

# **Taxation (Depreciation, Payment Dates Alignment, FBT and Miscellaneous Provisions) Bill**

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*Commentary on the Bill*

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# Changes to the tax depreciation rules

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## **CHANGES TO THE TAX DEPRECIATION RULES**

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*(Clauses 53 to 58, 80, 143(13), 151, 168, 169, 194, and Schedule 1)*

### **Summary of proposed amendments**

The bill introduces changes to improve the current tax depreciation rules by:

- more closely aligning the tax depreciation rates to estimates of how assets depreciate by changing the way depreciation rates are calculated; and
- reducing the compliance costs associated with the current rules by increasing the threshold for low-value assets.

### **Application date**

Most of the amendments will apply from the 2005-06 income year. The exception is the amendment to the low-value asset threshold, which will apply after 19 May 2005.

### **Key features**

The Income Tax Act 2004 is being amended as follows:

- The method for calculating depreciation rates will change so that tax depreciation rates for:
  - shorter-life plant and equipment will increase, with no change to depreciation rates for longer-life plant and equipment (the diminishing value depreciation rates will increase by up to 57%);
  - buildings will decrease (the building diminishing value depreciation rates will reduce between 10% and 25%).
- The immediate deduction allowed for low-value assets will increase from \$200 to \$500.

A number of consequential amendments are also being made to the Income Tax Act 1994 and the Tax Administration Act 1994.

### **Background**

In January 2003 the Minister of Finance asked officials to look at whether the present definition of “economic life” accurately reflects commercial reality.

An issues paper was released in July 2004 which reviewed the current depreciation rules and set out officials’ goals for depreciation reform. The paper also provided a framework for analysing how depreciation provisions can affect incentives to invest.

When taxes distort people's investment decisions the result is lower growth than otherwise would have occurred. From this starting point officials considered how the current tax depreciation rules might impact upon investment decisions. Their analysis suggests that the current tax depreciation rules can discourage investment in shorter-lived assets.

The amendments to the current tax depreciation rules will reduce the effects that the tax depreciation rules can have on investment decisions by dealing with the following concerns:

- That current depreciation rates are too fast for buildings and too slow for short-life plant and equipment. This can result in excessive investment in tax-preferred assets and under-investment in others.
- That a compliance cost-saving measure introduced in the early 1990s is not as effective as it could be.
- There is a minor problem with the tax depreciation rules where it is not clear whether all of an asset's disposal costs are deductible in full, especially when no consideration is derived.

## **Detailed analysis**

### *Economic rate*

Economic theory suggests that tax depreciation rates should mirror the way an asset declines in value. Tax depreciation rates that mirror economic depreciation help to avoid the situation whereby tax depreciation rates artificially encourage or discourage investment in particular types of assets.

The current method of calculating depreciation rates assumes a minimum residual value of 13.5% of an asset's original cost. Comparing the results of this method of calculating depreciation to international estimates of asset depreciation suggests that New Zealand's tax depreciation rates are too fast for buildings and too slow for short-life plant and equipment.

Section EE 25(6) grandfathers old depreciation rates for plant and equipment acquired before 1 April 2005 and buildings acquired before 19 May 2005.

### *New section EE 25B*

New section EE 25B sets out how the tax depreciation rate for an item of plant and equipment is calculated:

- Subsection (4)(b) introduces a reference to the new schedule 11B, which specifies the new depreciation bands for plant, equipment and structures. Depreciation bands standardise the number of depreciation rates that taxpayers and the Inland Revenue have to manage. New banded rates in column 2 are required to take account of the changes to the methods of calculating plant, equipment and structure depreciation rates.



- Subsection (5) introduces the formula for double declining balance ( $2/\text{estimated useful life}$ ) of an asset. This formula creates a depreciation profile that more closely follows estimates of how plant and equipment decline in value over time. Applying the new formula will increase depreciation rates for shorter-life plant and equipment and will not change depreciation rates for longer-life plant and equipment.
- Subsection (6) defines the term “estimated useful life” as set out in subsection (5). Estimated useful life will continue to be determined by the Commissioner of Inland Revenue following the procedure set out in subsection (3).

These changes will apply to assets acquired from 1 April 2005, and the new rates will apply from the 2005-06 and subsequent income years. Taxpayers will have the option to continue to depreciate these assets at current depreciation rates or at the new depreciation rates in future years under new section EE 26B.

#### *New section EE 25C*

New section EE 25C sets out how the economic depreciation rate for a building is calculated. The term “building” is not defined in the income tax legislation but does include: portable buildings, fowl houses, grandstands, hothouses, pig houses, shade houses and buildings with framing made from (or a combination of) steel, reinforced concrete, or timber. The amendments in the new EE 25C are:

- Subsection (3)(b) introduces a reference to the new schedule 11B, which specifies the new depreciation bands for buildings. Having depreciation bands standardises the number of depreciation rates that taxpayers and Inland Revenue must manage. New banded rates in column 3 are required to take account of the change to the method of calculating building depreciation rates.
- Subsection (4) introduces the formula for calculating the straight-line depreciation rate ( $1/\text{estimated useful life}$ ) of the building. This formula creates a depreciation profile that more closely follows estimates of how buildings are thought to decline in value. Applying the new formula will decrease depreciation rates for buildings.
- Subsection (5) defines the term “estimated useful life” as set out in subsection (4). Estimated useful life will continue to be determined by the Commissioner of Inland Revenue following the procedure in subsection (3).

The changes to building depreciation rates will apply to buildings acquired on or from 19 May 2005 and the new rates will come into effect from the 2005-06 and subsequent income years.

### *New section EE 26B*

New section EE 26B is a compliance cost-saving measure and applies to plant and equipment acquired by a taxpayer between 1 April 2005 and the end of their 2005-06 income year. This section enables taxpayers to make a one-off election, in the 2005-06 income year, to apply the new depreciation rates (as calculated under section EE 25B) or carry on with the current depreciation rates (as calculated under section EE 25). Taxpayers who elect to move to the new rates will need to revise the depreciation rates in their asset registers. They will need to apply the new depreciation rates from the beginning of the 2005-06 income year. Those who elect to continue to depreciate assets at the current rates will not need to make these adjustments.

### *Low value asset threshold EE 31 and EG 16*

Changing section EE 31 of the Income Tax Act 2004 and EG 16 of the Income Tax Act 1994 increases the low value asset threshold from \$200 to \$500 for assets acquired after 19 May 2005. The bill sets the application date and increases the thresholds from \$200 to \$500 for the Income Tax Act 2004. Inserting section (1B) in section EG 16 in the Income Tax Act 1994 increases the low value asset threshold for late balance date filers for the 2004-05 income year.

Current tax rules generally require taxpayers to capitalise and depreciate assets used in their businesses. The reason for this is that assets may provide economic benefits over a number of years, while the value of assets may decline over this time. This process of capitalising and depreciating virtually all of an enterprise's assets can, however, impose significant compliance costs on taxpayers. These costs arise because taxpayers must maintain information on all capital assets and track and make adjustments to this information over the life of the asset.

Taxpayers can currently write off a low-value asset immediately if its cost does not exceed \$200. This threshold was set in 1993, and taxpayers have submitted that it is too low.

The proposed increase in the low-value asset and single-supplier thresholds to \$500 more than doubles the current level. It also comes at a significant fiscal cost.

### *Consideration for the purposes of EE 37*

Inserting subsection (1B) in section EE 38 clarifies that all disposal costs are deductible in full. These costs can be significant if an asset has no scrap value. For example, Resource Management Act consents sometimes require demolition costs to be incurred when the asset is no longer used. Allowing a deduction for the cost of demolition and disposal is the economically correct outcome. Clarifying that this is the case may remove an artificial impediment to more environmentally friendly asset disposal practices. This change applies to asset disposals from the 2005-06 income year.

### *GC 6 Arrangement to defeat the application of depreciation provisions*

The anti-avoidance provision in section GC 6 is to be broadened to capture arrangements to defeat the depreciation provisions. Replacing specific section references in section GC 6 with the word “if” will address the potential problem that taxpayers have an incentive to sell and re-acquire assets for the benefit of the higher depreciation rates on assets acquired after 1 April 2005. Extending section GC 6 will allow the Commissioner to deny such a deduction if the Commissioner is of the opinion that existing assets have been subject to arrangements for the purpose of having the higher depreciation rates apply to them.

### ***Consequential changes***

#### *Changes to definitions*

Two changes to the Income Tax Act 2004 take account of the new methods for calculating economic rates of depreciation. The following amendments to definitions are being made:

- Section EE 58 is to include references to the new sections EE 25B and EE 25C in the definition of “economic rate”.
- In section OB 1 the definition of “finance lease” is to include reference to the new sections EE 25B and EE 25C.

#### *New schedule 11B*

New schedule 11B specifies the new depreciation rate bands (both straight line and diminishing value) for plant, equipment and structures; and buildings. Having depreciation bands standardises the number of depreciation rates that taxpayers and Inland Revenue have to manage.

#### *Amendments to the Tax Administration Act 1994*

Sections 91AAF and 91AAG are being amended as a consequence of changing the methods for calculating the tax depreciation rates for depreciable assets.

Section 91AAF currently allows the Commissioner to set an economic rate of depreciation in a determination having followed the procedure in section EE 25. The section is being amended to require the Commissioner to also have regard to section EE 25B for plant and equipment acquired on or after 1 April 2005 and section EE 25C for buildings acquired on or after 19 May 2005.

Section 91AAG requires the Commissioner to consider the formula in section EE 25 (4) when deciding whether to issue a special or provisional depreciation rate. It is proposed to amend this section to require the Commissioner to also have regard to section EE 25B for plant and equipment acquired on or after 1 April 2005 and section EE 25C for buildings acquired on or after 19 May 2005.



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# Changes to the way provisional tax and GST are paid

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## **CHANGES TO THE WAY PROVISIONAL TAX AND GST ARE PAID**

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*(Clauses 59, 79, 83, 84, 88, 99 to 103, 105, 108 to 110, 114 to 118, 120, 142, 143, 152, 155, 160, 161, 171 to 180, 183 to 185, 203, 210 to 217, 219, 221, and Schedules 2 and 3)*

### **Summary of the proposed amendments**

As part of the government's measures to reduce tax impediments for businesses, changes are being made to the way provisional tax and GST payments are paid and the way provisional tax is calculated. This will be achieved by:

- aligning the payment of provisional tax with GST due dates;
- changing the due date for both provisional tax and GST to the 28<sup>th</sup> of the month; and
- providing taxpayers with another method of calculating provisional tax by basing it on a percentage of their GST taxable supplies, known as the ratio method.

### **Application date**

The provisional tax reforms have a phased implementation:

- Those GST-registered taxpayers whose GST taxable periods are not aligned with their income tax balance dates will start being aligned from 1 April 2006.
- The due date for payments of GST will change from the last working day of the month to the 28<sup>th</sup> of the month, with effect from taxable periods ending on or after 31 March 2006.
- Provisional taxpayers will begin paying provisional tax along with their GST payments. They will also be able to base their provisional tax on a percentage of their GST sales with effect from the beginning of the 2007-08 income year.

### **Key features**

#### ***Changing the due date for GST***

The due date for the payment of provisional tax and GST will change from the 7<sup>th</sup> and last working day of the month respectively to the 28<sup>th</sup> of the month. Taxpayers will have just one fixed due date to remember instead of separate payment dates.

Changes will also be made to the new due date for payment of provisional tax and GST when the due date is the 28<sup>th</sup> of December. In this case, the due date will be the 20<sup>th</sup> of January.

In the case of terminal tax due on the 15<sup>th</sup> of January, this will now be payable on the 20<sup>th</sup>, in line with provisional tax and GST payments for that month.

### ***Aligning GST taxable periods to balance dates***

To enable provisional tax payments for an income year to be made along with GST payments, taxpayers' GST taxable periods must be aligned with their balance date. The vast majority of GST taxpayers have their taxable periods aligned, but a small percentage will have to change.

Currently there is considerable flexibility around the payment frequency for GST. This flexibility will reduce slightly under these proposals as a result of aligning the new taxable period with the taxpayer's balance-date month.

### ***Provisional tax paid along with GST***

Provisional tax payments will be paid at the same time as GST payments:

- Monthly and two-monthly GST taxpayers will be required to make three compulsory provisional tax payments on their GST due dates and will be able to make three voluntary payments on the remaining GST dates or at any time.
- Six-monthly GST taxpayers will make two compulsory provisional tax payments aligned to their two GST payment dates and will be able to make voluntary payments at any time.
- Taxpayers who adopt the ratio proposal will pay their provisional tax, together with their GST every two months.
- Provisional taxpayers who are not registered for GST will make three compulsory provisional tax payments and will be able to make voluntary payments at any time.

### ***Basing provisional tax payments on a percentage of GST taxable supplies***

The proposal to base provisional tax on a percentage of GST taxable supplies will enable taxpayers to align provisional tax payments with their cashflow. Only taxpayers that pay GST monthly or two-monthly, and whose residual income tax for the prior year is \$150,000 or less will qualify to use this option.

## **Background**

To identify the problems facing small businesses, the government undertook a number of surveys with small and medium-sized enterprises.

Two main contributors to tax compliance costs were identified – the time needed to fill out forms and the fact that provisional tax payments were not aligned with cashflow.



GST-registered taxpayers account for GST in relation to a taxable period. There are three categories of taxable period that a taxpayer could be assigned to: monthly, two-monthly or six-monthly. Payments of GST are due on the last working day of the month following their taxable period. Provisional taxpayers pay provisional tax three times a year on the 7<sup>th</sup> day of the 4<sup>th</sup>, 8<sup>th</sup>, and 12<sup>th</sup> months after balance date. GST payments are not aligned to provisional tax payments.

On 17 September 2003 the government released the discussion document *Making tax easier for small businesses*, which outlined proposals to address the concerns raised by small businesses, namely:

- to align the payment of provisional tax with GST payments, which involved most taxpayers making six provisional tax payments per annum linked with GST; and
- to base provisional tax payments on a percentage of GST-taxable supplies.

However, following submissions and consultation with the Institute of Chartered Accountants of New Zealand and business representatives, it became clear that for some taxpayers the compliance costs associated with making more frequent payments of provisional tax would not be offset by the benefits of better cashflow management. As a result of this feedback, the provisional tax proposal to align payments of provisional tax with GST payment dates was modified so that most provisional taxpayers will pay only three provisional tax payments and those wanting to pay more frequently can make voluntary tax payments.

### **Detailed analysis**

The legislative changes are broadly grouped into three areas:

- the changes made to section MB of the Income tax Act (which relates to provisional tax);
- the changes made to sections 120K of the Tax Administration Act (the interest sections); and
- the consequential changes, including those to the GST Act.

Owing to the extent of the changes to section MB of the Income Tax Act, this subpart has been rewritten to incorporate the changes. The changes cover the proposals to align provisional tax payments to GST due dates and to base provisional tax payments on a percentage of GST taxable supplies, referred to as the GST ratio in the legislation. The features of each proposal are outlined below:

#### ***Provisional tax aligned to GST payment dates***

Provisional taxpayers will pay provisional tax at the same time as GST payments are made, as follows:

- Two-monthly GST taxpayers will make three compulsory provisional tax payments aligned to their GST payment dates.

- Six-monthly GST taxpayers will make two compulsory provisional tax payments aligned to their GST payment dates.
- Taxpayers who are not registered for GST will pay provisional tax on the 5<sup>th</sup>, 9<sup>th</sup> and 13<sup>th</sup> month after their balance date.
- Taxpayers who adopt the GST ratio method will pay provisional tax every two months with their GST return.

Taxpayers will be able to make a voluntary payment of provisional tax at any time and the GST form will provide a mechanism for voluntary payment in the months when provisional tax is not due. Taxpayers wanting to pay provisional tax as they earn their income can make six payments per annum, whereas those that do not want to pay that frequently can continue with the current three payment dates and not face any additional compliance costs.

Taxpayers other than “safe-harboured” taxpayers<sup>1</sup> will be liable for use-of-money interest on the three compulsory provisional tax payment dates (two dates for six-monthly GST taxpayers). They will also receive credit use-of-money interest on voluntary payments made during the year, which will provide an incentive to pay earlier. As is currently the case, all compulsory provisional tax payments will be subject to standard penalties. Voluntary payments will not be subject to penalties.

The table below outlines the payment dates for a two-monthly GST-registered taxpayer.

<b>New GST/income tax payment dates</b>						
(Assumes a March balance date taxpayer paying GST two-monthly)						
	<b>1<sup>st</sup></b>	<b>2<sup>nd</sup></b>	<b>3<sup>rd</sup></b>	<b>4<sup>th</sup></b>	<b>5<sup>th</sup></b>	<b>6<sup>th</sup></b>
<b>GST taxable period</b>	Apr/May	Jun/July	Aug/Sept	Oct/Nov	Dec/Jan	Feb/Mar
<b>Proposed due date</b>	28 Jun	28 Aug	28 Oct	20 Jan	28 Feb	28 Apr
<b>Payments</b>	GST and voluntary payments	GST and provisional tax	GST and voluntary payments	GST and provisional tax	GST and voluntary payments	GST and provisional tax
Current provisional tax date		7 July		7 Nov		7 Mar
Proposed provisional tax date		28 Aug		20 Jan		28 Apr
<b>Deferral</b>		<b>52 days</b>		<b>74 days</b>		<b>52 days</b>
<b>Interest Credit</b>	Yes	Yes	Yes	Yes	Yes	Yes
<b>Debit</b>	No	Yes	No	Yes	No	Yes
<b>Student loans</b>		Payment 28 Aug		Payment 28 Jan		Payment 28 Apr

<sup>1</sup> “Safe-harboured” is where a natural person bases their provisional tax liability on 105% of their previous year’s residual income tax liability or if the return for the previous year has not been filed, 110% of the year before the previous year’s residual income tax liability and whose residual income tax for the current year is also less than \$35,000. Taxpayers who meet these criteria are not subject to use-of-money interest.

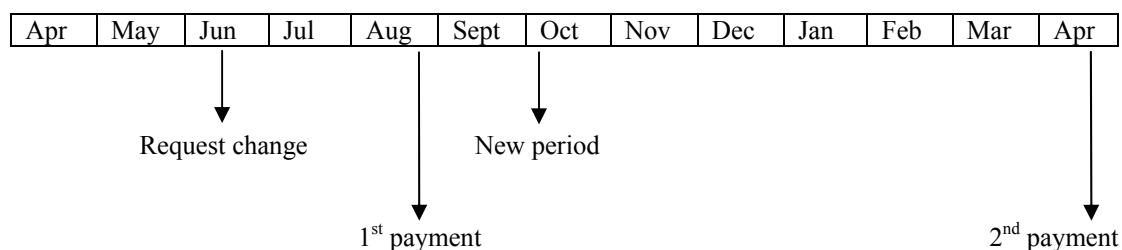
This proposal will produce a different treatment for those accounting for GST six-monthly and all other provisional taxpayers. Provisional taxpayers would generally be required to make three provisional tax payments, whereas those registered for GST on a six-monthly basis would make only two payments. This was a consequence of aligning provisional tax payments with GST. Also, paying on two instalment dates is limited to those taxpayers who are registered for GST and whose taxable supplies in the last 12 months were less than \$250,000.

Provisional tax will be paid on the GST form and taxpayers will be able to offset a GST refund against a provisional tax liability.

People with student loans who are liable to make interim repayments will continue to make three interim payments on the same dates as provisional tax is due. However, the new due date for these payments will be later than the current dates, so students will incur additional interest. If they do not want to incur the interest, they can make voluntary payments during the year.

When taxpayers change their GST taxable periods the new payment frequency must align with their balance date. The change must also occur on a date that aligns with the new payment frequency.

**Example 1: Change in GST taxable periods**



Wendy is registered for GST on a two-monthly basis and has a March balance date for income tax. She also pays provisional tax three times a year, on the 28<sup>th</sup> of August, 20<sup>th</sup> of January and the 28<sup>th</sup> of April. On the 10<sup>th</sup> of June Wendy asks to change to a six-monthly taxable period for GST.

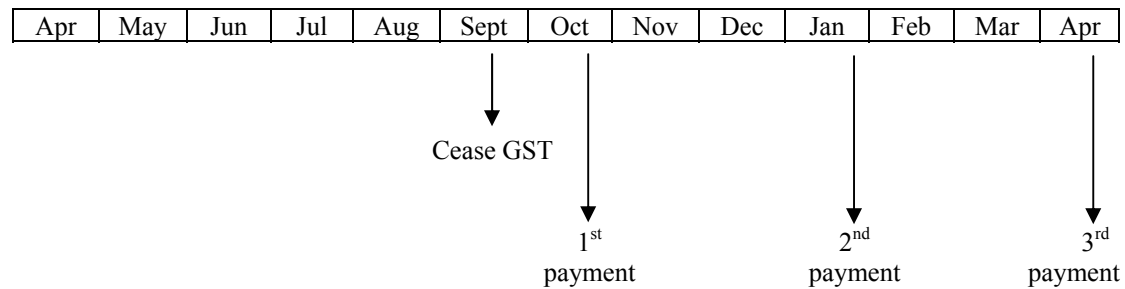
Wendy cannot change with effect from the end of her current two-monthly period (June/July) as it does not align with her new six-monthly cycle, which starts on 1 October. She must wait until the following two-month period, August/September, when the end of this period aligns with the start of the new six-monthly period.

Her provisional tax payments for the year would look like this:

- provisional tax instalment payable on old cycle due 28 August
- provisional tax instalment payable on the new six-monthly cycle due on 28 April.

GST-registered taxpayers who account for GST and provisional tax on a six-monthly basis who cease to be registered for GST will revert back to paying provisional tax three times a year, with effect from the date they ceased GST.

**Example 2: Ceasing GST – change in provisional tax due dates**



Kathryn is registered for GST on a six-monthly basis and has a March balance date for income tax. She pays provisional tax twice a year, on 28<sup>th</sup> of October and April.

Kathryn ceases being registered on 20 September. From this date onwards she begins to pay provisional tax three times a year. She will continue to make the payment due on 28 October (relating to the six-month period April to October) and will also be liable for provisional tax payments on the 20<sup>th</sup> of January and the 28<sup>th</sup> of April.

Taxpayers who start up a business part-way through a year will not be required to make a provisional tax payment if they do so within the period of 30 days before the instalment date and more than 30 days before the next instalment date.

***Provisional tax based on GST taxable supplies – ratio option***

At present, provisional taxpayers calculate provisional tax either by basing their payments on 105% of last year’s residual income tax liability or by estimating their current year’s residual income tax liability. To enable taxpayers to base provisional tax payments on their cashflow, a new provisional tax calculation method is being introduced. It is expected to benefit taxpayers with seasonal income or fluctuating income. Taxpayers who meet the qualifying criteria will be able to base their provisional tax payments on a percentage of GST taxable supplies for each two-monthly taxable period.

It was originally proposed that six-monthly GST taxpayers would be eligible to use this proposal. However, it was decided that reducing the number of payments would provide too great a gap between when the income is earned and the calculation and payment of the tax to assist in tax cashflow management. The proposal was therefore limited to monthly and two-monthly GST payers.

The measure will be voluntary as it may not benefit all businesses, owing to their circumstances. Taxpayers should seek expert advice or satisfy themselves as to whether they would benefit from using this provisional tax calculation method. Taxpayers will qualify for this proposal if:

- they are GST-registered;
- they are liable for provisional tax (residual income tax exceeds \$2,500) and their prior year’s residual income tax liability is \$150,000 or less;
- they pay both GST and provisional tax in their own right;

- their ratio is between 0% and 100%; and
- they pay GST on a two-monthly basis.

The ratio is determined by a taxpayer's residual income tax liability for the previous tax year divided by the previous year's GST taxable supplies. The resulting ratio is then applied to each two-monthly taxable supplies figure to determine the amount of provisional tax payable. Monthly GST payers will add together their current and previous month's taxable supplies figure and apply the ratio to this amount to calculate the provisional tax due.

A business could adjust for large asset sales of over \$1,000 or 5% of its taxable supplies for the last 12 months. The adjustment could apply to the current period's taxable supplies figure and/or the ratio that applies in the following year.

The business would elect to use this option either in writing or by phone at the beginning of the income year, before its first provisional tax payment is due. If a business elects to use the GST ratio option and subsequently elects out before its first provisional tax instalment, it could still be safe harboured.

Taxpayers are required to exit the scheme during the year if they:

- cease being registered for GST;
- fail to maintain the same IRD number for both GST and income tax; or
- enter into the scheme and then, following a reassessment of their income tax return, fail to meet the qualification criteria.

Taxpayers who exit the scheme part-way through the year will be required to advise the Commissioner in writing or by phone and estimate their provisional tax for the rest of the year.

Businesses that adopt the GST ratio method will be treated the same as a safe-harbour provisional taxpayer and will not be subject to use-of-money interest on provisional tax payments while they are using the GST ratio. Taxpayers will not be penalised for underpaying provisional tax if they have correctly used the ratio and GST figures at the time of filing. However, if they exit the GST ratio during the year they will be subject to use-of-money interest on any outstanding balances from the date they cease being in the ratio. This ensures that taxpayers cannot move between the ratio and safe harbour rules in order to reduce their tax liability.

Late payment penalties will be imposed for non-payment of provisional tax by the due dates, and shortfall penalties will apply for tax shortfalls that result from not using the correct GST figures or ratio.

For taxpayers who fail to file a return and pay, the provisional tax penalties will be calculated on the prior period's provisional tax liability or, when this is not available, the prior year's residual income tax figure divided by the number of provisional payments for the current year.

**Example 3: GST ratio method**

Adrian sells vintage car parts and is liable for both provisional tax and GST. His tax year finishes on 31 March. He meets all the qualifying criteria to use the ratio calculation method. Adrian is a two-monthly GST payer and decides to base his provisional tax on his GST taxable supplies starting in 2007-2008 income year.

Adrian's residual income tax and taxable supplies figures for the 2006-07 year were \$50,000 and \$453,000 respectively. By dividing the residual income tax figure by taxable supplies, we get the ratio of 0.11 ( $50,000/453,000=0.11$ ).

This ratio must be applied to each of Adrian's GST period's taxable supplies to determine the amount of provisional tax payable.

Adrian's taxable supplies for his first GST period (April and May 2007) amount to \$13,000 and his provisional tax liability for that period will be \$1,430 ( $13,000*0.11=\$1,430$ ). His provisional tax payment of \$1,430 will be due on 28 June 2007 along with his GST.

Adrian must use the same GST ratio to calculate his provisional tax liability for the other five GST periods.

The GST ratio method will also apply to consolidated groups provided the group meets the qualifying criteria. If a company joins a group that uses the ratio (assuming the group still qualifies), then the group's ratio will be adjusted to take account of the prior year's residual income tax and taxable supplies figures of the new company. If a company leaves the consolidated group part-way through an income year, then the company will have to estimate its provisional tax for the remainder of the year.

If a company that uses the GST ratio joins a group that does not use the ratio, the group cannot begin to use the GST ratio part-way through the year.

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# Subsidy for payroll agents

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## **SUBSIDY FOR PAYROLL AGENTS**

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*(Clauses 119, 143(28), (32) and (69), 155(19), (20), and (28), 188, and 189)*

### **Summary of proposed amendments**

The bill introduces a legislative framework that will enable the government to subsidise the voluntary use of PAYE intermediaries by small businesses. The subsidy will be paid by Inland Revenue to intermediaries acting for small employers<sup>2</sup> once the intermediary files Employer Monthly Schedules, pays tax and social policy deductions, and makes a claim for the subsidy correctly and in the prescribed format. To protect the integrity of the tax system, intermediaries who want to claim the subsidy will need to meet particular administrative standards and have a good record of meeting tax obligations (to become “listed PAYE intermediaries”).

### **Application date**

The machinery needed to list PAYE intermediaries will come into effect on the date of assent and the subsidy can be paid for pay periods beginning on or after 1 April 2006.

### **Key features**

The main change is a new subpart NBB in the Income Tax Act 2004 which will outline the:

- criteria payroll agents have to meet in order to be eligible for the subsidy;
- reasons the Commissioner can revoke listing and the administrative process for doing so;
- obligations on listed PAYE intermediaries;
- process and conditions for claiming the subsidy; and
- consequences of when employers and listed PAYE intermediaries terminate their arrangement with each other.

“Listed PAYE intermediary” and “listed PAYE intermediary claim form” will become defined terms in section OB 1 of the Income Tax Act 2004.

Amendments are being made to the definition of “tax” and “tax position” in the TAA 1994. Section 185 is being amended to allow the Commissioner of Inland Revenue to pay the subsidy out of a Crown Account, and new sections 185C and 185D establish the account and specify how it should be used.

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<sup>2</sup> The subsidy will be payable for up to five employees of a small employer. Small employers are employers who are only required to file monthly.

### ***Accreditation as listed PAYE intermediary and revocation of accreditation***

New section NBB 2 sets out the criteria to be used by the Commissioner to list intermediaries eligible to receive a subsidy. Generally, they will have to be an accredited PAYE intermediary and have a good record of meeting their own tax obligations and any PAYE obligations for people they have acted for as agents. They must also have administrative and information technology systems needed to meet their obligations. Those seeking to be listed must also inform employers they contract with that Inland Revenue does not guarantee payments made by them to employees of the employer, nor is Inland Revenue responsible for any services they provide to the employer.

The Commissioner will not list an applicant if doing so is inconsistent with the duty to protect the integrity of the tax system. Accreditation will be for a specified period.

The criteria and process for revocation are set out in new section NBB 4. Listing will be revoked if an intermediary:

- loses PAYE intermediary status;
- does not comply with its obligations as a listed PAYE intermediary;
- ceases to meet the criteria for listing; or
- does not file claim forms correctly.

The Commissioner is required to give a 30-day warning before listing can be revoked, setting out the reasons for the intended revocation. If the intermediary does not resolve those matters within that time the Commissioner will give notice of revocation, which will take effect 14 days after the date of that notice.

### ***Obligations on listed PAYE intermediaries***

A new section NBB 3 outlines the obligations on listed PAYE intermediaries. They are required to maintain their status as PAYE intermediaries, meet their obligations as PAYE intermediaries and continue to meet the criteria for listing. In addition, they need to maintain administrative and information technology systems to correctly return claim forms and to keep records so that information on claim forms can be verified.

### ***Claiming the subsidy***

New sections NBB 5 and NBB 6 set out the administrative process for claiming the subsidy and its payment by the Commissioner. The listed PAYE intermediary is required to file a claim form (a PAYE intermediary claim form) in a prescribed format, setting out information needed to calculate the amount of the subsidy. It must be filed within one month of the date of filing the employer monthly schedule to which the claim relates.

The Commissioner has powers to amend a claim form and is required to give notice of amendments. Any underpayments or overpayments that arise because a claim form has been amended must be paid within 30 days of the Commissioner's notice. The Commissioner is required to give intermediaries notice of the subsidy paid and information which can be used to resolve any differences between the amount claimed and what was paid. Such differences could arise, for example, if the intermediary is unaware that the employer is no longer a small employer and therefore is ineligible for the subsidy.

To provide flexibility in the way that the subsidy is calculated, the formula will be specified by regulation rather than in legislation.

The Commissioner has the power to withhold the subsidy if the intermediary has not met its obligations under the PAYE rules or if the claim form is incorrect.

### ***General administrative issues***

New section NBB 7 sets out the administrative process to be followed when an arrangement between an employer and intermediary is terminated. Fourteen days notice to each other and the Commissioner is required. Funds held by the intermediary are required to be handled as though the arrangement is still in place.

Amendments to the definition of “tax” and “tax position” in the Tax Administration Act 1994 mean that the normal rules in relation to audit and record-keeping will apply and that shortfall penalties will apply to the way that claims are calculated. However, late payment and late filing penalties will not apply to the claim, nor will use-of-money interest.

### **Background**

The amendments are intended to implement the first phase of a compliance cost-reduction measure outlined, in September 2003, in *Making tax easier for small businesses* by providing a subsidy to payroll agents who meet a variety of payroll obligations imposed by various government agencies on small employers. Its aim is to encourage small employers to outsource their compliance obligations so they can focus their efforts on their businesses.

The first phase deals with PAYE-related obligations and, because PAYE obligations form the bulk of payroll-related compliance costs, this is a priority for the government. As well as compliance cost reductions, efficiency benefits are expected to flow from specialisation and greater use of information technology. Administrative benefits include improvements in the quality, timeliness and accuracy of tax returns and payments received by Inland Revenue.



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# Fringe benefit tax

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## FRINGE BENEFIT TAX

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*(Clauses 14 to 16, 24 to 33, 40, 81, 121 to 132, 143, 145, and 148)*

### Summary of proposed amendments

Amendments to the Income Tax Act 2004 give effect to a set of changes to fringe benefit tax (FBT). The changes arise from a review of FBT and were signalled in the government discussion document, *Streamlining the taxation of fringe benefits*, released in December 2003. They are designed to reduce compliance costs and remove anomalies in the rules while maintaining the objectives of FBT.

### Application date

The amendments will apply from 1 April 2006 or, if an employer pays FBT on an income year basis, from the income year beginning on or after that date.

### Key features

#### *Motor vehicles*

- The current rules require employers to calculate the benefit from an employer-provided motor vehicle based on its cost. Section ND 1A and Schedule 2 are being amended to allow owners an alternative option of calculating the benefit on the vehicle's tax value for depreciation purposes (subject to a minimum value).
- The current annual valuation rate applying to motor vehicles is 24% of their cost. Amendments to Schedule 2 will reduce this rate to 20% of cost (or from 6% to 5% if FBT is paid quarterly). The equivalent rate under the alternative tax value option will be 36% (or 9% if FBT is paid quarterly). This reduction is in recognition of lower real motoring costs since the rate was set, in the mid-1980s.
- Other amendments to Schedule 2 will align the treatment of leased vehicles with that of owned vehicles so that the fringe benefit from a leased vehicle will be based on its cost or tax value, rather than as at present, its market value. This is to ensure that leases are not used to reduce the FBT liability.
- Similarly, new section CX 6C will override the "suspension" of vehicle leases so that private use is treated as a fringe benefit. This provision is designed to overcome the problem of shareholder-employees avoiding FBT by leasing their own vehicles to their employers and "suspending" the leases when private use occurs through such arrangements as "nine-to-five" and "flip-flop" leases.
- Currently, an FBT day is a calendar day and therefore begins at midnight, which can result in two days' FBT liability being incurred when a vehicle is taken home overnight. New section ND 1AB will ensure that one day's FBT is incurred in such instances, by allowing employers to elect the start time for an FBT day. An election will apply to all vehicles and normally last for two years.

### *Other changes*

- Section ND 1D is being amended to allow employers the additional option of using the relevant market interest rate as the benchmark for valuing the benefit from their loans to employees, in lieu of the current method of using the prescribed rate of interest. This rectifies the problem of the prescribed rate becoming out of date and fringe benefits arising even when the employer is charging an employee the market rate. The market rate is the rate the lender charges to other comparable groups of sufficient size on an arm's-length basis.
- Section ND 1Q is being amended to increase the minimum-value thresholds that have to be exceeded before unclassified fringe benefits are subject to FBT. The employee minimum value threshold is increased to \$200 per quarter and the employer minimum value threshold is increased to \$15,000 per annum. This change is designed to reduce compliance costs for employers who provide only small miscellaneous fringe benefits by keeping them out of the FBT net.
- New section CX 18B will allow the private use of employer-owned or leased business tools to be exempt from FBT when tools are provided primarily for business purposes, as long as the cost price of each tool does not exceed \$5,000. This exemption is intended to reduce compliance costs as it is difficult and costly for employers to monitor and value the private use of small items such as laptops and cellphones when they are provided primarily as business tools.
- Currently, benefits that might arise as a result of employers carrying out their health and safety obligations (for example, health checks) can fall within the scope of FBT if they are not provided on the premises of the employer. There seems to be no good policy reason for this. New section CX 20B will allow these benefits to be exempt from FBT irrespective of whether the benefits are provided on or off the employer's premises.
- New section DC 15, in conjunction with new sections CE 11 and CX 15B and an amendment to section CE 5, will allow employees to claim an income tax deduction for income protection insurance premiums paid by their employer on their behalf.
- Amendments to sections CX 20(1) and (2) extend the "on-premises" exemption to the premises of other companies in the same group when there is 66% or greater common ownership with the employer company.
- Section OB 6 is being amended so the Income Tax Act's general anti-avoidance rule also applies to FBT.
- New section CX 27B and an amendment to section ND 1K clarify that FBT should not apply to benefits that arise when an employer secures bulk discounts or provides services to employees, provided the price paid for the goods or services is no less than those available to other comparable-sized groups on an arm's-length basis unrelated to employment.
- Section CX 21 is being amended to specifically exclude the provision of credit cards and other short-term credit facilities from the exemption that charities have from FBT. This will not apply when the aggregate value of the benefits in a year does not exceed 5% of an employee's salary or wages.



- Section CX 17 is being amended to provide an exemption from FBT when an employer pays for a member of an employee’s family to travel to visit the employee. This exemption is limited to the amount that would have been exempt from FBT if the employee had made the visit.
- An amendment to section CE 2 will clarify that share options cancelled in exchange for cash are a “disposal” and therefore covered by the employment income provisions of the Act.
- Amendments to sections ND 2(3), ND 13 and ND 14 will provide more administrative flexibility in relation to elections to pay FBT on a quarterly, annual or income-year basis. An election to pay FBT quarterly will be able to be made at the time of filing irrespective of whether FBT is actually paid, and an election to change to paying FBT annually or on an income-year basis<sup>3</sup> will be able to be made by telephone rather than having to be in writing.
- Another amendment to section ND 14 will ensure that when a small close company with a non-standard balance date chooses to pay FBT on an income-year basis rather than a quarterly basis it is required to undertake the section ND 10 quarterly payment calculation in relation to any incomplete year that arises by virtue of the election.
- New section ND 8(3) will allow employers that cease to employ staff during the year, and have no intention of replacing them, the option of applying the 64% FBT rate rather than the multi-rate for their final quarterly return.

## **Background**

FBT was introduced in 1985 in response to a growing trend in the 1980s to provide in-kind benefits in lieu of cash remuneration. By taxing fringe benefits, FBT was intended to buttress the PAYE system so that all forms of remuneration were taxed equally. Although FBT is in effect a tax on employee benefits, for compliance cost-reduction reasons liability to pay the tax falls on employers.

Although there have been specific changes to the FBT rules, the FBT system has remained largely unchanged over the past 20 years. A review began in October 2002 when the government called for taxpayers to identify areas they wished to be addressed, and a discussion document, *Streamlining the taxation of fringe benefits*, was released in December 2003. Over 60 submissions were received, and officials undertook specific consultation with key submitters. The proposed legislative changes are the outcome of this process.

## **Detailed analysis**

### ***Motor vehicles***

The issue most frequently raised in submissions concerned the valuation of motor vehicles for FBT.

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<sup>3</sup> An income basis will differ from an annual basis when the employer has other than a 31 March balance date.

### *Valuation basis*

A motor vehicle fringe benefit is calculated on a quarterly or annual basis by taking a set percentage (currently 24% per annum), which reflects the costs of motoring, and multiplying it by the original cost of the vehicle. The result is reduced by the number of days in which the vehicle is not available for private use. Some taxpayers perceive this approach to be unfair because the FBT liability remains constant while the vehicle declines in value over time.

To overcome this perception problem, subsections ND 1A(1B) and ND 1A(1C) are being added, and Part A of Schedule 2 is being amended. These changes enable employers to use a motor vehicle's depreciated value (tax value) as the basis for valuing the fringe benefit, but at a higher rate than under the cost price option. A higher rate is needed to produce the same overall tax result as the rate takes into consideration all the costs, including depreciation, over the average period a vehicle is held privately (five years). Expressing these costs as a percentage of a lower base results in a higher percentage. However, the overall FBT liability, while higher in earlier years, will be lower in later years. In particular, the tax value option is useful to those employers who hold vehicles for more than five years, as the current formula tends to over-value the benefit in such cases.

There is a minimum tax value (\$8,333) to reflect the on-going benefits that an employer-provided vehicle affords even when it has depreciated significantly. This is because the employee still continues to save the costs of running a vehicle. The minimum tax value equates to cost savings of \$3,000 per annum given the proposed 36% valuation rate.

“Tax value” is defined in relation to subpart EE (depreciation), and is the depreciated value in the relevant quarter or year as determined under that subpart.

### *The valuation rate for motor vehicles*

The method used in the early 1980s to determine the current valuation rate of 24% was reviewed using current motoring costs and car prices. This showed that in real terms, the cost of motoring had declined significantly over the past 20 years and, therefore, using a rate of 24% of a vehicle's cost overstates the value of the benefit. Amendments to Schedule 2, Part A(1) reduce the rate to 20%. This reduction, which was signalled in the discussion document and well supported by submissions, should provide employers with a significant saving in FBT. The equivalent percentage that uses tax value as the base is 36% (see Schedule 2).

### *Leased vehicles aligned with owned vehicles*

FBT on leased vehicles is assessed on the vehicle's market value at the beginning of the lease. In practice, leasing a vehicle can produce a lower FBT impost because many leases are being structured so that they become renewable each year, resulting in a new (lower) market value annually and a commensurate reduction in FBT.

An amendment to Schedule 2, Part A(1) is designed to help ensure that the FBT base is not undermined and that the choice between leasing and owning is not driven by the tax outcome. Schedule 2, Part A(1)(b) provides lessees with the same options as proposed for owners – in other words, a rate of 20% on the cost price or a rate of 36% on the tax value of the vehicle.

To reduce compliance costs for lessees, Schedule 2, Part A(7) requires the lessor to disclose to the lessee for FBT purposes the relevant cost price or tax value of the vehicle to the lessor.

No transitional arrangements are proposed for leases that are part-way through their term when the legislation is enacted, meaning that the changes will generally apply to such leases from 1 April 2006. There are no transitional arrangements because the proposed reduction in the overall rate to 20% helps to reduce any extra FBT that would have to be paid on these leases and the change has been signalled well in advance.

The other change in relation to leases is the new section CX 6C, which further aligns leased vehicles with owned vehicles by addressing “nine-to-five” and “flip-flop” leases. Over the past decade an increasing number of employees (usually shareholder-employees) have entered into arrangements to lease their own vehicles to their employers for business use during specified hours (usually 9 a.m. to 5 p.m.) in exchange for a market rental. The objective of the leases is to enable the employees to enjoy private use of the vehicles when they are not being used for business purposes. Because the leases are in effect “suspended” when the private use occurs, the argument is made that there is no FBT liability.

Section CX 6C is designed to override this “suspension” for FBT purposes so the employee is deemed to receive a fringe benefit. The outcome is then the same as if the employer had either leased the vehicle from a company specialising in leasing vehicles to businesses, or purchased the vehicle, and in both cases made it available to the employee for their private use with the consequent FBT liability.

#### *Employers able to elect start time of an FBT day*

If a vehicle is available for private use at any time during the day, it is considered to be available for the whole day. This means that if an employee takes a vehicle home at night to take it to another work site the following morning, the vehicle is regarded as being available for private use for two days.

New section ND 1AB means an FBT day is now defined as any 24-hour period rather than a calendar day. For example, an employer may choose to begin the FBT day at 6 p.m. – in which case any private travel between 6 p.m. on a particular calendar day and 6 p.m. the following calendar day would be treated as being within the same day. An election applies across all the employer’s vehicles and lasts for two years, although section ND 1AB(6) enables the Commissioner to accept a change if an employer can show that there has been a material change in circumstance. If an employer makes no election, the current treatment of a calendar day would apply.

## *Other issues*

### *Loans to employees*

The value of a fringe benefit arising from an employee loan is the amount by which interest calculated according to the FBT prescribed rate of interest exceeds actual interest paid. The prescribed rate is set by Order in Council before each quarter begins but uses data from the previous quarter. This means the prescribed rate can become out of date, resulting in fringe benefits arising even when current market rates of interest are charged. Accordingly, section ND 1D is being amended to allow employers the option of using market rates rather than the prescribed rates.

The market rate is, in effect, the rate that the lender charges other comparable groups of a sufficient size on an arm's-length basis unrelated to employment. Section ND 1D(1) expresses this in terms of the rate that would apply to a borrower belonging to a group of persons to whom a loan of the kind provided to the employee is offered when the group:

- is assessed as having a comparable credit risk to the group to which the employee belongs;
- is employed by a person not associated with the employee's employer; and
- is of a sufficient size to ensure a transaction is on an arm's-length basis.

An election lasts for at least two years. Section ND 1D(2) requires employers to give one year's notice of an intended switch between using the prescribed rate and market rate, to deter "flip-flopping" between the options to get the lowest FBT rate.

### *Minimum thresholds*

Employers are currently not required to return FBT on miscellaneous fringe benefits that total \$75 or less per employee per quarter, provided the total value of these kinds of benefits to all employees does not exceed \$450 per quarter. This exemption does not apply to fringe benefits such as motor vehicles and loans, which are specifically listed in sections CX 6 to CX 15B.

Section ND 1Q is being amended to substantially increase the employee minimum threshold to \$200 per quarter and the employer minimum threshold to \$15,000 per annum. The revised employer threshold has been set to effectively exclude miscellaneous fringe benefits provided by small and medium-sized businesses (defined by the Ministry of Economic Development as having 20 employees or less).

Raising the thresholds generally will lower compliance costs for employers who provide only small miscellaneous fringe benefits (such as Christmas hampers) as these benefits will then fall out of the FBT net.

### *Business tools*

It is difficult and costly for employers to monitor and value the private use of small items such as laptops and cellphones when they are provided by employers primarily as business tools. If they are used away from the employer's premises, the currently available on-premises exemption will not apply. As these tools are mainly for business use, any private benefit will likely be incidental. The difficulty in measuring any private benefits that do arise effectively precludes them from being encompassed in the de minimis thresholds.

New section CX 18B specifically exempts the private use (and availability for private use) of business tools from FBT, subject to a limit of \$5,000 per tool. A business tool kept at the employee's home rather than being returned to the employer's premises will still qualify for the exemption if the employee performs a significant portion of his or her employment duties at home. A business tool is to be defined in section OB 1 as a portable item that is used in the performance by an employee of work duties, and therefore does not include a motor vehicle.

### *Specific exemption of employer health and safety-related benefits*

Currently, benefits that might arise as a result of an employer carrying out health and safety obligations can fall within the scope of FBT, depending on where they are provided. If they occur on the premises of the employer the benefits are exempt; if not, they may be taxed. There seems to be no good policy reason for basing the exemption on location. Accordingly, new section CX 20B provides a specific exemption for the minor benefits arising from employer health and safety-related obligations, irrespective of where they are provided.

To qualify for the exemption, the health and safety-related benefits must arise from responses aimed at eliminating workplace hazards under the Health and Safety in Employment Act. The exemption does not extend to a more general exemption of employer-paid health insurance premiums or gym membership fees.

### *The "on-premises" exemption*

The exemption from FBT for benefits provided on an employer's premises does not necessarily extend to premises of another member of a group of companies. This can produce inconsistent outcomes. For example, an employee can be employed by one member company, but receive a benefit on the premises of another member company while on a secondment. This benefit would currently be subject to FBT.

In recognition that entities within a group may operate more like a single economic entity, the general "on-premises" exemption in section CX 20 is being extended to include the premises of other companies in the same group who share 66% or greater common ownership with the employer company.

### *Income protection insurance*

The FBT treatment of income protection insurance policies should put the employee in the same position as if the employer had paid the employee a cash amount, and the employee had then paid the premium directly. Currently this is not the case, because employees who pay the premium directly can be eligible for a deduction for the premium paid, on the basis that it is to ensure future income. Employees do not, however, receive a deduction when the employer is liable to pay the premium on their behalf.

To ensure that the overall tax outcome is the same in both cases, new section DC 15 allows employees to claim an income tax deduction for income protection insurance premiums to the extent of their employer's contribution towards the premium if the employer is liable to pay the contribution. There are several consequential amendments. An amendment to section CE 5 excludes the premium amount paid by the employer from being expenditure on account of an employee; a new section CE 11 clarifies that an amount derived under the policy is income to the employee; and new section CX 15B states that the amount of the premium that the employer is liable to pay is a fringe benefit.

### *Application of general anti-avoidance rule*

FBT has its own anti-avoidance provision in the Income Tax Act. However, unlike many other specific anti-avoidance rules, it is not also bolstered by the Act's general anti-avoidance rule (section BG 1), which enables a tax avoidance arrangement to be voided and any associated tax advantage to be counteracted. The omission arises because of the wording in section BG 1, when read in conjunction with section OB 6 (definition of income tax). Section BG 1 voids arrangements for income tax purposes but section OB 6 specifically excludes FBT from the definition of income tax.

To rectify this oversight, section OB 6 is being amended to make FBT income tax for the purposes of section BG 1. A consequential change is also being made to the specific FBT anti-avoidance rule. The new section GC 17B will enable the Commissioner to alter a person's tax liability when an arrangement involving FBT is voided by section BG 1.

This change will mean that arrangements that survive the specific anti-avoidance rule on a technicality might still be caught as avoidance.

### *Bulk discounts and services to employees*

When an employer enters into an arrangement for a third party to provide an employee with a benefit, the employer is still regarded as having provided the benefit and is liable for the FBT on it.

It is questionable, however, whether a bulk discount for staff should be a fringe benefit because it is provided to them as employees when a comparable discount could be available to the employees if they were members of some other group unrelated to their employment.

Accordingly, new section CX 27B ensures that FBT will not apply to benefits that arise when an employer secures bulk discounts for employees – provided those discounts are available to other groups of a comparable size, who have negotiated the discounts on an arm’s-length basis unrelated to employment.

A similar issue has arisen with the valuation of services in terms of what constitutes an arm’s-length price. An amendment to section ND 1K reflects the concept of the price charged to other groups of a comparable size, to whom the services are offered on an arm’s-length basis in this case too. Any price charged below this level would be subject to FBT.<sup>4</sup>

#### *Changes to charities exemption*

Cash remuneration to employees of charitable organisations is taxed through the PAYE system, as for other employees. Non-cash benefits provided to employees of charitable organisations are, however, exempt from FBT, other than when the employees are employed in a charity’s business.

New subsection CX 21(2) will further restrict the exemption by specifically excluding credit cards and other short-term credit facilities when the aggregate value of the benefits to an employee in a year from the facilities exceeds 5% of the employee’s salary or wages. This change is designed to reduce the potential for charity employers to exploit the exemption by providing a significant proportion of employees’ remuneration in the form of fringe benefits. This is more likely to occur if a benefit is readily substitutable for cash and a wide range of goods and services can be purchased.

Subsection CX 21(3) provides a definition of what constitutes a credit card or short-term credit facility. Basically, the focus is on arrangements that enable an employee to charge non-business related purchases or hire costs to an account that the employer is liable to pay. It does not include employment-related loans under section CX 9.

New section ND 1IB indicates that the value of the benefit in these cases would be the cost to the employer of the non-business purchases of goods and services plus any interest incurred in relation to those purchases and, if a credit card is provided solely for non-business use, any account and service fees associated with the card.

#### *Employer-paid family travel*

If an employer pays for an employee to return home from out of town to visit his or her family, this payment may currently be exempt from FBT. This is on the basis that the payment removes a need to pay the employee a reimbursement allowance for additional travel costs the employee incurs because of a temporary change in the employee’s place of work. For example, the employee may have been seconded overseas. If the employer incurs the cost of a family member visiting the employee instead, the FBT outcome should arguably be the same and the benefit should be exempt.

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<sup>4</sup> This approach is also used in valuing low-interest loans (see earlier discussion).

Accordingly, new section CX 17(2) will exempt from FBT the amount paid by an employer for an employee's spouse/partner or relatives to travel to visit the employee. This exemption is limited to the amount that would have been exempt from FBT if the employee had made the visit, and been eligible for a tax-free reimbursement of travel costs. Section OB 1 is being amended so that paragraph (a) of the definition of "relative" applies to section CX 17. That definition covers blood relatives within the second degree of relationship and those married to them, and adopted children, including those of persons within the first degree of relationship.

#### *Share options cancelled in exchange for cash*

Share options provided to an employee by an employer are treated as employment income, with the value of the benefit being the difference between the value of shares on the date of acquisition – that is, on the exercise of the options – and the amount paid by the employee for them. To avoid double taxation, the FBT rules specifically exclude such benefits (see section CX 4).

Doubt has arisen over whether the treatment of options that are cancelled in exchange for cash rather than exercised and converted into shares would be treated as either employment income or a fringe benefit. This is because of an argument that a cancellation does not constitute a disposal.

The policy intent is to treat the cancellation of a share option the same as if the share had been disposed of. The reality is that the employee is receiving a payment for some form of benefit in this situation.

To rectify this position, an amendment is being made to section CE 2 to clarify that the cancellation of share options in exchange for cash is a disposal of rights in terms of section CE 2(3), and is employment income of the employee.

#### *Administrative simplifications to choosing when to pay FBT*

These remedial changes are aimed at providing greater administrative flexibility and lower compliance costs. An amendment to section ND 2(3) will enable an employer to choose to pay FBT on a quarterly basis at the time of filing irrespective of whether or not FBT has to be paid. Also, through amendments to sections ND 13 and 14, an election to pay FBT annually or on an income year basis rather than quarterly will be able to be made by telephone rather than having to be in writing.

#### *Non-standard balance date taxpayers and income year FBT elections*

Small close companies are allowed to file and pay FBT on an income year basis. A technical issue has been identified concerning such companies with non-standard balance dates who elect to switch from paying FBT on a quarterly to an income year basis. An election should apply from the beginning of the next income year so that all the necessary steps relating to the last year of quarterly payment, including the end-of-year multi-rate square-up, take place before the election applies.

It appears possible, however, for a company with a non-standard balance date to switch from a standard tax year to its income year part-way through a year and therefore avoid the end of year square-up, thus paying less FBT than it ought to. The Act does not include any provisions dealing with any partially completed year.



To rectify this situation a new subsection ND 14(2)B will require that in the case of a small close company the employer must undertake the section ND 10 final quarterly payment calculation in relation to any incomplete year that arises by virtue of the election.

*Employers ceasing to employ staff*

Employers ceasing to employ staff during the year with no intention of replacing them will be given the option of applying the flat rate of 64% in their final return rather than having to undertake the multi-rate calculation. The new section ND 8(3) gives effect to this change.

Employers choosing this option will still be required to undertake a square-up in that the 64% rate will be applied to fringe benefits provided from the beginning of the year up to the time staff ceased to be employed (with a credit for FBT already paid during the year). In other words, the 64% rate does not apply to just the last quarter. The difference from the current approach is that the employer will not need to calculate the appropriate multi-rates in relation to the employees.



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# Taxation of securities lending transactions

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## TAXATION OF SECURITIES LENDING TRANSACTIONS

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*(Clauses 13, 18, 35, 36, 39, 48, 50, 51, 63, 64, 67, 82, 91, 93, 104, 105, 107 to 109, 133 to 140, 143, 153, and 157)*

### Summary of proposed amendments

The tax treatment of securities lending transactions will be clarified and reformed by:

- introducing specific securities lending rules to allow the taxation of “qualifying” share lending transactions on the basis of economic substance; and
- strengthening the tax rules to ensure that non-qualifying share lending transactions do not give rise to an unintended fiscal cost.

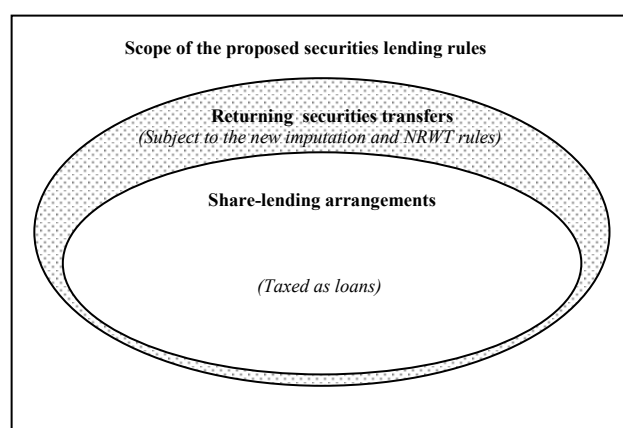
These changes will give greater consistency to the tax treatment of securities lending transactions and the treatment of other commercial transactions such as finance leases and hire-purchase agreements. The amendments will also give taxpayers more certainty about how these transactions should be taxed. Finally, the changes will protect the tax base by preventing taxpayers from using securities lending transactions to trade imputation credits and circumvent the non-resident withholding tax (NRWT) rules.

### Application date

The securities lending amendments will apply for income years beginning on or after the date of enactment. The associated base maintenance amendments will apply from the date that the amending legislation is enacted.

### Key features

The amendments to the Income Tax Act 2004 will introduce specific securities lending rules to tax “qualifying” share lending transactions on the basis of economic substance rather than legal form. They will also strengthen the imputation and NRWT rules to ensure that non-qualifying share lending transactions do not give rise to an unintended fiscal cost.



The new rules revolve around the definition of a returning securities transfer.

A returning securities transfer is an arrangement in which:

- a person (the share supplier) disposes of a share which is listed on a recognised exchange or is ordinarily available for subscription or purchase by the public;
- the person who obtains the share (the share user) agrees to transfer the original shares or replacement shares back to the share supplier; and
- the share user makes replacement payments to pass on the rewards of ownership for any distributions paid on the original shares during the period of the transaction. This can include the value of imputation credits and NRWT which would have otherwise been payable.

Returning securities transfers which meet a number of criteria (known as share-lending arrangements) will be taxed on the basis of their economic substance rather than legal form. This means that they will not be treated as a taxable disposal.

A “share-lending arrangement” is defined as a returning securities transfer where:

- the term of the transaction is no longer than 12 months;
- the original shares or replacement shares are transferred back to the share supplier;
- the share user maintains an imputation credit account (ICA);
- the share user pays withholding tax required under section NF 2(1)(g) in respect of any replacement payment;
- the share user transfers to the share supplier any rights and options, or equivalent rights and options, granted or received in relation to the original shares during the period of the transaction;
- the terms of the securities lending transaction are ordinary commercial conditions which are consistent with those that would apply between parties negotiating at arm’s length; and
- the transaction is entered into in an income year after the new rules take effect.

A replacement share is a share received as a replacement for an original share disposed of under a returning securities transfer. It must confer the same rights and impose the same obligations on the holder as the original share. If a share user defaults on a share lending transaction and the lender uses the collateral provided as part of the transaction to purchase identical securities in the market, then these will constitute replacement shares and the transaction will continue to qualify.

A replacement payment is a transfer of value (in the form of rights or options or other valuable consideration) under a returning securities transfer. It is intended to be economically equivalent to the value of the distributions which the share supplier would have been entitled to receive had they continued to hold the original share over the term of the returning securities transfer. This includes compensation for imputation credits or for NRWT which would otherwise apply or be paid.

Share-lending arrangements will be subject to the ordinary taxpayer record-keeping requirements. In general, this means keeping sufficient records to readily ascertain a taxpayer's tax position. Inland Revenue allows records to be kept in both paper and electronic form. For the purposes of recording share-lending agreements, it is expected that a copy of the master lending agreement, together with electronic recording of individual transactions would be permitted.

### ***Commissioner discretion***

To ensure that a minor breach of the qualification criteria does not disqualify commercial transactions from the new rules, the Commissioner of Inland Revenue will be given a discretion with respect to the term of qualifying transactions and what constitutes a replacement share.

### ***Treatment of returning securities transfers which are not share-lending arrangements***

The second key part of the securities lending proposals is the introduction of new imputation and NRWT rules. The securities lending rules are designed to ensure that imputation credits remain with the economic owner of securities and that NRWT cannot be circumvented. However, because the rules only apply to qualifying transactions, taxpayers could structure transactions outside the qualification criteria. Therefore new imputation and NRWT rules are required to bolster the securities lending rules.

The rules governing the treatment of returning securities transfers are designed to complement existing anti-avoidance provisions. They will apply to returning securities transfers which do not qualify as share-lending arrangements. The new base maintenance rules will apply where:

- A share user receives imputation credits as the holder of an original share acquired under a returning securities transfer.
- A share user makes a replacement payment to a non-resident which is intended to be economically equivalent to a reward of ownership which would be taxable in New Zealand if derived by the share supplier.

Where the new rules apply, the tax benefit obtained will be cancelled by a debit to the ICA account of the share user (if the tax benefit is in the form of imputation credits), or by denying the deduction for the replacement payment (if the tax benefit relates to the non-payment of NRWT).

## **Background**

Securities lending involves the lending of securities to another party for a fee and was developed to allow brokers to transact in securities in which they have a shortfall. Securities lending also provides a relatively risk-free way for larger holders of shares, such as banks, insurance companies, and funds managers, to increase their overall portfolio returns. Internationally, securities lending represents a substantial part of the daily settlement value in many transaction systems and can play an important role in facilitating market liquidity.

New Zealand does not have an onshore securities lending market, at least in part owing to the current tax treatment of these transactions. New Zealand, unlike many other jurisdictions, does not have special tax rules for securities lending. For New Zealand tax purposes, these transactions are taxed on the basis of legal form (a sale of shares) rather than economic substance (a loan), meaning that entering into a securities lending transaction is a taxable event.

There are a number of problems with the current New Zealand tax treatment of securities lending transactions:

- It is inconsistent with international trends.
- It is inconsistent with the economic and accounting treatment of these transactions.
- It is inconsistent with the treatment of other commercial transactions.

There are also base maintenance concerns with respect to the current tax treatment of securities lending transactions. There is evidence that securities lending transactions are being used to trade imputation credits, circumvent the NRWT rules and take advantage of the absence of specific tax rules in this area in New Zealand.

The income tax rules do already include anti-avoidance provisions which may apply to transactions involving transfers of securities. In particular, the current imputation anti-avoidance rule (section GC 22) was designed to ensure that the imputation credits are allocated consistently between shareholders on a basis that reflects actual rights to company cashflows. It is aimed at arrangements where the predominant underlying purpose is to transfer imputation credits from one party who is unable to use those credits to another party who is able to use them.

There is no question that a “tax advantage” arises from an imputation trading arrangement. However, because it can be difficult to determine whether this tax advantage is more than a merely incidental purpose of the arrangement, more certainty is required to protect the tax base.

Proposed changes to the tax treatment of securities lending were set out in the government discussion document, *Taxing securities lending transactions: substance over form*, released in November 2004.

## **Detailed analysis**

The intention of the proposed securities lending rules is to treat a share-lending arrangement as a loan for tax purposes rather than a taxable disposal. To achieve this, a number of changes are required to the Income Tax Act 2004.



### ***Impact of qualifying***

Under new section CX 44B, consideration received by a share supplier when disposing of a share under a share-lending agreement will be excluded income. Similarly, under new section CX 44C, when the share user returns either the original share or a replacement share, the consideration received by the share user is excluded income.

As a result of these amendments a share-lending arrangement should not be a taxable event as would otherwise occur under sections CB 1 to CB 4.

### ***“Cost” of borrowed securities***

A share-lending arrangement would normally be subject to the financial arrangement rules. However, in order to simplify the tax treatment, a change to section EW 5 will mean that a share-lending arrangement is an excepted financial arrangement.

A share supplier will continue to be able to claim a tax deduction for the original cost of acquiring the borrowed shares. However, as the share supplier is effectively treated as never having disposed of the shares amendments are required to ensure that a double deduction is not permitted for the cost of the returned securities. New section DB 12B will prevent a second tax deduction being claimed for the cost of reacquiring the original share or a replacement share.

The share user will be able to claim a deduction for the cost of a share acquired under a share-lending arrangement. However, when the shares are returned to the share supplier, the share user will derive taxable income equivalent to the cost claimed on acquisition of the original shares (new section CD 44). The cost of any replacement shares will still be deductible (new section DB 12C). These sections ensure that the cost of the borrowed shares to the share user is the cost of the replacement securities.

Section CH 1 is being amended to ensure that entering into a share-lending arrangement does not result in a tax adjustment from a change in the value of excepted financial arrangements “on hand”. When a share supplier enters into a share-lending arrangement the disposal of the shares would normally result in a reduction in the value of excepted financial arrangements. This is being countered by allowing the share supplier to include in the closing value of excepted financial arrangements the right to acquire original shares or replacement shares. Section DB 40 is being similarly amended to include the value of a right to acquire an original share or replacement share under a share-lending arrangement in the opening value of excepted financial arrangements.

As a result of these changes, section EA 1 is being amended to include a right to acquire an original share or replacement share in the transactions covered by the excepted financial arrangement matching rules. Section ED 1 will be amended to provide that a right to acquire an original share or re-acquire an original share or replacement share under a share-lending arrangement is valued at cost.

It is also necessary to switch off any section which would still recognise any of the “excluded” legs under the share-lending arrangement and otherwise apply a market value to these. For example, sections ED 2, EW 32 and GD 1.

Finally, new section EW 52B is inserted to ensure that any movement in the value of shares over the term of a share-lending arrangement is not picked up under the financial arrangement rules.

### ***Treatment of distributions***

If a distribution is paid on the original share during the term of the share-lending arrangement, the share supplier must receive a “replacement payment” from the share user. The aim of the replacement payment is to place the share supplier in the same tax position (as far as possible) as if they had received the actual distribution. The entity which issued the securities and any third-party purchaser of the shares should not be affected by the tax treatment of the share-lending arrangement.

The replacement payment will, in most cases, be deductible to the share user. This includes the cost of the imputation credits attached to the replacement payment (new section DB 12E). New section CD 43 ensures that the payments will also be taxable to the share supplier. However, if the replacement payment relates to an amount which would not have been a taxable dividend if it had been received by the share supplier, such as a non-taxable bonus issue, the payment will not be taxable (new section CD 43) or tax deductible (new section DB 12D).

Under the proposed rules, the share user will be required to maintain an ICA in order to attach credits to replacement payments. The share user can fund these credits either out of credits received on the underlying dividend (new section ME 6B), or where they have not received sufficient credits, by paying withholding tax. This payment will be a final tax made as part of the share user’s resident withholding tax return. It will not give rise to a withholding tax credit for the share supplier (amendment to section LD 3). Instead, it will give rise to a credit attached to the replacement payout (new section NF 8B). Credits received on any underlying dividend and subsequently attached to a replacement payment will not generate a tax credit for the share user (amendment to section LB 2).

An amendment is being made to section ME 5 to record a debit to a share user’s ICA where they have received imputation credits on borrowed shares and subsequently attached these to a replacement payment.

Credits received by a share supplier on a replacement payment are subject to the same treatment as normal imputation credits. An amendment is therefore being made to section ME 4 to allow credits attached to a replacement payment (either as a result of the share user passing on credits attached to the underlying dividend or from the share user paying withholding tax) to be entered into their ICA.

Share users will also need to provide a statement to share suppliers similar to a dividend statement. The requirements for the statement will be set out in new section 30B of the Tax Administration Act 1994.

The changes for individual ICAs are replicated in the consolidated ICA rules.

**Example: Fully imputed dividend**

A share supplier lends a New Zealand share to a share user. While the share user holds the original share a dividend of \$67 plus \$33 of imputation credits is paid.

The share user is taxable on the gross dividend plus imputation credits. They make a replacement payment of \$67 and attach \$33 of imputation credits. This is fully deductible leaving them in a neutral position for tax purposes with respect to the distribution. No credit is available for the credits received on the underlying dividend and subsequently attached to the replacement payment.

The share supplier is taxable on the replacement payment plus imputation credits. However, a tax credit is available for the imputation credit received on the replacement. This means (assuming a tax rate of 33%) that no further tax is payable by the share supplier.

**Example: Dividend with no imputation credits**

A share supplier lends a New Zealand share to a share user. The share user sells the share to a third party. During the term of the share-lending arrangement a dividend of \$100 (nil imputation credits) is paid.

The share user makes a replacement payment of \$67 and attaches \$33 of imputation credits. As the share user did not receive any credits on the underlying dividend, they are required to pay \$33 of withholding tax to pay for these credits. However, the replacement payment and imputation credits are fully deductible, leaving them in a neutral position for tax purposes with respect to the distribution.

The share supplier is taxable on the replacement payment plus imputation credits. However, a tax credit is available for the imputation credits received on the replacement payment. This means (assuming a tax rate of 33%) that no further tax is payable by the share supplier. There is no credit for the withholding tax as the share supplier received imputation credits instead.

### ***Withholding tax***

As mentioned above, a share user under a share-lending arrangement is required to attach imputation credits to a replacement payment either by passing on credits received on the underlying dividend or by generating credits through paying withholding tax.

To reduce compliance and administration costs, the withholding tax will be part of the resident withholding tax rules. The resident withholding tax rules are therefore being amended to apply to replacement payments made under share-lending arrangements (amendments to sections NF 1 and NF 4).

A new formula is being inserted into section NF 2 to calculate the amount of withholding tax payable on share-lending arrangements. The formula will effectively require RWT to be paid for any amount of replacement payment not fully imputed by credits from the underlying dividend.

The rate of withholding tax will be 33%. Amendments are being made to sections NF 2A, NF 2B, NF 2D and Schedule 14 to ensure this.

### ***Impact of ceasing to qualify***

Taxpayers will be required to determine whether a transaction qualifies as a share-lending arrangement at the start of a transaction and apply the new tax treatment from commencement.

If a taxpayer mistakenly treats a transaction as qualifying for the securities lending rules when they should not have done so, the taxpayer will need to restate the entire tax treatment of the transaction. Use-of-money interest and penalties could apply depending on the particular circumstances that gave rise to an incorrect tax treatment being adopted.

### ***Returning securities transfers which are not share-lending arrangements***

The securities lending rules are designed to ensure that imputation credits remain with the economic owner of securities and that NRWT cannot be circumvented. This includes where transactions qualify as returning securities transfers but are not share-lending arrangements.

Where the new rules apply, the tax benefit obtained will be cancelled. When the tax benefit is in the form of additional credits, this will occur by a debit to the ICA account of the share user (amendment to section ME 5). The debit will occur when a share user receives imputation credits on borrowed shares under a returning securities transfer which is not a share-lending arrangement.

If the tax benefit relates to the non-payment of NRWT, it will be cancelled by denying a deduction for the replacement payment, as set out in new section DB 12D. The deduction will be denied where:

- a share user makes a replacement payment under a returning securities transfer;
- the share supplier is non-resident;

- the replacement payment is not assessable income of the share supplier;
- the replacement payment is intended to be economically equivalent to a reward of ownership in relation to the original share that would be assessable income if derived by the share supplier; and
- the transaction is not a share-lending arrangement.

This is intended to deny a deduction where a share user makes a payment to a non-resident share supplier to compensate them, in whole or in part, for a dividend which would otherwise be subject to New Zealand NRWT.



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# Allocation of research and development tax deductions

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## **ALLOCATION OF RESEARCH AND DEVELOPMENT TAX DEDUCTIONS**

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*(Clauses 37, 38, 52 and 62)*

### **Summary of proposed amendments**

Amendments will allow taxpayers to allocate certain research and development (R&D) tax deductions to income years after the year in which the related expenditure (including a depreciation loss) is incurred. This means that deductions will not be lost if there is a shareholding change between when the expenditure is incurred and when the deduction is recognised by the taxpayer. This tax treatment will be optional. However, those who choose this approach must allocate R&D deductions against income resulting from R&D expenditure.

Companies that bring in new equity investors will have better access to tax deductions for R&D expenditure under the proposed amendments. Technology companies, in particular, often have a long lead-in period in which they incur major expenditure before realising income from it. Under current law they can lose R&D tax deductions if they bring in new investors after their initial development stage.

The changes will better suit the growth cycle of technology companies and remove a barrier to R&D investment by allowing R&D tax deductions to be matched with related income.

### **Application date**

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

### **Key features**

The amendments will better match the timing of deductions for R&D expenditure (including depreciation losses) with the timing of income resulting from R&D expenditure. Current tax law can result in deductions for R&D expenditure being inappropriately lost when companies bring in new equity investors. The new treatment will not be affected by changes in shareholding arising from companies bringing in new investors.

### ***Amounts qualifying for new allocation treatment***

Three types of R&D tax deductions will qualify for the new treatment and therefore be able to be allocated to income years after the year in which the related expenditure or depreciation loss is incurred:

- Deductions for expenditure covered by the main R&D deduction provision in section DB 26 of the Income Tax Act 2004 (proposed section DB 26(6B) of the Income Tax Act 2004).

- Deductions for depreciation losses under subpart EE of the Income Tax Act 2004 for property used in carrying out R&D (proposed section EE 1(4B) of the Income Tax Act 2004).
- Deductions for expenditure incurred on the market development for a product resulting from R&D expenditure. This market development expenditure needs to be incurred before the person first derives assessable income from the use of the product or before the start of commercial production of the product. The deductions for market development expenditure must already be allowed under the Act – for example, under the general permission in section DA 1 of the Income Tax Act 2004 (proposed section EJ 20 of the Income Tax Act 2004).

The proposed new allocation treatment for R&D expenditure will be optional. Therefore taxpayers who wish to continue to deduct their R&D expenditure or depreciation loss or their market development expenditure in the year it is incurred under section BD 4(2) of the Income Tax Act 2004 can do so.

Taxpayers can choose how much of a qualifying deduction will be allocated to a future income year. The amount not allocated under the new treatment will be deducted in the year the relevant expenditure or depreciation loss is incurred.

The new treatment will be available to all taxpayers with R&D expenditure and not just those whose main activity is R&D. This is because the principle of achieving a better matching of the timing of deductions for R&D expenditure with the timing of income resulting from the expenditure is of general application.

R&D expenditure covered by section DB 26 of the Income Tax Act 2004, and therefore by this proposed allocation treatment, includes overhead costs (other than interest) such as rent and power. In the case of a company whose business does not consist solely of R&D it will be necessary for the taxpayer to conduct an apportionment on a reasonable basis of overhead expenses between its R&D function and other functions.

Interest expenditure will be excluded from this treatment as a tax base protection measure.

The new provisions use the definitions of “research” and “development” contained in Financial Reporting Standard FRS 13: *Accounting for Research and Development Activities*. These definitions are already used in section DB 26.

In the case of a start-up technology company, which typically incurs significant expenditure for a long period before any income is realised, most of its pre-commercial production expenditure would qualify for this new deduction allocation treatment.

#### ***Allocation of deductions under new treatment***

Taxpayers may choose to allocate deductions that qualify for the new treatment to an income year after the income year in which they incur the relevant expenditure or depreciation loss.

If they choose to use the new allocation treatment they must allocate the deductions in accordance with new section EJ 21. This provision will generally require taxpayers to allocate a deduction to an income year in which they derive assessable income that they would not have derived but for R&D expenditure that gives rise to a deduction that may be allocated under new section EJ 21 (or the use of property for which the taxpayer has a deduction for a depreciation loss that may be allocated under the new treatment).

The assessable income referred to in proposed section EJ 21 includes any amount treated as assessable income under the Income Tax Act 2004, for example, depreciation recovery income.

The amount of qualifying tax deductions (that is, deductions for R&D expenditure and depreciation losses and market development expenditure) allocated to a particular income year under this new treatment will be the lesser of:

- the amount of the assessable income that would not have been derived but for the relevant R&D expenditure (including depreciation loss); and
- the amount of the qualifying deductions that has not been allocated to earlier income years.

Therefore, taxpayers who choose to use this treatment will be required to allocate the qualifying tax deductions to an income year to the extent of any income derived in that year resulting from the relevant R&D expenditure or depreciation loss.

This requirement is necessary as a tax-base protection measure to ensure that taxpayers do not use their R&D tax deductions to shelter their non-R&D income. Accordingly, the relevant R&D tax deductions cannot be deducted against unrelated income. The requirement is also consistent with the policy underlying the new treatment of achieving a better matching of deductions for R&D expenditure with the income resulting from that expenditure.

#### **Example**

A start-up technology company incurs \$5 million of expenditure on developing biotechnology products in the first five years of its existence. This amount includes deductions for depreciation losses on equipment used in carrying out the R&D and expenditure on surveys to gauge market interest in these products. The company utilises the new deduction allocation treatment for R&D (including market development) expenditure. At the end of this period the company has developed several innovative products which have significant commercial potential. The company brings on board new investors to fund the next stage of development which would lead to the start of commercial production of the products. Under previous tax laws, introducing new investors in a company could result in deductions for previous R&D expenditure being forfeited. However, under the new deduction allocation treatment for R&D expenditure the company's tax deductions are preserved until they can be offset against income resulting from the company's R&D products.

Taxpayers will also be able to allocate any deduction to which section EJ 21 applies to the current year if they would have been entitled under Part I of the Income Tax Act 2004 to carry forward to that year a net loss from the year in which they incurred the expenditure (or the depreciation loss arose) to which the deduction relates. In particular, this means that a company must have satisfied for the relevant period the shareholder continuity requirements in section IF 1 of the Income Tax Act 2004. This rule ensures that taxpayers do not have less flexibility in using their tax deductions for R&D expenditure than if they had not chosen to use the new allocation treatment.

Taxpayers' decisions on the amount of R&D tax deductions allocated under the new treatment will be reflected in the tax positions they take in their returns of income for each tax year. In line with normal tax treatment, these tax positions are binding on the taxpayer unless disputes procedures are initiated within the applicable response periods. The Commissioner will not consider it appropriate, outside a dispute, to exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment to adjust the amounts allocated under the new treatment.

## **Background**

This R&D deduction allocation reform is part of the government's Growth and Innovation Framework, which emphasises the importance of the technology sector to the country's economic and social development.

Four private-sector taskforces were established as part of the government's Growth and Innovation Framework to formulate policy initiatives to best develop sectors of the economy seen as key to New Zealand's future economic performance. They were: the Biotechnology Taskforce, the Information and Communications Technology (ICT) Taskforce, the Design Industry Taskforce and the Screen Production Industry Taskforce.

As part of their 2003 report, the taskforces made various recommendations, including several on tax-related issues. One tax issue raised by both the Biotechnology and ICT taskforces was the relaxation of the current loss carry-forward rules. The entry of new equity investors can currently result in any accumulated tax deductions (generally tax losses) being lost because of a breach of the shareholder continuity requirements for carrying forward tax losses.

The current tax rules broadly provide that a company can carry forward and offset its tax losses only where the tax benefit arising from the offset is obtained by at least 49% of the natural person shareholders who originally bore the loss.

The Biotechnology and ICT taskforces recommended that the government consider changing the tax rules to preserve tax losses where business continuity is maintained even though shareholder continuity is lost.

The government did not favour a general business continuity test to supplement the shareholder continuity test for the following reasons:

- It is contrary to the main policy underlying the loss carry forward rules, which is to prevent the trading of losses between unrelated parties.
- It is the experience of other countries that the test is difficult to apply in practice, creating both complexity and uncertainty.
- A general business continuity test could potentially lock companies into businesses that are only marginally profitable and do not represent the best use of capital.
- A general business continuity test could have significant revenue implications.

The government has continued to explore further options to remove any tax barriers to the growth of the technology sector in New Zealand.

The amendments in this bill are the outcome of this work.

### ***Current R&D tax rules***

The tax treatment of most R&D expenditure is covered by section DB 26 of the Income Tax Act 2004. That section allows taxpayers a deduction for R&D expenditure if the expenditure does not satisfy all the asset recognition criteria contained in Financial Reporting Standard FRS 13: *Accounting for Research and Development Activities*. These criteria are designed to approximate the point at which the R&D expenditure gives rise to a valuable asset.

Although most R&D expenditure is currently deductible, shareholding changes arising from the normal growth cycle of a technology company can, as outlined above, result in these deductions not being able to be used.

### ***Policy issues***

The amendments are based on achieving a better matching of the timing of tax deductions for R&D expenditure with the timing of income resulting from that expenditure. This treatment recognises that taxpayers in the development period of an R&D project are developing assets for the purpose of earning income in future periods instead of incurring economic losses in the initial development stage.

The current tax treatment results in R&D expenditure being recognised too early in relation to when the resulting income is recognised. However, the expenses are better viewed as developmental rather than operational expenses.

The current mismatch in the early recognition of expenditure and the later recognition of income means that deductions for R&D expenditure of a company may be inappropriately lost when there is a shareholding change in the company.

Current tax rules are problematic for the growth cycle of technology companies because these companies typically have a long lead-in period where significant expenditure is incurred before any income is realised. It is part of the normal financing process for such companies to bring in additional equity investors after the initial development work has been successful. If tax deductions for that development work cannot be used because of shareholding changes it can effectively result in technology companies being taxed on their gross income. This is not an appropriate result given that the purpose of the Income Tax Act 2004 is to tax mainly net income.

The proposed treatment will better suit the growth cycle of technology companies as deductions for R&D expenditure will not be affected by changes in shareholding resulting from technology companies bringing in new investors.

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# Corporate migration

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## **CORPORATE MIGRATION**

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*(Clauses 9, 11, 78, 106, 111 to 113, 143(10), 191, 195 to 199, and 200(2))*

### **Summary of proposed amendments**

The bill introduces changes announced in March to ensure that migrating companies pay tax on their worldwide income earned while resident in New Zealand. The changes are intended to remove incentives for companies to migrate for tax reasons.

The existing tax rules that apply on the liquidation of a New Zealand company will also apply in the event of a company ceasing to be a New Zealand resident. Thus, for tax purposes, a migrating company will be treated as if it had been liquidated and paid a distribution to its shareholders. The distribution will be subject to tax as a dividend under the usual rules.

Consequential technical amendments are also being made to the dividend withholding payment and conduit rules. For consistency with current imputation rules, a company that ceases to be resident will also cease to be a dividend withholding payment (DWP) account company and a conduit tax relief (CTR) company.

### **Application date**

The amendments (apart from the changes to the dividend withholding payment and conduit rules) will apply from 21 March 2005, the date of announcement. The amendments to the dividend withholding payment and conduit rules will apply from 1 April 1997 to remove any potential for taxpayers to claim a refund for any tax paid under the existing legislation.

### **Key features**

When a company ceases to be a New Zealand tax resident, the company will be treated as if it had been liquidated and paid a distribution to its shareholders.

This means that the existing tax rules that apply on the liquidation of a New Zealand company will also apply in the event of a company ceasing to be a New Zealand resident for income tax purposes.

The company will first be treated as disposing of its property at market value immediately before it ceases to be a New Zealand resident. Under existing legislation, certain amounts (such as gains in the value of revenue account property and excess depreciation deductions) will be subject to tax. This is consistent with the current treatment of financial arrangements and foreign investment funds when a company ceases to be a New Zealand resident.

The company will then be treated as having distributed all shareholder funds (which will include the proceeds of the deemed disposal) to its shareholders.

While realised capital reserves will generally be excluded from the distribution, a consequence of alignment with the liquidation rules is that they will be included for non-resident related company shareholders.

The amount of the deemed dividend will therefore vary between certain shareholders as shown in the table 1.

**Table 1: Treatment of shareholder dividends**

<b>Resident shareholder</b>	<b>Non-related non-resident shareholder</b>	<b>Related non-resident company shareholder</b>
Dividend subject to RWT = shareholder funds, less available subscribed capital and realised capital reserves.	Dividend subject to NRWT = shareholder funds, less available subscribed capital and realised capital reserves.	Dividend subject to NRWT = shareholder funds, less available subscribed capital.

In accordance with the usual tax rules applicable to dividends, a migrating company will be required to withhold tax from a deemed dividend distribution immediately before it ceased to be a New Zealand resident company, under the resident withholding tax (RWT) or non-resident withholding tax (NRWT) rules, as appropriate.

Under the current rules, RWT on dividends applies at the rate of 33%. A dividend distribution to a resident shareholder will then be taxed at the shareholder's marginal tax rate, less imputation credits attached by the company.

A dividend distribution to a non-resident shareholder will be taxed at 30% if the shareholder is a resident of a non-treaty country and the dividend is not fully imputed or credited with dividend withholding payments. If the treaty so provides, NRWT at 15% will apply to a dividend distribution to a shareholder from a treaty country or a shareholder from a non-treaty country if the dividend is fully imputed or credited.

Property will be treated as being re-acquired by the company at the same market value for which it was treated as being disposed of at the time of migration. For property that continues to be subject to tax in New Zealand after a company's migration (for example, standing timber situated in New Zealand), this will establish a new cost base to apply in the event of a subsequent disposal.

To remove potential double taxation in the event that, subsequent to its migration, a non-resident company pays a dividend to its shareholders, the amount of the distribution deemed to have been paid immediately before the company migrated is added to the company's available subscribed capital (which can be distributed tax free to shareholders in certain circumstances).

### ***Consequential technical amendments***

If a New Zealand-resident company migrates, it will cease to be a dividend withholding payment company and a conduit tax relief company. Its accounts will close and a debit adjustment made to bring any credit balance to nil. To recover the amount of conduit tax relief provided while the company was resident, a conduit tax relief company will also be required to make an additional dividend withholding payment of the amount of any credit balance in its conduit tax relief account.

## **Background**

### ***Applying the liquidation rules***

A company has migrated from New Zealand if it is no longer a resident company for New Zealand income tax purposes. This generally happens when companies transfer their place of incorporation overseas.

For New Zealand income tax purposes, a non-resident company:

- is not incorporated in New Zealand;
- does not have its head office in New Zealand;
- does not have its centre of management in New Zealand; and
- is not controlled by its directors in New Zealand.<sup>5</sup>

A company resident in New Zealand is liable to New Zealand tax on its worldwide income. However, a company is currently able to migrate without having necessarily paid tax on income that was earned while it was resident.

For example, any increase in the value of property situated outside New Zealand that accrued when a company was resident in New Zealand is not subject to New Zealand income tax if the company migrates and the property is then sold.<sup>6</sup> Income tax deductions may have been previously allowed in relation to the property on the assumption that there would be a resulting income stream that would be taxable in New Zealand.

Similarly, other income generated when a company is resident in New Zealand may not be subject to New Zealand tax until a distribution is made to the company's shareholders. However, when a company has migrated, distributions made to non-resident shareholders would not be taxed in New Zealand at all as the company is no longer a New Zealand-resident company. Distributions to resident shareholders would still be subject to tax, although offset to some extent by credits for tax paid on the distribution in the company's new country of residence.

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<sup>5</sup> Section OE 2 of the Income Tax Act 2004.

<sup>6</sup> Unless the property is a financial arrangement or a foreign investment fund interest.

A company that remains incorporated in New Zealand but moves its place of management to another country could also be treated as resident in the other country. In this type of situation, the company will not be considered to have migrated (because it remains a New Zealand resident company for New Zealand income tax purposes) and the new tax rules will not apply to it. It follows that if a dual resident company is treated as resident in another country under a double tax treaty the new rules will similarly not apply.

### ***Company law***

The Companies Act 1955 required the liquidation and discontinuation of the legal personality of a company before it could be removed from the New Zealand register of companies. Distributions made to shareholders on the liquidation of a New Zealand company are treated as a dividend.

In contrast, the Companies Act 1993 allows a company to transfer its place of incorporation offshore and become a non-resident company without the need to liquidate and pay New Zealand income tax. This has created a tax incentive for companies to migrate rather than liquidate.

Applying the same tax treatment to both liquidating and migrating companies will remove the existing tax incentive to migrate rather than liquidate, and increase the neutrality of the tax system.

### ***Dividend withholding payment and conduit tax relief accounts***

In most cases, a New Zealand-resident company must have an imputation credit account. When a company ceases to be a New Zealand resident, its imputation credit account must close and a debit adjustment made to bring any credit balance to nil.

A New Zealand-resident company may elect to maintain a dividend withholding payment (DWP) account to record credits for the amount of DWP paid by the company on foreign dividends it receives. These DWP credits are available for allocation to its shareholders. The company may also elect to be a conduit tax relief (CTR) company to obtain New Zealand tax relief on its foreign-sourced income to the extent of its foreign shareholding.

The company may subsequently elect to cease to be a DWP account company (and a CTR company). An election may not necessarily be made when a company migrates from New Zealand. If an election is made, the company's DWP accounts will close and a debit adjustment made to bring any credit balance to nil. To recover the amount of CTR provided while the company was resident, a CTR company is also required to pay additional DWP of the amount of any credit balance in its CTR account.

If a company ceases to be a New Zealand-resident company it is required to file a DWP account return but does not cease to be a DWP account company or a conduit tax relief (CTR) company. The DWP and conduit rules are being amended to ensure that the same treatment that applies to an imputation credit account company ceasing to be a New Zealand resident will also apply to DWP and CTR companies. Therefore if a company ceases to be a New Zealand-resident company, it will automatically cease to be a DWP account company and a CTR company and may be required to pay additional DWP. These amendments are in line with the policy intent of the DWP and conduit rules, and can be regarded as correcting an anomaly.

## **Detailed analysis**

### ***Deemed liquidation rules***

New subpart FCB contains the tax rules for migrating companies. New section FCB 1 is the purpose provision for the subpart. It will apply to a company resident in New Zealand that ceases to be a New Zealand resident for the purposes of New Zealand income tax. The company will be subject to the tax rules that apply when:

- a company disposes of its property at market value;
- is liquidated; and
- distributes shareholder funds (including the deemed disposal proceeds) to its shareholders.

Under new section FCB 2 a migrating company is treated as if, immediately before it became a non-resident company, it had paid as a cash dividend to its shareholders, the amount that would be available for distribution if the company had disposed of its property at market value and gone into liquidation.

Proposed section CD 18(1) provides that section CD 18 (which defines dividends on liquidation) will also apply if an amount is treated as being paid to shareholders of a migrating company. Therefore the amount in excess of the available subscribed capital per share and the available capital distribution amount will be a dividend. In relation to amounts paid to non-resident related companies, paragraph (c)(ii) of the definition of “dividend” in section OB 1 provides that only the amount in excess of available subscribed capital per share will be a dividend.

Under existing section ME 6 a migrating company will be entitled to attach existing imputation credits to distributions made under subpart FCB. Amendments to section ME 6 will allow a company to retrospectively attach imputation credits to a dividend arising from the migration. Tax paid that is attributable to the migration will be treated for imputation purposes as being paid immediately before the company ceases to be a New Zealand resident. For example, a company may have migrated before the new tax rules for migrating companies are enacted. The company will be able to attach the amount of the imputation credits available immediately before the company ceased to be New Zealand resident to a deemed dividend arising under the new legislation.

The amount that is treated as being paid to a resident shareholder will be resident withholding income to which the RWT rules in subpart NF apply.

The amount that is treated as being paid to a non-resident shareholder will be non-resident withholding income to which the non-resident withholding tax rules in subpart NG apply.

The due date for payment of the withholding tax by the company will be no later than the 20<sup>th</sup> of the month following the deduction of RWT or NRWT from the withholding income.

New section CD 32(15B) removes potential double taxation in the event that a migrating company subsequently pays a dividend to its shareholders. It provides that the amount of the dividend a migrating company is treated as having paid to shareholders immediately before the company migrated from New Zealand is added to the company's available subscribed capital that may be returned to shareholders tax free in certain circumstances.

New section FCB 3 provides that a migrating company is treated as disposing of all property at market value immediately before it ceases to be a New Zealand resident. In that income year, gains in the market value of revenue account property will be subject to tax under existing legislation (for example, section CB 3 or CB 4) and excess depreciation deductions will be recovered under existing section EE 41.

The section also treats the company as re-acquiring the property for the same market value for which it was treated as having been disposed of at the time of migration. This will establish a new cost base for property that will continue to be subject to tax in New Zealand.

### ***Amendments to the dividing withholding payment and conduit rules***

New section MG 2(6) provides that a migrating company ceases to be a dividend withholding payment (DWP) account company. New section MG 2(7) provides that the company must furnish a DWP return and pay any further DWP payable under section MG 9.

New section MI 2(8) provides that an emigrating company also ceases to be a conduit tax relief company and must furnish an imputation return and, under section MI 10(3), pay DWP of the amount of any credit balance in its conduit tax relief account.

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### **Example: Migration of a New Zealand company**

S Ltd was incorporated in New Zealand in 1995 and issued 140,000 ordinary shares at \$2 each to resident shareholders and 60,000 ordinary shares at \$2 each to non-resident shareholders (40,000 of those shares are held by related non-resident companies).

The shareholders resolve to transfer S Ltd's place of incorporation and its directorial and managerial functions offshore. S Ltd has a realised capital profit of \$150,000 and revenue reserves of \$300,000. S Ltd also owns shares held on revenue account in a company that owns commercial rental property in Wellington. The market value of these shares is \$500,000. They were purchased for \$450,000. S Ltd also owns a New Zealand-registered patent worth \$250,000. The cost of the patent was \$200,000, and depreciation deductions of \$50,000 have been claimed.

S Ltd's imputation credit account has a credit balance of \$100,000.<sup>7</sup>

### ***Disposal rules***

Under new section FCB 3, S Ltd will be treated as disposing of all its property at market value immediately before ceasing to be a New Zealand resident.

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<sup>7</sup> A company could make use of the foreign investor tax credit rules by paying a fully imputed dividend and a supplementary dividend to its non-resident shareholders before it ceases to be a New Zealand resident company.

The taxable amount from the disposal of the patent is \$100,000 (market value less cost (reduced by the amount of depreciation already claimed)).<sup>8</sup> The taxable amount from the disposal of the shares is \$50,000 (market value less cost).<sup>9</sup> Under the proposed amendments, S Ltd's tax liability on the deemed disposal of its revenue account property is therefore \$49,500, and the tax paid is credited to S Ltd's imputation credit account.

The company that owns the commercial property will remain in New Zealand, and the patent is registered in New Zealand. Therefore future income derived from the shares and the patent will continue to be subject to New Zealand tax.<sup>10</sup> Under new section FCB 2, S Ltd will be treated as re-acquiring the shares at \$500,000 and the patent at \$250,000, which will establish new cost bases for those assets.

### ***Liquidation rules***

Under new section FCB 2, S Ltd will be treated as if it had been liquidated and distributed all available amounts (being shareholder funds and the disposal proceeds) to its shareholders immediately before it became a non-resident company.

The total amount deemed to have been distributed by S Ltd to its shareholders is \$4.75 per share.<sup>11</sup>

In calculating the amount of the dividend paid by S Ltd it is first necessary to exclude capital amounts from total funds. For these purposes, capital amounts comprise the amount of ASC per share and, for shareholders that are not related non-resident companies, the available capital distribution amount.

Applying the formulae in the legislation, ASC per share is calculated as \$2, and the available capital distribution amount is 75 cents. Therefore the tax-free capital component of the amount distributed by S Ltd in respect of each share held by a shareholder that is not a related non-resident company is \$2.75, and the remaining \$2 per share (representing revenue reserves) is taxable to each shareholder as a dividend.

S Ltd may attach imputation credits of 70 cents per share<sup>12</sup> to dividends paid to its shareholders.

### ***Resident shareholders***

The total amount received per share by resident shareholders on S Ltd's migration is \$4.75, of which \$2.75 (being \$2 + \$0.75) is tax-free. The remaining \$2 per share is taxable to each shareholder as a dividend. The attached imputation credits of 70 cents per share can be used to satisfy the shareholder's income tax liability.

S Ltd is required to withhold resident withholding tax (RWT) from the dividends paid to resident shareholders. S Ltd's RWT amount per share is 19 cents.<sup>13</sup> S Ltd's total RWT amount is \$26,600.<sup>14</sup>

Under new section CD 32(15B), the amount of the distribution treated as a dividend is included in the subscriptions amount that S Ltd could return to shareholders tax-free.

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<sup>8</sup> See section CB 26, DB 29 and DB 31.

<sup>9</sup> See section CB 1.

<sup>10</sup> Assuming that there are no DTA implications.

<sup>11</sup>  $(400,000 + 150,000 + 300,000 + 150,000 - 49,500) / 200,000$ . Note that all figures in this example have been rounded to two decimal places.

<sup>12</sup> Existing imputation credit rules require the same imputation credit ratio to apply to all distributions within an income year. Applying this rule to the total imputation credit account balance of 149,500 allows dividends to resident shareholders to have 70 cents per share of imputation credits attached.

<sup>13</sup>  $((2 + .70) \times .33) - .70$

<sup>14</sup>  $.19 \times 140,000$

### *Non-related non-resident shareholders*

The total amount received per share by non-related non-resident shareholders on S Ltd's migration is \$4.75, of which \$2.75 (being \$2 + \$0.75) is tax-free. The remaining \$2 per share is taxable to each shareholder as a dividend.

S Ltd is required to withhold NRWT from dividends paid to non-related non-resident shareholders. S Ltd's NRWT amount per share held by these shareholders is 30 cents.<sup>15</sup> S Ltd's total NRWT amount in relation to these shareholders is \$6,000.<sup>16</sup>

### *Related company non-resident shareholders*

The amount of the dividend to the related non-resident company shareholders subject to NRWT is the amount paid in excess of ASC per share.

The total amount paid to related non-resident company shareholders on S Ltd's migration is \$4.75, of which \$2 is tax-free. The remaining \$2.75 (representing revenue reserves and capital profits) is taxable to the company shareholder as a dividend subject to NRWT. S Ltd's NRWT amount per share held by these shareholders is 41 cents.<sup>17</sup> S Ltd's total NRWT amount in relation to these shareholders is \$16,400.<sup>18</sup>

These calculations are summarised in table 2.

**Table 2: Summary of tax calculations**

	<b>Total (200,000 shares)</b>	<b>Resident shareholders (140,000 shares)</b>	<b>Non-related non-resident shareholders (20,000 shares)</b>	<b>Related non-resident company shareholders (40,000 shares)</b>
Distribution	\$950,500	\$4.75	\$4.75	\$4.75
ASC	\$400,000	\$2.00	\$2.00	\$2.00
Available capital distribution amount	\$150,000	\$0.75	\$0.75	\$0.00
Taxable amount	\$430,000	\$2.00	\$2.00	\$2.75
Imputation credits	\$149,500	\$0.70	\$0.70	\$0.70
RWT	\$26,600	\$0.19	–	–
NRWT	\$22,400	–	\$0.30	\$0.41

<sup>15</sup> .15 x 2 (assuming that the standard NRWT treaty rate of 15% applies).

<sup>16</sup> .3 x 20,000

<sup>17</sup> .15 x 2.75

<sup>18</sup> .41 x 40,000



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Temporary exemption from tax  
on foreign income for new  
migrants and certain returning  
New Zealanders

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## **TEMPORARY EXEMPTION FROM TAX ON FOREIGN INCOME FOR NEW MIGRANTS AND CERTAIN RETURNING NEW ZEALANDERS**

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*(Clauses 12, 14, 19, 20, 22, 43, 44, 63, 65, 66, 68, 69, 72, 76, 86, 87, 90, 141, 143(20), (30), (35), (40), and (80), 155(10), (15), (20), (25), and (38), 163, and 170)*

### **Summary of proposed amendments**

A number of amendments are being made to remove the tax barriers inhibiting international recruitment to New Zealand.

A two-tiered exemption will be introduced. The first tier proposes a five-year exemption for employees and the second tier a three-year exemption for all new migrants. In both cases the exemption will be from all foreign income except dividends, interest, employment income and business income relating to the supply of services. To qualify, an individual must not have been tax resident in New Zealand for at least 10 years.

### **Application date**

The amendments will apply from 1 April 2006 for people arriving in New Zealand on or after this date, with application from the 2005-06 income year and subsequent income years.

### **Key features**

New part 5B in the Tax Administration Act 1994 deals with the certification requirements.

#### ***Certified residents and certificates***

New section 91K allows for people who have been non-tax resident for 10 tax years to qualify as a certified resident and eligible for a resident certificate. It defines who is eligible for the employment resident certificate, the general resident certificate and the dependent resident certificate.

#### ***Applying for a new-resident certificate***

A new section 91L details who may apply for a new-resident certificate and the conditions that need to be satisfied in the application.

#### ***Issuing a certificate***

Section 91M allows the Commissioner of Inland Revenue to issue a new-resident certificate and states what is required on the certificate.

### ***Change in situation***

Section 91N requires individuals to notify the Commissioner in writing of any changes in circumstances that may affect the eligibility of the individual.

### ***Withdrawal or surrender of certificate***

Section 91O allows the Commissioner to withdraw a resident certificate if satisfied that the certificate is incorrect. Furthermore, the holder of a certificate may surrender the certificate at any time by returning it to the Commissioner.

### ***Other changes***

Section 61 will be amended so that certified residents do not have to disclose any interests in a foreign company and foreign investment fund.

The Income Tax Act 2004 is being amended as follows:

### ***Definitions***

Section OB 1 of the Income Tax Act 2004 will be amended to include definitions relevant to these changes. A certified resident is a person who holds a relevant new-resident certificate.

The definitions are replicated in section 3(1) of the Tax Administration Act 1994.

### ***Types of income exempt***

#### ***Foreign sourced income***

A new section will be included in subpart CW that allows certified residents to be exempt from all foreign-sourced income except dividends, interest, employment income, and business income relating to the supply of services.

#### ***CFC rules***

Certified residents will be exempt from the controlled foreign company (CFC) rules. Section CQ 2 is amended so attributed CFC income does not arise if the individual holding an interest in the foreign company is a certified resident. Section DN 2 will also be amended so CFC losses do not arise if an individual holding the interest in a foreign company is a certified resident.

#### ***FIF rules***

Certified residents will be exempt from the foreign investment fund (FIF) rules. Section CQ 5 will be amended so FIF income does not arise if an individual holding an interest in a foreign fund is a certified resident. Section DN 6 will also be amended so that FIF losses do not arise if an individual holding an interest in a foreign fund is a certified resident.

### *Accrual rules*

Part EW will be amended so that the accrual rules do not apply to foreign financial arrangements of certified residents.

### *Share options*

Section CE 2 will be amended so that if a certified resident derives an employee share option while non-resident and exercises the option while a certified resident, then the value of any benefit will be zero.

### *Trusts*

Section HH 2 is being amended to provide that a trust is deemed a foreign trust for the duration of the exemption if the settlor is a certified resident. This means that the 12-month period for an election for a foreign trust to become a qualifying trust will begin on the date that the individual is no longer a certified resident.

Section HH 4 is also being amended to provide that if the settlor is a certified resident, the trustee will not be subject to tax on income derived from outside New Zealand.

### *NRWT*

An addition will be made to section NG 2(1)(b) to remove the requirement of certified residents to withhold NRWT on foreign mortgages.

### *Other changes*

The definition of “qualifying person” in section KD 3 and in section OB 1 will be amended to exclude certified residents and their spouses. The effect will be that certified residents will not be eligible for any form of family assistance.

## **Background**

People coming to New Zealand from overseas may face extra tax costs compared with what they would face at home or in other countries. Often these extra tax costs are passed on to New Zealand businesses who recruit these people or who use their services. This occurs because the individual often negotiates higher remuneration to compensate for the extra tax burden.

In 2001 the Tax Review recommended, in its *Final Report*, that individuals with no previous connection to New Zealand who are resident for tax purposes should be taxed only on their New Zealand-sourced income for the first seven years.

The government discussion document, *Reducing tax barriers to international recruitment to New Zealand*, was released in November 2003. It proposed that an exemption be provided for new migrants and expatriates who come to work in New Zealand. The central aim of the proposal is to reduce the costs to New Zealand businesses associated with recruiting highly skilled, mobile, individuals.

The discussion document advanced two potential options for an exemption for migrant employees:

- A seven-year exemption from the most comprehensive aspects of our international tax rules, including the controlled foreign company rules (CFC), the foreign investment fund rules (FIF), accrual rules, non-resident withholding tax and the approved issuer levy, and possibly trust rules and share option rules (the narrow option).
- A three-year exemption from all foreign income of any description (the broad option).

Fifteen submissions were received on the proposals in the discussion document. Most welcomed the proposal. The policy decisions are designed to reflect the concerns raised by submitters.

## **Detailed analysis**

### ***Scope of the exemption***

The narrow option ensures that individuals are not disadvantaged by choosing to come to New Zealand rather than go to other countries. The broad option offers a tax incentive. The scope of the proposed amendment lies between the narrow and broad option. The exemption is from tax on all foreign income except dividends, interest, employment income and business income relating to services performed offshore. It includes:

- controlled foreign company income that is attributed under our CFC rules;
- foreign investment fund income that is attributed under our FIF rules (including foreign superannuation);
- non-resident withholding tax on foreign mortgages;
- approved issuer levy on foreign mortgages;
- taxation arising from the exercise of employee share options;
- accrual income (from foreign financial arrangements);
- income from foreign trusts;
- rental income derived offshore;
- royalties derived offshore;
- gains on the sale of property derived offshore (held on revenue account); and
- offshore business income (that is not related to the performance of services).

This would eliminate those taxes that are generally passed on to New Zealand employers and temporarily relieve migrants of the most compliance-cost intensive aspects of returning foreign income in New Zealand. Those eligible would continue to be taxed on New Zealand-sourced income.

The reason for continuing to tax dividends and interest is because people in most countries expect to pay tax on these items. The reason for continuing to tax employment income and business income relating to services performed offshore is to prevent New Zealand-sourced income from being re-characterised as foreign-sourced income.

### ***Eligibility***

The amendments will apply to new and returning residents who are natural persons and have not been tax-resident for at least 10 tax years. Returning New Zealanders can be as sensitive to New Zealand taxes as new migrants in making their decision about where to seek future employment. The 10-year non-residence rule is required to target those New Zealanders who have emigrated from New Zealand on a permanent basis and have, therefore, become as sensitive as a new migrant to New Zealand's taxes on foreign-sourced income.

### ***Applying for a new-resident certificate***

The new section 91L of the Tax Administration Act 1994 provides that an individual can apply for a new-resident certificate if the application is made before the end of the tax year. The application must:

- be in the prescribed form;
- specify the tax file number of the person or be accompanied by an application by the person for a tax file number;
- be signed by the person making the application;
- specify the type of certificate sought;
- specify the period for which the certificate is sought;
- provide all the facts relevant to the application;
- specify all assumptions that are relevant to the application; and
- provide all other information required by the Commissioner.

### ***The employed resident certificate***

The employed resident certificate lasts for five tax years. The majority of migrant employees take up employment contracts with a time span of three to five years. This view is supported by data collected by the Department of Labour (New Zealand Immigration Service) *Longitudinal Immigration Survey: New Zealand* (LisNZ) pilot survey.<sup>19</sup>

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<sup>19</sup> LisNZ has collected data on the experiences of migrants in New Zealand. In terms of employment and income, the LisNZ pilot survey reveals that of Skilled/Business Stream principal applicants surveyed 18 months after taking up residence in New Zealand, 52% had only one job in New Zealand. The Department of Labour advises that applicants for residence under the new Skilled Migrant Category, for example, are expected to hold a job offer for "ongoing employment". (This is defined as employment with a single employer for at least 12 months; or a contract basis where the applicant has one or more contracts totalling at least 12 months and has provided evidence of an employment history that includes at least two years of contract work.) For persons on a temporary permit, the maximum period of time for which they may be granted a temporary work visa or permit is three years. Renewals for a further period of time are possible, depending on the circumstances.

It is important to keep the threshold reasonably high to ensure the exemption is targeted at genuine employment cases. The concern is that if the threshold were lowered the employee exemption would be much more widely available than intended. Ensuring this boundary is robust is important to maintain the integrity of the reform. Also, it recognises the wider availability of the three-year general exemption.

To be eligible for the employed resident certificate an individual must either be:

- engaged in full-time employment 94% of the time. This rule gives employees three weeks to find a job once they arrive, or allows them three weeks between jobs. Full-time work is defined as 37.5 hours per week; or
- must be engaged in part-time employment earning a minimum of \$70,000 (pro-rata) per annum.

A further requirement is that the individual is not associated with the employer.<sup>20</sup> This should ensure that people who are effectively self-employed or are in retirement are not eligible for the employed resident certificate. However, these individuals may still be eligible for the general resident certificate

If an individual ceases to be an employee they must let the Commissioner know immediately in writing. They may be eligible for the general resident certificate.

### *The general resident certificate*

Independent contractors are widely used in New Zealand, especially where specialist skills are not available locally. Consequently, drawing a line between employees and non-employees is arbitrary.

Some independent contractors in contractual relationships that are broadly analogous to employment also explicitly (or implicitly) gross up their fee to compensate for New Zealand taxes on foreign-sourced income. This results in the New Zealand business having to pay more for the services provided by the contractor. Furthermore, some independent contractors will be deterred from working in New Zealand because of the tax impost and the associated compliance costs of New Zealand's comprehensive rules. In these cases, New Zealand business may end up with the second-best candidate, which also represents a cost to those businesses.

On the other hand, other independent contractors or entrepreneurs, particularly those in the business of providing services to multiple clients (such as consultants and professionals), may not gross up for these New Zealand taxes because they are exploiting a local opportunity, extracting economic rents, and are consequently less sensitive to New Zealand taxes on foreign income.

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<sup>20</sup> In the tax context "association" refers to family connections and companies controlled by the relevant party.



The problem is that it is very difficult to target only those independent contractors who are analogous to employees. In order to include independent contractors within the ambit of the exemption, the amendments will extend the proposal to all new migrants. The exemption is for three years for all new migrants who have not been resident in New Zealand for at least 10 years (as long as they meet immigration criteria). This would provide genuine independent contractors with relief from our international tax rules for the period they are in the country. (A shorter period is justified because the term of independent contractors' contracts will generally be shorter than that of an employment contract.) However, the exemption will also be available to migrants and returning New Zealanders who are outside the target group of highly skilled migrants.

An individual who becomes an employee will not be eligible for the employed resident certificate.

### ***The dependent resident certificate***

The amendments provide that a dependant of a person entitled to an exemption can receive the same exemption if the dependant is:

- a natural person;
- less than 20 years of age;
- financially dependent on a person who at the time is a certified resident; and
- is being maintained as a member of the family of the certified resident.

Therefore, dependants are entitled for the exemption only if they are under 20 years of age. It will be up to the individual to decide if it is more beneficial for them to apply for an exemption on their own right.

### ***Other specifics of the new-resident certificate***

Individuals are required to notify the Commissioner in writing of any changes in circumstances that may affect their eligibility. Furthermore, the Commissioner may withdraw a new-resident certificate if satisfied that the certificate is incorrect. In addition, the holder of a certificate may surrender the certificate at any time by returning it to the Commissioner.

### ***Exclusion from Family Support***

Family assistance entitlements are determined by a modified form of net income. If individuals derive offshore income that is exempted under the amendments their net income is reduced. Potentially, individuals deriving exempt offshore income could receive family assistance payments that they would not otherwise be entitled to, or receive higher payments than they would otherwise be entitled to, if this income was not exempt.

An individual should be able to claim a tax exemption on the one hand, and at the same time be receiving financial help from the government in the form of family assistance payments. Any assistance should be based on the family's total income.

For this reason there will be an amendment to the definition of "qualifying person" in sections OB 1 and KD 3. The effect of these amendments will be that an individual who has a new-resident certificate will be ineligible to receive family assistance payments.

***The exemption will apply only once in a person's lifetime***

A multiple exemption rule may adversely affect public perceptions of equity. It also gives rise to concerns that skilled individuals would leave New Zealand to keep refreshing their exemption.

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# Foreign trusts – information reporting and record-keeping requirements

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## **FOREIGN TRUSTS – INFORMATION REPORTING AND RECORD-KEEPING REQUIREMENTS**

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*(Clauses 87, 155(2), (12), and (14), 156, 162 and 182)*

### **Summary of proposed amendments**

New information reporting and record-keeping requirements will be introduced for New Zealand resident trustees of foreign trusts.<sup>21</sup> New Zealand resident trustees will be required to disclose limited information to Inland Revenue and keep financial records relating to each foreign trust for New Zealand tax purposes.

These new requirements are being introduced to ensure that New Zealand can meet its international obligations, such as satisfying requests for information from countries with which New Zealand has a double tax agreement. New Zealand resident trustees will be required to provide tax information relating to foreign trusts to Inland Revenue, if requested.

Failure to comply with these new requirements may result in a New Zealand-resident trustee being subject to sanctions, such as prosecution for failure to keep or provide information. In certain circumstances, the foreign trust may be treated as being taxable in New Zealand on its worldwide income.

### **Application date**

The amendments will apply from 1 April 2006.

### **Key features**

The new rules to introduce information reporting and record-keeping requirements for New Zealand-resident trustees of foreign trusts will amend both the Tax Administration Act 1994 and the Income Tax Act 2004.

A new section 59B of the Tax Administration Act will require New Zealand-resident trustees of foreign trusts to provide information to Inland Revenue upon their appointment, or the enactment of the legislation in relation to existing appointments. This requirement will not apply for a two-year period to trustees who satisfy the conditions set out in new section 59B(3).

Section 22 of the Tax Administration Act will be amended to impose record-keeping requirements on New Zealand-resident trustees of foreign trusts and specify the records that trustees are required to keep in New Zealand.

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<sup>21</sup> A “foreign trust” is a trust that has had no New Zealand-resident settlor from the later of 17 December 1987 or the date that the first settlement was made to the trust. For the purposes of the new rules, a “New Zealand-resident trustee” is an individual or corporate trustee of a foreign trust who is resident in New Zealand under section OE 1 or 2 of the Income Tax Act 2004.

The onus will be on New Zealand-resident trustees to keep the records required under section 22, maintain them in New Zealand and provide them to Inland Revenue if requested. To provide assurance to Inland Revenue that a trustee has the necessary expertise and incentives to maintain records of the required standard and will comply with the law, at least one New Zealand-resident trustee of each foreign trust will need to satisfy the new definition of “qualifying New Zealand-resident trustee” in section 3 of the Tax Administration Act. To satisfy the definition, a New Zealand-resident trustee or a New Zealand-resident director or manager of a New Zealand-resident trustee company, will need to be a member of an “approved organisation”.

An “approved organisation” will be an organisation that is approved by Inland Revenue, whose members are subject to a code of conduct and a disciplinary process intended to enforce compliance with the code, and who typically provide trustee services in the course of their business activities. Organisations that are likely to be approved will include the New Zealand Law Society and the Institute of Chartered Accountants of New Zealand, and similar overseas bodies.

The records required to be kept under the amendments to section 22 of the Tax Administration Act will be required to be provided to Inland Revenue by the New Zealand-resident trustee, if requested. Such requests will be made periodically in respect of foreign trusts that have an Australian-resident settlor, and on a case-by-case basis if a valid request for information is received from another country with which New Zealand has a double tax agreement.

The sanctions for failing to comply with the new information reporting and record-keeping requirements will be as follows:

- If a qualifying New Zealand-resident trustee does not disclose information or keep or provide records as required by law, the trustee will commit an offence under section 143 or 143A of the Tax Administration Act and, if convicted, will be subject to a monetary fine.
- If a New Zealand-resident trustee is not a qualifying New Zealand-resident trustee, the trustee will commit an offence under new section 143(1)(d) of the Tax Administration Act and, if convicted, will be subject to a monetary fine. Furthermore, under new section HH 4(3BB)(a) of the Income Tax Act, if the trustee does not become a qualifying New Zealand-resident trustee (or have a co-trustee appointed who satisfies this requirement) within 30 days of receiving notice that Inland Revenue intends to prosecute for the above offence, the foreign trust will become taxable in New Zealand on its worldwide income.
- If a New Zealand-resident trustee is not a qualifying New Zealand-resident trustee and records requested by Inland Revenue are not produced, new section HH 4(3BB)(b) will treat the foreign trust as being taxable in New Zealand on its worldwide income for the income years in which records cannot be produced. The New Zealand-resident trustee may also be prosecuted for failure to keep or provide records under section 143 or 143A of the Tax Administration Act, or for failure to be a qualifying New Zealand-resident trustee under new section 143(1)(d).

## **Background**

Under current tax law, a New Zealand-resident trustee of a foreign trust that receives no New Zealand-sourced income is not required to provide information to Inland Revenue or keep records for New Zealand tax purposes.

Information relating to foreign trusts may be requested by foreign tax authorities under the exchange of information provisions in New Zealand's double tax agreements. As some foreign trusts are not required to provide information to Inland Revenue, there is a risk that New Zealand may be unable to provide foreign tax authorities with information relating to certain trusts, if requested. If a foreign trust distributes property to its beneficiaries and ceases to exist or the New Zealand-resident trustee moves offshore, there may be no way of obtaining information relating to its earlier activities.

Failure to provide information could impact negatively on New Zealand's relationship with its double tax agreement signatory countries. Australian authorities, in particular, are concerned that foreign trusts could be established in New Zealand for the purpose of channelling funds through to tax havens.

The new rules for foreign trusts are intended to ensure that New Zealand can meet its international obligations, such as satisfying requests for information from its double tax agreement partners. The intention is also to maintain and further develop favourable relationships with Australia, while allowing for the continuation and development of the foreign trust industry in New Zealand.

## **Detailed analysis**

### ***Application of the rules***

The new foreign trust rules will apply to all New Zealand-resident trustees of foreign trusts, including foreign trusts that receive no New Zealand-sourced income.

### ***Disclosure of trust information to Inland Revenue***

Section 59B will impose a disclosure requirement on New Zealand-resident trustees of foreign trusts. New Zealand-resident trustees appointed on or after 1 April 2006 will be required to provide limited information to Inland Revenue within 30 days of their appointment. New Zealand-resident trustees appointed before this date will have 60 days to comply from 1 April 2006.

The following information will be required for each foreign trust that a trustee acts for:

- the name or other identifying features of each trust (such as the date of settlement);
- the name and contact details of the New Zealand-resident trustee(s);
- whether a settlor is resident in Australia; and
- the name of the approved organisation to which the New Zealand-resident trustee belongs.

A New Zealand-resident trustee who becomes aware that any of the information provided has changed will be required to advise Inland Revenue of the change within 30 days.

The collection of this information will assist Inland Revenue to identify the appropriate trustee(s) when information about a foreign trust is requested by one of New Zealand's double tax agreement partners.

Inland Revenue will automatically provide the Australian Taxation Office with information relating to foreign trusts that have a New Zealand resident trustee and an Australian-resident settlor. The requirement to inform Inland Revenue if a settlor of a foreign trust is an Australian resident is intended to ensure that Inland Revenue is in a position to provide this information.

Australia is the only country to which New Zealand is currently proposing to provide information on an automatic basis. Other countries may be added by legislation in the future, where appropriate.

New Zealand-resident trustees who fail to disclose the required information to Inland Revenue will commit an offence under section 143 or 143A of the Tax Administration Act.

### ***Keeping financial records***

Section 22(2) of the Tax Administration Act imposes an obligation on certain persons to maintain financial records in New Zealand for at least seven years after the end of the income year to which they relate. New sections 22(2)(fb) and (m) will extend this obligation to New Zealand-resident trustees of foreign trusts.

The definition of "records" in section 22(7) will be amended to require New Zealand-resident trustees of foreign trusts to keep the following records:

- evidence of the creation and constitution of a trust (trust deed or similar);
- details of settlements made on, and by a trust, and distributions to beneficiaries, including the name and address (if known) of settlors and beneficiaries;
- accurate descriptions of the assets and liabilities of a trust, and details of all sums of money expended and received by a trustee in relation to a trust; and
- the charts and codes of accounts, accounting instruction manuals and the programme documentation which describes the accounting system used in the administration of a trust.

Section 22(2) provides that a person who is required to keep records may apply to the Commissioner for permission to keep records offshore, or in a language other than English.

If a New Zealand-resident trustee does not personally hold information relating to a foreign trust's offshore interests, the trustee may apply to the Inland Revenue under this provision and the department may exercise its discretion to allow records to be kept offshore. If records are kept offshore, a trustee will be expected to provide records to Inland Revenue within a reasonable timeframe, if requested.



New Zealand resident trustees who fail to keep the required records or provide them if requested by Inland Revenue will commit an offence under section 143 or 143A.

Foreign trusts that have a non-qualifying New Zealand-resident trustee who fails to provide records requested by Inland Revenue, may also be liable to tax in New Zealand. This is described in the following section.

***Failure to be a qualifying New Zealand-resident trustee***

Under the new rules, the onus will be on New Zealand-resident trustees to maintain financial records and provide them to Inland Revenue, if requested. If at least one New Zealand-resident trustee of a foreign trust is a qualifying New Zealand-resident trustee, this will provide assurance to Inland Revenue that a trustee has the necessary expertise and incentive to maintain records of the required standard and will comply with the law.

If Inland Revenue requests information on a foreign trust and the trust does not have a qualifying New Zealand-resident trustee, the non-qualifying trustee will commit an offence under new section 143(1)(d) of the Tax Administration Act, unless the two-year exemption applies as explained on page 86.

If a New Zealand-resident trustee fails to become qualifying (or have a co-trustee appointed who satisfies this requirement) within 30 days of receiving notice from Inland Revenue of its intention to prosecute for this above offence, the worldwide income of the foreign trust will be taxed in New Zealand under new section HH 4(3BB)(a) of the Income Tax Act. This tax treatment will be applied on a prospective basis.

Under new section HH 4(3BB)(b), a foreign trust will be taxed on its worldwide income for any income year (from 1 April 2006) for which the trust had no qualifying New Zealand-resident trustee and financial records requested by Inland Revenue are not provided. If the non-qualifying trustee subsequently provides the information requested, the taxing provision will cease to apply.

The intention is not to tax foreign trusts on their worldwide income but, rather, to provide the necessary incentive for New Zealand-resident trustees to become qualifying, and keep and provide the required financial records. If the worldwide income of a foreign trust becomes liable to tax in New Zealand, the New Zealand-resident trustee will be required to file an income tax return on that basis. The tax return will provide Inland Revenue with information that it can provide to New Zealand's double tax agreement partners, if requested.

### ***Temporary exemption from the requirements***

Section 59B(3) will provide a temporary exemption from the information-reporting and record-keeping requirements for eligible New Zealand-resident trustees who are new migrants and for those who have not been resident in New Zealand for a period of at least five years before becoming a New Zealand resident.

To be eligible, a trustee will need to be appointed as trustee of a foreign trust before becoming a New Zealand resident. Trustee companies and sole or joint trustees who are in the business of providing trustee services will not be eligible for the exemption.

The exemption will apply for two years from the date that an eligible trustee becomes a New Zealand resident. A trustee who is still resident in New Zealand at the end of the exemption period will be required to disclose the required information to Inland Revenue and satisfy the approved organisation membership requirement within 30 days, and start keeping records for New Zealand tax purposes.

### ***Requests for information about trusts from other countries***

When a New Zealand-resident trustee indicates that a settlor of a foreign trust is an Australian resident, Inland Revenue will periodically request additional information about the trust (such as financial records, details of distributions to beneficiaries and the identity of the settlor) and automatically provide this information to the Australian Taxation Office.

Information will be provided to other double tax agreement signatory countries on a case-by-case request basis, when Inland Revenue considers that there are valid grounds for requesting the information. Inland Revenue will not entertain general “fishing expeditions” from tax treaty partners for information on foreign trusts, or satisfy requests for information from countries that do not have a double tax agreement or a tax information exchange agreement with New Zealand.

When a valid request for information is received, Inland Revenue will request additional information from the appropriate New Zealand-resident trustee.

Inland Revenue is permitted to require information to be provided under section 17 of the Tax Administration Act. That section imposes an obligation on persons to provide information that Inland Revenue considers necessary for any purpose relating to the administration or enforcement of the Inland Revenue Acts, or any other lawful function of the Commissioner.

Any information provided by a trustee will be subject to the existing tax secrecy laws. Section 81 of the Tax Administration Act prevents Inland Revenue from providing information to a foreign jurisdiction except as permitted by section 88 – under a reciprocal law, double tax agreement.

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## Other changes to the Income Tax Act

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## **CLARIFYING THE SCOPE OF OVERRIDING PROVISIONS RELATING TO DOUBLE TAX TREATIES**

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*(Clause 5)*

### **Summary of proposed amendment**

The amendment will narrow the overriding effect of double tax agreements in relation to domestic legislation so they override only the Inland Revenue Acts, the Privacy Act 1993 and the Official Information Act 1982. The amendment clarifies which enactments are overridden by double tax agreements which have entered into force under section BH 1 of the Income Tax Act 2004.

### **Application date**

The proposed amendment will apply from the date of enactment.

### **Key features**

The key amendment replaces the reference to “any enactment” in section BH 1(4) with a reference to “any other Inland Revenue Acts, the Official Information Act 1982 or the Privacy Act 1993”.

### **Background**

In March 2002, the Regulations Review Committee issued a report concerning overriding provisions such as section BH 1. Overriding provisions allow regulations to be made which override all domestic legislation. The report recommended that, among other sections, section BH 1 of the Income Tax Act 1994 (the predecessor to section BH 1 of the Income Tax Act 2004) be reviewed in the light of the recommendations in the Committee’s report. The government agreed to review the section in its response to the report.

The amendment specifically identifies enactments that double tax agreements override – namely the Inland Revenue Acts, the Privacy Act 1993 and the Official Information Act 1982.

## **DEDUCTIBLE DISTRIBUTIONS FROM CO-OPERATIVES**

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*(Clauses 10, 47, and 220)*

### **Summary of proposed amendments**

To remove an uncertainty in the treatment of payouts from co-operatives to members, an amendment ensures that payouts are deductible to the co-operative and taxable in the hands of members at their marginal tax rate. The amendment achieves this by specifically excluding such payouts from the definition of “dividend” and including them as an allowable deduction in the Income Tax Act 2004. To be deductible, however, the payout must be in relation to the supply of trading stock sold to the co-operative by the member or vice versa.

### **Application date**

The exclusion of payouts from the definition of a dividend will apply from the 2006-07 and subsequent income years.

### **Key features**

New section CD 24B in the Income Tax Act 2004 will exclude payouts by co-operatives to members from the definition of a dividend. A new section DV 10B will ensure that, if a payout from a co-operative meets the criteria outlined in section CD 24B, it will be considered deductible expenditure to the co-operative.

The amendment, however, will apply only to:

- shareholders that supply or receive trading stock to, or from, a co-operative which is tangible property (excluding intangibles such as intellectual property and marketing rights);
- current trading stock that is not sold as part of the disposal of a business;
- New Zealand-resident co-operatives or wholly owned subsidiaries of resident co-operatives; and
- members whose income is sourced in New Zealand.

Under the current mutuality provisions contained in section HF 1 of the Income Tax Act 2004, it is clear that co-operatives can already adopt this tax treatment, but only for the distribution of profits arising from transactions with members of the co-operative. Under the general deductibility provisions, however, it is not clear whether co-operatives can treat profits from activities not associated with members (for example, investment activities that do not relate to the purchase or supply of product to or from the member) in the same manner. The amendment effectively extends the existing treatment of payouts of profits from member transactions to non-member transactions so that they are deductible to the co-operative and taxable in the hands of the member shareholders at their marginal rate.

The deductible treatment of payouts will apply to most types of co-operatives, including those that receive payments from member shareholders and purchase product on their behalf (such as trading co-operatives). This ensures the equal treatment of payouts between different types of co-operatives. Discounts received by members on the price of product purchased on their behalf by the co-operative are economically equivalent to payments in cash received by members. Therefore both are to be treated the same.

The proposal also has some important limitations.

For the payout to be deductible, it must be connected to the supply of trading stock traded between the co-operative and the member. This ties any payout from the co-operative to the member to the sale or receipt of goods. The principal purpose of holding any shares in a co-operative must be for the trade in a product with the co-operative. This is to prevent the deductibility of payouts to shareholders that do not trade with the co-operative from receiving a payout that is clearly a dividend.

Payouts relating to the sale of intangibles, such as services and financing, will not be allowed to be deducted as trading stock by the co-operative. This is because it would allow businesses to re-structure as a co-operative in order to take advantage of the deductibility of payouts. Otherwise, there is a risk that co-operatives would be set up to finance investments and receive distributions that would be taxed at their personal marginal tax rate.

Payouts from co-operatives to charities and exempt taxpayers will receive the same treatment as taxpaying shareholders. This means that payouts to exempt taxpayers will not be taxed. This treatment is in line with the policy objective of not taxing such organisations.

## **Background**

Co-operatives contract with their member shareholders for the supply of product to the co-operative, particularly in the agricultural sector. In some cases, this payout exceeds the market price for the product because the payout also includes a return on additional activities, such as processing, that add value to the product purchased from the member. The payout might also include profits from investment activities undertaken by the co-operative. This “value added” component of the payout arises from business activities that do not involve transactions with members of the co-operative.

It is unclear, however, whether the value-added component of the payout should be treated as a dividend distributed to the member or as an expense to be deducted by the co-operative. Section CD 4(1) of the Income Tax Act 2004 generally treats as a dividend any consideration above market value for the provision of goods and services by a person to a company. In this case, the co-operative would not be able to deduct the value-added component of the payout. The co-operative would pay tax on it and pass on the tax paid as imputation credits to its shareholders when it paid the dividend (in other words, the value-added component of the payout). Such treatment is the norm for companies.

In some circumstances it may be difficult to distinguish the value-added component of the payout from the cost of the purchase of the product. Indeed, often the level of the payout varies in relation to the amount of product sold by the member to the co-operative.

The amendment therefore clarified the legislation and confirmed that payouts from co-operatives, including the value-added component from non-member transactions, are deductible to the co-operative.



## **ACC ATTENDANT CARE**

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*(Clauses 17, 144, 158, and 159)*

### **Summary of proposed amendment**

The Income Tax Act 2004 and Tax Administration Act 1994 are being amended to put in place a legislative framework to facilitate regulatory change that requires the Accident Compensation Corporation (ACC) to withhold tax at source on ACC attendant care payments when an independent caregiver is used. ACC withholding tax at source will move tax compliance obligations away from claimants to a more efficient party.

### **Application date**

The amendments will apply from 1 April 2006.

### **Key features**

- Section CF 1(2) of the Income Tax Act 2004 is being amended to explicitly include attendant care payments made to ACC claimants that are not then used to obtain attendant care services as income of the claimant.
- Section OB 2(1) of the Income Tax Act 2004 is being amended to prevent double taxation when a claimant pays a caregiver for attendant care services if tax has already been deducted by ACC.
- Section 33A(1)(a) of the Tax Administration Act 1994 is being amended to remove the requirement on claimants to file a tax return in respect of income from attendant care payments if tax has already been deducted by ACC.
- A new section, 33C, is being inserted in the Tax Administration Act 1994 to remove the requirement on caregivers to file a tax return in respect of income from providing attendant care services if tax has already been deducted by ACC. This only applies to caregivers who earn less than \$9,500 for providing attendant care services.

### **Background**

Attendant care payments are made by ACC to injured claimants so they can obtain personal care from a caregiver (or caregivers). ACC claimants may use ACC-contracted caregivers or independent caregivers. Taxation in the ACC-contracted industry works well. The amendments in the bill are aimed at independent caregivers.

Under current administrative practice, claimants are generally considered to be the employers of the independent caregivers that care for them. This means that claimants must meet all employer PAYE obligations. (Although if a caregiver works less than 20 hours per week, they are required to meet the PAYE obligations themselves.) This includes calculating and deducting tax from payments made to caregivers, and completing and filing monthly returns with Inland Revenue.

The amendments facilitate, rather than require, ACC to withhold tax at source on attendant care payments. Future regulatory change will be necessary to require ACC to do this. Requiring ACC to withhold tax at source would remove the employer PAYE obligations that are currently faced by claimants. It will also increase certainty surrounding tax treatment for the industry and reduce non-compliance.

## **FOREIGN VENTURE CAPITAL INVESTMENT ALONGSIDE THE VIF**

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*(Clause 21)*

### **Summary of proposed amendments**

The bill removes an impediment to New Zealand companies gaining access to offshore venture capital. The amendments exempt non-resident investors from tax on the sale of shares in companies that they have invested alongside the New Zealand Venture Investment Fund Limited (VIF).

### **Application date**

The amendments will apply from the date of enactment.

### **Key features**

A new section CW 11C is being added to the Income Tax Act 2004. Its purpose is to provide an exemption from tax for non-resident investors that have invested alongside the VIF on any realised gains on the sale of shares in New Zealand investee companies. The exemption applies to non-resident investors for investments in which the VIF has invested in, or committed to invest in, on or before 31 March 2008.

For the exemption to apply, it will be necessary for the non-resident to invest through a venture capital manager that purchases the shares on behalf of the non-resident in accordance with an agreement with the VIF.

The current dividend rules will continue to apply to dividends that non-residents derive from the investee companies.

### **Background**

The amendments complement reforms included in the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 that were aimed at removing tax barriers to international venture capital investment in New Zealand. Broadly, the recently enacted rules provide an exemption for certain non-residents on realised gains from the sale of shares in New Zealand unlisted companies and are available to non-residents that are tax exempt in their own country. The rules are restricted to non-resident investors that are resident in, or established in, a country with which New Zealand has a double tax agreement with the exception of Switzerland (because Switzerland does not engage in the exchange of information).

International venture capital investments in New Zealand can be made through countries with which New Zealand does not have a double tax agreement. These non-resident investors that make investments through those countries are not eligible for the recently-enacted exemption.

The amendments extend the exemption from tax on realised gains to all non-resident investors, regardless of their country of residence or their home country tax status, on venture capital investments made alongside the VIF. The VIF is a Crown-owned company that invests alongside private-sector co-investors into New Zealand venture capital.

The exemption applies to non-resident investors for investments in which the VIF has invested in, or committed to invest in, on or before 31 March 2008.

## **GAMING TRUSTS**

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*(Clause 23)*

### **Summary of proposed amendment**

An amendment provides a separate tax exemption for the gaming-machine income of licensed non-casino gaming-machine operators (gaming trusts). This removes concerns that the Charities Act may have provided an incentive for gaming trusts to give disproportionately to amateur sport by claiming exemptions under the Income Tax Act to avoid registering with the Charities Commission.

### **Application date**

The amendment will apply from the date of enactment.

### **Key features**

A new provision will be inserted into section CW 40B of the Income Tax Act 2004 to provide a separate tax exemption for the gaming machine income of gaming trusts. This exemption will apply only to those licensed operators who apply or distribute that income as required by the Gambling Act 2003.

### **Background**

During the select committee stage of the Charities Bill (now the Charities Act 2005) an issue was raised concerning the impact of new legislation on gaming trusts. Specifically, gaming trusts which are already subject to a regulatory regime imposed by the Department of Internal Affairs (under the Gaming Act 2003) would be subject to a second tier of supervision by the Charities Commission, and would be statutorily influenced in terms of their funding decisions. The amendment in this bill removes these concerns.

The Charities Act amends section CB4 (1)(c) and (e) of the Income Tax Act 2004, which provides income tax exemptions for charitable purposes. Organisations that want to claim a tax exemption under those paragraphs will be able to do so only if they have registered with the Commission.

At present, gaming trusts that give to amateur sports groups rely on section CB 4(1)(h) of the Income Tax Act 2004. That section provides a tax exemption for a non-profit organisation that has been established substantially or primarily for the purpose of promoting any amateur game or sport, provided that the sport or game is conducted for the recreation or entertainment of the general public.

The requirement for organisations claiming an income tax exemption under section CB 4(1)(c) or (e) to register with the Commission may have created an incentive for a gaming trust to give more money to the promotion of amateur sport than to any other authorised purpose. “Authorised purpose” includes a charitable purpose, a non-commercial purpose that is beneficial to the whole or a section of the community, or promoting, controlling and conducting race meetings under the Racing Act 2003, including the payment of stakes. This is because gaming trusts would be likely to rely on the sports exemption in section CB 4(1)(h), enabling them to receive an income tax exemption without registering with the Commission.

## TAX CONSEQUENCES OF NATURAL DISASTERS

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*(Clauses 34, 42, 49, 60, 61, 82, 98, 143(43) and (59), 186, 187, and 192)*

### **Summary of proposed amendments**

The bill introduces solutions to four technical problems that came to light as a result of the floods in the Lower North Island and the Bay of Plenty last year. The amendments provide that:

- Deductions for expenditure for which a restorative grant is made under the Agricultural Recovery Programme will not have to be reduced in the income year in which the expenditure was incurred; instead the grant will be deemed to be income in the year in which it is received.
- Livestock donated because of a self-assessed adverse event will be treated as leaving the donor's business at zero-value and entering the recipient's business at zero-value.
- Those affected by a self-assessed adverse event will be able to make late estimates of provisional tax.
- Applications for remission of late payment and late filing penalties will no longer need to be in writing.

### **Application date**

The amendments to the trading stock rules, penalty provisions and provisional tax provisions apply from the 2005-06 income year. The amendments in relation to the restorative grants apply retrospectively from the 2003-04 income year, so that they apply to those affected by the floods in February 2004 and in the Bay of Plenty in July 2004.

### **Key features**

#### ***Restorative grants***

The government is making restorative grants as part of the Agriculture Recovery Programme for those affected by the storms in the Lower North Island and Bay of Plenty in 2004. Unexpected use-of-money interest consequences can arise because of the way that section DC 1 of the Income Tax Act 1994 requires deductions for expenditure, for which a grant is subsequently made, to be reduced. Therefore section DC 1 is being amended so that it no longer applies to grants made under the Agriculture Recovery Programme.

While the deductions will not have to be reduced, the grant will no longer be deemed not to be gross income. As a result, the grant will be subject to the general rules that define income.

Section DC 1 of the Income Tax Act 1994 has been re-written into sections CX 41 and DF 1 in the Income Tax Act 2004. Section CX 41(3) is being replaced so that a restorative grant made under the Agriculture Recovery Programme is assessable income. A new paragraph is being added to section DF 1(1) to prevent the deduction, for expenditure for which the grant is given from being disallowed.

If the expenditure is incurred after the grant is received the grant will be excluded income, but no deductions will be allowed.

### ***Trading stock***

A number of amendments are being made to deal with stock that is donated for use in farming, agricultural, or fishing businesses that are affected by a self-assessed adverse event.

Section GD 1(4)(b) is being replaced so that the anti-avoidance provision does not apply to such stock.

A new section EC 5B is being inserted into the livestock rules to set the values that are to be used when livestock are donated to someone affected by a self-assessed adverse event. Stock donated or supplied for consideration worth less than market value is to be treated as having:

- to the donor, no value or the value of the consideration provided by the recipient; and
- to the recipient, no value or the value of the consideration provided by the recipient.

The amendment will mean that once closing value is determined at the end of the year, income arises with the recipient rather than the donor. The separate definitions of “self-assessed adverse event” in sections EH 36 and EH 63 have been replaced with a definition in section OB 1.

### ***Late election of provisional tax***

Section MB 3B of the Income Tax Act 2004 is being amended so that taxpayers with a farming, agricultural or fishing business affected by a self-assessed adverse event can request the Commissioner to accept a late estimate of provisional tax. Currently the provision only applies to those affected by a qualifying event.

### ***Remission of late filing and late payment penalties***

Section 183H of the Tax Administration Act is being amended to remove the requirement for applications for remission of late filing and late payment penalties to be in writing. The amendments to section 183ABA are consequential amendments.



## **Background**

The proposed changes address a number of issues that arose out of the February and July floods last year. While short-term solutions were put in place by the Taxation (Disaster Relief) Act 2004 and the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004, long-term solutions are needed. These changes address four high-priority issues. Another issue, in relation to the destruction of buildings, is being addressed as part of the Taxation (Base Maintenance and Miscellaneous Provisions) Bill introduced to parliament in November 2004. Any remaining issues will be addressed in subsequent legislation.

## **TAXATION OF FOREIGN HYBRIDS AND FOREIGN TAX CREDIT RULES**

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*(Clauses 8, 70, 71, 74, 75, 92, and 94 to 97)*

### **Summary of proposed amendments**

The law is being clarified to allow people who invest in “foreign hybrids” to receive “grey list” treatment and foreign tax credits for tax they pay overseas on income earned by a foreign hybrid. The changes will apply to foreign hybrids that are either a controlled foreign company (CFC) or a branch-equivalent foreign investment fund (FIF).

A foreign hybrid is an entity that has the characteristics of both a company and a partnership. It is treated as a company for New Zealand tax purposes, but is treated like a partnership (with “flow-through” tax treatment) under another country’s tax system.

### **Application date**

The amendments will apply from 1 April 2006 for the 2006-07 tax year and subsequent tax years.

### **Key features**

The Income Tax Act 2004 is being amended as follows:

- The grey list exemptions in sections EX 24 (CFCs) and EX 33 (FIFs) will be amended to allow taxpayers to receive a grey list exemption for investments in foreign hybrids.
- The CFC tax crediting provision in section LC 4(1) will allow shareholders with investments in foreign hybrids that are CFCs or branch-equivalent FIFs to receive tax credits for the foreign tax paid by the shareholder.
- The underlying foreign tax credit rules in subpart LF will allow corporate shareholders to receive these credits to offset their foreign dividend withholding payment for tax paid in respect of the foreign hybrid.

New section CD 10B will reduce the amount of a dividend received from a foreign hybrid if the New Zealand shareholder has paid foreign tax on income earned by the hybrid.

Similarly, there will be changes to the definition of “costs” in sections EX 44 (comparative value method) and EX 45 (deemed rate of return method) to take into account the foreign tax paid by the New Zealand shareholder on income earned by the hybrid.

## **Background**

Under New Zealand's domestic tax legislation, an interest in a foreign hybrid entity is treated as an interest in a "company" and taxed as such. An investment by a New Zealand-resident in a foreign company will usually be treated as an investment in a CFC or a FIF. An investor in a CFC (or FIF) can usually claim a foreign tax credit for tax paid on its foreign income.

Uncertainty arises, however, as to whether New Zealand members of a foreign hybrid entity can claim a foreign tax credit against their New Zealand income tax liabilities under the current tax credit provisions in the Act. The uncertainty arises because, under the CFC credit provision, a credit is given only for foreign tax paid by the CFC. Yet a foreign hybrid, that is a CFC, does not actually pay the tax because the tax is paid by its members.

A further technical problem is that it is uncertain whether a foreign hybrid cannot qualify for the grey list exemption from the CFC or FIF rules because of the flow-through tax treatment in the foreign jurisdiction.

## **EXEMPTION FOR INTERESTS IN EMPLOYMENT-RELATED FOREIGN SUPERANNUATION SCHEMES**

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*(Clause 73)*

### **Summary of proposed amendments**

The exemption for interests in employment-related foreign superannuation schemes, contained in section EX 36 of the Income Tax Act 2004 will be extended to apply to returning residents. It will be made permanent for all interests that were acquired in the first five years of each new period of New Zealand residence.

The measure will improve the tax treatment of new migrants and returning residents who hold interests in an employment-related foreign superannuation scheme, and increase the overall level of exemption for these interests under the foreign investment fund (FIF) rules. It is also consistent with and builds on proposals for the temporary exemption from tax on foreign income for new migrants and certain returning New Zealanders.

### **Application date**

The amendment will apply from 1 April 2006 for people arriving in New Zealand on or after this date, with application from the 2005-06 income year and subsequent income years.

### **Key features**

The exemption for interests in employment-related foreign superannuation schemes in section EX 36 of the Income Tax Act 2004 is being amended to:

- apply to returning residents – currently the exemption applies to new migrants only;
- provide a permanent exemption for all superannuation interests acquired within the first five years of New Zealand residence – currently the exemption applies to interests acquired by a person before they first became a New Zealand resident for tax purposes; and
- apply after any period of non-residence.

### **Background**

The measure is part of the wider policy initiative to resolve problems associated with the New Zealand tax treatment of accrued entitlements in foreign superannuation schemes. The issue was raised in the context of Australia's Superannuation Guarantee Scheme at last year's Australia-New Zealand Leadership Forum.

Individuals working in Australia generally have compulsory contributions made on their behalf by their employers into an Australian superannuation fund. In general, Australian and New Zealand citizens cannot access these superannuation interests until they reach retirement age. If they migrate or return to New Zealand they could be subject to tax on those interests, under New Zealand's FIF rules.

The FIF rules currently tax the income earned by a foreign entity (such as a foreign superannuation scheme) on the interests held by New Zealand residents. They ensure that foreign income earned by a foreign superannuation scheme on behalf of New Zealand residents is subject to New Zealand tax. An "interest" includes an entitlement to benefit from a foreign superannuation scheme.

Consultation with the private sector has indicated that people with Australian superannuation interests may not be complying correctly with their tax obligations under the FIF rules and, indeed, may not even be aware that they have to account for tax. It is likely that this non-compliance is not unique to people with Australian superannuation interests.

For those people who are aware of their tax responsibilities, determining whether they are required to pay tax under the FIF rules can involve high compliance costs. Although the current exemptions provide some relief from the rules, the difficulty is determining which exemption applies and how to meet the continuing requirements of the exemption if a person wants to continue to contribute to a foreign superannuation scheme after moving to New Zealand.

An inconsistency has also been identified in the way new migrants and returning residents to New Zealand are treated under the rules. There are more exemptions available to new migrants than for returning residents, giving rise to concerns about equity and consistency. For example, the current exemption for interests in employment-related foreign superannuation schemes applies to new migrants only and to interests acquired while the person concerned was not a resident of New Zealand.

The proposed amendment specifically addresses the inconsistency in the FIF treatment of new migrants and returning residents and increases the level of exemption for interests in employment-related superannuation schemes. Therefore, the amendment will improve the overall equity of the FIF rules and decrease the tax burden and the associated compliance costs for those people affected.

### ***Proposal under consideration***

In his speech to the International Fiscal Association on 29 April 2005, the Minister of Finance and Revenue signalled the government's intention to amend the FIF rules to exempt interests in specified Australian superannuation schemes, subject to further work by officials. The change will apply to new migrants and returning residents to New Zealand who hold interests in an employment-related superannuation scheme in which the entitlements under the scheme are generally locked in until retirement.

Further work on the exemption is required to determine the appropriate scope of the exemption. This work will consider whether the exemption should be extended to all Australian superannuation scheme interests and, if so, whether the extension will resolve the longstanding compliance issues or remove the disincentive for people to take up long-term or permanent employment in New Zealand.

The government hopes to be in a position to make decisions on this matter so that any amending legislation can be included in the first taxation bill to be introduced next year. Consultation on the proposal will be undertaken as part of the generic tax policy process.

## Detailed analysis

### *Scope of the exemption*

The exemption applies to new migrants and returning residents to New Zealand who hold employment-related foreign superannuation scheme interests. It will permanently exempt from the FIF rules interests that they acquired when they were not residents of New Zealand and interests acquired up to the end of the fifth year of New Zealand residence following each period of non-residence.

If a new migrant or returning resident continues to contribute to the scheme after five years of New Zealand residence, the current “de minimis” exemption<sup>22</sup> would then apply to interests acquired from day one of the sixth year – provided the total cost of the superannuation interests (and other FIF interests) at all times in the income year is \$50,000 or less. Thus, they would need to disclose their interests and calculate FIF income on those interests only if they continue to make contributions after the fifth year of residence and the cost of those interests (and other FIF interests) exceeds \$50,000.

<i>Scope of the exemption</i>	<i>Exempt/taxable</i>
Interests acquired while non-resident	Exempt
Interests acquired in the first five years of New Zealand residence	Exempt
Interests acquired after the fifth year of New Zealand residence	Income related to those interests is taxable if the cost of these interests, together with other FIF interests, total more than \$50,000

<sup>22</sup> If the aggregate cost of all interests held by a person at all times in the income year is \$50,000 or less, those interests are exempt. This exemption is referred to as the “de minimis exemption”. In determining whether the \$50,000 threshold has been met, exempt interests are ignored but all other interests are taken into account.

### ***Relationship to the temporary exemption from tax on foreign income***

Under the temporary exemption from tax on foreign income, employees who have not been resident in New Zealand for at least ten years would be entitled to a five-year exemption from tax on all foreign-sourced income, including any FIF interests (except dividends, interest, employment income and business income relating to services performed offshore). If the new migrant or returning New Zealander is not an employee, that person would be entitled to a three-year exemption. If these people continue to reside in New Zealand they could be subject to the FIF rules on all interests that they hold at the end of the prescribed time periods.

The employment-related foreign superannuation exemption gives further relief by providing a permanent exemption for any employment-related foreign superannuation scheme interests acquired when the person involved was not a resident of New Zealand or that were acquired in the first five years of New Zealand residence.

There are two key differences between the temporary exemption for foreign income and the exemption for interests in employment-related foreign superannuation schemes.

First, the temporary exemption from tax for foreign income will apply to individuals who were non-resident for at least ten years. However, the employment-related foreign superannuation scheme exemption applies to returning residents after any period of non-residence. The reason for this difference is that people working overseas for even short periods are often required to take out superannuation (as opposed to acquiring other forms of FIF interests). Accordingly, an exemption should be available for returning residents who have been non-resident for any period.

Secondly, the temporary exemption from tax for foreign income applies only once in a person's lifetime. There is no such limitation on the exemption for interests in employment-related foreign superannuation schemes.

## **ROLLOVER OF EXEMPTION FOR INVESTMENTS IN LISTED CONTROLLED FOREIGN COMPANIES**

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*(Clause 77)*

### **Summary of proposed amendments**

The statutory life of a provision exempting investments into certain controlled foreign companies (CFCs) that are listed on a recognised stock exchange will be extended by several years.

### **Application date**

The amendment will apply from the date of enactment and will apply up to and including the 2010-11 tax year.

### **Key features**

The statutory life of the exemption from the CFC rules, currently contained in section EZ 29 of the Income Tax Act 2004, is being extended so that it applies up to and including the 2010-11 tax year.

### **Background**

Section EZ 29 of the Income Tax Act 2004 provides an exemption from the CFC rules in certain circumstances if the CFC is resident in a “grey list” country and the company is listed on a recognised exchange in that country. (The grey list consists of Australia, Canada, Germany, Japan, the United Kingdom, the United States and Norway.) The exemption applies if, by virtue of the grey list country’s stock exchange listing rules, the New Zealand resident holding the CFC interest cannot obtain sufficient information to calculate income under the CFC rules.

The exemption will apply if the stock exchange listing rules of the grey list country:

- prevent the CFC from providing sufficient information for the person to calculate CFC income; or
- provide that, if the CFC gives sufficient information for the person to calculate CFC income, the CFC is required to make a further disclosure of information that would be harmful to the CFC’s commercial interests.

The exemption currently applies to the 2001-02 to 2005-06 income years. The amendment will extend the application of this provision up to and including the 2010-11 tax year.



## **INCREASE IN THE CHILD REBATE**

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*(Clause 89)*

### **Summary of proposed amendments**

The maximum child rebate payable will increase from \$156 to \$351 a year. This will allow an eligible child to earn income (less interest and dividends) up to \$2,340 per annum, tax-free.

### **Application date**

The amendment will apply from the 2006-07 income year.

### **Key features**

Section KC 2 of the Income Tax Act 2004 will be amended to increase the maximum child rebate payable from \$156 to \$351 per annum.

### **Background**

The child rebate was introduced in 1978 to avoid the need for children to pay tax on small amounts of income. As the child rebate has not been increased since 1983, its real value has eroded over time.

Consequently, an increasing number of children are earning income which exceeds the current rebate threshold. This is problematic as some child taxpayers incur compliance costs in relation to small amounts of income earned, while others fail to meet their tax obligations. When children comply, administrative costs associated with collecting and processing small amounts of tax can exceed the revenue collected.

Following the increase in the child rebate, some eligible children will no longer be required to deduct tax or meet other tax obligations for the income they earn. All eligible children whose annual income exceeds \$1,040 (less interest and dividends) will benefit from the increase.

Children who are under the age of 15, or under the age of 18 and attending primary or secondary school, or who turned 18 in the preceding income year and are still at school, are eligible to receive the rebate.

## REVERSE TAKEOVERS AND CONTINUITY RULES

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*(Clauses 143(25), (26) and (27), 146 and 147)*

### Summary of proposed amendments

The concessionary continuity rules, which apply to carrying forward losses and imputation credits when there is a change in a company's shareholding, are being extended to recognise that continuity can be maintained through reverse takeovers or mergers. The new rules apply when both of the companies involved in the takeover or merger are widely held or listed companies.

### Application date

The new rules will apply from the date of enactment.

### Key features

A new section OD 5AA is being inserted into the Income Tax Act 2004 to provide a new ownership tracing rule for reverse takeovers. The new rule will apply to a "changeover" in a limited attribution company (the initial parent) which is treated as holding ownership interests in another company (the subsidiary). A "changeover" can be a change in ownership, or a situation where the initial parent ceases to exist because of an amalgamation.

Continuity will not be lost if:

- immediately before the changeover the initial parent is treated as holding all the ownership interests in the subsidiary; and
- immediately after the changeover another limited attribution company (the new parent) is treated as holding all the ownership interests in the subsidiary; and
- immediately after the changeover all or part of the ownership interests in the new parent are treated as being held by the persons who were treated as shareholders of the initial parent (the initial shareholders) immediately before the changeover; and
- there is commonality (49% for the carry forward of losses, or 66% for the carry forward of imputation and dividend withholding payment credits) in:
  - the ownership interests in the initial company that are treated as being held by the initial shareholders immediately before the changeover; and
  - the ownership interests in the new parent that are treated as being held by the initial shareholders immediately after the changeover.

The definition of "limited attribution company" has been redrafted and moved to section OB 1 but, in effect, remains the same:

A “limited attribution company” is a:

- (a) building society
- (b) co-operative company
- (c) listed company
- (d) widely held company; and
- (e) foreign company that is not closely held.

### **Background**

Normally a company must have a continuity of shareholding of 49% to enable it to carry forward its tax losses for New Zealand income tax purposes. In relation to imputation credits, the required continuity percentage is 66%. These continuity rules are premised on tracing shareholding through groups of companies back to non-corporate shareholders. Concessionary continuity rules allow for the fact that this is not practical in a number of circumstances.

The concessionary continuity rules do not currently provide continuity when a smaller widely-held listed company takes over or merges with a larger one. However, at least conceptually, the takeover or merger itself might not cause a breach of the continuity rules. Such a takeover or merger should not result in the forfeiture of tax losses or imputation credits when the continuity of shareholding thresholds of at least 49% or 66% are satisfied.

## **INCOME TAX RATES**

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*(Clause 3)*

### **Summary of proposed amendments**

The bill sets the annual income tax rates that will apply for the 2005-06 tax year.

### **Application date**

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

### **Key features**

The annual income tax rates for the 2005-06 tax year will be set at the rates specified in Schedule 1 of the Income Tax Act 2004.

The rates in Schedule 1 that apply for the 2005-06 year are those that applied for the 2004-05 year.

### **Background**

The Income Tax Act 2004 provides that income tax is imposed on taxable income, at the rate or rates of tax fixed by an annual taxing Act.

## **ADDITION OF SPAIN TO THE GREY LIST**

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*(Clause 149)*

### **Summary of proposed amendments**

Spain is being added to the “grey list” of countries to which the controlled foreign company (CFC) and foreign investment fund (FIF) rules do not generally apply. However, investments in CFCs that take advantage of certain concessionary rules in Spain will not receive the advantage of the grey list exemption.

### **Application date**

The amendments will apply from the 2006-07 tax year.

### **Key features**

Part A of Schedule 3 of the Income Tax Act 2004 (the grey list) will be amended to include Spain. Part B of Schedule 3 of the Income Tax Act 2004 is also being amended to include certain corporate income tax regimes in the Canary Islands, Ceuta, Melilla, Alava, Guipúzcoa, Vizcaya and Navarra. Investments in CFCs that take advantage of regimes in these regions are not eligible for the grey list exemption.

### **Background**

The grey list is the list of countries contained in Part A of Schedule 3 of the Income Tax Act 2004. To be included on the grey list, a country’s tax system must meet certain Cabinet-agreed criteria. Spain meets these criteria.

Spain has a number of concessionary regimes that would present tax minimisation and deferral opportunities in New Zealand. Such regimes in grey list countries are listed in Part B of Schedule 3 of the Income Tax Act 2004. Under the new rules, CFC investments taking advantage of these regimes will not receive grey list treatment.

## FARM CONVERSIONS

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*(Clauses 45, 46, 143(12), 143(47), 150, 193, 200(4), 200(5), and 201)*

### Summary of proposed amendments

The bill clarifies the extent to which regrassing and fertilising expenditure that is associated with a significant capital activity, such as a farm conversion, is to be treated on capital account. The amendments will also provide that in all other circumstances, regrassing and fertilising expenditure will be fully deductible in the year incurred.

The capital account treatment will be updated to provide faster amortisation of expenditure to reflect modern farming practices involving shorter pasture rotation cycles. Provision will also be made for the amortisation rates for farming and agricultural expenditure to be updated in future by Order in Council.

### Application date

The amendments will apply to expenditure incurred on or after 1 July 2004.

### Key features

- **Capital account treatment:** To the extent that regrassing and fertilising expenditure is incurred in connection with a significant capital activity, such as a farm conversion, it will be amortised at 45% of the diminished value of that expenditure each year. Schedule 7 to both the Income Tax Acts 1994 and 2004 will be amended to achieve this while retaining the current 6% amortisation rate for expenditure incurred when preparing land for farming or agriculture.
- **Specific limitations:** The two limitations provided to further clarify the boundary between capital and revenue account will exclude from capital account treatment expenditure that is associated with:
  - pasture that has an estimated useful life of one year or less because it would ordinarily be deductible under ordinary principles (see the amendments to section DO 3 of the 1994 Act and section DO 1 of the 2004 Act); and
  - changes in the intensity of farming activities. This could include, for example, moving from eight (low intensity) to 12 (high intensity) sheep or other stock units per hectare. The change will provide consistency regardless of any debate that could support different tax positions such as whether the change occurs in one year, more gradually over a number of years, or as a result of changes in the general technology of farming practices (see the amendments to section OB 1 that define “significant capital activity”).

- ***Revenue account treatment:*** Re-grassing and fertilising expenditure will be fully deductible in the year it is incurred unless it is required to be treated on capital account and amortised. Section DO 3 of the 1994 Act and section DO 1 of the 2004 Act will be amended to provide for this.

## **Background**

Inland Revenue published guidelines (Operational Statement 007) in July 2004 on the treatment of expenditure in converting farms from one agricultural purpose to another. These guidelines set out Inland Revenue's position on the treatment of re-grassing and fertiliser expenditure – that it should be treated on capital account and amortised over time.

Reaction from accountants and farmers questioned the appropriateness of the result in light of modern farming practices and particularly because any re-grassing and fertilising expenditure not considered to be fully and immediately deductible would be required to be amortised at a rate of 6% a year. The amendments were developed in consultation with these groups to update the income tax rules in response to the concerns raised.





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## Other changes to the GST Act

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## **GST ON GOODS AND SERVICES SUPPLIED TO SECURITY HOLDERS**

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*(Clauses 203(2) and (6), 204, 205(2) and (4), 206, 207(2) and (5), and 209)*

### **Summary of proposed amendments**

Amendments clarify the application of GST to supplies of financial services following a recent Court of Appeal decision, *Commissioner of Inland Revenue v Gulf Harbour Development Limited*.<sup>23</sup> They also respond to concerns raised in the discussion document, *GST and financial services* regarding the definition of “financial services”.<sup>24</sup>

The amendments:

- protect the integrity of the tax base by ensuring that the consumption of goods and services in New Zealand remains subject to GST even though the rights to consume those goods and services were purchased using a GST-exempt debt, equity or participatory security;
- achieve this objective through rules that will require supplies of normally taxable goods and services that are made as part of a supply of financial services to persons in the form of debt, equity or participatory securities to be treated in a similar way as supplies between “associated persons”; and
- clarify the extent to which supplies can be treated as exempt supplies of financial services in this situation.

### **Application date**

The amendments, unless otherwise specified below, will apply from the date of enactment.

### **Key features**

The key changes to the GST Act are:

- A new term, “associated supply”, will be inserted into section 2. An “associated supply” includes:
  - supplies of goods and services for which the supplier and the recipient are associated persons; and/or
  - the supply of a right, under a debt security, equity security or participatory security, to a supply of goods and services which may be for a consideration that is other than at open market value.

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<sup>23</sup> See *Commissioner of Inland Revenue v Gulf Harbour Development Limited*, CA 5 November 2004, CA 135/03.

<sup>24</sup> See *GST and financial services; a government discussion document*, released October 2002, page 40.

- The meaning of the term “supply” will be amended by inserting new section 5(14B). Section 5(14B) will apply if part of a supply of a debt, equity, or participatory security involves an “associated supply”. The section treats the “associated supply” as separate from the debt security, equity security or participatory security. Section 5(14B) will apply to securities that are supplied on and after the date of enactment.
- The application of section 14(1)(a), which exempts the supply of financial services, will be modified. Existing sections 14(1)(a)(i) and (ii) will be moved to section 14(1B)(a) and (c) respectively. Section 14(1B) also includes a new paragraph (b) (which will apply to financial services supplied on and after the date of enactment) that excludes from the financial services exemption supplies that come within paragraph (b) of the definition of “associated supply” – that is, the supply of rights to goods and services under a debt, equity or participatory security.

Other changes include:

- Section 10(3), which treats transactions between associated persons as made at “open market value”, will be amended to extend to transactions covered by the definition of “associated supply”.
- Section 9(2)(a), which determines the time of supply involving transactions between “associated persons”, will be amended to extend to all transactions covered by the definition of “associated supply”. The time of supply for “associated supply” transactions will be the earlier of when:
  - an invoice is issued;
  - payment is made in respect of the supply;
  - the goods are removed by the recipient or made available to the recipient;
  - the services are performed.
- Section 3(3)(b), which removes from the definition of “financial services” debt, equity and participatory securities to the extent that they include an interest in land, will be repealed as the exclusion for these securities will be covered by the definition of “associated supply” section 5(14B) and section 14(1B)(b). The repeal of this section will apply to securities that are supplied on and after the date of enactment.

## **Background**

Since its enactment in 1985, the GST Act has contained a number of measures that address the substitution of otherwise taxable goods and services for GST-exempt financial services. Examples of these measures include the exclusions that remove from the definition of “financial services” transactions involving real property and shares in the capital of flat or office-owning companies. These measures are designed to prevent consumer preferences from being distorted as a result of otherwise taxable goods and services being repackaged as exempt financial services.

Concerns that similar repackaging could occur for non-land transactions were raised by the government in the discussion document *GST and financial services* in the context of “participatory securities”. However, as the recent Court of Appeal decision, *Commissioner of Inland Revenue v Gulf Harbour Development Limited*, has highlighted, the problem of substitution using the definition of “financial services” also applies to equity securities. Similar substitution could occur with debt securities.

In the *Gulf Harbour* case, the taxpayer group of companies entered into an arrangement to provide equity securities which gave the holder access to the facilities of a country club and were redeemable at the end of 75 years for \$1. The issue concerned whether the supply should be treated as a taxable supply (club membership) or an exempt financial service. The Court confirmed the principle that as GST is a tax on the supply of goods and services its imposition should be determined by reference to the contractual arrangements between the supplier and the recipient. The Court of Appeal concluded that the redeemable nature of the securities meant that they were “equity securities” as they represented participation in the capital of a body corporate. The supply was therefore exempt from GST.

For the most part, determining the GST treatment of a transaction according to its form produces the most efficient tax outcome. This outcome, however, needs to be balanced against the effect that substitution can have on consumer behaviour because of its potential tax advantages. If, in the absence of suitable anti-avoidance measures, a product can be offered without GST, consumers will have an obvious preference for this product over an identical product that is subject to GST, as in the example below.

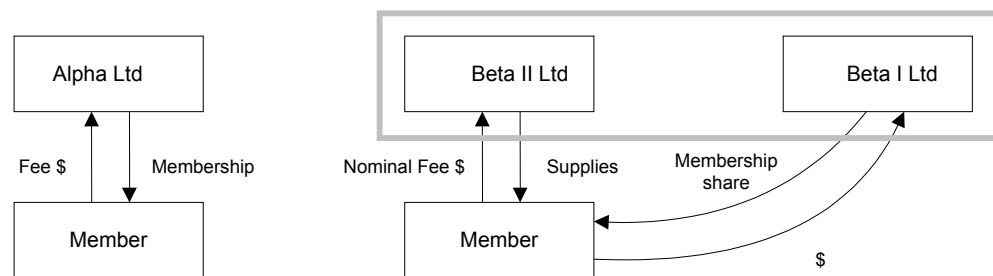
**Example 1: Substitution arrangement**

Alpha Club provides health-club facilities, including gymnasium and aerobic facilities. Membership to Alpha Club costs \$1,350 per annum including GST. Alpha Club requires \$1,200 (net of GST) from each member per annum to operate.

Beta Club, Alpha Club’s competitor, offers comparable facilities and also requires \$1,200 (net of GST) per annum from each member to operate.

**Alpha Club**

**Beta Club**



Instead of annual membership subscriptions, Beta Club’s members are offered shares in Beta Club’s holding company Beta I Ltd for \$11,600.<sup>see note</sup> The shares are redeemable for \$1 in 10 years and permit access to the Beta Club’s facilities which are held by Beta II Ltd. Beta I Ltd treats the supply of the membership share as a GST-exempt supply of financial services. Beta II Ltd charges shareholder members an annual fee of \$45 (including GST) to cover maintenance associated costs. The GST consequences arising from the different pricing structures between the competing facilities are as follows:

<b>Alpha Club</b>		<b>Beta Club</b>	
Taxable supplies	\$1,350	Exempt supplies	\$1,160 (allocated per annum)
GST collected	(\$150)	Taxable supplies	\$45
Net amount	\$1,200	GST collected	(\$5)
		Net amount	\$1,200
		<b>GST savings</b>	<b>\$145 per year</b>

Note: The value of the share is determined by subtracting the nominal annual charge (\$40 excluding GST) from the amount required each year from the members (\$1,200). Therefore \$1,200 - \$40 = \$1,160. \$1,160 x 10 years = \$11,600.

## Detailed analysis

### *General application*

The amendments are directed at arrangements involving supplies of goods and services to final consumers with either or both the following features:

- The supplies would be taxable supplies but for the terms of the debt security, equity security or participatory security.
- The supplies are for a consideration other than market value, which the recipient has a right to receive because of the terms of the debt security, equity security or participatory security.

Paragraph (b) of the definition of “associated supply” and section 10(3) will require the supply of a right under a debt, equity or participatory security to be valued at market if it allows the security holder or another person to receive, for no consideration or a consideration less than the open market value, a supply of goods and services.

These provisions, in combination with sections 5(14B) and 14(1B), attempt to remove any GST advantages that may arise as a result of:

- substituting the supply of otherwise taxable goods and services for a supply of GST exempt financial services; or
- substituting the consideration that would otherwise be payable for a supply of taxable goods and services for the consideration payable for the supply of GST-exempt financial services.

The GST advantages are removed as the supplier of the debt, equity or participatory security will be required to attribute the consideration received for a GST-exempt security to the supply of the goods and services to the extent of the open market value of those goods and services.

#### **Example 2: Marina berth**

Travis pays \$59,000 for a GST-exempt security offered by a company, Construction Ltd, who is constructing a new marina. Once the marina is completed, the security entitles Travis to berth a yacht at the facility. Travis is not required to make any further payments for using the marina facilities. Under the new rules the supplier of the marina will, as a result of paragraph (b) of the definition of “associated supply”, have to attribute (under section 10(3) and section 5(14B)), to the extent of the open market value, some or all of the \$59,000 received for the GST-exempt security to the marina berth.

**Example 3: Company shareholder**

Maude purchases shares in a company for \$20,000. The shares entitle Maude to dividends and supplies of goods and services. Under the new rules the company will, as a result of paragraph (b) of the definition of “associated supply”, have to recognise (under section 10(3) and section 5(14B)), a liability for GST on the market value of the goods and services supplied to Maude if those goods and services are supplied under the rights given by the shares.

***Limits to the term “associated supply”***

There are two exclusions from paragraph (b) of the definition of “associated supply”. The exclusions apply if the debt, equity or participatory security:

- gives a right to exempt supplies of goods and services, such as bonus share issues or residential accommodation; or
- provides rights in relation to the control of the issuer, such as voting rights.

These exclusions attempt to remove rights that would be exempt from GST or that are inherently associated with shares from the definition of “associated supply”.

***Market value***

The objective of the amendments is to ensure that GST correctly applies to supplies of taxable goods and services that arise as a result of a final consumer holding a debt, equity or participatory security. Although the amendments apply to “associated supplies” to both consumer and business security holders, the valuation rules in sections 10(3) and 10(3A) mean that the requirement to value at open market value goods and services treated as separately supplied under section 5(14B) at open market value generally arises only in respect of final consumers.

Specifically, “associated supplies” acquired by recipients for the principal purpose of making taxable supplies and who are entitled to deduct input tax on that supply are excluded from the open market value requirement. This exclusion reflects the fact that the transaction between the supplier and the recipient is effectively GST-neutral because the GST liability on the supplier would be offset by a corresponding deduction of input tax of equal value by the recipient.

The open market value rules also do not apply if the consideration for the “associated supply” equals or is greater than the open market value of the supply.

Section 4, which defines “open market value”, uses a “willing buyer/willing seller” test to determine the open market value of a supply. Inland Revenue has made a number of observations about the terms used in the definition of “open market value”.<sup>25</sup> The terms “similar circumstances” and “freely offered” in section 4 are particularly relevant for the treatment of goods and services that are supplied to the security holder for a discount.

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<sup>25</sup> See *Tax Information Bulletin*, Volume 6, Number 14 (June 1995), pages 6 to 8.

If an “associated supply” arises as a result of a discount, because a security holder holds a security in the GST-registered person supplying the goods and services, whether the discounted price may be treated as the open market value will depend on the circumstances under which the discount is offered. The discounted price could equate to open market value if, for example, it was comparable to a discount offered to an arm’s-length third-party or to the general public.

**Example 4: Company shareholder**

Cally pays \$11,000 for a parcel (5,000) of shares in Global Retail Ltd. The shares allow shareholders to vote at shareholder meetings and receive dividends. Shareholders of Global Retail Ltd are also entitled to acquire goods and services from Global Retail’s subsidiary company Local Retail Ltd for a discounted amount. The discount is 5% and is equivalent to discounts offered under Local Retail’s frequent shopper programme once the shopper has spent more than \$500 in three months.

The membership security is GST-exempt when supplied. However, if Cally purchases goods from Local Retail Ltd for a discount, consideration should be given at the time of supply as to whether GST should be returned on the full purchase price of the goods rather than the discounted price. As the discount offered by Local Retail Ltd is comparable to the discount it offers its customers under its frequent shopper programme, Local Retail is not required to return GST on the full price.



## **GST AND INTERNATIONAL POSTAGE STAMPS**

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*(Clauses 205(1) and (3))*

### **Summary of proposed amendment**

GST pricing advantages for postal operators who are not required to register under the Postal Services Act 1998, and therefore are arguably not required to pay GST on international outbound mail delivery, will be removed. The GST Act definition of “postage stamp” is linked to the Postal Services Act. The imposition of GST on postage stamps for international outbound mail is based on whether a person is registered under the Postal Services Act rather than on the nature of the postal services supplied. The differential GST treatment between registered and non-registered postal operators should be removed.

### **Application date**

The amendment applies from the date of enactment.

### **Key features**

The amendment will remove from the GST Act the reference to the definition of “postage stamp” as contained in the Postal Services Act and replace it with a generic definition of “postage stamp” in section 5(11)(a) of the GST Act. The amendment clarifies that all postage stamps supplied in New Zealand are subject to GST, irrespective of whether the stamps are used to send mail overseas and irrespective of whether the seller is registered under the Postal Services Act.

### **Background**

The sale or issue of the token, stamp or voucher is the supply for GST purposes. A supplier may treat as the supply the redemption of a token, stamp or voucher instead of the issue or sale if it is not practical to treat the issue or sale as the supply. If the supply occurs on redemption it can arguably be zero-rated as a transport of goods, as the “goods” are being transported at the time of redemption. However, this is not the case if the supply occurs on sale or issue.

The GST Act provides that the ability to treat the supply as occurring on redemption – and therefore zero-rated – does not apply to a “postage stamp” as defined in the Postal Services Act.

This means that postal operators registered under the Postal Services Act have to charge GST on sale or issue of the stamp, whereas postal operators not regulated by the Postal Services Act can, arguably, zero-rate stamps issued for international mail.

Ensuring that GST applies to the supply in New Zealand of postage stamps for international mail is consistent with the general policy of taxing services that are consumed in New Zealand at the single rate of 12.5%. The New Zealand-based sender of the mail is considered to receive the benefit of having it sent to another person and therefore as having consumed the postal services in New Zealand.

## **GST AND DISTRIBUTIONS FROM A TRUST MADE FOR NO CONSIDERATION BETWEEN ASSOCIATED REGISTERED PERSONS**

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*(Clauses 207(1) and (3) to (4))*

### **Summary of proposed amendment**

The amendment to the GST Act clarifies that distributions from a testamentary trust or by way of a gift between associated registered persons are revenue neutral.

The proposed amendment ensures that the market valuation rule does not apply if the supply is made for no consideration and the registered recipient applies the goods and services in a taxable activity from the time of supply.

### **Application date**

The amendment applies from the date of enactment.

### **Key feature**

Section 10 of the GST Act 1985 is being amended to preserve the intended revenue-neutral effect of a supply of goods and services between two registered associated persons when the goods or services are applied in the recipient's taxable activity from the time of supply.

### **Background**

The distribution of property to a beneficiary under a testamentary trust on the death of a registered person, or as a gift, is a supply for GST purposes. Such supplies will generally be between associated persons.

Supplies for no consideration between associated persons are valued for GST purposes at the open market value of the supply under section 10(3) of the GST Act. This rule applies when the supply is made to an unregistered beneficiary, or a registered beneficiary receives goods or services in their private capacity.

This valuation rule does not apply if the supply was acquired for the principal purpose of making taxable supplies and the associated supplier and recipient are both registered for GST purposes: section 10(3A) of the GST Act. In this situation the value of the supply is treated as the amount actually paid, which in the case of a distribution under a trust is nil, the rationale being that with two registered associates the result is tax neutral whatever valuation is used.

In the case of a supply made under a testamentary trust or as a gift between two GST-registered persons, the recipient could be regarded as merely receiving the goods as a beneficiary. The recipient has no *purpose* of acquisition. Therefore output tax would be charged at the open market value. The beneficiary would be denied an input tax deduction because the goods were not acquired for the *principal purpose* of making taxable supplies. The transaction would no longer be tax neutral as intended by section 10(3A). The amendment seeks to remove this anomaly.

## **GST ON GOODS OUTSIDE NEW ZEALAND AT THE TIME OF SUPPLY**

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*(Clause 208)*

### **Summary of proposed amendments**

An amendment confirms that goods such as motor vehicles that are contracted for and consumed in New Zealand but located outside New Zealand at the time of supply are charged at the standard rate of GST. It is a revenue base protection measure designed to prevent the attempted avoidance of GST by using third parties to import goods that were offshore at the time of supply.

A second amendment deals with the possibility of the first amendment giving rise to double taxation when GST is payable on the supply of goods under the contract and again payable (but not able to be claimed back by way of input tax credit) on importation of the goods.

### **Application date**

The amendments will apply to supplies made on or after the date of introduction of the bill.

### **Key features**

Section 11(1)(j) of the Goods and Services Act 1985 (the GST Act) is being amended to allow zero-rating of goods outside New Zealand only if the goods are not in New Zealand at the time of delivery to the recipient. This confirms that the standard rate of GST should apply to goods consumed in New Zealand.

A specific rule is also being included to eliminate the possibility of consequential double taxation by allowing the supply to be zero-rated if the recipient pays GST on the import to the New Zealand Customs Service. Double taxation could arise if the recipient is unregistered and imports the goods but is unable to claim an input tax credit on the GST paid on import. By allowing the supply to be zero-rated the double impost is avoided but GST is still collected at the border.

### **Background**

The amendments confirm the principle that GST should be applied to goods consumed in New Zealand. Section 11(1)(j) is intended to allow a zero-rate of GST to be applied to a supply of goods not consumed in New Zealand that would otherwise attract the standard rate of GST.

For example, a New Zealand-resident car dealer contracts with a recipient to provide a vehicle that, at the time of supply, is in Australia (possibly held in an Australian branch or warehouse). Rather than using the vehicle in New Zealand the recipient retains the vehicle in Australia to use in its Australian operations. In the absence of section 11(1)(j), the vehicle would be considered to be supplied in New Zealand and GST would be required to be applied at the standard rate. However, section 11(1)(j) overcomes this by zero-rating the supply if the vehicle is not going to be used in New Zealand.

The main amendment removes the incentive to insert third parties to perform importing functions in an attempt to avoid GST, This is achieved in the amendment by focusing on the physical delivery of the goods to the recipient.

The related amendment includes a specific rule to deal with double taxation occurring in some situations. This may occur where the New Zealand recipient is unregistered and assumes responsibility for importing the goods contracted for with the New Zealand retailer. Without the additional specific rule, the consumer would be required to pay GST to the New Zealand retailer on the supply and on the importation of the goods.

The specific rule zero-rates the supply, thereby eliminating the double impost and instead relies on GST being collected on importation. The outcome is that GST is paid, albeit at a different collection point.

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## Other changes to the Tax Administration Act

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## **MINOR REMEDIAL AMENDMENTS TO THE TAX ADMINISTRATION ACT 1994 (TAA)**

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*(Clauses 155(17) and (23), 164, 165, 166, and 167)*

A number of minor remedial amendments are required following enactment of the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 (the amending Act) which made changes to the disputes resolution process contained in the Tax Administration Act (TAA) 1994.

### **Two-month response period to a notice of disputable decision**

Section 3 contains a definition of “response period” within which parties to a dispute must produce the relevant document. The two-month response period for taxpayers to issue a notice of proposed adjustment (NOPA) to their self-assessment or the Commissioner’s assessment was changed in the amending Act to four months. However, the response period for a taxpayer to issue a NOPA to a disputable decision that is not a notice of assessment remains at two months.

For consistency, the two-month period for a taxpayer to issue a NOPA to a notice of disputable decision should also be changed to four months.

The amendment applies from 1 April 2005, the date the new disputes rules took effect.

### **Commissioner may issue an assessment without first issuing a NOPA**

Section 89C allows the Commissioner to issue an assessment without first issuing a NOPA in certain circumstances. Section 89C(db), introduced in the amending Act, provides for a new circumstance where the assessment is made in respect of the facts and law which are identical to a previous assessment of the taxpayer “...for another income year...”.

The amendment ensures that this exclusion also applies to previous GST return periods as well as income years.

The amendment applies from the date of enactment.

### **Suspension of the dispute in a test case**

The amending Act introduced a new section 89O to allow for the suspension of a dispute following the outcome of a test case. The suspension may be agreed in relation to a dispute between the Commissioner and a taxpayer if the Commissioner has designated a case involving another taxpayer as a test case. Any applicable time bars are stayed until the outcome of the test case.

The period of the suspension starts from the date of the agreement and ends on the earliest of:

- the date of the court's decision in the test case: or
- the date on which the test case or the dispute is otherwise resolved.

A further provision describes the period of time within which the Commissioner must make the assessment. The period could require the Commissioner to issue the assessment on the date of the relevant decision. Practically, it will not be possible to issue the assessment if the period from the application to the time bar is not included in the time allowed for the suspension.

The amendment clarifies that the period starting on the date of the agreement (made within the time bar) is in addition to the period within which the Commissioner must make the assessment (the four-year time bar). If the agreement to suspend the dispute is reached shortly before the application of the time bar, the amendment allows a further 60 days to issue the assessment.

The amendment applies from the date of enactment.

### **Application to High Court to issue an assessment without completing the disputes process**

Section 89N applies in situations where the Commissioner applies to the High Court for an order to allow more time to complete the disputes process, or issue an assessment without completion of the disputes process.

The period of time is the total of the four-year time bar, and the period of time that starts on the date of the application (made within the time bar) and ends on the earliest of the date of the Court's decision, the date on which the application or dispute is otherwise resolved. The period could require that the Commissioner issue the assessment on the date the relevant decision is made, rather than also allowing the time from the date of the application to the time bar to be included in the total time of the suspension.

The proposed amendment clarifies that the period starting on the date of the application is in addition to the period within which the Commissioner must make the assessment (the four-year time bar).

The amendment applies from the date of enactment.

### **Request for information under a statute**

Section 89N(1)(c)(vi) enables the Commissioner to issue an assessment without completing the disputes process where the disputant has failed to comply with an information *request*.

The provision of information is generally *required* by the Commissioner under the TAA. Therefore the proposed amendment replaces all references to the word “request” in the provision allowing the Commissioner to issue an assessment without completing the disputes process with the word “require”.

The amendment applies from the date of enactment.

### **Cross reference correction**

Section 89D(2C) provides that if the Commissioner has made a GST assessment for a taxpayer, the taxpayer can dispute the assessment only if they provide a return for the relevant GST-return period. The proposed amendment provides that the general requirement in section 16(3) of the GST Act for a return to contain a notice of assessment does not apply in this case.

The amendment applies from the date of enactment.