

Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill

Commentary on the Bill

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Taxation of investment income

OVERVIEW

The bill introduces a major reform of the rules on taxing income from investment through New Zealand collective investment vehicles and on taxing income from offshore portfolio investment in shares.

The current tax rules on investment operate very unevenly. They over-tax some investors, they favour direct investment by individuals over investment through funds, and they favour investment in some countries over investment in others.

A basic principle of taxing investment income is that the tax rules themselves should not create investment distortions. Investments should be taxed the same regardless of where the investment is located, and those who invest through intermediaries such as managed funds should be taxed in the same way as those who invest directly.

The amendments in the bill aim to achieve a coherent and balanced tax treatment of New Zealanders' investment income.

NEW TAX RULES FOR COLLECTIVE INVESTMENT VEHICLES

(Clauses 6, 12, 85, 86, 98, 99, 100, 101, 102, 104, 113(2), 120, 122, 126, 129, 144, 145, 148, 154, 155, 160, 167, 168, 169, 170 and 171)

Summary of proposed amendments

The bill introduces new tax rules for collective investment vehicles that meet the definition of a “portfolio investment entity”. Under these optional rules, collective investment vehicles that satisfy certain criteria will not be taxable on realised shares gains made on New Zealand and Australian companies. Portfolio investment entities will pay tax on investment income based on the tax rates of its investors (capped at 33%). Income earned via a portfolio investment entity will not affect investors’ entitlements to family assistance or their student loan repayment and child support obligations.

The new rules will treat investment through portfolio investment entities in the same way same as direct investment by individuals, thus removing long-standing disadvantages of saving through intermediaries like managed funds. They will also prevent over-taxation of lower income savers, and eliminate the taxation of capital gains on New Zealand and Australian shares held through a fund. These changes are particularly important given the anticipated 1 April 2007 implementation of KiwiSaver.

Application date

The new rules for portfolio investment entities will apply from 1 April 2007. Collective investment vehicles will be able to adopt the new rules on or after this date by registering with Inland Revenue.

Key features

Collective investment vehicles that meet certain qualifying criteria will be able to choose to adopt new tax rules to become portfolio investment entities. The portfolio investment entity rules will be contained principally in new subpart HL of the Income Tax Act 2004. The rules will be compulsory for KiwiSaver default funds and will come into effect in tandem with the start-up of KiwiSaver.

Qualification criteria for becoming a portfolio investment entity

To qualify to be a portfolio investment entity:

- A collective investment vehicle must have as its principal activity the provision of investment and savings services (as defined by the proportion of its underlying assets that are used to derive specified investment income).

- It must have at least 20 investors, with no individual investor holding more than a 10% ownership interest in the vehicle – the “portfolio investment in” test. There will be some exceptions from these requirements – for example, when a portfolio investment entity invests in another portfolio investment entity.
- It must own not more than 25% of any underlying entity – the “portfolio investment out” test. There will be exceptions from this requirement for investments in other portfolio investment entities and when the total of investments greater than 25% is not greater than 10% of the value of the portfolio investment entity’s total assets.
- It must not issue separate classes of interests that stream different types of proceeds from the same asset to different interest holders.
- It must be a New Zealand tax resident.

If an entity fails to meet one or more of these requirements, it will result in forfeiture of portfolio investment entity status. A portfolio investment entity will be able to breach one of the requirements temporarily without forfeiting its qualifying status if the breach is due to factors outside the entity’s control (for example, on start-up and wind-down of the entity) and is rectified in a specified timeframe (within six months).

The rules for electing to become a portfolio investment entity and ceasing to be such an entity are contained in new sections HL 2, HL 4 and HL 7 of the Income Tax Act 2004. The eligibility requirements for a portfolio investment entity are contained in new sections HL 5 and HL 6 of the Income Tax Act 2004.

Definition of “income” for a portfolio investment entity

Portfolio investment entities will not be taxable on realised gains on domestic shares (investments in New Zealand-resident companies) and Australian shares (investments in Australian-resident companies listed on the Australian Stock Exchange). This non-taxation of realised domestic and Australian share gains will not extend to situations where a portfolio investment entity does not have full equity risk associated with an investment. This exclusion for realised New Zealand and Australian share gains is contained in new section CX 44C of the Income Tax Act 2004.

For offshore shares held outside Australia, income will be calculated under one of the calculation methods under the new foreign investment funds rules (described in greater detail in the section on the new tax rules for offshore portfolio investment in shares). The definition of “taxable income” will otherwise remain the same as it is under the Income Tax Act 2004.

Requirements for investors in portfolio investment entities

Savers will need to know whether their collective investment vehicle has adopted the new rules, as the associated benefits will arise only for investment via portfolio investment entities. Lower income savers will be able to elect a tax rate of 19.5% if their previous year’s total income (such as salary and wages, interest and any other investment income) is \$48,000 or less. Other individual investors will be taxed at a 33% tax rate on their investments via a portfolio investment entity.

A portfolio investment entity will apply a 0% tax rate for any resident entity investors (such as companies and trusts). Tax on investment income derived via a portfolio investment entity will be payable by the resident entity investors themselves. Any losses made by the portfolio investment entity and tax credits received will “flow through” to resident entity investors.

The tax rates that investors in a portfolio investment entity can elect to use are contained in the new definition of “prescribed investor rate” in section OB 1 of the Income Tax Act 2004.

The tax paid by a portfolio investment entity based on investors’ tax rates will generally be a final tax for individual investors. Individual investors will generally therefore not need to return this income in their tax returns, and individuals who are not currently required to file a tax return will not have to file a return under the new rules.

If a portfolio investment entity makes a net loss or receives tax credits that exceed investment income, their benefit will generally be available to individual investors without their having to file a tax return – in other words, losses and excess credits will be available as a rebate. The amount of the rebate will be calculated under new sections HL 13 and KI 1 of the Income Tax Act 2004.

Portfolio investment entity income will not affect individuals’ entitlements to family assistance (under the *Working for Families* package) or their student loan repayment and child support payment obligations.

The fees incurred by investors on their investments in a portfolio investment entity will be subject to the general rules for deductibility of investment fees.

Requirements for portfolio investment entities

A portfolio investment entity will be required to pay tax on investment income based on the elected tax rates of its investors. It will pay tax on investment income quarterly (although it will have the option of doing so more frequently), with tax paid based on the tax rates of all persons who were investors at any time during the relevant income calculation period. The provisions for calculating the tax payable by a portfolio investment entity are contained in new sections HL 10 and HL 12 of the Income Tax Act 2004.

Defined benefit superannuation schemes electing to be portfolio investment entities

A defined benefit superannuation scheme is a type of collective investment vehicle in which investors’ entitlements are not linked to their contributions. Defined benefit superannuation schemes that meet the definition of portfolio investment entity will be able to elect into the new rules and receive the exclusion for realised New Zealand and Australian shares gains. Instead of paying tax based on investors’ tax rates, defined benefit schemes that adopt the new rules will be required to pay tax at a flat 33% tax rate. The tax payable by a defined benefit superannuation scheme that elects to be a portfolio investment entity is contained in new section HL 12 of the Income Tax Act 2004.

Transitional rules on election to be a portfolio investment entity

On becoming a portfolio investment entity, a collective investment vehicle will need to undertake a “notional windup” (a deemed disposal and reacquisition of the vehicle’s underlying assets) under which any underlying assets held on revenue account will be brought to tax and spread forward over three years. Any losses arising on transition will be available to offset against income of the portfolio investment entity in future years. The transitional rules for an entity electing to be a portfolio investment entity are contained in new section HL 2 of the Income Tax Act 2004. The rules for use of transitional losses are contained in new section HL 13.

Background

In June 2004, the government released a discussion document – *Taxation of investment income* – outlining proposals to reform the tax rules for New Zealand-based investment and savings vehicles, as well as the tax rules for offshore portfolio investment in shares. The proposals in the discussion document built on the work carried out in a series of earlier reviews, including one by Mr Craig Stobo in 2004. The proposals for collective investment vehicles have been subject to robust consultation, both from feedback on the discussion document and subsequent consultation with key stakeholders, which has informed the new tax rules for portfolio investment entities proposed in the bill.

The current tax rules for investment income create a number of problems. The first problem is the difference in tax treatment when people invest directly in New Zealand shares and when they invest in such shares via a New Zealand collective investment vehicle. Someone who invests in New Zealand shares directly will probably be taxed only on dividends because the investment is likely to be on capital account. Gains of a capital nature are typically not taxable in New Zealand because there is no general capital gains tax here. However, an equivalent investment via a collective investment vehicle will typically be taxed on dividends as well as any realised New Zealand share gains. This is likely to occur because the vehicle will generally be in the business of trading in shares. When a taxpayer is in the business of trading in shares (or other assets) any income from this business is taxable.

Similar problems arise in relation to investment in offshore shares via a collective investment vehicle. Under the current “grey list” exemption, investments in companies resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States are broadly taxable only on dividends if held directly by individual investors. Investment in these countries via collective investment vehicle are taxable on full realised share gains (as well as dividends) because the vehicle is in the business of trading in such shares.

The second problem that arises with investment via collective investment vehicles is the non-alignment of tax rates of investors with the rate at which these vehicles are taxed. For example, superannuation schemes are taxed at 33%, although the investor might have a lower marginal tax rate (say, 19.5%). This creates a significant tax disincentive for lower income savers to use managed funds in order to have access to a diversified range of investments.

Therefore, under the current rules, collective investment vehicles, while having the greatest mainstream appeal, often suffer the worst tax result. As a result, many less sophisticated investors are discouraged from investing as they may lack the experience or resources to invest directly. This can create a bias against financial intermediation, which is economically harmful and could undermine participation in the proposed KiwiSaver initiative.

The magnitude of the problem is potentially very large as New Zealanders have approximately \$56 billion in financial assets, including superannuation, shares and interests in managed funds – according to Statistics New Zealand and the Retirement Commission (*The net worth of New Zealanders: a report on their assets and debts, 2002*). The current tax rules for investment adversely affect New Zealand firms' access to capital by reducing financial intermediation.

Under the new rules, lower income savers investing in collective investment vehicles that elect to become portfolio investment entities will be taxed at their correct tax rate – 19.5%. The investment income of higher income savers will continue to be taxed at 33%. This is important to ensure that such investors continue to have the incentive to save via collective investment vehicles.

Another benefit is that capital gains on New Zealand and Australian shares held via a portfolio investment entity will no longer be taxed. As noted earlier, these gains are generally taxed if held through a collective investment vehicle, even though the individual savers would generally not be taxed on capital gains if they held New Zealand and Australian shares directly. Further, the proposed market and smoothed market value methods for investments in offshore shares (outside Australia) should more broadly align with the treatment of direct portfolio investment offshore, under the reforms proposed for individual investors. These reforms for individual and non-managed fund investors are discussed in the next section.

Overall, the portfolio investment entity rules are designed to put investment in New Zealand and offshore shares via collective investment vehicles that elect into the new rules on a broadly similar tax footing to investment in those assets directly.

Detailed analysis

Definition of a portfolio investment entity

Principal purpose of savings and investment

Under new section HL 6(5), a portfolio entity must pool investors' funds and invest these funds (at least 90% of the entity's assets) to derive income from investment in land or investment or trading in:

- loans;
- securities;
- shares;
- futures contracts;
- currency swap contracts;

- interest rate swap contracts;
- forward exchange contracts;
- forward interest rate contracts; and
- rights or options in respect of any of these or similar financial arrangements.

An investor in a portfolio investment entity must also not be able to influence the entity in making or disposing of the investments listed above under new section HL 5(4).

“Portfolio in” requirements

Under new section HL 6(2) a portfolio investment entity must have at least 20 investors. Associated persons, as defined in section OD 8(3), will be treated as one investor for the purposes of this requirement. Each investor (including associates) is not allowed to hold more than a 10% ownership interest in the portfolio investment entity, under new section HL 6(4)(b).

The following exceptions will apply to the “portfolio in” requirements:

When an investor is another portfolio investment entity, the 20% investor and 10% ownership interest requirement does not need to be satisfied, although the 10% rules must be complied with by all non-portfolio investment entity investors. This exemption will also arise when the investor is a foreign collective investment vehicle that meets the definition of a portfolio investment entity except for the residence requirement. These exemptions are provided for in new section HL 6(2)(b), (c) and HL 6(4).

A New Zealand-resident qualifying unit trust, a group investment fund, a life insurance company that is a New Zealand resident, and a superannuation fund can all hold up to 20% of a portfolio investment entity, without themselves being one. The 20 investor requirement will still have to be met, however. This exemption is provided for in new section HL 6(4)(a).

“Portfolio out” requirements

A portfolio investment entity must not hold more than 25% of the beneficial ownership in any underlying entity. To hold up to 25% of an underlying entity, the investors in the portfolio investment entity must be able to buy their interest in the portfolio investment entity at the estimated net market value of the underlying assets at least once every five years. If a portfolio investment entity does not offer such a mechanism, it must not own more than 10% of an underlying entity. These requirements are provided for in new section HL 6(7) and (8).

The following exceptions will apply to the “portfolio out” requirements:

A portfolio investment entity can hold a greater than 25% interest in another portfolio investment entity or a foreign collective investment vehicle if the foreign vehicle meets the definition of a portfolio investment entity except for the residence requirement under new section HL 6(6).

Under new section HL 6(6) and (7), a portfolio investment entity can hold more than 25% of an underlying entity if the total of all such investments do not amount to greater than 10% of the total value of the assets held by the entity.

A portfolio investment entity can also hold any interest in real property, subject to certain limitations on use of land losses. This limitation will not apply if the total of all interests in land do not exceed 10% of the total value of the assets held by the portfolio investment entity, under new section HL 17.

Interests give rights to all proceeds from underlying investment

A portfolio investment entity must not issue different classes of units that stream different categories of income from the same asset to different interest holders (such as the dividend stream from New Zealand equities to low-tax rate investors and tax-free capital gains to high-rate investors). This is provided for in new section HL 5(3).

Entity is a New Zealand tax resident

A portfolio investment entity must be a New Zealand tax resident at all times under new section HL 5(2). A portfolio investment entity does not qualify as a New Zealand resident if it is treated under a double tax agreement as not being resident in New Zealand.

Breaches of the portfolio investment entity definition

A portfolio investment entity must monitor compliance with the preceding definition criteria and satisfy those criteria each quarter.

Under new section HL 6(9) a portfolio investment entity will be able to breach the definition criteria temporarily, without forfeiting portfolio investment entity status, for the following reasons:

- *Start-up and wind-down*: an entity can breach the “portfolio in” requirement for up to six months from the date of election into the new tax rules or on announcement of winding up.
- *Breaches owing to factors outside the entity’s control* (such as exit of investors, fall in the value of investments, company amalgamations): the entity will have six months to deal with breaches of the “portfolio in” and “portfolio out” requirements.

A temporary breach that is not rectified in these time frames will result in a permanent breach. Failure to meet any of the other definition criteria will also result in a permanent breach. Portfolio investment entity status will be lost from the date of the breach. A disposal and reacquisition of the underlying assets will be deemed to occur at the point of breach under new section HL 4(2).

An entity that breaches the definition of portfolio investment entity will not be able to elect back in.

Electing into the portfolio investment entity rules

Under new section HL 7, an entity must elect to be a portfolio investment entity by giving notice to the Commissioner of Inland Revenue. In the first year (2007-08 year) an entity will be able to elect into the portfolio investment entity rules with effect from the start of each quarter following the date notice is given. In every other year, an election into the new rules has to be made before the start of a tax year and will take effect from the following year beginning 1 April. The income year for a portfolio investment entity will run from 1 April to 31 March.

Electing out of the portfolio investment entity rules

New section HL 7 also allows a portfolio investment entity to elect out of the new rules by giving notice to the Commissioner. The election will become effective on the following 1 April, with the entity ceasing to be a portfolio investment entity from that date. A portfolio investment entity that elects out of the new rules must undertake a deemed disposal and reacquisition of its underlying assets, for tax purposes, on 31 March.

A portfolio investment entity that elects out of the new rules can only elect back into the portfolio investment entity rules after a period of five years from the year it elected out of the rules.

Definition of “income” for a portfolio investment entity

Under new section CX 44C, gains on sale of shares of New Zealand-resident companies, Australian-resident companies and companies listed on the Australian Stock Exchange are excluded income for a portfolio investment entity.

Under this new section, the exclusion will not apply when a portfolio investment entity does not have full equity risk associated with an investment, for example, by entering into an arrangement with another party to guarantee a gain on disposal. Similarly, if a portfolio investment entity sells and then buys the same New Zealand or Australian shares within 30 days, the gains from the sale will be taxable.

Offshore share investments, outside Australia, held by a portfolio investment entity will be taxable under one or more of the income calculation methods proposed under the new tax rules for offshore portfolio investment in shares.

Income from dividends, interest, rents and other amounts defined as assessable income under the Income Tax Act 2004 will remain taxable.

Rules for investors in portfolio investment entities

Individuals will be able to elect a 19.5% tax rate if their total income from all sources (including portfolio investment entities) in the previous year is \$48,000 or less. All others will be subject to tax at 33%.

The tax rate elected by individuals will be a final tax rate. Investment income from portfolio investment entities will not be returned in individuals' income tax returns and will not affect their entitlements to family assistance (under *Working for families*) or their student loan and child support payment obligations.

A portfolio investment entity will apply a 0% tax rate for its resident entity investors (entities that are required to file tax returns such as companies and trusts). These entities will report portfolio investment income in their tax return and pay provisional tax. A resident entity investor will include another portfolio investment entity.

The portfolio investment entity would apply a 33% tax rate to its income to the extent it is owned by non-resident investors.

If investors' interests are held through a custodian or nominee company it must provide the portfolio investment entity with the tax rate information of its membership (the proportion of 19.5% rate and 33% investors, respectively).

The tax rates that an investor can elect to use for a portfolio investment entity are contained in the definition of "prescribed investor rate" in section OB 1.

A portfolio investment entity is not responsible if an individual elects the wrong rate. It would be responsible, however, if it did not pay tax at the rate elected by its investors. If an individual knowingly elects a tax rate that is too low, he or she could be subject to penalties. In addition, the investor will be subject to tax on income earned through investing in the portfolio investment entity. This could also affect entitlements to family assistance and student loan and child support obligations.

Expenses, such as interest costs, incurred in deriving excluded income by investors will continue to be deductible under ordinary principles.

Tax calculation for a portfolio investment entity (new sections HL 8, HL 9, HL 10, HL 11 and HL 12)

A portfolio investment entity must calculate, at least quarterly, the taxable income earned in that period and pay tax on that income based on the tax rates of all investors who were present during the period. This calculation could occur more frequently than quarterly if a portfolio investment entity wishes to do so.

A portfolio investment entity will calculate taxable income in each quarter as follows:

- Gross income
- Deductible expenses
- = Net income
- + Current year land loss
- Land loss carry-forward
- Transitional losses carried forward (formation loss)

- = Portfolio investment entity taxable income

Under new section HL 12, the tax payable by the portfolio investment entity in each quarter would then be calculated with reference to the tax rates elected by investors, investors' ownership interests, and the period each investor was present in the quarter. Tax credits received by the portfolio investment entity will be available to offset the tax payable on portfolio investment entity income.

Loss limitation for land losses (new section HL 8 and HL 17)

Land losses are ring-fenced when the total value of land owned by a portfolio investment entity exceeds 10% of the total value of the entity's assets. A portfolio investment entity must first calculate the share of net income or loss from land. This is:

$$\begin{aligned} & \text{Land gross income} \\ - & \text{Land deductible expenses} \\ = & \text{Land net income / loss} \end{aligned}$$

If there is a land loss, it is added to a carry-forward amount ("portfolio investor class available land loss"). If there is a land income, the loss carry-forward is reduced by the amount of the income.

The amounts are then used in the section HL 8 portfolio entity taxable income calculation. "Class income" is the taxable income, including any current land income or loss. If there is a net land loss, it is added back as an "excess loss" (so the net land loss does not reduce other income earned by the entity). If a loss carry-forward has been used (the "portfolio investor class available land loss" has reduced) it is allowed as an additional deduction ("land loss used").

Payment of tax by portfolio investment entities and filing requirements (new section 57B of the Tax Administration Act 1994)

Portfolio investment entities will be required to remit tax payments to Inland Revenue quarterly, together with an accompanying return in a prescribed electronic format. These quarterly payments and returns will be due by the end of the month following the end of a quarter.

They must also file an annual reconciliation statement each year, by 20 May of the calendar year in which the tax year ends, in a prescribed electronic format.

Portfolio investment entities will not be subject to the provisional tax rules.

Other issues

Tax paid by the portfolio investment entity will be allocated to each investor by reference to their tax rates and deducted from their ownership interest in the entity under section HL 6(3).

Any distribution paid by a portfolio investment entity made up of income that has been subject to tax under the portfolio investment entity rules will be excluded income of its investors under new section CX 44D. Because the distribution is not taxed, a portfolio investment entity will not be able to be an imputation credit account company.

A portfolio investment entity will be eligible to receive an exemption certificate from application of the resident withholding tax rules.

Investors with losses from portfolio investment entities (new sections HL 16, HL 18 and KI 1)

For individual investors with portfolio investment entity losses and tax credits that exceed portfolio investment entity taxable income, Inland Revenue will compare the losses and tax credits with other tax paid by the investor (PAYE and provisional tax). If enough tax has been paid in relation to these sources Inland Revenue will issue a rebate. Resident entity investors will be attributed any net losses and excess tax credits directly for inclusion in their tax return.

Defined benefit schemes

Defined benefit schemes, as defined in the Income Tax Act 2004, will be able to elect to be portfolio investment entities if they satisfy the definition of a portfolio investment entity. These entities will receive the exclusion for New Zealand and Australian realised shares gains but will not be required to pay tax based on investors' tax rates. They will instead be taxed at 33% on their income under new section HL 12.

Transitional rules for portfolio investment entities

A "notional wind-up" will need to occur at the point a collective investment vehicle elects into the portfolio investment entity rules. This will result in a deemed disposition and reacquisition at market value of the entity's assets under new section HL 2(3).

An entity's tax year is deemed to end the moment before the "notional wind-up", with the entity required to do a normal tax return and pay tax on any income derived in the tax year that ends before the "notional wind-up".

Tax payable on "notional wind-up" will not give rise to imputation credits if paid after the entity becomes a portfolio investment entity. This tax becomes due and payable in three equal instalments over the next three years. Tax payable on transition will not be included in the provisional tax calculations of the entity that is being wound up. The use-of-money interest rules will also not apply in respect of these tax payments.

If a loss arises on "notional wind-up", it will be ring-fenced at the portfolio investment entity level under new section HL 13(3). Any loss that cannot be offset against net income of a portfolio investment entity will give rise to a formation loss carry forward amount. Any losses that relate to the period before a collective investment vehicle elected to be a portfolio investment entity (under new section HL 13(1)) will also be carried forward into the new rules but ring-fenced against portfolio investment entity investment income under new section HL 13(3).

NEW TAX RULES FOR OFFSHORE PORTFOLIO INVESTMENT IN SHARES

(Clauses 5, 7, 8, 19, 20, 21, 22, 51, 54, 55, 56, 57, 58, 59, 60, 61, 62, 63, 64, 65, 66, 67, 68, 69, 70, 71, 72, 73, 75, 79, 82, 87, 88, 126 and 127)

Summary of proposed amendments

The bill introduces new rules for taxing income from investment in a foreign company when the investor owns less than 10% of the company.

Under the new rules, investments by individuals in Australian-resident companies listed on the Australian Stock Exchange will be taxed the same as New Zealand investments: they will be taxable on dividends if the investment is held on capital account or on dividends and realised gains if held on revenue account. Investments in Australian-resident listed companies via portfolio investment entities will generally be taxable only on dividends (to mirror the treatment of realised New Zealand share gains made via portfolio investment entities). There will also be an exemption for interests of less than 10% in foreign companies in “grey list” countries that have a small number of New Zealander shareholders who collectively own 10% or more of the foreign company.

There will be a \$50,000 cost threshold for investments outside Australia and New Zealand held by individuals, below which these investment will continue to be taxable as at present (for example, on dividends only if held on capital accounts). For investments above the threshold, investors will have the option of electing a number of methods. The two main ones are generally being taxed on a maximum of 5% of the opening value of the offshore shares each year (the smoothed market value method) and being taxed on 85% of the change in share value each year (called the market value method).

Under the new rules, offshore portfolio investment in shares will be taxed consistently, whether the investment is made by an individual directly or through a collective investment vehicle. Portfolio investments into certain countries will no longer be disadvantaged, while the tax-favoured treatment of investments in a handful of countries (under the current “grey list” exemption) will be removed.

Application date

The new rules for offshore portfolio investment in shares will apply from 1 April 2007.

Key features

Under the new rules, the exemption from the foreign investment fund rules for investments of less than 10% in companies resident in “grey list” countries will be abolished. The “grey list” currently consists of Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.

The “grey list” will continue to apply for non-portfolio investments of 10% or more in foreign companies. However, owing to their widely held nature, the following will not qualify for this grey list exemption: portfolio investment entities, superannuation schemes, unit trusts, life insurance companies and group investment funds.

Two current income calculation methods under the foreign investment funds rules – the comparative value and deemed rate of return methods – are being replaced by three new calculation methods: market value, smoothed market value and cost. The new methods, plus the current accounting profits and branch equivalent methods, will be available to investors who hold non-controlling investments in foreign companies, irrespective of the level of the interest, and interests in foreign superannuation schemes and foreign life insurance policies.

NZD\$50,000 minimum threshold for application of new foreign investment fund rules (new sections CQ 5(1)(d) and DN 6(1)(d))

A minimum threshold will apply to individuals’ investments in companies other than New Zealand companies and Australian-resident listed companies. If the original cost of the shares purchased totals NZD\$50,000 or less, the foreign investment fund rules will not apply. The investors will continue to pay tax only on dividends if they hold the shares on capital account (meaning they do not actively trade these interests). This minimum threshold will also apply to interests in foreign superannuation schemes and life insurance policies.

For the purposes of applying the threshold, individual investors will also have the option of taking into account half the market value (on 1 April 2007) of interests acquired before 1 January 2000. This is designed to assist investors who cannot remember the cost of investments that they have held for a number of years. This amount will be added to the cost of investments purchased on or after 1 January 2000, to determine whether the NZD\$50,000 minimum threshold has been breached.

Investment in Australian-resident listed companies (new section EX 33(1)(a))

Individual investors and investors other than portfolio investment entities who invest directly in Australian-resident companies listed on the Australian Stock Exchange will continue to be taxed as at present: they will be taxed on dividends only if the share is held on capital account, and on dividends and realised share gains if held on revenue account.

Investments in Australian-resident listed companies by portfolio investment entities will be taxable only on dividends (subject to the portfolio investment entity having full equity risk in the Australian share).

The exemption applies only to Australian companies subject to Australian tax law. To effect the exemption, the Australian company must have a franking account in accordance with Australian tax law. Interests in Australian unit trusts do not qualify for the exemption and generally will be subject to the new rules.

Investment in foreign companies in which a small number of New Zealanders collectively hold a “non-portfolio” interest (new sections EX 33(1)(c) and EX 46B)

Investments in certain foreign companies resident in “grey list” countries will not be subject to the new rules. This exemption will apply when the total number of New Zealand shareholders is 100 or fewer (not including any widely held investors such as superannuation funds) and these shareholders collectively own 10% or more of the foreign company. Such a situation could arise when New Zealand venture capital investors hold interests in New Zealand companies that migrate offshore to gain access to finance. As these investments are more representative of non-portfolio investments (which will still receive the “grey list” exemption) they should be treated similarly. This means investors will be taxed only on any dividends received if the investment is held on capital account.

Other exemptions from the new rules

Other current exemptions from the foreign investment fund rules, such as those for interests covered by the controlled foreign company rules and employment related pensions, will continue to apply.

Income calculation method 1: smoothed market value method (new section EX 44C)

Under this method, which will be available to all investors, foreign investment fund income in a year will be “capped” at the higher of 5% of an investment’s opening market value or the net cash-flow from that investment (dividends and the proceeds from realisations that are repatriated to New Zealand). This method will apply in respect of an individual investor’s total portfolio of offshore shares that he or she elects to treat under this method, instead of having to apply this calculation to each security separately. For investors to calculate their tax under the smoothed market value method, the following steps will be required:

- Step 1: Investors will need to measure the change in the value of their offshore share portfolio over the year. If the value has increased, 85% of this increase plus dividends is the maximum amount that will be taxable.
- Step 2: Investors will then calculate what portion of 85% of the increase in value should be taxed in that year. If they have dividends or repatriated proceeds of at least 5% then that is their total taxable income.

If an investor receives less than 5% in net cash but has positive share gains, 85% of the gains up to a maximum of 5% of the opening value or cost will be taxed. Any excess not taxed will be carried forward to the next year.

For individuals (including trusts established for their benefit) applying the smoothed market value method any gains that are carried forward will be taxable only on repatriation of funds. This means that the proceeds from selling offshore shares will not trigger a tax liability unless they are repatriated (that is, not reinvested in other qualifying offshore shares). Resident entity investors, such as companies and portfolio investment entities, that elect to use the smoothed market value method will not receive the benefit of this rollover relief. Any carried forward gains would also not be taxable on the death of an individual investor.

Losses of up to 5% of the opening value or cost of an investor's share portfolio will be allowed if an investment falls in value, with losses in excess of 5% available when the investment is realised in full and the proceeds are not re-invested in other offshore shares. These losses can be offset against the investor's other taxable income in a year.

Income calculation method 2: "market value method" (new section EX 44B)

Under this method, which will be available to all investors, 85% of the change in share value (plus full dividends) will be taxable each year. This method will also apply to an investor's total portfolio of offshore shares that he or she elects to treat under this method.

Income calculation method 3: cost method (new section EX 45B)

Under this method, which will be available to all investors, offshore investments will be taxed each year on 5% of their cost or dividends, if higher. The cost base is increased each year by the excess of the 5% deemed income over dividends. On realisation of an investment, and repatriation of funds, there will be a wash-up to ensure that 85% of excess gains and losses, respectively, are taxed or allowed as a deduction.

Income calculation method 4: accounting profits method (section EX 42)

The accounting profits method set out in the current foreign investment fund rules will continue to be available. It taxes investments in foreign companies by calculating an investor's share of the underlying after-tax accounting profit of the foreign company.

Income calculation method 5: branch equivalent method (section EX 43)

The branch equivalent income calculation method, which currently taxes interests in offshore companies as if the company were a New Zealand company, will also continue to be available for those investors with sufficient information to use this method.

Background

Proposals to reform the tax rules for offshore portfolio investment in shares were outlined in the government discussion document *Taxation of investment income*, released in June 2004. As with the new tax rules for portfolio investment entities, the proposed reform of the offshore tax rules has been the subject of significant consultation and reflects a number of amendments in the course of policy development, to take into account various concerns raised in consultation.

The current tax rules for offshore portfolio investment in shares favours investment in eight so-called “grey list” countries (Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and United States). Investments in companies resident in these countries are taxed only on dividends if they are held on capital account (which is likely to be the case for most individuals). Dividend-only taxation has become, in many instances, an inappropriate tax base because many foreign companies have a policy of paying low or no dividends. The investor can still, however, derive an economic gain from the investment via an increase in the share price. It is therefore quite easy at present to achieve a low tax or no tax result for direct portfolio investment in shares outside New Zealand. Furthermore, dividend paying and non-paying offshore investments are often substitutable. This can leave higher income or more sophisticated taxpayers with significant ability to minimise their tax burden by investing offshore.

On the other hand, investment in some high growth and lower tax countries, including trading partners in Asia and Latin America, are currently over-taxed relative to investment in countries such as the United States and the United Kingdom. In particular, direct investors currently face significant tax barriers to investment in these countries as a result of the application of the current foreign investment fund rules, which generally tax full accrued capital gains (and capture the full effect of currency fluctuation and share price volatility). This hurts linkages with these newer and increasingly important investment destinations. A more coherent and comprehensive set of tax rules is needed for offshore portfolio investment in shares so that historical investment destinations do not continue to receive undue benefit relative to new destinations.

A further problem with the “grey list” exemption is the difference in tax treatment between investments in those jurisdictions directly and those made through a collective investment vehicle. Under the “grey list” exemption, individuals typically get taxed only on dividends because they will probably hold their shares on capital account. On the other hand, collective investment vehicles are taxed on their “grey list” investments on a revenue account basis (dividends and realised gains) because they are normally in the business of trading in shares. As is the case with investment in New Zealand companies, collective investment vehicles face a tax disadvantage under the current tax rules for offshore portfolio investment in shares.

The new rules are aimed at creating more consistent tax rules for offshore portfolio investment in shares by type of investment (direct versus investment through a collective investment vehicle) and jurisdiction (grey list versus non-grey list and New Zealand) than exist at present. In particular, the changes reflect the need to ensure that investments via portfolio investment entities and other managed funds are not tax disadvantaged relative to direct investment; this is important from the perspective of encouraging investment through KiwiSaver.

Overall, the new rules attempt to levy a reasonable level of tax on offshore share investments. The special case for Australia reflects the fact that Australian dividend yields, like those in New Zealand, are relatively high. Consequently, dividend-only taxation is a reasonable approach for Australian-resident listed companies because a significant portion of the earnings of Australian companies are paid out as dividends because the Australian tax system encourages distributions, as the new Zealand tax system does. Dividend-only taxation is not feasible for taxing investments in companies resident in jurisdictions whose tax systems do not encourage the payment of dividends. For these investments a reasonable level of tax should be collected each year. The proposed method, which broadly taxes 5% of a portfolio's opening value each year, attempts to do so.

Detailed analysis

Interests subject to the modified foreign investment fund rules

The following interests, subject to certain exemptions, will be subject to the new rules from 1 April 2007:

- non-controlling interests in a foreign company. The “grey list” exemption will continue to apply to non-controlling interests of 10% or more, unless the interest is held by a portfolio investment entity, superannuation scheme, unit trust, life insurance company or group investment fund because of the widely held nature of such investors;
- interests in a foreign superannuation scheme subject to the current foreign investment fund rules; and
- interests in foreign life insurance policies subject to the current foreign investment fund rules.

NZD\$50,000 minimum threshold for application of new rules for individuals (new sections CQ 5(1)(d) and DN 6(1)(d))

Individuals (“natural persons” in the bill) with non-controlling interests in foreign companies (outside those subject to the Australian exemption) costing NZD\$50,000 or less will continue to pay tax only on dividends if the interests are held on capital account. This minimum threshold will also encompass any interests in foreign superannuation schemes and foreign life insurance policies. The minimum threshold will be available for a narrow variety of trusts that arise under operation of the law: when the settlor of the trust is a legal guardian of the beneficiary or a person associated with a relative or legal guardian of the beneficiary and is required by a court order to pay damages to the beneficiary; when the settlor is the ACC; and when the trust is of the estate of a deceased person. Discretionary trusts, such as family trusts, will not qualify for the minimum threshold.

A special rule will be available for establishing whether investments that were acquired before 1 January 2000 fall within the minimum threshold. For these shares, the market value as at 1 April 2007 may be halved and used to calculate the amount to be added to the value of interests acquired after 1999 in establishing whether the minimum threshold is breached. If this amount added to the cost of interests acquired after 1999 is more than NZD\$50,000, the minimum threshold will be breached. Treating the cost of pre-2000 interests as half of the market value is optional but, once elected, the treatment cannot be changed in subsequent income years.

Investment in Australian-resident listed companies (new section EX 33(1)(a))

For interests in Australian-resident companies listed on the Australian Stock Exchange (ASX) and held by individuals and resident entity investors other than portfolio investment entities, the current tax rules will continue to apply. These investments will be taxable only on dividends if the shares are held on capital account and on dividends and realised share gains if the shares are held on revenue account. To qualify for this treatment the Australian company must maintain a franking credit account and be liable for tax in Australia on its worldwide income. This will mean that interests in Australian unit trusts that are listed on the ASX will not qualify for the exemption.

When a portfolio investment entity invests into an Australian-resident company listed on the ASX (as defined above) any realised gains on the sale of interests in the company will be treated as excluded income under new section CX 44C. Again, this exclusion will be subject to the portfolio investment entity having full equity risk in relation to the Australian share.

Investment in foreign companies in which a small number of New Zealanders collectively hold a “non-portfolio” interest (new section EX 33(1)(c) and EX 46B)

Investments of less than 10% in foreign companies resident in “grey list” countries will not be subject to the new rules if:

- the total number of New Zealand shareholders in the foreign company is 100 or less with associated parties counting as one person; and
- the New Zealand shareholders collectively own 10% or more of the foreign company; and
- none of the New Zealand shareholders is a widely held company, superannuation scheme, unit trust, life insurance company, group investment fund or portfolio investment entity.

Interests in these companies will be subject to tax under current tax rules: they will be taxable on dividends if held on capital account and on dividends and realised gains if held on revenue account.

If the foreign company has more than 5% of its total assets in non-grey list and non-controlling grey list investments, the income from those investments will be attributed to the New Zealand investors under one of the foreign investment fund calculation methods outlined below.

Methods for calculating foreign investment fund income or loss

Investors will be able to use any one of the following calculation methods in respect of non-controlling interests in offshore companies (other than those subject to the Australian exemption):

1. the market value method;
2. the smoothed market value method;
3. the cost method;
4. the accounting profits method; and
5. the branch equivalent method.

The market value, smoothed market value and cost methods replace the current comparative value and deemed rate of return methods under the foreign investment fund rules. The smoothed market value method and cost method (if the smoothed market value method is not practical) will be the default methods under section EX 41.

1. *The market value method (new section EX 44B)*

Under this method, all offshore interests for which this method is selected will be treated as a pool. Dividends will be fully taxable (and grossed up for foreign non-resident withholding tax with a credit allowed for these amounts).

The calculation method for working out the foreign investment fund income or loss for the year is:

$$0.85 * ((A + B) - (C + D))$$

Where:

- A is the market value of the pool of offshore assets at the end of the income year;
- B is the aggregate proceeds derived in the income year (excluding dividends, but including any proceeds from the sale of pooled assets);
- C is the market value of the pool at the beginning of the income year; and
- D is the aggregate of expenditure incurred on acquiring any assets during the income year.

2. *The smoothed market value method (new section EX 44C)*

Under this method, all offshore interests for which this method is selected will also be treated as a pool. The calculation method will work as follows:

Step 1: Calculating the foreign investment fund income or loss

$$0.85 * ((A + B) - (C + D)) + E + F$$

Where:

- A is the market value of the pool of offshore assets at the end of the income year;
- B is the aggregate cash receipts derived in the income year (excluding dividends, but including any proceeds from the sale of pooled assets)
- C is the market value of the pool at the beginning of the income year;
- D is the aggregate of expenditure incurred on acquiring any assets during the income year; and
- E dividends
- F is the foreign investment fund income or loss carried forward from the previous year after subtracting the gain / loss for that year, calculated using step 2.

Step 2: Calculating the amount of the foreign investment fund income that is actually subject to tax or the foreign investment fund loss that is available as a loss in the year

When step 1 results in foreign investment fund income, the amount of the income that is actually taxable will be the greater of:

- dividends, plus proceeds from realisations (less amounts that are reinvested offshore – for individuals and some trusts only); and
- a deemed percentage, 5%, of the opening market value of the pool.

The amount that is taxable in a year will always be capped by the amount of the foreign investment fund income calculated under step 1. When the income in step 1 is greater than the taxable amount in step 2, the difference is the foreign investment fund income that is carried forward to the next year.

When step 1 results in a foreign investment fund loss, the amount of the loss that is actually allowed in the year will be the greater of:

- a deemed percentage, 5%, of the opening market value of the pool; and
- a deemed percentage, 5%, of the historical cost of all offshore interests in the pool; and

- the amount of the foreign investment fund loss, calculated under step 1, if the closing value of the pool is zero (meaning all offshore interests have been fully disposed of in the year).

Any foreign investment fund income that is carried forward will not be subject to tax on the death of an individual investor.

3. *Cost method (new section EX 45B)*

This method will apply on an interest-by-interest basis, rather than be treated as a pool, and will work as follows:

An investor will be taxable on the following two aspects:

- at the higher of 5% of opening value or any dividends derived each year; and
- 85% of the difference between the sales proceeds and the interest's opening value, on disposal of the interest.

In the year in which the offshore interest is acquired, the opening value will be zero. If the interest is held for the duration of that year, tax will be payable if a dividend is received. In the following year, the opening value for the year will be the sum of all acquisitions in the previous year, less any dividends plus foreign investment fund income in the previous year. In subsequent years, when calculating the opening value for the year, the formula to be used will be:

Opening value in previous year + acquisitions in previous year – dividends received in previous year + foreign investment fund income in previous year.

On the disposal of an interest, 85% of the difference between the sales proceeds and the opening value of the interest in the year of sale will be taxable. When only part of the interest is sold, the part of the opening value of the interest that is sold must be calculated (by reference to the percentage of the interest that is realised).

4. *The accounting profits method (section EX 42)*

The accounting profits method set out in the current foreign investment fund rules will continue to be available.

5. *The branch equivalent method (section EX 43)*

The branch equivalent method set out in the current foreign investment fund rules will continue to be available.

Rules for converting amounts from foreign currency into \$NZD

Under the market value, smoothed market value and cost methods, investors will have two options for performing exchange rate conversions:

- conversion using the exchange rate on the day each amount is derived; or
- conversion at the average of the close of trading spot exchange rates for the fifteenth day of each month that falls in the year.

Values at which offshore interests enter the new rules and other transitional rules (new sections EX 51B and EX 54B)

For investors other than individuals who hold their offshore interests on capital account, the opening value, for the purposes of the market value and smoothed market value methods, is the market value of the investment at 1 April 2007.

For individuals who hold their offshore interests on capital account, the opening value, for the purposes of the market value and smoothed market value methods, is the higher of cost or market value on 1 April 2007.

All persons who hold their offshore interests on revenue account will enter the new rules at cost.

If a taxpayer is currently using a current foreign investment fund income calculation method (for example, under the “comparative value” and “deemed rate of return” income calculation methods) the new opening value is the closing value used for the current foreign investment fund income calculation method.

If a taxpayer has a ring-fenced foreign investment fund loss carry-over from 2006-07, it will become deductible in 2007-08 as foreign investment fund losses will no longer be ring-fenced (other than those arising from using the branch equivalent method).

Rules for moving between income calculation methods (new section EX 51(3) and (4))

When changing from the market value and smoothed market value methods to the cost method there will be a deemed disposal and reacquisition at market value. The opening value for the purposes of the cost method will be the acquisition price.

When changing from the cost method to either the market value or smoothed market value methods there will also be a deemed disposal and reacquisition at the interest’s opening value. The opening value, for the purposes of the market method or smoothed market method, will be this value.

Other policy matters

EXEMPTION FOR MILITARY SERVICE IN OPERATIONAL AREAS

(Clauses 2(14), 10, 126(22) and 126(24))

Summary of proposed amendments

Allowances paid to members of the New Zealand Defence Force that are directly and solely for defence force service in operational areas will be automatically exempt from income tax.

A ministerial committee will also continue to have the ability to exempt from income tax the pay and other allowances paid to members of the New Zealand Defence Force who are serving in operational areas.

The amendments are intended to remove administrative difficulties in the payment system.

Application date

The amendments come into force three months after the date on which the bill receives the Royal assent.

Key features

Section CW 19 is being amended to allow:

- additional allowances paid to members of the New Zealand Defence Force as a direct result of their deployment to an operational area to be automatically exempt from income tax; and
- a ministerial committee (which includes the Prime Minister, the Minister of Defence, the Minister of Finance and the Minister of Foreign Affairs) to determine that any amounts of pay and/or allowances (other than allowances paid as a direct result of the deployment to an operational area) are exempt from income tax.

An “operational area” is an area that satisfies a two-part test. First, the Minister of Defence must have ordered the deployment of New Zealand Defence Force members for a specific mission authorised by the government. Second, the Chief of Defence Force must have defined the area in which the mission is to be carried out.

Operational allowances currently paid under the Defence Force Allowance Programme (a special assistance programme under the Social Security Act 1964) will be exempt under this provision when it comes into force and the programme is terminated.

Background

Allowances are paid to New Zealand Defence Force members serving in operational areas. These allowances are typically paid in recognition of the level of military and/or environmental threat associated with an operational area.

Currently, section CW 19 of the Income Tax Act 2004 provides that all pay and allowances received by members of the New Zealand navy, military or air force while serving in an operational area are exempt income for tax purposes. A ministerial committee comprised of the Prime Minister, the Minister of Finance and the Minister of Defence is responsible for determining if a specified area is an operational area.

As the exemption currently applies on an “all or nothing” basis, the ministerial committee has declined to declare areas to be operational areas. It has considered that allowances paid as a result of a deployment to an operational area should be exempt, but not the full pay and other allowances paid to Defence Force members. Consequently, section CW 19 has not been used.

Instead, operational allowances are paid to New Zealand Defence Force members as special assistance under the Social Security Act 1964, in a programme referred to as the Defence Force Allowance Programme. The current payment system was adopted to ensure that New Zealand Defence Force members could receive additional allowances associated with operational deployments without any flow-on reduction in entitlements to benefits that they, or their dependents, were receiving. The current payment system was intended as a temporary measure only until a long-term payment arrangement for New Zealand Defence Force service allowances could be developed.

CHANGES TO THE TAX TREATMENT OF EXPENDITURE ON GEOTHERMAL WELLS

(Clauses 13, 23, 24, 33, 37, 38, 39, 40, 42, 126, 157, 159 and 162)

Summary of proposed amendments

Changes to the tax treatment of expenditure on geothermal wells remove uncertainty about the deductibility of capital losses arising from failed wells drilled in New Zealand. Under the changes, the owner of a geothermal well will determine whether the well is a failure. This decision determines the tax treatment of these costs:

- If the well is a failure (meaning there is no reasonable prospect of it being used in an income-earning process) a deduction for its cost or the remaining book value will be allowed. If a failed geothermal well is subsequently sold or used, the value of the well will be written back and will be assessable for income tax. In the case of a sale, the write-back value will be the lesser of its original cost or the price received. When a failed well is subsequently used, the write-back value will be the amount of the previously allowed deduction.
- In other cases the costs will be depreciated over the estimated useful life of the well from the date the well is completed. If the well is subsequently sold or written off, a deduction for any losses will be allowed. If the price received for a successful well exceeds its tax book value, the excess up to the original costs of the well will be assessable for income tax.

The changes respond to tax-related problems identified by the industry.

Application date

There are two application dates. The first application date is the 2003-04 income year and relates to the proposal to allow a deduction for failed wells if drilling began, or the well was purchased in or after 2003-04. The other amendments will apply to geothermal wells begun, or purchased, after the date of introduction of the bill.

Key features

The proposed changes will allow a deduction for the capital cost of failed geothermal wells. In the absence of these changes, it is arguable that such expenditure is not deductible. The Income Tax Act 2004 is being amended as follows:

- New subsection EE 6(4) provides that capital expenditure on geothermal wells drilled in New Zealand will be treated as in use, or available for use, for business purposes from the time that the well is completed. The new definition “geothermal energy proving period” is important in this respect.

- Section EE 32 is being amended to ensure that if the well is a failure (meaning there is no reasonable prospect of it being used in an income-earning process) its cost, or remaining tax book value, will be deductible, and in all other cases the cost a well can be depreciated over the estimated useful life of the well.
- Other amendments provide that if a previously failed well is subsequently used and the taxpayer has claimed a deduction for the cost of this well the taxpayer must write back the amount previously allowed as a deduction and this amount will be accessible for income tax.

Background

Power generators had raised concerns about the potential non-deductibility of the cost of unsuccessful geothermal wells. As a result, an officials' issues paper released in late 2005 sought feedback on an option to deal with these industry concerns. The original option, as set out in the issues paper, has been revised because of concerns raised about some of its features. The proposed amendments in this bill are designed to address broadly the industry's concerns.

SPREADING TAXABLE INCOME ON THE SALE OF PATENT RIGHTS

(Clause 45)

Summary of proposed amendments

Vendors will be allowed to spread income from sales of patent rights evenly over three years.

The change is intended to alleviate potential cashflow problems that may constitute a barrier to investment in research and technology.

Application date

The amendment will apply from the 2007-08 income year.

Key features

New section EI 3B will enable taxable income from the sale of patent rights to be spread over three years, including the year of sale.

Background

Patent rights are often sold for non-cash items such as shares or share options. Section CB 26 of the Income Tax Act 2004 makes gains on sale of patent rights taxable income, but if patent rights are sold for non-cash items, a vendor can have a tax liability without having the cash to pay it. This can create cashflow problems for vendors of patent rights, thus creating a potential barrier to investment in research and technology.

The three-year spread will be at the taxpayer's election, giving taxpayers greater capacity to plan for the required cashflows.

AUSTRALIAN SUPERANNUATION FUND EXEMPTION

(Clauses 52, 126(3), 126(14), 126(29) and 126(30))

Summary of proposed amendments

A new exemption is being added to the foreign investment fund (FIF) rules to apply to interests in all Australian superannuation schemes that are subject to strict preservation rules, including restrictions on the early release of those interests before a member's retirement.

The changes resolve compliance problems arising under the current rules and remove a potential disincentive for skilled people to come to New Zealand to work.

Application date

The new exemption applies for the income years corresponding to the 2006-07 and subsequent tax years.

Key features

New section EX 33 of the Income Tax Act 2004 will exempt from the FIF rules interests in the following Australian superannuation schemes:

- approved deposit funds;
- exempt public sector superannuation schemes;
- regulated superannuation funds; and
- retirement savings accounts.

These schemes are subject to strict preservation rules whereby the benefits are generally locked in until the member reaches retirement age. However, individual schemes may have some capacity to pay benefits to members experiencing severe financial hardship and on compassionate grounds, although these payments are strictly limited. (For example, payments are allowed to treat life-threatening illnesses or to prevent foreclosure by a mortgagee or the exercise of an express or statutory power of sale over the family home.) When a member dies the scheme will pay benefits in cash to his or her dependents or estate. It is also possible to transfer benefits between superannuation schemes, but only to Australian schemes that meet certain regulatory standards, including the preservation of benefits.

Background

Individuals working in Australia generally have compulsory contributions made on their behalf by their employers into a superannuation scheme. This type of scheme is an employment-related foreign superannuation scheme for New Zealand tax purposes.

Australian and New Zealand citizens generally cannot access these superannuation interests until they reach retirement age. If these individuals migrate or return to New Zealand they could be subject to tax on these interests under the FIF rules if they continue to make contributions to the scheme after being resident in New Zealand for five years.

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, might not even be aware that they have to account for tax. 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 have a FIF obligation can involve high compliance costs. Although the current exemptions provide some relief from these rules, members may have difficulty in determining which exemption applies to them and what their future obligations are.

In addition, the potential tax consequences under the FIF rules facing certain people with interests in particular superannuation schemes could be a disincentive for them to take up long-term or permanent employment in New Zealand. For example, members of defined benefit schemes¹ need to continue to contribute to such schemes in order to preserve the expected value of their future entitlements. If they cease making contributions, the ultimate benefit payout could be significantly reduced from the level expected had contributions continued. While it is in their interests to continue to contribute they would eventually face tax consequences under the FIF rules. A member could transfer his or her entitlements in a defined benefit scheme to another scheme such as a defined contribution scheme, but this transfer could also give rise to a FIF liability.

The scope of the proposed exemption would have a fairly wide coverage because most superannuation schemes in Australia (including those schemes that receive compulsory employment superannuation contributions under Australia's guarantee scheme) will fall within one of the listed schemes in new section EX 33. These schemes are all subject to strict prudential standards and rules relating to the preservation and early release of superannuation benefits. Therefore the proposed exemption should achieve the desired policy outcome – to resolve the tax and compliance problems arising under the FIF rules in relation to trans-Tasman migration.

¹ Defined benefit schemes provide superannuation benefits that are based on the member's salary at a particular time (or averaged over a particular period) or some other amount specified in the trust deed of the scheme.

Detailed analysis

Description of Australian superannuation schemes

The superannuation schemes listed in new section EX 33 are all constituted under Australian law. The principal legislation governing the regulation of superannuation in Australia is the Superannuation Industry (Supervision) Act 1993 (SISA) and the Superannuation Industry (Supervision) Regulations 1994 (SISR).

Approved deposit funds

An “approved deposit fund” is defined in section 10 of SISA. Approved deposit funds receive, hold and invest certain types of roll-over funds until such funds are withdrawn in accordance with the preservation rules in SISA. They were created as roll-over vehicles into which a member could transfer superannuation benefits so as to retain them in the superannuation system.

Exempt public sector superannuation schemes

An “exempt public sector superannuation scheme” is defined in section 10 of SISA. Exempt public sector superannuation schemes provide for the payment of superannuation, retirement or death benefits, and are established under:

- a Commonwealth, state or territory law; or
- the authority of the Commonwealth, state or territory government, or a municipal corporation, another local governing body or a public authority that is constituted by or under a Commonwealth, state or territory law.

These schemes are specifically listed in schedule 1AA of SISR. Although these schemes are not regulated under SISA, they do conform to the principles of that Act.

Regulated superannuation funds

A “regulated superannuation fund” is defined in section 19 of SISA. These funds have made an irrevocable election for the regulatory provisions of SISA to apply to them. Most entities involved in the provision of superannuation in Australia will be regulated superannuation funds. They include:

- corporate/employer funds, which are established and run by an employer (usually large) for its own employees;
- industry funds, which are for employees of different employers in the same industry, for example, hospitality industry or building industry;
- retail or public offer funds, which are open to any one to join, and are usually run by large banks or life insurance companies;
- small funds approved by the Australian Prudential Regulation Authority² and self-managed superannuation funds.³ These funds have five or fewer members and are predominantly used by the self-employed.

² The Australian Prudential Regulation Authority is responsible for prudential regulation of all superannuation funds, except self-managed funds, and for ensuring that those funds comply with the relevant regulatory standards.

³ Self-managed superannuation funds are administered by the Australian Tax Office.

Retirement savings accounts

A “retirement savings account” is defined in section 8 of the Retirement Savings Account Act 1991. These accounts are typically offered by banks or similar financial institutions and operate in a similar way to a bank account – accumulating small amounts deposited regularly by their members and by the member’s employer and paying interest on those deposits. The money is invested in assets that are low risk. The Retirement Savings Accounts Regulations 1997 contain preservation rules including restrictions on the early release of benefits from retirement savings accounts, which are identical to the preservation rules in the SISR.

Preservation rules and restrictions on early release

In general, superannuation benefits may only be paid out on the occurrence of one of the following events:

- retirement on or after reaching preservation age. A member’s preservation age depends on his or her date of birth – if before 1 July 1960, his or her preservation age would be 55 years.⁴ In addition, if a member is aged less than 60 the scheme must be satisfied that the member never intends to work again;
- reaching age 65 years;
- permanent incapacity;
- termination at any age of gainful employment with an employer who had contributed to the scheme, as long as the benefits are paid in the form of a non-commutable lifetime pension.

The early release of superannuation benefits is not permitted on any grounds other than those specified by the relevant legislation. The final decision on whether a release is permitted on any grounds rests with the trustees of the applicant’s superannuation schemes, subject to the governing rules of the scheme.

There are two main ways in which individuals may be able to access their superannuation benefits before reaching their retirement age. They can apply to their superannuation scheme’s trustee on the grounds of severe financial hardship or apply to the Australian Prudential Regulation Authority for release on compassionate grounds.

Benefits may be released on compassionate grounds only in very limited circumstances. These circumstances are defined in relevant legislation or in the trust deed of the scheme, and cover expenses in respect of medical treatment, medical transport, modifications necessary for the family home or motor vehicle owing to severe disability, palliative care, and funeral expenses. Funds may also be released on compassionate grounds to prevent foreclosure of a mortgage or exercise of a power of sale over the member’s principal place of residence. Benefits can also be released to meet expenses in other cases where the release is consistent with one of these grounds.

⁴ The preservation age is increasing from 55 to 60 on a phased basis between the years 2015 and 2025. This will mean that for an individual born before 1 July 1960, the preservation age will remain at 55 years, whereas for an individual born after 30 June 1964, the preservation age will rise to 60.

The regulatory arrangements attempt to balance the need for superannuation benefits to be protected for retirement purposes against the need for access to be provided where superannuation fund members experience personal emergency situations.

Non-preserved or unrestricted interests

The proposed exemption applies to interests in all Australian superannuation schemes that are subject to preservation arrangements. However, some interests that were acquired before certain dates might not be preserved or restricted. This is because, over the years, the rules relating to accessing Australian superannuation benefits have been gradually tightened to encourage or enforce the preservation of member interests, although the general practice has been to “grandparent” any interests that members have at the time of each change.

Even so, the government considers that these unpreserved or unrestricted interests should still qualify for exemption from the FIF rules as long as the scheme itself is now subject to the preservation rules, including restrictions on early release of benefits. Excluding these interests from the exemption relief would have led to both compliance costs for taxpayers and administrative costs for Inland Revenue, thereby negating any benefit to be gained from the proposed exemption.

CHARITABLE DONEE STATUS

(Clause 89)

Summary of proposed amendments

The Children on the Edge (NZ) Trust, the DIPS’N Charitable Trust (International), The New Zealand Council of the Ramabai Mukti Mission Trust Board, the Waterharvest Trust and the Zonta International District 16 (New Zealand) Charitable Trust are to be given charitable donee status. This will enable donors to obtain tax relief on their donations.

Application date

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

Key features

The following organisations are being added to section KC 5(1) of the Income Tax Act 2004, which lists the organisations that qualify for charitable donee status:

- Children on the Edge (NZ) Trust;
- DIPS’N Charitable Trust (International);
- The New Zealand Council of the Ramabai Mukti Mission Trust Board;
- Waterharvest Trust; and
- Zonta International District 16 (New Zealand) Charitable Trust.

Background

Donations to qualifying organisations entitle individual taxpayers to a rebate of 33 1/3 percent of the amount donated, to a maximum of \$630 a year.

Donations by non-closely held companies, and closely held companies which are listed on a recognised stock exchange, qualify for a deduction to a maximum of 5 percent of their net income.

A Maori authority may also claim a deduction from its net income. The maximum deduction for a Maori authority is 5% of its net income donated to charitable organisations and/or a body that has been defined as a Maori association under the Maori Community Development Act 1962.

Children on the Edge (NZ) Trust

The initial aim of the Children on the Edge (NZ) Trust is to assist children and alleviate poverty and hardship, initially in institutions and schools in Myanmar, and in other countries where children are subject to poverty and hardship.

DIPS'N Charitable Trust (International)

This organisation currently works in the South Pacific, India, Bangladesh and Nepal providing basic necessities to people with intellectual or physical disabilities who are neglected by their own communities.

The New Zealand Council of the Ramabai Mukti Mission Trust Board

This organisation's activities include providing children's homes, schools and medical services in the Maharashtra State in India.

Waterharvest Trust

The Waterharvest Trust has been established to work in developing countries to harvest water in arid areas to provide healthy water for human and animal consumption, and for agriculture. Its activities will be focused in the Middle East.

Zonta International District 16 (New Zealand) Charitable Trust

This organisation will work in countries which are recognised as developing countries by the United Nations promoting education, and the relief of sickness, disease and poverty for women.

THE IMPUTATION SYSTEM AND COMPANIES TREATED AS BEING NOT RESIDENT UNDER A DOUBLE TAX AGREEMENT

(Clause 113(1))

Summary of proposed amendment

An amendment clarifies that companies (other than Australian imputation credit account companies) cannot maintain an imputation credit account if they are treated as being not resident in New Zealand under a double tax agreement.

Application date

The amendment will take effect from the date of introduction of the bill.

Key features

This is a clarifying amendment. Section ME 1(2)(b) of the Income Tax Act 2004 is intended to prevent a company that is treated under a double tax agreement as being not resident in New Zealand for the purposes of the double tax agreement from maintaining an imputation credit account. The amendment makes clear that this provision applies to all resident companies treated as being not resident under a double tax agreement, irrespective of whether they have income that is exempted from tax under that agreement.

Background

Currently, section ME 1(2)(b) provides that a company must not establish and maintain an imputation credit account if it is resident in New Zealand but not subject to tax on part or all of its income under a double tax agreement when it is, for the purposes of that agreement, treated as not being a resident of New Zealand.

The reference in section ME 1(2)(b) to the company being “not subject to tax in respect of part or all of its income under a double tax agreement” is intended to be descriptive: it sets out the general consequence of deemed non-residence under a double tax agreement. It is possible, however, that this reference could be interpreted as narrowing the circumstances in which a company is prevented from maintaining an imputation credit account. A company that was treated as being not resident in New Zealand under a double tax agreement, but that did not actually have any income that was exempted from tax as a result, might consider itself to be outside the scope of section ME 1(2)(b).

Section ME 1(2)(b) is intended to cover all resident companies treated as being not resident under a double tax agreement, irrespective of whether they have income that is exempted from tax as a result. The amendment clarifies the provision to put this beyond doubt, bringing the drafting more closely into line with equivalent provisions elsewhere in the Act.

“SALARY SACRIFICE”: ENSURING THAT EMPLOYER SUPERANNUATION CONTRIBUTIONS ARE TAXED FAIRLY

(Clauses 2(11), 116, 117, 118, 119, 126(33), 130 and 143)

Summary of proposed amendments

The bill introduces changes to ensure that employer superannuation contributions are taxed at approximately the right marginal tax rate for individual employees. The changes are designed to minimise the potential for taxpayers to use excessive “salary sacrifice” as a means of paying less tax.

As a result:

- Specified superannuation contribution withholding tax (SSCWT) rates under the progressive scale will be based on the total of an employee’s salary or wages and employer superannuation contributions.
- The thresholds for SSCWT rates under the progressive scale are being increased by 15% over the corresponding personal income tax thresholds.

In addition, to reduce the complexity of the legislation, methods of assessing tax on employer superannuation contributions that are not being used (39% SSCWT flat rate) or are used only by a small number of offshore employees (the PAYE method) are removed.

Application date

The amendments will apply from 1 April 2007.

Key features

The Income Tax Act 2004 is being amended as follows:

- The basis on which tax rates are selected under the progressive SSCWT scale will be the “SSCWT rate threshold amount”, which is defined as the total of salary and wages and employer superannuation contributions (section NE 2B, definition “SSCWT rate threshold amount”, Schedule 1, clause 10(a), and Part C).
- The thresholds for the progressive SSCWT scale will be increased by 15% over the corresponding personal income tax thresholds (Schedule 1, Part C).
- The PAYE method for assessing tax on employer superannuation contributions will be removed (section NE 2A).
- The 39% SSCWT flat rate will be removed (section NE 2AA, Schedule 1, old clause 10(a)).

The Tax Administration Act 1994 is being amended to take account of the removal of the PAYE method and the 39% flat rate for assessing tax on employer superannuation contributions.

Background

A progressive scale for SSCWT was introduced on 1 April 2004. The intent was to ensure that lower paid workers would not be over-taxed on employer superannuation contributions, by allowing SSCWT rates to be matched with income tax rates, except that there was no 39% SSCWT rate. The rates were based on an employee's salary and wages in the previous income year or, if the employee was new, on an estimate of salary and wages in the current year. This created the potential for employees to sacrifice a portion of salary taxed at higher rates in return for increased employer superannuation contributions taxed at lower rates. If salary and wages were reduced to below \$9,500, the highest rate of taxation on remuneration, by the second year of such an arrangement, whatever form it was received in, would be 15%. Likewise, if salary and wages were reduced to below \$38,000, the highest rate of taxation on remuneration would be 21%. Officials were to monitor the occurrence and extent of salary sacrifice, if any. In 2005, anecdotal evidence, some of it suggestive of systematic misuse of the rules, indicated that the incidence of salary sacrifice – and the consequent risk to the revenue base – were increasing.

Excessive salary sacrifice using the progressive SSCWT scale could undermine the fairness of the tax system, because taxpayers who engage in the practice could pay significantly less tax overall than other taxpayers who earn the same or even less income. Those who engage in excessive salary sacrifice will typically be able to do so only because they have other sources of support, such as high assets or income from investments, or partners who are able to support them, so it is not available to all taxpayers. Government revenue may also be compromised, putting upwards pressure on other tax rates.

An officials' issues paper, *Countering extreme salary sacrifice: ensuring that employer superannuation contributions are taxed fairly*, was issued in February 2006. The issues paper suggested amending the SSCWT rules as set out in the bill. The paper also suggested reducing the complexity in the SSCWT rules by removing methods of assessing tax liabilities on employer superannuation contributions that are not being used.

The government announced in April that it would introduce legislation to ensure that employer superannuation contributions are taxed at about the correct marginal rate for each employee, thus minimising the potential use of excessive salary sacrifice as a means of paying less tax.

Detailed analysis

Changing the progressive SSCWT scale

The intention of the proposed changes to the progressive SSCWT scale is to ensure that employee remuneration received in the form of employer superannuation contributions is taxed at more or less the correct marginal rate for each employee. This is consistent with the original intent of the progressive scale.

New section NE 2B allows employers to choose to calculate SSCWT under the progressive scale, using the SSCWT rate threshold amount and Schedule 1, Part A, clause 10(a). A new definition of “SSCWT rate threshold amount” in section OB 1 sets out the basis for selecting SSCWT rates under the progressive scale as the total of salary and wages and employer superannuation contributions in the previous year or, when the employee is new, an estimate of the amount that he or she will receive as salary and wages and employer superannuation contributions.

However, adding employer superannuation contributions to salary and wages to determine the SSCWT rate threshold amount could result in some employees being over-taxed on employee superannuation contributions if those contributions are sufficiently high to move them over an SSCWT threshold.

Example 1: Over-taxation when SSCWT is based on salary and wages and superannuation contributions, and thresholds are the same as the effective personal income tax thresholds

Hemi earns \$36,000 salary, and also receives \$3,600 in employer superannuation contributions (total of \$39,600). If SSCWT rates are determined by the total of salary or wages and employer superannuation contributions, and thresholds are equivalent to personal income tax thresholds, his SSCWT rate would be 33%, and he would pay \$1,188 SSCWT. Had he received those superannuation contributions as salary or wages, \$2,000 of the \$3,600 would have been taxed at the lower effective rate of 21%. He is over-taxed by \$240 on his employer superannuation contributions.

To minimise the possibility of over-taxation, SSCWT thresholds will be increased by 15% over the equivalent personal income tax thresholds. Available evidence indicates that most employer superannuation contributions are equivalent to 15% or less of salary and wages, so increasing thresholds by this percentage means that employer superannuation contributions alone should not be sufficient to push an employee from one SSCWT threshold to the next.

The new SSCWT threshold scale will be:

<i>Salary and wages and employer superannuation contributions:</i>	<i>Employer superannuation contributions taxed at:</i>
Up to \$10,925	15%
Between \$10,925 and \$43,700	21%
Over \$43,700	33%

The rates and thresholds will be in Schedule 1, Part C.

Example 2: SSCWT based on salary or wages and superannuation contributions, and thresholds 15% higher than the corresponding effective income tax thresholds

Kylie earns \$36,000 salary, and also receives \$3,600 employer superannuation contributions (total of \$39,600). Under the proposed changes to the SSCWT thresholds and rates, her SSCWT rate will be 21%, and she will pay \$756 SSCWT.

As is the case now, there will be no 39% rate for SSCWT under the progressive scale. The 33% default rate will remain, as required under section NE 2(1) and Schedule 1, Part A, clause 10(b), so that employers can elect to pay the default rate of SSCWT. It can be paid even in respect of employees who would be subject to lower rates under the progressive scale, so that employers can elect to pay a higher rate of SSCWT in return for a simpler method of calculating SSCWT. This is similar to the approach taken with fringe benefit tax, where employers can elect to use a higher but simpler rate, or a lower but more complex rate.

Because the highest rate of SSCWT (33%) will be less than the highest rate of income tax (39%), fund withdrawal tax, effectively an extra 5% tax, will continue to apply to certain early withdrawals of employer superannuation contributions from superannuation funds. There will be exceptions in some cases such as hardship and division of matrimonial property, as at present.

Submissions on the issues paper raised concerns about retaining a savings incentive, the possibility of over-taxation, complexity and compliance costs. As detailed earlier, the existing difference between the top rate of SSCWT and the top rate of income tax will be retained, and KiwiSaver, which is expected to come into effect at the same time as the SSCWT changes, provides a savings incentive for all people, especially those on lower incomes. Further, the possibility of over-taxation will be minimised by increasing the SSCWT thresholds by 15% over the corresponding income tax thresholds, and employers will be able to avoid complexity and minimise compliance costs by paying the default rate of 33%.

Removing two options

The flat rate of 39% on all contributions made on behalf of an employee is not being used. This method was introduced so that an employee could bypass the FWT rules by having employer superannuation contributions taxed at the top marginal rate, but it is not being used. Removing this provision will simplify the legislation

The method for assessing tax on employer superannuation contributions whereby they are treated as part of salary and wages and subjected to income tax using the standard PAYE mechanisms is used only by a small number of non-resident employees. Removing this provision will simplify the legislation. Affected employees could be taxed under the progressive SSCWT scale, or at the default rate of 33%.

Consequential amendments

The rules for fund withdrawal tax are being amended to take account of the removal of the flat 39% rate of SSCWT and the PAYE methods of assessing tax on employer superannuation contributions. Both methods enabled employees to bypass FWT on withdrawing employer superannuation contributions from superannuation funds, because the full amount of tax had already been paid on the contributions.

CONSOLIDATED GROUPS AND FOREIGN LOSSES

(Clauses 126(10), 126(36), 126(37), 162(2), 162(4) and 162(5))

Summary of proposed amendment

Certain dual-resident companies will be prevented from grouping foreign losses under the rules for consolidated groups if they cannot do so under loss rules applying to non-consolidated groups.

The amendment will make the rules for consolidated groups consistent with loss rules for non-consolidated groups by preventing losses from being used in two different jurisdictions.

Application date

The amendment will apply from the 1997-1998 income year. However, it will not apply to taxpayers who took a tax position, in a return filed before the introduction of this bill, on the basis that they could group their losses under the current consolidation rules.

Key features

Currently, every member of a consolidated group must be an “eligible company” as defined in OB 1. The amendment will modify the definition of “eligible company” to require that the company in question be incorporated in New Zealand or carry on business in New Zealand through a fixed establishment. The amendment will also require that an eligible company must not be liable for tax in another jurisdiction by reason of domicile, residence or place of incorporation.

A similar amendment is being made to the Income Tax Act 1994 and will apply from the 1997-1998 income year, except for taxpayers who have already filed a return on the basis that they could group their losses under the current consolidation rules.

Background

Under group loss rules, a loss-making company can offset its losses against the income of another company in the same group. Companies can group their losses if they are at least 66% commonly owned.

Under the consolidation rules, companies can elect to be treated as a single entity (the “consolidated group”) if they are 100% commonly owned, subject to certain other requirements contained in the definition of “eligible company”. Effectively, this means that a loss-making company can offset its income against another company in the same consolidated group.

There are two restrictions that limit companies in a non-consolidated group from grouping the same loss in more than one jurisdiction. First, dual-resident companies may not offset losses against the income of other companies in a group. A “dual resident company” is defined as a New Zealand-resident company which is either treated as a non-resident under a double tax agreement or is liable for tax in another jurisdiction by reason of domicile, residence or place of incorporation. Second, in order to offset losses, the loss-making company must either be incorporated in New Zealand or carry on business in New Zealand through a fixed establishment. This requirement helps ensure that companies cannot change their residence to circumvent the restriction against grouping the same loss in more than one jurisdiction.

At present, these rules do not apply in the same way to consolidated groups. While the rules for consolidated groups require that a company be a New Zealand resident, they do not currently include the requirements in the loss rules for non-consolidated groups relating to incorporation or fixed establishment in New Zealand.

Further, although rules for consolidated groups require that a company must not be treated as a non-resident for the purposes of a double tax agreement, there is no restriction on grouping losses if a company in a consolidated group is also liable for income tax in another country because of domicile, residence or place of incorporation.

ANNUAL CONFIRMATION OF INCOME TAX RATES

(Clause 3)

Summary of proposed amendments

The bill confirms the annual income tax rates that will apply for the 2006-07 tax year.

The annual rates to be confirmed are the same rates that applied for the 2005-06 tax year.

Application date

The amendment will apply for the 2006-07 tax year.

Key features

The rates listed in Schedule 1 of the Income Tax Act 2004 will be confirmed for the 2006-07 tax year.

Background

The Income Tax Act 2004 provides for the rates of income tax specified in Schedule 1 of the Act to be confirmed each year.

ALLOWING DOCUMENTS TO BE REMOVED FOR INSPECTION

(Clauses 137 and 141)

Summary of proposed amendment

The Commissioner of Inland Revenue will be allowed to remove documents for inspection. The new power will assist Inland Revenue in its investigation of tax evasion and avoidance schemes, such as cases involving abusive GST refund claims, and, in particular, facilitate the forensic examination of documents.

Application date

The amendment will apply from the day of enactment.

Key features

Section 16B(1) of the Tax Administration Act 1994 allows the Commissioner to remove documents accessed under section 16 of the Act for copying. This provision will be amended to give the Commissioner an additional power to remove and retain the documents for a “full and complete inspection”. The wording of the amendment will therefore be aligned with the existing wording in section 17(3), which applies to documents produced for inspection under that section.

What constitutes “full and complete inspection” of documents will be defined in section 3 of the Act as including use of documents as evidence in court. It will be implicit that a right to “full and complete inspection” also includes the right to perform forensic tests and other actions within the ordinary meaning of the word “inspection”.

Section 16B(2B) will provide that the documents that have been retained by the Commissioner for a full and complete inspection may be retained for as long as is necessary for the inspection. The owner of any document removed will, however, be entitled to a copy of the document under section 16B(4).

Background

Sections 16, 16B and 17 of the Act, relating to access to premises and requisitions for information, constitute the Commissioner of Inland Revenue’s main information-gathering powers.

Currently, although sections 16 and 16B of the Act allow the Commissioner to inspect documents on premises and to remove them for copying, they do not give the Commissioner any power to retain and inspect the documents without making a request under section 17.

However, simply relying on a section 17 request for the provision of information may often be unsatisfactory as the person may refuse to provide the requested document or may even destroy it. Although it is an offence to fail to provide information to the Commissioner when required to do so by a tax law, there are situations when a person may choose that option. Thus a person may prefer to face a monetary penalty for not complying with a request under section 17 rather than be prosecuted for a more serious offence such as fraud or tax evasion based on the documents requested.

There are a number of other reasons for giving the Commissioner the power to remove, retain and inspect documents:

- Having original documents satisfies the “best evidence” rule by which courts may view an original document more favourably than a copy.
- It may be necessary to conduct a forensic examination of an original document. This may happen, for example, when there is a dispute as to who has created the document or to whether the information contained in the document has been altered.
- Section 17(3) of the Act already allows the Commissioner to retain and inspect original documents which are produced in response to a request under section 17. It is anomalous that Inland Revenue has wider powers in relation to documents belonging to a compliant taxpayer than it has in relation to documents belonging to a non-compliant taxpayer.

A system of checks and balances will apply in relation to the use of this new power. Inland Revenue officers are subject to the normal administrative law requirements; these require any public powers to be used for their proper purpose and to be exercised in good faith. In addition, there are internal Inland Revenue rules which preclude official powers from being used for any improper purpose. Inland Revenue advises that the decision to use this new power in a particular case will be delegated to the level of a Team Leader in investigations, and no lower.

EXTENDING THE CIRCUMSTANCES IN WHICH THE COMMISSIONER MAY MAKE AN ASSESSMENT WITHOUT HAVING FIRST ISSUED A NOPA

(Clause 149)

Summary of proposed amendment

The circumstances in which the Commissioner may make an assessment without having first issued a Notice of Proposed Adjustment (NOPA) will be extended to cover the situation when the Commissioner has reasonable grounds to believe that a taxpayer may have been involved in fraudulent activity, irrespective of whether the taxpayer remains in New Zealand. The purpose of the extension is to expedite assessments and allow for efficient debt recovery when there are reasonable grounds to believe that fraud exists.

Application date

The amendment will apply from the date of enactment.

Key features

Section 89C(eb) of the Tax Administration Act 1994 will be amended to remove the words “has left New Zealand”.

Background

When Inland Revenue makes an assessment of tax, it must first issue the taxpayer with a Notice of Proposed Adjustment (NOPA), unless one of the exceptions specified in section 89C of the Tax Administration Act 1994 applies. These exceptions include the situation when Inland Revenue has reasonable grounds to believe that the taxpayer has left New Zealand and may have been involved in fraudulent activity.

However, when Inland Revenue has grounds to believe that a taxpayer who is still in New Zealand may have been involved in fraudulent activity, under the current legislation Inland Revenue would first issue a NOPA, to which the taxpayer then has two months to respond by issuing a Notice of Response (NOR). If the taxpayer does not respond, Inland Revenue can then issue an assessment. This delay in issuing an assessment to allow time for the NOPA and NOR process could delay the debt recovery process, and consequently reduce available funds for collection.

The amendment will enable Inland Revenue to issue an assessment without having first issued a NOPA when it has reasonable grounds to believe that the taxpayer may have been involved in fraudulent activity, irrespective of whether the taxpayer remains in New Zealand.

Taxpayers will still have dispute rights in respect of any resulting assessments made by Inland Revenue. Extending the exception in this way will enable the Commissioner to begin tax debt recovery sooner when taxpayers do not exercise their dispute rights.

GST AND FINANCIAL SERVICES

(Clause 164)

Summary of proposed amendments

The definition of “financial services” in the Goods and Services Tax Act 1985 is to be amended. The amendments will treat certain activities involving actively managed investment in connection with equity securities and participatory securities as supplies of financial services. These financial services may be zero-rated if supplied to businesses.

The amendments, in combination with the zero-rating rules, remove the potential for tax cascades to arise in connection with actively managed investment in another entity.

Application date

The amendments will apply to supplies of financial services made on and after the date of enactment.

Key features

Section 3(1) is being amended by the insertion of new paragraph (kb). The new paragraph treats activities in connection with actively managed investment in equity securities and participatory securities as supplies of financial services.

Section 3(2) is being amended by the insertion of a new definition of “actively managed investment”. Active investment is considered to occur if an investor has an interest in another entity:

- that represents 10% or more of all the equity securities and participatory securities issued by the entity; and
- in which the investor is capable of influencing the day-to-day management of the entity.

Influence over an entity that is exercised through an “associated person” – for example, when the strategic or managerial role and board representation is carried out by an associated management company acting on the investor’s behalf – is also included in the definition.

Background

Supplies of financial services in New Zealand are generally exempt from GST. Since 1 January 2005, however, supplies of financial services to GST-registered persons whose taxable supplies equal or exceed 75% of their total supplies may be zero-rated.

The proposed amendment recognises that, in its absence, certain activities involved with equity investment, such as holding shares in another entity, may not be treated as supplies of goods and services for the purpose of the GST Act.

As a consequence of not supplying goods and services, entities that are solely involved in investing activities, such as investment companies or equity funds, may be unable to register for GST. Any GST incurred by these investors in the acquisition of goods and services is therefore irrecoverable. To the extent that this irrecoverable GST is passed on – for example, in the form of an investment company or equity fund requiring higher returns from investments in other GST-registered entities (investees) – tax cascades may arise. The more actively managed the investment, the greater the possibility that the investment company or equity fund will seek to recover these costs from the investee.

The amendment seeks to resolve this problem by treating actively managed investment in another entity as a supply of “financial services”. If the investment company or equity fund registers for GST it may elect to zero-rate the supplies of these financial services to entities in which they have an investment. This is provided that the investee is GST-registered and 75% of the investee’s total supplies are taxable supplies. Information on when financial services may be zero-rated can be found in Inland Revenue’s *GST guidelines for working with the new zero-rating rules for financial services*.⁵

Activities associated with arranging equity investment in equity securities and participatory securities will not be recognised as supplies of financial services. Such activities will continue to be outside the definition of “financial services”.

⁵ See www.taxpolicy.ird.govt.nz/ or *Tax Information Bulletin*, Vol 16 No 10 November 2004.

GST ON FRINGE BENEFITS

(Clause 165)

Summary of proposed amendment

The amendment extends the circumstances in which fringe benefits are not subject to GST if the GST-registered person providing the benefit is unable to deduct GST when the benefit is acquired.

The purpose of the amendment is to remove the possibility of GST being imposed twice on the supply of certain fringe benefits.

Application date

The amendment will apply to fringe benefits provided or granted on and after the date of enactment.

Key features

The amendment to section 10(7) of the GST Act ensures that fringe benefits deemed to be provided by a GST-registered employer under section 21I(1) have a nil value if the employer is unable to make a deduction under section 20(3) in connection with providing the fringe-benefit.

Background

Fringe benefits are generally subject to GST because the employer is considered to be making a supply of goods and services to the employee. GST, being a tax on final consumption in New Zealand, must be charged on fringe benefits unless the benefit is an exempt or zero-rated supply, or the employer is involved in an activity that makes exempt supplies. The GST treatment of fringe benefits assumes that the GST-registered employer can deduct any GST paid.

In some instances the employer will not be able to deduct GST paid. This can occur if the fringe-benefit is a GST-exempt supply (for example, a low-interest loan), or the fringe-benefit arises as part of a GST-exempt activity carried on by the employer (for example, a motor vehicle provided by an employer that is a financial institution). In these situations the GST Act does not require GST to be charged. However, there are other situations when GST-registered employers may not be able to deduct GST paid.

An example of when the amendment could apply is when gift vouchers are given to employees as a fringe benefit.

The rules relating to vouchers may prevent GST-registered employers from deducting input tax if the initial supply by the issuer of the gift vouchers to the employer is disregarded. Instead, under the rules, GST may be accounted for when the vouchers are redeemed for goods and services. Because GST is not charged by the issuer of the vouchers, the GST-registered employer cannot deduct GST when the vouchers are purchased. Section 211(1) requires tax to be charged when the employer provides the vouchers to an employee. GST would therefore be charged twice in this situation, once when the GST-registered employer provides the vouchers as a fringe benefit and again when the voucher is redeemed.

The amendment will, in this situation, treat the fringe benefit as having a nil value to address the fact that the GST-registered employer is unable to deduct input tax in connection with purchasing the vouchers. GST will still be imposed when the vouchers were redeemed for goods and services.

Remedial amendments

TAXATION OF BUSINESS ENVIRONMENTAL EXPENDITURE

(Clauses 2(8), 11, 47, 48, 49, 132, 142 and 158)

Summary of proposed amendments

New rules for business environmental expenditure were enacted on 21 June 2005 and took effect from 10 June 2005.

The changes clarified and expanded tax deductions available for business environmental expenditure. They were made to ensure that all business operating costs, including those for dealing with environmental concerns, are taken into consideration in calculating taxable income, and that the timing of such deductions is appropriate.

Several remedial changes are required to clarify the new business environmental tax rules and ensure that the original legislation has its intended effect.

Application date

Amendments proposed to the Income Tax Act 2004 will apply to expenditure incurred in an income year beginning on or after 10 June 2005. The proposed change to section DJ 10 of the Income Tax Act 1994 will apply for income years subsequent to 1994-95 if a taxpayer has taken a tax position on the meaning of “industrial waste” before 16 November 2004.

Key features

Treatment of by-products

The definition of “deductible environmental expenditure” allows a tax deduction for dealing with by-products on cessation of business. However, taxpayers may deal with by-products before cessation. The current wording is restrictive and creates a distortion between the treatment of by-products before and after cessation of business. The amendments will remove the words “incurred in the cessation of a business” from item 7, Part B of schedule 6B, to ensure that expenditure incurred before the cessation of business on the treatment of by-products is deductible.

ERA refunds

It was initially proposed that taxpayers would be able to make only one environmental restoration account (ERA) deposit or refund per year. However, in order to increase flexibility, this was subsequently changed. A drafting error means that section CX 43B, which treats certain refunds as excluded income, still refers to the limitation on multiple payments and refunds. This limitation no longer exists and therefore the proposed amendments will remove the words “or after earlier payment or request for refund” from section CX 43B.

The proposed amendments will also clarify that there are two types of refunds permitted under section EK 12, those requested by the taxpayer and those made by Inland Revenue when a taxpayer's ERA exceeds the maximum balance. In calculating the latter, the amount of the refund will be the difference between the actual and permitted balance. The amendments will remove the reference to any amount of refund requested by the taxpayer in subsection EK 12(8).

ERA transfers

To ensure that ERA deposits follow the associated restoration liability, taxpayers are allowed to make transfers from their ERAs in a number of circumstances. However, a number of the new ERA provisions are unclear when it comes to the treatment of transfers.

The proposed amendments will treat an amount as a payment under section EK 16 (transfer on death, bankruptcy or liquidation) unless the transfer is being made to the Ministry for the Environment. Section EK 6 (interest on payments to ERA) will also be amended so that interest is payable on an amount that is treated as a payment under section EK 15, EK 16 and EK 19.

Removal of the distinction between industrial and non-industrial waste

The previous environmental tax rules applied solely to dealing with "industrial" waste. There was no definition of this term, which led to uncertainty as to when tax deductions were available for environmental expenditure. The new rules no longer make this distinction and also retrospectively remove the word "industrial" for any income year for which a taxpayer took a position on the definition of industrial waste before the introduction of the new rules. The proposed amendment to section DJ 10 in the Income Tax Act 1994 will allow a taxpayer who initially qualifies to have the word "industrial" removed to apply this same treatment for subsequent income years up until the time that the new environmental tax rules apply.

TAX DEPRECIATION TREATMENT OF PATENTS

(Clauses 15, 23, 26, 27, 31, 32, 37, 42, 44 and 126)

Summary of proposed amendments

Unintended consequences arising from the new tax depreciation rules for patents, patent applications, and plant variety rights are being corrected to prevent:

- the double counting of the period a patent, patent application or plant variety rights are held when calculating the amount of depreciation loss allowed; and
- an anomaly that does not take into account the remaining life of a patent, patent application, or plant variety rights when additional costs are incurred.

Application date

The changes will apply to patent applications lodged with a complete specification before 1 April 2005 that are granted in the 2005-06 or later income years, patent applications lodged with a complete specification on or after 1 April 2005 and plant variety rights acquired or granted in the 2005-06 or a later year.

Key features

New section DZ 14 provides a one-off “catch up” deduction for the period a patent application was pending for patent applications with complete specifications lodged before 1 April 2007 that are granted in the 2005-06 or a later income year. New section EE 24B provides the one-off “catch up” depreciation deduction for plant variety rights applications that are granted in the 2005-06 or a later income year.

Sections EE 27B to EE 27E are being replaced by new section EE 27B, which provides the correct annual rate for patents acquired and patent applications granted in a person’s 2005-06 and subsequent years. This new provision provides for when a patent application has been completed and a patent is granted. Existing section EE 27 will apply to patent applications that are lodged on or after 1 April 2007 and plant variety rights that are acquired in the 2005-06 or a later income year.

A number of other consequential amendments are being made to sections DB 31(4), EE 16, EE 27(1), EE 37(2), EE 51 and to the definitions of “legal life” in section EE 58 and “acquire” and “dispose” in section OB 1 of the Income Tax Act 2004. The definition of “patent application date” in section OB 1 is being repealed.

Background

The Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 introduced new tax depreciation rules for patents. Under the changes, depreciation begins from the date a patent application is lodged, with a complete specification for patent applications lodged on or after 1 April 2005. For patent applications lodged before 1 April 2005, depreciation will begin from the date patent rights are granted with a “catch up” deduction for the period the patent application was pending. To accommodate the former, new sections EE 27C and EE 27D were added to the Income Tax Act 2004. To accommodate the latter new section EE 27B was added.

The new patent tax depreciation provisions contain the following unintended consequences:

- Sections EE 27B to EE 27D require taxpayers to make an adjustment for the period a patent application or patent is held when calculating the annual depreciation rate for a patent application or patent. However, a similar adjustment (for period of use) is also required under section EE 16 when working out the depreciation deduction that is allowed. This double counting of the period of use results in a lower depreciation deduction being allowed than should be the case.
- Under section EE 19, when additional costs are incurred in relation to fixed life intangible property, these additional costs are added to the asset’s adjusted tax value. This forms the new base for depreciation. The depreciation rate that applies is effectively adjusted up to reflect remaining legal life from the start of the income year in which the additional costs were incurred until expiry of the relevant property right. However, under new sections EE 27B to EE 27D, no such commensurate adjustment to the depreciation rate for a patent application or patent right occurs. This results in the allowable depreciation deduction being lower than it should be.

Similar problems arise in respect of the new provisions for depreciating plant variety rights (contained in section EE 27E).

DEPRECIATION RULES

Depreciation formulas – apportionment of business and private use

(Clauses 18, 25, 35, 36, 41 and 76)

Summary of proposed amendments

Two new formulas that calculate the apportionment between business and private use when there is a loss on a disposal of depreciable property are being added to the legislation. The new formulas correct mistakes in the legislation which prevent the current formulas from apportioning correctly when depreciable property is purchased and disposed of in the same income year.

Application date

The amendments will apply for the year starting on 1 April 2006 and subsequent years.

Key features

Deductions for depreciation are allowed only when assets are used or available to be used for business purposes. Therefore depreciation deductions must be apportioned for assets that are used for both business and private purposes. When assets are disposed of for a depreciation loss (the difference between the asset's depreciated value and the amount received on disposal), the amount of the depreciation loss must be apportioned.

Two identical formulas in sections FB 7 and DE 2 of the Income Tax Act 2004 achieve this apportionment. The formulas, however, do not function as intended when an item of depreciable property or a motor vehicle is disposed of in the same year it is acquired.

One of the variables in both formulas is all depreciation deductions that have been allowed on that asset. The problem is that this will always be zero for assets disposed of the same year they were purchased, since no depreciation deduction is allowed in the year a depreciable asset is disposed of. Therefore the formulas will always produce a result of zero, even though the taxpayer has suffered a loss.

The proposed amendments will rectify this anomaly by introducing two additional formulas into the Act. The new formulas will apply only when depreciable property or a motor vehicle is disposed of in the same year it is acquired. The current formulas will continue to apply when the property has been held for longer than a year.

The first new formula will be inserted into section FB 7. It will apportion depreciation loss on the disposal of depreciable property that was used for both business and private purposes.

The second new formula will be inserted into section DE 2. It will apportion depreciation loss on the disposal of motor vehicles used for both business and private purposes.

The new formulas will work by simply multiplying the depreciation loss on disposal by the proportion the asset was used for business purposes.

A person will be deemed to acquire an item of depreciable property or a motor vehicle when the person starts to use the item or the motor vehicle for business purposes or it is available for business use.

For the new formula to function as intended, consequential amendments are required to the definition of “base value” in section EE 49(2) and determining the “cost of the item” in sections EE 34(3) and EE 33(2).

Background

The rules that govern the income tax treatment of gains and losses from the disposal of depreciable property and motor vehicles include formulas that are used to apportion the proceeds from the disposal between the business and private use of the depreciable property or the motor vehicle.

The two formulas in question appear in sections FB 7(6) and DE 2(7). The former apportions an amount of depreciable loss of disposed depreciable property, while the latter does the same for motor vehicles.

A recently identified problem concerns the operation of the formulas. The formulas do not work when depreciable property is purchased and disposed of in the same income year, because, in those circumstances, one of the variables in the formulas would always be zero. As a result, they produce an indefinite result.

Amendments to the recently enacted tax depreciation rules

(Clauses 28, 29 and 30)

Summary of proposed amendments

Minor remedial changes are designed to ensure that the recently enacted tax depreciation rules operate correctly.

Defining motor vehicles for section EE 25D

Section EE 25D sets the depreciation rates for certain types of aircraft and motor vehicles. The policy intention was that section EE 25D apply only to these assets that previously had residual values above 13.5 percent of cost. The affected assets are cars, minibuses, taxis, and some domestic aircraft. Arguably, section EE 25D may also apply to a broader range of motor vehicles like vans and trucks. It is proposed that the policy intent be achieved by replacing in section EE 25D(3), “having seats for no more than 12 persons” with “that is designed exclusively or mainly to carry people, and has seats for no more than 12 people”.

Section EE 25E

Section EE 25E provides the Commissioner with a method of calculating depreciation rates for assets that have a residual value greater than 13.5 percent of cost. The word “before” was inserted in the legislation rather than the term “on or after”. The proposal is to amend section EE 25E so that it applies to plant and equipment acquired on or after 1 April 2005 and buildings acquired on or after 19 May 2005.

Section EE 26B

Section EE 26B says that taxpayers can elect not to apply the new depreciation rates to plant and equipment acquired before the beginning of the 2006-07 income year. There is a question of whether this section applies to some types of plant and equipment when the depreciation rate is not calculated under the new double declining balance method. The legislation is being amended to remove any uncertainty.

DEATH AND ASSET TRANSFERS

(Clauses 80, 81 and 151)

Amendments are being made to ensure that provisions relating to death and asset transfers in the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 (subpart FI) reflect their policy intention.

Forestry

An amendment ensures that the roll-over relief in section FI 6 of the Income Tax Act 2004 applies for forestry assets held at the date of a taxpayer's death irrespective of whether a life tenant is entitled to part of the trust property and irrespective of who the trustees of the estate are. The roll-over will apply as long as a relative to the second degree of the deceased is beneficially entitled to the forest.

The amendment is effective from 21 June 2005, the date the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 came into force.

10-year rule for land held on capital account

Section FI 7 is being amended to correct a drafting error. A reference to section CB 10 is being change to section CB 12.

Section CB 10 deals with situations where a development or subdivision of land began within 10 years of its acquisition. These sales are taxable, irrespective of when the sale occurred. Because a tax liability should always arise from a sale of land in these circumstances, there is no need to provide roll-over relief when an owner dies.

The reference to section CB 10 is being removed prospectively from 16 May 2006, the date of the introduction of the present bill.

On the other hand, section CB 12 provides that if land is sold within 10 years of acquisition and the land has been enhanced by zoning or similar factors, the profit on sale is taxable. However, if the owner had held the land for 10 years, no tax liability would have arisen on the sale of the land. Therefore the taxpayer's death, in itself, should not trigger a tax liability.

The reference to section CB 12 is being included retrospectively, from 21 June 2005.

Concessionary use-of-money interest

The intention of changes to the definition of "date interest starts" in section 120C of the Tax Administration Act 1994 was that concessionary use-of-money interest rules should apply to any income tax liability arising in the period that ends with the taxpayer's death (subject to the condition that the relevant liabilities are paid on time). An amendment is being made effective from 21 June 2005, to ensure the definition reflects this policy.

FAMILY ASSISTANCE PROVISIONS

(Clauses 90-97)

The bill contains several remedial amendments to the family assistance provisions in the Income Tax Act 2004. Some are required to fine-tune the provisions to ensure that they give full effect to the policy intent of the Working for Families package, while others correct minor drafting errors.

In-work payment and weekly compensation

Summary of proposed changes

The proposed changes are intended to remove any doubt that concurrent entitlement to the in-work payment and weekly compensation under the Injury Prevention, Rehabilitation, and Compensation Act 2001 is limited to accidents on or after 1 January 2006.

Application date

The amendments will apply from the tax year beginning 1 April 2006, the application date for the in-work payment.

Key features

The reference in section KD 2AAA(1)(d) to subsection (7) is being replaced by a reference to subsection (8). The change clarifies that when subsection (8), relating to eligibility for the in-work payment when weekly compensation payments are received as a result of personal injury by accident on or after 1 January 2006, applies, the requirements for income from an activity and full-time earner do not apply.

To further remove doubt, paragraph (xvi) of the definition of “salary or wages” is being omitted from the list in section KD 2AAA(5)(a)(i) of source deductions that are not eligible income from an activity. Paragraph (xvi) of the definition of “salary or wages” relates to payments of weekly compensation made under the Injury Prevention, Rehabilitation, and Compensation Act 2001. Instead, new subparagraph KD 2AAA(5)(a)(iii) is inserted to clarify that only weekly compensation payments under the 2001 Act in respect of accidents before 1 January 2006 are not eligible income from an activity.

In-work payment and paid parental leave

Summary of proposed change

The change clarifies that recipients of parental leave payments are not precluded from entitlement to the in-work payment if they met the necessary full-time work test before receiving paid parental leave.

Application date

The amendment will apply from the tax year beginning 1 April 2006, the application date for the in-work payment.

Key features

Paragraph (x) of the definition of “salary or wages” is being omitted from the list in section KD 2AAA(5)(a)(i) of source deductions that are not eligible income from an activity. Paragraph (x) of the definition of “salary or wages” relates to parental leave payments made under Part 7A of the Parental Leave and Employment Protection Act 1987.

The inclusion of parental leave payments in the list created an inconsistency between the requirement to have income from an activity and the requirement to normally be a full-time earner, both of which must be met, with the result that recipients of paid parental leave would have been precluded from entitlement.

Family assistance for shared care arrangements

Summary of proposed changes

The changes provide flexibility by allowing entitlement to the relevant elements of family assistance when a shared care arrangement is intended to continue for at least four months (one-third of a year), and the proportion of care is such that each parent has exclusive care for at least one third of the shared care period. This could mean, in some instances, that parts of a shared care period would fall in two tax years, something that is currently prevented if the shared care arrangement begins within four months of the end of a tax year.

Application date

The amendment will apply from the tax year beginning 1 April 2006, the application date for the in-work payment.

Key features

The rule in section KD 2 AA(2) that defines who is a principal caregiver is being replaced with a more flexible rule that maintains the idea of one-third of a year as being an indication of some permanence to the shared care arrangement. The flexibility is introduced by allowing any four-month period so that the period does not have to fall entirely within a tax year.

Example: A shared care arrangement that began on 1 February 2006 and was expected to continue at least until June 2006 would meet the proposed test. On the other hand, under current law, as there are less than four months to the end of the tax year, the sharing of the family assistance entitlement could not begin until the first day of the following tax year, 1 April 2006.

The provision relating to the parental tax credit is unchanged – the requirement is one-third of the entitlement period.

The current rule in section KD 2AA(2B) that defines who is a principal caregiver for the purposes of the in-work payment is slightly different in that the period of care does not have to coincide with the period of eligibility for the in-work payment. That rule is also being replaced to allow the greater flexibility in application.

In-work payment for continuous eligible periods

Summary of proposed changes

The concept of an “eligible period” is a critical building block for the design of the system that delivers family assistance. Under the proposed changes, when there are eligible periods of part weeks that together form one continuous period, families will not lose entitlement to the in-work payment in any weeks in which the eligibility criteria are otherwise met.

Application date

The amendment will apply from the tax year beginning 1 April 2006, the application date for the in-work payment.

Key features

The in-work payment is available only when the employment criteria are met for a full week. If an eligible period is less than a week, the current law would not allow in-work payment to be made for that week even if the eligible period is consecutive with another eligible period. This is contrary to the policy intent.

The replacement definition of “weeks” in section KD 2AAA(2) will allow the recognition of contiguous eligible periods as if they were one so that entitlement to the in-work payment is available for all full weeks in which the relevant employment criteria are met. It also maintains the current treatment when only one unbroken eligible period is involved.

Ring-fencing of family support

Summary of proposed changes

The change ensures that the ring-fencing provisions reflect the policy intent that maximum family support entitlement would be guaranteed for periods spent on a benefit if a family’s annualised monthly income (calculated on a month-by-month basis while on a benefit) is below the family support abatement threshold.

Application date

The amendment will apply from the tax year beginning 1 April 2005, the commencement date for the ring-fencing provisions.

Key features

Ring-fencing in the family assistance provisions is intended to protect families who move from benefit to work, or vice versa, during the year. Without ring-fencing, they would incur an end-of-year overpayment of family support if their full year income was at a higher level than their on-benefit income.

However, ring-fenced periods do not currently create new “eligible periods”. This means that when the abatement formula is applied to an eligible period that contains a ring-fenced period, it is possible for the income to eliminate entitlement, even for the periods that have been ring-fenced, and the benefits of ring-fencing are lost.

The proposed additional paragraph to be inserted in the definition of “eligible period” in section OB 1 will provide for a ring-fenced period also to be an eligible period so that it can be excluded from the abatement formula.

Minor technical and drafting amendments

A number of amendments correct errors of a minor technical or drafting nature. Some of these are the result of inadvertent wording and printing changes in the drafting of the Taxation (Working for Families) Act. Other amendments are needed to clarify the effect of links to definitions that also apply elsewhere in the Income Tax Act 2004.

Application date

The following minor amendments are to apply from the tax year beginning 1 April 2006.

Formula for calculating “net specified income”

The formula in section KD 1(1)(g)(ii) for calculating “net specified income” when the person is a major shareholder in a close company (generally, a company with five or fewer shareholders) is being amended to replace the item “(c – d)” with “c”. The change is needed to reflect the current tax position of a close company. Changes to close company and imputation rules created a need to amend the formula, but the need was overlooked when the relevant imputation credit provisions were introduced.

Formula for calculating family assistance tax credits

The definition of item “IWP or CTC” in the formula for calculating the subpart KD credits (family assistance) in section KD 2(2) is being amended to make it clear that a person may get the in-work payment (IWP) or the child tax credit (CTC) but not both concurrently.

Application of definitions

Section KD 3(1) is being amended to clarify that the definitions of “qualifying person” and “employment” specific to the purposes of the family tax credit apply to both the calculation of the family tax credit and the rules for the family tax credit.

Drafting oversight

Section KD 5(6A) (b)(ii) was amended by the Taxation (Working for Families) Act 2004 by replacing the former reference to section KD 5B with the words “sections KD 2 and KD 3”, section KD 5B having been repealed in that Act. However, the need for in-work payment in the list of rates to be included in the calculation of interim instalments in the section was overlooked. That oversight is being rectified.

Adjustment of amounts

The method by which the Governor-General, by Order in Council, is to adjust the threshold of the family tax credit is prescribed in section KD 5C.

Section KD 5C is being amended to correct an inadvertent wording change that would have required the Order in Council to change the whole of the family tax credit, rather than just the item amount in the formula, as was intended. This would have had the effect of prescribing a fixed amount of family tax credit, rather than an amount that has regard to after-tax income of an eligible family.

Payment of arrears by the Commissioner

Under the general rules for payment by instalment, instalment payments can be made only for a period going forward from the date of application.

However, the Commissioner is able to pay the arrears of tax credits for the period since a benefit ceased when a person goes off a benefit but delays application for family assistance to be paid by the Commissioner.

The opportunity has been taken to remove duplication in the relevant provisions by amending section KD 7(3A) to make it clear in what circumstances the provision can be used, and repealing section KD 7(3C).

LIMIT ON REFUNDS AND ALLOCATIONS OF TAX

(Clauses 112 and 161)

Summary of proposed amendment

The imputation rules are being amended to extend the circumstances when tax overpaid before a breach in shareholder continuity can be refunded. The amendment corrects an anomaly in the legislation.

Application date

The change will apply from the 2000-2001 year. This date is arbitrary. It has been chosen because it will ensure that the correct tax treatment is applied to the only case that has been identified so far that is affected by the anomaly.

Key features

Section MD 2(4) of the 1994 and 2004 Income Tax Acts effectively allows an imputation account debit that arises on a breach of shareholder continuity to be ignored for the purpose of calculating a tax refund, but only if the debit arose after the date of payment of the first instalment of provisional tax for the year to which the refund relates. The amendment allows the discontinuity debit to be ignored for the purpose of effecting the refund, whether the tax was originally overpaid before or after the date of the first instalment of provisional tax.

Background

The amendment is necessary because, generally, overpaid company tax cannot be refunded if a refund would result in a debit balance to the company's imputation credit account (ICA).

Under section ME 5(1)(i), a breach of shareholder continuity in a company results in a debit arising to the ICA equal to the balance in the ICA at the time of the breach. Although a "discontinuity" debit can effectively be ignored for the purposes of effecting the refund, there is a condition that the debit arise after "date of payment of the first instalment of provisional tax" for the tax year to which the overpayment applied.

Where a company does not pay provisional tax – for example, because its income tax liability is satisfied instead by resident withholding tax deducted from interest – there is no "date of payment of the first instalment of provisional tax". Therefore no adjustment can be made to the ICA balance under current law in relation to the overpayment that arose before a breach in continuity.

The anomaly has only recently been identified, although it has existed since the imputation rules were introduced. Inland Revenue is aware of only one case that has been affected by it.

FRINGE BENEFIT TAX TREATMENT OF VEHICLES ALREADY LEASED AT 1 APRIL 2006

(Clauses 115 and 131)

Summary of proposed amendments

Remedial amendments to the rules on how to value motor vehicle fringe benefits:

- clarify that, in general, vehicles acquired before 1 April 2006 should be subsequently valued at cost;
- qualify the reference to “the date on which the vehicle ceases to be leased”, to make it clear that it relates to all leases of the vehicle by the employer; and
- clarify that the market value that can be used as the cost price for a re-leased vehicle is the market value at the time the vehicle is first leased or rented to the employer.

The changes clarify the intent and application of the recently enacted changes to the fringe benefit tax rules.

Application date

The amendments apply to fringe benefit tax periods beginning on or after 1 April 2006.

Key features

A deficiency in the recent amendments to section ND 1A of the fringe benefit tax rules in the Income Tax Act 2004 has resulted in some confusion over how employers who had been leasing vehicles before the recent FBT changes should value those vehicles for FBT purposes once the changes come into effect. The first of these amendments addresses this deficiency. The other minor remedial drafting amendments are also aimed at further clarifying the intent of the provisions relating to leased vehicles.

Background

Before 1 April 2006, leased vehicles were valued at their market value at the beginning of the lease. This method is no longer available because of the tax advantages it potentially provided. Instead, the policy intent was that from 1 April 2006⁶ these vehicles should be valued at cost. However, in the process of streamlining the relevant provisions in light of submissions on the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Bill, the legislative clarity around existing leased vehicles was lost.

Similarly, the intention was that vehicles that continue to be subject to 9 to 5 and flip-flop leases should be valued at cost.

Making a change to rectify this oversight is necessary because many of the vehicles that are subject to FBT are leased, and the legislation as written has provided uncertainty for lessees. Accordingly, this legislative amendment ensures that the original policy intent is achieved. It means that one treatment applies to all vehicles on hand at 1 April 2006, irrespective of whether they are leased or owned by the employer as vehicles that were owned before 1 April 2006 must continue to be also valued at cost unless five years have elapsed since the first FBT return for the vehicle.

There is an exception from this requirement to use cost if the initial return period for the vehicle begins on or after 1 April 2006 and the vehicle is not subject to a 9 to 5 or flip-flop lease. The exception enables, for example, an employer who has acquired a vehicle that was previously subject to a 9 to 5 or flip-flop lease to value it at its tax value.

The second amendment is to the words in section ND 1A(1C)(a)(ii) “vehicle ceases to be leased”, to clarify that this means the date on which the vehicle ceases to be leased by the employer (or associated person), in any way. For example, if a series of leases is entered into, switching between methods can be done only once the last lease has expired.

The final change involves an amendment to item 7 of schedule 2, part A to clarify that the market value referred to in that item is the market value at the time the vehicle is first leased or rented to the employer. Item 7 enables an employer who leases a vehicle that has been previously leased to use its market value as its cost price provided the employer and any previous lessee are not associated.

⁶ Or from the income year beginning on or after 1 April 2006 if the employer returns FBT on an income year basis.

REWRITE ADVISORY PANEL – RETROSPECTIVE AMENDMENTS TO INCOME TAX ACT 2004

(Clauses 14, 16, 34, 53, 74, 77, 124, 126(16) and 134)

The Rewrite Advisory Panel has identified that the Income Tax Act 2004, as originally enacted, contains some unintended changes in legislative outcomes. The Panel has recommended that these changes in outcome be corrected, with effect from beginning of the 2005-06 income year.

The provisions affected are:

- section DB 9B (Base price adjustment under old financial arrangement rules);
- section DB 36 (Bribes paid to public officials);
- section EE 33 (Transfers of depreciable property between associated persons in a non-qualifying amalgamation);
- section EX 36(1) (Immigrant's accrued superannuation entitlement exemption),
- section EY 8(3)(b) (Meaning of life insurance),
- section FC 21(3) (Amounts derived by non-residents from renting films),
- section NG 1(2) (Application of NRWT rules),
- section OB 1 (Definition of fixed rate share), and
- schedule 22A (Identified policy changes).

In addition, some corrections to cross-references and terms used in sections EX 52, EX 53, OD 5(6F), and OD 8(3) are being made.

Section DB 9B (Base price adjustment under old financial arrangement rules)

Section DB 9B was inserted into the Taxation (Depreciation, Payment Dates Alignment, FBT and Miscellaneous Provisions) Act 2006 to provide for a deduction on certain amounts calculated under the base price adjustment within the old financial arrangement rules. The relationship between this section and section DA 3 was inadvertently overlooked in its enactment.

The amendment in this bill completes the amendment recommended by the Rewrite Advisory Panel, by setting out the relationship between section DB 9B and section DA 3. The new subsection states that the section supplements the general permission and overrides the general limitation. This is consistent with the application of section DB 9, which relates to a deduction for certain amounts calculated under the base price adjustment with the financial arrangement rules.

Section DB 36 (Bribes paid to public officials)

Section DB 36 permits a deduction for a corrupt payment made to a foreign official in New Zealand. This is an unintended change in the policy underlying the rule, although the corresponding rule in the 1994 Act (section DJ 22) was ambiguous.

The policy of this rule is that a corrupt payment (a bribe) made to a public official is not deductible. This policy complements the policy in sections 105 to 105E of the Crimes Act 1961 and clarifies the extent to which this type of payment is not a deduction for income tax purposes. This policy applies in determining a person's taxable income for a year, and includes payments made both in and out of New Zealand whether paid to a New Zealand or foreign public official.

There are two exceptions to this general policy, but they relate only to payments made to foreign public officials.

- The first exception is if the payment is made to a foreign public official related to routine government activity and is a very minor amount.
- The second exception is when the payment is made outside New Zealand and the payment is not illegal in the country which the foreign public official represents.

Section DB 36 is being amended to reflect the underlying policy more clearly than the present rule does.

Section EE 33 (Transfers of depreciable property in a non-qualifying amalgamation)

Section EE 33 of the 2004 Act is the rewrite of the combined effect of section EG 17 and FE 5(2) of the 1994 Act. The purpose of the rule is to ensure that associated companies cannot have an uplift in the depreciable value of the asset base for depreciable property transferred in a non-qualifying amalgamation. However, section EE 33 inadvertently omitted a reference to the test of association.

This amendment restores the test of association and reverses the order of sections EE 33 and EE 34. The reversal of the section order places the more generally applicable rule first, and also provides that in a non-qualifying amalgamation, the rule in the new section EE 34 will override the general rule in the new section EE 33.

The amendment restores the effect of the law to that existing in the 1994 Act. Section FE 5(2) is also being amended to provide a clear relationship with the new section EE 34.

Section EX 36 (Immigrants accrued superannuation entitlement exemption)

Section EX 36(1) of the 2004 Act contains an unintended change in law in that the words "to the extent that" qualify subsections (2) to (9) of section EX 36. This indicates that apportionment should be applied to all of these subsections.

However, in the corresponding provisions in the 1994 Act (the definition of “interest in an employment-related foreign superannuation scheme” in section OB 1 of the 1994 Act), apportionment is required for the provisions that correspond to subsections (2) to (4).

The amendment corrects section EX 36(1) to apply the apportionment rule just to subsections (2) to (4). This restores the requirement that subsections (5) to (9) are to be satisfied without any apportionment.

Section EY 8(3) (Meaning of life insurance)

In section EY 8(3)(b)(i), subparagraph (b)(i) did not contain a reference to a specified cause named in the a policy of accident or medical insurance. This arguably narrowed the meaning of “life insurance” from that set out in section OB 1 of the 1994 Act, The policy intent of the 1994 Act wording was to ensure that minor non-life benefits set out in a medical or accident insurance policy would not come within the life insurance taxation regime. An example of the type of benefit contemplated in this policy is funeral expenses.

This amendment restores the wording of the law to that set out in the definition of “life insurance” in the 1994 Act.

Section FC 21(3B) (Amounts derived by non-residents from renting films)

Section FC 21 rewrites section CN 2 of the 1994 Act.

Section CN 2(1)(b) and section CN 2(4) were omitted in rewriting the section. In the 1994 Act, CN 2(1)(b) extended the application of the film renter rule in section CN 2 of the 1994 Act to New Zealand-resident companies that were controlled by non-residents. Section CN 2(4) of the 1994 Act prevented tax being imposed twice on rentals. This could otherwise have occurred when rentals derived by a person subject to this rule were on-paid to another person under an agreement relating to those rentals.

The reason for removing the application of the film renter rules to New Zealand resident companies was set out in the exposure draft of rewritten legislation in the Income Tax Act (published in 2001). This drafting change was intended to facilitate the rationalisation of the provision with the transfer pricing rules, as sections CN 2(1)(b), CN 2(4) and section GD 13 were considered to address the same policy question.

This amendment to Schedule 22A clarifies that this rationalisation relating to the film renter rules is an intended change in law.

In addition, the effect of section CN 2(4) of the 2004 Act is reinstated. The omission of this rule from section FC 21 in the 2004 Act arguably leads to tax being imposed on a film rental derived by a non-resident operating through a fixed establishment in New Zealand, and again on certain on-payments related to that film rental to another non-resident if the source of the payment is in New Zealand. The amendment restores the law as it was under the 1994 Act to prevent this potential dual imposition of taxation.

Section NG 1(2) (Application of NRWT rules)

The Taxation (Core Provisions) Act 1996 removed the exclusion for exempt income from section NG 1. In making this change, it was intended that readers would rely on the core provisions exempt income rule to ensure that income of this nature would not be liable for non-resident withholding tax.

In the 2004 Act, the change in terminology from “gross income” to “income” in NG 1 coupled with the Core Provisions Act change has led uncertainty as to whether non-resident withholding tax can be imposed on non-resident withholding income that is exempt income.

The policy is that non-resident withholding tax should not be imposed on exempt income. This amendment clarifies the section to ensure that the policy is better expressed.

Section OB 1 (Definition of fixed rate share)

In the definition of a fixed rate share in the 2004 Act, it is unclear whether the term “dividend” in that definition includes an amount of any imputation credit or dividend withholding payment credit attached to the dividend. This is because the term “dividend,” as defined in sections CD 3 to CD 13, includes the amount of an imputation credit and dividend withholding payment credit attached to the dividend (section CD 9 is the relevant provision).

The policy is an imputation credit or a dividend withholding payment credit that is attached to a dividend is not taken into account in determining whether the share on which the dividend is paid is a “fixed rate share”.

The definition of “fixed rate share” is being amended to remove that uncertainty and reflect the policy more clearly.

MISCELLANEOUS TECHNICAL AMENDMENTS

Allocation of research and development tax deductions

(Clause 46)

A remedial amendment will be made to the recently enacted changes to the research and development (R&D) tax rules. An amendment to section EJ 21 of the Income Tax Act 2004 will clarify that where a company has had a breach of shareholder continuity the amount of R&D tax deductions allocated to an income year is the lesser of the R&D income in that year and the R&D deductions that have not been allocated to earlier income years. This amendment accords with the previously announced policy objectives of this reform.

Amendment to section HH 3C

(Clause 83)

Section HH 3C of the Income Tax Act 2004, which provides an exclusion from the minor beneficiary rule, is to be clarified to ensure that the test is satisfied when one or more of the conditions are met.

Corporate migration terminology

(Clauses 121, 125, 146 and 147)

To provide consistency of terminology in the recently enacted corporate migration amendments, the reference to “emigration date” in several provisions should be replaced with the correct defined term “emigration time”. These references are in sections NF 4 and NG 11 of the Income Tax Act 2004 and sections 49 and 51 of the Tax Administration Act 1994.

Date on which notices are delivered

(Clauses 138, 139 and 140)

Sections 14(9), 14B(8) and 14C(8) of the Tax Administration Act 1994 are being amended to repeal rebuttable presumptions that notices are posted on the day on which they are postmarked. As Inland Revenue does not copy or store envelopes, the presumption is of little value.

The effect of the repeal is that notices will be treated as having been given on the day on which they would have been delivered in the ordinary course of the post. That date will be determined after considering all the relevant evidence.

The amendment will apply from 1 April 2005, the date the presumptions applied from.

Share-lending rules

(Clauses 2(13), 103, 123 and 142)

Three remedial amendments will be made to the recently enacted share-lending rules. The amendments will clarify that where resident withholding tax (RWT) has been paid by the share user as part of a share-lending arrangement, that the share supplier does not get an imputation credit for that RWT as well as an imputation credit under section NF 8B. The amendments will also remove unnecessary requirements that are not relevant to share-lending arrangements from the share-lending statement and dividend withholding payment credit refund sections. These amendments accord with previously announced policy objectives of this reform.