

# **Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill**

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*Commentary on the Bill*

**Hon Peter Dunne**  
Minister of Revenue

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# Enhancements to KiwiSaver

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## ENHANCEMENTS TO KIWISAVER

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The government announced in Budget 2007 enhancements to KiwiSaver that significantly increase the incentives to join and to continue making regular contributions. The key features of the enhancements are:

- A tax credit to members that matches their contributions to a KiwiSaver scheme, or a complying superannuation fund, up to a maximum of \$20 per week (\$1,042.86 a year). The legislation giving effect to the member tax credit is included in the Taxation (KiwiSaver and Company Tax Rate Amendments) Bill and applies to contributions made from 1 July 2007.
- A compulsory employer contribution when an employee contributes to a KiwiSaver scheme or a complying superannuation fund will be phased in over four years, starting at 1 percent and reaching 4 percent of gross salary or wages from 1 April 2011. This will apply from 1 April 2008.
- An employer tax credit which will reimburse employers for contributions they will be required to make into their employees' KiwiSaver scheme or complying superannuation fund up to a maximum of \$20 a week for each employee. This will apply to employer contributions made from 1 April 2008.

### Compulsory employer contributions

*(Clauses 144(2)(b), 197 to 199, 201, 212, 215, 216, 217, 218(2), 219, 220, 222, 225, 227, 231 and 237)*

#### Summary of proposed amendments

New subpart 3A of Part 3 will be added to the KiwiSaver Act 2006 to require an employer to make an employer contribution for each employee who has deductions for KiwiSaver (or a complying superannuation fund) contributions made from his or her gross salary or wages. This requirement will be phased in as follows:

<b>From</b>	<b>Employer compulsory contribution rate as a percentage of gross salary or wages</b>
1 April 2008	1%
1 April 2009	2%
1 April 2010	3%
1 April 2011	4%

This proposal will increase the incentive for employees to contribute to a KiwiSaver scheme or a complying superannuation fund. The measure is supported by an employer tax credit, which will reimburse employers for matching contributions at the rate of 100 percent, up to a maximum of \$20 a week.

Employer contributions to an existing registered superannuation scheme will count towards the compulsory amount in limited existing circumstances.

To integrate compulsory matching employer contributions into the design of KiwiSaver, the following changes will be made:

- All employer contributions (whether compulsory or voluntary) to a KiwiSaver scheme will be required to be paid to Inland Revenue at the same time as the employee contributions are paid<sup>1</sup>.
- An employer's contribution will not count towards an employee's contribution rate from 1 April 2008. A transitional rule will apply for employees who choose to have an employer's contribution count towards their contribution rate during the period from 1 July 2007 to 31 March 2008.

### **Application date**

The compulsory matching employer contribution provisions will apply to KiwiSaver or complying superannuation fund contributions deducted from an employee's gross salary or wages on or after 1 April 2008. The provisions that allow the Government Actuary to notify the Commissioner of an amount of unpaid compulsory employer contributions payable to a complying superannuation fund come into force on 1 April 2009.

### **Key features**

#### ***Compulsory contributions***

The bill introduces the rules relating to compulsory employer contributions. The rules require employers to make an employer contribution for individual employees who have deductions for KiwiSaver (or a complying superannuation fund) contributions deducted from their gross salary or wages. The amount of the employer contribution will be phased in as follows:

<b>From</b>	<b>Employer compulsory contribution rate as a percentage of gross salary or wages</b>
1 April 2008	1%
1 April 2009	2%
1 April 2010	3%
1 April 2011	4%

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<sup>1</sup> The amendment to require all employer contributions to be paid to Inland Revenue is included in the Taxation (KiwiSaver and Company Tax Rate Amendments) Bill.

The effect of the phasing-in of compulsory employer contributions is shown in Table 1. It assumes that an employee is making a contribution at the minimum rate of 4 percent and the employer contribution does not count towards the employee's contribution rate<sup>2</sup>:

**Table 1**

<b>From</b>	<b>Employee contribution rate as a percentage of salary or wages</b>	<b>Employer compulsory contribution rate as a percentage of gross salary or wages</b>	<b>Total employee and employer contribution as a percentage of gross salary or wages</b>
1 April 2008	4%	1%	5%
1 April 2009	4%	2%	6%
1 April 2010	4%	3%	7%
1 April 2011	4%	4%	8%

Employers will be required to make contributions at the prescribed contribution rate for a pay period if:

- KiwiSaver contributions are deducted or required to be deducted from an employee's gross salary or wages under Part 3 of the KiwiSaver Act; and
- contributions are deducted from an employee's gross salary or wages for payment to the complying fund rules' section of a complying superannuation fund.

This requirement will apply to employers that are tax-resident or that carry on a business from a fixed establishment in New Zealand (see section 6(2) of the KiwiSaver Act). Furthermore, it will apply only to contributions made for employees who are over 18 years of age and under the age of eligibility to withdraw their KiwiSaver or complying superannuation fund member funds – that is, the age of eligibility for New Zealand superannuation (currently 65 years of age) or five years of membership, whichever occurs later.

There will be no requirement for ACC or Inland Revenue to make compulsory employer contributions if a person is having KiwiSaver contributions deducted from his or her ACC weekly compensation or paid parental leave (paid under Part 7A of the Parental Leave and Employment Act 1987).

New section 101G of the KiwiSaver Act provides that compulsory employer contributions will vest in the employee immediately. Employers may impose vesting requirements on any contributions over the compulsory amount.

<sup>2</sup> Under section 64 of the KiwiSaver Act 2006, the minimum contribution rate is 4 percent of the employee's gross salary or wages. Under paragraph (i) of the definition of "complying fund rules" in section OB 1 of the Income Tax Act 2004, an employee is required to contribute at least 4 percent of their annual gross salary or wages as amended by clause 144(2)(b).

### ***Existing superannuation schemes***

New section 101D of the KiwiSaver Act provides that employer contributions to an existing registered superannuation scheme will count towards the employer compulsory contribution rate in the following circumstances:

- The employer provides access to a registered superannuation scheme on 17 May 2007 (the date of announcement).
- The employer contributions are for employees who are members of that scheme before 1 April 2008 (the start-date for compulsory employer contributions) or, in the case of existing employees (employed before 1 April 2008), the employment contract provides access to that scheme.
- The employer contributions must be for employees who are employed before 1 April 2008. This rule is to prevent this provision being applied to new employees (those employed from 1 April 2008) who satisfy the above rules.

The contributions that count towards the compulsory employer contribution must vest immediately in the employee.

This provision is to mitigate the risk of wind-up of existing schemes if employers were required to contribute 4 percent of the employee's salary or wages to KiwiSaver in addition to contributing to an existing scheme. It will apply to defined contribution and defined benefit schemes regardless of whether the contributions are subject to complying fund rules.

An employer with an existing superannuation scheme will be required to make compulsory employer contributions in certain circumstances. This would apply, if an employer is a member of a KiwiSaver scheme and the employer contributions to an existing scheme that count towards the compulsory contributions are less than the compulsory contribution rate. In this situation, the amount of the compulsory contribution will be the difference between the compulsory contribution rate and the employer contributions to the existing scheme that count.

### ***Example***

Employer A has an existing superannuation scheme that provides a matching 2 percent employer contribution. Employee B contributes 2 percent of his or her gross salary or wages to this superannuation scheme. Both the scheme and employee B satisfy the rules governing whether employer contributions to an existing scheme count towards the compulsory employer contribution. To take advantage of the KiwiSaver enhancements, employee B joins a KiwiSaver scheme from 1 April 2008 and contributes to both schemes. The following table shows both B's and employer A's contributions:

From	Contributions to existing scheme		Contributions to KiwiSaver	
	Employer	Employee	Compulsory employer contribution	Employee
1 April 2008	2%	2%	Nil	4%
1 April 2009	2%	2%	Nil	4%
1 April 2010	2%	2%	1%	4%
1 April 2011	2%	2%	2%	4%

***Employer contributions counting towards the employee contribution rate***

At present, section 66 of the KiwiSaver Act allows employer contributions to count towards the employee's contribution rate (at the election of the employee). From 1 April 2008, an employee, who has not used this provision before that date will be required to contribute a minimum 4 percent of his or her salary or wages to a KiwiSaver scheme.

The new rules provide a transitional mechanism for employees who have chosen to have employer contributions count towards their contribution rate during the period 1 July 2007 and 31 March 2008. This transitional mechanism will apply, if:

- the employee is employed by the employer on 1 April 2008;
- the employee is a member of KiwiSaver on 1 April 2008; and
- the employer agreed before 1 April 2008 with the employee to make employer contributions.

If this new rule applies to an employee, the amount of the contribution to be deducted from the employee's salary or wages is the greater of:

- the minimum employee contribution rate specified in clause 1 of Schedule 4; and
- the amount equal to the transitional contribution rate specified in clause 2 of Schedule 4, minus the gross amount of the employer contribution paid in respect of the payment of salary or wages specified in clause 3 of Schedule 4.

The purpose of these rules is to increase the employee's contribution rate incrementally from 2 percent to 4 percent over four years.

The replacement paragraph (i) in the definition of complying fund rules in section OB 1 of the Income Tax Act 2004 allows these rules to apply in relation to complying superannuation funds if employer contributions count towards the requirement for the employee to contribute 4 percent of their gross salary or wages.

### ***Enforcement of the payment of compulsory employer contributions to KiwiSaver schemes***

At present, under the KiwiSaver Act the payment of employer contributions to a KiwiSaver scheme via Inland Revenue is optional. From 1 July 2007, a provision in the Taxation (KiwiSaver and Company Tax Rates Amendments) Bill will mandate that all employer contributions (both compulsory and voluntary employer contributions) be paid via Inland Revenue using the PAYE processes. This provides a mechanism to allow Inland Revenue to police the payment by employers of the compulsory employer contribution. Non-payment of compulsory employer contributions will be subject to the current compliance and enforcements practices and penalties that apply for tax. The definition of tax in section 3 of the Tax Administration Act 1994 will be amended to include compulsory employer contributions. This will allow the Commissioner to impose penalties and use existing collection powers. As a consequence, section 216 of the KiwiSaver Act which imposes a penalty on an employer for failure to deduct or for incorrectly deducting employee KiwiSaver contributions will be repealed.

### ***Enforcement of the payment of compulsory employer contributions to complying superannuation funds***

In relation to complying superannuation funds, employee contributions and compulsory employer contributions will be paid by the employer directly to the fund provider. The payment must be no later than one month after the payment of salary or wages to which the contributions relate. In keeping with current practice, it will be the responsibility of the provider to ensure that employer contributions are paid. Section 101H requires providers to take reasonable steps to recover unpaid compulsory employer contributions from an employer. If these amounts remain unpaid and total more than \$500 per employer, the provider is required to notify the Government Actuary that the employer has failed to pay the contributions.

New section 101I specifies that once a notification has been received, the Government Actuary must determine the amount of any short payment. The Government Actuary can use existing powers under the KiwiSaver Act to investigate the matter and determine the amount outstanding. Once the Government Actuary has determined the amount of any short payment, the employer will be notified of the amount and will have 28 days to pay or dispute the amount. If the amount remains unpaid and no objection has been received, the amount will be transferred to Inland Revenue for collection. The amount will be due and payable to the Commissioner 20 working days after the Commissioner receives the notice. The definition of tax in section 3 of the Tax Administration Act 1994 will be amended to include compulsory employer contributions to a complying superannuation fund. This will allow the Commissioner to impose penalties and use existing collection powers.

Section 120B of the Tax Administration Act will be amended to ensure that the use-of-money interest rules do not apply to unpaid compulsory employer contributions.

### ***Withdrawal of compulsory employer contributions***

Currently, the KiwiSaver Act allows a member to withdraw employer contributions that have vested in an employee in the following situations:

- to assist with purchase of the member's first home;
- for significant financial hardship;
- for serious illness;
- on permanent emigration from New Zealand;
- on the death of the member;
- as required by any statute such as an order made under section 31 of the Property (Relationships) Act 1976; and
- upon the age of eligibility of New Zealand superannuation or five years of membership, whichever is the later.

As compulsory employer contributions will vest immediately in the member, the contributions can continue to be withdrawn under the above situations.

The KiwiSaver Act prevents employer contributions being diverted under a mortgage diversion facility and this will continue to apply for compulsory employer contributions.

### **Background**

The government, as part of Budget 2007, announced a package of measures to improve the rate of private savings. As part of that package it will be compulsory for employers to match employee contributions to a KiwiSaver scheme or a complying superannuation fund, if the employee's contribution is deducted from his or her salary or wages. This will increase the incentive for employees to contribute to such schemes. The measure is supported by the employer tax credit, which will reimburse employers for matching contributions at rate of 100 percent, up to a maximum of \$20 a week.

## **Employer tax credit for employer contributions to a KiwiSaver or a complying fund scheme**

*(Clauses 142, 143, 144(3), (4), (5) and (6))*

### **Summary of proposed amendment**

A new subpart KJ of the Income Tax Act 2004 provides a tax credit to employers to help offset the costs of making matching compulsory employer contributions to an employee's KiwiSaver scheme or complying superannuation fund.<sup>3</sup> The tax credit will be equal to the lesser of the employer's contribution or \$20 a week for each employee. To minimise compliance cost and cash-flow implications of the compulsory employer contributions, payment of the tax credit will be integrated into the PAYE remittance process.

### **Application date**

The employer tax credit will apply to employer contributions made to a KiwiSaver scheme or a complying superannuation fund from 1 April 2008.

### **Key features**

New subpart KJ of the Income Tax Act allows an employer a tax credit for contributions (both compulsory and voluntary) that the employer makes to an employee's KiwiSaver scheme or complying superannuation fund. The tax credit for each employee per week is the lesser of:

- the amount of the employer contribution paid for that employer for that week; and
- \$20 a week.

The tax credit will be available to employers that are tax-resident or who carry on a business from a fixed establishment in New Zealand (section 6(2) of the KiwiSaver Act 2006). Furthermore, it will apply only to contributions made for employees who are 18 years of age and over, and under the age of eligibility to withdraw from their KiwiSaver or a complying superannuation fund member funds. That is, up to the age of eligibility for New Zealand Superannuation (currently 65 years of age) or five years of membership, whichever occurs later.

The tax credit will apply to employer contributions to a KiwiSaver scheme or contributions that are subject to complying fund rules.

The employer tax credit will be integrated into the PAYE remittance process so that the value of the tax credit is given to employers at the same time the employer is required to remit the contributions to providers or to Inland Revenue.

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<sup>3</sup> A complying superannuation fund is a section within a registered superannuation scheme that has been approved by the Government Actuary as having met certain criteria, such as KiwiSaver lock-in rules and portability.

For employer contributions to a KiwiSaver scheme the tax credit will be offset against the amount of the contribution that the employer is required to remit to the Commissioner as part of the PAYE remittance process. The employer will remit the difference between the employer contribution and the amount of the tax credit claimable. If the amount of credit exceeds the employer contributions, the credit will be used against other PAYE liabilities (including PAYE, child support, and student loan repayments) payable by the employer for that PAYE period.<sup>4</sup> Inland Revenue will on-pay the employer's contributions to the employee's KiwiSaver provider at the same time it pays the employee's contributions. If an employer does not remit the employer contributions or short pays, Inland Revenue will still on-pay the value of the employer tax credit to the provider.

For employer contributions to a complying superannuation fund, the tax credit will be offset against the PAYE liabilities payable by the employer for the PAYE period, as the employer will pay the employer contributions and the employee contributions directly to the complying superannuation fund, as it does now. The employer will be required only to remit to Inland Revenue the difference between amount of PAYE payable and the value of the tax credits for each PAYE period. If the amount of the tax credit is greater than the PAYE liability for the PAYE period, the tax credit will be offset against any other taxes owing by the employer or be refunded.

From 1 April 2009, new section 101I of the KiwiSaver Act will require the Government Actuary to send a notice to the Commissioner detailing the amount of compulsory employer contributions to a complying superannuation fund that is owed by an employer. When the Commissioner receives the notice, section KJ 4 of the Income Tax Act will allow the employer tax credits claimed or claimable to be used to meet the amount owing. When this occurs, the amount of PAYE liability that the tax credit was offset against originally will become a debt payable to the Commissioner.

New section KJ 7 of the Income Tax Act specifies that if an employee is employed by a number of employers who are associated for tax purposes, the associated employers will be considered as one employer for the purposes of claiming the tax credit. This is to prevent associated employers claiming more than one credit for the same employee.

Under section DC 6 of the Income Tax Act 2006, an employer is allowed a deduction for contributions to an employee's superannuation scheme. This section will be amended to limit the amount of the deduction for these contributions to the amount for which there is no tax credit. The effect will be that the tax deduction for these contributions will be limited to contributions over \$20 a week. In addition, the tax credit will be treated as excluded income for income tax purposes, which enables expenses associated with claiming the credit to be deducted.

The tax credit will be treated as a non-taxable grant or subsidy for the purposes of the GST Act, to ensure that the tax credits are not subject to GST in the hands of employers.

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<sup>4</sup> If a credit still remains after this offset, the amount will be offset against any arrears owed by the employer or refunded.

If a tax credit is claimed for contributions which are to be refunded because an employee has opted out, the credit amount will be repayable to the Commissioner.

## **Background**

As part of Budget 2007, the government announced a package of measures to improve private savings. As part of that package, employers will be entitled to a tax credit to help offset the impact of compulsory employer contributions. Table 2 shows the maximum annual gross salary or wages covered by the tax credit.

**Table 2**

<b>From</b>	<b>Compulsory employer contribution rate as a percentage of gross salary or wages</b>	<b>Annual gross salary or wages completely offset by the value of the employer tax credit</b>
1 April 2008	1%	\$104,000
1 April 2009	2%	\$52,000
1 April 2010	3%	\$34,000
1 April 2011	4%	\$26,000

## **Other amendments associated with the enhancements to KiwiSaver**

*(Clauses 222 and 144(2)(b))*

### **Summary of proposed amendments**

The bill includes amendments to the KiwiSaver Act 2006 and the Income Tax Act 2004 relating to the regulatory aspects of KiwiSaver and the complying fund scheme rules.

### **Application date**

The provisions come into force on 1 April 2008.

### **Key features**

#### ***Restriction on transactions***

Under the current KiwiSaver rules, there are no rules governing the number of members a KiwiSaver scheme may have. While section 196 of the KiwiSaver Act prevents a member's interest being assigned or charged, it does not prevent transactions between the trustee and member which allow the member access or use of their interest – for example, loaning money to the member as an investment.

New section 117B of the KiwiSaver Act will impose investment restrictions on KiwiSaver schemes with fewer than 20 members. For the purposes of determining the number of members, a person associated with a member under section OD 8(3) of the Income Tax Act will be treated as one person. This provision will:

- require a transaction between the scheme provider and a person associated with either the provider or a member to be at market value;
- limit to 5% of the scheme's assets, investments related to or managed by the provider (other than in their capacity as a provider), a member, or a person associated with a provider or member; and
- prevent a provider from lending money or providing financial assistance to a member or a person associated with the provider or member.

***Age limitation on joining a complying superannuation fund***

At present there is no age restriction on a person becoming a member of a complying superannuation fund. To be consistent with KiwiSaver, paragraph (j) in the definition of complying fund rules will be replaced to prevent a person over the age of eligibility for New Zealand Superannuation from being able to join a complying fund section of an existing superannuation scheme. The proposed amendment will not prevent a person from joining the non-complying fund section of an existing scheme if the trust deed permits.

**Background**

The government, as part of Budget 2007, announced a number of measures to enhance KiwiSaver. The amendment is consistent with the changes announced in the Budget.



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## Company tax rate

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## **COMPANY TAX RATE REDUCTION – CONSEQUENTIAL AND TRANSITIONAL AMENDMENTS**

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*(Clauses 9, 80, 92, 93, 97 to 99, 108(1), (2) and (4), 109, 110, 112 to 116, 117(2), 119(2), 121 to 128, 130, 134, 135(30) and (35) and 178 to 181)*

### **Summary of proposed amendments**

Following the reduction in the company tax rate and the tax rate for widely held savings vehicles and the top rate for portfolio investment entities (PIEs) from 33% to 30%, the bill introduces a number of mainly transitional amendments to the Income Tax Act 2004 and the Tax Administration Act 1994 in relation to imputation and dividend withholding payment (DWP) credit ratios, qualifying company election tax (QCET), branch equivalent and conduit memorandum accounts, and foreign investor tax credits (FITC).

### **Application date**

Most of the amendments apply from the beginning of the 2008–09 income year. The main exceptions are:

- the amendments that relate to a portfolio tax rate entity that does not choose to be subject to section HL 22, which will apply on and after 1 April 2008; and
- the amendments that relate to QCET, which will apply from the date of introduction.

### **Key features**

#### ***Imputation and DWP credit ratios***

A reduction in the company tax rate to 30% will automatically cause the maximum imputation credit ratio and the DWP ratio (“the tax credit ratio”) to fall to 30/70 credits to cash. To ensure that shareholders are not disadvantaged by this, a transitional period is proposed. During this period, a company will be able to allocate imputation and DWP credits at a maximum tax credit ratio of 33/67 in respect of profits that have been taxed at 33%. The transitional period will run from the beginning of a company’s 2008–09 income year to the end of its 2009–10 imputation year (being 31 March 2010).

When the 33/67 tax credit ratio is used during the transitional period, the amount of imputation and/or DWP credits included as a credit against shareholder companies and widely held savings vehicles income tax liability will be capped, applying the 30/70 tax credit ratio.

## ***QCET***

Following the reduction in the corporate tax rate, the rate of QCET will automatically fall to 30%.

This could increase incentives for companies that are contemplating winding up to convert to qualifying company status in order to reduce the tax liability on distributions. To deal with this problem, payments of QCET will be credited to the company's imputation credit account. QCET will then effectively become a withholding tax.

## ***Branch equivalent and conduit memorandum accounts***

The entries balances in these accounts that relate to periods when the tax rate was 33% will be reduced to reflect the lower corporate tax rate. This is necessary because credits in these accounts will be used to match future actual or potential income tax liabilities that will have been calculated using the lower company tax rate.

## ***FITC***

A reduction in the company tax rate will affect how FITC is calculated. Where a dividend is imputed at 30/70 or less the new 30/70 FITC formula will apply. If imputation credits exceed 30/70, they will be apportioned between 33% credits and 30% credits. As a result, two FITC formulas will apply during the transitional period.

## **Background**

In July 2006, the government released the *Business Tax Review* discussion document for public comment. It set out a range of possible business tax initiatives, including reducing the company tax rate to 30%, to help transform the New Zealand economy by enhancing productivity and improving our international competitiveness.

A reduction in the company tax rate will encourage more investment into New Zealand by businesses that have decided to locate here. This will tend to increase New Zealand's stock of plant, equipment and buildings, which will boost labour productivity.

A lower rate will reduce biases between different investments that companies undertake, which will tend to boost capital productivity.

A reduction in the company tax rate will tend to encourage New Zealand companies to stay here, rather than shift to Australia or elsewhere. It will also increase the after-tax profits of companies, which means more funds are available for reinvestment.

## Detailed analysis

The legislative changes are broadly grouped into two areas:

- the introduction of new sections MZ 10 to MZ 19 to the Income Tax Act (which are the substantive transitional amendments), and the “sign posts” to these sections; and
- the introduction of a new imputation and DWP penalty tax in the Tax Administration Act for companies that over-distribute their 33/67 tax credits during the transitional period.

### *Terminating provisions*

#### **Imputation and DWP credits**

From the 2008–09 income year the maximum imputation credit ratio (section ME 8(1)), the maximum DWP credit ratio (section MG 8(1)), and the maximum combined imputation and DWP ratio (section MG 10(1)) will change automatically from 33/67 to 30/70, in line with the company tax rate reduction.

Moving directly to a maximum 30/70 imputation credit ratio in 2008–09 would be the simplest option. However, it might be difficult for some companies which want to distribute profits that have been taxed at 33% with full credit for these taxes before 2008–09.

A maximum tax credit ratio of 30/70 applying from 2008–09 has the potential to disadvantage shareholders on income derived by companies before the new rate applies. Trapped credits may occur where the underlying tax that generated unused imputation credits was paid at 33%.

#### **Example 1: Trapped 33/67 imputation credits**

Palmer Limited derives \$100.00 of income during the 2007–08 income year, of which \$33.00 of income tax is paid, leaving \$67.00 of income available to be distributed to shareholders.

During the 2008–09 income year, Palmer Limited distributes the \$67.00 of income to its shareholders. Following the decrease in the company tax rate, Palmer Limited must impute the dividend using the new 30/70 tax credit ratio. As a result, only \$28.71 ( $\$67.00 \times 30/70$ ) of imputation credits can be attached to the dividend.

If Palmer Limited does not have any non-taxed reserves available for distribution, \$4.29 ( $\$33.00 - \$28.71$ ) of imputation credits will be trapped.

A number of shareholders would also be disadvantaged because they would need to pay more tax than if the distribution had been made before the reduction in the company tax rate.

**Example 2: Effect on shareholders**

Helen has a marginal tax rate of 33% and during the 2008–09 income year receives a cash dividend of \$67.00, with \$28.71 ( $\$67.00 \times 30/70$ ) of imputation credits attached. Following the decrease in the company tax rate, Helen will be required to pay additional income tax of \$2.87 calculated as follows:

	<i>Dividend received Pre-2008–09 income year</i>	<i>Dividend received during 2008–09 income year</i>
Cash dividend received	\$67.00	\$67.00
Imputation credits attached	\$33.00	\$28.71
Taxable income	<hr/> \$100.00	<hr/> \$95.71
Tax at 33%	\$33.00	\$31.58
Less: Imputation credits	(\$33.00)	(\$28.71)
Income tax to pay	<hr/> Nil	<hr/> \$2.87

*New section MZ 10 – override of maximum tax credit ratio*

To deal with these issues, new section MZ 10 allows companies a transitional period in which the core imputation and DWP maximum ratios set out in sections ME 8(1), MG 8(1) and MG 10(1) can be overridden. The section sets out how companies can elect to allocate imputation and DWP credits up to a maximum ratio of 33/67 from the 2008–08 income year until the end of their 2009–10 imputation year (being 31 March 2010), to the extent the underlying income was taxed at 33%.

*New section MZ 11 – benchmark dividends*

New section MZ 11 is a consequential amendment that alters the benchmark dividend ratios in sections ME 8(2) to (4) and MG 8(2) to (4) where an election has been made to use the 33/67 tax credit ratio. The objective is to provide that a change of tax credit ratio to or from 33/67 does not necessarily cause the benchmark dividend ratio to be changed.

***Shareholders' tax credits – general***

Section LB 1(1)(c), (d) and (e) sets out rules that determine or limit, in particular circumstances, the amount of imputation credit or DWP credit regarded as being attached to a dividend for shareholders. Under these rules, the amount of dividend included in the shareholders' gross income and the tax credits available to shareholders is limited to the maximum tax credit ratio of the time, that is, 30/70 from the beginning of the 2008–09 income year.

This needs to be overridden to allow for the new section MZ 10 over-imputed dividends.

### *New section MZ 12*

New section MZ 12 modifies the maximum tax credit ratio to be used in section LB 1 when the tax credit ratio is greater than 30/70 and less than or equal to 33/67 during the transitional period to allow for over-imputed dividends.

#### ***Limits on the amount of shareholders' tax credit***

The policy rationale for the limitation is set out in the following example. Consider a company that is owned by a savings vehicle that receives \$100 of income during the 2007–08 income year and pays tax of \$33 in respect of this income. No further income tax implications would arise if the income was passed out to the savings vehicle as a dividend during the 2007–08 income year. This would be the appropriate policy outcome, given that the company tax rate and tax rate on savings vehicles are currently aligned at 33%.

Suppose, however, that the dividend was paid out during the 2008–09 income year. In the absence of capping and assuming that the company imputes using the 33/67 tax credit ratio, the shareholder would have a grossed-up dividend of \$100 on which \$30 of gross tax would be payable. This would be offset by a tax credit of \$33, which would lead to a net tax credit of \$3. This \$3 of net credit would offset the tax due on \$10 of other income, which is inappropriate.

Under the capping proposal, distribution of these profits would once more result in the shareholder receiving a grossed-up dividend of \$100 on which gross tax of \$30 would be payable. However, capping would limit the amount the savings vehicle could claim as a credit in relation to the dividend to \$30. Therefore, there would be no net credit when the savings vehicle shareholder received the dividend, as would also be the case if the dividend was distributed during the 2007–08 income year.

### *New section MZ 13*

New section MZ 13 sets out how the tax credit under sections LB 2 and LD 8 will be calculated when the 33/67 tax credit ratio is used during the transitional period.

When a taxpayer whose tax rate is 30% (including all PIEs) receives a dividend with 33/67 imputation credits attached during the transitional period, the amount of credits included as a credit against their income tax liability will be capped at the 30/70 tax credit ratio.

These amendments are required to prevent taxpayers with a 30% tax rate from being able to use the additional 3% credit to shelter other income that would be taxed at 30%.

**Example 3: Limits on the amount of shareholder credit – fully imputed dividend**

JG Limited receives a cash dividend of \$1,200.00 during the 2008–09 income year with 33/67 imputation credits of \$591.04 attached. However, new section MZ 13 limits the amount of the tax credit available to \$537.31, calculated as follows:

Cash dividend received	\$1,200.00
Imputation credits attached	\$591.04
Taxable income	<u>\$1,791.04</u>
Tax at 30%	\$537.31
Less: Imputation credits (capped at 30/70)	<u>(\$537.31)</u>
Income tax to pay	<u>\$Nil</u>

The actual imputation credits attached to the dividend of \$591.04 are still included in income and the full \$591.04 of credits would also be credited to the company's imputation credit account.

**Example 4: Limits on the amount of shareholder credit – partially imputed dividend**

Morrison Motorcycles Limited receives a cash dividend of \$1,500.00 during the 2008–09 income year with \$701.87 of imputation credits attached (the dividend is 95% imputed with 33/67 imputation credits). New section MZ 13 limits the amount of the tax credit available to Morrison Motorcycles Limited to \$660.56, calculated as follows:

Cash dividend received	\$1,500.00
Imputation credits attached	\$701.87
Taxable income	<u>\$2,201.87</u>
Tax at 30%	\$660.56
Less: Imputation credits (capped at 30/70)	<u>(\$660.56)</u>
Income tax to pay	<u>\$Nil</u>

The actual imputation credits attached to the dividend of \$701.87 are still included in income and \$701.87 of credits would also be credited to the company's imputation credit account.

***Credits for non-resident investors***

The amount of the credit under the FITC regime is determined according to the amount of the imputation credit allocated to the shareholder. The credit is calculated by multiplying the amount of imputation credit by a formula in section LE 2(2).

The formula in section LE 2(2) is being amended to reflect the reduced company tax rate. The new formula for calculating the tax credit and supplementary dividend is  $IC * 7/10$ . Consequently, the credit is set at 70 cents for every dollar of FITC-adjusted imputation credits attached to dividends paid to non-resident investors.

In practical terms, it is often more straightforward to calculate the FITC by multiplying by 0.411806 the imputation credits the New Zealand company would usually distribute on dividends paid to the non-resident shareholders. The previous calculation for the 33/67 ratio used 0.358275.

**Example 5: Foreign investor tax credits – fully imputed 30/70 dividend**

During the 2008–09 income year NZ Co pays a fully imputed (at the 30/70 ratio) dividend of \$100 to a shareholder resident in the United States of America. At the same time, NZ Co pays a supplementary dividend to the USA shareholder for the original dividend. The amount of the supplementary dividend and the FITC credit is calculated as follows:

$$30/70 \times \$100 = \$42.86$$

$$\$42.86 \times 0.411806 = \$17.65$$

The amount of imputation credit attached to the original dividend is reduced by the amount of FITC to \$25.21 (\$42.86 – \$17.65). NZ Co is also liable to deduct NRWT from both dividends.

*New section MZ 14 – credits for non-resident investors*

New section MZ 14 sets out how the FITC credit should be calculated during the transitional period where the imputation credit ratio or combined imputation and dividend withholding payment ratio is greater than 30/70 and less than or equal to 33/67.

**Example 6: Foreign investor tax credits – 33/67 fully imputed dividend**

During the 2008–09 income year, NZ Co elects under the new section MZ 1 to pay a fully imputed 33/67 dividend to its shareholders. A shareholder resident in the United Kingdom receives a \$100 cash dividend plus imputation credits. At the same time NZ Co pays a supplementary dividend to the UK shareholder for the original dividend. The amount of the supplementary dividend and the FITC credit is calculated as follows:

$$\$49.25 \times 0.358275 = \$17.65$$

The amount of the imputation credits attached to the original dividend is reduced by the amount of the FITC to \$31.60 (\$49.25 – \$17.65). NZ Co is also liable to deduct NRWT from both dividends.

**Example 7: Foreign investor tax credits – 60% imputed at 33/67, 40% imputed at 30/70**

During the 2008–09 income year NZ Co elects under section MZ 10 to pay a dividend that is 60% imputed using the 33/67 tax credit ratio and 40% imputed using the 30/70 tax credit ratio. An Australian shareholder receives a \$100 cash dividend plus imputation credits.

At the same time, NZ Co pays a supplementary dividend to the Australian shareholder for the original dividend.

The dividend is effectively split into two parts, one dealing with the 33/67 credits, and one dealing with the 30/70 credits. The amount of supplementary dividend and the FITC credit of \$17.65 is calculated as follows:

$$\$100 \times 33/67 \times 60\% = \$29.55 \text{ of imputation credits}$$

$$\$100 \times 30/70 \times 40\% = \underline{\$17.14} \text{ of imputation credits}$$

$$\$46.69$$

The respective FITC formula is then applied to each part of the dividend, to get the supplementary dividend payable and the FITC claimable by the company. That is the sum of:

$$\$10.59 (\$29.55 \times 0.358275) + \$7.06 (\$17.14 \times 0.411806) = \$17.65$$

The amount of the imputation credit attached to the original dividend of \$46.69 is then reduced by the amount of the FITC of \$17.65 to \$29.04 (\$46.69 – \$17.65).

NZ Co is also liable to deduct NRWT from the both dividends.

### ***Available subscribed capital amount***

The concept of available subscribed capital is relevant when a company cancels its shares and pays consideration to compensate the shareholder for the cancellation. The calculation to be made for the purpose of ascertaining the extent of crediting of a dividend is set out in section CD 32(25) and (26).

Section CD 32(26), which calculates how much of a dividend is fully imputed, is being amended to enable the actual ratio to be modified when a dividend has an imputation ratio greater than 30/70 and less than or equal to 33/67 during the transitional period.

### ***New section MZ 15 – fully credited***

New section MZ 15 sets out the actual ratio that should be used where a dividend has an imputation ratio greater than 30/70 and less than or equal to 33/67 during the transitional period (period beginning of the 2008–09 income year and finishing on 31 March 2010). In these circumstances, new section MZ 7 treats the actual ratio as being 30/70.

### ***Dividends from qualifying companies***

When a qualifying company pays a dividend, the amount of any credits that may be attached during an imputation year is calculated at the end of each imputation year and is the lesser of the maximum imputation credits able to be attached under the imputation rules or an amount calculated in accordance with the formula set out in section HG 13(3). A similar exercise is carried out under section HG 13(4) for DWP credits when a company maintains a DWP account. These provisions need to be overridden to allow for dividends to be over-credited during the transitional period.

### ***New section MZ 16 – dividends from qualifying companies***

New section MZ 16 sets out that when an election is made by a qualifying company to allocate imputation credits at the 33/67 rate during the transitional period, section HG 13 is modified to ensure that the correct amount is treated as a taxable dividend in the shareholders' hands.

**Example 8: Dividends paid by a qualifying company**

Wilton Limited, a qualifying company, declares a dividend during the 2008–09 income year of \$85,000, to which \$33,000 of 33/67 imputation credits are attached. The gross dividend including imputation credits is \$118,000. New section MZ 16 calculates the non-exempt portion of the dividend as \$100,000 ( $\$33,000 / 0.33$ ). The exempt portion of the dividend is \$18,000.

The shareholder will be required to include as income in their personal tax return the gross dividend of \$100,000 with \$33,000 of imputation credits attached.

***Statutory producer boards and co-operative companies***

Statutory producer boards and co-operative companies which are imputation credit account or DWP companies may allocate imputation credits or DWP credits to cash distributions and to notional distributions.

For a statutory producer board, the allocation of imputation credits to cash distributions must be done according to the formula in section ME 31. Section ME 33 allocates imputation credits for statutory producer boards' notional distributions.

For a co-operative company, the allocation of imputation credits to cash distributions must be done according to the formula in section ME 36. Section ME 38 allocates imputation credits for co-operative companies' notional distributions.

*New section MZ 17 – attaching imputation credits and notional distributions*

New section MZ 17 amends the imputation provisions relating to statutory producer boards (sections ME 31 and 33) and co-operative companies (sections ME 36 and 38), as required, to take account of the dual imputation credit ratios during the transitional period.

***Branch equivalent tax account (BETA) and conduit tax relief account***

It is proposed that all entries that relate to 2007-08 and earlier years will be adjusted to reflect the reduced company tax rate of 30%. These adjustments are found in new sections MZ 18 and MZ 19.

***Other amendments***

*Credits arising to imputation credit account*

A number of consequential amendments are being made to section ME 4 to reflect the reduced company tax rate. These include:

- in section ME 4(1)(ab), “49.25%” is replaced by “42.86%” to ensure the appropriate entry is made when the attribution rules applies;
- new section ME 4(1)(ae) is introduced allowing a credit for the amount of any QCET paid by the company for the imputation year (discussed in more detail below);

- new section ME 4(2)(ae) is introduced allowing the date of the credit under section ME 4(1)(ae) to arise on the date the QCET is paid.

### *QCET*

Section ME 4(1) is being amended to include payments of QCET as a credit to the ICA. The credit will arise on the date the QCET is paid. This will address inappropriate tax planning opportunities that currently exist with the qualifying company rules, which are exacerbated by the reduction in the company tax rate.

QCET is a tax on the company's reserves at the time when a company elects to become a qualifying company. The purpose of QCET is to ensure that profits distributed by qualifying companies that relate to a period before the company gained that status are taxed in a similar way as distributions by non-qualifying companies.

Whereas distributions by qualifying companies are either fully imputed or exempt from tax, distributions by non-qualifying companies are taxed at the shareholders' marginal tax rate and imputation credits are allowed to the extent they are available.

However, since the top individual marginal tax rate was increased to 39%, the qualifying company rules have provided unintended opportunities for inappropriate tax planning. Non-qualifying companies with high income shareholders and a significant amount of reserves may currently gain a tax advantage if they convert to the qualifying company rules immediately before winding up. The advantage occurs because, once imputation credits have been fully-allocated, reserves can be distributed by qualifying companies tax-free to shareholders. This is not appropriate because distributions from profits earned before the company became a qualifying company should be taxed at the shareholder's marginal tax rate (less imputation credits.)

The QCET rate is the same as the company tax rate, and will reduce automatically when the company tax rate falls. This will exacerbate existing opportunities for inappropriate tax planning.

To deal with this problem, payments of QCET will be credited to the company's imputation credit account. The effect of this will be that subsequent distributions of profits derived before the company became a qualifying company will need to be fully imputed. Those distributions would then be subject to tax at the shareholder's marginal tax rate.

### *Section OB 1 – definitions*

Two new definitions are included in the bill to reflect the reduced company tax rate. These include:

- *New tax rate person* – a person who uses a 30% basic rate that applies from the 2008–09 and later income years and a portfolio tax rate entity.
- *Old company tax rate* – the 33% rate that applied before the 2008–09 income year.

### ***Imputation and DWP penalty tax***

Section 140B of the Tax Administration Act provides that where an imputation credit account has a debit balance at 31 March the company must pay further income tax equal to the debit balance plus a 10% imputation penalty tax.

If a company elects to over-impute dividends in accordance with the new section MZ 10, and in doing so, causes a debit balance to arise in relation to the number of 33/67 credits, it is proposed that a new 10% transitional imputation penalty tax will apply.

#### *New section 140BB – imputation penalty tax payable in some circumstances*

New section 140BB sets out how the transitional imputation penalty tax should be applied and calculated.

The 10% penalty will only be applied at 31 March 2010 if the taxpayer has a debit 33/67 imputation credit account balance.

When a taxpayer is in a debit position in both their 33/67 and overall imputation account, two imputation penalties will apply. However, the section 140B penalty will apply only if it exceeds any section 140BB penalty.

#### **Example 11: Transitional imputation penalty tax**

Company A has a credit balance of \$150,000 in its 2007–08 imputation credit account. No entries are made to the imputation credit account during the 2008–09 income year.

During the 2009–10 income year, the company distributes a cash dividend of \$406,060 and elects under the new section MZ 1 to attach \$200,000 of 33/67 imputation credits. The company also pays 30% income tax of \$100,000.

These transactions result in a net credit balance of \$50,000 in the 2009–10 imputation credit account. However, the balance is made up of a debit of \$50,000 33/67 imputation credits and a credit of \$100,000 30/70 imputation credits.

A transitional imputation penalty tax of \$5,000 ( $\$50,000 \times 10\%$ ) will be payable by the company as a result of the debit balance in the number of 33/67 imputation credits.

#### *New section 140CA – dividend withholding payment penalty tax in some circumstances*

New section 140CA sets out how the transitional DWP penalty should be applied and calculated.

As with new section 140BB, the 10% will be only applied once on the taxpayer's debit 33/67 DWP account balance as at 31 March 2010.

### ***Resident withholding tax***

No changes have been made in relation to the rates of resident withholding tax on interest and dividends. Inland Revenue is currently considering an operational review of RWT to determine whether efficiencies can be made.

As a result, when a taxpayer (who is taxed at the 33% marginal rate or otherwise) receives a dividend fully imputed using the 30/70 tax credit ratio, they will be subject to withholding tax deductions of 3% unless they hold a Certificate of Exemption from RWT.

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# Research and development tax credit

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## RESEARCH AND DEVELOPMENT TAX CREDIT

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*(Clauses 2(21), 100, 108, 111, 129, 135(8), (9), (22), (23), (26), (33), (42), (44), (49), (54), (55), (56), (60), 146, 147, 151, 156, 158, 166, 167, 169, 171, 172, 182 and 270)*

### **Summary of proposed amendments**

The bill provides a tax credit for research and development (R&D) conducted by New Zealand businesses. The aim of the incentive is to encourage businesses to invest more in R&D, which is expected to have wider benefits for the New Zealand economy and lead to improved productivity and international competitiveness.

The credit applies to businesses that conduct R&D on their own behalf, or commission others to do it, provided the R&D is performed predominantly in New Zealand. The definition of R&D is in line with that in comparable jurisdictions where it has proved to be sustainable. It applies not just to white-coat research but to the development of new or improved products or processes in a variety of industries.

R&D expenditure that is eligible for the credit includes the cost of remuneration, training and travel of employees conducting R&D, depreciation of tangible property, consumables, certain overheads and payments to entities conducting R&D on behalf of the claimant.

The credit applies at the rate of 15 percent of eligible expenditure in a year. It is claimed in the annual tax return, offsetting the tax liability of the claimant. Surplus credits are refundable. This means that businesses that have a tax loss or are tax-exempt receive the credits in cash.

### **Application date**

The credit will apply from the 2008–09 income year. There is provision for the Commissioner to issue individual determinations on the eligibility of a business for the credit. However, because of resource constraints, this will not be possible until a future date to be appointed by the Governor-General by Order in Council but not later than 1 April 2010.

### **Key features**

#### ***Eligibility criteria (sections LH 1, LH 2, LH 4 to LH 6)***

To claim an R&D tax credit, a business must be eligible (section LH 2), the activities must be “research and development activities” (sections LH 4 and LH 5) and the expenditure must be eligible (section LH 6).

To be eligible, a claimant must be in business in New Zealand, with a fixed establishment in New Zealand, and the expenditure for which a claim is made must relate to that business. An exception exists for industry research co-operatives which do not need to be in business and have special rules. Crown Research Institutes, tertiary institutions, and District Health Boards, their associates and entities under their control are not eligible for the credit.

Claimants must bear both the financial and technical risk associated with the R&D project, have control over the work and own the project results. When R&D is outsourced, this distinguishes the person who commissions the R&D (who is eligible for the credit) from the person who merely performs the R&D on behalf of someone else. The performer is not eligible for the credit, and the incentive is provided to the party making R&D investment decisions.

The claimant must also spend at least \$20,000 of eligible expenditure in the year a claim is made unless the R&D services are purchased from a listed research provider. These are entities that perform research for others on a commercial basis. This exception enables small businesses to access the credit.

To qualify for the credit, R&D must be conducted predominantly in New Zealand (the credit can apply for R&D conducted overseas up to a limit of 10 percent of the eligible expenditure incurred in New Zealand where the project is based in New Zealand). Businesses can do more R&D overseas but it does not attract the credit.

R&D activities must be systematic, investigative and experimental. They must either seek to resolve scientific or technological uncertainty or involve an appreciable element of novelty and be directed at acquiring new knowledge or creating new or improved products or processes. These are “core” R&D activities. Certain activities are excluded, as they are in other jurisdictions, generally to delineate more clearly the boundary between innovative and routine activity. Activities that support core R&D activities can be eligible.

Eligible expenditure is listed and includes the cost of employee remuneration, training and travel; depreciation of tangible assets used primarily in conducting R&D; certain overhead costs; consumables and payments to entities conducting R&D on behalf of the claimant.

Certain expenditure is ineligible. The main items are interest; loss on sale or write-off of depreciable property; the cost of acquiring core technology (technology used as a basis for further R&D); expenditure funded from a government grant or the required co-funding; expenditure on intangible assets and professional fees in determining eligibility.

#### ***Cap on internal software development (sections LH 9, LH 11)***

There is a cap of \$2 million on eligible expenditure where the R&D core activity is in-house-use software development. This can be waived by the Minister of Finance when it is in the national interest. Claimants under common control that undertake software development will be required to calculate such expenditure as a group and to allocate the cap between members.

### ***Rate of credit (section LH 3)***

The credit applies at the rate of 15 percent of eligible expenditure.

***Administrative procedures (sections ME 4, ME 11 and MK 4 of the Income Tax Act 2004; sections 3(1), 22(2) and (7), 33A(2), 43A(2), 68D and 68E, 91AAP, 91C(1), 141(7C) and (7D), 108(1B) and 113D of the Tax Administration Act 1994)***

Businesses will claim the tax credit in an income tax return. They will work out their liability for tax in the normal way, and then subtract the amount of the credit. Where the amount of the credit exceeds the tax liability, the balance is used to reduce other tax liabilities, or is refundable in cash.

The credit will reduce residual income tax, which will reduce provisional tax liability, allowing businesses to receive the benefit of the credit closer to the time they incur R&D expenditure. This reduction will be immediate for people who estimate provisional tax, but delayed for people who use the “uplift” method for calculating provisional tax.

Companies and Māori authorities will receive a credit in their imputation credit accounts for a tax liability that is satisfied by way of the credit.

To be eligible for the credit, a business must provide – in addition to the income tax return – a detailed statement of R&D activities and expenditure. This is collected for administrative, including evaluation, purposes.

There are a number of other minor and consequential amendments to the Tax Administration Act 1994 relating to the new tax credit.

From a date to be appointed by the Governor-General by Order in Council (but no later than 1 April 2010), a taxpayer will be able to apply to the Commissioner to determine whether an activity is R&D, whether a person is eligible for the credit, and whether expenditure is eligible for the credit. Binding rulings are not available on these matters.

### **Background**

In its *Business Tax Review* discussion document, released in July 2006, the government put forward several possible tax initiatives targeted at transforming the New Zealand economy by enhancing productivity and improving international competitiveness with Australia. The measures included an R&D tax credit.

R&D tax incentives are common overseas. The rationale for them is that there is under-investment by businesses in R&D because the investing firm does not capture all of the benefits of the investment. The government considers that there are wider benefits to New Zealand when businesses invest in R&D and that providing an R&D tax credit will encourage firms to invest more in R&D. There is a body of international evidence that suggests that these tax credits have been effective at encouraging business R&D.

An issues paper on the general eligibility criteria, the definition and eligible expenditure on R&D was released in November 2006. Submissions on that paper have been considered in developing the policy.

## **Detailed analysis**

### ***Entitlement to credit (section LH 1)***

Section LH 1 sets out the requirements for entitlement to the credit and describes the nature of the credit.

To claim an R&D tax credit, a claimant must, in any year, be an eligible person under section LH 2(1) and meet the eligibility requirements in section LH 2(2). That is, the claimant must, in that year:

- carry on business in New Zealand;
- not be a Crown Research Institute, tertiary institution, District Health Board or an entity associated with or controlled by them;
- carry on eligible R&D activities related to the business;
- control the R&D, bear the financial and technical risk and own the results of the project;
- have eligible expenditure or depreciation that is deductible (or would be deductible in certain events); and
- have eligible expenditure of \$20,000 or more (unless the R&D is contracted out to a listed research provider).

They must also file an R&D statement in relation to that year under new section 68D or 68E of the Tax Administration Act 1994.

The amount of the credit is set out in section LH 3 – 15 percent of the “eligible amount” of expenditure.

The credit is applied to satisfy a person’s tax liability for as far as the credit extends (section LH 1(4)). Surplus credits are applied, in turn, to satisfy an income tax or provisional tax liability that is payable in relation to other years, or any amount payable under an Inland Revenue Act (such as GST, or PAYE). Any excess credits are refunded (section LH 1(5)).

There are special rules for industry research co-operatives (discussed in relation to section LH 8) and for determining the credits in relation to depreciation for tax exempt entities (section LH 10).

### ***Eligible person (section LH 2(1))***

#### *In business in New Zealand (paragraph (a))*

To be eligible, a claimant must carry on business in New Zealand through a fixed establishment in New Zealand. This requires their activities to be a profession, trade, manufacture or undertaking and they must have an intention to make a pecuniary profit. All types of New Zealand businesses are eligible, whether incorporated or not, including businesses that earn only exempt income.

In the case of partnerships, the business test is applied at the partnership level, rather than to individual partners (section LH 2(6)).

An exception exists for industry research co-operatives which do not need to be in business. These entities are discussed further below in relation to section LH 8.

#### *Crown Research Institutes, tertiary institutions and District Health Boards (paragraph (b))*

Crown Research Institutes, tertiary institutions, and District Health Boards, their associates and entities controlled by them are not eligible for the credit. These entities are defined in section OB 1 through cross-references to their enabling Acts. Crown Research Institutes are defined in section 12 of the Crown Research Institutes Act 1992. A tertiary institution is a body established under section 162 of the Education Act 1989. A District Health Board is a board established under section 19 of the New Zealand Public Health and Disability Act 2000. Association is determined using the test in section OD 8(3).

#### **Example**

A Co is 25% owned by a CRI and 26% owned by a wholly-owned subsidiary of a university. It is not an eligible person.

Much of the R&D performed by these entities would be ineligible in any event because it is performed on behalf of other entities (which get the credit), or because it is funded by government grants. However, they do undertake some R&D on their own account that would otherwise be eligible. These entities are excluded because the credit is designed to target private sector business R&D. If the government wishes to increase R&D by these Crown entities, there are more effective and appropriate ways to do this than by providing a non-discretionary credit through the tax system.

### ***Other eligibility criteria (section LH 2(2))***

A business has a tax credit for a year if it satisfies the requirements in subsection (2).

#### *R&D must be related to the business of the claimant (paragraph (a))*

The expenditure for which a claim is made must relate to the business of the claimant. Special rules apply to an industry research co-operative which are discussed in relation to section LH 8.

#### *Claimants must bear the risk, have control over the project and own the results (paragraph (b))*

To avoid double dipping when R&D is outsourced, either the person commissioning or the person performing the R&D receives a tax incentive, not both. Paragraph (b) provides the credit to the person making the R&D investment decision (the person commissioning the R&D). Someone who merely performs R&D on behalf of another person is therefore not eligible.

Claimants must be able to show that they bear both the financial and technical risk associated with the project, have control over the R&D work and own the project results. This is broadly in line with the Australian requirements, but what constitutes ownership of the project results is more relaxed.

The person who has control over the R&D work is the person with the ability to choose the project, decide on major changes of direction, stop an unproductive line of research, follow up an unexpected result and end a project.

Ownership of the results means that the claimant must have access to and control over the results. It does not require the claimant to own the intellectual property arising out of the project, or to continue to own the project results, or mean that they cannot share the results.

#### *Expenditure or depreciation loss (paragraphs (c) and (d))*

The claimant must have expenditure on R&D activities (as defined in section LH 4) or depreciation on depreciable property used in the R&D activities. The expenditure or depreciation loss must be included in the list of eligible expenditure in section LH 6(1) and not excluded by section LH 6(2).

#### *Deductible expenditure (paragraph (e))*

The R&D expenditure or depreciation loss must be deductible in the year in which it is incurred to be eligible for the credit. Non-deductible expenditure, such as GST input tax, capital expenditure on land or on non-depreciable intangible property will not be eligible. This is intended to reduce the fiscal risk associated with the credit.

There are two exceptions to this. First, if a person has only tax exempt income, the requirement is that the expenditure or depreciation would be deductible if the person derived income other than tax-exempt income.

The second exception applies if a person has R&D expenditure that is capitalised for accounting and not immediately deductible for tax, and that expenditure is on creating an asset that would be depreciable – for example, a prototype or software. In this case, the requirement is that the expenditure would be deductible if the person had expensed it for accounting and section DB 26(1) of the Income Tax Act 2004 had applied. In the absence of this exception, capitalised development expenditure in creating a depreciable asset would never attract the credit – depreciation deductions attract the credit only if property is wholly or mainly used in the R&D process and is not created by the R&D. (See section LH 6(1)(b) and (e).)

**Example**

A Co has R&D expenditure in creating a plant variety right (which is depreciable property). Much of this is expensed for accounting and is immediately deductible for tax under section DB 26. The credit applies in the year the expenditure is incurred. The development expenditure that is capitalised for accounting also attracts the credit in the year in which it is incurred.

*Minimum expenditure threshold (paragraph (2)(f), subsections (3) and (4))*

To qualify for the credit, a person must have an “eligible amount” of expenditure of at least \$20,000 (unless the R&D is contracted out to a listed research provider). “Eligible amount” is defined in subsection (3) and the substance of the minimum threshold requirement is in subsection (4).

**“Eligible amount” of R&D expenditure (section LH 2(3))**

“Eligible amount” is a critical concept because the amount of the credit is calculated on the “eligible amount”. This is the amount of expenditure that is deductible in the year and eligible under section LH 6 and that remains after adding back adjustments in subpart CH. The provision in that subpart most likely to apply is section CH 2.

**Example**

In March 2010, A Co incurs \$100,000 of expenditure on R&D services to be provided by B Co. The services have not been performed by the end of A Co’s income year. The amount of the unexpired portion under section EA 3 is therefore \$100,000 which is income of A Co under section CH 2. The eligible amount is therefore \$0 (\$100,000 deductible eligible expenditure less \$100,000 added back as income).

If the expenditure is on trading stock that is the subject of processing, only the net expenditure is eligible under section LH 6(1)(g). Therefore the closing value is not added back under this provision.

If the R&D expenditure relates to “internal software development” (software developed mainly for in-house use), the eligible amount cannot exceed \$2 million unless this cap is waived by the Minister of Finance. This is discussed further in relation to section LH 9.

***Minimum expenditure threshold (section LH 2(4) and (5))***

A claimant must have an “eligible amount” of expenditure of at least \$20,000 to qualify for the credit. This is pro-rated when a person is not eligible under section LH 2(1) for part of a year (for example, when they carry on business for part of a year only).

An exception to the minimum threshold exists if the R&D services are outsourced to an unassociated listed research provider. This provision allows small businesses to claim the credit for amounts of R&D under \$20,000, but only if the R&D is performed by a listed research provider. The requirements to be a listed research provider are set out in section LH 7.

**Example**

In 2010, A Co spends \$10,000 undertaking its own R&D. This is not eligible.

In 2010, B Co spends \$10,000 contracting an unassociated listed research provider to do its R&D. This may be eligible.

In 2010, C Co spends \$100,000 undertaking its own R&D. All of this may be eligible.

The rationale for a minimum threshold is administrative – to avoid disproportionate compliance and administrative costs being incurred on small claims and to discourage small firms from reclassifying expenditure as R&D.

***Partnerships (section LH 2(6))***

For partnerships, the requirements to be in business and carry on R&D in relation to that business, as well as the minimum eligible amount threshold, are applied at the partnership level.

***Amount of tax credit (section LH 3)***

The amount of the tax credit is 15 percent of the “eligible amount” of R&D expenditure in a year.

### ***Definition of R&D activities (section LH 4)***

Eligible research and development activities are defined in section LH 4. The definition is:

- (a) systematic, investigative and experimental activities that seek to resolve scientific or technological uncertainty or that involve an appreciable element of novelty and that are carried on for the purposes of
  - acquiring new knowledge; or
  - creating new or improved materials, products, devices, processes or services;
- (b) other activities that are commensurate with, required for, and integral to, the carrying on of the activities in paragraph (a).

The definition is expected to apply to a wide range of development activities in a variety of industries. It is not limited to basic research. It draws on elements of the R&D definitions in the United Kingdom, Ireland, Canada and Australia (these definitions are in Appendix 1 of the issues paper released in November 2006).

It is most similar to the Australian definition, which has advantages for businesses operating on both sides of the Tasman and also for Inland Revenue, which will be required to implement the credit within a short timeframe. In particular, it is expected that application of the “appreciable element of novelty” limb would draw on Australian experience (the United Kingdom, Ireland and to some extent Canada focus on the resolution of scientific or technological uncertainty).

Activities described in paragraph (a) are “core” activities and activities in paragraph (b) are support activities. This is relevant in relation to the exclusions, and the in-house software development cap, discussed below.

The creation of new or improved production equipment and machinery would be included in paragraph (a) as new or improved products or processes.

R&D need not be successful to qualify for the credit. It is sufficient if the activities seek to resolve uncertainty or seek an output with sufficient novelty.

There is legislative clarification of the meaning of some of the terms used in the definition. Further elaboration on the definition will be in general and industry-specific guidelines (for example, software, oil and gas exploration, and pharmaceuticals). There will be consultation with these industries in developing guidelines.

### ***Systematic, investigative and experimental activities (subsection (2))***

Claimants will need to demonstrate that the R&D process followed a planned, logical progression of work involving hypothesis, experiment, observation and evaluation.

### *Scientific or technological uncertainty (subsection (3))*

This exists when knowledge of whether something is scientifically or technologically possible, or how to achieve it in practice, is not publicly available or deducible by a competent professional working in the field. This definition, and the definition of “technology”, are derived from the United Kingdom R&D definition.

### *Novelty (subsection (4))*

For activities to be “novel” there needs to be some development of the technology or a new use of existing technology. To establish whether something is new, it should be compared with what is already available in the public arena on a reasonably accessible world-wide basis at the time in that technology.

The “appreciable element of novelty” limb is drawn from the Australian R&D definition and the statutory clarification discussed in the paragraph above is based on the explanation of that term in the Australian *R&D Guide* (Part B page 16). The provisions should be very similar in scope.

### *Technology (subsection (5))*

For the purposes of the R&D definition, technology is the practical application of scientific principles and knowledge.

### *Simultaneous R&D*

Under the definition, R&D can be done:

- by two firms simultaneously and independently doing the same innovative work;
- when work has already been done but this is not public knowledge because it is a trade secret, and another firm repeats the work.

### *Improvements to existing products/processes*

Improvements to existing products or processes can qualify as R&D. However, the improvement that is sought would have to be one that involved an appreciable element of novelty or attempted to resolve scientific or technological uncertainty. It therefore should be more than routine upgrading.

### *Support activities (paragraph (b) of R&D definition)*

Supporting activities that are commensurate with, required for, and integral to the carrying on of core R&D activities referred to in paragraph (a), but which in themselves are not systematic, investigative and experimental, are eligible R&D. Support activities are eligible only if there is a core R&D activity.

“Commensurate with” and “required for” mean that the supporting activity must be only to the degree necessary to support the project. For example, if a drilling company is developing an innovative piece of drilling equipment that can be adequately tested using computer simulation, drilling is not “required for” the core R&D activity. If drilling is required to test the equipment, only drilling that is the minimum necessary qualifies as commensurate with or required for the development.

“Integral to” means that such activities must be part of an R&D project (rather than indirect supporting activities such as cleaning and administration, which are dealt with as expenditure on overheads).

Examples of support activities that could be eligible are scientific or technological planning activities, mathematical analysis or modelling used to analyse the results of the experiments and routine data collection.

The definition of “research and development activities” applies only for the purposes of the credit. The definitions of “research” and “development” in section DB 27 which apply to allow tax deductibility to follow accounting treatment remain (although the definitions are updated in the bill). As the tax treatment is so closely linked to accounting, the accounting definitions have been retained for that purpose.

Following release of the issues paper in November 2006, some submissions were received which argued for extending the proposed definition – for example, to adopt the accounting definition for the purposes of the tax credit. The government is concerned that extending the definition beyond the scope of that in comparable jurisdictions may result in a definition that is not sustainable. Overseas experience is that perceived stability in an R&D tax incentive is critical in increasing investment in R&D.

#### ***Activities excluded from “core” R&D (section LH 5)***

Certain activities are routinely excluded from R&D tax incentives. This can be because governments do not wish to incentivise a particular activity through an R&D concession, or to remove uncertainty over whether a particular activity could be considered R&D, or clarify the boundary between development and post-development activity, or innovative and routine work.

The activities listed below are excluded from being core activities in paragraph (a) of the R&D definition in section LH 4(1). The exclusions are broadly the same as in Australia (though certain exclusions in that jurisdiction, such as preparation for teaching and specialised routine medical care, have been omitted because it is considered that they clearly would not fall within paragraph (a) in any event). It is doubtful that some that have been included would fall within paragraph (a) but they are included for avoidance of doubt. The excluded activities are:

- prospecting, exploring or drilling for, or producing, minerals, petroleum, natural gas or geothermal energy;
- research in social sciences, arts or humanities;
- market research, market testing or market development, or sales promotion (including consumer surveys);

- quality control or routine testing of materials, products, devices, processes or services;
- the making of cosmetic or stylistic changes to materials, products, devices, processes or services;
- routine collection of information;
- commercial, legal and administrative aspects of patenting, licensing or other activities;
- activities involved in complying with statutory requirements or standards;
- management studies or efficiency surveys;
- the reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information; and
- pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs.

It is important to emphasise that, as in Australia, these activities are excluded from being core activities only – they may still be support activities within paragraph (b) of the definition. For example, routine data collection will not be eligible as a core R&D activity but can qualify as a support activity.

*Prospecting, exploring or drilling for, or producing, minerals, petroleum, natural gas or geothermal energy (paragraph (a))*

It is possible to have R&D in extractive industries – for example, R&D to develop new exploration techniques, but the exploration in itself is not R&D. Drilling can be a supporting activity if it is commensurate with, required for and integral to the development of a new exploration technique or new equipment – for example, testing of new drilling equipment.

*Research in social sciences, arts or humanities (paragraph (b))*

Research in these disciplines is excluded in each of the jurisdictions considered in the development of the R&D definition. The focus of R&D tax incentives is on extending business scientific and technological know-how rather than promoting research in these areas which are funded by other means.

The exclusion covers, for example, research in economics, classics, languages, literature, music, philosophy, history, religion, and visual and performing arts. Examples of activities excluded under this head would be the study of the historical development of a language or the role of the family in society, or writing a novel or screenplay.

The scope of this exclusion was queried in submissions. If a business is developing an innovative product and the development process satisfies the criteria in the definition in section LH 4, the development is not excluded simply because the product is used in the arts or humanities. For example, if a business develops computer software for use in the film industry in a process that satisfies the criteria in the definition, the software development is not excluded under this paragraph. Similarly, if a business develops and manufactures innovative ceramic glazes, the development is not excluded under this paragraph because glazes are used in the visual arts.

As with the other exclusions, this research is excluded from being a core R&D activity only. Where research in these fields is required for development of a new product or process, the research can be an eligible support activity. For example, if research into human behaviour is required for innovative product development, the research can be an eligible R&D support activity.

*Market research, market testing or market development, or sales promotion (including consumer surveys) (paragraph (c))*

Conducting of market research is excluded. However, it can be a supporting activity when the research is commensurate with, required for and integral to development of a product or process. For example, if a firm is developing a new food product and needs to determine the appropriate level of sweetness for the market in different countries, the taste-testing research would be an eligible support activity.

*Quality control or routine testing of materials, products, devices, processes or services (paragraph (d))*

Quality control in itself is excluded as a core activity. However, the development of new or improved methods of quality control testing can be eligible R&D. Quality control may also be a supporting activity – for example, in the development of a new manufacturing process, checking that the products in a trial run meet the desired quality.

*Making cosmetic or stylistic changes to materials, products, devices, processes or services (paragraph (e))*

Changes that are purely cosmetic or stylistic (such as changes to colour or pattern) are excluded from being a core activity. For example, this would include design changes for fabrics and wallpapers.

However, work to create a desired cosmetic or aesthetic effect through the application of science or technology can require the resolution of uncertainty and can be R&D.

Also, cosmetic or stylistic changes that meet the requirements in paragraph (b) of the R&D definition can be a supporting activity. For example, if a firm is improving a product it manufactures in a way that falls within the definition of a core R&D activity, work on the associated stylistic changes can be eligible R&D.

*Commercial, legal and administrative aspects of patenting, licensing or other activities (paragraph (g))*

This is post-R&D work which is very unlikely, even in the absence of the exclusion, to qualify as a core R&D activity.

It is also unlikely to be a supporting activity because patenting or licensing would seldom be “required for” a core activity.

*Activities involved in complying with statutory requirements or standards (paragraph (h))*

This exclusion targets routine testing and analysis of materials, products and processes to check that they comply with statutory requirements or standards. It does not apply to development of new technologies to comply with standards. Activities involved in developing, rather than complying with, standards is also not excluded. Checking that new products meet relevant standards can be an eligible R&D support activity.

*Management studies or efficiency surveys (paragraph (i))*

In Australia this includes studies relating to inventory control (such as Just-in-Time), work practices, industrial relations, feasibility analysis, and time and motion studies. The exclusion also covers industry research – for example, where a company carries out a survey into a particular industry’s characteristics and future needs.

These studies or surveys can be a supporting activity. For example, if a manufacturer’s improvement to its processes is R&D, a monitored test to determine how efficient the new process is would be eligible as a supporting activity.

*The reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information (paragraph (j))*

No R&D is involved in simply reproducing an existing product or process, and this is excluded as a core R&D activity.

*Pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs (paragraph (k))*

This excludes activities that are post-R&D but pre-production. It is very unlikely that any of these activities would be a core R&D activity in the absence of the exclusion.

However trial runs are likely to be eligible as a qualifying supporting activity, as could tooling up (for example, to test a new manufacturing process). It is unlikely that demonstration of commercial viability is required for and integral to the core R&D and therefore is unlikely to be a supporting activity.

### ***Eligible expenditure (section LH 6(1))***

Only the following expenditure is eligible for the credit:

- salaries and other remuneration of employees conducting R&D;
- depreciation of tangible assets used wholly or mainly in conducting R&D;
- costs of staff training, recruitment, relocation and travel incurred directly as a result of R&D;
- the cost of materials incorporated into prototypes and pilot plant;
- overheads that relate to administration, personnel, repairs and maintenance, cleaning and security, rates, utilities, insurance and leasing of buildings, plant and equipment;
- the cost of items consumed, and the net cost of items processed or transformed, in R&D activities; and
- payments to an entity or person conducting R&D on behalf of the claimant.

#### *Salary and other remuneration of employees conducting R&D (paragraph (a))*

Salary, wages, allowances, bonuses, commissions, extra salary, overtime, holiday pay and long-service pay paid to employees who are conducting core or supporting R&D activities are eligible for the credit.

If an employee works part-time on R&D, the credit only applies to remuneration in relation to that portion of the employee's time that is spent on R&D.

#### *Depreciation of tangible property (paragraph (b))*

Annual depreciation on **tangible** property wholly or mainly used in conducting R&D is eligible (depreciation on intangible property is excluded under subsection (2)(o)). Expenditure on depreciable property created from the R&D (such as a prototype) is not eligible under this paragraph (see subsection (2)(e)). This expenditure would attract the credit during the development process.

The credit is available to the extent the property is used or available for use in conducting R&D. If assets are not wholly or mainly used for R&D, the depreciation is not eligible.

#### **Example**

A Co has equipment that is used 20 percent of the time on R&D, 10 percent on other activities and 70 percent is downtime (evenings, weekends, holidays). The equipment is therefore used mainly in conducting R&D and is eligible for the credit. It is used or available for use for R&D 90 percent of the time and therefore the credit may be claimed in relation to that annual depreciation.

If the equipment was used 10 percent of the time for R&D and 20 percent of the time for other activities, it would not be eligible.

To minimise compliance costs, there is no clawback of credits on disposal of assets for more than their tax book value. When the asset is sold to an associate, the price above the vendor's adjusted tax value does not attract the credit in the hands of the associated purchaser (section LH 6(2)(f)).

Similarly, any loss on sale or write-off of depreciable property does not attract the credit. This is discussed further below under "ineligible expenditure" (section LH 6(2)(b)).

The credit does not apply to depreciable assets in a tax depreciation pool unless the pool consists solely of R&D assets used wholly in conducting R&D.

Special rules are provided in section LH 10 to calculate the amount of depreciation loss in relation to tax exempt entities.

*Employee training, recruitment, relocation and travel (paragraph (c))*

The cost of training, recruitment, relocation and travel of employees is eligible when it is incurred directly as a result of R&D activities.

*Materials incorporated into prototype products and plant (paragraph (d))*

The cost of materials incorporated into a trial model or preliminary version of a product or plant is eligible for the credit.

*Overhead costs (paragraph (e))*

Expenditure incurred on the following overheads is eligible when they are incurred as a result of the following R&D activities:

- costs of administration, personnel, repairs and maintenance, cleaning and security;
- rates, utilities (including telecommunications) and insurance; and
- costs of leasing buildings, plant and equipment.

This paragraph does not include depreciation deductions, which may only be claimed under paragraph (b).

Apportionment is required when overheads are only in part incurred as a result of R&D activities.

*Items consumed in R&D activities (paragraph (f))*

Items consumed in the R&D process are eligible for the credit. This would include, for example, laboratory chemicals and stationery.

*Net cost of items processed or transformed in R&D process (paragraph (g))*

For items that are processed or transformed during R&D activities, only the net expenditure is eligible – that is, the excess of the cost of the items which are the subject of processing or transformation, over the value of the output. The value of the output is the sale proceeds when the products are sold in an arm’s-length transaction and, when they are not, the market value of the products. This replicates the Australian treatment of “feedstock” expenditure.

*Payments to a person conducting R&D activities (paragraph (h))*

When part or all of an R&D project is outsourced, a payment for the R&D to the person or entity conducting the R&D is eligible expenditure. The performer of the R&D does not get a credit (they will fail the requirement to control the project, bear the risk and control the results). When the R&D is outsourced to an associate, some of the payment may be ineligible under section LH 6(2)(c).

The payment must relate only to the R&D conducted by the third party. If the payment is for multiple items (such as R&D services and feedstock), costs must be separately identified.

Payments for core and supporting activities are included under this paragraph.

***Ineligible expenditure (section LH 6(2))***

The following expenditure is ineligible:

- interest;
- loss on sale or write-off of depreciable assets;
- profits on R&D services and property provided by an associate;
- amounts in excess of market value for leasing property of an associate;
- depreciation on property created from the R&D;
- certain depreciation deductions on assets acquired from an associate;
- the cost of acquiring core technology (technology used as a basis for further R&D);
- in-house software development costs exceeding \$2 million (unless the cap is increased by Ministerial waiver);
- the cost of R&D conducted overseas (except the credit may be claimed for up to 10 percent conducted overseas if it is part of a larger project based in New Zealand);
- expenditure funded from a government grant or any required co-funding;
- the making of donations;
- professional fees in determining whether the person, activities or expenditure are eligible;

- the cost of acquiring intangible assets; and
- expenditure of an industry research co-operative funded by an ineligible person.

Some of this expenditure (for example, professional fees and donations) would not be eligible in any event, as it would not fall within the list of eligible expenditure in subsection (1). It is inserted to make the provisions as clear as possible, and for avoidance of doubt.

*Interest (paragraph (a))*

Interest incurred in financing R&D activities is not eligible. This replicates the position in Australia where, to control fiscal cost, interest no longer attracts the 125 percent deductibility concession. Allowing interest to be eligible would also increase complexity as allocation rules would be required so that all interest paid was not attributed to the R&D.

*Depreciation loss on disposal or write-off of assets (paragraph (b))*

As noted earlier, to reduce compliance costs, there is no clawback of credits when depreciable property used in R&D is sold for more than its adjusted tax value. There is a corresponding restriction in relation to a loss on disposal of depreciable assets and the write-off when depreciable items are no longer used (sections EE 11(3) to (5) and EE 32). No credit is available in relation to this loss or write-off.

**Example**

A Co purchases an asset for \$1 million which is used wholly in R&D for three years. Credits are claimed in relation to that depreciation. The adjusted tax value at the time of sale is \$700,000. The asset is sold for \$650,000. No credit is available for that \$50,000 loss.

*R&D services and property purchased from an associate (paragraph (c))*

When R&D is outsourced to an associate of the claimant, or property used in R&D is acquired from an associate, the credit cannot be claimed for any profit margin of the associate in supplying the services or property. The credit is payable on the lesser of the amount paid to the associate (eligible under section LH 6(1)(h)) and the eligible expenditure of the associate incurred in a third-party transaction.

**Example**

A Co contracts its sister company B Co to perform R&D services. B Co obtains all the services and property used to perform the R&D from third parties unassociated with the company (for example, employees and contractors). Unassociated T Co provides core technology to B Co to enable B Co to perform the services. B Co spends \$30,000 on the core technology and incurs \$50,000 eligible expenditure on performing the R&D services (salary of employees and depreciation on equipment). B Co charges A Co \$100,000 for the services. A Co may claim the credit only on \$50,000.

*Property leased from an associate (paragraph (d))*

When property is leased directly or indirectly from an associate at more than market value, the excess over market value is not eligible for the credit.

*Property created from R&D (paragraph (e))*

The cost of property created by R&D attracts the credit as it is created. In the unlikely circumstance that this property could be “used wholly or mainly in conducting R&D”, this paragraph specifies that depreciation on it is not eligible for the credit.

*Depreciation deduction on property purchased from associate (paragraph (f))*

Because there is no clawback of credits when depreciable property used in R&D is sold for more than its tax book value, a rule is required to prevent associated entities claiming credits twice for depreciation. Paragraph (f) therefore provides that when depreciable property is sold to an associate for a price in excess of the vendor’s tax book value, the excess over the vendor’s tax book value does not attract the credit in the hands of the purchaser. This rule is required even if the sale price is less than the vendor’s cost (that is, it is required even though there are restrictions on the associated purchaser’s ability to deduct depreciation under section EE 34).

**Example**

A Co sells an asset that cost \$200 and has a tax book value of \$100 to associated B Co for its market value of \$130. The \$30 is not eligible for the credit in the hands of B Co.

*Core technology (paragraph (g) and section LH 6(3))*

Core technology is technology which is used as a basis for further R&D. It may be intellectual property or a tangible asset such as a prototype. Core technology is ineligible for the credit for two reasons.

First, it is excluded to prevent double dipping when development of the underlying technology has already attracted the credit. For example, a firm could build a prototype which is a capital asset, with the inputs treated as immediately deductible under general R&D rules. The inputs would be eligible for the credits but no tax or claw-back of credits would arise on sale of the prototype. If the prototype was sold to another party for use as a basis for that party’s R&D, the cost of the prototype would, but for paragraph (g), again be eligible for the credits as expenditure on an input into that party’s R&D.

Secondly, even if the core technology has not previously attracted the credit, this restriction provides some protection against credits being claimed for excessive input costs for marginal R&D. For example, a company could claim to be attempting to improve further on expensive technology developed by an associate so that it could claim the credit on the purchased base technology.

In Australia the 125 percent concession does not apply to core technology, and the ability to deduct it is limited to one-third of related R&D expenditure.

“Core technology” is defined in subsection (3). The definition is in substance the same as it is in Australia.

*Cap on certain in-house software development (paragraph (h))*

This is discussed under section LH 9 at the end of the commentary on R&D.

*R&D conducted outside New Zealand (paragraphs (i) and (j) and section LH 6(4))*

Paragraph (i) applies where a project is based overseas (see the definition of R&D project). While the credit is available for the R&D conducted in New Zealand, it is not available for any of the work done overseas.

Where the project is based in New Zealand expenditure on R&D performed outside New Zealand is not eligible except to the limited extent set out in paragraph (j). The amount of eligible expenditure on overseas R&D that attracts the credit in any year cannot exceed 10 percent of the eligible expenditure incurred on R&D conducted in New Zealand in that year. Companies may do more R&D overseas but it is not eligible for the credit.

**Example**

In 2009, A Co incurs eligible expenditure of \$1 million on R&D conducted in New Zealand. It also incurs \$500,000 eligible expenditure in relation to R&D conducted overseas. It may claim a credit in relation to \$100,000 of that expenditure on overseas R&D.

“R&D project” is defined in section LH 6(4).

*Grants and required co-funding (paragraphs (k) and (l))*

Expenditure funded from a government or local authority grant or any required co-funding is ineligible for the credit because the R&D project is already subsidised by government.

The rule applies when the co-funding is required from the person receiving the grant or from another party.

**Example**

A Co receives an R&D grant of \$2 million from the Foundation for Research Science and Technology. As a condition of the grant, A Co is required to contribute \$1 million of its own funds towards the project. The \$3 million is used to pay for R&D salaries and to purchase depreciable property that is mainly used in the R&D. It is ineligible expenditure.

If A Co receives the \$2 million grant on the condition that B Co provides \$1 million to A Co towards the project, A Co receives no credit for the \$3 million expenditure.

*Donations (paragraph (m))*

Making donations towards the R&D of others is not eligible. In Australia, making of donations is excluded as an activity.

*Professional fees in determining eligibility (paragraph (n))*

Fees paid to accountants, lawyers, scientists and others in determining whether claimants, activities and expenditure are eligible and calculating the amount of the claim are not eligible for the credit.

*Cost of acquiring intangible assets (paragraph (o))*

The credits are not available for the cost of purchasing, leasing or obtaining the right to use intangible assets. The expenditure on intangibles can be by way of royalties or a lump sum capital cost.

The extent to which they can be included in eligible expenditure requires careful consideration as such assets tend to be the focus of tax avoidance schemes. This policy work will be done once the R&D credit is in effect.

**Example**

A Co acquires a licence to use software in its R&D process. Depreciation on, or licence fees for, the software are not eligible.

The paragraph does not exclude the cost of creating intangible assets from R&D.

*Certain expenditure of an industry research co-operative (paragraph (p))*

Paragraph (p) provides that expenditure of an industry research co-operative that is sourced from funds contributed by a person who is ineligible under section LH 2(1) is not eligible expenditure of the co-operative. This is to prevent co-operatives being used to circumvent the requirements for eligibility.

Industry research co-operatives are discussed in more detail in relation to section LH 8.

### ***Listed research providers (section LH 7)***

Section LH 7 sets out the requirements to be listed with the Commissioner as a research provider. Payments to a listed research provider are eligible even if they are under the minimum threshold of \$20,000.

To be listed, a person must give notice to the Commissioner that it has the capability to perform contracted R&D, has R&D facilities in New Zealand, charges fees on commercial terms, is available to undertake work on behalf of multiple unrelated organisations, and will maintain records to show that they satisfy those criteria and to show the amounts derived and incurred in carrying out R&D on behalf of others.

Inland Revenue will check the first two requirements and list the research provider if it is satisfied they are met. The provider is listed until it seeks to be removed from the list or is delisted by the Commissioner.

### ***Industry research co-operatives (section LH 8)***

Industry research co-operatives fall into two categories. They can be organisations, generally in the primary sector, that collect levies from those in an industry and apply them to various purposes including R&D – for example, Meat and Wool New Zealand Limited.

Outside of the primary sector, they may be co-operatives set up within an industry that receive contributions for various activities including R&D.

These organisations are unlikely to be in business, but the R&D they either conduct or commission on behalf of businesses in the relevant industry should be eligible for the credit (those in business in the industry and making payments to the co-operative will not be eligible for the credit in relation to those levies or contributions). Industry research co-operatives are therefore exempt from the business test.

Instead:

- they must be undertaking or commissioning R&D mainly on behalf of New Zealand businesses that, but for the minimum threshold, would be eligible for a tax credit if they were carrying out the R&D activities; and
- those businesses make contributions or pay levies that are used in financing the R&D; and
- the R&D relates to the businesses of those who make contributions or pay levies (section LH 2(a)(ii)).

### ***Depreciation base for tax exempt entities (section LH 10)***

R&D tax credits are potentially available to most entities undertaking an R&D activity, including charities and not-for-profit entities which have only exempt income.

The normal rules for calculating depreciation loss are ineffective for entities which generate only exempt income from an asset. Section LH 10 provides rules to calculate the amount of depreciation loss these entities can claim a credit for.

When a person conducting or commissioning R&D has not previously been allowed a deduction for an amount of depreciation loss for an asset because they derive only exempt income, they are treated as acquiring the asset on the first day of the 2008–09 income year for market value, or on the actual date of acquisition at cost, whichever is the later.

These entities are then considered, solely for the purposes of calculating the amount of depreciation loss for the purposes of the credit, to have had deductions for depreciation in every year since acquisition. This does not allow the person to claim a depreciation loss, but does lead to the correct amount of depreciation loss to use in calculating the amount of R&D tax credit.

### Example

Physicists Having Borders, a charitable society, undertakes R&D in 2010–11. A Digital Serial Analyser, purchased new in 2007, is mainly used in the R&D activity and the resulting depreciation loss would be deductible if PHB were in business. PHB’s income year runs from 1 April to 31 March, and an independent valuation of the analyser on 1 April 2008 puts its market value at \$35,000.

For the purposes of calculating the depreciation loss which is eligible for the credit in 2010–11, PHB assumes the analyser was purchased on 1 April for \$35,000. The applicable depreciation rate for the analyser is 26.4 percent (diminishing value rate for an oscilloscope with 20 percent loading).

PHB is treated as being allowed a deduction for depreciation loss in each of the 2008–09, 2009–10, and 2010–11 income years, being the completed income years following deemed acquisition. Therefore, the assumed amounts of depreciation loss and adjusted tax values (ATV) in each year are:

<i>Income year</i>	<i>ATV at beginning of year</i>	<i>Depreciation loss</i>
2008–09	Cost = \$35,000	26.4% x \$35,000 = \$9,240
2009–10	\$35,000 – \$9,240 = \$25,760	26.4% x \$25,760 = \$6,800
2010–11	\$25,760 – \$6,800 = \$18,960	26.4% x \$18,960 = \$5,005

In the 2010–11 income year PHB can claim a tax credit for \$5,005 of eligible depreciation loss.

If the Digital Serial Analyser, instead of being purchased new in 2007, was purchased second-hand, the applicable depreciation rate for the analyser would be 22 percent (diminishing value rate for an oscilloscope without 20% loading).

### ***R&D tax credits and imputation accounts (sections ME 4, ME 11, MK 4)***

In other jurisdictions such as Australia, tax credits to companies are “clawed back” when paid out as dividends. The New Zealand credit has been designed to reduce such “clawback”.

If a person has an imputation credit account or a Māori authority credit account, an R&D tax credit will lead to a credit to that account. A refund of R&D tax credit will lead to a debit (existing sections ME 5, ME 12 and MK 5). The result is that companies receive an imputation credit for a tax liability satisfied by way of the credit.

The credit is equal to the amount of the R&D tax credit (sections ME 4(1)(ib), ME 11(1)(ib) and MK 4(1)(gb)), and the debit is equal to the amount of the refund. The credit arises on the day the relevant income tax return is received by Inland Revenue (sections ME 4(2)(gb), ME 11(2)(db) and MK 4(2)(db)).

**Examples: Tax credit leads to credits and debits to imputation credit account**

1. Company A receives a tax credit of \$10,000 for expenditure incurred in its 2008–09 income year, reducing its tax-to-pay to \$100,000. Company A’s income tax return for the 2008–09 year is received by Inland Revenue on 1 June 2009. On 1 June 2009, there is a credit to A’s imputation credit account of \$10,000.
2. Company B receives a tax credit of \$10,000 for expenditure incurred in its 2008–09 income year, pushing it from tax-to-pay of \$5,000 to a tax loss of \$5,000. Company B’s income tax return for the 2008–09 year is received by Inland Revenue on 1 March 2010. B receives a cash refund of \$5,000, being the amount of the surplus refundable tax credit, on 1 April 2010. On 1 March 2010, there is a credit to B’s imputation credit account of \$10,000. On 1 April 2010, there is a debit for B’s imputation credit account of \$5,000.

***Claiming the credit***

Taxpayers will claim the tax credit in an income tax return. The taxpayer will work out the liability for tax in the normal way, and then subtract the amount of the credit. If the amount of the credit exceeds the tax liability the balance is used to reduce other tax liabilities, or is refundable in cash.

The tax will reduce residual income tax, which will reduce provisional tax liability, allowing taxpayers to receive the benefit of the credit closer to the time the related eligible expenditure is incurred. This reduction will be immediate for people who estimate provisional tax, but delayed for people who use the “uplift” method for calculating provisional tax.

To be eligible for the credit, the taxpayer must provide – in addition to the income tax return – a detailed statement of R&D activities and expenditure, containing essential information for administrative purposes, by a due date.

There are a number of other minor and consequential amendments to the Tax Administration Act 1994 relating to the new tax credit.

**Example: Claiming the tax credit**

In 2010, Company A has assessable income of \$200,000 and allowable deductions of \$170,000, \$100,000 of which is an “eligible amount” of R&D expenditure. A claims an R&D tax credit of \$15,000 of R&D expenditure.

Assessable income	\$200,000
<i>Less</i>	
Deductions	<u>\$170,000</u>
Net income	\$30,000
<b>Tax liability (@ 30%)</b>	<b>\$9,000</b>
<i>Less</i>	
R&D tax credit	\$15,000
<b>Tax to pay</b>	<b>\$0</b>
<b>Refund of surplus credit</b>	<b>\$6,000</b>

*Addendum*

Credit to imputation credit account	\$15,000 (on date return is received)
Debit to imputation credit account	\$6,000 (on date refund is paid)

*Requirement for a detailed supporting statement (section LH 1(3) Income Tax Act 2004; sections 68D and 68E Tax Administration Act 1994)*

A person claiming a tax credit on an income tax return is required to furnish electronically file a detailed supporting statement. The detailed statement contains essential information to be used for audit, forecasting, statistical and evaluation purposes, and is expected to have similarities to Australian and Canadian statements.

If a person is a member of an internal software development group, the detailed statement must be filed by a nominated member of the group on behalf of all group members.

A partnership may elect to file the detailed statement, in relation to the partnership's R&D activities, on behalf of all the partners, for convenience. A partnership which elects to file a statement on behalf of all the partners, and does internal software development, is not an internal software development group merely because it makes this election. Alternatively, if the partnership does not make this election, each partner must separately file their own detailed statement, including their share of the partnership's eligible expenses and tax credit.

The statement must be filed before the due date. If a statement is filed late, there will be no tax credit for the year and there could be use-of-money-interest and penalties to pay.<sup>5</sup>

The government recognises that taxpayers and their agents need sufficient time to prepare the statement. Therefore, the statement is never required to be filed before the due date for the associated income tax return.

The due date of the detailed statement for an individual is the same as the due date for the person's income tax return. The due date for an internal software development group is the latest income tax return due date of any of the group's members. The due date for a partnership which elects to file a statement for all the members of the partnership is the latest income tax return due date of any of the partners.

**Example: Due date for filing a detailed statement**

A's income year runs from 1 April to 31 March. B and C have income years which run from 1 November to 31 October. A, B and C are under common control and have amounts eligible for a tax credit. B and C have a tax agent who is granted an extension of time, until 31 March 2010, to file B and C's 2008–09 income tax returns. A's internal accountant files its income tax return.

A must file its 2008–09 income tax return by 7 July 2009. B and C have until 31 March 2010. The group's detailed statement must therefore be furnished by 31 March 2010.

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<sup>5</sup> There may be an exception in one situation: when a group return is filed on time but is incorrect due to a simple oversight, the Commissioner has discretion to grant an extension of time to file a corrected version. This exception was created to avoid the situation in which a group accidentally omits a member from its group return, causing the other members of the group to lose entitlement to their credits.

It is possible that a person will be required to file (or have filed on their behalf by a group or partnership) more than one detailed statement for an income year.

*Provisional tax (section OB 1 Income Tax Act 2004; section 3(1) Tax Administration Act 1994 – definition of residual income tax)*

The R&D tax credit reduces residual income tax. Taxpayers therefore have the option of reducing their provisional tax payments in anticipation of an R&D credit at the end of the year.

**Example: estimating provisional tax including tax credit**

Company A expects to have a tax liability of \$100,000 for the 2008–09 income year (before credits). A also expects to receive a credit of \$40,000, so estimates its RIT to be \$60,000. A furnishes this estimate to Inland Revenue and thereby elects to use the estimated provisional tax method (see subparagraph MB 2(1)(c) of the Income Tax Act 2004). On each provisional tax instalment date, A pays provisional tax payments of \$20,000.

***Changes to the disputes and reassessment rules***

*Time limit for notice of proposed adjustment (section 3(1) Tax Administration Act 1994 – definition of response period)*

The government recognises that claimants and their agents will require time to prepare and check their claims for tax credits. The time for reassessing the amount claimed has therefore been extended from the standard four months.

In the case of only R&D tax credit amounts, the time limits within which the taxpayer can issue a notice of proposed adjustment (NOPA) are:

- For a person who is not a member of an internal software development group, one year following the date the income tax return is received by Inland Revenue.
- For a person who is a member of an internal software development group, from the date the person's income tax return is received by Inland Revenue, up until one year after the due date for the group's detailed statement of R&D activities.

**Example: Taxpayer issues NOPA within the new response period**

Company A is in the process of internally auditing its R&D expenditure. On 15 March 2010, A's agent files A's 2008–09 income tax return and files a detailed statement of R&D activities, claiming a \$50,000 tax credit. Inland Revenue receives the tax return on 17 March. When A completes its audit, A discovers that it was actually entitled to a tax credit of \$60,000.

As long as Inland Revenue receives the notice of proposed adjustment by 16 March 2011, the disputes process will begin and, subject to the outcome of the process, A could receive the additional \$10,000 credit. If the notice of proposed adjustment is received after 16 March 2011, the notice will not be effective.

Issuing a NOPA for an amount of R&D tax credit does not allow the taxpayer to reopen any other aspect of the income tax return.

*Time limit for Commissioner's reassessment (sections 108(1B), 113D Tax Administration Act 1994)*

Overseas experience suggests that when taxpayers are given long periods to reconsider their original claims, practitioners have incentives to trawl through past years' accounts and identify R&D expenditure that the taxpayer was unaware was R&D. This practice of "grave-digging" is at odds with the intent of the R&D tax credit policy, which is that the credit should provide an incentive to undertake R&D. If credits are being given for R&D which the taxpayer was unaware they were undertaking, it is clear that the credit has not provided any incentive.

To prevent "grave-digging", the Commissioner will not be allowed to reassess an amount of R&D credit upwards if one year has passed since the end of the year in which the original income tax return was filed.

**Example: Taxpayer requests amendment after more than a year**

Company A claims a \$50,000 credit for R&D undertaken in the 2008–09 year, by filing an income tax return on 6 June 2009. The return is filed in the 2009–10 tax year, which ends on 31 March 2010.

On 1 June 2011, A discovers that it was actually entitled to a \$60,000 credit for R&D and asks the Commissioner to amend the amount originally self-assessed. However, Inland Revenue may not amend the amount to \$60,000 after 31 March 2011.

There is an exception to the new rule. When the taxpayer has issued a NOPA on their claim for an R&D credit within the response period for doing so, the Commissioner has the normal four years to reassess the amount of credit, allowing time for disputes procedures to be completed. In no case may the Commissioner increase the amount of the R&D tax credit by more than the adjustment proposed in the NOPA which arrived within the original response period.

**Example: Taxpayer requests amendment after more than a year, having issued a NOPA**

Company A claims a \$50,000 credit for R&D undertaken in the 2008–09 year, by filing an income tax return on 6 June 2009. The return is filed in the 2009–10 tax year, which ends on 31 March 2010.

On 1 June 2010, A discovers that it was actually entitled to a \$60,000 credit for R&D and issues a notice of proposed adjustment. The notice is issued within the response period (one year following the date the tax return was received), so the disputes process begins. The disputes process is concluded on 30 August 2011, and Inland Revenue agrees the credit should be \$60,000. Normally, Inland Revenue would be unable to reassess the amount of the credit, since the date for doing so (31 March 2011) has passed. However, because the taxpayer had issued a NOPA relating to the amount of the R&D tax credit, Inland Revenue will reassess the amount to \$60,000.

**Example: Taxpayer requests amendment after more than a year, having issued multiple NOPAs**

Company A claims a \$50,000 credit for R&D undertaken in the 2008–09 year, by filing an income tax return on 6 June 2009. The return is filed in the 2009–10 tax year, which ends on 31 March 2010.

On 1 June 2010, A discovers that it was actually entitled to a \$60,000 credit for R&D and issues a notice of proposed adjustment. The notice is issued within the response period (one year following the date the tax return was received), so the disputes process begins.

On 20 August 2010, A issues another NOPA, revising up the credit again to \$70,000.

The disputes process relating to the first NOPA is concluded on 30 August 2011, and Inland Revenue agrees the credit should be \$60,000. Because the taxpayer issued a NOPA relating to the amount of the R&D tax credit within the response period, Inland Revenue will reassess amount to \$60,000.

The second NOPA is ineffective because it was issued outside the relevant response period, being the first year after the income tax return was originally filed. Inland Revenue is unable to reassess the tax credit amount above \$60,000.

***Determinations (sections 91AAP, 91C(1)(eb)(vb) Tax Administration Act 1994)***

Taxpayers who are uncertain about their eligibility for the tax credit will be able to apply for a determination that:

- they meet the eligibility criteria in Section LH 2;
- their activity meets the definition of R&D in Section LH 4; and
- their expenditure or depreciation loss is an eligible amount, as defined in LH 3.

Taxpayers will not be able to obtain binding rulings about these matters.

There will be regulations to prescribe how taxpayers should apply for a determination on these matters. The determinations will be binding on the taxpayers who request them, and on the Commissioner, from the date the determination is signed by the Commissioner of Inland Revenue.

When there is an amendment or repeal of the law relevant to the determination, and this detrimentally affects the person who relies on the determination, the determination is no longer binding and cannot be relied upon.

Where the applicant has misrepresented or omitted facts relevant to the determination, whether intentionally or not, the determination is no longer binding and cannot be relied upon.

Inland Revenue may withdraw the determination by notice, at which point it can no longer be relied upon. There is an exception, however – when the taxpayer is already undertaking an activity in reliance on the determination, and was doing so before the notice of withdrawal, they can continue to rely on the determination as originally set down for the activity.

The ability to apply for a determination might not be available immediately after this Bill is assented to, owing to resource constraints. The provision allowing for determinations will therefore come into force by Order in Council, but not later than 1 April 2010.

***Record-keeping (sections 22(2) and 22(7) Tax Administration Act 1994)***

Taxpayers must keep sufficient records to support their claim for an R&D tax credit. For a business, general record-keeping requirements are laid out in detail in section 22(1). An entity which is not a business is expected to keep records of a similar standard to support its claim for a tax credit.

In addition, all entities claiming a tax credit will be expected to keep a wider range of records than specified in section 22(1). For example, non-accounting documents such as project plans or test-reports might be required to provide evidence of a scientific, investigative and experimental approach to an activity.

***No exemption from filing an annual return of income (sections 33A(2) and 43A(2) Tax Administration Act 1994)***

A person who claims a tax credit under section LH 1 must file a return of income for the year the credit relates to. The exemption from filing in section 33A does not apply to a person who claims the tax credit.

A non-active company which claims a tax credit under section LH 1 ceases to be a non-active company and must file an income tax return.

***Refunds of surplus credits not subject to GST (section 6 Goods and Services Tax (Grants and Subsidies Order) 1992)***

A refund of surplus tax credits under section LH 1 is not subject to GST.

***Cap on internal-use software expenditure eligible for a credit (sections LH 9, LH 11)***

A maximum of \$2 million of internal software development will be eligible for an R&D tax credit. The cap may be lifted by the Minister of Finance if it is in the national interest.

In other jurisdictions, claims for R&D incentives relating to internal software development have been problematic. In Australia, the 125% and 175% deductibility R&D tax incentives are not available for software developed for solely internal use.

The New Zealand credit allows claims for internal software development, but caps these claims to limit the fiscal risk of abuse.

### *Outline of the sections*

Section LH 9 limits the eligible amount of credit a person can claim for internal software development, and also calculates the eligible amount. In particular:

- Subsection (1) determines when a person is eligible for a credit for internal software development and therefore has to apply LH 9.
- Subsection (2) determines which other subsections to use in calculating the eligible amount.
- Subsections (3) and (4) calculate the eligible amount to use for a period that a person is not a member of an internal software development group.
- Subsections (5) to (10) calculate the eligible amount to use for a period that a person is a member of an internal software group in which all members have the same income year.
- Subsections (11) to (14) calculate the eligible amount to use for a period that a person is a member of an internal software group in which not all members have the same income year.
- Subsection (15) gives the Minister of Finance discretion to determine a higher level of the cap for a person, and provides criteria that the Minister will use in exercising this discretion.

Section LH 11 defines the terms “internal software development”, “associated internal software developer”, “internal software development controller” and “internal software development group”.

### *Internal software development*

In section LH 11, “internal software development” is defined as the development of software, as a core R&D activity, that does not have a main purpose of sale, rent, license, hire or lease to two or more people who are not associated with the developer or with each other.

Software developed as part of a supporting activity, rather than as a core R&D activity, is not subject to the cap.

#### **Examples: definition of internal software development**

1. Company B is undertaking R&D to develop software which it will use internally. The cap applies, because Company B is developing the software with no purpose of sale. Company B may not claim credits for more than \$2 million of its software development expenditure.
2. Company C is undertaking R&D to develop software which it will sell to Company D, its parent. The cap applies, because Company C is developing the software with a purpose of sale only to an associate.
3. Company E is undertaking R&D to develop software which it will use internally. The board members of Company E have also discussed the possibility of sale of the software to other large companies that are not competitors, to recoup some development costs. The board members have instructed a staff member to investigate the potential market for the software and to ensure that the software is easily customised. The developers have been advised that they need to build some flexibility into the design of the software. The cap applies, because Company E has a purpose of sale of the software, but does not have a main purpose of sale of the software. The purpose of sale is ancillary to the purpose of internal use.
4. Company F is undertaking R&D to develop software which it will sell to utility companies. It has signed contracts with three companies to supply the software and it is actively marketing to other interested parties. One of these companies is Company F's parent, Company G, which is also a utility company. The other companies are not connected in any way to Company F or to each other. All the contracts are for similar amounts. In this case, the cap is unlikely to apply, since the main purpose of development is sale to multiple non-associates. The sale to an associate is ancillary to the main purpose in this case.

#### *Internal software groups (section LH 11)*

To prevent multiplication of caps through the use of subsidiaries, people who undertake internal software development are required to group themselves with other developers under the same control, and the expenditure of the entire group counts towards a single cap.

Each person undertaking internal software development (a “developer”) has an internal software development controller (a “controller”). The controller is the person, or group of people, who have ultimate control over the developer. In simple cases, the developer and the controller might be the same person.

The test for control of an entity by a person is that the person has the power to govern the financial and operating policies of the entity to obtain benefits from its activities. The test is based on the definition of “control” in New Zealand International Accounting Standard 27 (Consolidated and Separate Financial Statements), so if two people would be required to consolidate for financial reporting purposes, it is highly likely that they would be under common control.

When a person has the same controller as other people, then those people are members of an internal software development group (a “group”). A person is a member for as long as the person's controller does not change, provided that there is at least one other person with the same controller at the same time.

A person can be a member of no group for all or part of the year, one group for all or part of the year, and more than one group over the course of a year.

### **Examples: mechanics of internal software development groups**

- ACo, BCo and CCo have the same internal software development controller (implying they undertake internal software development) and are therefore members of an internal software development group. ACo stops doing internal software development. Therefore, ACo no longer has an internal software development controller, and ACo is not a member of the group any longer. The group continues to exist, however, with BCo and CCo as members.
- DCo, ECo and FCo have the same internal software development controller and are therefore members of an internal software development group. DCo and ECo stop doing internal software development. Therefore, DCo and ECo no longer have an internal software development controller, and are not members of the group any longer. FCo no longer has any other person having the same internal software development controller, so the group ceases to exist.
- GCo and HCo both have the same, single shareholder, Carol. GCo undertakes internal software development, and Carol is GCo's internal software development controller. HCo does not undertake internal software development. HCo begins internal software development. Therefore, GCo and HCo are now the members of an internal software group.
- JCo and KCo are the members of an internal software development group, X, controlled by Mrs X. LCo and MCo are the members of another internal software development group, Y, controlled by Mr Y. Mr Y sells LCo and MCo to Mrs X. Group Y ceases to exist, and LCo and MCo become members of Group X.
- At the beginning of the year, NCo, OCo and PCo have the same internal software development controller and are therefore in an internal software development group, Z. OCo is sold to a non-associate in the middle of the year. QCo is purchased by PCo in the last quarter of the year. NCo, OCo, PCo and QCo are all members of Z at some time over the course of the year. NCo and PCo are members for the entire year, OCo is a member for the first half of the year and QCo is a member for the last quarter of the year.

### *Allocation of the cap (subsections LH 9(3) to LH 9(14))*

#### When not a member of any group (subsections LH 9(3) and LH 9(4))

For the period a developer is not a member of any internal software development group, the developer will have an eligible amount of internal software development expenditure.

The eligible amount of internal software development expenditure for which a credit may be claimed is capped. The cap is \$2 million for a full year. If the period for which the person is not a member of any group is less than a year, then the formula in subsection (3) prorates the \$2 million on a daily basis.

#### **Example: credit for internal software development when not in a group**

ACo undertakes internal software development. For the first 73 days of the year, ACo is not under common control with any other developer. However, on 13 June 2008, BCo – also a developer – purchases 100 percent of ACo. For the purposes of claiming a credit, ACo is limited to an eligible amount of internal software development expenditure, for the period it was not in any group, of \$2 million  $\times 73 \div 365 = \$400,000$ . If ACo's actual eligible amount for the period is \$300,000, ACo will be able to claim a credit for \$300,000. If ACo's actual eligible amount for the period is \$500,000, ACo will only be able to claim a credit for \$400,000.

### Allocation when a member of a group

For the period that a person is a member of an internal software development group, that person is not entitled to any credits for an individual eligible amount relating to internal software development expenditure, but might be entitled to a share of credits for the combined eligible amounts of group members.

The entitlement to credits for a share of the combined eligible amounts of group members depends on the nature of the group, but in no case can a group allocate more than \$2 million across all its members for a full year. The group members are free to decide the exact allocation, subject to the restrictions described below.

An overriding requirement in all cases is that no member may have an eligible amount which is greater than the eligible amount that person would have had, during the period of membership, in the absence of section LH 9.

Note that in the special case where a person leaves a group and one person or no-one is left in the group, the group ceases to exist. In that case, the person leaving and the person remaining in the group (if any) will have their entitlement to credits determined on the basis of part-year membership.

### Members of a group with identical income years (subsections LH 9(5) to LH 9(10))

If all the members of the group have the same income year (same length of year and same balance date), then a member can have an eligible amount allocated to it and claim a credit.

The eligible amount available to be allocated to all group members is \$2 million for a full year, and this amount is required to be prorated on a daily basis where the period for which the member is in the group is less than a full year.

### Members of a group with non-identical income years (subsections LH 9(11) to LH 9(14))

If any member, X, of the group has an income year which differs from the income year of another member, then X will only be able to receive an amount of credit if X has been a member of the group for X's entire income year. It has not been possible to derive a simple and fair formula for when members have different income years and a member is only a member for part of the year.

The eligible amount available to be allocated across all group members is \$2 million for a full year.

### Examples: allocation of the cap

- ACo and BCo are members of an internal software development group. ACo and BCo have the same (standard) income years, and are members of the group for the entire year. ACo would have an eligible amount of internal software development expenditure of \$1.2 million for the year, in the absence of section LH 9. BCo would have an eligible amount of \$1.5 million. ACo and BCo may share credits for an eligible amount of \$2 million. The allocation may be made as the parties see fit, as long as ACo receives no more than \$1.2 million and BCo receives no more than \$1.5 million.
- CCo and DCo, which have standard income years, are not members of any internal software group, but are under common control. CCo and DCo begin internal software development on 1 July 2008. Therefore, they are the members of an internal software development group from 1 July. The group exists for 274 days of the income year (1 July 2008 to 31 March 2009), and CCo and DCo are members for this entire period. CCo would have an eligible amount of internal software development expenditure of \$4 million in the absence of section LH 9. DCo would have an eligible amount of \$5 million. CCo and DCo can share credits for an eligible amount of  $\$2 \text{ million} \times 274 \div 365 = \$1,501,369$  (see subsection LH 9(6)). This can be shared in any way.
- ECo and FCo are members of an internal software development group. ECo and FCo have the same (standard) income years, and are members of the group for the entire year. ECo would have an eligible amount of internal software development expenditure of \$1.2 million for the year, in the absence of section LH 9. FCo would have an eligible amount of \$1.5 million. GCo, an internal software developer with a standard income year, is bought by FCo on 1 July 2008, so is a member of the group for 274 days of the year. GCo has an eligible amount of internal software development expenditure of \$1 million for the first 91 days of the year, and in the absence of section LH 9 would have an eligible amount over the other 274 days of \$3 million. GCo calculates that the group can allocate up to  $\$2 \text{ million} \times 274 \div 365 = \$1,501,369$  to it for the period it is a member (according to subsections LH 9(6) to LH 9(10)). ECo and FCo calculate that the group can allocate up to \$2 million to either of them for the full-year period they are members (also according to LH 9(6) to LH 9(10)). Assume GCo has received the full \$1,501,369 available for the period it was a member, with ECo and FCo receiving no amount for the period. Then of the \$2 million available to the group over the (full-year) period of ECo and FCo's membership, \$498,631 is left for distribution to ECo and FCo. This distribution may be made as the parties see fit. GCo is also entitled to a credit for  $\$2 \text{ million} \times 91 \div 365 = \$498,630$  for the eligible amount relating to its time outside the group.
- HCo and ICo are members of an internal software development group. HCo and ICo have the same (standard) income years, and are members of the group for the entire year. HCo would have an eligible amount of internal software development expenditure of \$1.2 million for the year, in the absence of section LH 9. ICo would have an eligible amount of \$1.5 million. JCo, an internal software developer with an income year ending 31 December 2008, is bought by ICo on 1 July 2008, so is also a member of the group for 184 days of its income year. JCo has an eligible amount of internal software development expenditure of \$1 million for the first 181 days of the year and, in the absence of section LH 9, would have an eligible amount over the other 184 days of \$2 million. HCo and ICo share credits for an eligible amount of \$2 million (according to the formula in subsection LH 9(13) to LH 9(14)). The allocation may be made as the parties see fit, as long as HCo receives no more than \$1.2 million and ICo receives no more than \$1.5 million. JCo receives no credit for the internal software expenditure incurred while a member of the group, because it is a member for less than its full income year (see subsection LH 9(12)). JCo is, however, entitled to a credit for  $\$2 \text{ million} \times 181 \div 365 = \$991,780$  for the eligible amount relating to its time outside the group (subsection LH 9(3)).
- KCo and LCo are members of an internal software development group. KCo has an income year ending 31 March and LCo has an income year ending 30 April. KCo would have an eligible amount of internal software development expenditure of \$1.2 million for the year, in the absence of section LH 9. LCo would have an eligible amount of \$1.5 million. KCo is liquidated on 30 November 2008, and the group ceases to exist on this date. KCo and LCo are members of the group for only part of their 2008–09 income years and have different income years, so receive no credit relating to internal software development expenditure incurred while members of the group. LCo is entitled to credits for such expenditure incurred after the group dissolves, according to the formula in LH 9(3).

### *Waiver of the cap (LH 9(15))*

The \$2 million cap is not expected to affect many claimants, but in exceptional cases where expenditure does exceed the cap, the cap may be waived by notice in the *New Zealand Gazette*. The waiver may be granted on application to the Minister of Finance, if the expenditure meets the other eligibility requirements and the Minister considers that three further requirements are all met. The three requirements are based on similar requirements for obtaining government-provided incentives in Australia and New Zealand, and are:

- *That the R&D will be exploited mainly for the benefit of the New Zealand economy.* In practice, the Minister might look at whether the profits or gains resulting from the exploitation of a particular result of an R&D activity are commensurate with the amount expended in the carrying on of that activity in New Zealand. This would involve consideration of the value of the result of the activity, the profits or gains to non-residents accruing directly from the exploitation of the result of the activity, the amounts expended in the carrying on of the activity inside and outside New Zealand respectively, and any other relevant matters.
- *That New Zealand will derive a substantial net benefit from the R&D.* In practice, the Minister might look at whether the R&D will generate substantial net economic benefits for New Zealand, such as increased gross domestic product, gross national product and employment, or substantial positive publicity (such as defining New Zealand as a world-leader in a particular area).
- *That the claimant has a commitment to retain the value of their business in New Zealand.* In practice, the Minister might look at whether the entity is majority-owned by New Zealand residents, or whether the entity habitually reinvests a high proportion of earnings in its New Zealand operations.

### ***Use-of-money interest and penalties (section 141(7C) Tax Administration Act 1994)***

Use-of-money interest and penalties generally apply to amounts of tax credit as they would apply to other amounts of tax.

However, there is an exception to the normal shortfall penalty rules, applying only to internal software development groups. Where the members of an internal software development group reallocate the credits for internal software development undertaken by the group, there will not be a shortfall as long as the reallocations are offsetting. This recognises that group members who file a tax return early might not yet know the internal software development expenditure of other group members.

**Example: reallocation of credits for internal software development (no shortfall)**

Company A and Company B, standard balance date companies, are members of an internal software development group from 1 October 2008 to 31 March 2009.

The following expenditure is undertaken:

- Company A spends \$1 million on internal software development in the period from 1 April 2008 to 30 September 2008, and \$1 million on internal software development in the period from 1 October 2008 to 31 March 2009. Company A also spends \$6 million on other R&D over the year.
- Company B spends \$0.5 million on internal software development in the period from 1 April 2008 to 30 September 2008, and \$1.5 million on internal software development in the period from 1 October 2008 to 31 March 2009. Company B also spends \$4 million on other R&D over the year.

Company A files its tax return on 1 May 2009, claiming a tax credit for \$7,997,260 of R&D expenditure (\$1 million of internal software development expenditure before it was part of the group, \$997,260 of internal software development expenditure afterwards, and \$6 million for other R&D expenditure). This gives a total credit of \$1,199,589.

Company B files its tax return on 1 July 2009, claiming a tax credit for \$4.5 million of R&D (internal software development expenditure of \$0.5 million incurred before it was part of the group, and \$4 million of other R&D expenditure). This gives a total tax credit of \$675,000. Company B would also like to claim for internal software development expenditure incurred while in the group, but is aware that the group's expenditure cap has been reached.

Company B negotiates with Company A. Company A files a notice of proposed adjustment and reduces its claims for tax credits by \$90,000. Company B files a notice of proposed adjustment and increases its claim for tax credits by \$90,000. The Commissioner makes both adjustments. Because the \$90,000 is less than the credits Company A received for internal software development expenditure incurred while in the group, and because Company B is entitled to more than \$90,000 of credits for internal development expenditure incurred while in the group, Company A has no tax shortfall.

The provision only applies where there is reallocation of credits for internal software development expenditure incurred while in the group. It neither allows reallocation of any credits for expenditure incurred outside the group, nor reallocation of any credits for expenditure which is not on internal software development. The taxpayer who is allocated a greater amount of credits must also have a sufficient eligible amount, relating to internal software development undertaken while in the group, to justify those credits.

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# Penalties

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## OVERVIEW

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The compliance and penalties rules in the Tax Administration Act 1994 came into effect on 1 April 1997. They were designed to promote effective and fairer enforcement of the Inland Revenue Acts by providing better incentives for taxpayers to comply voluntarily with their tax obligations.

The discussion document, *Tax penalties, tax agents and disclosures*, was released in October 2006. The discussion document examined the current compliance and penalty rules, and identified several areas where the rules could be clearer, more consistent and better targeted to encourage voluntary compliance. It discussed options for the relaxation of penalties when taxpayers have genuinely and consistently tried to do the right thing. The discussion document also proposed that, in future, before recognising a person as a “tax agent” the Commissioner must be satisfied that doing so is consistent with the protection of the integrity of the tax system.

The following amendments result from the proposals in the discussion document.

## **THE DEFINITION OF “TAX AGENT”**

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*(Clauses 146(1) and (3), 153, 154 and 160(2))*

### **Summary of proposed amendment**

Inland Revenue will have a discretion to withhold recognition or remove a person as a tax agent when the action is necessary to protect the integrity of the tax system.

### **Application date**

The amendment will apply from the date of the bill’s enactment.

### **Key features**

The definition of “tax agent” in section 3(1) of the Tax Administration Act 1994 is being amended to give Inland Revenue a discretion to withhold recognition or remove a person as a tax agent when the action is necessary to protect the integrity of the tax system.

Operational guidelines will set out the circumstances in which the discretion might be exercised. It is envisaged that the discretion not to grant, or to remove, tax agent status will be exercised only in a very small number of cases. Potential factors that might be taken into account, while not necessarily definitive, include:

- whether a person has been found guilty of an offence or breach by the disciplinary body of a professional organisation of which they are a member – for example, the New Zealand Institute of Chartered Accountants;
- whether the person is an undischarged bankrupt or an insolvent entity;
- whether the person is an individual or a body corporate that has been convicted of a crime involving dishonesty (within the meaning of section 2(1) of the Crimes Act 1961) and has been sentenced for that crime within the last seven years;
- whether an individual is prohibited from being a director or promoter of, or taken part in the management of a company under sections 382, 383 or 385 of the Companies Act 1993;
- whether a person has been convicted of an offence under the Tax Administration Act 1994; and
- the tax agent’s compliance history – including both their own tax affairs and their level of compliance as an agent.

Inland Revenue will be required to give a tax agent notice of the intention to revoke the agent's status and give reasons for the intended revocation. The agent will be given a 30-day period (or a shorter period if Inland Revenue is concerned that there is a substantial risk to the revenue) in which to resolve the matters raised in the notice of intended revocation. If the agent does not resolve the matters to the satisfaction of Inland Revenue, the agency status will be revoked and the agent and taxpayers linked to that agent advised accordingly. If, because of a revocation of tax agency status, a taxpayer fails to meet a filing deadline, the legislation will provide an appropriate extension to the deadline so that penalties are not imposed.

Entities will be recognised as tax agents along with individuals, provided that the entity supplies Inland Revenue with the names of:

- each person responsible for filing returns if the entity is a body corporate;
- all shareholders of closely held companies;
- all partners if the entity is a partnership; and
- all individuals who are members of the entity, if the entity is an unincorporated body.

Individual agents currently recognised by Inland Revenue as tax agents will not be required to reapply for their agency status. Entities currently listed will continue to be listed as tax agents provided they supply Inland Revenue with the above information within 12 months of the enactment of the new rules. The information is necessary to enable the Commissioner to be satisfied on an ongoing basis that, given the involvement of these individuals, it is consistent with protection of the integrity of the tax system for the entity to have agency status.

Inland Revenue's secrecy provisions will be amended so that information can be provided to professional bodies (for example, the New Zealand Institute of Chartered Accountants) about the removal of any person as an agent.

## **Background**

Currently, provided an agent meets the limited criteria required, Inland Revenue cannot refuse to register a person as a tax agent even if, for example, that person has a long record of non-compliance in their own tax affairs or those of their clients, or they have been convicted of offences involving serious dishonesty.

The amendments will allow Inland Revenue to withhold recognition, or remove a person as a tax agent when the action is necessary to protect the integrity of the tax system.

## **LATE FILING PENALTY**

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*(Clause 174)*

### **Summary of proposed amendment**

The amendment clarifies that when an employer monthly schedule is filed late a warning will be given, and that late filing penalties will be imposed on subsequent late filing.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

The late filing penalty rules will be clarified to reflect the current practice of not imposing a late filing penalty the first time an employer monthly schedule is filed late, but rather advising the taxpayer that the schedule is late and warning that subsequent breaches will be penalised. The late filing penalty will be payable if a schedule is filed late in the 12 months following the first breach. If all schedules are filed on time for a year, the process will start again – that is, if a schedule is late, the taxpayer is warned.

### **Background**

The current late filing penalty rules generally require Inland Revenue to impose the penalty when an employer monthly schedule is filed late. However, in practice the first time an employer monthly schedule is late Inland Revenue provides the taxpayer with a warning. If the employer is again late in filing the schedule (within 12 months of the first schedule being filed late), the late filing penalty is assessed.

The legislation is being clarified to reflect Inland Revenue's current practice.

## **LATE FILING PENALTIES FOR GST RETURNS**

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*(Clauses 175 and 192)*

### **Summary of proposed amendment**

A late filing penalty will be introduced for GST returns that are not filed by the due date.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

A late filing penalty will be imposed for failing to file a GST return on time. There will be two levels of penalty: if the taxpayer accounts for GST on an invoice basis the late filing penalty will be \$250, and for taxpayers who account for GST on a payments basis the penalty will be \$50.

As is the practice in relation to late filed employer monthly schedules, the first time a GST return is filed late Inland Revenue will advise the taxpayer that the return is late and warn that subsequent breaches will be penalised. The late filing penalty will be payable if any GST returns are filed late in the 12 months following the first breach. If all returns are filed on time for a year, the process will start again – that is, if a subsequent return is late the taxpayer will be warned.

### **Background**

Currently, when taxpayers fail to file their GST returns Inland Revenue issues a default assessment. A default assessment is an estimation of tax liability and remains in place until the taxpayer files the return. A default assessment is likely to present a slightly larger debt than a self-assessment as it is intended to encourage taxpayers to file their returns.

The default assessment is in many cases an excessive response to non-filing. Imposing a late filing penalty would be a more appropriate response, with the default assessment reserved for significant or ongoing non-compliance.

## **LATE PAYMENT PENALTIES**

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*(Clause 176)*

### **Summary of proposed amendment**

The amendment specifies that Inland Revenue will notify a taxpayer the first time their payment is late rather than imposing an immediate late payment penalty. If payment is not made by a certain date the penalty will be imposed.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

Inland Revenue will notify taxpayers the first time their payment is late. The notification will explain that if the payment is not made by a certain date, a late payment penalty will be imposed. The notification will also state that if taxpayers make late payments within the next two years, further leniency will not be granted. Inland Revenue will not send the taxpayer any further notifications for two years, and the initial late payment penalty will be imposed in the normal manner.

If the warning does not result in payment, the late payment penalty will be imposed in the normal manner as if the warning had not been given.

All taxpayers will start with a clean slate. After 1 April 2008, the first time a taxpayer pays late (irrespective of whether a payment has been paid late in the previous two years) a warning will be given.

### **Background**

One of the basic obligations of taxpayers is to pay their taxes on time. To encourage taxpayers to do this, those who pay late face late payment penalties. The late payment penalty is imposed in two stages: the initial late payment penalty and the incremental late payment penalty. The initial late payment penalty is also applied in two steps: a 1 percent penalty imposed the day after the due date and a 4 percent penalty imposed at the end of the sixth day if the tax owing remains outstanding. An incremental late payment penalty of 1 percent is imposed each month the tax remains outstanding.

The amendment will ensure that those taxpayers who are usually compliant, but have inadvertently missed a payment, do not have late payment penalties imposed on them. In these cases, the penalty can be disproportionately high compared with the severity of the breach. The effect of the amendment will therefore be to give consideration to the taxpayer's previous record of compliance before imposing the late payment penalty.

## **ASSOCIATED PERSONS**

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*(Clauses 182(1), (2), (3) and (5))*

### **Summary of proposed amendment**

The amendment will enable Inland Revenue to treat return periods that overlap as the same return period for associated persons, allowing a tax refund to be used to reduce an associated person's tax shortfall.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

Under the proposed changes, Inland Revenue will be able to treat return periods that overlap as the same return period for associated persons, allowing a tax refund to be used to reduce an associated person's tax shortfall. This discretion will not apply when the tax shortfall arises as the result of an abusive tax position or evasion – for example, when a taxpayer deliberately claims an input tax credit in the wrong entity to claim the refund early.

The proposed provision will also apply when the adjustment results in less tax to pay for the second taxpayer.

### **Background**

Occasionally, taxpayers include transactions in the wrong entity's return – for example, in an associated person's return. Because they do not know they have included the transaction in the wrong return, the tax shortfall does not show up when a reconciliation is undertaken. These shortfalls are often not voluntarily disclosed because the taxpayer is unaware they have occurred and the shortfall cannot be considered "temporary".

Currently, if there is a tax shortfall in one taxpayer's return and, as a result an associated taxpayer's return is adjusted, resulting in an entitlement to a refund or an increased refund, the refund may be used to reduce the tax shortfall of the associated taxpayer. The returns must, however, be for the same tax type and return period.

Problems arise when the return periods are not the same – for example, when one associated taxpayer files the GST return on odd months and the other associated taxpayer files on even months. Because the return periods are not the same, the refund cannot be used to reduce the tax shortfall. The amendment will allow periods that overlap to be treated as the same return period for an associated taxpayer.

The current provision also applies only when adjustment results in a refund or an increased refund for the second taxpayer. The proposed provision will also apply where the adjustment results in less tax to pay for the second taxpayer.

## **TAX AGENTS AND THE SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE**

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*(Clause 183)*

### **Summary of proposed amendment**

The legislation will prescribe the circumstances in which a shortfall penalty for not taking reasonable care can be imposed when taxpayers have used a tax agent.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

The legislation will prescribe the circumstances in which a shortfall penalty for not taking reasonable care can be imposed when taxpayers have used a tax agent. The circumstances include:

- failing to provide adequate information to the agent;
- failing to provide adequate instructions to the agent;
- unreasonably relying on an agent or advisor; and
- having had a previous tax shortfall penalty imposed for the same error or action.

### **Background**

Taxpayers who have relied on the advice of a tax agent will usually be considered to have exercised reasonable care. This principle is not set out in the legislation but has developed over time through practice. The current practice is that taxpayers who use an agent may still be exposed to a penalty for not taking reasonable care if they:

- fail to provide adequate information when seeking advice;
- fail to provide reasonable instructions to a tax agent; or
- unreasonably rely on a tax advisor or on advice that they have reason to believe is not correct.

Outside these exceptions, the shortfall penalty for not taking reasonable care is generally not assessed if the taxpayer has used a tax agent. This does not apply to the unacceptable tax position shortfall penalty, which is assessed if the tax position taken does not meet the standard of “being about as likely as not to be correct” and the tax shortfall is greater than the prescribed thresholds. In this case, the penalty may be assessed, irrespective of whether an agent is used.

In this bill the scope of the unacceptable tax position shortfall penalty will be reduced. This highlights the need to clarify the scope of the penalty for not taking reasonable care. The standard of “reasonable care” is not excessive and does not require perfection. However, many taxpayers use an agent because agents have more knowledge about the requirements of the tax system.

There needs to be a better balance, however, between recognising that tax agents are not infallible, while providing a greater incentive for them to, as far as possible, determine the taxpayer’s correct tax position. Accordingly, the legislation will prescribe the circumstances in which a shortfall penalty for not taking reasonable care can be imposed when taxpayers have used a tax agent.

As well as incorporating current practice, the amendment will take into account the situation of the taxpayer having had a tax shortfall previously and the same error or action being repeated in relation to the same tax type. In this situation the taxpayer should have been aware that there was a known risk associated with a particular action. Depending on the facts, a reasonable person in the taxpayer’s circumstances would check that the correct tax position had been taken in the second instance.

## **REFINING THE SCOPE OF THE UNACCEPTABLE TAX POSITION SHORTFALL PENALTY**

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*(Clauses 184(2), (3) and 191)*

### **Summary of proposed amendments**

The amendments will remove GST and withholding-type taxes from the scope of the unacceptable tax position shortfall penalty. The thresholds for the assessment of the unacceptable tax position shortfall penalty will be increased.

### **Application date**

The amendments will apply to tax positions taken on or after 1 April 2008.

### **Key features**

The discretion allowing Inland Revenue to cancel or not impose the unacceptable tax position shortfall penalty in some situations will be repealed and replaced with other measures that will refine the scope of the penalty.

GST and withholding-type taxes will be removed from the scope of the unacceptable tax position shortfall penalty so that the penalty will apply only to tax positions relating to income tax. For other types of tax, the shortfall penalty for not taking reasonable care will apply in appropriate cases.

The thresholds above which the unacceptable tax position shortfall penalty is assessed will be increased. Under the proposed changes, the penalty will apply when the tax shortfall arising from the taxpayer's tax position is more than both:

- (a) \$50,000; and
- (b) 1 percent of the taxpayer's total tax figure for the relevant return period.

As well as increasing the minimum threshold to \$50,000 (from \$20,000), the amendments will remove the upper threshold of \$250,000, thus significantly further increasing the thresholds. Removing the \$250,000 limit ensures that the penalty does not apply to what may be regarded as everyday transactions for some large corporates.

### **Background**

An unacceptable tax position shortfall penalty of 20 percent of the shortfall is assessed if, viewed objectively, a taxpayer's tax position fails to meet the standard of being "about as likely as not to be correct". The penalty is applied only in cases where the tax shortfall is significant – which is currently a tax shortfall of more than \$20,000 and the lesser of either 1 percent of the total tax figure or \$250,000. The penalty does not apply to tax shortfalls that arise from mistakes in the calculation or recording of numbers in a return.

Under the current rules, taxpayers who make and acknowledge errors in taking a particular tax position cannot be regarded as having met the standard of being “about as likely as not to be correct”. If the standard is not met, unacceptable tax position shortfall penalties may apply. The legislation has had an adverse effect on taxpayer behaviour by making them less inclined to disclose errors to Inland Revenue. To counter this problem, a recent amendment, section 141KB, provides Inland Revenue with the discretion either to cancel or not impose the unacceptable tax position shortfall penalty if:

- the tax position taken is the result of a clear mistake or simple oversight;
- the shortfall arising from the tax position is or would be subject to a reduced penalty because the shortfall was voluntarily disclosed before notification of a pending tax audit or investigation, or is a temporary shortfall; and
- it is appropriate that the taxpayer not be liable to pay an unacceptable tax position shortfall penalty in relation to the tax position taken.

Section 141KB applied retrospectively from 1 April 2003. When introduced, the discretion was signalled as a short-term solution only because:

- it gives rise to significant increases in administrative and compliance costs;
- it does not fit well with the self-assessment environment; and
- using the words “clear mistake and simple oversight” in the penalties context is inherently uncertain and could create a revenue risk if the term became more broadly interpreted over time.

The amendments in this bill will result in the penalty being refocused by being limited to income tax only with higher thresholds applying. This will provide incentives for greater voluntary compliance. The bill consequently also repeals section 141KB.

## **ABUSIVE TAX POSITION SHORTFALL PENALTY THRESHOLD**

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*(Clause 185)*

### **Summary of proposed amendment**

The threshold for imposing the abusive tax position shortfall penalty will be repealed.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

The current \$20,000 threshold for the imposition of the shortfall penalty for having an abusive tax position will be repealed.

### **Background**

An abusive tax position shortfall penalty of 100 percent of the tax shortfall applies when the tax position taken is an unacceptable tax position that has a dominant purpose of reducing or removing a tax liability or giving tax benefits.

Currently, for an abusive tax position shortfall penalty to be imposed the tax shortfall must be greater than \$20,000. Although an abusive tax position is an unacceptable tax position, it is also at the more aggressive end of the non-compliance scale. While it is appropriate that the unacceptable tax position shortfall penalty has a threshold, as it would be overly onerous to apply the standard to all tax positions, this does not hold true for abusive tax positions.

## **LATE PAYMENT OF PAYE**

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*(Clauses 186, 187 and 194)*

### **Summary of proposed amendment**

A new graduated penalty to replace the current shortfall penalty in relation to PAYE will apply when an employer has filed an employer monthly schedule but not paid the PAYE. Inland Revenue will contact the employer and, if payment or an arrangement for payment is not made, a 20 percent penalty will be imposed. This will be reduced to 10 percent if the employer pays the outstanding PAYE within one month of the penalty being imposed. If the payment is not made, the process will repeat itself – that is, another 20 percent penalty will be imposed, which will reduce to 10 percent if payment is made within 30 days. The penalty will not exceed in total any penalty that could be charged under the shortfall penalty rules.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

A new penalty will be introduced to replace the current shortfall penalty in relation to PAYE. The new rules will better reflect the degree of seriousness shown by employers in meeting their PAYE obligations, while adopting a more graduated approach will provide better incentives for taxpayers to correct any non-compliance.

Shortfall penalties for evasion will not be imposed if the employer files the employer monthly schedule but does not pay the PAYE. Instead, Inland Revenue will contact the employer to establish the reason for the non-payment and offer to assist the employer to establish or enhance its systems to ensure future compliance. The legislation will require that Inland Revenue warn the employer that a 20 percent PAYE shortfall penalty will be imposed if payment, or an arrangement for payment, is not made by the date specified.

If the employer does not make the payment or enter an instalment arrangement, the employer will receive instruction requesting payment within 30 days. On the expiry of 30 days, the PAYE shortfall penalty of 20 percent of the unpaid PAYE will be imposed. If the PAYE is paid within the 30 days specified, the penalty will be reduced to 10 percent. If the payment is not made, the process will repeat itself – that is, another 20 percent penalty will be imposed, which will reduce to 10 percent if payment is made within 30 days. The penalty will not exceed in total any penalty that could be charged under the shortfall penalty rules.

This proposal is aimed at encouraging employers to pay the outstanding PAYE. Compliance includes entering into an instalment arrangement. If the employer enters an instalment arrangement the new penalty will not apply unless the employer defaults on an instalment arrangement. In this case, the penalty will be imposed at 20 percent, with no reduction to 10 percent.

The normal late payment penalties, use-of-money interest and ability to prosecute will continue to operate as they do at present.

## **Background**

One of the basic tax obligations of employers is to withhold PAYE tax on behalf of their employees and pay the PAYE to Inland Revenue by specific dates. If the employer fails to pay Inland Revenue on time, penalties will apply. Non-payment of PAYE may be regarded more seriously than failure to pay other taxes, as PAYE places a special responsibility on the employer to make payment on behalf of the employee.

The current penalties that apply in relation to PAYE obligations include late filing penalties, late payment penalties, shortfall penalties for evasion and prosecution.

When considering non-compliance in relation to PAYE obligations there are a number of possible scenarios, including:

- employers who have some or all of their employees outside the PAYE system;
- employers who pay the PAYE to Inland Revenue but do not file the employer monthly schedule; and
- employers who file the employer monthly schedule but do not pay the PAYE to Inland Revenue.

In relation to the first scenario, the current penalty rules should continue to apply. In the second scenario, penalties are limited because the tax is paid. In the third situation, when the employer files the schedule but does not pay the PAYE, the current rules give rise to a number of concerns:

- *Distortionary outcomes in different situations:* A taxpayer with a good record of tax compliance incurs the same (or a higher) level of penalty as a taxpayer with a record of non-compliance. An employer who fails to file an employer monthly schedule could be eligible for a 75 percent reduction for voluntary disclosure, while an employer who files an employer monthly schedule, but no payment, is not eligible for any voluntary disclosure penalty reduction as disclosure has already occurred. This is effectively providing a disincentive for employers to file.
- *A lack of opportunity for taxpayers to correct non-compliance:* The shortfall penalty for evasion can be imposed the day after PAYE has not been paid to Inland Revenue, leaving taxpayers with little opportunity to address non-payment.

- *A perception that the current rules may be harsh:* In theory, taxpayers could incur shortfall penalties for evasion (150 percent of the unpaid PAYE) plus the initial late payment penalties, even if payments are made only a few days late.

The amendment is aimed at encouraging employers to pay any outstanding PAYE by providing better incentives to comply.

## **PENALTY REDUCTIONS FOR VOLUNTARY DISCLOSURES**

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*(Clauses 188 and 190)*

### **Summary of proposed amendment**

The shortfall penalty for not taking reasonable care or taking an unacceptable tax position will not be imposed when a tax shortfall is voluntarily disclosed before notification of a pending tax audit or investigation.

### **Application date**

The amendment, once enacted, will apply from the date the bill was introduced.

### **Key features**

To increase the incentive for taxpayers to comply voluntarily, shortfall penalties payable for “not taking reasonable care” and “unacceptable tax positions” will not be imposed when the shortfalls are voluntarily disclosed before taxpayers are notified of pending tax audits or investigations.

### **Background**

Currently, shortfall penalties may be reduced if taxpayers voluntarily disclose tax shortfalls. Penalties are reduced by:

- 75 percent if the disclosure is made before the taxpayer is notified of a pending tax audit or investigation; or
- 40 percent if the disclosure is made after the taxpayer is notified of the pending tax audit or investigation but before the audit or investigation starts.

The penalty reduction reflects the lower administrative cost of having the tax shortfall identified before resources are committed to an investigation. It also recognises the taxpayer’s intention to comply and co-operate with Inland Revenue.

However, the current rules do not adequately encourage taxpayers to disclose a tax shortfall. Imposing shortfall penalties in cases when taxpayers voluntarily disclose tax shortfalls, even though the penalties are reduced, reduces the incentive for taxpayers to make voluntary disclosures. This is because taxpayers know that a consequence of making a voluntary disclosure is the assessment of shortfall penalties.

The amendment will encourage taxpayers to come forward and tell Inland Revenue when they discover they have a tax shortfall.

The bill incorporates two changes as the result of submissions received on the 2006 discussion document, *Tax penalties, tax agents and disclosures*.

First, the proposal as set out in the discussion document required that the tax shortfall be disclosed within two years of the tax position being taken. Submissions noted that the time bar provisions provide a window of four years in which to make a disclosure. A two-year limit on the non-application of shortfall penalties would mean that taxpayers may decide not to disclose errors and omissions outside of the two-year period, even when they arose from the same issue as that in the two-year time span. By removing the two-year period from the proposal, the incentive for taxpayers to voluntarily disclose tax shortfalls is increased.

Secondly, submissions also recommended that the voluntary disclosure proposal should apply as soon as possible. Submissions were concerned that some taxpayers may refrain from making voluntary disclosures until the legislation is enacted. The proposal once enacted will therefore apply to voluntary disclosures made after the day the bill was introduced.

## TEMPORARY SHORTFALLS

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*(Clause 189)*

### **Summary of proposed amendment**

For temporary shortfalls to which a 75 percent reduction in the shortfall penalty applies, the legislation will clarify that a tax shortfall has been permanently reversed or corrected if it appears from the taxpayer's actions or through operation of law that the shortfall will be remedied. For a shortfall to be considered temporary it must be permanently reversed or corrected within two years of the tax position being taken.

### **Application date**

The amendment will apply to tax positions taken on or after 1 April 2008.

### **Key features**

The legislation will be clarified, in line with current practice, to ensure that the reduction for a temporary shortfall applies, even though the opportunity has not yet arisen to deal with it in a subsequent return, if:

- it appears from the taxpayer's actions that steps taken will remedy the tax shortfall; or
- through operation of law or circumstances, the matter will reverse itself.

The amendment will require the temporary shortfall to be permanently reversed or corrected within two years of the tax position being taken.

### **Background**

A shortfall penalty is reduced by 75 percent if the tax shortfall is temporary. The legislation sets out what is meant by "temporary".

When the compliance and penalty rules were first introduced, there was considerable criticism relating to the imposition of shortfall penalties in cases where there had been little or no fiscal risk. This problem was particularly obvious when a GST refund check was made by Inland Revenue and a timing difference was detected. The rules reducing the penalty for temporary shortfalls require the taxpayer to permanently reverse or correct the situation in a subsequent tax-return period. However, in some cases, there is little or no opportunity for this to occur.

Inland Revenue's *Standard Practice Statement* INV-231, released in May 1998, dealt with this concern. The legislation requires that the temporary shortfall is:

... permanently reversed or corrected before the taxpayer is first notified of a pending tax audit or investigation.

The Standard Practice Statement states that

... the Commissioner will accept that a tax shortfall has been permanently reversed or corrected if:

- it appears from the taxpayer's actions that steps taken will remedy the tax shortfall;  
or
- through operation of law or circumstances, the matter will reverse itself.

The legislation is being clarified to reflect Inland Revenue's current practice.

## **TAX COMPLIANCE INITIATIVES**

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### *(Clause 195)*

#### **Summary of proposed amendment**

Inland Revenue will be given the power to offer limited amnesties to specific industries where tax evasion is a significant concern.

#### **Application date**

The amendment will apply from the date the bill is enacted.

#### **Key features**

Under the proposed rules, an affected person will have to pay tax on previously undisclosed income from the specific industry for two years (covering the current filing year and the year before that).

Inland Revenue will be able to offer a limited amnesty to a specific targeted industry or activity. The terms of the offer will specify the taxes that are included in the amnesty and a period in which the tax evader can come forward under the amnesty. It will also be clearly communicated that after the amnesty offer expires, investigations and audits of the affected industry will begin. The amnesty will apply to those who have undisclosed income earned from the targeted industry.

The overall determination of the person's liability for the period being assessed will include use-of-money interest and shortfall penalties. The shortfall penalties will be reduced by 75 percent for voluntary disclosure and 50 percent for previous good compliance if appropriate.

The amnesty will apply only to income from the specific industry. If an affected taxpayer discloses income from another source the two-year limit will not apply to that other income. The assessment of this income will also include use-of-money interest and shortfall penalties. If the income is not disclosed and the taxpayer is investigated, the full rate of the shortfall penalty may apply.

Any consequential effects of disclosing income for family assistance, student loans and child support liabilities will also be included in the assessment.

Having qualified for one amnesty, a taxpayer will not be able to then qualify under another amnesty. This is because the objective of the amnesty is to give affected taxpayers a single opportunity to come forward and start to comply.

To provide some assurance when coming forward under an amnesty, the amendment provides that an affected taxpayer coming forward under an amnesty will not be prosecuted.

## **Background**

The discussion document, *Options for dealing with industry-wide tax evasion*, was released in August 2004.

The discussion document noted that New Zealand's tax laws contain severe penalties for evasion. This can make it difficult for people who have failed to meet their tax obligations in the past and who want to comply with the law to come forward and sort out their tax affairs. The document also noted that existing rules do not deal with the problem of industry-wide tax evasion because the rules are designed to apply to individual businesses. This fails to recognise that a different approach to promoting compliance is required when evasion becomes commonplace within an industry.

The discussion document recommended that Inland Revenue be given the power to offer limited amnesties to specific industries in which tax evasion is a significant problem. Following the amnesty, the affected industry would be subject to increased audit, and any tax shortfalls detected would face the full range of penalties and other sanctions provided in the legislation.

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## Other policy matters

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## **TAX EXEMPTION FOR TOKELAU AND NIUE INTERNATIONAL TRUST FUNDS**

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*(Clauses 22, 135, 244, 254 to 255 and 258)*

### **Summary of proposed amendments**

Amendments to the Income Tax Act 1994, the Income Tax Act 2004 and the Estate and Gift Duties Act 1968 are being made to ensure that the contributions received, income earned and distributions made by the Tokelau and Niue International Trust Funds are exempt from taxation.

### **Application date**

The amendments will apply to the Tokelau and Niue International Trust Funds from the start of the tax year in which contributions were first made to the funds – the 1999–2000 tax year for the Tokelau International Trust Fund and the 2003–2004 tax year for the Niue International Trust Fund.

### **Key features**

Sections CB 4(1) and CB 9(1) of the Income Tax Act 1994 will be amended and new sections CW 49B and CW 49C of the Income Tax Act 2004 will be added to ensure that income earned by the Tokelau International Trust Fund or the Niue International Trust Fund is exempt from income tax, and distributions made from the Tokelau International Trust Fund or the Niue International Trust Fund are not subject to taxation.

Section 73(2) of the Estate and Gift Duties Act 1968 will be amended to ensure that contributions made to the Tokelau International Trust Fund or the Niue International Trust Fund are not subject to gift duty.

### **Background**

The Tokelau and Niue International Trust Funds were established by the New Zealand Government in 2000 and 2004 respectively and trust deeds for the Trust Funds were subsequently executed, with the parties to the trust deeds agreeing to ensure that the Trust Funds would be exempt from all direct taxation.

Existing tax provisions did not appear to provide the certainty needed to ensure that the income earned, distributions made or contributions received by the Tokelau and Niue International Trust Funds were exempt from tax.

The amendments therefore ensure that the contributions received, income earned and distributions made by the Tokelau and Niue International Trust Funds are exempt from taxation, and that such legislative amendments apply from the date that the Tokelau and Niue International Trust Funds were established.

## **REWRITE ADVISORY PANEL – RETROSPECTIVE AMENDMENTS TO INCOME TAX ACT 2004**

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### **Major land developments**

*(Clauses 6 to 8)*

#### **Summary of proposed amendment**

An amendment ensures that the rule in section CB 11 will not apply to sales of land made after commencement of the Act if the landowner uses the land for the purposes of and use in their own commercial undertakings, including rental income. However, these exclusions will not generally apply if the landowner is a land developer.

#### **Application date**

The changes are intended to ensure that the tax treatment outlined above extends back to open tax years if a person has taken a tax position consistent with the policy intent of the amendment.

#### **Background**

Section CB 11 has been the subject of a number of submissions to the Rewrite Advisory Panel. These submissions asserted that the drafting of the provision contains an unintended change in law. While the Panel did not agree the provisions contained an unintended change in law, it considered that that the rule contained uncertainty about whether the provision applies to developments undertaken by a landowner for the purposes of and use in their own commercial undertakings.

### **Petroleum mining operations**

*(Clauses 16, 17 and 135(36))*

#### **Summary of proposed amendment**

The amendment ensures that the petroleum mining provisions continue to apply to a petroleum miner who undertakes prospecting and exploration activities outside New Zealand.

#### **Application date**

The amendment will apply from the beginning of the 2005–06 income year, being the income year the Income Tax Act 2004 came into effect.

## **Background**

The Rewrite Advisory Panel has identified that the 2004 Act, as originally enacted, contains an unintended change in legislative outcome when compared with corresponding provisions in the Income Tax Act 1994. The change identified is that the petroleum mining provisions do not apply to prospecting and exploration activities undertaken outside New Zealand by a petroleum miner.

The provisions affected are those that rely on the meaning of the defined term “petroleum mining operations”, which include sections CT 5, DT 15 (DK 2 – 1994 Act), DT 20, DZ 4 (seal and abandonment – 1994 Act), DZ 5, DZ 7, EJ 16, EZ 3(2), GC 12(3), IH 3(2), OB 1 – definition of “removal or restoration operations”, and OB 1 – definition of “seal and abandonment.”

## **Employment obligations transferred on sale of a business**

*(Clause 28)*

### **Summary of proposed amendment**

The amendment to section DC 9 ensures that, on the transfer of a business with continuing employees, the purchaser is allowed a deduction for satisfying transferred employment obligations to the extent that the amount paid in satisfying the obligations exceeds the valuation of the obligations in the transfer (sale and purchase) agreement.

### **Application date**

The amendment applies from the beginning of the 2005–06 income year, being the income year the Income Tax Act 2004 came into effect.

## **Background**

The Rewrite Advisory Panel has identified that the 2004 Act, as originally enacted, contains an unintended change in legislative outcome when compared with corresponding provisions in the Income Tax Act 1994.

The change identified is that a purchaser of a business would not have a deduction for the payment of a contingent liability, transferred as part of the sale and purchase agreement when a business was sold, if that payment is more than the amount provided for that liability in the sale. As the previous employer had incurred the obligation to meet those employment obligations, the purchaser’s payments to satisfy these obligations’ nature were regarded as part of the price of acquiring the business and so were payments of capital (*Commissioner of Inland Revenue v New Zealand Forest Research Institute Limited* (2000) 19 NZTC 15,689). The amendment restores the effect of section DF 10(5) of the 1994 Act.

## **Correction of cross-references**

*(Clauses 84 and 247)*

The Rewrite Advisory Panel has also noted cross-references should be corrected in section IG 2(9) of the Income Tax Act 2004 and section 10(7) of the GST Act.

## **IMPLEMENTING THE FAIR DIVIDEND RATE IN LIFE INSURANCE**

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*(Clauses 2, 4, 77, 78 and 135)*

### **Summary of proposed amendment**

The fair dividend rate (FDR) treatment of all portfolio shares with interests of less than 10 percent in non-resident companies other than Australian-listed companies will be extended to a life insurer's policyholder base tax calculation. The change is intended to correct an anomaly arising from implementing FDR for life insurers.

### **Application date**

The amendment will apply from as early as 1 April 2007, with some elections available to life insurers on the effective date.

### **Key features**

The policyholder income calculation in section EY 42 (1) will be amended by amounts referred to in subsection (5B) as the "FDR adjustment" and the "PIE adjustment". The PIE adjustment applies only to unit-linked life policies that have elected to be portfolio investment entities and incorporates the FDR adjustment within the formula. The FDR adjustment applies to all other life insurance products.

New section EY 42C (1) to (6) prescribes the "PIE adjustment" for assets held in a portfolio investment-linked life fund, defined in section OB 1 to mean a fund where investments are held subject to a life policy under which benefits are directly linked to the value of investments held in the fund. The portfolio investment-linked life fund must also be eligible to be, and elect to be, and has not ceased the election to be, a portfolio investment entity.

The PIE adjustment is contained in a formula in new section EY 42C (2). The part of the formula relevant for the FDR adjustment is:

$$0.9 \times (\text{FIF accounting income or loss} - \text{FDR income})$$

"FIF accounting income or loss" is defined in subsection (4) as the positive income or negative loss on FIF property for the income year calculated under accepted accounting practice. The accounting income or loss must materially be the same amount as foreign investment fund income if not for the replacement of the FIF rules by the FDR method (in other words, the amount calculated under the comparative value method). The formula thus excludes the after-tax amount of the actual returns on the property as recorded in the life insurer's financial statements, which should be the same amount excluded by life insurers in calculating the FDR return for their life office base income.

“FDR income” is defined in subsection (5) and refers to the amount of fair dividend rate income on that property. It will be the same amount that was calculated in the life insurer’s life office base income calculation. The net amount is adjusted by a factor of 0.9 which reflects the typical amount of income included in policyholder base income with these products.

The “PIE adjustment formula” also contains an amount of 0.9 of “excluded shares”. This refers to exclusion of realised and unrealised Australasian capital gains, which are discussed separately in the item *Inclusion of life insurance in portfolio investment entity rules*.

New section EY 42B describes the “FDR adjustment” for life insurance savings products other than for those in portfolio investment-linked funds which have elected to be portfolio investment entities. These include traditional participating life insurance savings products such as whole of life and endowment policies, and also investment-linked products which the life insurer has not elected to be portfolio investment-linked products. The FDR adjustment for FDR income on FIF property is the same as that used in the PIE adjustment formula except that there is an adjustment factor of 0.4 of the net amount. This is an estimated average of the income that is included from these products in the annual policyholder base calculation and is used to minimise compliance costs.

The PIE adjustments and FDR adjustments will be effective from:

- the beginning of the 2008–09 income year; or
- on 1 October 2007, if an election by the life insurer to do so is received by the Commissioner before 1 April 2008; or
- the first income year beginning on or after 1 April 2007 if an election by the life insurer to do so is received by the Commissioner before 1 April 2008.

## **Background**

In 2006, Parliament enacted major changes to the taxation of offshore portfolio equity. As a result, all portfolio shares with interests of less than 10 percent in non-resident companies other than Australian-listed companies will be taxed on a deemed fair dividend rate (FDR) of 5 percent instead of actual returns (dividends, plus realised gains in the case of revenue account holders). The fair dividend rate is effective from the beginning of the first income year beginning after 31 March 2007. However, entities electing to become PIEs have the option of making the fair dividend rate apply from 1 October 2007, regardless of their income year.

Under the current life insurance tax rules, a life insurer effectively annually pays tax on the higher of the life office base and the policyholder base. Tax on the life office base is determined under the normal tax rules, which takes into account the fair dividend rate on the relevant equities. However, tax on the policyholder base is calculated on actual returns (through movements in reserves) of these equities, and not at the fair dividend rate. The policyholder base tax calculation therefore requires a change so that the appropriate amount of tax based on the fair dividend rate will result in both bases.

## **INCLUSION OF LIFE INSURANCE IN PORTFOLIO INVESTMENT ENTITY RULES**

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*(Clauses 2, 4, 77, 78, 81, 82, 83 and 135)*

### **Summary of proposed amendment**

The amendment allows life insurers to elect to have New Zealand and Australian-listed equity gains from investment-linked insurance products excluded from tax.

The change is intended to allow policyholders with unit-linked life insurance products to access some of the benefits of the new portfolio investment entity (PIE) rules.

### **Application date**

The amendment will apply from 1 October 2007.

### **Key features**

Life insurers will be able to elect to have realised New Zealand and Australian-listed equity gains from investment-linked life insurance products excluded from both the life office base and policyholder base calculations of tax.

New section HL 3(5B) prescribes the eligibility requirements for life insurers who can elect to be subject to the new rules. The life insurer must first meet the eligibility requirements to be a portfolio investment entity. The gains exclusion is then only available for assets held by a “portfolio investment-linked life fund”. This is defined in section OB 1 as a fund where investments are held subject to a life policy under which benefits are directly linked to the value of investments held in the fund. The portfolio investment-linked life fund must also be eligible to be, and elect to be, and has not ceased the election to be, a portfolio investment entity.

In these circumstances, realised New Zealand and Australian-listed equity gains for these life saving products which are excluded from the calculation of the life insurer’s life office base under section CX 44C are also excluded from the policyholder base income calculation. This is achieved under amended section EY 42C by exclusion of the “PIE adjustment”. The PIE adjustment outlined in new section 42(C) (1) to (5) and (6) excludes from the calculation of policyholder income 0.9 of, amongst other things, “excluded shares”. These are defined in subsection (6) as realised gains or losses of New Zealand and listed Australian equities that were excluded from the calculation of tax under the life office base, in addition to unrealised gains or losses on those equities that would qualify for the exemption if sold during the year. The 0.9 adjustment factor recognises the approximate average amount of income that is included in the policyholder base income for these types of products.

Life insurers who elect into the new rules will have a deemed disposal of the excluded shares, with any tax to pay spread over a period of three years from the date of election.

Other consequential amendments for these funds are contained in sections HL 8(1) and HL 11(2B), and to the definitions in section OB 1 for “investor”, “portfolio investment entity”, “portfolio listed company” and “portfolio tax rate entity”.

## **Background**

Life insurers pay tax at 33 percent on investment income in unit-linked life insurance products. The investment return to policyholders is determined by the rise (or fall) in their investment units, reflecting the after-tax performance in the underlying investment assets. Tax not paid on realised Australasian equity gains leads to a commensurate increase in the value of units and therefore an increase in savings.

Under current life insurance tax rules, a life insurer is subject to tax on its life office base and the policyholder base, with tax paid on the life office base being able to be credited towards the tax liability on the policyholder base. Investment income on the life office base is calculated under tax principles applicable to other taxpayers, whereas special rules apply to the calculation of policyholder base income. Realised New Zealand and Australasian-listed equity gains therefore have to be excluded from both the life office base tax calculation as well as the amount included in the policyholder base. Further, as the policyholder base income also includes unrealised equity gains or losses, these amounts will also need to be excluded from the policyholder base tax calculation.

## **GREATER TAX INCENTIVES FOR CHARITABLE DONATIONS**

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*(Clauses 27, 33 and 85)*

### **Summary of proposed amendments**

The bill introduces changes that will enhance the current tax incentives for donations of money made by individuals, companies and Māori authorities. The changes are aimed at facilitating greater giving to donee organisations and encouraging a culture of generosity in New Zealand.<sup>6</sup>

Enhancements include removing the current rebate threshold on donations made by individuals, removing the deduction limit on charitable donations made by companies and Māori authorities, and extending the company deduction for charitable donations to include unlisted companies with five or fewer shareholders.

The changes result from options canvassed in the government's October 2006 discussion document, *Tax incentives for giving to charities and other non-profit organisations*. The discussion document was issued as part of the government's commitment to its Confidence and Supply Agreement with United Future, to develop a new tax rebate regime for charities during the current term of Parliament.

### **Application date**

The changes will apply from the 2008–09 income year.

### **Key features**

The Income Tax Act 2004 is being amended as follows:

- The individuals' rebate threshold limit for charitable donations will be removed (section KC 5). The current limit is \$1,890.
- The company deduction limit for charitable donations will be removed (section DB 32). The current limit is 5 percent of the net income of the company before taking into account the donation deduction.
- The company deduction for charitable donations will be extended to close companies (companies with five or fewer shareholders) not listed on a recognised stock exchange (section DB 32). Unlisted close companies are currently not eligible for the company deduction.
- The Māori authority deduction limit will be removed (section DV 11). The current limit is 5 percent of the net income of the Māori authority before taking into account the donation deduction.

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<sup>6</sup> A donee organisation is an entity or trust whose activities are not carried out for the private pecuniary profit of any individual and whose funds are applied principally for charitable, benevolent, philanthropic or cultural purposes in New Zealand. Some of the major donee organisations include churches and social service organisations.

In general, removing these limits will mean that the total of all donations made in a tax year for which tax relief is available will be limited only by the amount of the donor's net income.

## **Background**

Under current law, individuals are entitled to a tax rebate at a set 33 $\frac{1}{3}$  cents in the dollar up to a maximum of \$1,890 for cash donations made to donee organisations. Companies and Māori authorities are entitled to a deduction for cash donations made to donee organisations but the deduction cannot exceed 5 percent of their net income before taking into account the donation deduction. Close companies that are not listed on a recognised stock exchange are not eligible for tax relief for their donations.

The policy approach for developing tax incentives for promoting charitable giving in New Zealand has been to make small incremental enhancements to the existing tax incentives for charitable donations, while maintaining a cap on eligible donations and limits on overall eligibility. The most recent changes occurred in 2002.

As part of the government's Confidence and Supply Agreement with United Future, the government released the October 2006 discussion document, *Tax incentives for giving to charities and other non-profit organisations*. The discussion document took a wider, more comprehensive and radical approach to the whole area of tax incentives for promoting charitable giving. The options canvassed in the discussion document included:

- enhancements to the current tax incentives for donations made by individuals, companies and Māori authorities;
- a rebate or grant that recognises the time and skills provided by volunteers to charities and other non-profit organisations;
- clarifying and streamlining the tax obligations of volunteers in receipt of reimbursement payments and honoraria recipients; and
- tax incentives offered by other countries, such as the United Kingdom's gift aid scheme, payroll giving, deductibility of non-monetary donations, and Australia's specialised charitable trust rules.

The discussion document also sought people's views on what further initiatives could be employed to encourage increased generosity and to support any tax measures that could arise out of the discussion document.

To support the discussion document, a series of consultation workshops were held and 300 people attended these workshops. A total of 229 written submissions were received from a wide range of people and organisations. Feedback from consultation strongly supported most of the options put forward in the discussion document.

## CHARITABLE DONEE STATUS

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*(Clause 85)*

### **Summary of proposed amendments**

The Hamlin Charitable Fistula Hospitals Trust, the Hope Foundation Development Trust, the Hope International Charitable Trust, the Limbs 4 All Charitable Trust, the New Zealand Disaster Assistance Response Team Trust, the Operation Restore Hope Charitable Trust and The World Swim for Malaria Foundation (New Zealand) are to be given charitable donee status. This will enable donors to these organisations to obtain tax relief on their donations.

### **Application date**

The amendments will apply from the 2007–08 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:

- Hamlin Charitable Fistula Hospitals Trust;
- Hope Foundation Development Trust;
- Hope International Charitable Trust;
- Limbs 4 All Charitable Trust;
- New Zealand Disaster Assistance Response Team Trust;
- Operation Restore Hope Charitable Trust; and
- The World Swim for Malaria Foundation (New Zealand).

### **Background**

The current rules for a rebate or deduction are:

- Donations to qualifying organisations entitle individual taxpayers to a rebate of 33½ 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 Māori authority may also claim a deduction from its net income. The maximum deduction for a Māori authority is 5 percent of its net income donated to charitable organisations or a body that has been defined as a Māori association under the Māori Community Development Act 1962.

### ***Hamlin Charitable Fistula Hospitals Trust***

This organisation's activities focus on the treatment and prevention of obstetric fistulae. Treatment of obstetric fistulae is carried out in the Addis Ababa Fistula Hospital in Ethiopia.

### ***Hope Foundation Development Trust***

This organisation provides education, medical and humanitarian aid to children in developing countries who have been affected by poverty, HIV/AIDS or abuse. It also assists young adults affected in this way with university education.

### ***Hope International Charitable Trust***

The organisation is part of an international organisation founded in 1975 in Canada. It provides humanitarian aid in developing countries, such as establishing clean water supplies and assisting in self-help activities by providing microfinance.

### ***Limbs 4 All Charitable Trust***

This organisation provides disabled people with artificial limbs and devices, and encourages and supports research into new limbs and devices. It will carry out these activities both in New Zealand and overseas. While not limited to any overseas country, it is particularly aimed at Cambodia, Tibet and Nepal.

### ***New Zealand Disaster Assistance Response Team Trust***

The New Zealand Disaster Assistance Response Team Trust operates both in New Zealand and overseas and provides disaster rescue training, education and resources for rescue teams.

### ***Operation Restore Hope Charitable Trust***

This organisation provides assistance to indigent children born with, or afflicted by, functional or cosmetic defects. It provides surgical and medical services, and other assistance that improves their educational, economic, vocational, physical and social welfare needs. It also carries out research.

### ***The World Swim for Malaria Foundation (New Zealand)***

This organisation is part of an international organisation aimed at the prevention and treatment of malaria.

## **TECHNICAL AMENDMENTS TO BRANCH EQUIVALENT TAX ACCOUNT RULES**

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*(Clauses 117(1), 118, 119(1), 120, 256 and 257)*

### **Summary of proposed amendments**

The amendments make two changes to the rules for branch equivalent tax accounts (BETAs).

Branch equivalent tax accounts are memorandum accounts designed to prevent the double taxation of foreign income which might otherwise occur as a result of the accrual taxation of controlled foreign companies (CFCs) and foreign investment funds (FIFs), in combination with the imposition of dividend withholding payments (DWPs) on foreign dividends received by New Zealand companies.

The amendments tighten and clarify the rules applying to these accounts to ensure their operation is consistent with this objective and that they are not used inappropriately to offset or defer tax on other income.

### **Application date**

The amendments to sections MF 5 and MF 10 of the Income Tax Acts 1994 and 2004 will apply for the 1997–98 and subsequent income years, except when taxpayers have already filed returns based on existing law at the time the bill was introduced.

The amendments to sections MF 4(3)(a) and MF 8(4)(a) of the Income Tax Act 2004 will apply from the date of the bill's introduction.

### **Key features**

Sections MF 5 and MF 10 of the Income Tax Act 2004 are being amended to clarify that companies' and consolidated groups' access to BETA debits is limited to the amount necessary to offset the tax on their foreign income (before any New Zealand losses are taken into account). Equivalent changes are being made to the Income Tax Act 1994 (the section references are the same).

Sections MF 4(3)(a) and MF 8(4)(a) of the Income Tax Act 2004 are being amended to prevent BETA debits being generated when a dividend withholding payment (DWP) is paid on dividends received from grey list investments in controlled foreign companies (CFCs).

## **Background**

Under the CFC and FIF rules, foreign income derived from outside one of the eight “grey list” countries is taxed on accrual as it is earned. It may also be subject to DWP if subsequently repatriated to New Zealand as dividends. Branch equivalent tax accounts are designed to prevent double taxation arising as a result. When tax is paid on foreign income on accrual, or when New Zealand losses are used to relieve this tax, credits to the account are generated. These credits can be then be used to offset a subsequent liability to DWP. Alternatively, if dividends are received first, the company pays DWP, generating debits to the account which can then by used to offset accrual taxation under the CFC and FIF rules.

### ***Clarifying access to BETA debits***

Amendments introduced initially by sections 61 and 64 of the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 corrected an anomaly in the BETA rules whereby a company could retain New Zealand losses carried over from previous years or from other companies in the same group and use its BETA debits to offset tax on foreign income, while current year losses made by that company had to be set against its foreign income. The anomaly was corrected by allowing debits in excess of the income tax liability on foreign income (after New Zealand losses have been allowed) to be converted into a loss which can be carried forward and set against future income. The change applied for the 1997–98 and subsequent income years.

The underlying assumption is that debits can only be converted into a loss to the extent that this is necessary to offset income tax on attributed CFC income in the absence of New Zealand losses. The scope of relevant elections is not expressly limited in this way, however. If companies could convert debits into losses regardless of the level of their attributed CFC income, they could use those losses to relieve other income that is properly taxable.

The amendments to section MF 5 of the 1994 and 2004 Income Tax Acts clarify that companies can access BETA debits only to the extent necessary to offset the tax on their foreign income before any New Zealand losses are taken into account. Once those losses are factored in, the company may be left with excess BETA debits that can be converted into a loss and set against other taxable income, but any larger pool of excess debits has to remain untouched until future foreign earnings justify their use.

The amendments to sections MF 10 of the 1994 and 2004 Income Tax Acts make equivalent changes in relation to consolidated groups.

### ***Preventing BETA debits for DWP on grey list investments***

There are circumstances in which a company may accrue surplus BETA debits, with no prospect of ever having a corresponding liability on attributed CFC income. This can happen when dividends are received from grey list countries. Generally, no DWP is paid on these dividends because the New Zealand company can claim underlying foreign tax credits that reduce its DWP liability to nil. Where section LF 2(2) of the Income Tax Act 2004 applies, however, underlying foreign tax credits are not available. In those cases, DWP is payable on dividends received from grey list countries, and BETA debits are generated in the usual way.

The generation of BETA debits in these circumstances is anomalous because there is no corresponding accrual taxation of the underlying profits. This can leave a company with a pool of surplus debits which, potentially, can be used to offset or defer tax on other income.

Sections MF 4(3)(a) and MF 8(4)(a) of the Income Tax Act 2004 are therefore being amended to ensure that, in future, BETA debits will not be generated when DWP is paid on a dividend derived from a CFC that, at the time, is an unqualified grey list CFC. This brings the law for dividends received from grey list CFCs into line with existing law applying to dividends derived from grey list FIFs.

## **INCOME TAX RATES**

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*(Clause 3)*

### **Summary of proposed amendment**

The bill sets the annual income tax rates that will apply for the 2007–08 tax year.

### **Application date**

The provision will apply for the 2007–08 tax year.

### **Key features**

The annual income tax rates for the 2007–08 tax year will be set at the rates specified in Schedule 1 of the Income Tax Act 2004.

The rates in Schedule 1 that apply for the 2007–08 year are those that applied for the 2006–07 year, except that a new rate will be added for Portfolio Investment Entity (PIE) income, and new thresholds set for Specified Superannuation Contribution Withholding Tax (SSCWT) where SSCWT rates are determined by the combined total of an employee's salary or wages and employer superannuation contributions. The PIE tax rate and new thresholds for SSCWT are those set by the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006.

## **RETIREMENT SCHEME CONTRIBUTION WITHHOLDING TAX (RSCWT)**

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*(Clauses 5, 10, 14, 23, 24, 59, 66, 87, 94, 96, 133, 135(47), 135(48), 139, 147, 148, 157, 168 and 193)*

### **Summary of proposed amendments**

The bill introduces new rules for taxing contributions to retirement savings schemes so that:

- a withholding tax is imposed on contributions instead of income tax;
- tax rates on contributions are set at 19.5%, 33% and 39%, based on taxable income in the previous income year; and
- contributions are not taken into account for social assistance purposes.

### **Application date**

The amendments will apply from 1 April 2007.

### **Key features**

The Income Tax Act 2004 is being amended as follows:

- Subject to the approval of the Commissioner of Inland Revenue, companies (but not close companies), widely held unit trusts and Māori authorities will be able to apply a withholding tax on certain contributions they make to members' accounts in retirement savings schemes.
- Contributions will not be included in members' taxable income, but will be subject to the withholding tax instead.
- The tax rates on contributions are set at:
  - 19.5% if taxable income in the previous income year is \$38,000 or less;
  - 33% if taxable income in the previous income year is more than \$38,000 and \$60,000 or less; and
  - 39% if taxable income in the previous income year is greater than \$60,000.
- Contributions will not be taken into account in determining members' entitlement to social assistance.

## **Background**

Te Rūnunga o Ngāi Tahu (TRoNT) asked government to consider new rules for taxing contributions to retirement savings schemes. TRoNT was setting up a retirement savings scheme for its members, and was planning to make contributions to the scheme on behalf of its members. The contributions would be distributions of TRoNT's profits. Members' funds, including contributions made by TRoNT, would be locked in until retirement. However, withdrawals would be permitted for first home purchase, tertiary education (defined as repaying a student loan), significant financial hardship, serious illness (permanent and total disability, or imminent death) and permanent emigration.

Under current law, any contributions that TRoNT made to the scheme on behalf of members would be subject to income tax. Resident withholding tax (RWT) would be deducted, and if a member wanted to claim a refund on RWT paid or was required to pay additional tax as the RWT was insufficient, then he or she would have to file a tax return. Contributions would also be taken into account for social assistance purposes.

TRoNT proposed that instead of being subject to income tax, contributions could be subject to a final withholding tax. This would ensure that members would not be required to file tax returns solely on the basis that they are receiving locked-in retirement savings contributions. TRoNT also proposed that the contributions should not be taken into account for social assistance purposes, given that contributions would be locked in and would not be available for day-to-day living expenses.

Taxing contributions through a final withholding tax instead of subjecting them to income tax in the hands of members is consistent with the treatment of employer superannuation contributions, fringe benefits, and portfolio investment entity (PIE) income. Excluding contributions from being taken into account for social assistance purposes is also consistent with the treatment of employer superannuation contributions, fringe benefits and PIE investment income, and is reasonable given that the contributions will be locked in and unavailable for day-to-day living purposes.

Although the impetus for developing the new withholding tax rules came from TRoNT, the rules have been designed to accommodate companies (but not closely held companies), widely held unit trusts and other Māori authorities in addition to TRoNT.

## **Detailed analysis**

### ***Eligibility to use the RSCWT rules***

Entities that want to make contributions to retirement savings schemes will be able to request the Commissioner's approval to apply the retirement scheme contribution withholding tax (RSCWT) rules to those contributions.

In order to use the RSCWT rules, the contributing entity and the scheme to which the contributions are made must meet specific criteria.

The contributing entity must be either:

- a company but not a closely held company;
- a widely held unit trust; or
- a Māori authority.

The scheme to which contributions are made must be a PIE.

The scheme must have rules to lock contributions in until retirement and the age of retirement must be specified in the scheme's trust deed. Contributions must remain locked in even if individuals sell their shareholding or unit holding, or cease to be a member of the contributing Māori Authority.

Withdrawals other than retirement withdrawals may be permitted for:

- first home purchase;
- significant financial hardship;
- serious illness (permanent and total disability, or imminent death);
- permanent emigration; and
- repayment of student loans.

Contributions to individuals' retirement savings accounts must be made on the basis of those individuals' shareholdings, unit holdings or membership in the contributing entity. Contributions must remain locked in even if the saver sells their shareholding or unit holding in the contributing entity, or ceases to be a member of the Māori authority.

If the Commissioner is satisfied that the contributing entity and the scheme meet the criteria, and that the withdrawal rules are fair and reasonable, then the contributing entity will be able to use the RSCWT rules in respect of contributions.

### ***Excluding retirement scheme contributions from taxable income***

The RSCWT rules exclude the contributions from taxable income for individual savers, and impose a withholding tax instead. Because a withholding tax is applied, the contributions will not be subject to the resident withholding tax rules.

Excluding the contributions from taxable income means that they will also be excluded from being taken into account for social assistance purposes, when social assistance is delivered through the tax system. The definition of income used for social assistance delivered through social welfare systems already excludes income which is locked in and not available for day-to-day living purposes, so no further amendment is needed.

In some cases, retirement schemes may set an age of retirement that is earlier than the age of eligibility for New Zealand Superannuation, but is still fair and reasonable. In those cases, if a person is eligible to receive retirement scheme contributions, and he or she makes retirement withdrawals, including withdrawals of retirement scheme contributions, those retirement withdrawals may be taken into account for social assistance purposes.

### ***RSCWT rates***

Contributing entities will be obliged to collect RSCWT rates from individual savers. Savers will be required to declare a tax rate to the contributing entity for the purposes of calculating and deducting RSCWT.

The applicable tax rates are:

- 19.5% if the individual's taxable income in the previous income year is \$38,000 or less;
- 33% if the individual's taxable income in the previous income year is more than \$38,000 and \$60,000 or less; and
- 39% otherwise.

This aligns RSCWT rates with income tax rates and thresholds.

### ***Calculating and paying RSCWT***

When a contribution is made, the contributing entity must calculate the amount of RSCWT owing, and return it to Inland Revenue by the 20th of the month following the month in which the contribution was made.

The RSCWT liability can be satisfied with imputation credits or Māori authority credits attached to the contributions in the ordinary way, if the contributions are dividends or Māori authority distributions. There may be some cases where the imputation credit attached to the contribution exceeds the RSCWT liability. In that case, any remaining imputation credits will be passed on to the individual savers to whom they belong, who may then use the credits in their own income tax return. This situation should not arise for contributions from Māori authorities, because the maximum value allowed for a Māori authority credit is 19.5 percent, which is the same as the minimum rate of RSCWT. However, the same provision is made for excess Māori authority credits to be passed on to individual investors, to maintain consistency.

The contributing entity is required to send an annual reconciliation statement to Inland Revenue. The statement must record the following details for the contributing entity:

- total contributions paid;
- total RSCWT liability;
- total imputation credits used to pay the RSCWT liability;

- total Māori authority credits used to pay the RSCWT liability; and
- total money paid to Inland Revenue for any remaining RSCWT liability.

The reconciliation statement must record the following details for each person who has received a contribution:

- the saver's name;
- amount of each contribution;
- RSCWT rate used to calculate RSCWT on the contribution;
- RSCWT for the contribution;
- imputation credits attached to the retirement scheme contribution;
- imputation credits used to meet the RSCWT liability;
- Māori authority credits attached to the retirement scheme contribution;
- Māori authority credits used to meet the RSCWT liability;
- RSCWT owing on the retirement scheme contribution after the use of imputation credits and Māori authority credits;
- RSCWT paid in cash;
- the saver's IRD number, if a rate of less than 39% is used to calculate RSCWT for that individual; and
- any other particulars the Commissioner may require.

The contributing entity may nominate the retirement savings scheme to act as its agent in fulfilling its tax obligations.

### ***Penalties***

If an individual declares the wrong rate to the contributing entity, that person will be required to file a return, pay any tax owing and may be required to pay use-of-money-interest. However, entitlements to family assistance will not be affected.

The same penalties that apply to any failure to deduct and pay resident withholding tax will apply to any failure to deduct and pay RSCWT.

### ***Consequential amendments***

RSCWT rates will be included in Schedule 1 of the Income Tax Act. The name of the Schedule will be changed to reflect this, and consequently, the name of the Schedule has been changed wherever it appears in the Income Tax Act.

## **ACCELERATED WRITE-DOWN RATES FOR SHUTTLE STALLIONS**

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*(Clause 39)*

### **Summary of proposed amendments**

The bill introduces changes to the write-down rules for bloodstock so that shuttle stallions qualify for the same write-down rates as other stallions that are new to New Zealand ownership.

### **Application date**

The amendments will apply to shuttle stallions purchased on or after 1 August 2007.

### **Key features**

The Income Tax Act 2004 is being amended so that shuttle stallions are included in the list of types of bloodstock that can be written down as if they were new to breeding in New Zealand, despite having been used for breeding in New Zealand in the past.

### **Background**

Shuttle stallions are stallions that are owned overseas but are brought to New Zealand for a breeding season. Under existing rules, if shuttle stallions have been used for breeding in New Zealand, and are subsequently bought by a New Zealand breeder, they must be written down over five years, even though they are new to New Zealand ownership. This is inconsistent with the treatment of stallions which have previously been used for breeding, but not in New Zealand. If these stallions are purchased by New Zealand studs, they can be written down over two years, or at 75 percent reducing value. The amendment will allow shuttle stallions to qualify for the same accelerated write-down rate.

## **ACC ATTENDANT CARE PAYMENTS – SETTING THE WITHHOLDING RATE AND DELAYING IMPLEMENTATION**

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*(Clauses 11, 12, 23, 30, 95, 135(3), 136, 151, 152 and 272)*

### **Summary of proposed amendments**

The application date for amendments made last year in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act to the taxation of payments by the Accident Compensation Corporation (ACC) to attendant caregivers is to be deferred from 1 April 2008 to 1 July 2008.

In addition, the Income Tax (Withholding Payments) Regulations 1979 are being amended to set the withholding rate from these payments at 15 cents in the dollar.

### **Application date**

The amendments will apply from 1 July 2008.

### **Key features**

The changes made in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006, which were to have come into effect on 1 April 2008, are being repealed and replaced to allow implementation to be deferred to 1 July 2008. A number of drafting changes are being made to ensure that the changes achieve the original policy intent.

The Income Tax (Withholding Payments) Regulations 1979 are being amended to make ACC attendant care payments subject to the withholding tax rules. Withholding tax of 15 cents in the dollar will be withheld from ACC attendant care payments made by ACC to claimants or to a caregiver on behalf of claimants.

### **Background**

Attendant care payments are made by ACC to injured claimants for the provision of personal care to those claimants. Claimants may use ACC-contracted caregivers or independent caregivers.

Uncertainty about the correct tax treatment of ACC attendant care payments led to some inconsistent practices. It was decided to address these inconsistencies by requiring ACC to withhold tax at source from the payments. Legislative amendments were made last year to establish the tax treatment of these payments.

The changes were to come into effect on 1 April 2008, but the government has agreed that they should be deferred until 1 July 2008 to allow ACC to implement its new claim management system.

## **THE ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) FOR TAXATION PURPOSES**

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*(Clauses 25, 26, 34, 35, 36, 37, 38, 40, 45, 46, 47, 48, 49, 50, 51, 52, 53, 54, 55, 56, 57, 58, 135(15), (19), (21), (32), (34), and (51), 164 and 184)*

### **Summary of proposed amendments**

Changes to the research and development expenditure and trading stock tax rules align references in the Income Tax Act 2004 to the new International Financial Reporting Standards (IFRS) and ensure that taxpayers who adopted IFRS can continue to use these tax rules.

Changes to the financial arrangement tax rules incorporate the IFRS accounting methods into the financial arrangement timing rules.

### **Application date**

The proposed changes to the research and development expenditure and trading stock tax rules ensure that IFRS must be adopted for taxation purposes from the first income year for which a person adopts IFRS for the purpose of financial reporting, or the 2007–08 income year, whichever is earlier.

However, taxpayers do not have to apply the changes to the financial arrangement rules until the 2007–08 income year. They can use the existing financial arrangement rules in earlier income years even though they have adopted IFRS for the purpose of financial reporting.

The exemption from unacceptable tax position penalties applies only to taxpayers who adopted IFRS for the purpose of financial reporting and tax before the 2007–08 income year.

### **Key features**

The amendments:

- update the existing trading stock and research and development expenditure rules to reflect changes following the adoption of IFRS; and
- modify the existing financial arrangement timing rules to allow taxpayers to use the method they adopt under IFRS, but the Commissioner will provide alternative spreading methods to limit the effect of any volatility of income and expenditure; and
- provide legislative relief for taxpayers who adopt IFRS before the 2007–08 income year from unacceptable tax position penalties in some circumstances.

## **Background**

Current taxation rules are linked to accounting practice in areas such as the trading stock valuation rules, research and development expenditure rules and in areas where the Courts and tax legislation have relied on generally accepted accounting practice. The tax rules' reliance on accounting practice in these areas is "ambulatory" in principle, meaning that changes in accounting practice arising from the adoption of IFRS are also brought into effect for tax purposes and automatically reflected in tax law. However, some areas, such as the research and development expenditure and trading stock valuation rules, require legislative amendments to incorporate the specific changes brought about by the adoption of IFRS.

IFRS have introduced significant changes to the methods of accounting for income and expenditure of financial arrangements. These changes bring financial accounting methods closer in line with existing tax timing rules. Although the IFRS methods could, arguably, be applied for taxation purposes under the existing rules as the "financial reporting" methods, there are considerable uncertainties on the acceptability of these methods under the existing legislative provisions. The legislative amendments will set out the circumstances when taxpayers who adopted IFRS methods can rely on the same methods for taxation purposes.

## **Detailed analysis**

### ***Research and development expenditure***

The research and development expenditure rules in section DB 26 are updated to reflect changes brought about by IFRS. Under IFRS, the treatment of research and development expenditure is dealt with under the general accounting standards on intangibles (NZ IAS 38). The core standards for capitalisation of development costs under NZ IAS 38 are substantially the same as the old accounting standards and should continue to be appropriate for taxation purposes. However, some provisions in the old standards (such as paragraphs 2.3 and 5.4 of FRS-13) are no longer applicable and have been amended accordingly.

### ***Trading stock tax rules***

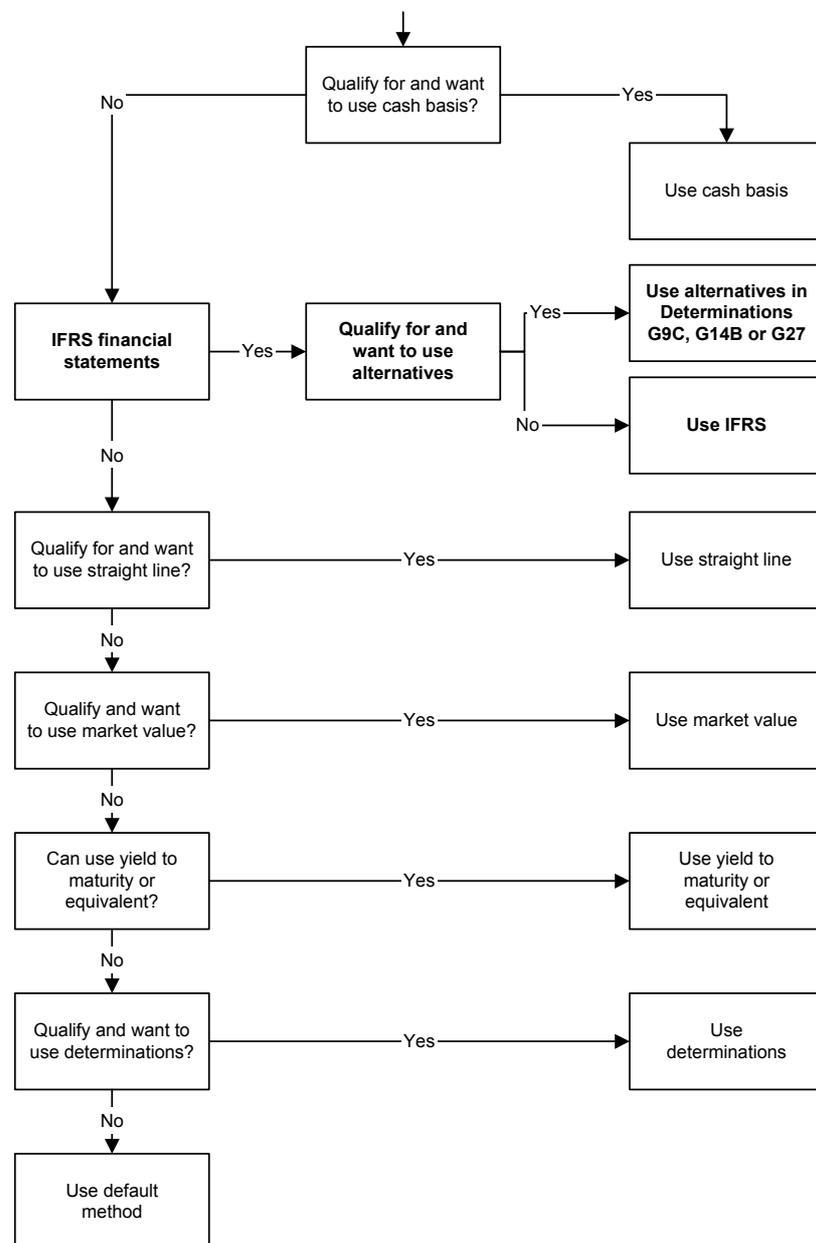
The trading stock valuation rules in subpart EB are amended to reflect the application of a new accounting standard, NZ IAS 2, under IFRS. The trading stock valuation rules under the new standards are largely consistent with the old accounting standards and continue to be appropriate for taxation purposes.

However, primary sector producers may be required to use another new accounting standard, NZ IAS 41, to value their trading stock. NZ IAS 41 requires primary sector producers to value their trading stock at fair value, which includes gains and losses that should not be included for taxation purposes. Special rules are provided to ensure that these taxpayers can continue to value their trading stock at cost, despite having to fair value them under NZ IAS 41.

## Financial arrangement rules

The financial arrangement spreading rules have been re-ordered so that taxpayers who adopted IFRS for financial reporting purposes would generally be required to follow the IFRS timing rules for taxation purposes. In addition, these IFRS-compliant taxpayers will have an option to use alternative spreading methods for financial arrangements that are within the scope of specific determinations. Taxpayers who do not prepare IFRS accounts will continue to apply the current tax timing rules for financial arrangements, except that they will not have the option of using the financial reporting method that is currently available. A summary of the spreading methods available to taxpayers under the proposed legislative changes is presented in Figure 1.

**Figure 1**  
**Proposed financial arrangement spreading rules**



Adopting the IFRS methods for taxation purposes means that income and expenditure of financial arrangements are calculated before their maturity using either the “fair value method” or the “effective interest method” under NZ IAS 39. Income and expenditure calculated under these methods would include fees that are “integral” to the financial arrangement. The determination of whether fees are “integral” to the financial arrangement made for financial reporting purposes would be acceptable for taxation purposes.

Taxpayers who adopt IFRS methods for taxation purposes are expected to satisfy additional conditions. First, income and expenditure reported under IFRS in both the income statement and the statement of changes in equity should be included for taxation purposes. Secondly, credit impairment adjustments made under IFRS must be reversed out for taxation purposes. Credit impairments of financial arrangements will be deductible of tax purposes only when the debt is written off as being “bad” in accordance with section DB 23.

In addition to the IFRS methods, the proposed legislation will provide other spreading methods based on the existing determinations. Taxpayers who prepare IFRS accounts will have the option of using the determination methods or an alternative that is not materially different from these methods. The existing determinations that will be available are:

- Determination G9C – Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach;
- Determination G14B – Forward contracts for foreign exchange and commodities: an expected value approach; and
- Determination G27 – Swaps (specifically, Method C as outlined in sub-clause 6(3)).

### ***Transitional rules***

#### *Application of the existing financial arrangement rules*

The proposed amendments will “grandparent” existing financial arrangement spreading rules until the 2007–08 income year. This means that early adopters of IFRS (who may be preparing their IFRS-based tax returns from the 2005–06 income years) could continue to file on the basis of the existing financial arrangement rules (and the pre-IFRS accounting treatment of financial arrangements). This provision is necessary because significant changes are proposed to the financial arrangement spreading rules and these provisions would not have been enacted by the time early adopters are required to file their tax returns.

#### *Exemption from unacceptable tax position penalties*

Further legislative relief from unacceptable tax position penalties is provided for early adopters of IFRS who may be filing their tax returns before enactment of the proposed amendments. The legislative relief would be available for the 2005–06 and 2006–07 income years for an IFRS-related tax position, provided that the taxpayer has adopted an interpretation for tax purposes that is “as likely as not” to represent generally accepted accounting practice under IFRS and full disclosures are provided to Inland Revenue.

## **COMMISSIONER'S ACCEPTANCE OF A TAXPAYER'S NOTICE OF PROPOSED ADJUSTMENT**

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*(Clause 163)*

### **Summary of proposed amendment**

An amendment is being made to the Tax Administration Act 1994 to clarify when the Commissioner of Inland Revenue can begin a new tax dispute. The change will make it clear that the Commissioner cannot issue a notice of proposed adjustment (NOPA) in respect of the same issue after accepting (or being treated as having accepted) a taxpayer NOPA except when the taxpayer:

- was fraudulent;
- wilfully misled the Commissioner; or
- failed to supply the Commissioner with relevant information.

The change will ensure that disputes procedures have their intended effect. However, to protect the revenue base, the timeframe may be overridden in cases of misrepresentation, material omission or fraud.

### **Application date**

The amendment will apply from the date of enactment.

### **Key features**

New disputes procedures were introduced in the Tax Administration Act 1994 (Part IVA) from 1 October 1996.

The disputes procedures involve various steps that are undertaken when the Commissioner and a taxpayer cannot agree on a matter.

A key feature of the disputes rules is the timeframe allocated to parties to lodge notices and respond to notices received from the other party.

Underpinning the response time limits is an acceptance rule that applies when a party fails to respond within the specified period. However, current law is uncertain about whether the Commissioner can issue a new NOPA to replace a taxpayer's NOPA when the Commissioner has accepted an earlier taxpayer NOPA in relation to the same issue or has failed to respond within the set time period.

A change has therefore been proposed to clarify that the Commissioner cannot generally issue a NOPA on the same matter after accepting (or being treated as having accepted) a taxpayer NOPA. This change will ensure that the disputes procedures have their intended effect. Revenue concerns will be addressed by still allowing this timeframe to be overridden in cases where the taxpayer wilfully misleads the Commissioner, or there is material omission or fraud.

## **Background**

A NOPA is the document that begins the disputes resolution process. The Commissioner may issue a NOPA to alter a return as filed or amend an existing assessment. A taxpayer can also issue a NOPA.

Taxpayer NOPAs play an important role in the disputes process. They disclose the taxpayer's position and minimise the taxpayer's exposure to shortfall penalties. They also require the Commissioner to focus on an issue and explicitly decide on the correct position. This provides certainty for taxpayers.

Section 89H(2) states that if the Commissioner does not, within the response period, reject an adjustment contained in a taxpayer NOPA, the Commissioner is considered to have accepted the proposed adjustment and section 89J applies.

Under section 89J, if the Commissioner accepts or is treated as having accepted the proposed adjustments in the taxpayer's NOPA, the Commissioner must include or take account of the adjustments in a notice of assessment issued to the taxpayer. This is intended to be the end of the disputes process on issues within that NOPA.

The only intended exception is if the Commissioner applies to the High Court for an order allowing a notice of response to be issued outside the two-month response period (section 89L).

While the intention behind the disputes procedures was for all parties to be bound by the time limits incorporated in the rules, the current law is uncertain (and has been challenged in at least two recent cases) on whether the Commissioner can begin a new dispute on the same issue once a time limit has been exceeded.

## GST AND CONSUMABLE STORES

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*(Clause 248)*

### **Summary of proposed amendments**

Changes are being made to the Goods and Services Tax Act 1985 to clarify the circumstances when a supply of consumable stores to departing aircraft and commercial ships may be zero-rated.

### **Application date**

The changes will apply to consumable stores supplied on and after the date of enactment.

### **Key features**

Section 11(1)(l) of the GST Act governs when a supply of consumable stores is zero-rated. Changes are being made to that section to clarify, in the case of New Zealand stopovers, the requirement that consumable stores be used by an aircraft or commercial ship that is going to a destination outside New Zealand. The changes require that the consumable stores are *intended for use* on an aircraft or commercial ship on an international flight or voyage.

The supply of consumable stores to ships, other than pleasure craft, which are in turn used to provide consumable stores to “fishing ships” and “foreign-going ships” will also be zero-rated. For example, the supply of consumable stores to motherships used to support fishing fleets operating outside New Zealand fisheries waters will be zero-rated.

Consequential changes are also being made to the definitions of “foreign-going ship” and “consumable stores” in section 11(9) of the GST Act.

### **Background**

The changes clarify when consumable stores provided to aircraft and commercial ships are considered to be “exported” from New Zealand and therefore treated as a zero-rated supply for GST purposes.

The term “consumable stores” in section 11(9) includes goods such as fuel and lubricants and other goods that may be consumed by passengers and crew on board an aircraft or ship. “Consumable stores” do not include spare parts.

The proposed changes are designed to zero-rate supplies of consumable stores in the following circumstances:

- Aircraft or commercial ships that are in transit in New Zealand as part of an international flight or voyage – for example, an aircraft or commercial ship that travels from Christchurch to Auckland en-route to Singapore. (The current legislation requires that the aircraft or commercial ship must be going to a destination outside New Zealand and is ambiguous concerning stopovers in New Zealand).
- Commercial ships that do not necessarily travel to countries outside New Zealand but carry consumable stores to other commercial ships that are leaving New Zealand or fishing ships operating outside New Zealand fisheries waters.

The changes are also intended to deal with the situation when consumable stores are supplied to a non-resident broker but the goods are delivered directly to a third-party aircraft or commercial ship that is departing New Zealand. The changes ensure that the contract for consumable stores with the non-resident broker does not preclude zero-rating.

## SHARED TAX INVOICES

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*(Clauses 246, 250 and 251)*

### **Summary of proposed amendment**

An amendment is being made to the Goods and Services Tax Act 1985 to allow two or more suppliers to invoice a customer using one tax invoice. The change is intended to simplify the way in which suppliers are required to invoice customers for bundled supplies of goods and services for GST purposes.

### **Application date**

The amendment will apply from the date of enactment.

### **Key features**

The amendment will allow certain multiple suppliers to issue a single, simplified shared tax invoice.

The GST Act will be amended by a new section 24BA which will allow a single shared tax invoice to be issued by one principal supplier on his or her own behalf and on behalf of other GST-registered suppliers.

The change specifies that shared invoices can be issued in two situations:

- when suppliers have statutory obligations which make it practical to use a single invoice (for example, a levy imposed by statute); or
- when suppliers are part of the same GST group of companies.

Section 24BA will also specify what information should be contained on a shared tax invoice for it to be considered a valid tax invoice. This information will be similar to the current requirements of a tax invoice.

Section 2, the definition section of the GST Act, will also be amended to include shared tax invoices in the definition of “tax invoice”.

### **Background**

A tax invoice is a document that contains certain details as set out in the GST Act. The Act broadly requires disclosure of the name and address of the supplier and their GST registration number in addition to a description of the goods and services sold, the name and address of the recipient and the date the invoice is issued.

A situation may arise where two GST-registered persons, Supplier A and Supplier B, provide goods and services to the same customer, although Supplier B is the only supplier with whom the customer has actual communication. For example, when selling house and contents insurance, an insurer not only collects a house insurance premium, but also a Fire Service levy and an Earthquake Commission levy. The current legislation does not clearly allow a single invoice for the transactions.

To simplify invoice issuing requirements for multiple suppliers, the amendment will allow members of the same GST group or parties to arrangements created by statute to use shared tax invoices.

## **CHILD SUPPORT INFORMATION SHARING BETWEEN INLAND REVENUE AND CUSTOMS**

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*(Clauses 160(1), 160(3), 263, 265, 266 and 267)*

### **Summary of proposed amendments**

The proposed changes introduce information sharing between Inland Revenue and the New Zealand Customs Service. The purpose of information sharing is to allow Inland Revenue to identify when certain persons with outstanding child support debt are entering or leaving New Zealand.

### **Application date**

The changes will apply from the earlier of a date to be fixed by the Governor-General by Order in Council or 1 April 2009.

### **Key features**

New section 280J-L of the Customs and Excise Act 1996 allows information sharing of child support information between Inland Revenue and Customs. Section 81 of the Tax Administration Act 1994 is also being amended.

Inland Revenue will provide Customs with the names and other identifying information of certain parents who have outstanding child support debts. An information match will occur by Customs, comparing identifying information against arrival and departure information it holds on liable parents. Customs will then supply Inland Revenue with information on liable parents identified by the information match.

This information will give Inland Revenue the opportunity to take the administrative and legal steps, where appropriate, to recover outstanding debt from liable parents while they are located in New Zealand and, if necessary, stop liable parents from subsequently leaving New Zealand to avoid meeting their child support obligations.

The Commissioner of Inland Revenue and the Chief Executive of Customs may enter into an agreement to determine the frequency, form and method for the exchange of information.

Schedule 3 of the Privacy Act 1993 is also being amended.

## **Background**

At present, outside of its reciprocal agreement with Australia, New Zealand has limited authority to enforce payment from liable parents who are overseas. This highlights the importance of Inland Revenue being able to contact liable parents whenever they are back in New Zealand to make arrangements for payment of their outstanding child support liability.

Urgent recovery action is often required while the liable parent is still in New Zealand. Inland Revenue currently has the ability to obtain an arrest warrant to detain non-compliant liable parents who attempt to leave New Zealand to avoid child support liabilities. However, this power is limited because it relies on third parties advising Inland Revenue when a liable parent has arrived in, or is about to leave, New Zealand. In addition, Inland Revenue often does not have any New Zealand contact information for liable parents living overseas.

The government agreed to investigate introducing information sharing to help Inland Revenue track the New Zealand movements of liable parents living overseas. Under the proposed changes, if a liable parent living overseas is known to be visiting New Zealand, effective steps can be taken to recover outstanding liabilities before the person attempts to leave the country.

## **TAX EXEMPTION FOR HOSPITALS OPERATED AS CHARITIES**

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*(Clauses 19, 20, 21, 253 and 254(3))*

### **Summary of proposed amendment**

The amendment re-instates an income tax exemption for hospitals operated as charities by council-controlled organisations (CCOs). Activities of CCOs generally do not qualify for the charitable tax exemption.

### **Application date**

The amendment will apply from 1 April 2001, which is consistent with the date when District Health Boards were deemed to be public authorities, and therefore, exempt from income tax.

### **Key features**

Income derived by hospitals that are operated as charities by CCOs will qualify for the charitable tax exemption. Consistent with the tax treatment of other charities, the hospitals must register under the Charities Act 2005.

### **Background**

Commercial activities by most, if not all CCOs, such as water and waste water services, roading, public transport facilities, public culture and recreational facilities and various other public works activities can be considered as beneficial to the community. Generally, activities that are beneficial to the community would qualify for the charitable tax exemption, but the policy intention is that commercial activities should not. Therefore, income derived by CCOs is specifically excluded from the charitable exemption.

However, District Health Boards are exempt from income tax because they are treated as public authorities, so there is no reason why income derived by a hospital operated by a CCO as a charity should be denied the charitable tax exemption.

## **TAXATION REVIEW AUTHORITY COSTS**

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*(Clauses 260 and 261)*

### **Summary of proposed amendments**

An amendment to the Taxation Review Authorities Act 1994 will allow the Taxation Review Authority to make an award of costs for the TRA filing fees.

Another amendment will introduce a provision in the TRA Act to empower the government to make regulations in relation to the Authority's filing fees and fee waiver.

### **Application dates**

The amendment allowing the Authority to make an award of costs for the TRA filing fees will apply from 1 April 2008.

The amendment introducing the empowering provision will apply from the date of assent.

### **Key features**

The TRA Act will be amended by a new section 22B which will allow the Authority to order the Commissioner to pay to an objector or a disputant an amount of costs. The amount of costs will be limited to the amount of the filing fee paid by the objector or the disputant.

Another amendment will introduce a provision in the TRA Act to empower the government to make regulations in relation to the Authority's filing fees and fee waiver.

### **Background**

In 2001 the Working Party on Civil Court Fees set up by the Minister for Courts initiated a review to determine an appropriate level of fees for each general civil court.

In 2004, following the review, the then government decided, in relation to the Taxation Review Authority, to:

- raise the filing fees for the Authority to \$400;
- enable the Authority to waive filing fees in appropriate circumstances; and
- allow the Authority to award costs for fees.

The proposed amendments deal with the last of the Cabinet's decisions, and empower the government to make regulations to implement the first two of the Cabinet's decisions.



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# Remedial amendments

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## **OFFSHORE PORTFOLIO SHARE INVESTMENT RULES**

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*(Clauses 13, 31, 60 to 65, 67 to 76, 93(2) and 165)*

### **Summary of proposed amendments**

New tax rules for offshore portfolio investment in shares were enacted on 18 December 2006, with application for income years beginning on or after 1 April 2007.

Several remedial amendments are required to make application of the new rules consistent with the policy intent. The more significant of these amendments are:

- That the Australian shares exemption will provide that Australian-resident companies may be included in an approved Australian Stock Exchange index at any time during the year for persons who are not managed funds or who do not do daily valuations (instead of at all times as currently required). For managed funds, or any other person applying the fair dividend rate method on a daily basis, this listing requirement will be tested on the first day of their income year.
- That the fair dividend rate method cannot be used for an interest in a non-resident which has 80 percent or more of the value of its assets, directly or indirectly, as debt instruments denominated in New Zealand dollars, or that are hedged to achieve the effect of New Zealand dollars.

### **Application date**

The amendments will come into force on 1 April 2007, which is the commencement date of the new offshore portfolio share investment rules. The exception is certain amendments concerning restrictions on the use of the fair dividend rate method, which will apply for the 2008–09 and subsequent income years.

### **Key features**

#### ***Australian shares exemption***

Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange (ASX), such as the All Ordinaries index, are exempt from the foreign investment fund rules. To assist compliance with this exemption in section EX 33C the current requirement that Australian-resident companies must be included in an approved ASX index at all times during the income year will be amended to an “at any time during the year” test for persons who are not managed funds or who do not do daily valuations. This means, for example, that the exemption will apply for an income year if a company that is listed on the ASX All Ordinaries index at the beginning of the year is omitted from the index during the year. For managed funds, or any other persons applying the fair dividend rate method on a daily basis, the listed requirement will be tested on the first day of their income year.

An amendment to the Australian shares exemption will also ensure that it does not apply to stapled securities. This means that a share in an Australian-listed company that would otherwise qualify for the exemption will not do so if it is stapled to another security. Stapled securities are two or more securities that are contractually bound together so they can only be sold together and not separately. The result of this amendment is that the foreign investment fund rules (and most likely the fair dividend rate method) will apply to Australian stapled securities.

### ***Guaranteed returns***

The fair dividend rate method cannot be used for guaranteed return-type investments. The policy intent is that the fair dividend rate method should not be used for investments which are, in substance, debt instruments designed to achieve a return higher than the fair dividend rate. These investments should be subject to full taxation under the comparative value method.

Consistent with the policy intent, an amendment replacing current section EX 40(8)(a)(iii) will specify that the fair dividend rate method cannot be used for an interest in a non-resident which has 80 percent or more of the value of its assets, directly or indirectly, as debt instruments denominated in New Zealand dollars, or that are hedged to achieve the effect of New Zealand dollars. This amendment will generally apply for the 2008–09 and subsequent income years. However, the part of the amendment referring to “80 percent or more” by value of the non-resident’s assets will apply from 1 April 2007.

An amendment to section EX 40(8) will allow the Commissioner of Inland Revenue to determine that the fair dividend rate method may be used for an investment even though the specific requirements of the legislation may not otherwise allow it to be used.

The Commissioner’s power to make a determination that the fair dividend rate method cannot be used for a particular investment will be widened by removing the determination-making criteria in section 91AAO(2) of the Tax Administration Act 1994. For example, if the Commissioner considers that the compliance costs of applying the method to the investment would be higher than is appropriate and that not applying the method would not pose a revenue risk, then the Commissioner could make a determination that the fair dividend rate method may not be used for that investment. Any investment that is the subject of a determination would have to apply the comparative value method.

### ***Australian unit trusts exemption***

Investments in Australian unit trusts that meet minimum investment turnover requirements and use the RWT proxy rules are exempt from the foreign investment fund rules. An amendment is being made to this exemption in section EX 33D to ensure the turnover requirement relates only to shares held by the unit trust and not to all assets as currently worded.

A clarifying amendment will also ensure that the turnover requirement relates to the unit trust’s accounting year which falls within the investor’s income year.

The RWT proxy requirement will be amended to cater for investments acquired part-way through an investor's income year, and will apply when the unit trust makes a distribution to investors.

The exemption will also be expanded to include investments in Australian unit trusts that distribute at least 70 percent of their income and use an RWT proxy.

### ***Venture capital exemption***

An amendment will be made to the exemption in section EX 33(3) and (4) which is designed for certain venture capital investments, to ensure the exemption continues to apply if an original investor acquires more shares after the relevant company is listed.

A clarifying amendment will also ensure that the references to \$1 million of expenditure include expenditure over \$1 million.

The current reference in section EX 33(4)(d) to the grey list company directly or indirectly owning a New Zealand-resident company will be clarified by referring to a majority of voting interests.

### ***Employee share purchase scheme exemption***

There is a limited exemption in section EX 33(5) for offshore shares acquired through employee share purchase schemes if there are restrictions on the disposal of shares. The current eight-year restriction on the disposal of shares will be replaced with a restriction that affects the value of shares that only needs to apply for all of the relevant income year.

### ***Access to fair dividend rate method***

Share-lending transactions (tax rules for which were enacted last year) will be disregarded for all fair dividend rate purposes. Therefore, the "share supplier" in a "returning share transfer" will be treated as holding the "original shares". The share supplier will be treated as deriving any dividend paid on the original shares (this is not taxable under section EX 47 but is taken into account in calculating "quick sale gains"). Any replacement payment will not be taxable to the share supplier.

An amendment will allow any person to apply the fair dividend rate method under section EX 44D on a daily basis and not just unit valuers as currently provided. This means that the quick sale rules will not apply to that person.

### ***Quick sales rules***

A clarifying amendment will confirm that the annual average cost basis is used for both the "peak holding adjustment" and "quick sale gains" components of the "quick sale adjustment" in sections EX 44C and EX 44D.

The reference to "quick sale gains" in section EX 44D will be amended to refer to the gains for the unit valuation period instead of the income year, to be consistent with the rest of section EX 44D.

### ***Cost method***

An amendment will allow an investor with publicly available audited accounts to use as its opening value the net asset value of its attributing interests in foreign investment funds disclosed in the audited accounts if the offshore entity also has publicly available audited accounts.

The definition of “opening value” in section EX 45B(4)(b) will be amended to require an independent valuation on entry into the cost method when a person has an old attributing interest that was previously covered by the \$50,000 minimum threshold. It would not be appropriate to allow what could be a very old historical cost to be used as the opening value.

It will also be clarified which of the paragraphs in the definition of “opening value” in section EX 45B(4) has priority in a particular case. In particular, this ensures that the independent valuation requirement in paragraph (b) applies to old grey list investments entering the cost method rather than paragraph (d).

### ***Average cost definition***

The definitions of “average cost” in the fair dividend rate and cost methods currently only take into account expenditure incurred in a particular year. This could lead to an inappropriate result in deferred purchase situations.

There is no need for the legislation to refer to the period in which the expenditure is incurred. The definitions of “average cost” in the fair dividend rate and cost methods will be amended to refer to expenditure incurred in acquiring or increasing the attributing interest during the relevant period. This will deal with deferred purchase situations.

### ***Currency conversion rules***

To provide clarity and consistency for foreign currency conversion provisions in sections EX 44C(11) and EX 44D(13), these provisions will be amended to include references to amounts derived.

### ***Credits***

An amendment to section LB 2 will ensure that a New Zealand investor is entitled to an imputation credit under the trans-Tasman imputation rules when they receive a dividend from an investment in an Australian company that is subject to the distribution exclusion in section EX 47. The amount of “gains” under the comparative value method in section EX 44 will be grossed up by the amount of this imputation credit.

### ***Change of calculation method***

Section EX 51, which deals with the consequences of changing foreign investment fund calculation methods, will be amended to include a rule for changing between the fair dividend rate and comparative value methods.

The new rules will provide that there is a deemed disposal and reacquisition of the interest at its market value at the start of the income year to which the new method applies.

### ***Changes in application of exemptions***

Clarifying amendments are being made to ensure that the deemed disposition and reacquisition that occurs when there is change in application of exemptions from the foreign investment fund rules are ignored for the purposes of the \$50,000 minimum threshold rules in sections CQ 5 and DN 6. This will ensure that the original cost basis applies.

### ***Measurement of cost***

Section EX 56(2) (requiring an average cost per income year approach) will be replaced with the previous EX 56(2), which mandates a FIFO (first-in-first-out) cost flow identification approach. This provision will be subject to sections EX 44C(12) and EX 44D(14), which require a LIFO (last-in-first-out) approach for purposes of calculating “quick sale gains” to ensure these specific provisions prevail.

### ***Family trust definition***

A clarifying amendment will be made to the family trust definition used in sections EX 40(6)(d) and EX 50(8)(c) to ensure that it also includes a testamentary trust.

### ***Transitional rules***

Offshore investments which become subject for the first time to the new foreign investment fund rules enter the new rules at their market value on the start date of the new rules. This is achieved by a deemed disposition and reacquisition under section EX 54B. A clarifying amendment will ensure that this provision applies as intended to persons intending to become portfolio investment entities and who elect to defer the start date of the new foreign investment fund rules.

Clarifying amendments are also being made to the \$50,000 minimum threshold rules in sections CQ 5 and DN 6 and the fair dividend rate method in sections EX 44C and EX 44D to ensure that the deemed transaction under section EX 54B is ignored for the purposes of these provisions.

### ***Cross-reference and terminology corrections***

In sections EX 45B(6)(c) and EX 45B(12)(c), the current reference to section EX 44C will be changed to section EX 44E.

In section EX 33B, the references to a company listed on a recognised exchange will be replaced with the correct references to shares that are listed on a recognised exchange.

## **FAMILY ASSISTANCE (WORKING FOR FAMILIES TAX CREDITS) PROVISIONS**

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The bill contains remedial technical amendments to the family assistance provisions in the Income Tax Act 2004 and gives legislative effect to the name change from family assistance to Working for Families Tax Credits.

### **Name changes**

*(Clauses 79, 86, 107, 135 of Part 1; clauses 155, 159 and 162 of Part 2; clauses 264, 268, 269, 271, 273 and 274 of Part 3, and Schedules 1 and 2)*

### **Summary of proposed amendments**

The changes replace the term “family assistance” with “Working for Families Tax Credits” to describe the package of tax credits for families. From 1 April 2007, the names Family Support, In-Work Payment, Family Tax Credit and Parental Tax Credit will be replaced with Family Tax Credit, In-Work Tax Credit, Parental Tax Credit (unchanged), and Minimum Family Tax Credit as set out in Table 1:

**Table 1**

<b>Current</b>	<b>New Names</b>
Family Assistance	Working for Families Tax Credits
Family Support	<i>family tax credit</i>
In-work Payment	<i>in-work tax credit</i>
Parental Tax Credit	<i>parental tax credit</i>
Family Tax Credit	<i>minimum family tax credit</i>

### **Application date**

The amendments will apply from the tax year beginning 1 April 2007.

### **Key features**

The grouping of the credits as family support and family plus is removed.

The names are replaced as shown in Table 1 wherever they occur in subpart KD and elsewhere as cross-references in:

- The Income Tax Act 2004
- The Tax Administration Act 1994
- The Housing Restructuring and Tenancy Matters Act 1992
- The Rates Rebate Act 1973

- The Social Security Act 1964
- The Health Entitlement Cards Regulations 1993
- The Social Security (Temporary Additional Support) Regulations 2005
- The Student Allowances Regulations 1998

The amendments to the Income Tax Act 2004, other than the amendments to subpart KD are in Part 1; the amendments to the Tax Administration Act 1994 in Part 2; the amendments to other Acts and Regulations in Part 3 and Schedule 2; and the amendments to subpart KD in Schedule 1.

## **Parental tax credit**

*(Clauses 88, 89 and 90)*

### **Summary of proposed amendments**

Under the proposed amendments, lump sum payments will be calculated as if the whole of the entitlement period, up to the maximum of 56 days, is in the year of birth when a child is born in the last 56 days of the tax year and parents choose to receive the parental tax credit as a lump sum. Currently, because the calculation formula spans two tax years, it concedes entitlement at levels of income that should extinguish entitlement.

### **Application date**

The amendments will apply from the tax year beginning 1 April 2008.

### **Key features**

The item FCA in the formula in section KD 2(2) will be modified, as applicable, by sections KD 2A(2) and KD 2B. The new sections will apply only for the purposes of calculating a lump sum entitlement to the parental tax credit at the end of the tax year for a birth that has occurred within the last 56 days of the tax year.

## **Determination of net income for the purposes of the minimum family tax credit**

*(Clause 135(29))*

### **Summary of proposed amendment**

The minimum family tax credit tops up after-tax income to an annually specified amount. Currently, the relevant provisions have the effect of deeming that tax has been paid for certain types of income when it has not been paid, and vice versa for some other items of income.

The proposed replacement definition “net specified income” in section OB 1 is intended to ensure that the minimum family tax credit is calculated from a base of after-tax income in all cases.

### **Application date**

The amendment will apply from the tax year beginning 1 April 2008.

### **Write-off of additional instalment in some years**

*(Clause 91)*

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

Because a year cannot be divided evenly into weeks or fortnights, there are some years in which more than 26 fortnightly or 52 weekly instalments fall within the tax year. The Act already provides for the automatic write-off of a 27th fortnightly instalment paid by Inland Revenue or a 53rd weekly instalment paid by the Ministry of Social Development. At the time the relevant provisions were introduced, Inland Revenue did not pay weekly interim instalments and there was an expectation the problem may be resolved before the next incidence of 27 fortnightly instalments to be paid by the Ministry of Social Development in the 2008–09 tax year.

The proposed amendments will provide an automatic write-off of a 53rd interim weekly instalment paid by Inland Revenue, or a 27th interim fortnightly instalment paid by the Ministry of Social Development in the years in which those events occur, to ensure no-one is disadvantaged.

### **Application date**

The amendments will apply from the tax year beginning 1 April 2008.

### **Key features**

The proposed amendments to section KD 7A are intended to ensure that the end of year calculation formula when there have been 53 weekly or 27 fortnightly interim instalments applies regardless of whether those interim instalments have been paid by Inland Revenue or by the Ministry of Social Development.

## **ALIGNING PROVISIONAL TAX PAYMENTS WITH GST**

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*(Clauses 102, 102, 103, 104, 105, 106, 173, 177 and 249)*

The bill contains several remedial amendments to the legislation to align the payments of provisional tax with GST payments and to provide another method of calculating provisional tax by basing payments on a percentage of their GST taxable supplies (the GST ratio method).

These amendments are required to give full effect to the policy intent of the recently enacted GST and provisional tax legislation.

### **Provisional tax payment frequency**

#### **Summary of proposed amendment**

The proposed change makes it clear that when a taxpayer ceases using the GST ratio method and elects to pay GST on a six-monthly basis they will have to make just two provisional tax payments along with their six-monthly GST payments.

#### **Application date**

The amendment applies from the start of the 2008–09 tax year, which for most taxpayers begins on 1 April 2008.

#### **Key features**

Under the current rules, taxpayers who change from paying GST monthly or two-monthly to paying GST six-monthly would no longer qualify to use the GST ratio method for calculating provisional tax. Their provisional tax payments would change from three payments to two payments to align with their six-monthly GST filing frequency. However, the current legislation still requires the taxpayer to make three provisional tax payments instead of the two payments originally intended.

The amendment to section MB 6(5) of the Income Tax Act 2004 ensures that taxpayers who change from using the GST ratio method to paying GST on a six-monthly basis will make two provisional tax payments. This is achieved by referring to the six-monthly payment dates in section MB 6(5).

### **Determining ratio percentage**

#### **Summary of proposed amendment**

When a taxpayer has an extension of time to file their tax returns and uses the GST ratio method to calculate provisional tax, their ratio is based on the latest tax and GST information available. The amendment enables taxpayers to use information which is three years old if this is the latest information available.

### **Application date**

The amendment applies from the start of the 2008–09 tax year, which for most taxpayers begins on 1 April 2008.

### **Key features**

The ratio used to determine provisional tax payments is based on figures from the taxpayer's latest income tax return, which is usually two years old. In some circumstances the latest return may be three years old, if a taxpayer has been given an extension of time (up to 31 March of the following year) to file their income tax return and Inland Revenue has not processed the return before the first provisional tax instalment date.

Section MB 7(3) of the Income Tax Act 2004 provides for the GST ratio to be based on information up to two years old, not three years old.

The amendment enables taxpayers, who have an extension of time to file their income tax return, to use information from three years earlier to calculate the GST ratio if that is the latest information available.

### **Application by phone**

#### **Summary of proposed amendment**

Taxpayers will be allowed to apply by phone to continue to use the GST ratio method in circumstances when a default is as the result of circumstances beyond their control or they have a reasonable justification for defaulting.

### **Application date**

The amendment applies from the start of the 2008–09 tax year, which for most taxpayers begins on 1 April 2008.

### **Key features**

Currently, taxpayers have the option of applying to the Commissioner for remission of penalties by phone rather than in writing.

However the current legislation requires taxpayers who have defaulted in filing their GST return to apply in writing to the Commissioner to continue to use the GST ratio method when the default was the result of circumstances beyond their control or where they have a reasonable justification for defaulting.

The bill amends section MB 15(8)(a) of the Income Tax Act 2004 to enable taxpayers to apply by phone.

## **Sale of assets**

### **Summary of proposed amendment**

Taxpayers who account for GST on a payments basis and who use the GST ratio method will be allowed to exclude asset sales (if they have received payment for the asset) when basing their provisional tax payments on a percentage of their GST taxable supplies.

### **Application date**

The amendment applies from the start of the 2008–09 tax year, which for most taxpayers begins on 1 April 2008.

### **Key features**

For taxpayers who use the GST ratio method, their GST taxable supplies figure for a two-month period is used to calculate their provisional tax liability. When the taxpayer sells a significant asset, the taxable supplies figure on which the ratio is based is adjusted to exclude the GST-inclusive proceeds from the sale of the asset. The current legislation, section MB 18 of the Income Tax Act 2004, works well for taxpayers who account for GST on an invoice basis but does not provide the correct outcome where a taxpayer accounts for GST on a payments basis.

The amendment to section MB 18(2) ensures that taxpayers who account for GST on a payments basis can only adjust for asset sales when they have received payment for the asset.

## **Late payment penalty**

### **Summary of proposed amendment**

The late payment penalty will be extended to late payments of provisional tax when the taxpayer uses the GST ratio method to calculate their provisional tax payments.

### **Application date**

The amendment applies from the start of the 2008–09 tax year, which for most taxpayers begins on 1 April 2008.

### **Key features**

The original policy intent was for all late payments of provisional tax to be subject to late payment penalties, including taxpayers who use the GST ratio method. When legislation was enacted last year, the late payment penalty provisions were not extended to cover taxpayers who use the GST ratio method and who pay their provisional tax after the due date.

The proposed amendment to section 139C(2) of the Tax Administration Act 1994 ensures that a penalty is imposed for late payments of provisional tax by taxpayers who use the GST ratio method.

Late payment penalties are only imposed on provisional tax payments after the end of the income year when the taxpayer's actual tax liability is known. This ensures penalties are not imposed on amounts that exceed a taxpayer's final tax liability.

The late payment penalty that applies to taxpayers who use the GST ratio method will also be imposed at year end, to ensure penalties do not exceed the taxpayer's final tax liability. The penalty will be based on the lower of the actual GST ratio for the year (determined when the tax return is filed) or the GST ratio that applied at the date the payment was due.

## **Special GST returns**

### **Summary of proposed amendment**

Additional time will be provided for GST-registered taxpayers to file special GST returns which are due over the Christmas and Easter periods. The new due dates will be 15 January and 7 May respectively.

### **Application date**

The amendment applies to taxable periods ending on or after 30 November 2007, in time for the amendments to apply to the 2007 Christmas period.

### **Key features**

When a registered person's goods are seized and sold to pay a debt owed by the registered person, the seller has to provide a special GST return and account for the GST on the sale of the asset. The special return is due on the 28th of the month following the month in which the sale occurred.

The extension of the GST due dates for ordinary GST returns around Christmas (due 15 January) and Easter (due 7 May) does not apply to special GST returns. To ensure consistency of due dates for all GST returns, the bill amends section 17 of the Goods and Services Tax Act 1985 to change the due date for November and March special returns to the 15th of January and 7th of May respectively.

## **Minor amendments**

### **Summary of proposed amendments**

Amendments are being made to address five minor drafting oversights and cross-referencing errors in the GST and provisional tax legislation:

- Section MB 8(6) of the Income Tax Act 2004 incorrectly refers to section MB 6. The bill removes this reference.
- Section MB 15(2) of the Income Tax Act 2004 requires taxpayers to be registered for the whole of the previous tax year in order to qualify for the GST ratio method. The reference to “tax year” is incorrect and is being changed to “income year” to reflect the intent of the legislation.
- Section MB 17(2) of the Income Tax Act 2004 incorrectly refers to subsection (3) when it should refer to subsection (5). The bill makes the necessary amendments.
- Section MB 17(4) of the Income Tax Act and section 120KE (6) of the Tax Administration Act 1994 are amended to ensure taxpayers who elect not to use the ratio method before their first provisional tax instalment are able to receive use-of-money interest on any voluntary payments made before their election.

These amendments apply from the start of the 2008–09 tax year, which for most taxpayers begins on 1 April 2008.

## **KIWISAVER – EXCLUDING CASUAL EMPLOYEES FROM THE AUTOMATIC ENROLMENT RULES**

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*(Clause 203)*

### **Summary of proposed amendment**

An amendment is being made to the KiwiSaver Act 2006 to exclude casual employees from the automatic enrolment rules.

### **Application date**

The amendment will apply from 1 April 2008.

### **Key features**

Section 12 of the KiwiSaver Act 2006 is being amended to exclude casual employees from the automatic enrolment rules.

“Casual employment” is defined by reference to the Holidays Act 2003, as employment that is “intermittent or irregular”. The effect is that if an employee is paid holiday pay regularly with their salary or wages they will be excluded from automatic enrolment. Those employees can continue to opt-in to KiwiSaver, either by providing a deduction notice to their employer or by contracting directly with a scheme provider.

The current rules will continue to apply to temporary fixed-term employment. Employees are excluded from the automatic enrolment rules if their employment contract is for a period of 28 continuous days or less. If employment was extended beyond 28 days, on day 29 the employee would then become subject to the automatic enrolment rules (as if they had started new employment). Casual agricultural workers (as defined in section OB 1 of the Income Tax Act) are also excluded from automatic enrolment. If an employee ceases to be a casual agricultural worker, the automatic enrolment rules then apply.

### **Background**

The policy intention for KiwiSaver was for employees to be exempt from the automatic enrolment rules if they were employed for a continuous period of 28 days or less. If employment was extended beyond 28 days, the employee would then become subject to the automatic enrolment rules (as if they had started new employment).

These rules are simple to apply in circumstances where employers and employees are fully aware of the length of employment when it is contracted. Employment law, however, has shown that in the case of “casual” employment, there is not continuous service between assignments. In these situations an employer would need to have a tracking system in place to determine whether an employee is employed for a continuous 28 day period.

A further problem arises when the initial contract is for less than 28 days and, before it ends, is extended beyond 28 days. Case law has shown that in these circumstances employment is considered to be one assignment, meaning that the employee should have been automatically enrolled on day one (because the contract lasts longer than 28 days). In this circumstance, employers inadvertently breach their obligations.

## **KIWISAVER AMENDMENTS**

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*(Clauses 141, 144, 200 to 202, 204 to 211, 213, 214, 218, 221, 223, 224, 226, 228 to 230, 232 to 236 and 238 to 243)*

The bill contains several remedial amendments to the Income Tax Act 2004, the Superannuation Schemes Act 1989 and the KiwiSaver Act 2006. Some are required to fine-tune the provisions to ensure they give full effect to the policy intent of KiwiSaver, while others correct minor drafting errors.

### **Fund withdrawal tax**

#### **Summary of proposed amendment**

New section CS 10B of the Income Tax Act 2004 will ensure that no permitted KiwiSaver withdrawal or no complying superannuation fund withdrawal is subject to fund withdrawal tax.

#### **Application date**

The amendment will apply from 1 July 2007.

### **Implied terms: transfers without consent**

#### **Summary of proposed amendment**

An amendment is being made to section 9BAA(1) of the Superannuation Schemes Act 1989 to ensure that the provisions in the Superannuation Schemes Act 1989 enabling transfers to alternate schemes without member consent (when the Government Actuary approves the alternate scheme as having no less favourable conditions and benefits) override any express provisions in superannuation and KiwiSaver trust deeds that prevent these transfers occurring.

#### **Application date**

The amendment will apply from the date of enactment.

### **Transfers from a complying superannuation fund to a KiwiSaver scheme**

#### **Summary of proposed amendment**

An amendment is being made to section 226(1)(b) of the KiwiSaver Act 2006 to ensure that when a person is transferred from a complying superannuation fund to a KiwiSaver scheme they will be eligible to receive the \$1,000 Crown contribution.

### **Application date**

The amendment applies from 1 July 2007.

### **Serious illness withdrawal**

#### **Summary of proposed amendment**

Amendments to clauses 12(2) and (3) of the KiwiSaver scheme rules (Schedule 1 of the KiwiSaver Act 2006) will ensure that the serious illness withdrawal facility applies only when the member is permanently and totally disabled or when death is imminent. The member will then be able to withdraw the \$1,000 Crown contribution.

An amendment to clause 13 of the KiwiSaver scheme rules also ensures that applications for withdrawal on the grounds of serious illness can be made without the need to complete a statutory declaration of the assets and liabilities of the applicant.

#### **Application date**

The amendment applies from the date of enactment.

### **SSCWT exemption and participation agreements**

#### **Summary of proposed amendment**

An amendment is being made to section 35(1)(e) of the Superannuation Schemes Act 1989 to ensure that the complying superannuation fund SSCWT exemption applies to participation agreements or schemes which replace those that were in place on 1 July 2007. However, the exemption does not apply if an employer enters into a participation agreement after 1 July 2007, if no agreement had been previously held.

#### **Application date**

The amendment applies from 1 July 2007.

### **Minor technical and drafting amendments**

A number of amendments are being made to the KiwiSaver Act to correct errors of a minor technical or drafting nature.

#### **Application date – 1 July 2007**

The following minor amendments apply from 1 July 2007:

#### ***PAYE intermediaries accepting opt-out notices***

An amendment is being made to section 17 to ensure that PAYE intermediaries can accept KiwiSaver opt-out notices.

### ***Final allocation of members to a scheme***

The amendments to sections 48 and 51 ensure that final allocation to a KiwiSaver scheme does not occur when a dispute is underway and will ensure that final allocation to a KiwiSaver scheme occurs “as soon as practicable” three months after the Commissioner received the first contribution for a person.

### ***Employer chosen schemes***

Amendments are being made to section 50 to clarify that the exemption for the Commissioner from sending an investment statement for a default scheme because an employer has a chosen scheme will apply only to employment that triggered the automatic enrolment rules.

### ***Refunds by employers by direct credit***

Amendments to section 221 clarify that the requirement to give a refund by direct credit to a bank account applies only to the Commissioner.

### ***Involuntary transfers – employer chosen schemes***

An amendment to section 57 provides that an employer choice of scheme does not apply in the case of involuntary transfers.

### ***Information packs***

Amendments to section 40 ensure that there is no inference that the Commissioner would, on an ongoing basis, forecast the number of information packs employers would need and issue them automatically. The Commissioner will regularly remind employers of the need to ensure they have adequate information packs.

### ***KiwiSaver penalties***

An amendment is being made to section 215 to ensure that a KiwiSaver penalty will not be imposed if the Commissioner has not given the employer notice within the preceding 12 months that a penalty may be, or has been, imposed.

### ***Late opt-out notices***

An amendment to section 18 ensures that the Commissioner is able to accept a late opt-out notice if it is received by the employer or the Commissioner in the period ending three months after the date on which the Commissioner received the first contribution for the person.

### ***Pro rating of employer contributions when contributions short paid***

An amendment is being made to section 99 to allow the formula providing for the pro rating of employer contributions where the contribution is short paid to consider part payments. The amendment will also clarify that if an employer contribution is short paid, no more than 100 percent of the contribution recorded for an employee is attributed to that person.

### ***Refunds of ad hoc contributions***

An amendment is being made to section 80 to allow refunds of ad hoc contributions (contributions not deducted from salary or wages).

### **Application date – date of enactment**

The following proposed minor amendments will apply from the date of enactment.

### ***Employer chosen schemes***

An amendment is being made to section 46 to ensure that an employer can have a chosen KiwiSaver scheme for its employees only if the scheme is open to all employees (whether new or existing).

### ***Delegated authority for administration of \$1,000 kickstart payment***

An amendment to section 225 removes the ability for the Chief Executive of the Ministry of Economic Development to delegate authority for administration of the \$1,000 Crown contribution.

### ***Transfers from a complying superannuation fund to a KiwiSaver scheme***

An amendment is being made to section 102 so that if a member transfers from a complying superannuation fund to a KiwiSaver scheme, the time during which they have contributed to the complying fund counts toward the time for eligibility for a contributions holiday.

### ***Mortgage diversion***

Amendments to section 229 clarify that the mortgage diversion facility may be used more than once, provided the mortgage is for the person's principal residence. Also, contributions to a complying superannuation fund can be diverted and applied towards payment of the person's mortgage, provided the same conditions that apply to KiwiSaver mortgage diversion are met.

### ***Refunds by providers to the Commissioner***

An amendment to section 81 will ensure that providers are required to refund to the Commissioner the amount of contribution that the Commissioner requests, up to the amount that is in excess of what was required to be paid under the Act.

### ***Amendments to participation agreements***

An amendment to section 129 will ensure that if trustees of a KiwiSaver scheme propose to make any changes to any participation agreement entered into between the scheme trustees and any employer, the solicitor of the scheme must provide certification that the amendment is consistent with the requirements of the KiwiSaver Act and the Superannuation Schemes Act.

### ***Involuntary transfers – unvested employer contributions***

An amendment to section 210 will specify that if an involuntary transfer arises under KiwiSaver, the amount that is transferred is, at a minimum, the member's accumulation.

### ***Wording changes***

The reference to a "superannuation scheme" in section 121(3)(a) of the KiwiSaver Act 2006 is being replaced with the term "KiwiSaver scheme".

A provision will be inserted in section 123 of the KiwiSaver Act 2006 requiring the provision of the annual report to the Government Actuary in accordance with section 14(3) of the Superannuation Schemes Act. Regulation 6 will be amended and Regulation 7 of the KiwiSaver Regulations 2006 will be revoked, as they deal with the requirement to provide an annual report and will be redundant.

### **Application date – 1 April 2008**

The following proposed minor amendment will apply from 1 April 2008.

### ***Application of Act***

An amendment to section 6 will provide that the KiwiSaver Act 2006 applies to people who, at the time they become subject to automatic enrolment or opt in are, or normally are, living in New Zealand.

## **LARGE BUDGET SCREEN PRODUCTION GRANTS**

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*(Clauses 32 and 41 to 44)*

### **Summary of proposed amendments**

Remedial amendments are being made to ensure that provisions in the Income Tax Act 2004 relating to the tax treatment of large budget screen production grants reflect their policy intention. Deductions should be allowed for costs incurred in acquiring or producing a film, irrespective of whether a large budget screen production grant is paid.

### **Application date**

These amendments will apply from the 2005–06 income year, the same application date as the Income Tax Act 2004.

## MISCELLANEOUS TECHNICAL AMENDMENT

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### **Taxable bonus issue definition**

#### ***(Clause 258(3))***

The definition of “taxable bonus issue” in the Income Tax Act 1994 is being amended to align it with the tax treatment of bonus issues in the Income Tax Act 2004. The new definition recognises that taxable issues that are exempt dividends in the hands of shareholders can be treated as taxable bonus issues, but only if they are restricted to the value of the reserves capitalised.

The amendment applies from 16 November 2004, the date when equivalent changes were made in the 2004 Act.