not recommend any further extensions of the period within which taxpayers must issue a NOPA without extending other time-frames, most notably the four-year period for the Commissioner to amend an assessment. Officials consider that increasing the overall period for issuing an assessment would need to be widely consulted on as it is outside the scope of the bill and could be viewed as inconsistent with the objective of the disputes process to achieve early finality of the assessment.

Recommendation

That the submission be declined.

Issue: The inability of taxpayers to amend their self-assessment at any time

Submission
(27 – KPMG)

Taxpayers should have the power to amend their assessments at any time since under self-assessment they are charged with making their assessment.

Comment

The ability of the Commissioner to amend an assessment is based on the requirement that the Commissioner collect the correct amount of tax. The four-year time period within which to increase an assessment and the discretion to consider reductions in liability raised by taxpayers ensures that this is achieved efficiently.

If taxpayers had the ability to reconsider their own assessments at any time within the four-year period, it would mean that the Commissioner's audit activities could begin only after the end of four years because any prior audit would be subject to taxpayer amendments.

Therefore any increase in time for taxpayers to make adjustments would need to be matched by an increase in time for the Commissioner to audit those changes. Given that the Commissioner has four years to review returns, the Commissioner would need another four years to review an amendment made by the taxpayer. This would mean that if a taxpayer made an adjustment, there would be no final assessment until eight years after the return is furnished. This is contrary to the objective of the disputes process to achieve early resolution of disputes over tax liability.

Recommendation

That the submission be declined.

Issue: Changes to the definition of "disputable decision"

Clause 70

Submission

(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

If these proposals, which define the matters that may be brought under the disputes process, are enacted, disputants will no longer be able to challenge procedural decisions made by the Commissioner. It needs to be clarified that the government intends that these decisions would be open to court review through the judicial review process. The proposals appear to be an erosion of taxpayers' rights.

Comment

The term "disputable decision" is defined in the TAA to mean an assessment and a decision of the Commissioner under a tax law. The definition also includes exceptions to what is a disputable decision.

The proposal excludes from the definition of "disputable decision' decisions left to the Commissioner's discretion that occur specifically under the disputes legislation contained in Part IVA of the TAA.

The amendments ensure that only substantive issues are disputed as "disputable decisions" and that mechanical sections of the disputes process do not in themselves give rise to disputes.

The right to commence proceedings pursuant to the Judicature Amendment Act 1972 (judicial review) is not removed as the proposals do not affect that Act.

Recommendation

That the submissions be declined.

Issue: Exceptional circumstances – section 89K

Clause 82

Submission

(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The proposed amendment to extend the circumstances in which the taxpayer may file a late document should proceed. However, clarification is needed as to how the Commissioner's discretion will apply to situations where statutory holidays fall within the response period. If there is a reluctance to be too prescriptive in the legislation guidance as to what is "minimal" could be provided by way of a standard practice statement. This approach is acceptable provided that Inland Revenue is reasonable in its approach.

The same expanded definition should be used in sections 89L and 138D.

Judicial review of the decision should be available to taxpayers but clarification that this is intended would be useful.

Comment

The Commissioner is able to accept a late document within the response period if exceptional circumstances apply. The current definition of "exceptional circumstance" is too restrictive and is, therefore, being extended.

Section 89K is being amended to give the Commissioner the discretion to accept a late document outside of the applicable response period if the lateness is minimal or the document is late owing to one or more statutory holidays falling within the response period.

Officials agree that a standard practice statement should be issued to provide guidance as to what is "minimal". This would be expected to include at least that the document was one or two days late.

Officials do not consider that it is appropriate to amend section 89L and 138D in the same manner as section 89K. This is because section 89L provides that the Commissioner may apply to the High Court for an exception where the Commissioner considers exceptional circumstances apply. Section 138D applies when a hearing authority may hear a late challenge. In these situations, it is left to the discretion of the Court to determine if the exceptional circumstances the Commissioner considers apply are in fact justifiable reasons to allow a notice to be issued late.

The right to commence proceedings pursuant to the Judicature Amendment Act 1972 (judicial review) is not removed as the proposals do not affect that Act.

Recommendation

That the submission be noted.

Issue: Section 114 – validity of assessments not affected by failure to comply with section 89N

Clause 100

Submission

(21 – New Zealand Law Society, 27 – KPMG)

The submissions consider that the requirement in proposed section 89N to follow the full disputes process becomes entirely ineffective if section 114 of the TAA can validate an assessment notwithstanding the fact that the Commissioner may have failed to comply with section 89N. Paragraph (a) in section 114 should be amended or deleted to prevent this.

Comment

Section 114 provides that the validity of an assessment shall not be affected if any of the Revenue Acts have not been complied with.

Section 114 of the TAA is intended to prevent arguments that the Commissioner was not entitled to make an assessment at all. The section, in essence, directs the taxpayer to convince the Commissioner (in a dispute) or the court (in a challenge) that the amount of the assessment is incorrect and by how much, rather than argue the validity of the assessment on procedural grounds.

In considering section 114 the courts have noted that an assessment takes its character from the nature and quality of the decision made and not from matters of process or administration. In *CIR v Canterbury Frozen Meat Co Ltd* [1994] 2 NZLR 681, Richardson J held that in practice there were only two situations where the validity of the assessment itself could be attacked:

- when, in law, no assessment was actually made – for example, a tentative or provisional assessment; or
- the Commissioner did not exercise proper judgment in arriving at the decision to assess. (There must be a genuine attempt to ascertain the taxable income of a taxpayer even if carried out cursorily or perfunctorily.)

In *Dandelion Investments Ltd v CIR* [1997] 2 NZLR 96 Salmon J concluded that there was no need to consider validity in any depth; rather, the taxpayer should have used the hearing to convince the court the assessment was incorrect and to what extent.

In addition, even in the unlikely event that Inland Revenue were to circumvent the disputes process through reliance on section 114, the courts have the power to cure any procedural defects relating to the assessment.

A proposed amendment to section 114 does not alter its scope. The amendment confirms that an assessment made at the direction of an authorised officer, for example at the direction of an adjudicator, and assessments made following current policy or practice directed by the Commissioner is valid. The New Zealand Law Society has no concerns with this proposal.

Recommendation

That the submissions be declined.

Issue: Minor amendment to the challenge procedures – section 138B(3)(b)

Clause 102

Submission
(21 – New Zealand Law Society)

The legislation needs to specify what document is the "written disputable decision" for the purposes of section 138B(3).

Comment

Section 138B(3) provides taxpayers with the ability to challenge an assessment when the Commissioner has rejected (by issuing a notice of response) a notice of proposed adjustment issued by the taxpayer and the Commissioner does not subsequently issue an amended assessment. Therefore the section has a very limited application.

Some confusion has arisen for taxpayers in respect of the response period of the written disputable decision from the Commissioner provided for in section 138B(3)(b). Taxpayers can challenge an assessment if they file proceedings within that response period. This written disputable decision was not intended to be restricted to the notice of response referred to in section 138B(3)(a).

Therefore, the amendment clarifies this point by providing that the reference to "within the response period of the written disputable decision from the Commissioner" is not restricted to the notice of response issued by the Commissioner. This means that the full disputes process will more clearly be provided for in the case of a taxpayer-initiated dispute.

Officials consider that it is not appropriate to further define what the written notice is. This is because the ability to challenge may arise at any stage of the disputes process – for example, where the taxpayer and the Commissioner agree to proceed to court and the Commissioner does not issue an amended assessment. This could occur in a taxpayer-initiated dispute.

Recommendation

That the submission be declined.

Issue: Test cases

Clause 84

Submission
(27 – KPMG)

It should be clarified that the taxpayer does not have to agree to be bound by the outcome of the test case, and can have the disputes procedures recommenced. If a taxpayer agrees to suspend the disputes procedures, all time periods necessary for the completion of the dispute should be reinstated. The outcome of the test case should be notified to all taxpayers who suspended their dispute under the test case procedures.

Comment

New section 89O allows for the suspension of a dispute as the result of the outcome of a test case. If the section does apply, the taxpayer and the Commissioner may agree to suspend the dispute from the date of the agreement until the earliest of the date of the court's decision, the date on which the test case is otherwise resolved, or the date on which the dispute is otherwise resolved. In agreeing to suspend the dispute, the taxpayer agrees to be assessed (or not as the case may be) on the basis of the test case. In such a case, any time bars affecting the dispute are stayed.

Enabling the taxpayer and the Commissioner to agree to designate a case as a test case earlier in the disputes process will reduce administrative and compliance costs that might otherwise arise if the case involves, say, a taxpayer who is one of a number involved in a single scheme or in a series of similar transactions.

The new test case process for disputes does not affect the taxpayer's ability to challenge the assessment through the court process.

Recommendation

That the submission be declined.

Issue: Self-assessment of GST and section 108A of the TAA

Clause 96

Submission

(21 – New Zealand Law Society, 27 – KPMG)

Both the existing and proposed exceptions to the GST time bar, read literally, in most cases remove any effect of the time bar. That is because the time bar will not apply if a taxpayer "fails to disclose…all material facts that are necessary for determining the amount of GST payable for a GST return period". Therefore the materiality element should be removed.

Comment

The submission refers to an existing element in the wording of section 108A, which is not being amended in this bill. The amendment contained in the bill to section 108A of the TAA is a consequential amendment to reflect the move to self-assessment of GST. Therefore the requested amendment is outside the scope of the bill.

Recommendation

That the submissions be declined.

Other policy issues

DEDUCTIBILITY FOR COSTS ASSOCIATED WITH PATENT AND RESOURCE MANAGEMENT CONSENT APPLICATIONS THAT ARE NOT GRANTED OR ARE WITHDRAWN

Issue: Resource management consents that are not fixed life intangible property

Clause 11

Submission
(6 – Holcim, 15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The changes should be extended to clarify that a deduction is available for costs associated with Resource Management Act consent applications that are not granted or are withdrawn, where a depreciation deduction would otherwise have been available if the consent had been issued. The deduction should not be limited to just consent applications that would have been treated as fixed life intangible property if granted.

Comment

The bill proposes amendments to allow costs associated with patent and resource management consent applications that are not granted or are withdrawn to be made deductible. In relation to resource management consents, the changes, as currently drafted, are limited to costs associated with consent applications that would have constituted fixed life intangible property (if granted). Fixed life intangible property is any depreciable intangible property that must be depreciated over its legal life. This includes certain resource management consents granted under the Resource Management Act 1991.

It has been submitted that the proposed changes should also recognise that some consents issued under the Resource Management Act are not fixed life intangible property. Such consents may be "depreciable intangible property" (but not fixed life intangible property) or may generally form part of the cost of other depreciable property (such as the cost of a building). The proposed changes should therefore be expanded to include expenditure in relation to consent applications that do not constitute fixed life intangible property, but would have been depreciable had an application been granted.

Officials agree with this recommendation and consider that the policy intent of the change is to allow a deduction for costs associated with patent and resource management consent applications that are not granted or are withdrawn, to the extent these costs would have been depreciable had a patent or consent been granted.

Recommendation

That the submissions be accepted.

Issue: Application date of the proposed changes

Clauses 10 and 11

Submission
(15 – PricewaterhouseCoopers)

The proposed changes allowing costs associated with patent and resource management consent applications that are not granted or are withdrawn to be made deductible should apply to applications that are not granted or are withdrawn on or after the earlier of 1 April 2004 or the commencement of the person's 2004-05 income year.

Comment

It has been submitted that the current application date for the proposed change – patent and resource management consent applications that are not granted or are withdrawn in the 2004-05 or a subsequent income year – may disadvantage late balance date taxpayers. They are taxpayers who have accounting years ending with a balance date that falls between 1 April and the following 30 September. They may still be in the 2003-04 income year for tax purposes (for example, an income year beginning 1 October 2003 and ending on 30 September 2004).

The current application date should not disadvantage any taxpayers, as it is designed to ensure that the change will become effective from the 2004-05 income year, regardless of balance date. We therefore do not consider that the application date for this proposal should be changed.

Recommendation

That the submission be declined.

Issue: Tax treatment of patents and resource management consents that are granted

Submission
(10 – Business New Zealand)

The appropriate tax treatment of patents and resource management consents that are granted should be reconsidered.

Comment

While the submission supports allowing costs associated with patent and resource management consent applications that are not granted or are withdrawn to be made deductible, it has been suggested that consideration should be given to moving away from capitalisation of patent and resource consent costs that are granted. In the case of patents, the submission comments that, even when granted, many patents will not eventuate into earning opportunities but are required to be depreciated over their legal life. The submission considers this to be a barrier to research and development.

The tax treatment of patents reflects the fact that a patent, once granted, allows the patent holder monopoly rights over a particular mode of manufacture and the right to exclude others from using a patented process. It is therefore an asset to the holder and one which will last for a specified fixed term (a maximum of twenty years). Consequently, the costs associated with patents are required to be capitalised until the patent is granted and can then be depreciated for tax purposes.

The submission effectively raises the issue of the economic life of a patent – where the expected income-earning capacity from a patent does not eventuate or where the patent (or more specifically the patented invention) becomes obsolete before the cessation of the patent's legal life. Technically, in these scenarios the economic life of the patent would be less than its legal life. However, the difficulty that arises is determining the actual economic life of patents (and those of the underlying inventions). Depending on the invention being patented, economic life could vary significantly (for example, pharmaceutical versus other patents). Also, it is difficult to verify when a patent stops being used (or if it is ever used) in a taxpayer's income-earning process. For example, some patents may simply be held to stop competitors from developing a patented product or using a patented process. Owing to these verification issues, the tax system uses the maximum legal life of a patent as a proxy for economic life. (Officials have recently released an issues paper reviewing the tax depreciation rules, which includes a discussion of the issues around the economic lives of patents.)

The tax rules do, however, allow the cost of patents that are not renewed to be deductible. A patent must be renewed after the 4th, 7th, 10th and 13th years for legal protection to be ongoing. If a taxpayer does not renew a patent at any of these renewal dates, the tax rules allow the remaining tax-book value of a patent to be written off.

Recommendation

That the submission be noted. The concerns raised in the submission are being considered in the current review of the tax depreciation rules.

Issue: Deductibility for all costs that do not lead to a depreciable asset

Clauses 10 and 11

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

Relief should be extended to all applications that do not lead to a depreciable asset.

Comment

The submission comments that the proposed changes ignore a number of categories of expenditure that do not lead to the recognition of an asset (and hence may not be deductible), such as abandoned projects, failed consents, feasibility studies and aftercare expenditure.

The scope of the proposed changes is to allow the deductibility of costs associated with patent and resource management consent applications that are withdrawn or are not granted, not the total cost of projects that are abandoned. Extending the proposed changes to include costs of feasibility studies and aftercare expenditure is also not within the scope of the proposed changes. Issues around deductibility of costs of feasibility studies for waste management and aftercare expenditure (such as site-restoration) are being considered separately as part of a project on expenditure incurred in preventing, combating and rectifying pollution. These issues are also canvassed in the officials' issues paper reviewing the tax depreciation rules. The issue of feasibility expenditure, more generally, is the subject of an Inland Revenue draft interpretation statement recently released for public comment. We consider that these are more appropriate vehicles for dealing with these issues.

Recommendation

That the submission be declined.

Issue: Carry-back of losses

Clauses 10 and 11

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

A provision should be made for costs that would become deductible under the proposed changes to be carried back to previous accounting periods.

Comment

The submission comments that where a failed resource management consent application leads to a cessation of business, the resulting deduction may create a tax loss. The submission suggests that a taxpayer in such a situation should have the option of offsetting the loss against trading profits in a prior income year.

The New Zealand tax rules do not allow carry-back of tax losses. Losses must be carried forward and offset against income in future years. Allowing carry-back of tax losses in the case where a consent application fails would require consideration of this option in respect of other expenditure incurred in the year of or after the cessation of business. This would have significant implications for the certainty of government revenue flows (as revenue collected in the past would be subject to taxpayer claim in future years) and would also require Inland Revenue to reopen assessments for previous income years for an uncertain number of taxpayers.

Recommendation

That the submission be declined.

HORTICULTURAL PLANTS

Issue: General support for changes

Clauses 5, 12, 13, 14, 65, 68 and 90

Submissions

(3 – National Council of Women of New Zealand, 10 – Business New Zealand, 17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

All submissions welcomed the proposed changes.

The National Council of Women say that the "amortisation changes … should be welcomed … [and] are seen as offering relief from dependency on bank overdraft facilities." Business New Zealand "supports the intent of the new rules to provide greater certainty for the treatment of replacement plants."

The Fruitgrowers Federation supports the introduction of the proposed changes because they reduce the uncertainties with regard to the tax treatment of replacement horticultural plants and will reduce the compliance costs for the industry. The rules will provide an objective measure rather than having to relying on subjective tests. The proposed rules closer reflect the commercial realities of sometimes replacing damaged trees by using different varieties.

ICANZ support the introduction of proposed changes provided they are an optional extension because in the Institute's view, in some instances, greater deductibility remains under general principles.

Comment

The amendments are in response to concerns raised by the Fruitgrowers Federation and trade off the flexibility of general principles to provide certainty. In addition to the Fruitgrowers Federation, officials have consulted New Zealand Winegrowers (Wine NZ), the New Zealand Berryfruit Growers Federation and Olives NZ.

Recommendation

That the general support for the amendments be noted.

Issue: Higher yearly deductions for replacement plants

Clause 13

Submissions

(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

The Fruitgrowers Federation submits that the annual allowable replacement planting for which a complete deduction is allowed should be 15% of an orchard in one year in any three-year period.

ICANZ accepts that a large proportion of a total block of trees or vines may be capital. However, they believe that more than say 7.5% of a block of tree or vines could be replaced in the ground with the same variety, with the expenditure deductible under normal principles.

Comment

The proposed amendments are intended to allow replacement plantings that are necessary to repair and maintain a larger planting to be made and be treated as a deductible expense, regardless of whether the same type or variety of plant is used as a replacement.

The replacement deduction rules will generally apply to a whole orchard, so that damaged trees or vines can be replaced anywhere. The thresholds have been designed in consultation with the Fruitgrowers Federation, on an agreed basis that an orchard could require up to 5% replacement in a year to repair damaged, diseased or dead trees to maintain a productive enterprise.

Moreover, to provide extra flexibility, 50% more – 7.5% – will be allowed to be fully deductible in any one year, with no more than 15% in a three-year period being fully deducted. This extra flexibility addresses concerns raised earlier by the Fruitgrowers Federation regarding delays that growers experience in receiving nursery stock – though this is not strictly a tax policy matter.

Increasing the annual deduction threshold could disadvantage new orchardists over existing orchardists. The threshold is set so that replacement planting programmes do not, to a large extent, result in fully productive orchards being renewed without recognising the capital value of large-scale replanting activities. Without this being recognised, existing orchards that are replanted with a new type or variety of plant would have an advantage over new orchards that put in the same plants for the first time.

These amendments will not restrict replacement planting activities but will provide certainty on the extent to which replacement planting will be treated as repairs and maintenance. Replacement planting in excess of the thresholds provided will be deducted over time under the amortisation rules proposed in the amendments. This excess will be accounted for as part of the capital value of the orchard.

Recommendation

That the submissions be declined.

Issue: Factors in determining a plant's useful life

Clauses 65 and 90

Submissions
(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

It is more appropriate to look at the actual useful life of a tree, rather than its natural life when determining tax amortisation rates.

Economic factors should be expressly provided for in either the definition of "estimated useful life" (clause 65) or in the list of factors the Commissioner of Inland Revenue can take into account in determining the estimated useful life of a plant (clause 90).

Comment

The amendments provide that estimated useful life is:

> "in respect of a listed horticultural plant, the period of time over which the listed horticultural plant might reasonably be expected to be useful to a person in deriving income or in carrying on a business in New Zealand, *having regard to such factors as natural and incidental damage, decay, disease, or exhaustion,* with the expectation based on an assumption of normal and reasonable maintenance."

The definition focuses on the period within which a plant is useful for earning business income. For most plants it would be reasonable to expect that this period would be less than their natural life. There appears to be doubt as to whether the other factors listed in the definition are additional matters to be taken into account or specify the kinds of factors to be taken into account.

The overall clarity and operation of this provision could be improved by removing the (italicised) list of factors which are also addressed by the replacement planting rule. This change would address the concerns raised in submissions to the extent that economic factors affect the time over which plants can reasonably be expected to be useful to a person in producing income. However, some matters affecting the economic viability of some plants cannot be predicted and taken into account – for example, changes in world production or consumer markets.

Directly referring to other economic factors in broad terms in the statute would introduce too much uncertainty about what might reasonably be expected to affect the useful life of a plant. More specific factors such as the lifecycle of a product in a market cannot be estimated with sufficient certainty or reliability to provide a consistent result over time in the Commissioner's determinations of amortisation rates.

Officials note that because the amortisation of planting expenditure uses only a diminishing value method, most of that expenditure will be deducted in the first years of amortisation. This ameliorates the effect of unpredictable changes in the market in later years.

Recommendation

That the submissions be accepted in part, by clarifying that the Commissioner is not limited to considering the specific factors currently listed in the definition of "estimated useful life".

Issue: Amortisation rates

Clause 13

Submission
(17 – Fruitgrowers Federation)

The current amortisation rate should be a minimum rate in the future.

Comment

The amortisation rate should reflect the estimated useful life of a plant. The current single rate that applies to vines and trees provides an arbitrary result to the extent that the useful lives of different plants differ. The current rate remains as a default rate for plants not listed as plants that the new rules will apply to.

Recommendation

That the submission be declined.

Issue: Leasing horticultural businesses

Clause 13

Submissions
(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

The rules should apply to both landowners and growers if the landowner is not also the grower.

Comment

Submissions highlight a change in the horticulture industry over time whereby it is becoming increasingly common for the ownership and operation of orchards to be separated.

Changing the proposed amendments, as submitted, so that they apply to both parties would risk one item of expenditure being deducted by both a landowner and an orchard operator (when they are different people).

Officials consider that some change to the proposed amendments is required, to ensure that planting expenditure does not fall into a black hole where no-one can deduct it. The drafting of proposed section DO 4C should be amended to refer to "developed land" rather than referring to development by the taxpayer who is in the business of operating the orchard.

The proposed amendments should allow the person who carries on a horticultural business to deduct planting development expenditure associated with their business, regardless of whether the development is on land they lease or own. On the termination of a lease arrangement, a landowner who then operates the orchard should be able to continue to amortise the value of any development done by a lessee – the value of which may then be reflected in any subsequent lease arrangement. Also, even if the owner does not operate the orchard, the owner should be able to pass on the ability to amortise the value of the development to a subsequent lessee. These situations are currently provided for under section DO 4 and, therefore, proposed section DO 4C should be amended accordingly.

If landowners do not operate the orchards on their land, any planting activities carried out by them while the orchard is operated by another person should be recognised under the lease or other contractual arrangements they have with their orchard operators. As the planting expenditure in this kind of situation effectively provides additional capital for the orchard operation, the recognition of the landowners' planting activities would be a commercial matter to be managed by contract. This is the position under the current rules, and it ensures that neither two deductions nor no deduction are available for an amount of planting expenditure under the amortisation rules for horticultural plants.

Recommendation

That proposed section DO 4C be amended to refer to "developed land" rather than development by a taxpayer.

Issue: Whether horticultural replacement planting rules should apply more broadly

Clauses 13 and 65

Submissions

(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

The wording in sections DO 4C(1) and DO 4D(1) should be the same.

Comment

The difference in the wording used in sections DO 4C(1) and DO 4D(1) is deliberate as the replacement planting rules in DO 4D(1) should apply only to horticultural activities. The replacement planting rules should not apply to non-horticultural farming and agricultural businesses.

Officials accept that minor changes to the drafting of the opening words could improve consistency of expression without affecting the substantive difference in the provisions. This is being considered by drafters.

Recommendation

That the submissions be declined.

Issue: Defining horticultural plants

Clause 65

Submissions

(26 – Institute of Chartered Accountants of New Zealand)

The exclusion for timber trees should be removed.

Instead of a definition of non-listed horticultural plants it would be simpler for the Act to refer to "a horticultural plant, tree, vine, bush, cane or similar plant that is not a listed horticultural plant".

Comment

Both suggestions would have the effect of including timber trees within the scope of the rules for horticulture. The tax treatment of timber trees is covered by a separate set of rules for forestry that provide a different treatment.

Recommendation

That the submissions be declined.

Issue: Specify method of election

Clause 13

Submissions
(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

The rules should state how to make the election referred to in section DO 4D(2)(c). This is done elsewhere in the Act – for example, section EH 25(4)

Comment

It is currently implicit that an election would be made by a person in making their assessment (and filing a return). However, officials agree that it can be explicitly stated that an election is given effect by taking a tax position in filing a return.

Recommendation

That the submissions be accepted.

Issue: Extra immediate deduction for storm damage

Clause 13

Submission
(17 – Fruitgrowers Federation)

Storm damage should be able to be immediately deductible, in addition to the allowance guaranteed under the proposed amendments.

Comment

Damage from a range of sources, including storm and weather damage, and disease, have been factored into the thresholds provided for immediate deduction.

Large-scale replacements, whether they are due to storm damage or are carried out for other reasons, give rise to deductions for the book-value of plants written off. Replacement plants will be immediately deductible up to the thresholds provided in the proposed amendments and thereafter will be capitalised and deducted under the amortisation rules. This ensures that the productive capital of an orchard is recognised for tax purposes.

The reason for these amendments is to provide certainty and to save the industry compliance costs, including those that would be incurred in arguing a complex set of legal propositions with Inland Revenue or through the Courts. The amendments are intended as an alternative to the industry having to argue under general principles. They are also intended to avoid arguments about, for example, what constitutes a storm and, therefore, storm damage.

Recommendation

That the submission be declined.

Issue: Terminology – "vines and trees" and "horticultural plant"

Clause 65

Submissions
(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

Changing the terminology from "vines and trees" to "horticultural plant" could narrow the types of plants that could be included by using the word "horticultural". There is a risk that blueberry bushes fall outside the current rules.

Comment

The definition of "listed horticultural plant" for the new rules, in addition to trees and vines, specifically includes things over which there could be doubt, such as bushes and canes. In addition, greater specificity would be provided by the Commissioner when listing plants under the rules.

Recommendation

That the submissions be declined.

Issue: Definitions of "plot" and "planting"

Clause 13

Submissions

(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

The definition of "planting" relates only to new listed horticultural plants which are planted in an income year. The definitions of "plot" and "planting" should encompass all land at the end of a year on which listed horticultural plants are planted as there is a requirement for separate accounting.

Comment

In section DO 4B "planting" refers to plants, and "plot" refers to the land on which plants are planted. "Replaced area fraction" refers to the proportion of the plot on which plants are replaced. There is a requirement to account separately for replacement plants on newly acquired land for as long as the three-year, 15% replacement planting threshold would be affected. Otherwise plantings on all land are encompassed by the rules on the same terms.

If situations involving the acquisition of land were not provided for, the rule for the three-year threshold would be too uncertain, with the risk that growers would not be able to deduct the costs of replacement plantings on a newly acquired block because they had reached the replacement planting threshold in relation to an existing part of their business.

Officials note that submissions appear not to have noted the effect of proposed section DO 4B(3), which permits amalgamations of plantings under certain circumstances. The drafting of proposed section DO 4B could contain cross-references to help readers.

Recommendation

That the submissions be declined.

Issue: Other drafting concerns

Clause 13

Submissions

(17 – Fruitgrowers Federation, 26 – Institute of Chartered Accountants of New Zealand)

- Section DO 4C(6) could be more clearly expressed.
- The use of the words “that” and “is” in the words before the formulae in DO 4C and DO 4D should be consistent.
- Item f in DO 4D(4)(b) should refer to “income years” rather than “income year”.
- The rules should state that listed horticultural plants can be replaced by listed horticultural plants of any variety.

Comment

A number of drafting matters have been raised throughout submissions for clarification or suggested changes of wording. These as with other drafting matters will be considered by drafters.

Officials consider changes could be made to accommodate the first three points. However, we note that some concerns raised are already addressed in the legislation but using slightly different words that appear to achieve the same effect. For example, with regard to the fourth point, “replacement plant” means “a listed horticultural plant that replaces a listed horticultural plant, whether or not it is of the same type of listed horticultural plant”.

Recommendation

That the submissions be noted.

Issue: Exclusion for wine growers

Clause 65

Submission
(Matter raised by officials)

The treatment for wine growers should remain under the current rules rather than being included in the new rules.

Comment

In consultation prior to this bill being introduced, the wine-growing industry asked to be included within the scope of the new rules on the basis that they would further consider their position and, if needed, would raise the matter of exclusion in a submission to this Committee. On 8 July 2004 officials contacted the Grape Growers Council (which represents growers of grapes for wine production and is part of Wine NZ) and learned that, despite not having made a submission on the proposed change, the industry wished to remain under the current rules.

Officials consider that vines used to grow grapes for wine production should be included in the list of excluded plants in the definition of "listed horticultural plant". These vines will consequently fall into the definition of a "non-listed horticultural plant", for which the current treatment continues under the proposed amendments.

Recommendation

That the submission be accepted.

SALE AND LEASEBACK OF INTANGIBLES

Issue: Rely on anti-avoidance rules instead of proceeding with reform

Clauses 19 and 65

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

The proposed amendment should be reconsidered after Inland Revenue has determined whether the anti-avoidance provisions deal with the issue. In the commentary to the bill it is stated that the anti-avoidance provisions in the Income Tax Act 1994 may apply to the type of transaction that the amendment is intended to capture. If the anti-avoidance rules do apply there is no requirement for the amendment, and therefore it is unnecessary.

Comment

The type of transactions that the amendments are directed against raise significant tax base protection concerns. They involve the sale and leaseback of intangibles under which tax deductions are claimed for what are, in substance, repayments of principal under a loan. The proposed amendments are designed to protect the tax base by ensuring that such deductions cannot be taken.

The submission argues that the amendments are unnecessary because the type of transaction causing concern should be able to be countered under the general anti-avoidance rules in the Income Tax Act 1994: sections BG 1 and GB 1. Although it is possible that Inland Revenue could apply the general anti-avoidance rules in the income tax legislation against this type of transaction, this may involve litigation where the outcome is not certain. Also, any possible litigation involving the application of the general anti-avoidance rules can take a considerable period of time to complete. Therefore officials do not consider that it is sufficiently certain or timely to rely on the general anti-avoidance provisions to counter the type of schemes causing concern, instead of proceeding with the proposed amendments.

The best way of protecting the tax base with sufficient certainty and in a timely manner against the type of transaction causing concern in this case is to proceed with the proposed amendments.

Recommendation

That the submission be declined.

Issue: Review of finance lease rules instead of proceeding with proposed amendments

Clauses 19 and 65

Submission
(18 – Corporate Taxpayer Group)

Concerns about any deliberate or inadvertent changes to the finance lease rules is reinforced by the existing difficulties with these rules. These difficulties arise from inadvertent consequences and the different factual permutations that exist. The submission considers that piece-meal changes to the finance lease rules should not be made but, rather, a review should be undertaken of the entire finance lease provisions.

Comment

The proposed amendments are being made to ensure that taxpayers entering into transactions involving the sale and leaseback of intangibles such as trademarks do not get deductions for what are, in substance, repayments of loan principal. The proposed amendments are designed to protect the tax base. In particular, it is proposed to amend the tax rules for finance leases, which prevent deductions being taken for the principal amount of a deemed loan, to ensure that the transactions involving the sale and leaseback of intangibles that cause concern are caught by these rules.

The tax base protection concerns which will be addressed by the proposed amendments are significant and need to be addressed now and cannot wait until any wider tax review of the finance lease tax rules. Any other remedial amendments to the finance lease rules to improve the operation of these rules can be dealt with under the general tax policy work programme. It is not necessary or desirable to defer the proposed amendments until any remedial amendments to the finance lease rules are also prepared.

Recommendation

That the submission be declined.

Issue: Concern over scope of proposed amendments

Clauses 19 and 65

Submissions
(18 – Corporate Taxpayer Group, 19 – Minter Ellison Rudd Watts, 10W – Business New Zealand, 15 – PricewaterhouseCoopers, 21 – New Zealand Law Society))

A number of submissions expressed concern over the scope of the proposed amendments and, in particular, on any adverse and unintended implications for leases of tangible assets.

The Finance and Expenditure Committee should carefully consider the implications the bill's provisions on the sale and leaseback of intangible property might have on leases of other assets. *(Business New Zealand)*

The proposed amendments may also cause some leases to inadvertently fall into the definition of "finance lease" when previously they did not. *(Corporate Taxpayer Group)*

The proposed changes go further than is necessary to achieve the stated tax objective and if the proposed legislation were to proceed without further changes, a degree of uncertainty would be introduced with respect to non-targeted commercial leasing arrangements. *(PricewaterhouseCoopers)*

The proposed changes to the law to deal with the government's concern about the sale and licence back of intangible property will adversely affect a wide range of genuine leasing and licencing transactions. *(Minter Ellison Rudd Watts)*

Comment

The proposed amendments are designed to protect the tax base against transactions that could otherwise raise significant tax base protection concerns by allowing taxpayers to obtain deductions for what are, in substance, repayments of loan principal. Such an outcome is contrary to the policy intent underlying the tax treatment of debt transactions.

It is not desirable for the proposed amendments to affect normal commercial leasing transactions that do not raise tax base maintenance concerns. Officials consider that concerns raised by submissions about the scope of the proposed amendments can be adequately addressed by either amending the proposals or issuing guidance on Inland Revenue's interpretation of these amendments in the *Tax Information Bulletin* item published following the enactment of the amendments. These changes and departmental interpretations are discussed under the specific issues set out below in this report.

Recommendation

That the submissions be noted.

Issue: Replacing substantive rights-based test with more targeted test

Clause 65

Submissions

(15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society)

The current wording for proposed new paragraph (d) of the finance lease definition will lead to uncertainty (and therefore increased compliance costs) over the application of the finance lease rules to both tangible and intangible property leases. The uncertainty is brought about by the fact that the phrase "substantive rights or obligations" is not defined and does not have a clearly discernible ordinary meaning in the context of leasing transactions. *(PricewaterhouseCoopers)*

New paragraph (d) of the finance lease definition should be redrafted so that it applies only to the mischief the amendment is seeking to correct. A replacement form of wording focusing on the ability of the lessee or an associate, since a period of previous ownership, to reacquire or control the disposition of the lease asset, is suggested. As currently drafted, it is not clear what paragraph (d) achieves. *(Minter Ellison Rudd Watts)*

The wording in new paragraph (d) should be more targeted at the sale and leaseback transactions that are causing concern. The meaning of the words "no substantive rights or obligations in relation to the lease asset other than rights or obligations that relate to the enforcement of the lease" in proposed new paragraph (d) is not clear and the words themselves are very broad. Replacement wording for paragraph (d), focusing on a feature of the arrangements causing concern, involving an associate of the lessee having an option to acquire the lease asset who is not entitled to all of the lease payments accruing after the acquisition of the lease asset, is suggested. *(New Zealand Law Society)*

Comment

The bill proposes to expand the definition of "finance lease" in section OB 1 of the Income Tax Act 1994 (by adding a new paragraph (d) in the definition) to include a sale and leaseback arrangement under which the lessor has no substantive rights and obligations of ownership, other than those relating to enforcement of the lease agreement. An example of this would be where the lessee or an associate had always retained the ability, since the period of previous ownership, to reacquire or control the disposition of the lease asset.

Although officials consider that the proposed amendment would be effective in relation to the type of transactions causing concern, we agree that the current wording of the proposed amendment may catch inadvertently other leasing transactions which do not have tax base protection concerns. This could have the consequence that some ordinary operating leases may be treated inappropriately as finance leases. We therefore agree with submissions that the substantive rights-based test in new paragraph (d) of the definition of "finance lease" should be replaced with a more targeted test.

Officials prefer the approach suggested by the New Zealand Law Society, which focuses on a feature of the transactions causing concern, that the sale of the lease asset back to the associate of the lessee does not involve the associate receiving all the rentals accruing from the date of sale; instead, lease payments continue to flow to the lessor (the financier). This is an unusual feature as, normally, following the sale of a lease asset, the new owner is entitled to the lease payments following the sale. It is this feature of the transactions that indicates their financing nature and, accordingly, it is appropriate to treat arrangements with this feature as finance leases.

Specifically, paragraph (d) should include in the finance lease definition arrangements that involve an associate of the lessee having an option to acquire the lease asset (or the lessor having an option to require an associate of the lessee to acquire the lease asset) if under the terms of the option the associate is not entitled to all of the lease payments (if any) accruing after the acquisition of the lease asset under the option.

Recommendation

That the submissions be accepted and that the approach suggested by the New Zealand Law Society for new paragraph (d) of the definition of "finance lease" be adopted.

Issue: Arrangement-based test

Clause 65

Submission
(15 – PricewaterhouseCoopers, 19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society)

The proposed changes to the finance lease definition would subject a lease "that involves or is part of an arrangement that involves" the various events specified in the finance lease definition limbs to the finance lease rules. The new test will necessarily involve a determination of the "arrangement" in respect of which the lease forms part of, and an assessment of whether the tests set out in the finance lease definition are met in relation to that arrangement rather than just the lease itself. In our view, the inherent difficulty in determining the composition of an "arrangement" for the purposes of the finance lease rules would lead to increased uncertainty for taxpayers. *(PricewaterhouseCoopers)*

The current definition of a finance lease is clear, by use of the words "under which" in the opening paragraph, that for tax purposes only the lease document itself needs to be considered by the taxpayers that are a party to that lease agreement in determining whether the lease is a finance lease. Under the current definition it can be established at the time of entering into the lease whether the lease will be a finance lease by reviewing the lease contract. This definition, which has had application since 20 May 1999, uses the words "under which" in order to provide certainty that was lacking in the pre-20 May 1999 specified lease definition. *(New Zealand Law Society and Minter Ellison Rudd Watts)*

The opening paragraph of the finance lease definition should not be amended as proposed. The finance lease definition should retain the words "under which", as these words provide the certainty that is a key feature of the current finance lease definition which was enacted in 1999. *(Minter Ellison Rudd Watts)*

The submission understands that it is not the intention of the government to broaden the scope of the finance lease definition so that events that occur subsequently to entering into the lease can retrospectively cause it to be a finance lease from the time the lease was entered into. However, the use of the word "arrangement" in the proposed amendment could have such an effect. *(New Zealand Law Society)*

When this amendment is enacted, an explanatory *Tax Information Bulletin* item should be issued, in which it is confirmed that in interpreting the term "arrangement" in the amended finance lease definition only any arrangement existing at the time the lease is entered into should be taken into consideration in determining whether or not a lease is a finance lease. It should be made clear that subsequent events are not considered part of an "arrangement" for the purposes of the application of the "finance lease" definition. *(New Zealand Law Society and alternative Minter Ellison Rudd Watts submission)*

Comment

The bill proposes to amend the definition of "finance lease" to provide that a lease "that involves or is part of an arrangement that involves" a situation specified in one of the limbs in the definition is a finance lease.

Officials confirm that it is not intended to broaden the definition so that events that occur subsequently and independently to entering into the lease (other than an effective extension of the lease term, which is specifically dealt with) can retrospectively cause it to be a finance lease from the date the lease was entered into. The amendment is intended to clarify that the finance lease rules can apply if a feature referred to in the finance lease definition limbs, such as a transfer of ownership to the lessee or an associate or an option granted to a lessee or an associate, is contemporaneously part of the leasing arrangement when the lease is entered into but is not specified in the lease agreement itself. (Instead, such a feature is separately documented.)

The interpretation guidance given in *Tax Information Bulletin* Vol. 11 No. 6 (July 1999) remains applicable. In particular, when taxpayers enter into a lease they should generally be able to ascertain whether the lease is a finance lease or an operating lease. Certainty therefore remains one of the aims of the finance lease definition.

Officials would therefore support the New Zealand Law Society and alternative Minter Ellison Rudd Watts submissions that, following the enactment of the amendment, an explanatory *Tax Information Bulletin* should be published confirming that in interpreting the term "arrangement" in the amended finance lease definition only any arrangement existing at the time the lease is entered into should be taken into account in determining whether a lease is a finance lease. Subsequent and independent events will not be considered to be part of the arrangement.

In relation to the example in the New Zealand Law Society submission, officials consider that the subsequent and independent agreement under which the lessee acquires the lease asset at the end of the lease term would not be considered part of the leasing arrangement.

Recommendation

That the submissions be accepted in part by agreeing to the publication of an explanatory *Tax Information Bulletin* item after the amendment is enacted which confirms that in interpreting the term "arrangement" in the amended finance lease definition only any arrangement existing at the time the lease is entered into should be taken into account in determining whether or not a lease is a finance lease.

Issue: Limiting amendments to leases of intangible property

Clauses 19 and 65

Submissions
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The background material to this amendment clearly envisage the proposed amendments to be a revenue base protection measure in the context of sale and licence or leaseback transactions involving intangible property which is not depreciable intangible property. However, the proposed legislative amendments have not been specifically restricted to intangible property transactions and, as drafted, are likely to result in the application of the finance lease rules to many non-targeted commercial sale and leaseback transactions involving depreciable intangible property. Our primary submission therefore is that the legislation should be limited to intangible property leases in order to preserve the policy intent underlying the changes. *(PricewaterhouseCoopers)*

That, consistent with the intent to capture sale and leaseback transactions involving intangible property, paragraph (d) be redrafted to restrict its scope to leases of intangible property only. Although the transaction, giving rise to the concern, will certainly be captured by the new paragraph, we are not convinced there is any mischief in the sale and leaseback of tangible items that needs to be caught under the finance lease rules. *(Institute of Chartered Accountants of New Zealand)*

Comment

Officials consider it is difficult to justify limiting particular aspects of the finance lease definition (as proposed to be amended) to specific types of property. This is currently not done in the definition.

Although the type of transactions causing concern currently are certain sale and leasebacks of intangible property, and one of the specific amendments clarifies that the finance lease rules may apply to the granting of a licence to use intangible property, other amendments address general weaknesses in the definition of "finance lease" which are not restricted to a specific type of property. For example, an amendment will widen the application of paragraph (a) of the definition to include a lease which involves the transfer of ownership of the lease asset to the lessee or an associate during or at the end of the lease term rather than only at the end of the lease term, as the current definition provides. It is difficult to justify limiting this amendment to leases of intangible property only.

Officials consider that the replacement paragraph (d) recommended in this report should address many of the concerns raised by submissions. There would seem to be no reason for limiting the new paragraph (d) in the definition, which focuses on whether the associate of the lessee is entitled to the lease payments after it purchases the lease asset, to leases of specific types of property only.

Recommendation

That the submissions be declined.

Issue: Non-exclusive licences to use intangible property

Clause 65

Submission
(19 – Minter Ellison Rudd Watts, 21 – New Zealand Law Society)

A licence to use intangible property should only be a finance lease where the licensee obtains an exclusive right to use the licensed property. The deeming of all licences to use intangible property to be leases for tax purposes will have a very wide and unintended application. *(Minter Ellison Rudd Watts)*

Paragraph (c) of the finance lease definition, which refers to leases with a lease term of more than 75 percent of the lease asset's estimated useful life, should not apply to licences to use intangible property which the bill proposes to include in the definition of "lease" for the purposes of the finance lease definition. This inclusion of licences to use intangible property could deem ordinary commercial licences to be finance leases for tax purposes under paragraph (c) of the finance lease definition. This must be unintended. If the decision is made that paragraph (c) of the finance lease definition should apply to licences of intangible property, then this should only be the case where the licence gives the licensee exclusive rights to use the licensed property. *(New Zealand Law Society)*

In particular, the submissions give examples of the licencing of the right to use sales-related software to shops by a software owner as types of transaction that could be treated inadvertently as finance leases under the amendments.

Comment

An amendment will clarify that the finance lease rules can apply to the grant of a licence to use intangible property by the owner of the property. This proposed amendment is in line with the definition of "lease" recommended in 1992 by the Valabh Committee, which proposed the revised finance lease rules that came into effect in 1999. (The Committee recommended that "a definition of lease would refer to any arrangement entered into involving the grant of the use or the right to use any lease asset".)

Officials consider that restricting this amendment to exclusive licences to use intangible property could leave the amendments vulnerable to circumvention. This is because it is a feature of intangible property that it can be easily subdivided in terms of geography, time and in other ways. Therefore it would be quite easy to convert what is, in substance, an exclusive licence into what is formally a non-exclusive licence, which would then fall outside the ambit of the amendments if they were restricted to exclusive licences, as proposed by the submissions.

Importantly, officials do not agree that commonplace computer software transactions such as those referred to in the submissions would be caught by the proposed amendment to include licences to use intangible property. This view is based on the principles contained in the Inland Revenue Department interpretation guideline "Non-resident software suppliers' payments derived from New Zealand – income tax treatment", which was published in November 2003. The principles set out in that guideline on the classification and income tax treatment of various software transactions involving non-resident suppliers of software are also applicable to wholly domestic situations.

These guidelines state that computer software transactions can generally be classified into two types: those relating to the copyright rights in the computer program and those relating to copies of the computer program that is protected by copyright. Functionally, the two types of transaction relate to the use of copyright and the use of a copy of the program respectively.

Commonplace software transactions generally involve copies of computer programs (which may be protected by copyright), not copyright rights in the computer program. The amendment to include licences to use intangible property could apply only to transactions involving the supply of copyright rights (for example, the licence of a copyright right in a computer program). The type of computer software transactions that the submissions are concerned about involve the supply of a copy of a computer program (by way of sale or lease) that is used in the business of the recipient and do not involve the supply of intangible property such as copyright rights.

The interpretation guideline draws a distinction between acquiring a computer program for personal or business use (as occurs in the examples in the submissions) and acquiring the program for commercial exploitation through the use of one or more of the copyright rights. It is only where a supplier gives a customer the ability to exploit the supplier's copyright rights in a program that the transaction will be a copyright right transaction, and therefore could come within the meaning of the words "licence to use intangible property". Where a customer is not granted the ability to exploit the copyright rights in the program, but is merely provided with the right to use a copy of the program for personal or business use, the transaction will be a

copyrighted article transaction, which does not involve the use of intangible property such as copyright rights and therefore is not covered by the amendment in the bill.

The Inland Revenue interpretation guideline also makes it clear that the fact that some form of end-user licence may accompany a transaction involving the supply of a copy of a computer program (by way of sale or lease) does not change the transaction to one involving the supply of copyright rights. The purpose of such licences is generally to restrict the recipient contractually from exploiting any of the rights protected by copyright. The licence is not for the use, or the right to use of, any copyright (as would be so in the case of a reproduction licence) but to prohibit use of the copyright. The licence is a vehicle to further assert the copyright owner's rights. There is no transfer of the copyright. From a practical and business perspective, the contract between the parties is for the supply of a copy of a copyrighted article.

Recommendation

That the submissions be declined.

Issue: Technical error in paragraph (c) of the finance lease definition

Clause 65

Submission
(21 – New Zealand Law Society)

If the decision is made that paragraph (c) should potentially apply to licences of intangible property, there is a technical error in the wording of the paragraph. The error is the reference in paragraph (c) to an asset's estimated useful life "as that term is used in the formula applied by the Commissioner under section EG 4(3)". The purpose of section EG 4(3) is to set the diminishing value economic rate of depreciation for an asset. However, intangible property that is "fixed life intangible property" (FLIP) must be depreciated using the straight line depreciation basis (pursuant to section EG 3(2))) and cannot be depreciated on a diminishing value basis. Therefore, section EG 4(3) can have no application to FLIP (as it refers to diminishing value depreciation) which in turn arguably means that paragraph (c) of the "finance lease" definition can never apply to FLIP or to intangible property generally.

Comment

Officials agree that the technical error identified by the submission should be corrected. The current wording of paragraph (c) of the definition of "finance lease" should be replaced with "the lease term is more than 75 percent of the lease asset's estimated useful life". The definition of "estimated useful life" in section OB 1 applies to all depreciable property, including fixed life intangible property. The definition of "fixed life intangible property" in turn refers back to the definition of "estimated useful life".

Recommendation

That the submission be accepted.

Issue: Application of accrual rules to "in substance" principal

Clauses 19 and 65

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

The submission refers to the example in the commentary on the bill and assuming the policy intent is to treat the sale and leaseback transaction as a $9 million loan with $3 million interest payable, existing section FC 8A(2) and (3) treats the value of the loan to be the "lessor's disposition value" and the "lessee's acquisition cost" respectively.

As the transaction now falls within the accruals rules, it will be necessary to determine the consideration paid/received for the acquisition/disposal of the property in order to be able to apply an appropriate spreading method and calculate the base price adjustment when appropriate. Existing section EH 48(2) requires the value of the property to be determined by applying subsection (3)(a) to (d) in alphabetical order until a paragraph applies. The submission considers that it is not clear how section EH 48(3) identifies the "in substance principal" of $9 million.

Therefore, more work be undertaken to clarify how the "in substance" amounts are to be brought to tax once captured by the finance lease definition.

Comment

Officials consider that the amended finance lease rules would apply in the following way to the example in the commentary in the bill. Under section FC 8A the trademark is treated as being sold from the non-resident bank to B Co on the day the lease starts. The bank is treated as giving B Co a loan for the trademark, and B Co is treated as using the loan to purchase the trademark.

For B Co, the amount of the loan is the "lessee's acquisition cost" (section FC 8A(3)). This is defined in section OB 1 to mean the consideration provided to the lessee under the finance lease. "Consideration" is defined in section OB 1 as meaning an amount determined in accordance with section EH 48. Section EH 48(2) states that for an original party to a finance lease (such as B Co), if the consideration includes property or services, the value of the property or services is determined by applying subsection (3)(a) to (d) in order until a paragraph applies. The consideration provided to B Co is essentially the value of the trademarks that B Co is deemed to have purchased from the bank with the proceeds of the deemed loan under section FC 8A.

It is officials' view that section EH 48(3)(a) is applicable in this situation. It provides that the value of the property (the trademarks) is the lowest price the parties would have agreed, on the date the licence agreement was entered into, if payment would have been required in full at the time the first right in the trademarks was transferred.

Officials consider that the lowest price the bank would have accepted for the trademarks on the commencement of the licence is $9 million, being the difference between $20 million (the amount the bank paid A Co for its purchase of the trademarks immediately before the commencement of the licence) and the $11 million amount payable to the bank by C Co for its purchase of the trademarks under the call option.

The same interpretation of section EH 48(2) is used for the purpose of calculating and spreading B Co's interest deduction under the accrual rules (including calculating the base price adjustment). The interest component of the deemed loan is $3 million (being $9 million consideration payable to B Co less $12 million consideration payable by B Co). This amount is deductible to B Co and spread under the accrual rules. B Co is treated as owning the lease asset (the trademarks) but as trademarks are not depreciable property, there is no depreciation deduction. This treatment accords with the correct policy outcome.

Recommendation

That the submission be noted.

EARLY PAYMENT REBATE

Clause 33

New small businesses are not required to pay income tax for their first year in business until their second year, when they also have to pay tax for their second year. Some businesses face financial difficulties as a result.

To address this problem, the early payment rebate provides an incentive by way of a 6.7 percent rebate for self-employed taxpayers or partners in a partnership to pay tax voluntarily during their first year in business.

Issue: Support for the proposal and advertising the rebate

Submission
(10W – Business New Zealand, 15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The submissions strongly support the proposal and consider the measure to be a positive move to encourage new businesses to pay tax early so as not to face financial difficulties in year two.

However, one submission considered that resources should be targeted for a major education programme to communicate the concession to the newly self-employed. There is a risk that self-employed taxpayers will not be aware of the proposal as they tend to get tax advice after the end of their first year, when it is too late to take advantage of the rebate.

Comment

Officials agree that an education campaign needs to be undertaken to promote the rebate and that using the standard methods of communication may not be appropriate for this group of people. Inland Revenue will undertake a number of initiatives aimed at targeting information and advertising to new small businesses or those considering starting a business. The specific initiatives are in the process of being developed. This will be in addition to information provided to agents and those newly registered for GST.

Recommendation

That the submissions be noted.

Issue: Rate of the early payment rebate

Submission
(10 – Business New Zealand, 15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

The rate of the early payment rebate should be increased from 6.7 percent to a more generous 10 percent. The Colmar Brunton Final Quantitative Research Report stated that the 10 percent rate was the most commonly suggested by businesses and tax agents. The rate recognises only the time-value of money and does not provide a sufficient marginal benefit to encourage early payment of tax during time when a business is likely to be cash-strapped. The rate should be more in line with the bank overdraft rate faced by small business taxpayers.

Comment

The Colmar Brunton survey asked for businesses' reaction to providing a 7 percent discount for early payment of tax. Of those businesses surveyed, 64 percent rated this option 5 or greater out of 10, and 45 percent indicated a strong prospect of their taking up this option (a rating of 7 or greater out of 10). They were also asked what would be a reasonable discount rate. Forty-five percent of businesses indicated a 10 percent rate.

However, the 6.7 percent rate is a risk-free, tax-free return on money deposited with Inland Revenue. This rate is more generous than the 12-month term deposit rates of the major trading banks (which would be subject to income tax) and is above the credit interest rate (4.83%) provided by Inland Revenue on overpaid income tax, which is what this payment is.

Recommendation

That the submission be declined.

Issue: Application of the rebate regardless of business structure

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

The early payment rebate is available only to self-employed taxpayers or partners in a partnership. The rebate should be available to all provisional taxpayers, regardless of the business structure used by the taxpayer. Submissions acknowledged that companies could establish a new subsidiary in order to be eligible for the rebate but considered that an appropriate anti-avoidance provision could exclude group companies.

Comment

While there is some merit to the idea that the choice of business structure should not affect entitlement to the rebate, if entitlement were extended to entities such as companies or trusts (excluding groups of companies), it could be claimed a number of times by the same person. Clearly, this would be an inappropriate policy result. For example, a person could get a rebate when he or she becomes self-employed or a partner in partnership, as well as when the business is incorporated as a company and again if the business is transferred to a trust. The same taxpayer could benefit by being a major shareholder of the company and major beneficiary of the trust.

Recommendation

That the submission be declined.

Issue: Availability of the early payment rebate

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

Section MBC 2(1)(c), which deals with restrictions on who would be eligible to claim the rebate, should be removed. PricewaterhouseCoopers considers that the section is unclear and, rather than ceasing business for four years, the rebate should refer to ceasing to be a provisional taxpayer with no specified "stand-down period". The Institute considers that the requirement for a four-year gap between businesses is arbitrary and lacking detail, and difficulties will be experienced in determining "what is a business" as some businesses move from being a hobby to a business.

The proposal also needs to address circumstances where a taxpayer has previously been in business or been liable to pay provisional tax before they start up business.

Comment

Restrictions are placed on who is eligible to claim the rebate in order to ensure that it is effectively targeted at businesses that could face financial difficulties. The rebate increases awareness of the financial difficulties that a business could face in the second year and provides an incentive to pay tax in the first year to avoid these difficulties. Once a business is in the provisional tax system or has been a provisional taxpayer in recent years, officials consider that the business is aware of the need to make provision for tax. The rebate has therefore not been extended to those who are liable for provisional tax before they start up business.

However, taxpayers who have been out of business for some time may be less aware of the need to budget for two year's worth of tax due in their second year in business. In this case it is appropriate to provide the rebate again to increase awareness and provide an incentive to make voluntary payments. Although the choice of a time period is arbitrary, a four-year period is considered long enough for a taxpayer to benefit from the reminder.

If the rebate were available to those who cease paying provisional tax only for four years (rather than cease business), a company that ceased paying provisional tax because it was in a tax loss situation would qualify for the rebate once it became profitable again. The company would still be filing tax returns and might make voluntary tax payments in case it found itself with unexpected tax to pay. These taxpayers would not need to be reminded of their obligations.

The income tax system already has to distinguish between a hobby, which is not taxable, and a business, which is taxable. There is a definition of "business" in the Income Tax Act 1994, and established case law in this area. Any difficulties in determining whether an activity is a business or a hobby exist, irrespective of the proposal, and any clarification would be outside of its scope.

Recommendation

That the submission be declined.

Issue: Application date of the early payment rebate

Submission
(19 – Minter Ellison Rudd Watts, 27 – KPMG)

The early payment rebate should apply from 1 April 2004, not 1 April 2005, as proposed, to relieve financial strain earlier.

Comment

The aims of the rebate are to increase awareness of the financial difficulties that could occur in the second year in business and to receive tax payments earlier, as well as enabling the business to make payments during the year when their income is earned.

The bill is not expected to be passed before September this year, leaving little time to develop advertising and publicise the rebate, for Inland Revenue to implement the changes, and for new businesses to pay tax during the year. A prospective application date would enable these to occur and provide a greater possibility of successful implementation.

Recommendation

That the submission be declined.

Issue: Rebate be available for all of the first three years in business

Submission

(26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

KPMG submits that in some cases the rebate should be able to be claimed in all of the first three years in business, as chosen by the taxpayer. This would compensate taxpayers who pay early in year 1 in anticipation of being a provisional taxpayer in year 2 but later find out they do not have to pay provisional tax in year 2. The same situation could occur in years 2 and 3. Taxpayers in this situation should be rewarded for paying their tax early.

The Institute suggests that taxpayers should be able to retrospectively elect which year the rebate should apply to. This would enable taxpayers to claim the rebate in a year when their income is positive and higher rather than a year when income is declining or the taxpayer makes a loss.

Comment

Allowing the rebate to be claimed in each of the first three years would effectively extend interest to these taxpayers at a more generous rate than the current credit rate of interest. It would also provide an incentive to use Inland Revenue as a bank.

The measure proposed in the bill allows some flexibility around when the rebate is claimed. However, allowing the taxpayer to retrospectively elect which year to claim the rebate in has less to do with cash flow and more to do with minimising tax liability.

A rebate for a three-year period would be fiscally expensive and beyond what this initiative is trying to achieve, that is encouraging taxpayers to pay tax in the first year of business and reduce the financial strain associated with paying two years' worth of tax in the second year in business.

Recommendation

That the submission be declined.

Issue: Index the early payment rebate rate

Submission

(26 – Institute of Chartered Accountants of New Zealand)

There needs to be a mechanism for the 6.7 percent discount to be increased in line with interest rate movements or inflation in order to maintain its relevance.

Comment

The rebate is a risk-free, tax-free rate currently set above the deposit rate of the major trading banks. Officials consider that the rebate does not need to be aligned with movements in the rate of inflation. However, the submission has prompted the question of whether the rate should be able to be changed quickly if there is a significant change in interest rates. Officials therefore propose that the rate should be able to be changed by Order in Council.

Recommendation

That the submission be declined, but that the Committee agree to an amendment to enable the rate to be changed by Order in Council.

Issue: Payment date for rebate

Clause 33

Submission
(Matter raised by officials)

Currently the bill does not provide an effective payment date for the early payment rebate in order for use of money interest to be calculated.

Comment

If the taxpayer has applied for the early payment rebate and the Commissioner has failed to pay the rebate then interest would normally apply. However, an effective payment date is required in order for the rebate to be included in the interest calculation.

Officials recommend that an effective date be included in the bill. The effective date should be the day after the end of the income year in which the rebate is claimed.

Recommendation

That the submission be accepted.

Issue: Applying for rebate

Clause 33

Submission
(Matter raised by officials)

Taxpayers who have made an error in completing their tax return and elected not to receive the early payment rebate should be able to change their election.

Comment

Taxpayers who have made a mistake by omitting to claim the early payment rebate in their tax return should be able to apply separately to the Commissioner to claim the rebate.

Officials propose that taxpayers be required to elect before the last date for furnishing the return for the income year in which the early payment rebate is claimed. This would allow mistakes to be corrected while not opening up the rebate to retrospective applications.

Recommendation

That the submission be accepted.

Issue: Not withdrawing early tax payments

Clause 33

Submission
(Matter raised by tax adviser)

Taxpayers who deposit their money in order to qualify for the early payment rebate should not be able to withdraw their money after the end of the income year and before their return is filed.

Comment

As the legislation is drafted a taxpayer could make voluntary payments of income tax on or before 31 March of a year in order to obtain the early payment rebate and then withdraw the money shortly after 1 April. The intention of the rebate is to ensure that voluntary payments made during the year stay with Inland Revenue and are offset against the taxpayer's end of year tax liability.

Officials propose that the provision be amended so that in order to qualify the taxpayer not only has to make voluntary payments but that those payments remain with Inland Revenue until the return is filed. Once the return is filed then the lesser of the voluntary payments or the taxpayer's terminal tax liability has to remain with Inland Revenue until the taxpayer's terminal tax date.

Recommendation

That the submission be accepted.

Issue: Terminology change

Clause 33

Submission
(Matter raised by officials)

The term "early payment rebate" should be replaced with "early payment discount" in order to be consistent with the structure and core provisions of the Income Tax Act 1994.

Comment

This measure is correctly contained in Part M of the Income Tax Act 1994 concerning tax payments. It is not correct, however, to use "rebate" terminology for this reform because rebates are dealt with in Part K of the Income Tax Act and are taken into account in calculating a person's income tax liability. Instead, the use of the word "discount" would be more accurate. Therefore the term "early payment rebate" should be replaced with "early payment discount".

Recommendation

That the submission be accepted.

Issue: Elevation of issues to the Policy Advice Division

Clause 36

Submission
(13 – Jeff Owens & Company Ltd)

While the submission supports the proposal in respect of imputation credits, the Finance and Expenditure Committee should instruct the Commissioner that where an obviously inappropriate result arises out of faulty legislation or Inland Revenue's interpretation of legislation, an issue must be elevated to Inland Revenue Policy Advice Division as a matter of course.

Comment

Where tax law appears not to achieve its policy intention it is the practice for staff to escalate the matter. As a result, the Policy Advice Division should be advised if a policy problem is confirmed. There will be occasions when the policy issue is simply not recognised by Inland Revenue's field staff, but this does not happen very often.

An instruction to the Commissioner, as suggested in the submission, is therefore unnecessary.

Recommendation

That the submission be declined.

Issue: Consolidated groups

Clause 36

Submission
(27 – KPMG)

Proposed section MD 4(2)(b) should be amended to include a reference to the consolidated group's nominated company.

Comment

Paragraph (b) specifies the taxpayers who are likely to have requested a transfer. It already refers to a company or a consolidated group. Reference to the nominated company of a consolidated group is unnecessary because the nominated company will always be part of the consolidated group.

Recommendation

That the submission be declined.

Issue: Drafting issue (section MD 4(3))

Clause 36

Submissions

(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

A reference to section ME 5(1)(e) in new subsection MD 4(3) needs to be expanded to include sections ME 12(1)(d), MG 5(1)(d) and MG 15(1)(d).

Comment

Under new subsections MD 4(2) and (3), companies will be able to elect that a credit (a permitted credit) arises to the imputation credit account (ICA) or dividend withholding credit account (DWPA) in certain circumstances when overpaid tax was transferred before the transfer rules came into effect.

The amount of the permitted credit is the amount transferred less the amount of the debit that would have arisen if the overpayment had been refunded. Section ME 5(1)(e) is one section that provides for a debit to arise if overpaid tax is refunded. Other sections are ME 12(1)(d), MG 5(1)(d) and MG 15(1)(d) and these sections should also be specified in section MD 4(3).

Recommendation

That the submissions be accepted.

Issue: Drafting issue (section MD 4(2))

Clause 36

Submissions

(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The criteria in section MD 4(2) should apply to Inland Revenue-initiated transfers as well as taxpayer requested transfers.

Comment

Transfers of overpaid tax can be initiated by Inland Revenue where there is an underpayment in one year or revenue, and an overpayment is identified in relation to another year or revenue. Where such transfers satisfy the other criteria in section MD 4(2), a company should be able to elect that a permitted credit should arise in respect of that transfer also.

Recommendation

That the submissions be accepted.

PAYE BY INTERMEDIARIES

Issue: Minimum number of employers

Clause 65(17)

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

The requirement for a PAYE intermediary to represent at least ten employers should be reduced to five.

Comment

The submission comments that the threshold of ten employers may eliminate smaller genuine intermediaries and start-up intermediaries from the scope of the "PAYE by intermediaries" rules.

The ten-employer minimum threshold was introduced to reduce the risk of the "PAYE by intermediaries" rules being abused by entities registering as intermediaries who do not intend to represent any employers. A minimum of ten employers was considered to provide a reasonable balance between the need to ensure intermediaries are not disadvantaged (especially during start-up) and the need to mitigate the risk of abuse. We consider that it is not unreasonable for a genuine PAYE intermediary to have at least ten clients.

Recommendation

That the submission be declined.

Issue: Definition of "officer"

Clause 54

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The term "officer" in the "PAYE by intermediaries" rules should be clarified by referring to the definition of "officer" in section 3(1) of the Tax Administration Act 1994.

Comment

The submissions comment that the proposed clarification of the term "officer" in the "PAYE by intermediaries" rules is incomplete in that it does not specify that the director, secretary or statutory officer should hold these positions in respect of a "corporate body". They suggests the inclusion of a new section in the "PAYE by intermediaries" rules (section NBB 1 of the Income Tax Act 1994) defining "officer" to have the same meaning as the definition of "officer" in section 3(1) of the Tax Administration Act 1994. There would need to be a corresponding amendment to the definition in the Tax Administration Act.

The proposed changes to sections NBB 2(1)(c) and NBB 2(4)(b) clarify that "officer" means a director, secretary or statutory officer of the applicant if the applicant is not a natural person. "Person" is defined in section OB 1 as including a company and a local or public authority. Consequently, we do not consider that the further clarification suggested in the submissions is required.

However, the definition of "person" also includes an unincorporated body of persons. Where an unincorporated body of persons, such as a partnership, wishes to be accredited as a PAYE intermediary we consider that the individual partners should be subject to the accreditation requirements in section NBB 2. Consequently, we consider that the proposed changes should be extended to clarify that where the applicant is an unincorporated body of persons, sections NBB 2(1)(c) and NBB 2(4)(b) apply to each member of the unincorporated body.

Recommendation

That the submissions be declined. However, the proposed changes should be extended to encompass members of unincorporated bodies (such as partnerships).

REDUCTION OF NON-DECLARATION RATE FOR NON-RESIDENT CONTRACTORS WHO ARE COMPANIES

Clause 59

Issue: Support of lower non-declaration rate

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The lower non-declaration rate imposed by clause 59 is supported.

Comment

The submissions supports clause 59 as a positive measure to reduce the compliance burden imposed by the non-resident contractors' withholding tax rules. The Institute of Chartered Accountants also supports the inclusion of a specific anti-avoidance measure.

Recommendation

That the submission be noted.

Issue: Application date for lower non-declaration rate

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

The date from which the proposed change apply should be brought forward to 1 April 2004 or the date of enactment.

Comment

Adjusting the non-declaration rate for payments already made would generate administrative and compliance costs for little benefit. However, there should be no difficulty in making the proposal applicable from the date of enactment.

Recommendation

That the submission to make the proposal applicable from the date of enactment be accepted. That the submission to make the proposal applicable from 1 April 2004 be declined.

Issue: Lowering the rate of non-resident contractors’ withholding tax

Submission
(27 – KPMG)

The rate of non-resident contactors’ withholding tax should be lowered from 15% to 10%.

Comment

The submission states that when the non-resident contractors’ withholding tax was introduced the company tax rate was much higher. The withholding rate was initially set with a 50% tax rate in mind. The tax rate for companies is currently lower, and the withholding rate, therefore, should be reduced as well.

The submission does not take into account that the non-resident contractors’ withholding tax applies to companies and individuals. The top personal income tax rate of 39% is higher than the company tax rate (33%). Individuals may also have lower overheads than companies, and the margin between individuals’ gross income and net income will therefore be lower.

There is a higher risk of non-compliance by non-resident contractors than by resident contractors. This favours a higher withholding rate.

The submission also does not relate to the proposed changes contained in the bill.

Recommendation

That the submission be declined.

RWT ON USE-OF-MONEY INTEREST

Issue: Commissioner should be subject to the same rules as others

Clause 62

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

The proposed amendment should not be enacted.

Comment

When use-of-money interest (UOMI) paid by the Commissioner was introduced, it was considered appropriate that it should be taxable and subject to the resident withholding tax (RWT) rules. The intent was to ensure that from the taxpayer's perspective, UOMI paid by the Commissioner was treated, as much as possible, like interest received from a bank.

In practice, however, it has resulted in an overly complex system with significant compliance costs for taxpayers and increased administrative costs for Inland Revenue. Officials consider that these costs justify adopting a different tax treatment for such payments. The proposed amendment will reduce both the compliance costs for taxpayers and administrative costs for Inland Revenue.

This proposed amendment is supported by the submissions of Business New Zealand, PricewaterhouseCoopers and KPMG. Business New Zealand and KPMG note the complexity under the current rules.

Recommendation

That the submission be declined.

Issue: Provisional tax threshold

Clause 62

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

Any use-of-money interest received should be excluded from residual income tax.

Comment

Removing the requirement to deduct RWT from use-of-money interest paid by the Commissioner will move 30 taxpayers into the provisional tax system. This represents $75,000 of payments brought forward from terminal tax to provisional tax.

The proposed amendment is intended to reduce compliance costs for taxpayers and administrative costs on Inland Revenue. Officials consider the overall reduction in compliance costs for taxpayers to far outweigh any added compliance costs for this very small group of taxpayers.

This proposed amendment is supported by the submissions of Business New Zealand, PricewaterhouseCoopers and KPMG. PricewaterhouseCoopers note that only a limited number of taxpayers will become liable to provisional tax as a result of the proposed change.

Recommendation

That the submission be declined.

Issue: Support for proposal

Clauses 65(26), 65(29), 65(30), 67 and 142

Submission
(10W – Business New Zealand)

Business New Zealand notes its support for the proposed amendments.

Comment

Incorporated societies will be allowed to carry forward tax losses and offset income and losses against the income and losses of companies in the same group. They will also be allowed, for a limited period, to offset income and losses against those of their commonly owned incorporated societies.

These amendments ensure that incorporated societies that are treated as companies for tax purposes, can avail themselves of the same rules that allow other corporate entities to carry forward and offset tax losses against those of companies in the same group.

Recommendation

That the submission be noted.

Issue: Application date – defining incorporated societies as a "special corporate entity"

Clauses 65(26), 65(29) and 65(30)

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

The submission supports the proposal to define incorporated societies as a "special corporate entity" to allow them to carry forward tax losses and offset income and losses against the income and losses of companies in the same group.

However, the application period for including incorporated societies in the definition of "specified corporate entity" should be simplified to be the 1995-96 and subsequent income years. The intended requirement that the assessment is not time barred should be removed, except in relation to the amendment to the Income Tax Act 1976 which should remain effective for the period from 1992-93 to 1994-95 subject to the time bar.

Comment

The loss carry forward rules were redrafted in 1992 to introduce the new ownership tests of voting and market value interests to determine a person's interest in a company. An unintended outcome was that incorporated societies that did not issue shares were no longer able to access the loss carry forward rules due to their inability to satisfy the new ownership tests. As a result, some incorporated societies incorrectly applied the loss rules, while others correctly applied the law.

The proposed amendments in the bill ensure that incorporated societies that do not issue shares are able to carry forward losses and offset such losses against income earned in future income years. This rule existed prior to the redrafting of the loss carry forward rules and, therefore, the proposed amendment applies retrospectively to the 1992-93 income year.

Incorporated societies will also be able to offset their income and losses against the income and losses of companies in the same group. The previous legislation did not provide for such offsets. However, officials are aware of some incorporated societies that did offset income and losses against the income and losses of companies in the same group.

The retrospective application of the proposed amendment will prevent the Commissioner from denying such group offsets and thereby protect the tax position adopted by some incorporated societies. The rationale for providing a four-year period in which an incorporated society can use the proposed amendment to amend its returns to offset such losses is to limit the potential revenue and administrative implications associated with the retrospective application of the amendment.

The purpose of the proposed application date, in relation to allowing for offset by companies in the same group, was to provide that all incorporated societies could apply the proposed amendment to any assessment that was not subject to the time bar for the Commissioner to amend the assessment. However, officials acknowledge the point made in the submission: that the current application provisions may be unworkable in the way they interact with the statute bar date provisions.

Officials therefore consider that the amendments allowing incorporated societies to offset income and losses against the income and losses of companies in the same group in past years should be retrospective to the 1992-93 income year, to protect the position adopted by an incorporated society if it filed on that basis. However, if an incorporated society did not file on that basis, it would be able to amend its return to take advantage of the proposed amendments for the 2000-01 and subsequent years.

Recommendation

That the submission be declined but the proposed application date be redrafted to allow:

- retrospective application to the 1992-93 income year for incorporated societies that filed on the basis of group offset; and
- retrospective application to the 2000-01 income year for those incorporated societies that have not filed on that basis.

Issue: Application date – the offsetting of losses between commonly owned incorporated societies

Clause 67

Submission

(26 – Institute of Chartered Accountants of New Zealand)

The provision that allows commonly owned incorporated societies to offset their income and losses should apply for the 1995-96 and all subsequent income years, and not be restricted to the income years from 1997-98 to 2002-03.

Comment

Officials consider that treating incorporated societies that do not issue shares as special corporate entities is the correct policy outcome, as it is consistent with the rationale for the special corporate entity concept.

The special corporate entity concept and associated rules were introduced to deal with entities that do not issue shares or have ultimate natural person shareholders. Without the special corporate entity concept, this lack of easily-identified owners would create major problems for the application of some of the standard company tax rules such as carry forward and grouping losses.

The members or directors of a special corporate entity are deemed to be a single person (and not a company) holding all the shares and options over shares in the entity and holding nothing but rights over the entity. Therefore no breach of shareholder continuity is possible in respect of the special corporate entity or its subsidiaries. By the same token, a special corporate entity can group only with its own subsidiaries, because there is no look-through to the individual owners or members of the incorporated society on which common ownership would be determined. Grouping for loss offsets requires common ownership.

Clause 67 has been proposed to deal with a specific situation where a set of incorporated societies and their subsidiaries "grouped" their losses and income on the basis of common membership. The taxpayer contends that tax rules treated membership rights as shares for the purposes of the tax loss rules. The Commissioner contends that they did not. However, the proposal – retrospectively allowing grouping in this situation for a relatively brief period – provides a pragmatic resolution for this dispute. In discussions with the parties involved, they have accepted that the special corporate entity concept is the appropriate approach going forward. Officials are not aware of other situations that need to be covered by the application date of this provision.

Recommendation

That the submission be declined.

Issue: Shares in deemed companies should be deemed to carry all shareholder decision-making rights

Clause 67

Submission
(14 – Russell McVeagh)

Proposed new section OD 3(4) will provide that, if no shares have been issued by the incorporated society, the incorporated society will be deemed to have issued shares to its members and these shares will carry all the shareholder decision-making rights. This will result in the creation of a voting interest that can be used to allow the incorporated society to offset income and losses against those of its commonly owned incorporated societies.

A similar provision is required to make it explicit that the shares deemed to be issued by a company that is deemed to exist under section OE 3 carry all the shareholder decision-making rights in the deemed company. Under section OE 3, a non-resident life insurer can elect for its New Zealand life insurance business to be treated as carried on by company resident in New Zealand.

Comment

Officials consider that the proposed amendment should not be included as part of the Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill, as further analysis is required to identify any risks or unintended consequences associated with the proposal.

Recommendation

That the submission be declined at this stage. Officials recommend that this work be added to the government's tax policy work programme and prioritised as resources permit.

CONFIRMATION OF ANNUAL INCOME TAX RATES

Clause 3

Issue: Reduction in the tax-to-GDP ratio and in overall tax rates

Submission
(10W – Business New Zealand, 27 – KPMG)

Business New Zealand submits that the tax-to-GDP ratio and tax rates overall should be reduced, requiring lower government expenditure relative to GDP. It argues that the "headline" company tax rate should be reduced over time to 20%, and that this would not have a significant revenue cost.

KPMG submits that the corporate tax rate should be lowered to a rate that is competitive with those of its neighbours, and personal marginal tax rates lowered and aligned with the corporate tax rate.

Both submissions argue that current tax rates constrain New Zealand's international competitiveness, appeal to investors and economic growth.

Comment

The Income Tax Act 1994 provides for the rates of income tax specified in Schedule 1 of the Act to be confirmed each year. It has been a long-standing practice of Parliament to confirm the tax rates annually. The bill provides that the annual income tax rates for the 2004-05 income year will be the same as the rates that applied for the 2003-04 income year.

The rates being confirmed reflect the government's policy on the rates of income tax it wishes to levy on businesses and taxpayers. The government's main concern in setting rates has been to generate sufficient revenue to meet its policy commitments.

In regard to Business New Zealand's proposal for a 20% corporate tax rate, removing the alignment between the current corporate tax rate and the middle personal tax rate would come at a cost in terms of revenue, administration and compliance.

Recommendation

That the submissions be declined.

Issue: Need for empirical international evidence to support New Zealand's current tax rates

Submission
(27 – KPMG)

New Zealand should undertake a comparative analysis of income tax and economic growth rates in comparable foreign jurisdictions to ensure that New Zealand's rates are achieving the best possible trade-off between government revenue and private sector investment.

Comment

The Treasury and the Ministry of Economic Development are already researching the many influences on growth rates internationally, including the impact of tax systems.

Recommendation

That the submission be noted.

Issue: Inflation-adjustment of tax rate thresholds

Submission
(27 – KPMG)

New Zealand's personal marginal tax rate thresholds and other thresholds (such as de minimis rules) in the Revenue Acts should be inflation-adjusted now and on an on-going basis. By not inflation-adjusting marginal tax rate thresholds the government is effectively increasing tax rates and increasing its revenue as wages increase. This is incongruous with the inflation-adjustment of such things as excise taxes.

Comment

The rates being confirmed reflect the government's policy on the rates of income tax it wishes to levy on businesses and taxpayers.

Changing tax thresholds involves a number of costs such as changing PAYE tables and accounting systems, so it should not occur frequently. Changes in thresholds can be more complex than is implied by the submission. (For example, the current straightforward relationship between the low income rebate, the $9,500 threshold, and the $38,000 threshold would be complicated by inflation-adjustment.) Furthermore, if revenue is sufficient to adjust for inflation, alternative changes to tax schedules may offer better outcomes that deal with changes other than just the price level.

Recommendation

That the submission be declined.

PENALTIES APPLICABLE TO NON-RESIDENT CONTRACTOR IF TOTAL DOUBLE TAX RELIEF APPLIES

Clauses 106, 107, 118 and 119

Issue: Support for the lower penalty contained in the proposal

Submission
(15 – PricewaterhouseCoopers)

The submission supports the lower penalty provisions contained in the proposal.

Comment

The submission supports the proposal as a positive measure to reduce the compliance burden imposed by the non-resident contractors' withholding tax regime.

Recommendation

That the submission be noted.

Issue: Section 141AA should not be enacted

Submission
(19 – Minter Ellison Rudd Watts)

Section 141AA should not be enacted, because it would be illogical to impose a penalty on an employer who does not deduct a withholding tax that, ultimately, will always be refundable to the non-resident contractor.

Comment

The proposal does not introduce a new penalty; it limits an existing penalty.

Where no certificate of exemption is obtained, but the non-resident contractor is exempt from all tax under a double tax agreement or otherwise, the New Zealand employer is required to withhold tax. The non-resident contractor can claim this amount withheld as a credit against its taxable income by filing an income tax return in New Zealand. If the New Zealand employer does not withhold the required tax then penalties apply to the employer.

The proposed section 141AA will restrict the amount of penalty payable in these situations to $250 per incorrectly filed employer monthly schedule with a cap of $1,000. This limitation is necessary because it recognises that the non-resident will be exempt from paying tax in New Zealand. The Inland Revenue Department, however, still needs the information connected with the activities of the non-resident contractor for tax audit and enforcement purposes.

Recommendation

That the submission be declined.

Issue: Filing requirement imposed as an alternative to the penalty

Submission
(10W – Business New Zealand, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

As an alternative to the proposed penalty contained in section 141AA, there should be a requirement that information is filed with the Inland Revenue Department.

Comment

The submission assumes that taxpayers will comply with the proposed information filing requirement if no penalty is imposed for not doing so. There is currently a mechanism for filing information where no penalty arises.

Where the non-resident contractor applies for an exemption certificate the New Zealand employer is exempt from the withholding requirement in this context. This is essentially a filing requirement with no penalty. However, in the event that a certificate is not filed, some enforcement mechanism should exist. Rather than imposing a late filing penalty, the exemption from withholding is removed. There is another opportunity for taxpayers to comply without incurring any penalty. If the withholding obligations are complied with, no penalty will arise. However, where taxpayers fail to utilise both these opportunities to avoid the imposition of a penalty, some enforcement mechanism is required if the non-resident contractors' tax is to work effectively.

The non-resident contractors' tax has a high risk of non-compliance. The proposal to apply a penalty for not filing is premised on the assumption that non-compliance will continue in the absence of an enforcement mechanism. The penalty is similar to a late filing penalty.

The submission from KPMG proposed that the penalty be remitted in the event that the information is provided. However, the point of the penalty is to ensure that the information is provided in a timely manner. If this is done then no penalty will arise. However, if the information is not provided in a timely manner its usefulness is eroded. The penalty is therefore required to ensure that the information is provided on a timely basis.

Recommendation

That the submission be declined.

Issue: Reference to "contract payment" or "withholding payment"

Submission
(27 – KPMG)

Section 141AA should refer to "contract payment" rather than "withholding payment" when referring to the payment from the New Zealand employer to the non-resident contractor.

Comment

The submission is technically correct. The term used in the Income Tax (Withholding Payments) Regulations 1979 is "contract payment".

Recommendation

That the submission be accepted.

Issue: Reference to non-resident contractors' income tax liability

Submission
(27 – KPMG)

Section 141AA(1) should refer to the non-resident contractor's income tax liability in New Zealand as opposed to the contractor's liability to pay tax on the withholding payment.

Comment

Officials agree that the payer's liability to deduct tax from a contract payment and pay it to the Commissioner should be more clearly distinguished from the non-resident contractor's liability in respect of the payment.

Recommendation

That the submission be accepted.

Issue: Limitation of application to double tax agreements

Submission
(27 – KPMG)

The penalty should not be limited to non-resident contractors who are exempt from all tax under a double tax agreement, but should apply in all cases where the non-resident contractor is completely exempt from paying tax in New Zealand.

Comment

There is no policy reason why the penalty should apply only in situations where the non-resident is exempt from tax under a double tax agreement. The policy underlying the proposal is to reduce a more onerous penalty from applying in situations where no tax is ultimately payable by the non-resident contractor. The proposed penalty should therefore apply in all situations where the non-resident contractor is completely exempt from tax in New Zealand.

Recommendation

That the submission be accepted.

TAX SHORTFALLS – LOSS ATTRIBUTING QUALIFYING COMPANIES

Clauses 109 and 110

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

The Institute supports this change because this approach better reflects the underlying policy intent of the loss attributing qualifying company (LAQC) regime.

Comment

To the extent that an adjustment reduces a net loss of an LAQC, any penalties will be charged to the shareholder, not the company. If the shareholder has not claimed a deduction for the attributed loss, no penalty will be charged.

Recommendation

That the submission be noted.

Issue: Tax shortfalls – shareholders acting in good faith

Clauses 109 and 110

Submission
(10W – Business New Zealand)

Business New Zealand supports the amendment, but questions the need to penalise shareholders who may be acting in good faith.

Comment

The courts have recently held that both the company and the shareholder takes a tax position where losses are attributed to a shareholder. The shareholder, therefore, has a responsibility to ensure that he or she has taken an acceptable tax position. If the tax position proves to be unacceptable, the shareholder should be treated in the same way as any other person who has taken such a tax position.

Recommendation

That the submission be declined.

Issue: Tax shortfalls – penalise the company in the first instance

Clause 110

Submission
(15 – PricewaterhouseCoopers)

The proposed provision should charge the LAQC with the shortfall penalty in the first instance, as opposed to the shareholders.

Comment

Officials have no particular preference in relation to whom the penalty should be applied. However, we consulted with ICANZ, who have a strong preference for the penalty to be charged to the shareholder.

Further, such a change would involve unilaterally extending the LAQC shareholder tax guarantee, as the submitter acknowledges. Such a change should be the subject of explicit consultation.

Recommendation

That the submission be declined.

Issue: Drafting clarification

Clause 110

Submission
(27 KPMG)

Proposed section 141FD(1)(a) should refer to a shareholder of the loss attributing qualifying company on any day in the income year in relation to which the company had the net loss that was attributed to the taxpayer.

Comment

A net loss is generally not determined until the full year's position is determined, usually after the end of the particular year. It is not correct, therefore, to refer to the income year "in which" the company had the loss, and the bill should be amended to refer to an income year for which the company had the loss.

Recommendation

That the submission be accepted.

Issue: Tax shortfalls – drafting issue

Clause 110

Submission
(15 – PricewaterhouseCoopers)

The provision should consistently use the term "shareholder" rather than interchange between "shareholder" and "person".

Recommendation

That the drafting be made consistent.

Issue: Tax shortfalls – application date

Clause 110

Submission
(15 – PricewaterhouseCoopers)

The proposed provision should apply retrospectively from 1 April 1998.

Comment

Officials are aware of a number of cases where the current law is being relied on. Accordingly, making this provision retrospective to 1 April 1998 is not appropriate.

Recommendation

That the submission be declined.

Issue: Tax shortfalls – application date inconsistency

Clause 110

Submission
(15 – PricewaterhouseCoopers)

The Commentary states that the amendment will apply to shortfalls that relate to periods starting on or after 1 April 2005. However, clause 110(2) states that the amendment will apply to shortfall penalties imposed on or after 1 April 2005.

Comment

The intention is that the provision apply to shortfalls that relate to periods starting on or after 1 April 2005.

Recommendation

That the application date in the bill be amended to reflect the intention as stated in the Commentary.

Issue: Tax shortfalls – voluntary disclosure of shortfalls

Clauses 109 and 110

Submission
(29W – Murray Harden)

If LAQCs qualify for a reduction of penalties because of a voluntary disclosure, this reduction should automatically flow through to shareholders.

Comment

This submission was received very late, and officials have had insufficient time to work through all the implications.

Recommendation

That the submission be declined at this stage, but full analysis will be undertaken by officials, with a view to amending the legislation, if appropriate, in the future. Officials will liaise with the submitter on this matter.

Issue: Over-taxation of New Zealand investors investing through pooled investment vehicles

Submission

(15A – PricewaterhouseCoopers, 23W – Money Managers Limited)

The proposals do not address the fundamental problem in this area, which is the over-taxation of New Zealanders that save through New Zealand pooled investment vehicles.

Comment

Officials agree that New Zealand resident investors can face over-taxation if they invest via a New Zealand pooled investment vehicle such as a unit trust. One of the main reasons for this is that the investment vehicle will generally be taxed on the profits it derives from the sale of its investments (such as shares), on the basis that such profits comprise its business income. The imposition of tax on the investment vehicle's business profits will reduce the ultimate return to the investor.

New Zealand investors that invest directly rather than through a pooled investment vehicle will generally not pay tax on the profits they derive from the sale of investments such as shares. This is because the individual investor will not generally be in the business of investing in the underlying investments. This distinction between the tax treatment of pooled and direct investment means that the tax system can be said to encourage individuals to invest directly rather than through a pooled fund.

There are also a number of other problems with the tax treatment of New Zealand pooled investment vehicles. These include the various different tax rules that can apply depending on the particular vehicle invested into and the problem of the vehicle's tax rate being different to those of its ultimate investors.

The government is aware of these problems and has announced a review of the tax rules that apply in this area. A key aspect of this review is working with industry stakeholders in an attempt to ascertain what they see as the key problems and whether a consensus is emerging on an approach to address these problems. An independent private sector expert, Craig Stobo, is coordinating this work and is due to report to the Minister of Finance and Revenue on options for reform in October this year.

Recommendation

That the submissions be noted.

Issue: Uncertainty with the vesting rule

Submission

(7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers, 18A – Corporate Taxpayer Group, 27 – KPMG, 26 – Institute of Chartered Accountants of New Zealand)

The proposed section CF 2(1)(ib) provides that a dividend includes "income or property of a unit trust in which a beneficial interest vests absolutely in a unit holder".

It is submitted that the term "vests absolutely in interest" is a trust term and to introduce it to the unit trust tax area would create uncertainty. ISI suggests further that it is

> …very difficult in logic and at law to tax income, that is already deemed to be gross income derived by a company, to the shareholders as beneficiary income, then try and deem that to be a dividend. Although the Courts could arguably force the rule to work, the tension between the trust regimes and company regime is likely to cause unnecessary uncertainty.

There is also a concern that the proposals could inadvertently prohibit New Zealand resident unit trusts making non-taxable bonus issues even though there is no revenue leakage from these unit trusts.

It is submitted, therefore, that the proposed vesting rule should be limited to offshore unit trusts.

Comment

Officials do not agree that there would be a general problem in applying the proposed vesting rule to New Zealand unit trusts. An amount that vests absolutely in the beneficiary of a unit trust is almost certainly already treated as a dividend under section CF 2(1)(a). The proposed section CF 2(1)(ib) makes this absolutely clear.

The effect of the provision is not to deem an amount to be "beneficiary income" and then deem that amount to be a dividend. Instead, its effect is to treat an amount that has been identified by trust law as a dividend for income tax.

However, officials accept that New Zealand unit trusts are not the intended target of the proposed rules as they are fully taxable on both their New Zealand sourced and non-New Zealand sourced income. Further, we are not aware of any circumstances where the proposed vesting rule would change the tax treatment of distributions from New Zealand unit trusts.

Therefore, officials agree with the submitters' conclusion that the proposed vesting rule should be limited to offshore unit trusts.

Recommendation

That the submission be accepted.

Issue: Uncertainty with the vesting rule

Submission

(7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers, 27 – KPMG, 26 – Institute of Chartered Accountants of New Zealand)

The term "vests absolutely in interest" is not widely understood outside New Zealand trust tax rules and is not common commercial usage in relation to unit trusts. This, it is suggested, may give rise to uncertainty as to how the vesting rule in the proposed section CF 2(1)(ib) would operate in practice. The daily unit pricing of units in a unit trust is an example that submitters suggest could give rise to an unintended vesting.

It is submitted, therefore, that the proposed vesting rule should be limited to offshore unit trusts.

Comment

Officials do not consider that the practice of daily unit pricing would give rise to a vesting. The daily unit pricing is a re-calculation of the value of the units held in the unit trust. The process for achieving this is to (i) revalue the underlying assets of the unit trust (this valuation includes realised and unrealised gains); and (ii) divide the value of the underlying units by the number of units on issue. This calculation provides an updated unit price.

A vesting does not occur simply when the unit price is recalculated. A vesting requires the beneficial interest in the property or income to move from the general pool of unit trust assets to the individual beneficiary. This can only occur through the action of the trustee pursuant to the trust deed.

However, officials accept that New Zealand unit trusts are not the intended target of the proposed rules as they are fully taxable on both their New Zealand sourced and non-New Zealand sourced income. Further, we are not aware of any circumstances where the proposed vesting rule would change the tax treatment of distributions from New Zealand unit trusts.

Therefore officials agree with the submitters' conclusion that the proposed vesting rule should be limited to offshore unit trusts.

Recommendation

That the submission be accepted.

Issue: Vesting rule is unnecessary and should be repealed

Submission

(19 – Minter Ellison Rudd Watts)

The submission considers that it is a:

> …well understood point of NZ tax law that the vesting of an absolute beneficial interest in property of a trust in a beneficiary is treated as a transfer of effective ownership of that property. In a unit trust context, such an absolute vesting is clearly a distribution by the unit trust to a unitholder.

It is further suggested it is equally clear that such a vesting is caught by the broad wording of section CF 2(1)(a) and is, therefore, already treated as a dividend. It is submitted that the attempted clarification in section CF 2(1)(ib) of something that is already clear is confusing and should not be proceeded with.

Comment

While officials consider that it is almost certain that an amount that vests absolutely in a beneficiary is already treated as a dividend under section CF 2(1)(a), we also consider that this should be put beyond doubt. That is, for the proposed provisions to deal effectively with Australian unit trust (AUT) structures it is vital that a vesting from a unit trust is treated as a dividend. If it could be argued that such a vesting was not currently treated as a dividend, the AUT structures could still provide an opportunity for New Zealand resident investors to minimise or eliminate tax on their investments.

This could be achieved by the AUT vesting an amount of income absolutely in the New Zealand resident beneficiary. This would result in the income not being taxed in Australia and, if the amount that was vested was not a dividend for New Zealand tax purposes, the amount would not be taxed in New Zealand. It would not be necessary for the vesting to be accompanied by the issue of a new unit. The vested amount would simply be reflected in a higher value for existing units. If the New Zealand resident beneficiary held such units on capital account, this additional value could be realised as a tax-free capital gain when the unit was eventually sold.

Recommendation

That the submission be declined.

Issue: Potential double taxation when amount that vests is issued as a bonus issue

Submission
(15 – PricewaterhouseCoopers)

When bonus units are issued to unit holders it is likely that the units issued will include amounts that have already vested absolutely in unit holders and, therefore, have already been taxed as dividends. In other words, an amount that vests absolutely will be taxed as a dividend once and, potentially, again when the amount vested is issued as a bonus unit.

Comment

The scenario described in the submission is one where an amount that has vested absolutely in the unit holder is used as consideration for the issue of new units. This is equivalent to a purchase of units. In a situation where units are purchased, the new units will not meet the definition of a dividend. Therefore double taxation will not occur in the scenario described.

Recommendation

That the submission be declined.

Issue: Bonus issue rule is flawed and should be repealed

Submission
(27 – KPMG)

The rule that renders a bonus issue taxable if there is an arrangement to issue the unit instead of distributing money is flawed and should be repealed (the proposed new paragraph (c) of the definition of "taxable bonus issue"). It is suggested that it is difficult to envisage a situation where a trustee could make a bonus issue of units that has not vested absolutely in the beneficiary.

Comment

Officials do not agree with the submission. Aside from a "bonus issue in lieu", the definition of "bonus issue" requires that the company issuing the unit or share does not receive consideration for the issue. If a unit trust vests an amount in a beneficiary and this amount is then reinvested in new units, it would seem clear that the company has received consideration for the issue. A unit issued under these circumstances would, therefore, not satisfy the definition of "bonus issue".

The proposed amendment is not aimed at this scenario. The proposal is designed to address a situation where a unit is issued and no consideration passes from the beneficiary to the unit trust at the time the unit is issued. For example, a common feature of the AUT structures is an agreement, when units of a particular class are purchased, to receive future distributions as additional units rather than cash.

Recommendation

That the submission be declined.

Issue: Unintended consequences of bonus issue rule

Submission

(22W – Westpac Banking Corporation of New Zealand, 7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers, 27 – KPMG)

The proposed addition to the definition of "taxable bonus issue" should not apply where a bonus issue is made by a New Zealand resident unit trust for the purpose of providing a fee rebate. The fee rebate mechanism is explained very clearly in the Westpac submission.

Management fee rebates are provided for certain investors in unit trusts that, for example, hold fund balances that exceed a certain level. The mechanism by which the rebate is achieved is to reduce the total management fee paid by the unit trust by an amount equal to these fee reductions. The additional cash retained in the unit trust is vested in the appropriate investors' accounts via regular issues of additional units. These take the form of "non-taxable bonus issues". It is very likely that these bonus issues will be caught by the new rule and rendered taxable bonus issues.

Submitters suggest that one solution to address this issue is to limit the application of the bonus issue rule to offshore unit trusts.

Comment

Officials agree that the provision of rebates in the form of additional units may, in certain situations, be caught by the proposed addition of paragraph (c) to the definition of "taxable bonus issue". This is because, in a fee rebate scenario, there could be "an arrangement or decision that the unit trust will make the bonus issue instead of causing a beneficial interest in money… to vest absolutely in the unit holder".

The intention of the new rules is not to change the current tax treatment of this type of fee rebates. Whether or not it is appropriate to tax the issue of a new unit in the situations described above is, therefore, not an issue that should be addressed by the proposed rules. For these reasons we agree with the submitters and recommend that the proposed addition to the definition of "taxable bonus issue" be limited to offshore unit trusts.

Recommendation

That the submission be accepted and the proposed addition to the definition of "taxable bonus issue" be limited to offshore unit trusts.

Issue: Unintended consequences of bonus issue rule

Submission
(22W – Westpac Banking Corporation of New Zealand, 7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers, 27 – KPMG)

Retail unit trusts often use wholesale unit trusts to invest on their behalf. A wholesale unit trust offers obvious advantages, including the ability to make larger and more diverse investments.

Before section DI 3B was enacted, a problem arose for retail unit trusts that invested in wholesale unit trusts because expenses incurred at the retail level were not able to be deducted. This is because the retail unit trust received only fully imputed dividends from the wholesale unit trust.

Section DI 3B addresses the issue by allowing the retail unit trust to transfer expense deductions up to the wholesale unit trust. The wholesale unit trust generally pays for the expense deductions by the issue of additional units, rather than consideration in cash.

It is suggested that the issue of units as consideration for such expense deduction transfers should not be caught as a taxable bonus issue under the new rule. Submitters suggest that this could be achieved by confining the application of the proposed addition to the definition of "taxable bonus issue" to offshore unit trusts.

Comment

Officials agree that the provision of units by a wholesale unit trust as payment for expense deductions that it receives from its retail unit trust investors may, in certain situations, be caught by the proposed addition of paragraph (c) to the definition of "taxable bonus issue".

The intention of the new rules is not to change the current tax treatment of expense transfers between retail and wholesale unit trusts. For these reasons we agree with the submitters and recommend that the proposed addition to the definition of "taxable bonus issue" be limited to offshore unit trusts.

Recommendation

That the submission be accepted and the proposed addition to the definition of "taxable bonus issue" be limited to offshore unit trusts.

Issue: Expenditure incurred by a company in deriving exempt dividends

Submission

(24 – BNZ Investment Management, 15A – PricewaterhouseCoopers, 27 – KPMG, 18A – Corporate Taxpayer Group)

Following the proposed reform, the treatment of certain bonus issues of units from unit trusts will change from non-taxable in nature to taxable dividends. For a company that holds units in such a unit trust, this will result in the issue of those units being treated as exempt dividends under section CB 10(1) and, therefore, subject to a dividend withholding payment (DWP) deduction of 33%. Expenditure incurred by the New Zealand resident company in deriving the exempt dividends is not likely to be tax-deductible as the expenditure was incurred to derive exempt income (section BD 2(2)(b)).

The submitters suggest that this result is inappropriate as the expenditure is incurred in deriving an amount that is subject to a deduction (the DWP) that is equivalent to the imposition of tax. It is therefore submitted that expenditure incurred by a company to derive DWP should be made fully tax-deductible.

Comment

Officials have been aware of this problem for some time and the issue is currently on the government's tax policy work programme. Clearly, from a policy perspective, a full deduction should be allowed where the income is fully subject to either New Zealand income tax or DWP. However, if a New Zealand resident company derives a dividend from a non-resident company, situations can arise where the dividend is not subject to full New Zealand tax or full DWP. Allowing a full deduction in these situations would give rise to an inappropriate result.

For example, consider a New Zealand resident company that is 100% owned by non-New Zealand residents that derives a foreign dividend. In this situation, the conduit tax rules will generally apply and would reduce the DWP liability of the New Zealand resident company to zero. When the New Zealand resident company distributes the amount represented by the dividend to the foreign company, this flow will generally only be subject to non-resident withholding tax at 15%. Allowing a full deduction for expenditure incurred in deriving the exempt dividend in this situation is inappropriate from a tax policy perspective.

Officials recommend, therefore, that a deduction be allowed for expenditure incurred by a company deriving dividends that are exempt under section CB 10(1) to the extent that DWP on the dividends is not relieved by the conduit tax rules.

Recommendation

That the submission be accepted and a deduction be allowed for expenditure incurred by a company deriving dividends that are exempt under section CB 10(1) to the extent that DWP on the dividends is not relieved by the conduit tax rules.

Issue: Rules necessary to determine value of the bonus issue

Submission

(7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers, 27 – KPMG)

If a dividend arises from a bonus issue, valuation rules are necessary to determine the amount of the dividend. Two approaches seem possible (i) valuation by reference to the underlying income (ii) valuation by reference to the value of the bonus issue to the beneficiary.

In the absence of a valuation rule, unit trusts can utilise a mechanism in section CF 8 to determine the amount of the taxable dividend arising from the bonus issue. If the section CF 8 method of valuation remained available, unit trusts could elect to value the units at a nominal amount. This, it is suggested, is not an outcome that the government would regard as appropriate.

Comment

Officials agree with this submission. As the submissions correctly point out, if the proposal did not include rules to value the bonus issue it may be unclear as to what value is to be attributed to the unit. In addition, unless the ability to determine a value under section CF 8 is removed for these units, it would be open for unit trusts to value the units at a nominal amount.

Officials recommend, therefore, that the current proposals be amended to remove taxable bonus issues that arise under the proposal from section CF 8. It is also recommended that valuation rules be included that would value taxable bonus issues that arise under the proposal by reference to the amount of money or property which would have vested in the unit holder had the arrangement referred to in the taxable bonus issue definition not been entered into. This is consistent with the approach adopted for valuing a "bonus issue in lieu" in section CF 2(6).

Recommendation

That section CF 8 be amended so that a taxable bonus issue arising under the proposal will not be able to be valued under section CF 8. That a valuation rule is enacted that would provide that the amount of the taxable dividend arising from this type of taxable bonus issue is calculated by reference to the amount of money or property which would have vested in the unit holder had the arrangement referred to in the taxable bonus issue definition not been entered into.

Issue: Potential double taxation if units held on revenue account

Submission

(7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers)

A unit holder that holds the units on revenue account receives a unit that is a "taxable bonus issue" under the proposal, there is a risk of double taxation. The unit will be taxed as a dividend when it is derived and, unless a cost base is provided, could be taxed again when it is sold.

Comment

Officials agree that the current tax rules could be interpreted to result in double taxation for unit holders that hold their units on revenue account. A simple example illustrates the point.

> Johnny is in the business of investing in shares and other equities. This means that, generally, the profits that Johnny makes on the sale of his shares and units will be treated as part of his taxable business income. Essentially, Johnny's profits are calculated by deducting the cost of the property from the gross proceeds on sale.
>
> In tax year 1 Johnny derives an issue of new units from an AUT that is treated as a taxable bonus issue under the proposals. The value of the "taxable bonus issue" is NZD$100,000. In tax year 3 Johnny sells these units to a third party for $200,000.
>
> Double taxation could occur in this example if Johnny was taxed on the full $200,000 that he derives from the sale in tax year 3. This is because Johnny has already paid tax on the $100,000 taxable bonus issue in tax year 1. The solution to the potential double taxation is to provide Johnny with a tax deduction (or a cost base) for the $100,000 in tax year 3 that can be offset against the $200,000.

This issue currently arises for existing bonus issues. The current practice is to assume that a cost base arises that is equal to the initial bonus issue. Assuming a cost base in this manner provides the correct policy result. The *Tax Information Bulletin* item published following the enactment of this proposal will confirm this treatment. Therefore, given that the correct result is currently occurring in practice, officials do not consider that a law change to deem a cost base is necessary at this stage. However, if this issue gives rise to practical problems in the future, officials would recommend such an amendment.

Recommendation

That no amendment is required at this stage.

Issue: Changes to section CF 3(2)(c)

Submission
(7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

The "taxable bonus issue" is regarded as an amount "paid" by the unit holder in obtaining the units for the purposes of section CF 3(2)(c) in order to ensure that an appropriate amount of "available subscribed capital" (ASC) arises.

Comment

ASC is the amount of shareholders' funds that have been paid for the issue of a company's shares. The amount of ASC per share is significant because it represents the shareholders' funds that can ultimately be returned to the shareholder tax-free.

A "taxable bonus issue" under the proposed new rule will be taxed as a dividend when it is derived. It is therefore appropriate to include this amount in the ASC per share. The method for determining the ASC per share for unlisted foreign widely-held trusts is contained in section CF 3(2)(c)(ii). Essentially, this provision provides that the ASC per share is equal to the amount paid for the share (in situations where the shareholder cannot obtain sufficient information to calculate that amount).

Therefore officials agree with submitters that section CF 3(2)(c)(ii) should be amended so that the "taxable bonus issue" is treated as an amount "paid".

Recommendation

That the submission be accepted.

Issue: Limit provision to situations where there is a reduction of foreign tax

Submission
(19 – Minter Ellison Rudd Watts)

The new bonus issue rule should render the issue of a unit taxable if the unit trust pays no tax on the distributed income as a result having made the distribution. The following draft is suggested:

> "a bonus issue that is made by a unit trust if, as a result of making the bonus issue, the unit trust is liable to pay no income tax in relation to any part of an amount from which the bonus issue is sourced."

Comment

Conceptually, there is some merit to this approach as it focuses on the mischief apparent in the AUT structures – that is, a reduction or elimination of tax paid in New Zealand and Australia.

The proposal in the bill takes a different approach by focusing on bonus issues that arise out of what are, essentially, dividend reinvestment schemes. The rationale for this approach is that if there has been an arrangement at the outset for the unit holder to receive additional units instead of a distribution of cash, this is in substance akin to the unit holder agreeing to have dividends reinvested in new units. The distributions that are reinvested in new units under such dividend reinvestment schemes are currently taxed as dividends. The current proposal takes a similar approach but, instead, treats the issue of new units as a "taxable bonus issue".

Recommendation

That the submission be declined.

Issue: Application date – grandparenting existing investments

Submission
(19 – Minter Ellison Rudd Watts)

The proposed changes should not apply to distributions from unit trusts in respect of arrangements that were already in existence on 11 May 2004, which have a finite life and where investors are not free to withdraw without adverse consequences.

While the amendments would be prospective in effect, the changes will affect adversely investments to which investors have committed irrevocably. Such investors are often effectively locked into such investments until well after the date that the proposals are due to take effect.

Comment

The submission is essentially suggesting that investors that have entered certain schemes before the date that the current proposals were tabled should continue to be able to benefit from the tax-advantaged nature of these investments. Officials disagree with this submission. It is clearly reasonable for investors, as a general rule, to have an expectation that tax laws will not change retrospectively. However, an expectation that there will be no change during the life of a particular investment is not reasonable.

In addition, investors have had significant notice that a change was likely. Public statements by the Minister of Finance and Revenue as far back as August 2003 have signalled clearly the government's intention to amend the tax law relating to AUTs and remove the advantage. The intervening period has provided investors with sufficient opportunity to reorganise their affairs.

Recommendation

That the submission be declined.

Issue: Application date should be 1 April 2005

Submission
(7A – Investment, Savings and Insurance Association of New Zealand, 15A – PricewaterhouseCoopers, 18A – Corporate Taxpayer Group, 20W – New Zealand Funds, 27 – KPMG, 26 – Institute of Chartered Accountants of New Zealand)

The proposed changes should take effect from 1 April 2005. Applying the changes from the beginning of a new tax year would prevent a situation where an investor with a 31 March balance date would, for the current income tax year, be required to calculate dividend income pre- and post-application date.

In addition, an application date occurring during the current income year could result in certain investors becoming provisional taxpayers, or being required to reassess their current provisional tax liability.

Also, investors should be given more time to understand the changes and their implications. A 1 April 2005 application date would provide investors with sufficient time to organise (i) an exit from the AUT investment if desired and (ii) how they will meet any additional tax that may arise as a result of the proposed changes.

A 1 April 2005 application date would provide unit trusts and financial advisers with sufficient time to make the necessary system changes, amend the literature and rethink strategies.

The submissions acknowledge implicitly that a delayed application date may give rise to some risk to the revenue. However, it is noted that AUTs will generally distribute at the end of June each year, being the end of the Australian tax year.

Comment

The bill provides that the proposed amendments will apply from the date that the bill receives its Royal assent. This is likely to be in about October this year.

Officials acknowledge that an October application date could give rise to some issues for individual investors in AUTs. As the submissions note, individual investors could be faced with doing two tax calculations (one pre-change and one post-change) for the current income year, as well as potential provisional tax difficulties. Addressing these issues would delay the application of the proposals until the start of the next income year – 1 April 2005.

The issue of compliance costs for investors should, however, be weighed against the fact that certain industry players acted in reliance on the Minister of Finance and Revenue's warnings that the tax advantage would be removed and did not market AUT products (see the ASB submission below). Officials understand that these industry players have already suffered a significant competitive disadvantage by not developing AUT products. The longer that the tax advantage remains, the longer these players will continue to suffer this disadvantage.

In addition, investors have had significant notice that a change was likely. Public statements by the Minister of Finance and Revenue as far back as August 2003 have signalled clearly the government's intention to amend the tax law relating to AUTs and remove the advantage. The intervening period has provided investors with sufficient opportunity to reorganise their affairs.

On balance, officials consider that the compliance cost advantage of delaying the application of the new rules until 1 April 2005 is outweighed by concerns over the competitive disadvantage faced by those fund managers that have decided not to market AUT products and the fact that investors have had significant notice of these changes.

Recommendation

That the submissions be declined.

Issue: Application date should be 1 July 2004

Submission
(25W – ASB Group)

The proposals should be implemented from 1 July 2004, being the commencement of the 2005 Australian tax year.

The Minister first announced an intention to close this loophole in August 2003. ASB suggests that those members of the industry that acted in reliance on the Minister's warning and did not launch AUT products have suffered a significant commercial disadvantage. Therefore to delay the application of the proposed changes to the date of Royal assent (probably around November this year) would, it is suggested, extend this commercial advantage unreasonably.

ASB describes how it has been commercially disadvantaged by acting in reliance of the Minister's statements. ASB notes that it has abandoned AUT products that, prior to the Minister's announcement, it was ready to launch. It estimates that around 50 percent of the industry players would, like ASB, be further disadvantaged by any further delay to the application of the new rules.

ASB also downplays the extent that the industry would incur significant compliance costs as a result of a 1 July 2004 application date. That is, it suggests that the unit trusts have ample time to develop reports providing details of the bonus issues made during the year ended 31 March 2005. The reports would not have to be provided to the New Zealand investors until April or May 2005, giving investors sufficient time to complete tax returns by 7 July 2005.

Comment

Officials understand ASB's concern that a number of industry players have suffered a competitive disadvantage by acting in reliance on the Minister of Finance and Revenue's public statements and not marketing AUT products to their clients. However, we disagree with the proposal to apply the rules from 1 July 2004 as this would constitute retrospective application.

In addition, for the reasons explained above, we consider that a date of Royal assent application date for the new rules is appropriate.

Recommendation

That the submission be declined.

SUPPLEMENTARY ORDER PAPER – FEBRUARY STORM ISSUES

The Institute of Chartered Accountants of New Zealand and Federated Farmers of New Zealand (Inc) strongly support the proposals to assist businesses affected by the February storm, but they have raised some issues.

Issue: Taxation (Disaster Relief) Act 2004, destroyed buildings, destroyed farming land improvements, and donated trading stock

Clauses 14C, 18C and 23B

Submission
(26 – Institute of Chartered Accountants of New Zealand, 28 & 28A – Federated Farmers of New Zealand (Inc))

The Institute seeks a commitment that a larger review will be undertaken in these areas of tax legislation.

Federated Farmers seek to extend the application of the Taxation (Disaster Relief) Act 2004 and also to widen the application of the proposed legislation to include other adverse climatic events, rather than only the February storm event.

Comment

The Institute seeks a wider review because it believes that broader consideration of these issues is needed before the provisions can be extended to other situations. It considers that such a review would be reasonably complex and could not be completed in time for inclusion in the bill. We agree with that view.

Federated Farmers consider that the relief measures enacted in the Taxation (Disaster Relief) Act 2004 should be extended to more localised events and events that occur in sparsely populated areas. They also state that the amendments proposed in the SOP that relate to deductions for destroyed buildings, destroyed land improvements and donated trading stock should be extended to apply to a wider range of adverse climatic events rather than only to the February storms. Federated Farmers are also concerned that the relief afforded to donated trading stock in relation to the February storm would not be available if the transaction is identified subsequently in a tax audit.

While amendments to the Taxation (Disaster Relief) Act 2004 are outside the scope of the SOP, we agree that there may be some merit in reconsidering the application of that legislation. However, as is the case with extending the provisions in the SOP to events outside the February storm, further consultation is required, and it is necessary to consider issues that did not arise in the February storm. For example, in general, the trading stock donated as a result of the February storm was not donated to associated parties but to non-profit organisations who will subsequently distribute the donations. That may not be the case in a future event, and a different mechanism will be required to address donations to associated parties.

The measures in the SOP aim to provide certainty for taxpayers affected by the February storms without prejudging the outcome of a wider review. For example, the SOP makes it clear that donations of trading stock made as a result of the February storm will not be subject to the anti-avoidance provision, regardless of whether the donation is made in a subsequent income year.

A review of the treatment of losses on destroyed buildings and losses on destroyed farming land improvements is part of the current review of the depreciation rules. The treatment of donated trading stock and extending the scope of the Taxation (Disaster Relief) Act can be considered for later legislation, with its work programme priority decided in consultation with the Ministry of Agriculture and Fisheries.

Recommendation

That the submission to amend the SOP be declined, though a wider review will be undertaken of the areas of tax law covered in the SOP.

Issue: Extending section EG 19(3)

Submission
(Matter raised by officials)

Section EG 19(3) of the Income Tax Act 1994, which is being inserted by clause 14C of the SOP, should be made subject to section EG 19(4) of the Income Tax Act 1994.

Comment

Section EG 19(3) allows a deduction for losses on disposal of some depreciable property. That provision is being extended to create a deduction for losses on disposal of buildings that were destroyed or rendered useless as a result of the February storms. The original provision is subject to the application of section EG 19(4). That qualification was inadvertently omitted when the provision was redrafted for inclusion in the SOP.

Recommendation

That the submission be accepted.

Issue: New start grants

Clauses 18B, 65, 116B and 134B

Submission
(28 – Federated Farmers of New Zealand (Inc))

Federated Farmers support the proposal but consider that the provision should ensure that, if in the future new start grants are provided in relation to "adverse events," they should be treated in the same manner as those made in relation to the February storms.

Comment

Federated Farmers consider that recipients of new start grants in relation to future events should be automatically eligible for the relief provided by section 177D(3) of the Tax Administration Act 1994, and they are concerned that new legislation would be needed if such grants are made in the future.

If the government decides to make new start grants in the future, it will be necessary to define the triggering event in the tax legislation (as part of the definition of "adverse event" or "qualifying event", depending on the severity of the event). Any supporting legislative changes to the definition of "new start grants" should be made at that time rather than as part of this bill because the threshold for relief under section 177D of the Tax Administration Act is relatively high, and it cannot be determined now that all future new start grants will be eligible for this type of relief. Further, new start grants are made very occasionally. The last time they were used was in the mid-1980s.

Recommendation

That the submission be declined.

Issue: Use-of-money interest and restoration grants

Submission
(28 – Federated Farmers of New Zealand (Inc))

Inland Revenue should investigate measures to provide the Commissioner with power not to require use-of-money interest to be paid on any increased tax liability created by the receipt of restoration grants.

Comment

Federated Farmers are concerned that the receipt of restorative grants could potentially give rise to unexpected use-of-money interest liabilities. Tax law requires that deductions taken for expenditure in relation to which the restorative grants are made should be reversed in the income year in which the expenditure was actually incurred. If the deduction is reversed in a year prior to which the grant was received, the tax liability for the previous year will increase, while the grant will actually not be received until the following year (or even the year after that). A positive amended assessment of income in the prior year will trigger a use-of-money interest liability.

At this stage the scope of the potential problem is unclear. It is likely to be an issue only for businesses that do not have losses arising in the year in which the expenditure is made and for those where the expenditure was incurred in an income year prior to the receipt of the grant. Also, it is not clear at this stage what grants will be paid to individual businesses and when the grants will be made.

We consider that more work is required to determine the scope of this potential problem before a legislative amendment can be proposed, and therefore we do not support an amendment to the bill. The issue can be considered for later legislation, with its work programme priority decided in consultation with the Ministry of Agriculture and Fisheries.

Recommendation

That the submission be declined, but that the issue raised in the submission will be considered further to determine whether significant tax policy issues arise.

Issue: Bay of Plenty storm event

Clauses 14C, 18B, 18C, 23B, 116B, and 134B

Submission
(Matter raised by officials)

The relief mechanisms enacted as part of the Taxation (Disaster Relief) Act 2004 and some of the proposals to address tax technical issues contained in Supplementary Order Paper 218 to the March Tax Bill in relation to the February 2004 storms should be extended to those affected by the recent Bay of Plenty storm event.

Comment

A number of tax measures have been enacted or are in the process of being enacted in response to the damage and hardship caused by the storms in February this year.

Similar damage and hardship, though more localised and on a smaller scale, have been caused by the recent storms in the Bay of Plenty. We have been approached by representatives of Federated Farmers Inc seeking the same tax treatment for those affected by the Bay of Plenty storm event as that being provided to those affected by the February storms.

Officials agree with Federated Farmers. The extension of the relief provisions in the Taxation (Disaster Relief) Act 2004 and the technical tax matters in Supplementary Order Paper number 218 to the Bay of Plenty storm event would:

- allow Inland Revenue to remit interest, late payment penalties and late filing penalties for those severely affected by the Bay of Plenty storm event;
- allow Inland Revenue to accept late estimates of provisional tax;
- create a deduction for the tax loss on commercial buildings destroyed in the storms;
- create a deduction for the tax loss on farming land improvements destroyed in the storms;
- exclude gifts of trading stock and consumables, made as a result of the storms, from the anti-avoidance provision that treats them as sales and purchases at market value; and
- prospectively address tax issues in relation to new start grants, should they be made in relation to the Bay of Plenty storm event.

An amendment is also required to correct an oversight in the definition of "qualifying event" enacted by the Taxation (Disaster Relief) Act 2004. The definition needs to include the possibility of declarations of civil emergency made under either the Civil Defence Act 1983 or Civil Defence Emergency Management Act 2002. Currently it only refers to declarations made under the 2002 Act.

For simplicity, the amendments to provide relief from interest and penalties, which will allow late estimates of provisional tax to be made, and the remedial amendment to the definition of "qualifying event" to include declarations made under the Civil Defence Act 1983 should apply from the same time that the relevant provisions in the Taxation (Disaster Relief) Act 2004 came into force, 1 February 2004. Also for simplicity, the other measures should apply from the same time that the relevant provisions in the Supplementary Order Paper No. 218 will apply from, from the 2003-04 income year.

Recommendation

That the submission be accepted.

Remedial issues

BRANCH EQUIVALENT TAX ACCOUNTS AND LOSSES – REMEDIAL ISSUES

Issue: Consequential drafting issues

Submission

(Matter raised by officials)

The references in section MF 5(2) should be updated to take into account the changes made to the branch equivalent tax account rules by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003.

Comment

Section MF 5(2) currently refers to section MF 4(1)(a) and (b) as they were before the 2003 changes were made. An amendment should be made to align section MF 5(2) with the new section MF 4(1)(a).

Recommendation

That the submission be accepted.

Issue: Late elections

Submission
(1W – Ernst & Young)

Elections received by the Commissioner that are otherwise valid should apply to all dividends paid within the imputation year it is received and not just to dividends paid after the election received. This is consistent with the trans-Tasman imputation legislation generally, which allows an imputation credit account to be maintained from the beginning of the imputation year in which a valid election is received.

Alternatively, should that not be acceptable, the Commissioner should be given the discretion to accept late elections that would otherwise be valid from all taxpayers in the first year of operation, and newly formed or newly eligible companies in subsequent years of operation of the rules.

Comment

The requirement that an election be made 30 days before the payment of a dividend was to ensure that the identity of the Australian company can be verified and an IRD number issued before any imputed dividends are paid to shareholders. Officials do not, therefore, support allowing the election to be made at any time in the imputation year in which a dividend may have been paid.

Officials accept, however, that in the early years of the new legislation the requirement that elections are to be made 30 days before a dividend is paid may not be well known. Officials also accept that the consequence of otherwise valid elections being made less than 30 days before a dividend is paid would be that the Commissioner would have to disallow the imputation credits attached to dividends of the Australian company concerned.

As this would cause substantial compliance and administration costs when there is neither a policy concern nor an avoidance risk, officials agree with the alternative submission made that the Commissioner be given a discretion to allow later elections for newly formed or newly eligible Australian companies.

Given the newness of the legislation, however, officials are of the view that it would be prudent to also allow the Commissioner's discretion to apply to Australian companies generally for the first two years of the rules rather than the first year, as proposed in the submission.

In both situations, the discretion would apply only to elections that would have been valid had they been made on time.

Recommendation

That the primary submission be declined but the alternative submission be accepted but extended to all taxpayers for the first two years of the operation of the legislation.

Issue: Common ownership of a consolidated group

Clause 22

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

Common ownership should be based on ownership of the consolidated group, irrespective of individual companies entering or exiting the group. This is because the current legislation gives rise to unintended consequences such as shelf companies, with no credits, breaching the common ownership requirements.

Comment

Officials agree with this submission. The policy intent of this provision is that more than one consolidated group may form an imputation group only if all the imputation credits of the consolidated groups have the same continuity profile. The emphasis of this provision is meant to be on common ownership when the credits were earned rather than common ownership generally.

Recommendation

That the submissions be accepted.

Issue: Recording of debits and credits by a resident imputation subgroup

Clause 38

Submission
(15 – PricewaterhouseCoopers, 26 – Institute of Chartered Accountants of New Zealand)

While the current wording of section ME 10(1D)(b) does not make it clear that entries other than entries from transactions should go to the resident imputation subgroup, the proposed amended provision is also unclear and does not clarify the position. It is proposed that for simplicity the original drafting be restored but the words “arise from transaction” be omitted.

Comment

Officials agree that the drafting of the current provision could be made clearer.

Recommendation

That the submissions be accepted.

Issue: Transfers of credits between imputation credit accounts and policyholder credit accounts

Submission
(14 – Russell McVeagh)

- Consistent with the commentary, the legislation governing transfers from an individual policyholder credit account should allow transfers of credits between a company's policyholder credit account and its imputation credit account regardless of whether the company is a member of an imputation group.
- Where an election is made to transfer a credit from a company's policyholder credit account to the imputation credit account of its imputation group, the transferred credits should be added to the group's imputation credit account. The credit should arise on the date the company makes the election.
- Similarly when an election is made to transfer a credit from a consolidated imputation group's imputation credit account, the legislation should be amended to ensure a debit arises to the imputation credit account of the consolidated imputation group.

Comment

Officials agree with the submissions.

Recommendation

That the submission be accepted, with application from 1 April 2003, the application date of the original amendments.

Issue: Australian imputation credit account companies

Submission
(14 – Russell McVeagh)

Contrary to previous commentary on trans-Tasman imputation, it is arguable that the current legislation only allows companies that are also New Zealand residents to elect to have an imputation credit account. The legislation should be clarified.

Comment

The maintenance of an imputation credit account is mandatory for New Zealand resident companies unless they fall within one of the exceptions. One of the exceptions is if the company is a non-resident company. This exception appears to have been enacted to put beyond doubt that non-resident companies cannot maintain imputation credit accounts.

The trans-Tasman legislation then used the non-resident company exclusion as a base for carving out Australian companies. It could be argued that the current legislation is in fact correct, as provided for in the exception; it targets Australian companies that are also not resident in New Zealand. Officials do, however, agree that Australian companies that were not also New Zealand resident companies were never entitled to maintain an imputation credit account as they were not resident in New Zealand.

On balance, officials' view is that for the avoidance of doubt this provision should be amended to make it clear that all Australian resident and Australia/New Zealand dual resident companies can elect to maintain an imputation credit account.

Recommendation

That the submission be accepted with application from 1 April 2003, the application date of the original amendments.

Issue: Imputed dividends paid in a foreign currency

Submission
(14 – Russell McVeagh)

The dividend withholding payment rules should be amended to adjust the amount of dividend withholding payment due when the foreign dividend and any foreign withholding taxes are converted to New Zealand dollars at an exchange rate that differs from the exchange rate used to attach imputation credits. Currently the inconsistent treatment of exchange rates means that full imputation credits may not fully cover a dividend withholding payment liability.

Comment

The issue of exchange rates when a dividend is paid in Australian dollars and the imputation credits are attached in New Zealand dollars proved to be one of the more complex technical issues to resolve during the consultation phase before the trans-Tasman imputation legislation was introduced last year. The complexities involved are borne out by the extensive discussion of three possible options in the discussion document, *Trans-Tasman Triangular Tax*.

In the end, and on balance, the government decided that to minimise compliance costs the best option was that New Zealand dollar imputation credits should be attached to Australian dollar dividends based on the exchange rate on the date of declaration.

It was accepted that as there was no perfect solution, there would at times be winners and losers, and so the lowest compliance cost option was chosen. While officials agree with the point made by the submission, our view is that this is an outcome envisaged at the time the legislation was introduced, and to make the suggested amendments would unduly complicate the dividend withholding payment rules.

Recommendation

That the submission be declined.

Issue: Consequential drafting issues

Clauses 40 and 64

Submission
(Matters raised by officials)

The legislation should be amended to allow transfers from a company's dividend withholding payment account to its imputation group imputation credit account.

Section ME 18(4)(b) should be amended to include a reference to the imputation credit account of an imputation group.

Section NH 6(6)(a)(ii) should be amended to refer correctly to a "dividend withholding payment account".

Comment

Currently, the legislation envisages only transfers from a company's dividend withholding payment account to the company's imputation credit account. To incorporate the imputation grouping rules in this area, officials recommend that an amendment be made.

Section ME 18(4), the provision governing the timing of debits in a company's policyholder credit account, needs to be updated to take account of the recent imputation group amendments.

Section NH 6(6), which enables the transfer of the credit balance in the dividend withholding payment account of a consolidated group, contains an incorrect reference to "dividend withholding account". This reference should be replaced by "dividend withholding payment account".

Recommendation

That the submission be accepted.

ALLOCATION DEFICIT DEBIT RULES FOR LIFE INSURANCE COMPANIES

Issue: General support for amendments

Clauses 40, 42, 47-49, 51-52, 64 and 65

Submissions

(5 – Promina Group New Zealand Ltd, 15 – PricewaterhouseCoopers, 7 – Investment Savings & Insurance Association of New Zealand, 26 – Institute of Chartered Accountants of New Zealand, 27 – KPMG)

Submissions support the introduction of new allocation deficit debit rules for life insurance companies subject to their specific submissions discussed in this report.

We commend Inland Revenue officials for consulting with the industry and for including these provisions in the bill to resolve the inadequacies in the current legislation. *(PricewaterhouseCoopers)*

ISI is pleased that the life insurer dividend withholding payment rules are being changed to remove the incongruous results that arose under the previous rules, and we support the amendments being made. *(Investment Savings & Insurance Association of New Zealand)*

The policy underlying the proposal appears consistent with the general approach to both dividend withholding payments and the life insurance rules. *(Institute of Chartered Accountants of New Zealand)*

Comment

The amendments in the bill have resulted from extensive consultation with members of the life insurance industry. The new rules are designed to prevent the distorted and unintended results that can arise under the current allocation deficit debit rules.

Recommendation

That the submissions be noted.

Issue: Earliest DWP reference period

Clause 49

Submission
(5 – Promina Group New Zealand Ltd)

The definition of "DWP reference period" in new section MG 8B(3) should be amended so that the DWP reference period will not commence earlier than 1 April 2004 unless a company has elected to apply section MG 8B retrospectively to an imputation year beginning after 31 March 1995 and before 1 April 2004. If such a retrospective election has been made, the DWP reference period should not commence earlier than the beginning of the imputation year in which the new rules have application.

As currently drafted, the first DWP reference period arising in respect of a post-1 April 2004 "dividend year" could potentially commence a number of years before the imputation year starting 1 April 2004. This is because the DWP reference period includes both the dividend year and also extends back to include all consecutive years in which no dividend has been paid with DWP credits attached. In cases where no prior dividends have been paid with DWP credits attached, this period could extend indefinitely. Obviously this is not an intended result.

Comment

Officials agree that the first DWP reference period should start no earlier than 1 April 2004 unless a taxpayer elects to apply the new rules from an earlier date, in which case the first DWP reference period should start from that earlier date. This is in line with the policy intention of the new rules as described in the commentary to the bill.

Recommendation

That the submission be accepted.

Issue: Clarify that section MG 8B(2) conditions are cumulative rather than disjunctive

Clause 49

Submission
(5 – Promina Group New Zealand Ltd, 15 – PricewaterhouseCoopers)

Section MG 8B(2) should be amended to clarify the intention of the legislation that an allocation deficit debit arising only where both paragraphs MG 8B(2)(a) and MG 8B(2)(b) are satisfied, that is, these are not alternative tests for determining whether an allocation deficit debit arises.

Comment

Officials agree that it is the intention of the legislation that an allocation deficit debit should arise only where both paragraphs MG 8B(2)(a) and MG 8B(2)(b) are satisfied. Accordingly, the full colon between these paragraphs should be replaced by "; and".

Recommendation

That the submission be accepted.

Issue: Application date provisions

Clauses 40, 42, 47-49, 51-52, 64 and 65

Submission
(5 – Promina Group New Zealand Ltd, 15 – PricewaterhouseCoopers)

The new allocation deficit debit rules for life insurance companies are intended to apply generally for the 2004-05 and subsequent imputation years. However, the application date provisions are contingent on the payment of a dividend. For example, clause 48(2) of the bill is currently drafted so that clause 48(1) (which repeals the existing sections MG 8(5) to (7) of the Income Tax Act 1994) applies only for dividends paid in the 2004-05 and subsequent years. However, the repeal of sections MG 8(5) to (7) should be effective from the start of the 2004-05 imputation year regardless of whether or not a dividend is paid in that or any subsequent imputation years.

Similarly, the ability to elect in writing to retrospectively apply the new allocation deficit debit rules to an imputation year that begins after 31 March 1995 and before 1 April 2004 should also not be contingent on dividends being paid in an imputation year. Therefore, taxpayers should be allowed to elect to apply the new rules retrospectively even where they have not paid a dividend with dividend withholding payment credits attached in an imputation year that begins after 31 March 1995 and before 1 April 2004.

The Promina Group submission also suggests a different drafting approach for the application date provisions. This approach involves removing the application date provisions from clause 49 and a number of other provisions making consequential amendments and instead providing that new section MG 8B should apply automatically to an imputation year in respect of which an election to apply clause 48(1) (which repeals section MG 8(5) to (7)) has been made.

Comment

Officials agree with the submission's main point that there should be no requirement in the various application date provisions for a dividend to be paid. For example, the application date provision in clause 48(2) should simply provide that subsection (1) (repealing current section MG 8(5) to (7)) applies for the 2004-05 and subsequent

imputation years. The repeal of the existing allocation deficit debit rules in section MG 8(5) to (7) should not be dependent on whether or not a dividend is paid in a particular imputation year.

Officials do not agree with the part of the Promina Group New Zealand Ltd submission that requested that the application date provisions should be structured in a different way. The suggested restructuring would not be consistent with the general approach to application date provisions in the bill. For example, it would result in clause 49, which inserts new section MG 8B (the new allocation deficit debit rules) into the Income Tax Act 1994, having no application date provision itself. Also, the subject matter of clause 48 should be limited to the repeal of section MG 8(5) to (7) and should not include (as suggested by the submission) the application date of new section MG 8B.

Officials will also make a number of drafting improvements to the application date provisions. In particular, it would be an improvement if the election provisions for the new rules to apply retrospectively to imputation years beginning after 31 March 1995 and 1 April 2004 were located within the new section MG 8B itself instead of in the amendment Act. It should also be clarified that if a taxpayer makes an election to apply the new rules retrospectively to an imputation year beginning after 31 March 1995 and before 1 April 2004 then that election applies for subsequent imputation years as well. That is, it should not be possible to opt in and out of the new rules for imputation years beginning before 1 April 2004.

Recommendation

That the submissions be accepted in part by removing the requirement for a dividend to be paid from the various application date provisions and that the application date provisions be modified as outlined above.

Issue: Guidance on reduced deficit debit calculation

Clause 49

Submission
(15 – PricewaterhouseCoopers)

The reduced deficit debit calculation in new section MG 8B may not achieve its intended objective. Inland Revenue is requested to provide further guidance on its application with some worked examples. The submissioner was not able to verify the rationale for the result achieved under the reduced deficit debit calculation.

Comment

The reduced deficit debit formula applies if the DWP account balance is less than the maximum deficit debit (before any allocation deficit debit arises). The application of the formula is favourable to taxpayers and is intended to ensure that inappropriate or disproportionate debits do not arise. It is intended that the application of the formula will ensure that the credit ratio is the same for both policyholders and shareholders.

An example of the application of the reduced deficit debit formula is given in the commentary to the bill. Inland Revenue will monitor the application of the new allocation deficit debit rules and will consider any further submissions made on them.

Recommendation

That the submission be noted.

Issue: DWP reference period definition

Clause 49

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

The reference to "maximum" in the DWP reference period definition in new section MG 8B(3) has no reference point. It is therefore unclear what it is intended to achieve and what it does in fact achieve.

Comment

The new rules will apply only to an imputation year in which a dividend payment, with DWP credits attached, is made. For the purposes of the allocation deficit debit allocation, the relevant period of time to be considered will be from the end of that imputation year back to the start of the imputation year following the imputation year in which a shareholder dividend was last paid. This period is referred to in the legislation as the "DWP reference period". The reference to "maximum" is intended to ensure that this period, regardless of the number of imputation years, is measured correctly. Officials consider that no change needs to be made to the legislation to clarify this point.

Recommendation

That the submission be declined.

Issue: DWP reference period definition

Clause 49

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

Clarity should be added to the DWP reference period definition by stating a commencement for the period. The commencement of a DWP reference period is implicitly the beginning of the first imputation year in the period in which no dividend is paid. The current drafting, because it has no beginning reference point, begs that question.

Comment

Officials agree that the commencement of a DWP reference period is the beginning the first imputation year in the period in which no dividend is paid. Officials consider that the current drafting achieves that effect and that further clarification is not required.

Recommendation

That the submission be declined.

Issue: DWP reference period definition

Clause 49

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

Compliance costs could be minimised by providing a rolling but limited starting point for the DWP reference period. The new rules compare allocation of DWP credits to policyholders and allocations of DWP credits to shareholders on dividend distributions. As currently drafted, the period over which the two allocations can be compared is potentially unlimited. This creates compliance costs (with respect to retention of records and knowledge) and uncertainty. Consideration should be given to limiting the period to, say, the seven-year period for retention of records.

Comment

Although limiting the DWP reference period to the seven-year period for retention of records could reduce compliance costs, it could also disadvantage taxpayers if they had policyholder net losses in years earlier than the seven-year period. This is because net losses reduce the amount of potential allocation deficit debit. Taxpayers may prefer to incur the compliance cost of keeping information for longer periods rather than incur larger allocation deficit debits.

Another reason for not supporting this submission is that the type of information used in the calculation would generally be included in a company's ordinary financial statements, which are normally retained for longer periods that the seven-year period for retention of records for tax purposes.

Recommendation

That the submission be declined.

Issue: Policyholder DWP ratio definition

Clause 49

Submission
(7 – Investment Savings & Insurance Association of New Zealand, 27 – KPMG)

The denominator used in the policyholder DWP ratio should be changed to: taxable income to the life insurer, less underwriting profit and dividends paid to shareholders. This would be adjusted to remove losses carried forward. The submission considers that this would give a better proxy for the income that is derived by the policyholders than the net policyholder income used in the formula in the bill. The formula in the bill is always going to give a result that is less than the shareholder DWP ratio when the policyholder base is in an overall loss for the DWP reference period. That is, when the policyholder base is in loss, there will always be streaming when dividends are paid to shareholders with DWP credits attached.

Comment

The policyholder DWP ratio definition in the bill is the result of extensive consultation with members of the life insurance industry. Officials consider that instead of making a fundamental change at this stage to the formula it is preferable to see how the current formula works in practice. Inland Revenue will be monitoring the application of the new allocation deficit debit rules and will consider any further submissions made on them.

Officials also do not agree with the part of the submission that says that the policyholder DWP ratio definition will always give a result less than the shareholder DWP ratio (thereby indicating streaming) when the policyholder base is in an overall loss for the DWP reference period. This is because new section MG 8B(2)(a) provides that an allocation deficit debit will not arise in this situation.

Recommendation

That the submission be declined.

Issue: Conduit tax relief companies

Clause 49

Submission
(7 – Investment Savings & Insurance Association of New Zealand)

The allocation deficit debit rules should not apply to life insurers that are conduit tax relief companies.

Comment

New section MG 8B(1) already provides that the allocation deficit debit rules do not apply to conduit tax relief companies.

Recommendation

That the submission be declined.

Issue: Application of reduced deficit debit formula

Clause 49

Submission
(27 – KPMG)

The formula used for calculating the reduced allocation deficit debit should be used in all cases. It seems arbitrary that the debit in the DWP account should vary depending on the balance of that account.

Comment

The reduced deficit debit formula is used to calculate the allocation deficit debit if the DWP account balance is less than the maximum deficit debit (before any allocation deficit debit is imposed). The formula has been designed to ensure that inappropriate or disproportionate debits do not arise in this situation. The formula has not been designed to apply in all cases.

Recommendation

That the submission be declined.

Issue: Consequential amendments

Clauses 49, 51, 52 and 64

Submission
(Matters raised by officials)

In new section MG 8B(3), in item c of the definition of "policyholder DWP ratio", the reference to "dividend withholding payment credit account" should be replaced by "dividend withholding payment account". In item c of the definition of "reduced deficit debit", the reference to "imputation credit account" should be replaced by "dividend withholding payment account".

In section MG 15(1)(f), the reference to "section MG 8" should be replaced by "section MG 8(4)".

The replication of rules concerning the application of section MG 8 to consolidated groups that is contained in section MG 16A(1) and NH 6(3) and (4) should be removed.

Comment

Two terminology drafting errors in the formulas in new section MG 8B(3) should be corrected.

A cross-referencing amendment, similar to that being made by clause 47(1) of the bill to section MG 5(1)(f), should also be included in clause 51 by amending section MG 15(1)(f).

There is currently a replication of the rules concerning the application of section MG 8 (dealing with allocation rules for DWP credits) to consolidated groups. This replication is contained in sections MG 16A(1) and NH 6(3) and (4). This replication should be removed by repealing section NH 6(3) and (4) and replacing section MG 16A(1) with a provision that follows the approach used in the repealed section NH 6 provisions.

Recommendation

That the submission be accepted.

Issue: Drafting suggestions – clause 7

***Clause** 7*

Submission
(27 – KPMG, 26 – Institute of Chartered Accountants of New Zealand, 15 – PricewaterhouseCoopers, 8 – The Association of Superannuation Funds of New Zealand Inc)

The words "amount withdrawn" should be used in the new formula in section CL 4(2) instead of using the word "withdrawn". Unless the legislation intended to use the word "withdrawal" in the formula in section CL 4(2), instead of the word "withdrawn," defining withdrawal is unnecessary and should be removed. If "amount withdrawn" is used in the formula, the issue goes away. *(KPMG, Institute of Chartered Accountants of New Zealand)*

The formula in CL 4(2) refers to "withdrawal" and should be amended to refer to "withdrawn". *(PricewaterhouseCoopers)*

Section CL 4(2)(a) should refer to "withdrawal" rather than "withdrawn". *(The Association of Superannuation Funds of New Zealand Inc)*

Comment

We agree that the wording in section CL 4(2) needs amendment. The proposed legislation intended to use the word "withdrawal" in the formula in section CL 4(2), instead of the word "withdrawn".

Recommendation

That the submission that the formula in section CL 4(2) be amended to refer to "withdrawal" be accepted.

Issue: The term "other contributions" should be clarified

***Clause** 7*

Submission
(27 – KPMG, 26 – Institute of Chartered Accountants of New Zealand)

The definition of "other contributions" in the proposed section CL 4 (2) should be further clarified. It would assist if the definition of "other contributions" actually referred to Subpart NE.

Comment

The definition of "other contributions" refers to an existing defined term "employer contributions to superannuation savings". This definition is in section OB 1 and means:

- employer superannuation contributions made on or after 1 April 2000 other than contributions which are subject to the 39% rate or treated as salary or wages;
- any return on the contributions above; and
- reserves, except those allocated to an account of the member's contribution for smoothing of investment returns (this exception only applies if the superannuation fund has 10 or more unassociated members).

"Other contributions", therefore, is a residual sum which excludes "employer contributions to superannuation savings". The amendment proposed in the submissions to define "other contributions" as part of the amount withdrawn that is not employer contributions subject to section NE 2(1) would mean that some employer contributions that are currently treated as other contributions and, therefore, not subject to the fund withdrawal tax, would become subject to fund withdrawal tax. The amendment proposed in the submissions would narrow the scope of the concept of "other contributions", which is not the intent of the proposed legislation.

Recommendation

That the submission be declined.

Issue: Drafting suggestions – clause 8

Clause 8

Submission
(7 – Investment Savings and Insurance Association of New Zealand Inc, 8 – The Association of Superannuation Funds of New Zealand Inc)

In section CL 8(2)(a)(ii) and section CL 8(2)(b)(ii) the words "its members" should be replaced with "the member". This section may be interpreted as applying only in the situation where all members have been transferred from the predecessor fund, which is unnecessarily restrictive. It should be adjusted to allow for the situation where the member in question has transferred, but the superannuation fund has not been transferred in its entirety. *(Investment Savings and Insurance Association of New Zealand Inc, the Association of Superannuation Funds of New Zealand Inc)*

In section CL 8(2)(a)(i) "the period that includes" should be deleted. The words "and ends when" should be replaced with "before". *(Investment Savings and Insurance Association of New Zealand Inc)*

Comment

We agree that the amendment should be clarified so that it applies in the situation where a member transfers rather than when a fund has transferred in its entirety.

We have clarified with the Investment Savings and Insurance Association of New Zealand that the changes suggested to section CL 8(2)(a)(i) were intended to shorten or simplify the wording of the proposed amendment. We do not consider the suggested changes would have this effect.

Recommendation

That sections CL 8(2)(a)(ii) and CL 8(2)(b)(ii) be amended to make it clear that the legislation is not restricted to a situation where all members have transferred from the predecessor fund.

That the submission in relation to section CL 8(2)(a)(i) be declined.

Issue: Uncertainty on application of provision

Clause 8

Submission
(8 – The Association of Superannuation Funds of New Zealand Inc)

The wording of the proposed section CL 8(2) of the bill does not state that the exemption applies if either the conditions of section (a) apply or the conditions of (b) apply. The submitter has assumed that it is not necessary that both paragraphs (a) and (b) need to be satisfied for the exemption to apply. This change removes the need for trustees to obtain details of employer contributions made to a previous fund in situations where no funds have been transferred, and reduces compliance costs.

Comment

This assumption is correct and will be set out clearly in the *Tax Information Bulletin* that provides commentary on the enacted legislation. Paragraphs (a) and (b) are separate tests applying to different situations. Paragraph (a) relaxes the "two years or more" employment requirement in current section CL 8(2)(a), allowing for previous employment to be counted where the employer changes (such as part of business restructuring) or where the employee has made contributions throughout that period and his or her employer's contributions have not been more than 150 percent of a previous year's contributions.

Paragraph (b) covers the situation where the employee meets the "two years or more" employment test but fails the contribution tests in either section CL 8(2)(b) or section CL 8(2)(c) because the employee has been in a scheme for less than three complete years before ceasing employment. The amendment in paragraph (b) therefore intends to allow for the contribution test to be relaxed for those whose membership to a

scheme is less than three years, provided they meet the employment test and the employer contributions paid on their behalf are considered normal employer contributions and there is no avoidance concern.

It is standard drafting practice in New Zealand to distinguish between three possible situations in which consequences flow from the satisfaction of factors that are listed in paragraphs. If all the factors in the list must be satisfied to produce the consequence, the paragraphs are linked by "and", if only one factor must be satisfied to produce the consequence, the paragraphs are linked by "or" and in any other situation the paragraphs are linked by colons.

Recommendation

That the submission be noted.

Issue: Redefining "employer"

Clause 8

Submission
(27 – KPMG, 26 – Institute of Chartered Accountants of New Zealand).

Section CL 8 has given rise to interpretation issues since its inception. The use of the language in paragraph (iv) and (v) is only going to exacerbate things. The Commissioner's ability to exercise discretion in a timely and appropriate manner is quite limited. It is also hard for taxpayers to know who in IRD to approach to get such a determination.

The objective of the changes to section CL 8 could be better achieved by redefining the "employer" for the purposes of this section or by regarding cessation of employment in these circumstances as a valid commercial occurrence. While this poses a small risk that employers could deliberately structure their affairs in such a way as to thwart section CL 8, the Commissioner either has the option of applying the general anti-avoidance rules or just living with the risk on the basis that it is very small and unlikely to happen in practice.

Comment

The Commissioner's discretion does not relate to the employment test but to the contribution test in section CL 8(2)(b). The proposed amendment recognises that contributions can be made by more than one employer. Furthermore, officials are recommending that a de minimis rule be introduced, together with the Commissioner's guidelines, to assist trustees in determining whether the exception applies (see below).

Recommendation

That the submission be declined.

Issue: Increased compliance costs from exercise of Commissioner's discretion

Clause 8

Submission

(27 – KPMG, 26 – Institute of Chartered Accountants of New Zealand, 7 – Investment Savings and Insurance Association of New Zealand Inc, 8 – the Association of Superannuation Funds of New Zealand Inc)

The application of the changes in the proposed section CL 8(2)(b) is expected to increase the compliance costs and increase uncertainty for trustees. *(KPMG, Institute of Chartered Accountants of New Zealand, Investment Savings and Insurance Association of New Zealand Inc, the Association of Superannuation Funds of New Zealand Inc)*

In order to take account of the range of possible contribution scales in a fund's trust deed, the proposed section CL 8(2)(b)(iv) and section CL 8(2)(b)(v) give the Commissioner discretion to determine whether the amount contributed and subsequently withdrawn is consistent with the fund's documentation, or otherwise should have been subject to withdrawal tax. The trustees of the fund will need to be satisfied of the above before making the payment under this section. New section CL 8(2)(b)(iv) is subjective and can be a contentious point. This lack of clarity introduces the possibility of trustees paying an amount without deducting fund withdrawal tax, then being subsequently challenged by the Commissioner and being subject to penalties and interest.

Clear guidance should be provided by the Commissioner on the exercise of this discretion. That should include a de minimis level, recognising that most withdrawals will be small amounts reflecting the short period of fund membership, below which the trustees need not seek a decision from the Commissioner. *(Investment Savings and Insurance Association of New Zealand Inc)*

The Commissioner should issue guidelines as to what payments will be exempt and any discretionary elements should be referred to the Government Actuary for his consideration, rather than the Commissioner. *(The Association of Superannuation Funds of New Zealand Inc)*

Comment

We agree that the legislation should be amended to provide clarity for trustees concerning whether or not an amount is subject to a fund withdrawal tax deduction. Reference to the Commissioner's discretion only relates to new section CL 8(2)(b). This was intended to prevent the abuse of the relaxed contribution tests provided by this amendment. Officials have been discussing with submitters the most appropriate way to provide certainty while dealing with avoidance concerns.

We agree that there is merit in the use of a de minimis. We suggest a de minimis of $5,000 applying to the amount of employer contributions withdrawn would be appropriate. We also suggest that the de minimis be annual to make it more robust for short serving members.

We acknowledge that the Commissioner should provide guidance for those cases that do not fall within the de minimis. This will ensure that those who are not within the de minimis are able to take advantage of the relaxed contribution tests provided the contributions are considered "normal" employer contributions in the particular situation and there are no avoidance concerns. The guidance will set out the factors to be considered in determining whether the exemption applies.

Recommendation

That new section CL 8(2)(b) be redrafted to include an annual de minimis of $5,000 for employer contributions withdrawn.

The Commissioner will issue guidance concerning the exercise of the discretion in section CL 8(2)(b)(iv) and (v) following appropriate consultation with interested parties.

Issue: Overseas transfers

Submission
(8 – The Association of Superannuation Funds of New Zealand Inc)

On the current wording of the legislation the benefit of an employee who ceases employment in New Zealand by reason of transfer to an overseas company that is related in terms of CL 11 is subject to fund withdrawal tax. Transfers to overseas retirement benefit schemes that are operated by a related employer should be exempt from fund withdrawal tax.

Comment

Because the submission is outside the scope of the remedial matters included in the bill officials have not been able to consider it fully. Officials acknowledge the issue raised. However, any such exemption does give rise to avoidance concerns if the employer contribution made in New Zealand could be withdrawn without being subject to fund withdrawal tax, which will be the case if the member's interests have been transferred to a foreign superannuation scheme. Officials propose that the issue be added to the tax policy work programme and addressed as resources permit.

Recommendation

That the submission be declined.

Issue: Credits from reserves

Submission

(8 – The Association of Superannuation Funds of New Zealand Inc)

There are situations where fund withdrawal tax will apply if credits have been made to a member's accounts from the fund's reserve accounts which do not appear to follow the intention of the legislation. We believe that section CL 8(4) should be amended to allow credits from Reserve Accounts to be recognised as specified superannuation contributions.

Comment

The definition of "employer contributions to superannuation savings" includes reserves (paragraph c). However, officials note that the definition of "reserves" is restricted to contributions that were made after 1 April 2000, and the issue raised in the submission concerns credits from reserves that existed before 1 April 2000, which are therefore excluded from the definition. Because the submission is outside the scope of the remedial matters included in the bill, officials have not been able to consider it fully. Officials recommend that the issue be added to the tax policy work programme and addressed as resources permit.

Recommendation

That the submission be declined.

Issue: Defined benefit to defined contribution conversions

Submission

(8– The Association of Superannuation Funds of New Zealand Inc)

The rules do not contemplate the situation where a defined benefit fund converts to a defined contribution fund. This raises two issues, the treatment of the accrued benefit of the member at the time of the conversion, and the assessment of the extent of any increase in the rate of the employer's contributions on behalf of the member. Provision should be made in the legislation to cover these situations. As the issues are complex and relatively infrequent it may be the case that these need to be considered on a case-by-case basis by the Government Actuary (or the Commissioner).

Comment

In some situations a conversion can occur within the existing trust framework or may constitute a transfer to a new fund (in which case it will not be a withdrawal). The issue raised in the submission is the determination of what level of employer subsidy in the defined contribution scheme is reasonable given the exchange of benefits that have occurred. The level could then be used as the baseline for determining whether the change constitutes an increase in the employer contributions.

Because the submission is outside the scope of the remedial matters included in the current bill officials have not been able to consider it fully. Officials recommend that the issue be added to the tax policy work programme and considered as resources permit.

Recommendation

That the submission be declined.

Issue: Deferral of losses

Clause 18

Submission
(15 – PricewaterhouseCoopers)

The amendment needs to be changed to ensure that it applies only to net losses from a loss attributing qualifying company (LAQC).

Alternatively, the application of the deferred deduction rule should be amended to clarify that losses arising from an arrangement which arose prior to the 2004-2005 income year are excluded from the adjustment under the rule.

Comment

The intention is that the deferred deduction rule should apply to deductions incurred in the 2004-05 and subsequent income years. It should apply to some arrangements entered into before the start of the 2004-2005 year, but only to deductions incurred after the start of that year, not to losses carried forward from years prior to 2004-2005.

Where allowable deductions exceed gross income for any taxpayer, a net loss results which can be carried forward to a future year by the taxpayer involved. The submission argues that references to the term “allowable deductions and losses” in section ES 3(2) could be interpreted to include a net loss carried forward from before the 2004-2005 income year. This interpretation is not consistent with the intention of the legislation and the matter should be addressed.

Recommendation

That references to “losses” in section ES 3(2) should be clarified or removed.

Issue: Exclusion for foreign company shares held on capital account

Clause 16

Submission
(15 – PricewaterhouseCoopers)

The exclusion for shares in a foreign company held on revenue account, should be extended to all foreign shares, irrespective of whether they are held on revenue or capital account.

Comment

The exclusion for foreign shares held on revenue account was introduced because comprehensive tax rules surround such investments, and the deferred deduction rule should not impose further potential tax obligations. Further, losses from such a company cannot be utilised by a New Zealand shareholder.

Other exclusions already exist for share investments, that is, where 70 percent of the total cost of the arrangement assets are from portfolio investments in a listed company, or shares that are part of an employee share scheme.

Accepting the submission would have the potential to render the deferred deduction rule worthless.

Further, the submission argues that, in the example provided, there is no requirement to consolidate the assets and liabilities of the target company. This is not the case. In the example, consolidation is required.

Recommendation

That the submission be declined.

Issue: Application of deferred deduction rule too wide

Clauses 16-18

Submission
(15 – PricewaterhouseCoopers)

The application of the deferred deduction rule (even after the proposed amendments in the bill) is still too wide and has potential to capture commercial arrangements.

Comment

The deferred deduction rule has been carefully designed to provide objective tests for determining when the rule should apply and when it should not. Various submissions (in relation to the issues paper that was published initially, as well as at the 2003 bill introducing the rule, and since) have identified various arrangements that could be caught, and each has been carefully considered in relation to whether the rule should apply or not.

This process will continue, and further changes will be made to the scope of the rule, as appropriate.

Recommendation

That the submission be noted.

Issue: Two drafting issues

Submission
(15 – PricewaterhouseCoopers)

Two technical aspects of sections ES 2(3)(c) and ES 3(2) should be corrected and clarified.

Comment

Section ES 2(3)(c)

This section currently states:

> "… has an effect, or has a purpose or effect of achieving an economic effect that is similar to the effect, of – …."

The submission suggests that this should be changed to:

> "… has a purpose or an effect of – …".

Officials agree that this suggested change would result in an improvement in drafting style without changing the meaning of the law.

Section ES 3(2)

The submission states that this section has a paragraph (b), but no paragraph (a). This is not correct.

Recommendation

That the submission to amend section ES 2(3)(c) be accepted and the submission to amend section ES 3(2) be declined.

Issue: Drafting issue

Clause 17

Submission
(19 – Minter Ellison Rudd Watts)

The proposed section ES 2(3)(d) should be clarified, with the word "and" inserted between subparagraphs (A) and (B).

Comment

The effect of the current provision is that, if parties are non-associated, and the loan is not arm's length:

- if the lender usually lends on arm's length terms, and is resident in New Zealand, the loan will not be a limited recourse loan;
- if the lender does not usually lend on arm's length terms, and is resident in New Zealand, the loan will be a limited recourse loan;
- if the lender usually lends on arm's length terms, and is not resident in New Zealand, the loan will be a limited recourse loan; and
- if the lender does not usually lend on arm's length terms, and is not resident in New Zealand, the loan will be a limited recourse loan.

This reflects the intended policy.

Recommendation

That the submission be declined.

Issue: Technical issue

Clause 17

Submission
(19 Minter Ellison Rudd Watts)

Section ES 2(3)(d)(i) should be extended to cover banks and insurance companies that are tax-resident in "grey list" countries.

Comment

The "grey list" consists of Australia (excluding the Territory of Norfolk Island), Canada, the Federal Republic of Germany, Japan, the United Kingdom, the United States of America and Norway.

Loans are excluded from the definition of "limited-recourse loan" where the terms are on an arm's-length basis, and the lender regularly lends money on arm's-length terms and is resident in New Zealand. This is on the basis that, where appropriate, enquiry can be made of the lender. In contrast, loans from some overseas lenders may be difficult to verify.

Further, some overseas entities that call themselves banks may not, in fact, be banks. For example, the state of Delaware in the United States allows any company incorporated there to call itself a bank.

Accordingly, officials do not agree that the definition should be amended, at least at this stage.

Recommendation

That the submission be declined, but the issue be kept under review.

WRITE-OFF – DATE OF MEASUREMENT OF NET LOSS

Issue: Whether drafting achieves policy intent

Clause 116

Submission
(15 – PricewaterhouseCoopers)

The submission supports the proposed amendment. However, it considers that the current drafting does not reflect the policy intent. In particular, the submission is concerned with the part of the amendment that refers to the "net loss of the taxpayer at the time at which the outstanding tax is written off". This wording suggests that consideration of part year loss rules could be required, which would not seem to be the policy intent.

Comment

Officials consider that the policy intent of the amendment – which is to allow a taxpayer's net loss to be measured as at the time the last return was filed – is achieved by the wording, which provides that when extinguishing a taxpayer's net loss the Commissioner "may use a figure for that net loss based on the most recent return of income furnished by the taxpayer". The wording referred to in the submission does not affect this measurement rule and is merely intended to assist in identifying whose net loss is being extinguished. Consideration of the part year loss rules will, therefore, not be required if the most recent return did not apply those rules.

Recommendation

That the submission be declined.

Issue: Dividend withholding payments by local authorities

Clause 63

Submission
(2 – Deloitte and Dunedin City Council)

While supporting the change, the submission suggests that consideration should be given to the clause being made retrospective from either 1 April 1988 (when the dividend withholding payment rules were originally introduced) or from the application date of the core provision amendments (1997-1998 and subsequent income years).

Comment

Under sections NH 1 and CB 10 of the Income Tax Act, local authorities have a liability to account for dividend withholding payments on dividends received from investments held directly in foreign companies. Tax has to be accounted for at 33%. They are unable to reclaim this tax. By virtue of section CB 3(b) local authorities are not liable to tax on any other investment income, although they do pay tax on income derived from their trading enterprises. They are unable to use the tax paid on foreign dividends against any other liabilities.

In 2002 the legislation was amended to remove charities from the obligation to account for dividend withholding payment (charities then being in the same position as local authorities). This took effect retrospectively from 1997-98.

Clause 63 puts local authorities in the same position as charities. The clause, as it is currently drafted, would apply to dividends received on or after the date of Royal assent. As the reason for amending the legislation is the same as the reason for amending it for charities in 2002, it would seem reasonable to make clause 63 retrospective from 1997-98, the application date of the core provision amendments.

Recommendation

That the submission be accepted by making the clause apply to dividends received during 1997-1998 and subsequent years.

Issue: Redundant commencement date provision

Clause 6

Submission
(Matter raised by officials)

Clause 6(2) of the bill should be omitted.

Comment

The commencement date provision in clause 6(2) of the bill states that clause 6(1) (which removes a redundant reference to "assessable income") comes into force on the date of Royal assent. This commencement date provision is redundant as it replicates the general commencement date provision in clause 2(1) of the bill, and should therefore be omitted.

Recommendation

That the submission be accepted.

Issue: Timing of expenditure on leases of land and buildings

Clause 65

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

The amendment should not apply retrospectively to those taxpayers who have treated the relevant payments in accordance with the law prior to this amendment being made in a return filed or notice of proposed adjustment issued prior to the date the bill was first introduced to Parliament.

Comment

A drafting error at the time the finance lease rules were enacted in 1999 resulted in expenditure on leases of land and buildings being excluded inadvertently from the definition of "accrual expenditure" in section OB 1, which in turn means that such expenditure is not covered by the timing rule in section EF 1. An unintended consequence is that a taxpayer may claim an upfront deduction for the entire amount of a lease prepayment, instead of spreading the prepayment over the term of the lease as always intended. The bill proposes to fix this drafting error with effect from 20 May 1999.

Officials do not consider that taxpayers could be regarded as having a legitimate expectation that lease prepayments were not subject to the accrual expenditure timing rule in section EF 1. This timing rule has been a long-established feature of the income tax rules and, given the drafting error background, there was obviously never any public indication given by the government that this long-standing treatment would change. It was clearly never intended by Parliament that expenditure on leases of land and buildings would not be subject to the timing rule in section EF 1.

Recommendation

That the submission be declined.

Issue: Matters that cannot be challenged

Clause 103

Submission
(Matter raised by officials)

The reference to section 103 in the commencement date provision in clause 2(13) should be omitted so that the commencement date for clause 103 is the date of Royal assent.

Comment

The commencement date for clause 103 (relating to certain decisions of the Commissioner under the GST Act that cannot be challenged) is currently stated to be 1 April 2005 by virtue of that clause being listed in clause 2(13) of the bill. It is intended that the commencement date for this provision be the date of Royal assent. Removing the reference to section 103 from clause 2(13) would mean that the general date of Royal assent commencement provision in clause 2(1) would apply to clause 103.

Recommendation

That the submission be accepted.

Issue: Transitional provision for supplies of imported services

Clause 140

Submission

(26 – Institute of Chartered Accountants of New Zealand)

The submission supports the proposed amendment. However, it considers that the amendment should go further to deal with services that are not physically performed.

The amendment should not apply to contracts entered into before the enactment of the legislation. Taxpayers should be entitled to rely on the legislation as enacted when determining the results of their actions. If taxpayers have acted in reliance on the legislation as enacted rather than the *Tax Information Bulletin* item, they should be protected from the retrospective amendment proposed.

Comment

The submission assumes that new section 84B – containing the transitional provisions for supplies of imported services which will be made subject to GST at a future date – caters only for services that are physically performed and not for other types of services that are not physically performed, such as choses in action (for example, the supply of a trademark). This assumption is not correct. The transitional provision will apply to all services that are performed. The transitional provision is therefore applicable to services that are of a type that are not physically performed, such as rights under a chose in action. This view is supported by section 84(1A) – which is used for the purposes of the imported services transitional provision in section 84B, which refers to rights granted or exercisable under a statute, which clearly includes the supply of a chose in action such as a copyright right that would normally not be described as being "physically performed".

The submission also states that section 84B should contain provisions dealing with services that are not physically performed that are similar to the provisions used for the introduction of GST in 1986. Section 84B, by virtue of utilising the time of performance tests in subsections (1) to (1B) in section 84 (the transitional provision for the introduction of GST in 1986), already contains such provisions.

Officials do not consider that the amendment made by this bill to section 84B of the GST Act has a retrospective effect. This is because the amendments concerning the supply of imported services have not yet come into force. Although the provisions were enacted on 25 November 2003, the amendments will come into force on 1 January 2005. This bill, containing the amendment to the transitional provision for supplies of imported services in section 84B, should be enacted before that date.

Also, as the submission acknowledges, the amendment being made by clause 140, which is to ensure that section 84B refers to the time of performance of the services, is consistent with the *Tax Information Bulletin* item published following the enactment of the imported services legislation on 25 November 2003.

The submission that the amendment made by clause 140 should not apply to contracts entered into before the enactment of this bill could also disadvantage taxpayers in certain circumstances. This is because the amendment in this bill would allow imported services that are performed before the imported services legislation comes into force, but are treated as being made after that date by the ordinary time of supply rules, not to be subject to the reverse charge. However, in the absence of this amendment such services would be subject to the reverse charge. Therefore, agreeing to this aspect of the submission would result in some supplies of imported services being subject to the reverse charge when they would otherwise not be.

Recommendation

That the submission be declined.

Issue: Determinations in relation to financial arrangements

Clause 85 – 89

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

The submission supports the amendment, but seeks to allow the Commissioner discretion to allow the old determination to apply to a financial arrangement in cases where the requirement to change is materially disadvantageous to the taxpayer.

Comment

Sections 90(6), 90AC(6) and 90AE allow the Commissioner to "vary, rescind, restrict, or extend a determination" made under section 90(1) and section 90AC(1) by replacing the determination or by making a new determination. The determination does not have to be used for a financial arrangement which was entered into before the new determination was published until four years after the date of publication of the new determination.

It has become apparent that if a determination has been issued, it cannot be withdrawn unless a replacement determination is issued. This was not intended by the original legislation, and a situation has arisen where a determination has been issued to an entity, has not been used, is not correct but cannot be withdrawn.

The submission questions whether it is fair for taxpayers to be forced to use new determinations on existing financial arrangements.

The amendment is only seeking to give the Commissioner the power to rescind a determination without replacing it. The taxpayer can continue to use the determination for four years after the date that the determination is rescinded. This gives the taxpayer a long period of certainty. There is no justification for giving the Commissioner a discretion to allow the continued use of an old determination where this is advantageous to the taxpayer after the period of four years has expired.

Recommendation

That the submission be declined.

Submission
(10 – Business New Zealand)

Officials should be asked to provide best quantitative estimates on the financial and economic impacts of the changes contained in the bill.

Comment

The submission expresses concern in relation to the analysis of compliance cost implications of proposed legislation contained in Regulatory Impact and Business Compliance Cost Statements attached to bills. It comments that there is often very little quantitative analysis in Regulatory Impact and Business Compliance Cost Statements (for example, the degree to which compliance costs are expected to change) and, equally, a lack of analysis of the wider economic impacts, thereby making it difficult for those making submissions to assess the financial and economic impact on compliance costs, either individually or in aggregate.

It is often quite difficult to quantify the compliance impacts of proposed changes, as the impact can vary across the population according to factors such as taxpayer size and behaviour. While high-level estimates of compliance costs impacts are provided where possible, more often the impacts can only be qualitatively assessed. Inland Revenue is, however, in the process of improving its capacity to analyse the compliance cost implications of proposed changes to the tax system, to better comply with Regulatory Impact and Business Compliance Cost Statement requirements. The department has commissioned research into the tax compliance costs of small and medium-sized business, which should, among other things, allow the compliance impacts of proposed tax policy initiatives to be tested in an experimental way prior to implementation. An initial benchmarking survey of businesses' tax compliance costs is expected to be underway in late 2004.

It is also worth noting that the Generic Tax Policy Process ensures that proposed changes to the tax system are publicly consulted on at a very early stage, a feature acknowledged in the submission (that is, Inland Revenue being found to be one of the better agencies for consulting with the business community). This process allows affected parties the opportunity to raise concerns they may have in relation to the compliance cost impacts of proposed tax changes prior to legislation being introduced.

Recommendation

Note that officials are doing further work to improve the analysis of compliance cost impacts in Regulatory Impact and Business Compliance Cost Statements.

NUMBER OF REMEDIAL AMENDMENTS

Issue: Care when amending legislation

Submission
(10W – Business New Zealand)

The government should take more care when amending the legislation to ensure that fewer subsequent remedial amendments are required. The large number of remedial changes in the bill calls into question the quality of the legislation and whether too many changes are pushed through the system too quickly. Hurried law is not good law.

Comment

Officials acknowledge the need for great care when amending legislation, to minimise the number of flaws and subsequently the number of remedial amendments. To this end, the government always endeavours to promote well-drafted legislation. However, tax legislation is very complex, and unfortunately some mistakes, and therefore remedial amendments, are inevitable.

Recommendation

That the submission be noted.

Other amendments proposed by officials

INCOME FROM STANDARD-COST HOUSEHOLD SERVICES TREATED AS SCHEDULAR GROSS INCOME

Submission
(Matter raised by officials)

Income from standard-cost household services should be removed from the definition of "schedular gross income", and so be treated as ordinary income.

Comment

Rules providing for the tax treatment of standard-cost household services were enacted by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003. Income received from standard-cost household services was treated as schedular income. This income is treated separately from ordinary income. A taxpayer's income tax liability is calculated for their schedular income, and separately for their ordinary income. These are then aggregated to get the taxpayer's total income tax liability.

Schedular income was used to ensure that income from standard-cost household services was matched with the standard costs attributed to that income. This prevented any excess standard costs from being used to minimise a taxpayer's income tax liability on income from other sources. However, treating this income as schedular income has had two unintended consequences.

First, because a taxpayer's schedular income tax liability is calculated separately, they will have to fill out a separate tax return for their schedular income and their ordinary income. Given that the amendment was intended to reduce compliance costs, officials consider this to be of significant concern, and justifying remedial amendment.

Secondly, as the two sources of income are not aggregated before applying the applicable tax rates, the threshold for moving to a higher marginal tax rate is raised. Income from one source, rather than total income, needs to be over $38,000 or $60,000 before a higher tax rate applies. A taxpayer is able to earn over a threshold but pay no more tax, if their income is split between schedular and other sources. This undermines the progressive structure of the income tax system and was not an intended result of the amendment.

Officials consider remedial amendments to the Income Tax Act 1994 and the Tax Administration Act 1994 should be made to remove standard-cost household services from the definition of "schedular gross income". A further amendment to the Tax Administration Act 1994 should be made to continue to prevent excess standard costs from being used to minimise a taxpayer's income tax liability on income from other sources.

Recommendation

That the submission be accepted.

Issue: Zero-rating under the reverse charge

Submission

(Matter raised by officials)

Section 11A(1B) of the Act should be amended to more clearly reflect Parliament's intent. The amendment should apply from the date section 11A(1B) comes into effect, on 1 January 2005.

Comment

Section 11A(1B) provides that the supply of imported services physically performed outside New Zealand or the arranging of services that are physically performed outside New Zealand will not be zero-rated if "the nature of the services is such that the services are physically received at –

(a) The time and place at which the services are physically performed; and
(b) No other time or place."

It is intended that the supply of imported services may be zero-rated if the services are physically performed outside New Zealand and the nature of the services is such that they can be physically received only at the time and place at which the services are physically performed. For example, accommodation can be physically received only at one time and place.

The nature of certain intangible services, such as legal services, supplied offshore means that they could be physically received other than at the time and place at which they are physically performed. Therefore they should not be zero-rated.

It is possible that the current legislation would allow services to be zero-rated if they are physically received offshore irrespective of any ability to receive the services at another time or place. For example, legal services supplied offshore could be zero-rated, although they are able to be received anywhere at any time.

Section 11A(1B) should be amended to remove this possibility.

Recommendation

That the submission be accepted.

Issue: Correction required to prevent GST double dipping

Submission
(Matter raised by officials)

A deduction from output tax, calculated under section 20C of the GST Act, does not reflect its policy intent as it allows taxpayers to double dip in respect of claiming input tax credits. The amendment should apply from the date section 20C comes into effect, which is planned for 1 January 2005.

Comment

Sections 20(3)(h) and 20C were inserted into the GST Act by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003.

Section 20(3)(h) allows taxpayers a deduction from output tax in relation to exempt supplies of financial services to another financial service provider. This section was in response to concerns that continuing to exempt supplies of financial services between financial service providers under the newly enacted zero-rating rules would not address the policy concerns that formed the basis of the reforms, that is, to remove tax cascades, or over-taxation, of financial supplies consumed by businesses.

The value of the deduction is calculated according to a formula, which is contained in section 20C.[4] The formula provides a proportional deduction from output tax and is in addition to that which can be recovered as a deduction from output tax using the principal purpose test or by way of a change in use adjustment.

The proportion is found by multiplying two fractions. The first fraction is the proportion of the total value of supplies made by you that consists of exempt supplies of financial services to a recipient financial services provider (the direct supplier). The second fraction is the proportion of the total value of supplies made by the direct supplier that consists of taxable supplies (including zero-rated supplies of financial services).

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[4] The formula is as follows:

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

Where:

a is total GST that would be recoverable by you under section 20(3), other than under section 20(3)(h), in respect of the taxable period if all financial services supplied by the financial service provider were taxable supplies:

b is the total value of exempt supplies of financial services made by you to the direct supplier in respect of the taxable period:

c is the total value of supplies made by you in respect of the taxable period:

d is the total value of taxable supplies made by the direct supplier in respect of the taxable period as determined under section 20D:

e is the total value of supplies made by the direct supplier in respect of the taxable period as determined under section 20D.

The formula is limited to the activities of the direct supplier. Further supplies of financial services – for example, by the direct supplier to a third or subsequent financial services provider – are not included in the formula.

A problem arises as the formula assumes that in respect of determining the value of item “a”, the taxpayer is unable to deduct input tax at all. This is not always the case. If a taxpayer can claim back GST paid on the purchase of goods and services on the basis of the principal purpose test and the other specific deductions allowed under 20(3), the application of “a” in the formula will allow taxpayers to effectively double dip, once in respect of the initial deduction under, for example, the principal purpose test, and again under the formula. This is inconsistent with the policy intent.

Item “a” in the formula should be redrafted to ensure that where a taxpayer has deducted input tax under section 20(3) that a further deduction is not allowed under the formula.

Recommendation

That the submission be accepted.

MINOR DRAFTING CHANGES

Issue: Grammatical correction

Submission
(Matter raised by officials)

The definition of "resident" in section 2(1) of the Goods and Services Tax Act 1985 (the Act) should be amended to correct a grammatical error.

Comment

The definition of "resident" in section 2(1) of the Act currently reads:

> "**Resident**" means resident as determined in accordance with sections OE 1 and OE 2(1) of the Income Tax Act 1994:
>
> Provided that, notwithstanding anything in that section, – …"

The definition should be amended so that it reads:

> ""**Resident**" means ….
>
> Provided that, notwithstanding anything in those sections, – …"

Recommendation

That the submission be accepted.

Issue: Consequential effects of Income Tax Act 2004 on amendments to other Acts

Submission
(Matter raised by officials)

The Income Tax Act 2004 contains concepts and terminology that differ from the concepts and terminology in the Income Tax Act 1994. Amendments to other statutes that currently refer to the Income Tax Act 1994 must take into account the differences in the Income Tax Act 2004. It is proposed that several amendments made by this bill, in particular amendments to the Tax Administration Act 1994, be made in two forms. One form uses the concepts and terminology of the Income Tax Act 1994 and applies before the end of the 2004-05 income year. The other form uses the concepts and terminology of the Income Tax Act 2004 and applies from the beginning of the 2005-06 income year.

Comment

These minor remedial amendments are necessary to ensure that the Income Tax Act 2004 is able to function as intended.

Recommendation

That the submission be accepted.

Issue: Numbering and other errors and omissions in Income Tax Act 2004

Submission
(Matter raised by officials)

Some numbering and other errors and omissions have been identified in the Income Tax Act 2004. Details of the sections and other items proposed to be amended and of the proposed amendments are as follows:

CQ 2(1)(e)
Replace "EX 16" by "EX 17".

CQ 6
Replace "EX 42" by "EX 38".

DN 7
Replace "EX 42" by "EX 38".

DP 8(3)(a)
After the words "the cost of", insert "the".

DZ 6
Replace "DZ 2" by "DZ 3".

DZ 7
Replace "DZ 2" by "DZ 3".

EE 11(5)
Replace "EE 42" by "FB 7(6)".

EX 5(4)
After the word "definition", insert the words "of **shareholder decision-making rights**".

EX 15(1)
Replace "EX 46(1)(b)" by "EX 46(1)(a)".

FE 9
Replace “IE 1(4)” by “DB 38”.

KB 3
Replace “subpart” by “Part”.

KD 1(3)(c)(ii)
Replace “counted” by “assessable”.

LC 14(1), item b of formula
Replace “counted” by “assessable”.

MK 7(5)
Insert the definition of “distributions”, ie,—

distributions is the total of all taxable Maori authority distributions made by the Maori authority during the imputation year, exclusive of any Maori authority credit attached to the distributions

MZ 7
Omit.

OB 1
Insert the following definition of “cost of timber”:

cost of timber, for some timber, means the amount given by section DP 10(1) for the timber that is a deduction under section DP 10(2).

Schedule 21

Student Loan Scheme Act 1992
Replace existing amendment to section 49 by—
In section 49(2), replace “an income year” by “a tax year”.
In section 49(2), replace “that income year” by “that tax year”.

Taxation Review Authorities Act 1994 (1994 No 156)
Replace “156” by “165”.

Financial Reporting Order 1994
Replace existing amendment by—
In clause 4, replace “rates permitted under the Income Tax Act 1976” in all places in which it appears by “rates permitted under the Income Tax Act 2004”.
In clause 4, replace “section 222A of the Income Tax Act 1976” by “section OB 1 of the Income Tax Act 2004”.

Schedule 22A

Column 1
Replace “2002” by “2004”.
Insert “CB 7(2),” after “CB 6,”.

Schedule 23

p 1981 CB 5(1)(a) column3 - add “, (b)”
p 1984 CD 2 column 3 – replace “10” by “9”
p 2004 DK 2 column 3 - replace “16(1), (2)” by “15”
p 2006 DM 1(2)(b) column 3 - insert “(2)” after “5”
p 2006 DM 7(1) column 3 - insert “DT 20,” after “CT 5,”
p 2010 EB 1(1) column 3 - replace “(3)” by “(4)”
p 2011 ED 5 column 3 – replace “9” by “8”
p 2014 EG 3(2) column 3 – replace “(1)” by “(2)(b)”
p 2014 EG 3(3) column 3 - add “, (4)”
p 2014 EG 3(4) column 3 – replace “(4), (5)” by “(5), (6)”
p 2014 EG 3(5) column 3 – replace “(6)” by “(2)(c)”
p 2016 EG 19 column 2 – insert “(2A)” and column 3 – insert “omitted”
p 2026 EO 4 column 2 – insert “(1B)” and column 3 – insert “DS 2(3)”
p 2026 EO 4B column 3 – replace “(3)” by “(6)”
p 2030 column 1 – insert “GC 27B” and column 3 - insert “GC 27A”
p 2036 column 1 - insert “LD 3B” and column 3 - insert “LD 3A”
p 2037 MB 2AB column 1 – omit “MB 2AB” and column 3 – omit “omitted”
p 2037 column 1 – insert “MD 2B” and column 3 - insert “MD 2B”
p 2040 MZ 7 column 3 - replace “MZ 7” by “omitted”
p 2042 column 1 – insert NF 8B and column 3 – insert “NF 8A”
p 2043 column 1 – insert “OB 3B” and column 3 - insert “OB 3A”
p 2043 OB 7 column 3 – replace “40” by “34”
p 2083 MZ 7 columns 1 & 2 – omit “MZ 7”
p 2086 column 1 – insert “NF 8A” and column 2 - insert “NF 8B”
p 2087 column 1 – insert “OB 3A” and column 2 - insert “OB 3B”

p 2032	columns 1 & 3	Should have HI 6 to HI 9
p 2037	columns 1 & 3	Should have subpart MBB going to subpart MBA
p 2040	columns 1 & 3	Should have subpart MK going to subpart MK
p 2040	columns 1 & 3	Should have subpart NBB going to subpart NBA
p 2076	columns 1 & 2	Should have HI 6 to HI 9
p 2080	columns 1 & 2	Should have subpart MBA going to subpart MBB
p 2083	columns 1 & 2	Should have subpart MK going to subpart MK
p 2083	columns 1 & 2	Should have subpart NBA going to subpart NBB

Punctuation

During the select committee stages of the Income Tax Bill 2002, a decision was made in relation to the punctuation style for lists of paragraphs and subparagraphs. In the bill as introduced, items in a list could be separated in 3 ways — by a colon, by “; or”, or by “; and”, depending on the relationship between the items. The decision was to change all colons to “; and” or “; or”.

Subsequent analysis has determined that this change in punctuation style has resulted in material changes in the intended effect of a number of sections. Accordingly, officials propose to revert to the use of colons in provisions that apply whether 1 or more than 1 of the paragraphs or subparagraphs in a list are satisfied. In provisions that do not apply unless all of the items in a list are satisfied, “; and” is retained. In provisions that apply if 1, but not more than 1, of the items in a list is satisfied, “; or” is retained. The use of colons in such a way is consistent with the practice of the

Parliamentary Counsel Office as well as earlier Inland Revenue drafting style in provisions drafted for inclusion in both the Income Tax and other Inland Revenue Acts. Some 600 sections are affected.

Comment

These minor remedial amendments are necessary to ensure that the Income Tax Act 2004 is able to function as intended.

Recommendation

That the submission be accepted.

Issue: Numbering of sections inserted in the Tax Administration Act 1994 by Schedule 22 and Part C of Schedule 23 of the Income Tax Act 2004

Submission
(Matter raised by officials)

Schedule 22 of the Income Tax Act 2004 contains amendments to other Acts that are consequential to the provisions of the Income Tax Act 2004. Included in Schedule 22 are numerous amendments to the Tax Administration Act 1994. Part C of Schedule 23 to the Income Tax Act 2004 lists sections in the Income Tax Act 1994 that correspond to the new sections in the Tax Administration Act 1994. Twenty of the new sections are numbered in a manner that is inconsistent with the numbering style used for inserted sections. While inappropriately numbered, the new sections are, however, in their correct sequence in the Tax Administration Act.

To remedy the situation, officials propose to amend Schedule 22 and make consequential amendments to the third column of Part A of Schedule 23 and the first column of Part C of Schedule 23. Some consequential changes to provisions in the Income Tax Act 2004 are also proposed.

The changes are summarised by the amendments to the first column of Part C of Schedule 23, which are:

(a) "14A" is replaced by "14B":
(b) "14B" is replaced by "14C":
(c) "91(1A)" is replaced by "91(1B)":
(d) "91AAA" is replaced by "91AAC":
(e) "91AB" is replaced by "91AAD":
(f) "91AC" is replaced by "91AAE":
(g) "91AD" is replaced by "91AAF":
(h) "91AE" is replaced by "91AAG":
(i) "91AF" is replaced by "91AAH":
(j) "91AG" is replaced by "91AAI":
(k) "91AH" is replaced by "91AAJ":

(l) “91AI” is replaced by “91AAK”:
(m) “91AJ” is replaced by “91AAL”:
(n) “91AK” is replaced by “91AAM”:
(o) “108(3A)” is replaced by “108(3B)”:
(p) “113A” is replaced by “113B”:
(q) “113B” is replaced by “113C”.

Comment

These minor remedial amendments are necessary to correct the numbering of new sections inserted in the Tax Administration Act 1994 by the Income Tax Act 2004.

Recommendation

That the submission be accepted.