

Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill

Commentary on the Bill

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Minister of Revenue

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Livestock valuation

OVERVIEW

The proposals in the bill further expand on legislation in Budget 2012 that provided that elections to use the herd scheme to value specified livestock are irrevocable unless an election to exit was made before 18 August 2011. This Budget 2012 legislation followed the release of the officials' issues paper, *Herd scheme elections*, on 18 August 2011 and the subsequent consultation.

There are generally two ways that farmers can value their livestock (mainly beef and dairy cattle, and sheep (but also deer, goats and pigs)), at balance date for tax purposes.

The herd scheme treats livestock more as if they were a capital asset by using *national average market values* (commonly called "herd values") with changes in values from year to year on tax-free capital account.

National standard cost or NSC is similar to a typical trading stock scheme where changes in values from year to year are on tax account. The major difference from a standard trading stock scheme is that on-farm costs for breeding, rearing and growing home-bred livestock are, for simplicity, standardised nationally.

As could be expected for a home-breeding operation, herd values generally exceed NSC. This difference is tax-deductible to a farmer who elects to exit the herd scheme, usually over about six years as replacement livestock are home-bred. It is this difference that gives rise to the tax advantage that was addressed in the Budget 2012 legislation.

Further, farmers could elect out of the herd scheme with a short advance notice period.

However, there can be legitimate reasons for electing out of the herd scheme. This is particularly the case when there is a change in a farming regime from breeding to fattening for which a cost-based regime is more natural. The proposals in the bill will explicitly recognise this by allowing an election to exit the herd scheme for a type of livestock when there has been a change to a fattening regime.

Section EC 20 of the Income Tax Act 2007, which presently provides for an election to be made about which herd values to use when the farmer has sold up and ceased farming before 1 February of a year, will be amended. The use of section EC 20 will be compulsory when the sale occurs before 1 November of a year, except when the sale is to an associated person.

The proposed new rules will require persons who acquire livestock from an associated person to use that associated person's herd scheme election and base herd numbers, if any. This associated persons' rule will apply to matrimonial property settlements and to the tax consequences of death. Therefore section EC 21, which currently deals with death in some circumstances, will be repealed.

There will be an exception to this for inter-generational disposal if the vendor ceases farming and the children or grandchildren previously had no interest in the livestock.

The Friesian and Jersey dairy classes, and Red and Wapiti deer classes will be combined. Currently, the line between these classes is not clear, making this change the simplest and most appropriate response.

EXCEPTION TO HERD SCHEME ELECTIONS BEING IRREVOCABLE

(Clauses 28(1) and 29)

Summary of proposed amendments

Section EC 8 of the Income Tax Act 2007 contains some of the rules concerning restrictions on the use of the herd scheme. When a farmer has elected to use the herd scheme, unless that election was revoked before 18 August 2011, a Budget 2012 amendment to section EC 8 provided that it cannot be subsequently revoked. The current bill rewrites section EC 8 so that the restrictions on the use of the herd scheme and exceptions from those restrictions are clearer.

As part of this, a new exception to the Budget 2012 amendment is proposed in clause 28(1) and will allow a farmer to elect to exit the herd scheme when they change to a fattening regime because a cost-based valuation regime much more naturally suits a fattening operation. Clause 29 amends section EC 11 to provide that this is by way of a “same year notice”.

Other changes are also proposed to section EC 8 by way of clause 28(2) – these are discussed separately.

Application date

The rewrite to section EC 8 will apply from 18 August 2011, the date the Budget 2012 legislation on irrevocability applies from.

Key features

It is proposed that section EC 8 be rewritten to more clearly set out its intent as follows:

- Subsection (1) will re-enact the Budget 2012 irrevocability legislation.
- Subsection (2) will contain the exception to this, which is for a change to a fattening regime.
- Subsection (3) will re-enact the “alternative valuation option” which allows that increases in the number of a class of livestock for which a herd scheme election has been made do not need to be valued under the herd scheme.
- Subsection (4) will re-enact the requirement that where the herd scheme has been chosen for a type of livestock, the male breeding stock must be valued under the herd scheme (this is an exception to subsection (3)).

The subsection (2) exception to the irrevocability rule applies to a type of livestock for which a herd scheme election is in place and allows for a one-off election to be made to exit the herd scheme. This is in the year that the female breeding livestock are intended to cease being used for breeding purposes and when the livestock of that type are used in a fattening farming business.

Clause 29 proposes to amend section EC 11(2) to allow the farmer to give same-year written notice of the change with the tax return for the year.

CESSATION OF FARMING – GENERAL RULE

(Clause 30)

Summary of proposed amendments

Section EC 20 of the Income Tax Act 2007 will be amended to provide that when a farmer completely sells their specified livestock before 1 November of a year and ceases deriving income from the disposal of specified livestock, they do not complete the herd scheme adjustment to opening livestock for that year. This date is about half-way between the annual mid-May announcements of the herd values, and so provides a more reasonable basis of valuation of opening herd scheme livestock in the year of the sale.

Currently, this section is optional so long as the farmer qualifies, which provides farmers with a tax opportunity. By making it compulsory, appropriate certainty is provided to both farmers and to the Government.

An exception is noted in section EC 1B where the disposal is to an associated person. This is discussed separately below.

Application date

The amendment is effective from 28 March 2012 (in practice, from the 2012–13 income year).

DISPOSAL OF LIVESTOCK TO AN ASSOCIATED PERSON

(Clauses 26, 28(2), 31, 57(8) and (11))

Summary of proposed amendments

New section EC 4B of the Income Tax Act 2007 will provide that the acquirer will be required to use the disposer's herd scheme elections and base numbers, if any, if the two parties are associated persons. This is to prevent an associated person's disposal being used to circumvent an election to use the herd scheme.

An exception will be made if there is an inter-generational disposal in certain circumstances. To qualify, children or grandchildren must have had no direct or indirect interest in income from the livestock before the transaction (as a discretionary beneficiary or otherwise) and the disposer will be required to cease farming and have no remaining interest in income from the disposal of the livestock after the transaction.

Proposed new section EC 4B will contain the core associated person's transaction rule and the inter-generational exception. Section EC 8 will be amended so that when a farmer has acquired herd scheme livestock from an associated person, the "alternative valuation" rule works by increasing the minimum number of livestock the farmer is required to have to be in the herd scheme.

Application date

The amendments will apply from 28 March 2012, the date they were announced.

Key features

Subsection EB 4B(1) proposes that the section applies when livestock that otherwise would have been valued under the herd scheme are transferred to an associated person other than in the ordinary course of business.

Subsection (2) proposes that an exception applies when the transfer is inter-generational and the "person" making the transfer is either the parents or the grandparents of the person receiving the livestock. The major requirements will be that:

- the person making the transfer ceases owning and earning income directly or indirectly from the disposal of specified livestock as a result of the transfer; and
- before the transfer, the person receiving the livestock had no direct or indirect interest in the livestock except through the blood relationship with their parents or grandparents.

The sale or other disposal by a dairy farmer of dairy cows to his or her children who then begin 50/50 sharemilking would typically qualify for the exception (because the transferor would not be receiving income from the disposal of specified livestock). Likewise, earning interest or rent from the new farming enterprise would also typically qualify for the exception.

However, because of the common use of companies (or sometimes, trusts) for farming purposes, this exception is conceptually complex. It applies to a transfer by an entity associated with the parents or grandparents so long as the children or grandchildren have no association with the entity (for example, they aren't shareholders or beneficiaries) other than by way of the blood relationship they have with their parents or grandparents.

Likewise, the transferee can be an entity associated with the children or grandchildren so long as the parents or grandparents have no association with the entity other than by way of the blood relationship they have with their children or grandchildren.

Subsection (3) proposes that, when section EC 4B applies, the transferee is considered to have made an election to use the herd scheme.

Subsections (4) and (5) contain the mechanics of the section, as follows:

- The classes of livestock transferred to the associated person are classified into the classes they would have been in at the end of the transferor's income year if the transferor still had them on hand.
- The actual number of livestock of that class that the transferor has on hand at the end of that income year is increased by the reclassified number transferred to the associated person determined immediately above.
- Then the transferor's actual number of livestock on hand at the end of this year is subtracted from the lesser of the adjusted number on hand determined immediately above and the number actually on hand at the end of the last year.

If positive, any base "alternative valuation" number that the transferee has from the previous year will be increased by this amount. This increase in base number is effected by clause 28(2), which proposes new subsections EC 8(3) and (4) (and subsection EC 8(4) (part of the 18 August 2011 rewrite of section EC 8) is renumbered subsection EC 8(5)).

The inter-generational exception is handled by way of new definitions of "descendant" and "descended associate" in sections EC 4B(6) and YA 1.

The associated persons rules will apply to subparts FB (matrimonial property transactions) and FC (death and distributions).

Section EC 21 will be consequentially repealed.

Examples of the associated persons rule and its inter-generational exception

Example 1: Associated persons rule

Joe has 250 mixed age (MA) dairy cows on hand that he sells to Joe Farm Limited, a company he owns. Joe would have had to value these cows in the herd scheme at year-end if he hadn't sold them.

Regardless of how it values any other livestock it might own, Joe Farm Limited must value these 250 MA dairy cows in the herd scheme and, if necessary, will be deemed to have made an election to use the herd scheme in the year of acquisition. Joe Farm Limited will be, for the purposes of what is called the "alternative valuation method", be deemed to have a minimum number of herd scheme livestock on hand at the end of last year and will be required to have regard to that minimum number at year-end.

Further, Joe will have to make an opening herd scheme livestock adjustment so that the tax values that Joe and Joe Farm Limited are the same in the year of the sale. This neutralises any taxation impact.

For example, Joe Farm Limited might already own 450 MA dairy cows and have valued 300 of those in the herd scheme at the end of the previous year. Joe Farm Limited will be required to value 550 (300 + 250) MA dairy cows in the herd scheme at year-end.

Example 2: Inter-generational exception

Jill Farm Limited is solely owned by Jill, the daughter of Jack. Further, Jack is ceasing farming as a result of the sale of his 250 dairy cows to Jill Farm Limited. So long as Jill Farm Limited makes the appropriate election, Jill Farm Limited may value the 250 dairy cows using the national standard cost regime under the inter-generation exception to the associated persons rule.

Jack may leave part of the purchase price in and derive interest on this and, as well, may work for Jill Farm Limited for wages (so long as these arrangements did not amount to profit sharing). Further, Jill Farm Limited and Jack could enter into a 50/50 sharemilking arrangement. None of these transactions will disturb the inter-generational exception.

The key point is that Jill Farm Limited and Joe are not associated persons except for the blood relationship between Jack and Jill. However the exception would not be available if Jack was also a shareholder in Jill Farm Limited, or a beneficiary of a trust that was a shareholder, as both of these ownership models would make him an associated person of Jill Farm Limited other than by the blood relationship.

LIVESTOCK CLASSES

(Clause 59)

Summary of proposed amendment

During submissions on the 18 August issues paper, *Herd scheme elections*, it became clear that there was confusion (and according to some, opportunity) around the boundary between Friesian and Jersey cattle, and Red and Wapiti deer. Combining these deer and cattle classes was suggested to address this.

To address these concerns, the weighted average figures will be used to determine values in the future. At the margin, the value of Friesian cattle will decrease and Jersey values will increase, and the same will apply to Wapiti and Red deer. However, over the life of a farming enterprise these amounts will be immaterial.

Application date

The amendment will apply to values declared in May 2013 for the 2012–13 income year.

Assets expenditure

OVERVIEW

Some assets, such as holiday homes, aircraft and boats are often used to earn income for their owners and are also used privately. These are commonly referred to as mixed-use assets.

Currently, the tax rules allow deductions for expenditure incurred in earning taxable income and disallow deductions for expenditure that relates to the private use of an asset. However, these rules can be difficult to apply to expenditure that does not clearly relate to either the income-earning or private use of an asset. Examples include expenditure that arises while a holiday home, boat or aircraft is unused, and expenditure on general repairs and maintenance.

The general presumption is that owners will claim that their asset is available for income-earning use while the asset is not being used privately. This provides them with a basis for claiming tax deductions for expenses relating to this period. However, if the asset is primarily used privately, or the income-earning and private use is relatively equal, the level of deductions owners can claim is often not aligned with the actual income-earning use of the asset.

The bill proposes new rules that prescribe the amount of deductions that owners of certain assets can claim. Generally, the rules will apply to assets used to earn income, are used privately and are unused for more than 62 days in an income year. The rules apportion general expenditure on the basis of actual income-earning use divided by the total actual use of the asset. The resultant expenditure will be an allowable deduction.

The proposed new rules are designed to improve fairness in the tax system by ensuring that tax deductions are broadly aligned with the income that is earned. They are also intended to increase economic efficiency by reducing the extent to which investment in such assets is driven by tax considerations.

The proposed new rules have been developed in response to submissions received in response to the officials' issues paper, *Mixed-use assets*, released in August 2011 and subsequent consultation with interested parties.

APPLICATION OF THE RULES

(Clauses 19 and 35)

Summary of proposed amendments

The new rules will apply to assets that are used to earn income, are used privately and unused for a period during the year. Assets typically used in this way are holiday homes, boats and aircraft. Expenditure on motor vehicles and assets that are subject to apportionment of expenditure based on space (such as a room used as an office) is excluded from the new rules.

The new rules will apply to assets held in a range of structures, such as assets held by individuals, partnerships, trusts and certain companies.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

The new rules will apply to all forms of ownership, whether the asset is held by an individual, a trust, a partnership or a company. However, when the asset is held in a company the rules will only apply to close companies.

Only assets that are used in a particular way will be subject to the new rules. New section DG 3 states that assets will be within the rules if they are:

- used to earn income;
- used privately; and
- not used for at least 62 days (62 working days if the asset is typically only used on work days) in an income year.

An asset used in this way will not be subject to the new rules unless it is land (including improvements to land) or has a cost greater than \$50,000 (“cost” refers to the cost of the asset to the person).

Section DG 3(2) excludes from the rules motor vehicles and assets when existing methods of apportioning expenditure based on space are used. For example, a person who uses a room in his or her family home for business purposes will still be required to apportion expenditure on a floor area basis.

“Private use” is defined in the new rules under section DG 4. Private use includes use, regardless of whether market value is paid, by the person who holds the asset or a person who is associated with that person. For the purposes of these rules, associated persons include a partner, siblings, parents, children, grandparents and grandchildren. However, private use will not include use by the person if the asset is of a type that requires expert or specialist knowledge in order for it to be used, the person uses it in

that capacity, the income derived directly or indirectly from the use is at market value, and the income derived includes an amount paid for the services of the person. For example, a helicopter used by the owner, for the owner's commercial farming operation, would not be considered to be private use.

Any use at below market value will also be regarded as private use of the asset. Market value is considered to be the price for the use of an asset at a particular time in an open market, freely offered, made on ordinary terms, and to a member of the public at arm's length.

Background

Under current legislation a person is allowed a deduction for expenditure incurred in earning income or in the course of carrying on a business. No deduction is allowed, however, if the expenditure is private or domestic in nature.

These two general rules are difficult to apply to expenditure that has both income-earning and private elements. This type of expenditure often arises when assets such as holiday houses, aircraft and boats are used partly to earn income, partly used privately, and are unused for a portion of the year.

Example

A holiday house is used by the owner and the owner's family for 30 nights and rented out for 30 nights in an income year.

There is no concern about the owner claiming deductions for expenditure which directly relate to the 30 nights the house is rented out. It is equally clear that no deductions can be claimed for expenditure that directly relates to the 30 nights when the house is used by the owner and the owner's family.

However, it is unclear to what extent the owner can claim a deduction for expenditure that arises when the house is not in use, or expenditure that does not clearly relate to either the income earning or private use of the house, such as repairs and maintenance. Present rules presume that provided the asset is "available for income-earning use", the associated expenditure is deductible.

Consequently, the new rules focus on assets that are used to earn income, that are used privately and are unused for a period during the year. They do not apply to assets where existing rules provide a reasonable basis for apportioning expenditure – such as motor vehicles, that are subject to fringe benefit tax or the log book rules. Further, the rules will not apply when rules and existing practice operate to apportion expenditure based on floor area.

Since assets used in this way can be held in various entities, the rules apply to a range of entities types and structures. The new approach is intended to avoid creating an incentive for owners to shift assets from one entity type to another to achieve a more favourable tax outcome. However, when such assets are owned by companies, this has led to complex and detailed rules, particularly for interest apportionment.

FULLY DEDUCTIBLE EXPENDITURE

(Clause 19)

Summary of proposed amendments

Expenditure will be fully deductible if it is incurred only to derive income from the asset and delivers no private benefit, or is incurred to meet regulatory requirements.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

Expenditure will be fully deductible under section DG 7 if it relates solely to using the asset for deriving income and is either:

- incurred to earn income, and cannot reasonably be expected to deliver any private benefit – for example, advertising expenditure; or
- a reasonable amount and incurred to meet a regulatory requirement that enables the owner to earn income from the asset and would not have been incurred but for the requirement. For example, if all the conditions are met, Maritime New Zealand survey costs that boat owners must incur so they can charter out their own boats would be fully deductible under this rule.

Expenditure that is fully deductible does not include expenditure on repairs and maintenance.

Background

It is intended that the majority of expenditure incurred in relation to assets subject to the new rules will be apportioned. However, there are circumstances when apportioning expenditure would be inappropriate. For example, the costs associated with advertising an asset for rental use deliver no material private benefit and therefore should not be apportioned. Consequently, these costs will remain fully deductible. However, any costs that can be reasonably expected to deliver a private benefit, such as installing a new television, will not be fully deductible. Expenses of this type will typically be apportioned or a deduction will be denied completely if they only deliver a private benefit.

Some costs must be incurred to meet regulatory requirements in order to earn income from an asset. For example, certain boats must undergo Maritime New Zealand surveys before the boat is legally allowed to be chartered out. These costs would not normally have been incurred but for the income-earning use of the asset. Consequently, these costs will be fully deductible. However, these costs cannot exceed what would normally be considered reasonable to meet these requirements, nor will they be fully

deductible if the owner would have incurred the cost anyway. For example, if an owner of a boat purchases equipment required by regulation in order for the boat to be chartered, and the items purchased are of a higher quality than required under the regulations (and therefore more expensive), the owner can claim a full deduction for the amount up to the amount that is reasonable to meet the requirement for the equipment. The additional cost would be apportioned, as discussed later in this Commentary.

APPORTIONMENT OF MIXED-USE EXPENDITURE

(Clause 19)

Summary of proposed amendments

This is the key element of the proposed new rules. Expenses which are neither solely private in nature nor eligible to be deducted in full will be required to be apportioned by dividing the income-earning use by the total use (income-earning use plus private use) of the asset. The resulting amount will be an allowable deduction.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

Section DG 8 applies to apportion the expenditure incurred by persons that hold a mixed-use asset and section DG 9 sets out the method for apportioning expenditure relating to the asset. Under section DG 9(2), the amount of deductible expenditure, including depreciation, will be calculated as:

$$\text{Expenditure} \times \frac{\text{Income earning days}}{\text{Income earning days} + \text{private days}}$$

Example

A boat is chartered for 30 days and used by its owners for 30 days. Fifty percent of the general expenditure will be deductible (30 days income-earning use / 60 days total use).

The expenditure subject to the formula is the total expenditure incurred minus purely income-earning expenditure under section DG 7 (discussed earlier) and purely private expenditure.

“Income-earning days” is defined in section DG 9(3)(b) as the total number of days or other appropriate unit the asset is used to earn income at or above market value. This excludes any days on which the asset is used by the owner, unless that use is an incident of ordinary commercial use (as described in the definition of private use under section DG 4).

“Private days” is defined in section DG 9(3)(c) as the total number of days or other appropriate unit the asset is in active use and is not regarded as an income-earning day. For example, days when the owner of a holiday home rents it out to friends and family at below market value will be regarded as private-use days.

Example

The owner of a boat uses the boat for private enjoyment. The owner also charters the boat to unrelated parties on an arm's-length basis. The unrelated parties pay market value and the owner skips the boat during the time the boat is chartered. The owner's private use of the boat is not regarded as an income-earning day and is, therefore, regarded as a "private-use day". The chartering to unrelated parties is regarded as an "income-earning day", even though the owner skips the boat, as the type of use by the owner is part of the ordinary commercial use of the boat.

The unit of measurement used in the formula is a unit that achieves the most appropriate apportionment of expenditure. This might be by reference to days, nights, or hours depending on the asset and how that asset is used.

Example

The owner of a holiday home rents it out during the year. The owner charges rent by reference to the nights it is occupied. Consequently, the appropriate unit of measurement the owner should use in the formula is nights.

INTEREST EXPENDITURE

(Clauses 15, 16, 17, 19 and 66)

Summary of proposed amendments

The proposed new rules require that when a close company holds an asset subject to the rules, any interest expenditure incurred in relation to debt within the company, where the debt is equal to or less than the cost (or rateable value if land) of the asset, will be subject to apportionment.

If the debt within the company is less than the cost of the asset, the rules may require group companies, corporate shareholders and non-corporate shareholders, if applicable, to apportion interest on the shortfall of debt.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

Sections DG 11, DG 12, DG 13 and DG 14 contain the rules that track interest expenditure within and outside of close companies that hold mixed-use assets.

Asset-holding company

Section DG 11 applies to a close company that holds a mixed-use asset. It requires the company to compare the value of its interest-bearing debt to the value of the mixed-use asset. Interest on debt that is equal to or less than the value of the mixed-use asset is apportioned, under the apportionment formula in section DG 9(2). Interest on debt that exceeds the value of the asset would be subject to existing interest deductibility rules.

The asset value is either the cost of the asset or, in the case of land, the rateable value (or its cost on acquisition, if that occurs later). The company's debt value is the average outstanding amount of debt at the beginning and end of the year.

Example

Company A holds a mixed-use asset with a cost of \$100,000. The company has a total interest-bearing debt of \$75,000. The company is required to apportion the interest expenditure on the \$75,000 of debt.

Company B holds a mixed-use asset with a cost of \$100,000. The company has a total interest-bearing debt of \$150,000. The company must apportion the average interest expenditure on the \$100,000 of debt. Interest on the remaining \$50,000 is subject to existing interest deductibility rules.

If the company’s interest-bearing debt is less than the value of the asset, that shortfall is referred to as the “net asset balance”. Using the first example above, Company A has a net asset balance of \$25,000 (\$100,000 – \$75,000).

Group companies

If there is a net asset balance after the application of section DG 11, section DG 12 applies to apportion interest expenditure incurred by group companies, if that is applicable.

A group company is defined by reference to the loss grouping rules, being a company that has a 66 percent common voting interest in the company that holds the mixed-use asset. The group of companies is also treated as a wholly owned group.

Section DG 12 requires group companies to compare the value of its interest-bearing debt to the net asset balance. Interest on debt that is equal to or less than the net asset balance is apportioned, under the apportionment formula in section DG 9(2). Interest on debt that exceeds the net asset balance would be subject to existing interest deductibility rules.

Example

Building on the earlier example, Company A is 100 percent owned by another company (Group Company). The Group Company has total interest bearing debt of \$10,000. Company A attributes the net asset balance of \$25,000 to the Group Company. Group Company must apportion all of its interest expenditure.

Group Company	100%	Debt: \$10,000 Interest required to be apportioned: \$10,000
Company A		Net asset balance: \$25,000

The net asset balance reduces by the amount of debt in relation to which interest is required to be apportioned. Using the example above, the net asset balance is now \$15,000 (\$25,000 – \$10,000).

Section DG 12 applies to all group companies until the net asset balance is reduced to zero, or there are no longer any group companies in relation to which interest can be apportioned.

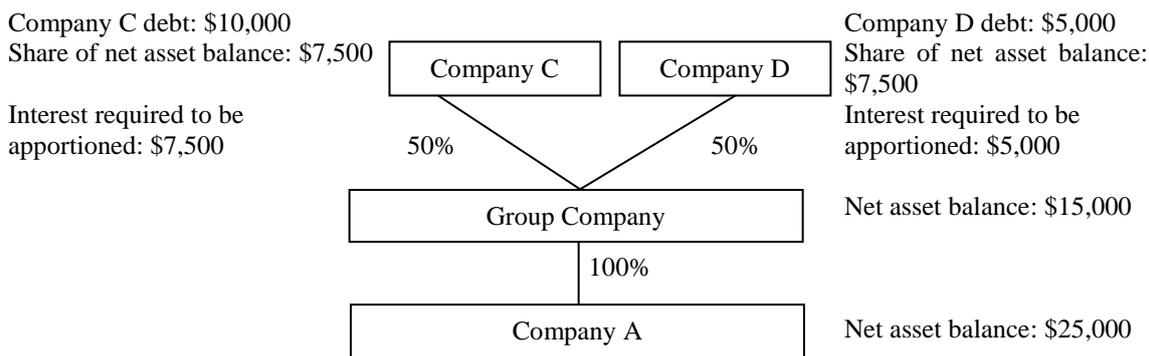
Corporate shareholders

If after the application of sections DG 11 and DG 12 a net asset balance remains, section DG 13 applies to apportion interest expenditure incurred by corporate shareholders that are not group companies. It requires corporate shareholders to compare the value of the company’s interest-bearing debt to the shareholder’s share of the net asset balance. Interest on debt that is equal to or less than the shareholder’s share of the net asset balance is apportioned, under the apportionment formula in section DG 9(2). Interest on debt that exceeds the shareholder’s share of the net asset balance would be subject to existing interest deductibility rules.

The shareholder's share of the net asset balance is the shareholder's voting interest, or market value interest (if applicable) expressed as a percentage multiplied by the net asset balance.

Example

Building on the previous example, Group Company has two corporate shareholders, Company C and Company D who have total interest-bearing debt of \$10,000 and \$5,000 respectively. Each company's share of the net asset balance is \$7,500 (\$15,000 x 50 percent). Therefore, Company C is required to apportion interest in relation to \$7,500 of debt, and Company D is required to apportion interest in relation to \$5,000 of debt.



The shareholders' share of the net asset balance reduces by the amount of debt in relation to which interest is required to be apportioned. Using the example, above Company C's share of the net asset balance is reduced to zero, and Company D's share of the net asset balance is reduced to \$2,500 (\$7,500 – \$5,000).

Section DG 13 applies first to corporate shareholders that have a shareholding in the close company that holds the asset, and corporate shareholders that have a shareholding in a group company that has a voting interest in the close company that holds the asset. If a net asset balance remains, the section then applies to their shareholders, and so on, until the net asset balance is reduced to zero, or there are no longer any corporate shareholders in which interest can be apportioned.

Non-corporate shareholders

If after the application of sections DG 11, DG 12 and DG 13, a net asset balance remains, section DG 14 applies to apportion interest expenditure in relation to interest-bearing debt held by non-corporate shareholders. It requires non-corporate shareholders to compare the value of its interest-bearing debt to the shareholders' share of the net asset balance. Interest on debt that is equal to or less than the shareholders' share of the net asset balance is apportioned, under the apportionment formula in section DG 9(2). If the non-corporate shareholder is an individual (natural person), the interest expenditure that is subject to apportionment is only the interest expenditure incurred to purchase shares in the company.

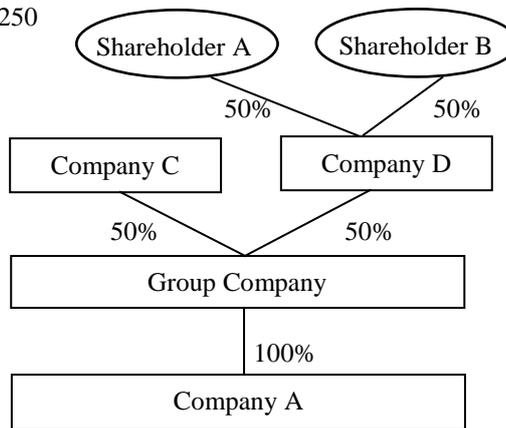
Example

Building on the previous example, Company D has two natural person shareholders. Shareholder A borrowed \$1,000 and Shareholder B borrowed \$10,000 to purchase 50 percent each of Company D. Shareholder A and Shareholder B's share of the net asset balance is \$1,250 each (\$2,500 x 50 percent). Shareholder A is required to apportion interest in relation to \$1,000 of the debt that was incurred to purchase a share in Company D, and Shareholder B is required to apportion interest in relation to \$1,250 of the debt that was incurred to purchase a share in Company D.

Shareholder A debt: \$1,000

Share of net asset balance: \$1,250
Interest required to be apportioned: \$1,000

Net asset balance: \$0



Shareholder B debt: 10,000

Share of net asset balance: \$1,250
Interest required to be apportioned: \$1,250

Net asset balance: \$2,500

Net asset balance: \$15,000

Net asset balance: \$25,000

Since Company C's net asset balance is zero, the rules do not require further interest expenditure to be apportioned by Company C's shareholders.

Notification

To enable the operation of sections DG 11, DG 12, DG 13 and DG 14, new section 30D of the Tax Administration Act 1994 requires companies to provide their shareholders with information to enable them to calculate the correct amount of allowable interest expenditure.

Background

Interest expenditure relating to mixed-use assets is an expense which must be apportioned like any other. This is straightforward for entities that are not companies. Tracing rules are currently used to identify interest expenditure that is related to the mixed-use asset for entities other than companies. The rules work by identifying what money has been borrowed and look at how that money has been applied. The proposed new rules apply the same approach to interest deductions incurred by entities that are not companies.

However, two specific issues arise when mixed-use assets are held in companies. The first issue arises because current legislation provides that all interest incurred by companies is fully deductible, unless a specific limitation applies. Consequently, rules are required to track interest on debt in companies and allocate it to mixed-use assets so it can then be apportioned. If this were not done, mixed-use assets funded by debt could be shifted into companies to avoid the apportionment of interest expenditure.

The second issue arises because an alternative to the company borrowing funds to acquire the asset is for a shareholder to borrow money and use it to subscribe for shares in the company. The overall economic effect is the same – funds have been borrowed and used to acquire a mixed-use asset – but the borrowing is outside the company. Without specific rules, interest on such debt would be outside the apportionment rules. Current law typically provides a deduction when funds are borrowed to acquire shares.

To ensure that this kind of structuring is not used to circumvent the proposed new rules, and to capture all relevant interest deductions when complex structuring has been entered into for other commercial reasons, the new rules will track interest incurred by the company's shareholders and other companies which could loss-group with the company which owns the asset.

QUARANTINING EXCESS EXPENDITURE

(Clause 19)

Summary of proposed amendments

Broadly, the new rules will quarantine excess expenditure when the gross income derived from the asset is less than 2 percent of the cost of the asset. The quarantined expenditure will be denied as a deduction in the current income year and can be used in a later year when there are sufficient profits derived from the asset.

The new rules will apply to quarantine expenditure incurred by the person who holds the asset, group companies, corporate shareholders and non-corporate shareholders.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

New sections DG 16 and DG 18 contain the rules that quarantine excess expenditure. The rules apply when the gross income derived from the asset, excluding income from associated persons, is less than 2 percent of the cost of the asset or, in the case of land, the rateable value (or its cost on acquisition, if that occurs later).

“Excess expenditure” is defined as the amount of apportioned deductions and previously quarantined amounts that exceed the income derived from the asset. Excess expenditure can be incurred by the person or company that holds the asset, group companies, corporate shareholders and non-corporate shareholders.

Section DG 16 – Asset-holding person or company

Section DG 16 applies to the person or company that holds the asset. It operates to quarantine excess expenditure that would otherwise be deductible in years when the person’s gross income from the asset is less than 2 percent of the cost or, in the case of land, the rateable value (or its cost on acquisition, if that occurs later). Excess expenditure is the amount by which the person’s total deductions under sections DG 7, DG 8 and DG 11, plus previously quarantined amounts exceed the income derived from the asset (including income from associates).

The excess expenditure is denied as a deduction in that year and cannot be used to offset income from other sources. The quarantined expenditure must be carried forward and may be an allowable deduction in future years if the requirements of section DG 17 are met. (This is discussed in more detail later in this Commentary.)

Example

Company A owns a mixed-use asset that costs \$500,000 and derives \$5,000 from non-associates and \$6,000 from associates for the use of the asset in an income year. Expenditure in that income year (after apportionment) is \$12,000. Therefore, Company A has \$1,000 of excess expenditure (\$12,000 – \$11,000). Since the income from the asset, excluding income of \$5,000 from associates, is less than 2 percent of the cost of the asset, the excess expenditure incurred by Company A is quarantined and denied as a deduction in the current year. The amount quarantined may be an allowable deduction in a later income year if the requirements of section DG 17 are satisfied.

It is possible for a company that holds a mixed-use asset to be in profit, but for the activity to be in overall loss (because group companies and/or shareholders' interest deductions exceed the company profit). In this situation, no expenditure incurred by the company will be quarantined. However, section DG 18 may apply to quarantine apportioned interest expenditure incurred by group companies and/or other shareholders.

Income derived from the asset that exceeds the deduction allowed under sections DG 7, DG 8 and DG 11 (including previously quarantined amounts), is referred to as the "outstanding profit balance". The outstanding profit balance is then used in section DG 18 to determine how much group company or shareholder-apportioned interest expenditure will be quarantined.

Section DG 18 – Group companies and other shareholders

Section DG 18 applies to quarantine excess interest expenditure incurred by group companies (under section DG 12) and other shareholders (under sections DG 13 and DG 14) when the income derived from the asset is below the percentage threshold.

The amount quarantined is the amount of interest expenditure calculated under sections DG 12, DG 13 and DG 14 (including previously quarantined amounts), which exceeds the outstanding profit balance (or person's share of the outstanding profit balance if the person is not a group company), calculated under section DG 16. The shareholder's share of the outstanding profit balance is the shareholder voting interest, or market value interest, if applicable, expressed as a percentage multiplied by the outstanding profit balance.

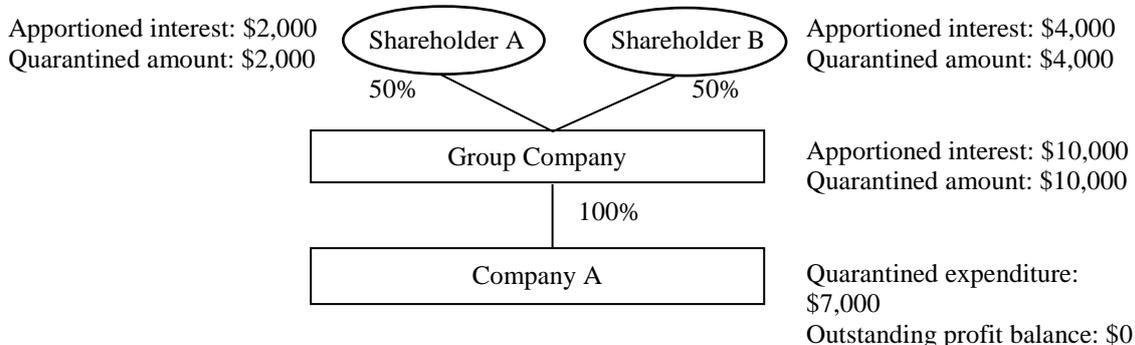
If the outstanding profit balance is zero under section DG 16, all of the group companies' and other shareholders' interest expenditure identified under sections DG 12 to DG 14 will be quarantined.

Section D 18 first applies to group companies, until no other group companies exist that have apportioned interest expenditure, and then to other shareholders, until no other shareholders exist that have apportioned interest expenditure. As each group company or shareholder applies the section, the outstanding profit balance reduces by the amount of apportioned interest expenditure that is not required to be quarantined.

The example below demonstrates the application of section DG 18 when the outstanding profit balance is zero:

Example

Building on the previous example, Company A is 100 percent owned by another company (Group Company). The Group Company has apportioned interest expenditure under section DG 12 of \$10,000. Group Company has two equal natural person shareholders, Shareholder A and Shareholder B who have apportioned interest expenditure under section DG 13 of \$2,000, and \$4,000 respectively. As Company A's expenditure exceeded the income derived from the mixed-use asset, the outstanding profit balance is zero, and therefore, Group Company, Shareholder A and Shareholder B are required to quarantine all of their apportioned interest expenditure.



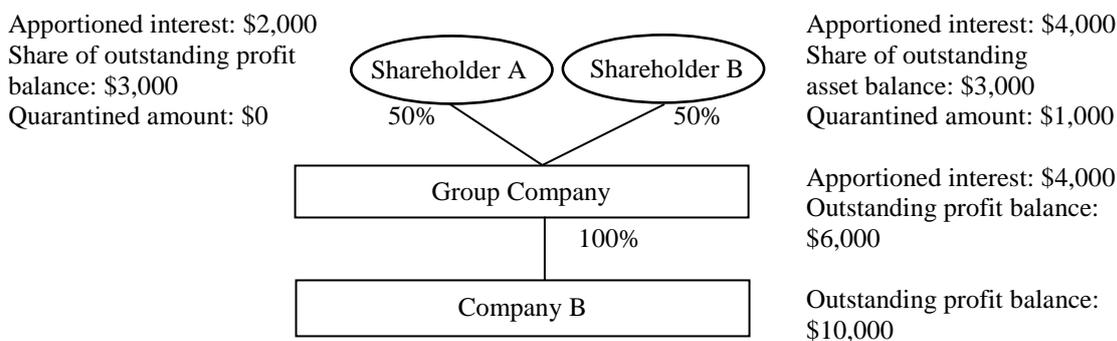
The example below demonstrates the application of section DG 18 when an outstanding profit balance has been calculated under section DG 16:

Example

Company B has an outstanding profit balance of \$10,000. Company B is 100 percent owned by Group Company, which has apportioned interest expenditure under section DG 12 of \$4,000. Group Company has two equal natural person shareholders, Shareholder A and Shareholder B who have apportioned interest expenditure under section DG 12 or DG 13 of \$2,000, and \$4,000 respectively.

Section DG 18 requires that Group Company apply that section first and since the outstanding profit balance exceeds Group Company's expenditure, it is not required to quarantine any of its apportioned interest expenditure. The outstanding profit balance is then reduced by the deductions claimed by Group Company. The new outstanding profit balance is \$6,000 (\$10,000 – \$4,000).

Section DG 18 then requires Shareholder A and Shareholder B to apply the section. Each shareholder's share of the outstanding profit balance is \$3,000 (\$6,000 x 50 percent). Shareholder A is not required to quarantine any interest expenditure and Shareholder B is required to quarantine \$1,000 of interest expenditure (\$4,000 – \$3,000).



Notification

To enable the operation of section DG 18, new section 30D of the Tax Administration Act 1994 requires companies to provide shareholders with information to enable them to calculate the correct amount of expenditure that is required to be quarantined.

Background

There is a concern that assets that earn only low levels of income may consistently incur losses, despite the apportionment of expenditure. Some owners of these assets are likely to hold the asset primarily for private enjoyment. Other owners may genuinely hold the asset to earn profits, but be in loss in one particular year due to circumstances outside their control, such as a poor rental season.

It is not practical for the tax rules to distinguish between these two situations in the year in which they occur. However, quarantining excess expenditure in particular years when the owner of a mixed-use asset earns low levels of income from the asset avoids the need to make such a distinction. Asset owners who are consistently incurring excess expenditure are very likely to be owners who hold the asset primarily for private enjoyment. They may never have the opportunity to use the quarantined amounts. Owners who genuinely hold their asset for income-earning purposes can still use quarantined amounts in future profitable income years.

Since expenditure can be incurred by group companies and other shareholders, the proposed new rules also quarantine expenditure outside the company that holds the asset. There would otherwise be an incentive to shift borrowings on assets subject to the rules to outside the company holding the asset to avoid quarantining.

Lastly, to prevent owners influencing gross income in order to satisfy the 2 percent threshold, and therefore gain access to excess expenditure arising from the asset to offset against other income, the rules exclude income from relatives and associates as defined in section DG 3.

ALLOCATING QUARANTINED EXPENDITURE

(Clause 19)

Summary of proposed amendments

The proposed new rules allow expenditure that has been quarantined in previous income years to be allocated to income years when there are sufficient profits derived from the asset.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

Sections DG 17 and DG 19 allow a deduction for expenditure previously quarantined under sections DG 16 and DG 18 in years when income from the asset exceeds deductible expenditure under sections DG 7, DG 8, and DG 11 to DG 14.

Section DG 17 – Asset-holding person or company

Section DG 17 applies to the person that holds a mixed-use asset. It allows the person a deduction for expenditure previously quarantined under section DG 16 in years when income from the asset exceeds deductible expenditure under sections DG 7, DG 8 and DG 11.

Previously quarantined expenditure which is allowed as a deduction is the lesser of the previously quarantined amount or the amount of company profit (current year income derived from the asset minus deductible expenditure under sections DG 7, DG 8 and DG 11).

Example

An owner of a mixed-use asset derives \$12,000 from the use of the asset, and has \$8,000 of deductible expenditure under sections DG 7 and DG 8 in the current income year. The owner also has \$10,000 of quarantined expenditure from the previous income year. In the current income year, the owner is able to claim a deduction of \$4,000 on previously quarantined expenditure (\$12,000 – \$8,000).

Company A holds a mixed-use asset and derives \$15,000 from the use of the asset and has \$4,000 of deductible expenditure under sections DG 7, 8 and 11 in the current income year. Company A also has \$6,000 of quarantined expenditure from the previous income year. In the current income year, the company can claim all of its previously quarantined expenditure.

If income derived from the asset exceeds both deductible expenditure under sections DG 7, DG 8 and DG 11 and previously quarantined expenditure, the excess is referred to as the “outstanding profit balance”. Using the example above, Company A has a \$5,000 outstanding profit balance ($\$15,000 - (\$4,000 + \$6,000)$). The outstanding profit balance can then be used under section DG 19 to unlock previously quarantined expenditure incurred by group companies, corporate shareholders and non-corporate shareholders.

Section DG 19 – Group companies and other shareholders

Section DG 19 applies to group companies, corporate shareholders, and non-corporate shareholders when there is an outstanding profit balance calculated under section DG 17. This section allows a deduction for expenditure previously quarantined under section DG 18 in years where the outstanding profit balance exceeds apportioned current-year interest deductions under sections DG 12, DG 13 and DG 14.

Previously quarantined expenditure allowed as a deduction is the lesser of the previously quarantined amount or the amount of outstanding profit balance (or the shareholder’s share of the outstanding profit balance if the shareholder is not a group company) minus current-year apportioned interest deductions.

The shareholder’s share of the outstanding profit balance is the shareholder voting interest or market value interest, if applicable, expressed as a percentage multiplied by the outstanding profit balance.

Section DG 19 first applies to group companies until the outstanding profit balance has been reduced to zero or no other group companies exist that have previously quarantined expenditure. The section then applies to other shareholders until the outstanding profit balance has been reduced to zero or no other shareholders exist that have previously quarantined expenditure. As each group company or shareholder applies the section, the outstanding profit balance reduces by the amount of quarantined expenditure allowed.

Example

Building on the previous example, Company A has an outstanding profit balance of \$5,000. Company A is 100 percent owned by Group Company, which has apportioned current year interest expenditure under section DG 12 of \$2,000 and previously quarantined expenditure of \$1,000. Group Company has two equal individual (natural person) shareholders, Shareholder A and Shareholder B, and has apportioned interest expenditure under section DG 14 of \$2,500 and \$1,000 respectively, and previously quarantined expenditure of \$4,000 and \$500 respectively.

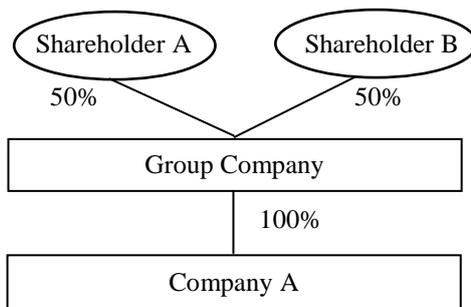
Section DG 19 requires that Group Company apply that section first. Since the previously quarantined amount (\$1,000) is less than the outstanding profit balance minus current year deductions (\$5,000–\$2,000), Group Company is able to claim a deduction in the current year for \$1,000. The outstanding profit balance is then reduced by the deductions claimed by Group Company. The new outstanding profit balance is \$4,000 (\$5,000 – \$1,000).

Section DG 19 then requires Shareholder A and Shareholder B to apply that section. Each shareholder's share of the outstanding profit balance is \$2,000 (\$4,000 x 50 percent). Shareholder A is unable to claim a deduction in the current year for any previously quarantined amounts and Shareholder B is able to claim a deduction in the current year for \$500.

Apportioned interest: \$2,500

Previously quarantined amount: \$4,000
Share of outstanding profit balance: \$2,000
Allowable amount: \$0

Apportioned interest: \$2,000
Previously quarantined amount: \$1,000



Apportioned interest:

\$1,000
Previously quarantined amount: \$500
Share of outstanding asset balance: \$2,000
Allowable amount \$500

Allowable amount: \$1,000
Outstanding profit balance: \$4,000

Outstanding profit balance: \$5,000

Notification

To enable the operation of section DG 19, section 30D of the Tax Administration Act 1994 requires companies to provide shareholders with information to enable them to calculate the correct amount of previously quarantined expenditure that is allocated to the current year.

Background

In years when income from the asset is below the specified threshold, excess deductions are quarantined. The quarantined expenditure should then be allowed as a deduction in years when the income from the asset exceeds the current year expenditure.

ASSETS USED IN BUSINESS

(Clause 19)

Summary of proposed amendments

The new rules will exclude assets predominantly used in business from the quarantining provisions.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

The new rules will apply to assets which are used in business as well as rented out. However, section DG 20 provides that the quarantining provisions will not apply when the asset is used in business activities and, because of the nature of that activity, income derived by that asset is not separately identifiable.

An exception to this is if 80 percent or more of the income-earning use of the asset is a use to which income can be separately attributed to. Income that can easily be attributed to the asset use will normally be rental income.

Example

A helicopter is used both in a farming business and for the farmer's personal enjoyment. The total farming operation earns \$100,000 of gross income. It is difficult to determine how much of the total farming operation's gross income is derived from the use of the helicopter. Therefore, the quarantining provisions will not apply unless the exception applies.

If the helicopter is used in the farming operations for 10 hours in an income year and is also rented out for 90 hours, the helicopter is subject to the quarantining provisions. This is because the rental use is 90 percent of the total income-earning use of the asset, which is greater than the 80 percent exception threshold.

Background

It is difficult to apply the 2 percent quarantining threshold to assets used in business. This is because it is impractical to distinguish the gross income derived directly from the mixed-use asset from the income derived from other assets or from labour.

Consequently, assets that are predominantly used in business will be excluded from quarantining rules. However, the expenditure relating to an asset will still be required to be apportioned based on the asset's income-earning days and private-use days.

Assets that have an income-earning use of 80 percent or more from rental (or other use where the monetary return on the use is clear) are still subject to the quarantining rules. This is necessary to prevent owners avoiding the quarantining rule by using their asset for a token amount of business use when the majority of the income-earning use was from rental.

Example

In an income year a helicopter is used in a farming operation for 50 hours, rented out for 100 hours, and used privately for 20 hours. Of the total income-earning use of 150 hours, 100 hours is rental use. This is 66.7 percent, and less than the 80 percent exception threshold. This means that quarantining does not apply expenses related to the helicopter. Apportionment still applies to the expenditure – with the apportionment calculation here being 150/170.

OPTION TO TREAT INCOME AS EXEMPT

(Clauses 4, 10 and 19)

Summary of proposed amendment

The proposed new rules will enable owners with low amounts of income, or losses incurred from the asset, to treat the income as exempt.

Application date

The amendment will apply from the beginning of the 2013–14 income year.

Key features

New section DG 21 will enable owners whose gross income from the asset in an income year is less than \$1,000 to choose to treat the income earned from the asset as exempt income. The owner will not be taxed on any income earned from the asset and cannot claim a deduction for expenses that are incurred in earning that income.

Owners who incur a loss from the asset can also choose to treat the income earned from the asset as exempt income.

When the mixed-use asset is owned by a company and the company chooses to treat the income earned from the asset as exempt, a deduction will be denied for interest expenditure incurred by shareholders and other group companies identified under sections DG 11, DG 12, DG 13 and DG 14.

No formal election or notification process is proposed. Asset owners can choose this approach by omitting the income and the relevant deductions from their tax calculations. However, asset owners must keep sufficient records to be able to verify that they are entitled to apply the section.

Background

New section DG 21 is designed to address compliance costs. If the potential tax revenue generated by the asset is very small, it is not considered cost effective to require asset owners to file returns and to have Inland Revenue process them.

To further reduce compliance costs owners that expect to systematically make tax losses that are quarantined under the rules can opt out of the rules.

APPLICATION OF RULES TO PART-YEARS

(Clause 19)

Summary of proposed amendments

The various calculations necessary under the new rules will be adjusted on a pro-rata basis if the asset is held for only part of the year.

Application date

The amendments will apply from the beginning of the 2013–14 income year.

Key features

Section DG 22 contains formulas for calculating the 62-day non-use threshold and a 2 percent quarantining threshold when the asset is held only for part of the year. The formulas are:

- The first is for calculating the 62-day unused threshold under section DG 2:

$$\text{Unused threshold} = \frac{\text{Days}}{365} \times 62$$

- The second is for calculating the 2 percent quarantining threshold under section DG 15:

$$\text{Quarantining threshold} = \frac{\text{Days}}{365} \times \text{Asset cost (or rateable value if land)} \times 2\%$$

Days in the formulas are the number of days in the income year in which the asset meets the definition of an asset under these rules.

Example

If an aircraft is purchased 100 days into an income year at a cost of \$100,000 and for the rest of the income year that aircraft is used both to earn income and used privately, the total amount of unused days that are needed to satisfy the unused time threshold in section DG 2 is 45 days ($265/365 \times 62$). The gross income required to exceed the 2 percent loss ring-fencing threshold in section DG 8 is \$1,452 ($265/365 \times \$100,000 \times 2\%$).

Section DG 22 also provides the rules for calculating a company's debt value and a company's interest expenditure when the asset is held for only part of the year:

- The debt value of the company is defined in section DG 11 as the average outstanding amount that gives rise to the interest payable by the company, measured by reference to the amounts outstanding at the start and at the end of an income year. However, if the asset was acquired or disposed of during the year, the average outstanding debt value is measured from the time the company acquired the asset or from the time the asset was disposed of.
- The interest expenditure of a company is also measured from the time the company acquired the asset or from the time the asset was disposed of.

Background

The proposed 62-day unused threshold and the 2 percent quarantining threshold are designed to work on an income-year basis. The two formulas in section DG 22 appropriately pro-rate the thresholds in years when the asset has been purchased or sold, and therefore only used for part of the year.

No pro-rating applies to the \$1,000 gross income threshold below which the person who has the asset can treat it as being outside the tax system. This threshold is set for compliance cost reasons, so it is appropriate that it applies at the same level regardless of how short a period in the income year the person has the asset.

MIXED-USE ASSETS: GST CHANGES

(Clauses 77(1), (2) and (4), 83(1), (3), (4) and (7), 84, 85, 86 and 87)

Summary of proposed amendments

Changes are being made to the Goods and Services Tax Act 1985 consistent with those being made in the Income Tax Act 2007 for mixed-use assets. These changes will ensure that asset owners that are registered for GST will be able to claim input tax deductions in a similar way as they would be able to claim income tax deductions for the same item.

Some GST-specific rules are required to cater for the fact that:

- The “main” asset will have a GST component that will need to be apportioned over the ownership period (whereas for income tax purposes this would be capital expenditure).
- Some items of expenditure relevant for the income tax calculation will not be relevant for GST (such as interest).
- GST is not calculated on an annual basis.

Application date

The amendments will apply to taxable periods starting from 1 April 2013.

Key features

Owners of mixed-use assets will, under the proposed changes, be required to apportion their input deductions in a way that reflects their relative taxable and non-taxable use of the asset. This is consistent with the proposed treatment of income tax deductions.

The formula used for calculating GST deductions (contained in new section 20G) incorporates the income tax definitions as far as possible. Having the GST calculations as close as possible to those for income tax is intended to reduce the compliance costs associated with the proposed rules.

The main differences between the income tax and GST definitions relate to what is “expenditure” and reflect the different nature of the two taxes. In particular, the GST formula replaces “expenditure” with “input tax”.

The replacement of expenditure for input tax ensures that GST deductions are based on what the GST Act allows. Expenditure on some assets will be subject to GST, but irrelevant for income tax purposes. The most obvious example is likely to be the main asset itself, which is likely to have a GST component (either explicitly or through the secondhand goods rules). It is also to clarify that input tax on durable assets (such as a holiday house) is relevant for each subsequent adjustment period in the same way as it is for the general apportionment rules. On the other hand, interest is a relevant expense for income tax but not for GST purposes.

Detailed analysis

Link with apportionment rules

The Taxation (GST and Remedial Matters) Act 2010 introduced a new set of rules that require registered persons to apportion input tax in accordance with the taxable and non-taxable use of the supply. For example, if a registered sole-trader acquired a car that she estimated was to be used half of the time for business purposes, she would be entitled to claim half of the input tax on the car as a deduction in the first period of ownership.

As mixed-use assets are also used partly for private and partly for business purposes, the apportionment rules should also apply to expenditure in relation to these assets. To this end, under the proposals in the bill, the definitions used in the apportionment rules: “percentage intended use”, “potential actual use” and “percentage difference” will be extended to apply to the mixed-use asset formula (section 20G).

As with the general apportionment rules and the formula used for income tax, section 20G will require a registered person to perform annual calculations to determine the level to which they can claim input tax deductions. Section 20G will then require the registered person to pay any output tax or allow them to claim input tax on any positive or negative adjustment produced by the formula.

As with the income tax rules, no apportionment is required for input tax that relates solely to the income-earning use of an asset and no deduction is available for amounts that relate solely to the private use of the asset.

Applying the new formula

One issue specific to GST is that GST is not generally calculated on an annual basis, so GST-registered owners of mixed-use assets will be required to file returns on a monthly, two-monthly or six-monthly basis. Although the general apportionment rules provide for annual adjustments, the bill provides guidance for determining when the calculation is performed and what to do for intervening taxable periods.

Proposed sections 20(3JB)(b) and 20G require a person to perform the calculation at the end of an adjustment period, as defined. This is usually an annual period. However, the proposed rules require the registered person to estimate their taxable use of a supply in the intervening periods and calculate their actual taxable use at the end of each adjustment period. This wash-up calculation will determine the person’s true tax position for each of the taxable periods within the adjustment period. To ease the compliance burden on registered persons, the rules require input tax in the adjustment period to be aggregated. Only if the estimated deductions are 10 percentage points or greater than the actual taxable use (or less than 10 percentage points but more than \$1,000) is a wash-up necessary (see section 20G(6)).

Example

In May, John, a registered person who accounts for GST on a six-monthly basis, acquires a holiday house on the open market for \$575,000 including GST. John's taxable periods conclude at the end of October and April, and he has a standard balance date. On acquisition, he estimates that his taxable use of the house will be 50 percent.

John's expenditure in the first period is:

Item	Cost	GST component
House	\$575,000	\$75,000
Rates, insurance and utilities	\$1,725	\$225

Based on his 50 percent taxable use estimate, John claims deductions of \$37,612 in his first return.

In the following six-months, John continues to incur rates, insurance and utilities expenses of \$2,070.

The end of the following period is also John's balance date, and John chooses to make this the end of his first adjustment period.¹ After performing the calculation for mixed-use asset expenditure, John discovers his actual taxable use of the asset for the adjustment period was 35 percent. This is greater than a 10 percentage points difference from his estimate, so a wash-up calculation is required.

John's total expenditure for the year is therefore:

Item	Cost	GST component
House	\$575,000	\$75,000
Rates, insurance and utilities	\$3,795	\$495

Based on his actual use of 35 percent, John's input entitlement for the year is \$26,423 ($\$75,495 \times 0.35$). John's claimed deduction of \$37,612 in his first return was an over-estimate. As a result of the wash-up calculation, he is required to account for output tax of \$11,189 (being the difference between the \$37,612 claimed and his actual entitlement of \$26,423) in his return following the end of the adjustment period.

An alternative approach, which ensures greater accuracy but that might reduce cash-flow, would be for the registered person to delay claiming input deductions in the intervening periods and instead claim their annual entitlement at the end of each adjustment period when the calculation is performed.²

Disposal

Proposed section 20G(7) provides that the disposal of the relevant asset by a registered person will be a taxable supply and sections 8 and 21F will apply. This means that output tax will be payable on the disposal and a registered person will be able to apply the section 21F formula to claim additional input tax.

¹ John does have the option of delaying the end of the first adjustment period for 12 months under section 21G(2)(a)(ii).

² Section 20(3) allows deductions from output tax to be claimed any time up to the second anniversary of the relevant supply.

Other policy matters

GST: CROSS-BORDER BUSINESS-TO-BUSINESS NEUTRALITY

(Clauses 68, 75(1), 79, 80(2), 83(2), (5) and (6), 89, 90, 91 and 92)

Summary of proposed amendments

The Goods and Services Tax Act 1985 (GST Act) is being amended to change the rules governing when a non-resident business can register for GST and claim input tax deductions.

As GST is intended to be a tax on final consumers rather than businesses, the amendments are intended to allow non-resident businesses to register and claim deductions in a broadly similar manner to a comparable New Zealand-resident business.

Non-resident businesses will, however, only be able to register if they are either registered for a consumption tax (such as GST, or value added tax in Europe) in the jurisdiction of which they are resident. If they reside in a country that does not have a consumption tax, the non-resident will need to satisfy the Commissioner that they carry on a taxable activity overseas with a turnover exceeding \$60,000 per annum.

Other provisions are also being proposed to protect the revenue base from fraudulent refunds. These provisions include the Commissioner having the ability to deregister a non-resident in certain circumstances.

Application date

The amendments apply from 1 April 2014.

Key features

Registration

Under section 51(3) of the GST Act, the Commissioner has the discretion to register any person that carries on a taxable activity, even if their taxable supplies are below the compulsory registration threshold. This section currently applies to both residents and non-residents that carry on a taxable activity.

New section 54B will apply to a non-resident that wishes to voluntarily register in New Zealand. New section 20(3L) will allow non-residents to claim input deductions without the need to be making taxable supplies in New Zealand.

Section 54B sets out that a non-resident can only register if they satisfy the Commissioner that:

- they are registered for a consumption tax in the jurisdiction they are resident in. This would include, for example, GST in other jurisdictions or VAT in Europe; or

- if they are resident in a jurisdiction that does not have a consumption tax, they carry on a taxable activity in another country that would require them to register for GST if that activity were carried out in New Zealand.

This means the person must be able to demonstrate that they make taxable supplies of greater than the \$60,000 registration threshold. The second criterion is necessary because not every country operates a GST or similar consumption tax. To protect the tax base, non-resident businesses who wish to register in New Zealand should have a significant offshore business presence.

In either case, the person must satisfy the Commissioner that their input tax in New Zealand for the first period of registration will be more than \$500. This measure recognises that the registration and return processing procedures require the Commissioner to incur administration costs. Having a minimum input tax amount, removes the ability to claim very small amounts, which are disproportionate to the administrative costs of processing the claim.

There is a further limitation on a non-resident's ability to register, proposed in section 54B(1)(c). This section provides that a non-resident is ineligible to register if they only supply services when it is reasonably foreseeable that those services will be received in New Zealand by a non-registered person. An example of this is tourism, where tourism products (such as coach tours and accommodation) are received in New Zealand by individual non-residents who are not themselves registered for GST. Given that these products are ultimately enjoyed in New Zealand by individuals, the policy is that GST applies to them. Although allowing registration would require the non-resident business to charge GST to the tourist, this would be difficult to enforce.

For migrating registered persons, section 54B(2) will require the person to treat the day of change of residency status as the end of a taxable period. This means that returns filed by the person will be either as a resident or a non-resident, with no requirement for a return reflecting both statuses.

Groups of companies

As a supplement to the registration rules, proposed section 55(1B) sets out that a GST group established after the date of introduction of this bill cannot include both resident and non-resident members. This is a departure from the current rules, but is considered necessary as a base protection measure. When a group comprises both resident and non-resident members, the input tax attributable to the activities of the non-resident members cannot be distinguished in the amalgamated return provided by the representative member. A tax advantage could be provided through offsetting input claims of a non-resident with the output liabilities of resident group members, which would be more apparent for non-residents with no economic activity in New Zealand. It would be preferable from a tax administration perspective to have some visibility on the level of input deductions being claimed by non-residents so that any tax base risk can be more readily identified. Having this change apply only from the date of introduction will save existing groups from having to separate.

If a cross-border group does form after the date of introduction, sections 55(9) and (10) will require it to split into its resident and non-resident components – with the Commissioner having the ability to limit the group to its resident members if such separation is not volunteered.

Claiming deductions

New section 20(3L) will provide the main deduction rule for registered non-residents. It effectively mirrors the main deduction rule in subsection (3C), but clarifies that the non-resident's ability to claim deductions is based on an assumption that all of their supplies were both made and received in New Zealand. This means that, for example, if a person makes worldwide supplies, some of which would be taxable and some exempt under New Zealand's domestic GST system, their ability to deduct will depend on the ratio of their taxable supplies. Such a system ensures that the non-resident is placed in roughly the same position as a New Zealand resident that provided a similar range of services.

Example 1

Air Africa is a passenger airline operating out of Cape Town. It flies domestically within South Africa and internationally. It sends some trainee pilots to New Zealand for some specialised training and incurs GST on those training costs.

If Air Africa were a New Zealand-resident airline making only domestic flights, its supplies would all be taxable. The training is expenditure for services that are used in making its general supplies of passenger transport. As a result, Air Africa is entitled to claim all of the GST incurred as a deduction. Assuming it makes no taxable supplies in New Zealand, the GST incurred will be available as a refund.

Example 2

Bank Co is a financial services and insurance provider that is registered for GST in Australia and is looking to expand into New Zealand. It registers for GST in New Zealand and incurs GST on professional services fees it receives from a New Zealand provider. Its Australian business comprises 50% household mortgages, 25% life insurance and 25% health and contents insurance.

Both the mortgage provider and life insurance components of its business would be exempt if they were made and received in New Zealand on the basis that they are financial services. Bank Co can therefore claim 25% of the GST incurred as a deduction in its New Zealand return.

A proposed amendment to section 20(3K) will also clarify that the input deduction rules that apply to non-profit bodies are limited to New Zealand resident non-profit bodies.

Registration status and administration

It is proposed that non-residents will only be able to be registered on a payments basis. New sections 19(1A) and 19A(1)(iv) will facilitate this. The provision is designed to limit the possibility of a non-resident claiming a refund on the basis of invoices provided by registered residents on which no payment is made and, therefore, no GST is paid. This is a tax base protection measure.

Similarly, proposed section 46(1B) will extend the timeframes for the Commissioner under section 46 from 15 days (as applies to residents) to 90 days for non-residents in certain circumstances. These are:

- issuing a refund;
- requesting further information; and
- investigating the circumstances of a return.

Extending the timeframes in these circumstances will afford the Commissioner more time to establish that a refund claim by a non-resident is valid. The extended period will allow the Commissioner time to establish contact with and engage the non-resident – recognising that there could be language barriers and other unforeseen delays in this communication. Where there is a more significant risk, it may also allow the Commissioner time to reconcile the claim with the GST return of the counter-party to a particular transaction.

A related change to section 120C of the Tax Administration Act 1994 also switches off use-of-money interest for the purposes of providing GST refunds to non-residents.

No special rules are proposed for the taxable periods of non-residents, so they will be registered on a monthly, two-monthly or six-monthly basis, as appropriate.

Cancellation of registration

Currently, section 52(7) allows the Commissioner to cancel the registration of a non-resident if they are not carrying out a taxable activity in New Zealand. This rule is incompatible with the aims of the changes in the bill, so this section is being repealed and replaced with a specific set of deregistration rules for non-residents in section 54C.

The Commissioner may cancel the registration of a non-resident if:

- The Commissioner is satisfied that the person no longer meets the requirements of section 54B(1)(a). This means that if the Commissioner is satisfied that the person is no longer registered for consumption tax in their resident jurisdiction or does not make taxable supplies of greater than the New Zealand registration threshold (as applicable), their registration may be cancelled.
- The non-resident fails to file a return, or files late returns for three consecutive periods. If a person is deregistered under this rule, they are deregistered effective from the first day of the third period and cannot apply for re-registration for five years. This exclusion also applies to non-resident associated persons to avoid effective re-registration under another name.
- The non-resident registers between the date of introduction of this bill and 1 April 2014, or migrates offshore at a later date, and does not satisfy the Commissioner that they are entitled to remain registered. This is to ensure consistent treatment across all non-residents that register after the announcement of the proposed rules.

Effect of cessation of registration

New section 5(3B) will apply to non-residents that cease to be registered. Similar to the general deregistration rule in section 5(3), this provides that output tax is payable on the relevant assets of the person's taxable activity. However, section 5(3B) recognises that it would not be appropriate to tax the worldwide assets of a non-resident at the time of deregistration. Instead, it provides that only goods present in New Zealand and services that would be supplied in New Zealand at the time of deregistration are subject to the deemed supply rules.

GST: ZERO-RATING OF TOOLING COSTS

(Clause 78)

Summary of proposed amendment

A new zero-rating rule is proposed that will allow GST-registered manufacturers to zero-rate the supply of certain tooling costs charged to a non-resident customer.

Application date

Given it is seen as part of a broader package of neutrality changes, this amendment also applies from 1 April 2014.

Key features

The tools must be:

- supplied to a non-resident that is not registered; and
- used solely to manufacture exported goods. The rule will not be available for tools supplied to a non-resident when the goods produced will be used for both the domestic and export markets.

Background

The proposed rule is part of increasing business-to-business neutrality (the bulk of these changes are set out above in the proposals to allow non-resident businesses to register for GST).

As the tooling costs are related to the broader export of goods, there are sound policy reasons for effectively treating these costs as part of the export. This is consistent with the rule in section 11A(1)(m) that zero-rates services provided directly in connection with exported goods.

The proposed rule also imports language used in Australian and European legislation, bringing New Zealand into line with international norms around the charging of tooling costs to non-residents.

TIME PERIOD FOR REFUNDS UNDER THE INCOME TAX ACT 2007

(Clauses 6, 7, 41 to 44, 46 to 56 and 67)

Summary of proposed amendment

An amendment is being made to reduce the time period when refunds can be claimed under the Income Tax Act 2007 to four years from the year of assessment.

Application date

The amendment will apply from the 2013–14 income year.

Key features

The Income Tax Act 2007 is being amended to reduce the time period for refunds under the Act to four years from the year of assessment. This time period would be applied consistently to all refunds. In the case of the donations tax credit which is cashed out separately from the income tax process, the time period for taxpayers requesting refunds will become four years from the end of the tax year in which the donation was made.

Background

If too much tax has been paid, the excess amount is refundable to the taxpayer. Over the years, the time periods for requesting refunds under the Income Tax Act have varied from between three and eight years.

The refund period was aligned with the time bar (four years) in 1944. At the time, it was considered that the time period for a taxpayer to claim a refund should be aligned with the time period for the Commissioner to amend an assessment. With the introduction of PAYE in 1957, the refund period was increased to six years in recognition of the possibility that employers could make mistakes in their calculations. It was increased to eight years in 1968. In 2004, the refund period was amended. The current period is four years from the date of assessment, with an eight-year period applying when the overpayment results from a clear mistake or simple oversight.

The longer periods for refunds were established in an era when the administrative environment was based on assessments carried out by the Commissioner. Departing from four years for a refund was aimed at ensuring taxpayers were not unduly prejudiced by any errors made by employers or the Commissioner when the PAYE scheme was introduced (as systems were not computerised).

The time limits on refunds of tax paid in excess, and on the Commissioner amending assessments when insufficient tax has been paid, represent a trade-off between achieving finality and ensuring the correct amount of tax has been paid.

In today's modern tax administration environment, there is some question whether an eight-year refund period is consistent with the policy objective of reaching a balance between the finalising of a taxpayer's tax position at the earliest practicable stage and the accuracy of that position.

The time limit on the Commissioner to increase an assessment of tax is generally four years from the year of assessment. The Commissioner requires a period in which to determine the accuracy of taxpayer assessments. Setting the time period for refunds at four years aligns the time period for taxpayers requesting refunds with the time period for the Commissioner increasing an assessment.

This approach will also mean that taxpayers requesting refunds will be treated similarly. The refund period for taxpayers who are personal tax summary taxpayers is currently four years. Under the proposed amendment all taxpayers will have a refund period of four years from the year of assessment.

The proposed new refund period is similar to that in other jurisdictions – for example, the time period in the United States is three years, and in the United Kingdom, Ireland and Australia it is generally four years.

FAIR DIVIDEND RATE FOREIGN CURRENCY HEDGES

(Clauses 9, 24, 33 and 57)

Summary of proposed amendment

At present, there is a mismatch in the tax treatment of foreign currency hedges and certain offshore assets – those that are taxed under the fair dividend rate (FDR) rules and certain Australian Stock Exchange (ASX) listed shares. This mismatch makes it more difficult to effectively hedge investments in certain offshore assets.

To address this, the bill provides for a new, optional rule that effectively allows eligible taxpayers to apply FDR to their foreign currency hedges rather than the financial arrangement rules. This new rule is designed to, as much as possible, eliminate the tax mismatch.

To ensure this new rule is robust, there will be restrictions on when the new rule can be applied to ensure that it is used as intended.

Application date

The new rule will come into effect from the beginning of the 2013–14 income year.

Key features

- The bill will create new subpart EM, which provides for a new tax calculation method for certain foreign currency hedges entered into for assets taxed under FDR or ASX-listed shares that are not subject to the foreign investment fund (FIF) rules provided the sale of those shares would not be taxable.
- The new rule will be optional. Eligible taxpayers will be able to elect what hedges it will apply to, and to what extent it will apply for each hedge (subject to maximums to ensure the use of the new rule is appropriate).
- The new rule will apply only to widely held entities to help ensure it is used only as intended. Such entities generally have muted incentives to take aggressive tax positions, have investment mandates and other documentation that disclose investment strategies.

Background

At present, there is a mismatch in the tax treatment of foreign currency hedges and certain offshore assets. For example, under the FDR rules, changes in an asset's value are not taxed. Instead, FDR assets are generally taxed on an imputed return of 5 percent. Conversely, changes in a hedge's value are fully taxed under the financial arrangement (FA) rules. This mismatch in treatment means that a hedge that is effective in removing the impact of unexpected currency fluctuations before tax ceases to be effective after tax.

To illustrate, say a person has an offshore asset portfolio worth US\$10,000 and the NZD/USD exchange rate unexpectedly rises from \$0.75 to \$0.80. The person's asset portfolio is taxed under the FDR rules. In New Zealand dollars, the portfolio's value falls from NZ\$13,333.33 to NZ\$12,500.00. If the person had used a foreign currency hedge to completely remove exchange rate risk, before tax is taken into account, the hedge will increase in value by NZ\$833.33, exactly cancelling the change in their portfolio's value. The hedge is totally effective before-tax.

The story is different after-tax. The offshore assets have lost NZ\$833.33 of value. However, under the FDR rules, no deduction is given for this decrease. Despite this, the \$833.33 increase in the hedge's value is taxable. After-tax, the person has lost NZ\$833.33 from their asset portfolio but gained only NZ\$600.00 from their hedge; the shortfall of \$233.33 is created by the tax payment.

Concept of a hedge

In essence, a basic foreign currency hedge is a currency swap. At some future date (*the "contract date"*), a person promises to exchange a fixed amount of foreign currency (*"foreign amount hedged"*) with a fixed amount of domestic currency (*"domestic amount hedged"*). Because the amount of foreign and domestic currency is fixed when the swap is entered into, this has the effect of "locking in" a future exchange rate for the person.

The value of a foreign currency hedge is measured as the difference between the hedged exchange rate and the market's best guess of what the exchange rate will be on the contract date. The fair value of a hedge should begin at zero as the "locked in" exchange rate will equal the market's best guess of what the exchange rate will be on the contract date.

In later periods the forward rate for the contract date may change. If this happens it will drive a wedge between the contract rate and the forward rate, increasing or decreasing the value of the hedge.

For example, say a hedge allows an individual to exchange (sell) US\$100 (i.e. the *foreign amount hedged*) for NZ\$200 (i.e. the *domestic amount hedged*) (*contract rate* of 0.50) for value 1 January 2011 (*the contract date*). This contract rate will be the same as the market calculated forward rate of 0.50 for 1 January 2011. The value of the hedge contract is therefore \$0 – the contract and forward rates are the same.

If at a later date the forward rate for value 1 January 2011 moves to \$0.60, the unrealised value of the hedge will increase to \$33.33. The reason for this is because the change in the forward rate indicates that it is now expected for the exchange rate on 1 January 2011 will be \$0.60. Accordingly, when the hedge is realised the individual would expect to make \$33.33 (they will give up US\$100, which at the current exchange rate is worth NZ\$166.66, and in return will receive NZ\$200).

Importantly, in order for something to be a "hedge" it must be used to back an asset denominated in a foreign currency. This means that changes in the value of the hedge will offset changes in the foreign denominated asset. The *foreign amount hedged* in the currency being hedged cannot exceed the value of assets denominated in that currency.

To illustrate, say in the example above the individual had US\$100 of USD-denominated assets. Because of the change in the exchange rate from \$0.50 to \$0.60, the value of these assets in NZD would fall from NZ\$200 to NZ\$166.66. However, the hedge has increased in value by NZ\$33.33, cancelling out this fall. If, however, the individual had no USD-denominated assets, they would have suffered no loss but have made a gain on the foreign currency swap. Thus the swap is not a true "hedge" – it is just currency speculation. Such speculation should rightly be taxed under the financial arrangement rules.

The apportionment rules and quarterly test described below are designed to ensure the new rule covers only true hedges.

Detailed analysis

New calculation for income or deductions from a hedge

New section EM 6 is the core of the new rule. It will provide that a taxpayer has income or an expense of:

$$\frac{FDR\ portions' \ value * 0.05}{days\ in\ the\ year}$$

FDR portions' value is the current market value of a taxpayer's hedges to the extent that the taxpayer has elected for this rule to apply to those hedges. This calculation will need to be carried out every day. Because hedges are generally short term, this calculation must be performed numerous times over a hedge's life for it to be effective.

This daily calculation aligns with how eligible entities calculate their tax liability on eligible assets. The tax calculation for FDR assets is based on an imputed 5 percent return and is done on a daily basis – a calculation that is very similar to the above. The calculation also closely matches the tax treatment of ASX-listed shares that are not subject to the FIF rules (meaning tax is simply levied on dividends received) as the estimated dividend yield from such a share is 5 percent per year.

The bill also inserts new sections CV 18 and DV 25, which will provide that the income or expense calculated using the above formula is taxable or deductible (as applicable). Note that section DV 25 does not override the general permission, so any deemed expense that arises under section EM 6 will need to be related to a taxpayer's business in order for it to be deductible. The capital limitation will be overridden to ensure that a negative result of the above formula arising due to eligible ASX-listed shares held on capital account is deductible.

Financial arrangement rules will not apply

New section EM 1(3) provides that the financial arrangement rules do not apply to a hedge to the extent a taxpayer has elected for this new rule to apply under section EM 4 (its *fair dividend rate hedge portion*). Tax on the hedge will be calculated solely under subpart EM.

The financial arrangement rules will apply as normal to the remainder of the hedge.

Eligible assets

The new tax calculation method will be available in relation to hedges that hedge:

- assets that are taxed under the FDR method; and
- shares listed on the ASX exchange which are not subject to the FIF rules provided the sale of those shares would be exempt under section CX 55 or would be a capital receipt as the shares are held on capital account.

The purpose of the new rule is to align the tax treatment of foreign currency hedges with the assets those hedges are entered into for. This mismatch is most significant for hedges entered into for the asset types listed above. For other assets the mismatch is either much less pronounced or does not exist, so the current treatment is more appropriate.

In addition to this asset-type requirement, an asset's market value must also be calculated on a daily basis in order for it to be an eligible asset. This is so the calculation in section EM 6 can be carried out daily, as set out above.

Eligible entities

The new rule is designed to apply only to widely held investment funds and other similar entities. This restriction is designed to help ensure the new rule will be used only as intended. Widely held funds generally have muted incentives to take aggressive tax positions and have investment mandates and other documentation that disclose investment strategies.

This restriction will be provided by new section EM 2, which will largely mimic the widely held entity criteria in the Portfolio Investment Entity (PIE) rules (sections HM 14 and HM 15, together with the exemptions in sections HM 21 and HM 22).

Eligible hedges and hedge portions

The new rule can only be used in relation to genuine foreign currency hedges – financial arrangements that are entered into with the sole purpose of offsetting exposure to foreign currency exchange movements in the value of their assets.

To reflect this, new section EM 3 provides the criteria for an eligible hedge. For example, a hedge must not be entered into with an associated person and, when it is first entered into, must have a fair value of zero.

An eligible hedge will not automatically be subject to the new tax calculation. A taxpayer will need to elect, on the day it enters into a hedge, that the new tax calculation is to apply.

The new calculation will be able to be applied to part or all of a hedge. Accordingly, the taxpayer's election will need to include the portion of the hedge to be subject to the new calculation (the *fair dividend rate hedge portion* of the hedge), although there are limits on this (see below).

There will be no prescribed way for how this election is to be made, but sufficient record of elections must be kept in order to satisfy the general record-keeping requirements placed on taxpayers.

Maximum fair dividend rate hedge portions

The intention of the new rule is that it should only apply to hedges entered into for certain types of offshore investment – those assets where the tax mismatch is most significant. It is appropriate that hedges entered into for other types of offshore investment continue to be taxed as they are currently. Accordingly, new section EM 5 provides rules that set out the maximum *fair dividend rate hedge portion* that a taxpayer can elect.

There are two possible methods that a taxpayer will be able to use to determine this maximum. A taxpayer will be required to use the same calculation method for all of its hedges. The first method is designed to be accurate but may be relatively complicated to apply. The second method is simpler but may be less accurate so, to balance this, it is more restrictive.

These calculations will only need to be performed on the day a hedge is first entered into. There will be a quarterly test, described below, to ensure that a hedge's initial *fair dividend rate hedge portion* remains appropriate over time.

Method one

The first calculation method will use the formula:

$$\frac{1.05 * (\textit{eligible currency assets} + \textit{proxied currency assets}) - \textit{FDR hedges amount}}{\textit{calculation hedge amount}}$$

Eligible currency assets will be eligible assets (as described above) denominated in the same currency as the hedge being entered into (the *calculation currency*). *Proxied currency assets* will be eligible assets denominated in a different currency but the taxpayer hedges that currency with the *calculation currency*.³ All amounts in the formula will be expressed in the *calculation currency*.

FDR hedges amount will be the amount of the *calculation currency* that is hedged by the taxpayer's hedges, excluding the hedge that the calculation is being carried out for (the *calculation hedge*), to the extent that they have elected for this new tax calculation method to apply (i.e. each hedge's *fair dividend rate hedge portion*).

Calculation hedge amount is the amount of foreign currency that is hedged by the *calculation hedge*.

³ It is generally impractical to hedge every currency a fund is exposed to. Funds therefore often do what is referred to as "proxy hedging". They find correlations between the smaller currencies and larger ones (such as the USD), and hedge their exposure to the smaller currencies using the larger ones.

Example

Z has a portfolio of:

- US\$20,000 worth of shares in US-based companies (eligible assets, worth NZ\$40,000)
- AU\$10,000 worth of shares in Australian companies (eligible assets, worth NZ\$15,000)
- AU\$20,000 worth of Australian bonds (non-eligible assets, worth NZ\$30,000)

Z has currently has two foreign currency hedges:

- A hedge for US dollars with a foreign amount hedged of \$20,000 (equivalent to NZ\$40,000) and a *fair dividend rate hedge portion* of 0.50.
- A hedge for Australian dollars with a foreign amount hedged of \$20,000 (equivalent to NZ\$30,000) and a *fair dividend rate hedge portion* of 0.25.

Z is looking to enter into a new hedge for AU\$10,000. The maximum *fair dividend rate portion* for the hedge would be 0.55:

$$\frac{1.05 * (AU\$10,000 + \$0) - (AU\$20,000 * 0.25)}{AU\$10,000} = 0.55$$

Method two

The second calculation method uses the formula:

$$1 - \frac{\text{non eligible currency assets}}{\text{hedges amount}}$$

Unlike method one, this calculation will be made with reference to a taxpayer's assets regardless of the currency they are denominated in, not just the *calculation currency*. This may make it simpler for some taxpayers.

Non eligible currency assets will be the total value of a taxpayer's foreign assets excluding eligible assets, converted to New Zealand dollars. *Hedges amount* will be the total amount of foreign currency that is hedged by a taxpayer's hedges including the *calculation hedge*, again converted to New Zealand dollars. Importantly, this is *not* the amount of New Zealand dollars hedged; it is the amount of foreign currency hedged expressed in New Zealand dollars at the day's prevailing exchange rate.

To ensure a taxpayer cannot over-hedge using method two, if the result of the formula below is above 1.05, a taxpayer will not be able to elect to use the new method for new hedges.

$$\frac{\text{currency assets}}{\text{hedges amount}}$$

Currency hedges will be the total value of the taxpayer's offshore assets converted to New Zealand dollars. *Hedges amount* will be the same as in the previous formula.

Example

Z from the example above decides instead to use the second method to calculate the maximum *fair dividend rate portion* for its new \$10,000 Australian dollar hedge. This hedge is equivalent to NZ\$15,000.

The value of Z's non-eligible assets in New Zealand dollars is \$30,000. The total amount of foreign currency hedged by Z, expressed in New Zealand dollars, is \$85,000. Accordingly, the hedge's maximum *fair dividend rate hedge portion* will be 0.65 unless the result of second formula below is greater than 1.05:

First formula

$$1 - \frac{\text{NZ\$30,000}}{\text{NZ\$85,000}} = 0.65$$

Second formula

$$\frac{\text{NZ\$85,000}}{\text{NZ\$85,000}} = 1.00$$

The second formula's result is 1.00, so the maximum *fair dividend rate hedge portion* of 0.65 stands.

Quarterly test

The two proposed apportionment methods described above will provide the appropriate maximum *fair dividend rate hedge portions* initially. However, a quarterly test is also required to ensure the taxpayer's initial allocation is still appropriate.

The formula below provides a taxpayer's *quarterly FDR hedging ratio*:

$$\frac{\text{FDR hedges amount}}{\text{eligible currency assets}}$$

FDR hedges amount will be the total amount of foreign currency that is hedged by a taxpayer's hedges to the extent the taxpayer has elected for this tax calculation to apply to those hedges (i.e. the *fair dividend rate hedge portion* of each hedge), converted to New Zealand dollars. Again this will not be the amount of New Zealand dollars hedged but is the amount of foreign currency hedged expressed in New Zealand dollars at the day's prevailing exchange rate. *Eligible currency assets* will be the total value of the taxpayer's eligible assets, also converted to New Zealand dollars.

If a person's *quarterly FDR hedging ratio* is greater than 1.05 they must adjust the *fair dividend rate hedge portion* to the result of the formula below:

$$\frac{0.85}{\text{quarterly FDR hedging ratio}} * \text{FDR hedge portion}$$

The effect of this formula will be to bring an entity's *quarterly FDR hedging ratio* to 0.85. This adjustment will be required to be carried out, at the most, five days after the end of the quarter.

If a taxpayer breaches the threshold in two consecutive quarters, they will not be able to use this new tax calculation method for the remainder of the income year and the next income year for any new hedges it enters into.

Example

At the end of a quarter, the value of Y's portfolio is:

- US\$10,000 worth of shares in US-based companies (eligible assets, worth NZ\$20,000)
- AU\$20,000 worth of shares in Australian companies (eligible assets, worth NZ\$30,000)

Y currently has a single foreign currency hedge: a hedge for US dollars with a foreign amount hedged of \$20,000 (equivalent to NZ\$40,000) and a *fair dividend rate hedge portion* of 0.40.

In the first formula, *FDR hedges amount* is NZ\$16,000 ($=\$40,000 * 0.40$) and *eligible currency assets* is NZ\$50,000 ($=\$20,000 + \$30,000$). The result of the formula is 0.32:

$$\frac{\text{NZ\$16,000}}{\text{NZ\$50,000}} = 0.32$$

Y will therefore pass the quarterly test.

Say next quarter Y enters into a hedge in addition to its USD hedge: a hedge for AU\$30,000 (equivalent to NZ\$45,000) with a *fair dividend rate hedge portion* of 1.00 (*note*: this would exceed the maximum *fair dividend rate hedge portion* allowed, but for simplicity is ignored).

If the exchange rate or prices do not change, *FDR hedges amount* will now be NZ\$61,000 ($=\$40,000 * 0.40 + \$45,000 * 1.00$) but *eligible currency assets* remains at NZ\$50,000. The result of the formula is now 1.22:

$$\frac{\text{NZ\$61,000}}{\text{NZ\$50,000}} = 1.22$$

This exceeds 1.05, so Y will have to adjust its two hedges as follows so the *fair dividend rate hedge portions* on its US dollar and Australian dollar hedges are 0.28 and 0.70, respectively.

US dollar hedge

$$\frac{0.85}{1.22} * 0.40 = 0.28$$

Australian dollar hedge

$$\frac{0.85}{1.22} * 1.00 = 0.70$$

CHARITIES WITH OVERSEAS PURPOSES

(Clauses 2(15) and 61)

Summary of proposed amendments

The bill adds three new charitable organisations to schedule 32 of the Income Tax Act 2007. Donors to the following charities will be eligible for tax benefits on their donations:

- The Hunger Project New Zealand;
- OneSight New Zealand; and
- Fund for Timor.

Application date

The amendments will apply from 1 April 2013.

Background

Donors to organisations listed in schedule 32 are entitled as individual taxpayers, to a tax credit of 33⅓% of the amount donated, up to the value of their taxable income. Companies and Māori authorities may claim a deduction for donations up to the level of their net income. Charities that apply funds towards purposes mostly outside New Zealand must be listed in schedule 32 of the Income Tax Act 2007 before donors become eligible for these tax benefits.

The three charitable organisations being added to schedule 32 are engaged in the following activities:

- The Hunger Project New Zealand works to reduce hunger and poverty in South Asia, Africa and Latin America. The aim of the group is to assist local groups to improve health education, nutrition and family income.
- OneSight New Zealand works to assist people with vision impairment, eye diseases and eye afflictions.
- Fund for Timor aims to improve education and literacy in remote areas of East Timor by funding local teachers' salaries.

Remedial matters

CLARIFICATION OF THE “DIVIDEND” DEFINITION

(Clauses 5, 57(4) and (5), 100 and 107)

Summary of proposed amendment

The definition of “dividend” is being amended to make it clear that certain transactions are not treated as dividends for tax purposes.

Application date

The amendments will apply from the beginning of the 2005–06 income year.

Key features

Both the Income Tax Act 2004 and the Income Tax Act 2007 will be amended so that it is clear that certain transactions are not dividends for tax purposes.

The transactions are listed below.

Rights issues

Companies can offer their shareholders rights to buy new shares, generally at a discount to the market value.

It is proposed that legislative changes be made to make it clear that the discounted amount is not a taxable dividend for those shareholders that exercise the right, and that the right itself (which has value and may in some cases be traded or renounced) is not a taxable dividend.

The policy rationale for ensuring that rights and discounted shares issued under a rights issue are not treated as dividends is that the company does not give up anything of value. A rights issue involves the company raising new equity when the shareholders invest new funds in the company.

Premiums paid under bookbuild arrangements

Following a rights issue, a bookbuild can take place. A bookbuild involves the rights of non-participating shareholders (who chose not to participate or were not entitled to participate) being offered to other investors who pay a premium for them. The original shareholder is paid all or part of this premium for giving up their rights.

It is proposed that changes be made to make it clear that premiums paid under bookbuilds are not dividends for tax purposes. From a policy perspective, a bookbuild should not be treated as a dividend because, like a rights issue, the company does not give up anything of value.

Share splits

A share split involves a company diluting its shareholding whereby the shareholding proportions are retained but the shareholding is split into a greater number of shares.

It is proposed that an amendment be made to the definition of “bonus issue” so that share splits that involve a subdivision of shares (that takes place under the Companies Act 1993) can be excluded from the dividend definition. Currently, only bonus issues that involve the issue of new shares can be excluded from the definition of “dividend” for tax purposes. However, a subdivision of shares does not necessarily involve the issue of new shares.

From a policy perspective, a share split should not be treated as a taxable dividend because the company does not give up anything of value. Furthermore, in a share split, the shareholder is generally not involved in a transaction with the company.

Background

The current dividend definition is based on the policy that, in general, distributions from a company to a shareholder should be taxed if there is a transfer of value to the shareholder and the transfer is made in recognition of the shareholder’s ownership interest in the company (instead of, for example, an employer/employee relationship between the company and shareholder).

Currently, there are views that the legislation is unclear on whether the transactions described above fall within the definition of “dividend”. The proposed changes do not involve a change in policy but are being made to clarify the policy intent for the specified transactions.

FARMERS' RIPARIAN PLANTING

(Clauses 20 and 21)

Summary of proposed amendments

Section DO 2, which presently deals with the planting of trees for certain purposes, is being extended to allow an immediate deduction for expenditure on plantings (plants or trees) to mitigate the detrimental effects on a water-course from the discharge of farming or agricultural contaminants.

It is officials' view that this merely confirms farming current practice.

A consequential amendment to the heading in section DO 1 is also proposed.

Application date

The amendment will be effective from the 2011–12 income year, except if the taxpayer has claimed such expenditure in an earlier period and that deduction is grandparented.

PRIMARY SECTOR BUSINESSES AND AMORTISABLE ASSETS

(Clauses 18 and 23)

Summary of proposed amendment

The bill contains amendments to better align the amortisation rules for primary sector businesses (farming, aquaculture, horticulture and forestry) with the general depreciation rules in the Income Tax Act 2007.

Application date

The amendment allowing primary sector businesses to claim deductions for the removal cost of subpart DO improvements will apply from the beginning of the 2010–11 income year.

The amendment to the capital contribution rules will apply from the beginning of the 2011–12 income year.

Key features

The proposed amendments will:

- allow primary sector businesses to claim deductions for the cost to remove subpart DO improvements, as well as the tax book value of the improvements, that have been rendered useless, if it is caused by an action outside the control of the taxpayer; and
- amend the capital contribution rules, so they apply to payments that contribute towards an amortisable asset.

Background

The kiwifruit Psa (*Pseudomonas syringae* pv *actinidiae*) virus has had a significant impact on New Zealand's gold kiwifruit industry. As a consequence, a number of kiwifruit gold orchards have been or will be destroyed. The effect of the virus has highlighted several minor technical problems with the tax rules.

Detailed analysis

Amortisation deductions for removal cost expenditure

The Income Tax Act 2007 allows primary sector businesses to amortise the costs of certain capital expenditure that are not expressly depreciable. This is similar to a taxpayer's entitlement to claim depreciation on fixed assets. Specifically, and subject to certain criteria, when an orchardist removes a horticultural plant, the orchardist generally receives a deduction for the net tax book carrying value of the horticultural plant.

However, the extra cost of removing a horticultural plant is capital in nature and the Income Tax Act 2007 does not explicitly provide a deduction for these costs. In contrast, when a taxpayer with a capital asset (for example, an item of physical plant or machinery) writes that item off, the taxpayer is entitled to a deduction for the tax book carrying value, and a deduction for the costs of physically removing the item.

The Psa virus has also highlighted an anomaly in the tax treatment of primary-sector improvements to land, damaged by natural events. For example, if a natural event such as a flood, damages an orchard's infrastructure (for example, trellising and wire) the orchardist would be allowed a deduction for the tax book carrying value of the infrastructure.

On the other hand, if an orchardist's infrastructure is rendered useless due to the Psa virus (which only affects the fruit) and they wish to change the crops that they grow, the cost of removing the infrastructure and the tax book carrying value of the infrastructure once it is removed, is considered to be capital expenditure or a loss, and is therefore non-deductible.

The lack of a provision for these types of costs was unintended, and accordingly the bill will amend section DO 11 of the Income Tax Act 2007, to explicitly allow a deduction for these removal costs, where improvements to the land have been rendered useless, if it is caused by an action outside the control of the taxpayer.

Capital contribution rules and amortisable assets

If a person receives a subsidy (or similar payment) as compensation and the subsidy is used to acquire depreciable property, the receipt is dealt with under the "capital contribution rules" in the Income Tax Act 2007. The capital contribution rules prevent a person claiming deductions for expenditure for which they have not borne the cost.

Kiwifruit orchardists affected by the Psa virus may receive non-governmental financial assistance, and some of these payments may be used to subsidise the cost of replanting. However, the capital contribution rules do not presently apply to these receipts, because the capital cost of replanting does not result in depreciable property, but rather "amortisable assets".

When the capital contribution rules were implemented, capturing contributions towards assets that were amortisable under subpart DO of the Income Tax Act 2007 was not considered.

This is inconsistent with the policy intent of the capital contribution rules, and the bill introduces an amendment to explicitly provide that the capital contribution rules apply where the relevant asset is amortisable, as well as where it is depreciable, so that taxpayers cannot claim a deduction for costs they have not in fact incurred.

GENERAL INSURANCE CLAIMS RESERVES AND EVENTS THAT OCCURRED BEFORE JULY 1993

(Clauses 2(3) and (4), 8, 25, 101 and 104)

Summary of proposed amendment

A technical change is proposed to the rules in the Income Tax Act 2007 that calculate a general insurer's outstanding claims reserve – sections CR 4 and DW 4.

The change explicitly excludes from the calculation certain insurance events that occurred before 1 July 1993.

Application date

The changes will apply from 1 April 2008, the date the tax and financial reporting treatment of general insurance outstanding claims reserve calculation were aligned.

Consequential changes are also being made to the 2004 Income Tax Act for earlier income years starting from 2006.

Key features

The change clarifies the interaction between the:

- rules for calculating an insurer's outstanding claims reserve; and
- taxation of offshore insurance business carried on by New Zealand-resident insurers before July 1993.

Background

Before July 1993, general insurance business carried on outside New Zealand was not subject to New Zealand income tax. As a result, New Zealand insurers were unable to claim deductions in respect of any claims that were connected with this offshore business. From 1 July 1993 insurance business carried on outside New Zealand by New Zealand residents was brought to tax. Specific transitional rules were included in the Income Tax Act 1976 to deal with the change.

The transitional rules deny insurers a deduction for any pre-1993 claims – see section DZ 10.

The rules for calculating the outstanding claims reserve do not explicitly exclude amounts relating to pre-1993 events and arguably track claims when an entitlement to a tax deduction for the claim does not exist under DZ 10. This outcome was not contemplated and appears to impose an unnecessary requirement on taxpayers to track insurance events when under the transitional rules no deduction would be allowed for a claim that is connected with a pre-July 1993 event.

TRANSITIONAL IMPUTATION PENALTY TAX

(Clause 71)

Summary of proposed amendment

As a result of the recent company tax rate change from 30% to 28%, relief is being provided to prevent the overreach of transitional imputation penalty tax. The penalty will not apply to dividends if they were paid out before the earlier of either the 2010–11 tax return being filed or 31 March 2012 (the deadline for filing 2010–11 tax returns).

Application date

The amendment will apply from 1 October 2010.

Key features

Relief is being provided to prevent the overreach of transitional imputation penalty tax following the change in the company tax rates from 30% to 28%. Under the proposed amendment, the penalty will not apply if dividends were paid out before the earlier of either the 2010–11 tax return being filed or 31 March 2012 (the deadline for filing 2010–11 tax returns).

The amendment is similar to the relief provided during the previous transitional period (when the company tax rate was reduced from 33% to 30%) and is consistent with the original policy intent of the transitional imputation penalty tax.

Background

As part of the company tax rate change from 30% to 28%, companies have approximately two years to pay out their 30/70 (or 33/67 credits at 30/70) imputation credits. During this “transitional period”, companies have the option to impute any credits at the old ratio of 30/70 or at the new ratio of 28/72. As part of this transitional period, a one-off transitional imputation penalty tax was put in place. The penalty is designed to ensure that companies do not excessively over-impute dividends during the transitional period, and to protect the tax base. This one-off penalty will be effective for balances as at 31 March 2013.

However, the transitional imputation penalty tax overreaches in some cases. Some companies that paid the dividends before the company tax rate changed on 1 April 2011 or before their 2010–11 tax return was filed and prepaid tax to fully impute to the extent allowed at that time, cannot avoid the penalty, even though any over-imputation was, on the face of it, not deliberate. This problem was identified during the previous transitional period (when the company tax rate was reduced from 33% to 30%), and relief was provided on the basis that the penalty should not apply if there was no intentional over-imputation.

DEDUCTIBILITY OF REPAIRS AND MAINTENANCE ON COMMERCIAL FIT-OUT

(Clause 14)

Summary of proposed amendment

The amendment clarifies when expenditure is deductible as repairs and maintenance when it is incurred on items of commercial fit-out. It removes an unintended policy outcome arising from an earlier decision to allow depreciation for commercial building fit-out.

Application date

The amendment will apply from 1 April 2011.

Key features

New section DA 5 ensures that the replacement or improvement of a previously separately depreciated item of commercial fit-out is capitalised and depreciated over its estimated useful life. Expenditure on repairs and maintenance of an item of commercial fit-out will remain immediately deductible.

Background

The decision to allow building fit-out to be depreciable property introduced a new definition of building which conflicted with an existing, related definition. This was an oversight which produced an unintended policy outcome that may have allowed the replacement of an item of commercial fit-out to be deductible as repairs and maintenance. Without an amendment, this oversight could be exploited to claim immediate deductions for expenditure on commercial fit-out that should be capitalised and depreciated over its estimated useful life.

GST: LOCAL AUTHORITIES

Repeal of sections 19A(1)(a)(ii) and 19AB

(Clauses 80 and 81)

Summary of proposed amendment

These parts of the Goods and Services Tax Act 1985 (GST Act) are being repealed to reflect the fact that from 1 July 2013, the eight local authorities named in the Goods and Services Tax Act (Local Authorities Accounting on Payments Basis) Order 2009 will no longer be eligible to account for GST on a payments basis.

Application date

The amendment in clause 81 will apply from the date of enactment.

The amendment in clause 80 will apply from 1 July 2013.

Key features

Section 19AB of the GST Act sets out that the Governor-General may specify a local authority which may continue to account for tax on a payments basis. As the only eight local authorities which are currently permitted to account for GST on a payments basis will be required to account for GST on an invoice basis from 1 July 2013, this section is no longer required.

Section 19A(1)(a)(ii) sets out that a local authority specified in an Order in Council made under section 19AB may account for GST on a payments basis. As the current Order expires on 30 June 2013, and no further Orders will be made, section 19A(1)(a)(ii) will no longer be relevant after 30 June 2013.

Background

The Goods and Services Tax Act (Local Authorities Accounting on Payments Basis) Order 2009 expires on 30 June 2013. The eight local authorities named in the Order will not be permitted to account for GST on a payments basis after it expires as the Order is not being extended.

Local authorities transitional provision

(Clause 95)

Summary of proposed amendment

Clause 95 sets out the transitional provision which will apply to the eight local authorities named in the Goods and Services Tax Act (Local Authorities Accounting on Payments Basis) Order 2009.

Application date

The amendment will apply from the date of enactment.

Key features

When a registered person changes from a payments basis to an invoice basis, section 19C sets out that they must perform a wash-up calculation based on their outstanding debtors and creditors at that time. The eight local authorities named in the Goods and Services Tax Act (Local Authorities Accounting on Payments Basis) Order 2009 will be required to change to an invoice basis when the Order expires. The bill contains a transitional provision which will allow those local authorities to spread payment of the amount calculated as a result of that wash-up calculation over 72 months. The 72-month period will begin on 1 July 2013.

If any of the local authorities choose to change to an invoice basis before 1 July 2013, they must perform the wash-up calculation based on their debtors and creditors at the end of the day before they change. Payment of this sum may still be spread over 72 months, again commencing from 1 July 2013. No interest or penalties will be imposed as a result of the local authorities spreading this payment.

Background

The GST Act was amended, with effect from 1 July 2001, to remove local authorities as a class of people who could account for GST on a payments basis. This eliminated the need for a dual system of accounting: an invoice system for financial reports and a payments system for GST purposes.

Since that time, three consecutive temporary exemptions have been made, the cumulative effect of which has been to allow eight local authorities until 30 June 2013 to prepare for the change to an invoice basis. From 1 July 2013 all local authorities are required to account for GST on an invoice basis.

The transitional provision is proposed to mitigate the significant cashflow implications which are likely to arise for the local authorities if they had to pay the sum determined by the wash-up calculation in one hit.

Amendment to section 19C

(Clause 82)

Summary of proposed amendment

Section 19C is being amended to include a reference to the proposed transitional provision for local authorities.

Application date

The amendment will apply from the date of enactment.

Key features

A reference to the proposed transitional provision for local authorities will be included in section 19C to clarify that the local authorities will be required to perform the wash-up calculation as set out in section 19C(3).

Background

Section 19C sets out that registered persons who change their accounting basis must perform a wash-up calculation in respect of the change. It currently refers to every registered person whose accounting basis is changed pursuant to section 19 or 19A of the GST Act. The eight local authorities which will be changing to an invoice basis on 1 July 2013 will not technically be changing their accounting basis pursuant to 19 or 19A, but rather as a result of the requirement in the new transitional provision that they account on an invoice basis.

GST: TREATMENT OF CASH PRIZES FOR PRIZE COMPETITIONS

(Clauses 74, 75, 76 and 77)

Summary of proposed amendments

Section 10 of the Goods and Services Tax Act 1985 is being amended so that organisers of prize competitions will be able to deduct cash prizes from the total proceeds received for a prize competition when determining the consideration made for that supply. Sections 5 and 9 will be consequently amended to include references to prize competitions. A definition of “prize competition” will also be included in section 2.

Application date

The amendments will apply from the date of enactment.

Key features

These amendments will restore the position which existed for prize competitions before 1 July 2004, and extend the ability to deduct cash prizes to a wider range of competitions for which participants pay money to enter, and stand to win cash prizes. While this amendment uses the term “prize competition”, the phrase is given a slightly wider meaning than it has under the Gambling Act 2003 to include analogous competitions (for example, amateur sporting competitions) that are not covered by that Act.

Drafting changes will also be made to section 10(14) to make it easier to understand.

Background

Before 1 July 2004, when determining the consideration of a supply, organisers of prize competitions were able to deduct cash prizes from the total proceeds collected for that supply.

The wording in the GST Act which permits cash prizes to be deducted was amended, effective from 1 July 2004, to use wording in the Gambling Act 2003. The wording in the GST Act had previously been based on terms contained in the Gaming and Lotteries Act 1977 which the Gambling Act replaced.

Some of the phrases and definitions contained in the Gambling Act are materially different from those which appeared in the Gaming and Lotteries Act. The phrase which is currently used in the relevant GST Act provisions is “gambling (including a New Zealand lottery)”. This is a narrower term than the collection of terms that was used before 1 July 2004, and does not include prize competitions.

GST: ADDING AN OPT-OUT PROVISION TO AGENCY RULES

(Clauses 88 and 93)

Summary of proposed amendments

The amendment will allow principals and agents to agree to “opt-out” of the agency rules in the Goods and Services Tax Act 1985. A new subsection is being consequently added to the bad debts rules in section 26.

Application date

The amendments will apply from the date of enactment.

Key features

The proposed amendment will allow principals and their agents to agree to “opt-out” of the agency rules in the GST Act, and permit each to issue a tax invoice in relation to what will be treated as two separate supplies. The principal will return output tax in respect of the tax invoice issued to the agent, and the agent will return output tax in respect of the tax invoice to the recipient and claim input tax in respect of the output tax charged by the principal.

The proposed amendment also requires a principal who normally accounts for tax payable on a payments basis to account on an invoice basis in respect of their supply to the agent. A new subsection will also be added to the bad debts rules to prevent a principal from claiming a bad debt deduction when they use the new opt-out provision if the agent has received payment for the supply.

The subsection which requires a principal to account on an invoice basis is not limited to situations where the recipient does not pay the agent. Such a limitation would require the principal to know in advance whether the agent would be paid for their supply to the recipient, and so would be unworkable.

The requirement for a principal to account for the tax payable on the first supply on an invoice basis is intended to prevent a revenue loss to the Government if the agent defaults on their GST obligation.

Background

The GST Act currently only allows one tax invoice to be issued when an agent makes a taxable supply for, and on behalf of, a principal. Some accounting systems, however, automatically issue invoices when goods and services are supplied. The principal’s accounting system might therefore issue a tax invoice when goods and services are provided to the agent, and the agent’s accounting system might also issue a tax invoice when goods and services are provided to the recipient. There is therefore a technical breach of the legislation. Without this amendment, taxpayers will have to adapt their accounting systems to avoid this situation, and are likely to incur significant compliance costs in doing so.

GST RECORD-KEEPING REQUIREMENTS

(Clause 94)

Summary of proposed amendment

An amendment is being made to align the record-keeping provisions in the Goods and Services Tax Act 1985 with proposed new amendments in the record-keeping provisions in the Tax Administration Act 1994 that:

- allow the Commissioner of Inland Revenue to authorise the storage of a taxpayer's income tax records offshore through applications from their data storage provider; and
- allow the Commissioner to impose reasonable conditions for that authorisation.

Application date

The amendment will apply retrospectively to align with the proposed record-keeping provisions in the Tax Administration Act 1994, which will apply from the date of enactment of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill.

Key features

Generally taxpayers are required to store their records in New Zealand. As taxpayers are increasingly managing their tax obligations through payroll or accounting software, the use of offshore data storage for information, records and returns is growing. Proposed changes in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill will give the Commissioner of Inland Revenue the ability to authorise an Inland Revenue-approved data storage provider to store a taxpayer's records offshore. These changes only apply to income tax and certain other records and not GST records.

The proposed amendment will also align the GST record-keeping provisions with the Tax Administration Act changes so that an Inland Revenue-approved data storage provider can keep a person's (who is registered for GST) records offshore.

Background

The proposed amendments in the Tax Administration Act have been developed to make it easier for taxpayers to conduct their tax compliance activities electronically. Inland Revenue will provide administrative criteria for the authorisation, which will outline the standards required of the data storage providers.

In the absence of such an amendment for the Goods and Services Tax Act 1985, a registered person would have to apply on an individual basis to the Commissioner for approval to keep their GST records offshore, even though they would not need to do so for income tax and certain other purposes.

Updating the record-keeping rules in this way should also assist with administering the amended GST registration rules for non-residents (also discussed in this Commentary), which are likely to result in an increased number of non-resident businesses registering for GST.

REPEAL OF SECTION 2(4) OF THE TAX ADMINISTRATION ACT 1994

(Clause 63)

Summary of proposed amendment

Section 2(4) of the Tax Administration Act 1994 is being repealed. Section 2(4) specifies that provisions in the Tax Administration Act that correspond to provisions in the Income Tax Act 1976 do not apply generally to any of the Inland Revenue Acts other than the Income Tax Act 2007.

Application date

The amendment will apply from the date of enactment.

Key features

Section 2(4) of the Tax Administration Act 1994 will be repealed. This means that provisions which originated in the Income Tax Act 1976 will now generally apply to the Inland Revenue Acts.

Background

Under section 2(4) of the Tax Administration Act 1994, provisions that correspond to provisions of the Income Tax Act 1976 do not generally apply to any of the Inland Revenue Acts other than the Income Tax Acts. This provision was transitional in nature and applied because many of the sections of the Tax Administration Act 1994 originated from the Income Tax Act 1976, and such provisions applied only to income tax.

However, in 1996 the definition of “tax” in section 3(1) of the Tax Administration Act 1994 was substituted and is no longer restricted to income tax. In conjunction with the replacement of other parts of the Tax Administration Act 1994, such as disputes and penalties with provisions that apply to all tax types, this means that section 2(4) is now spent.

REMOVING THE REMNANTS OF DEPRECIATION LOADING

(Clauses 22 and 60)

Summary of proposed amendment

As part of Budget 2010, it was announced that depreciation loading would be removed on a prospective basis from 21 May 2010. Depreciation loading was a policy that increased the amortisation rate of most depreciable assets by 20%.

When depreciation loading was first introduced, a 20% loading was also applied to two special amortisation regimes: one that applies to certain horticultural plants and one that applies to certain land improvements made by a person involved in an agricultural business (such as a farmer). Due to an oversight, this loading was not removed from these two special regimes as part of Budget 2010.

To correct this, it is proposed that this loading be removed on a prospective basis from the date the bill is introduced. Taxpayers who have purchased or planted, or were committed to purchasing or planting, relevant assets or plants on or before this date will continue to be able to apply the loading. The loading will cease to apply to assets purchased thereafter.

This application date is necessary to prevent taxpayers from bringing forward expenditure on relevant assets or plants to take advantage of the loading before its repeal.

Note that the amortisation rate for the regressing and fertilising of pasture (schedule 20, part A, row 2) is not being changed as it does not have the loading.

Application date

The amendment will apply on a prospective basis from the day the bill is introduced.

KIWISAVER AND VOLUNTARY BONDING SCHEME PAYMENTS

(Clause 96)

Summary of proposed amendment

Payments from voluntary bonding schemes administered by the Ministries of Health, Education and Primary Industries are to be excluded from the KiwiSaver Act 2006. Therefore, the requirements in the principal Act to make employee deductions and employer contributions will not apply to voluntary bonding scheme payments.

Application date

The amendment will apply from the date of enactment.

Key features

Section 4 of the KiwiSaver Act 2006 will be amended to exclude from the definition of “salary and wages” a payment under a voluntary bonding scheme that is funded by the Ministry for Primary Industries, the Ministry of Health or the Ministry of Education.

Background

Three voluntary bonding schemes were established by the Government in 2009. They are administered by the Ministry for Primary Industries (previously the Ministry of Agriculture), the Ministry of Health and the Ministry of Education. The schemes seek to encourage recent graduates to work in hard-to-staff specialities and geographical locations within the relevant industries.

Payments are available for up to five years for doctors, nurses, midwives, teachers and veterinarians who work in specified areas. The intention is that the payment amounts (after tax) will be used by the applicants to reduce their remaining student loan debt.

Detailed analysis

For applicants who are employees, the voluntary bonding scheme payments are income in connection with employment and fall within the definition of “extra pay” within the Income Tax Act 2007.

The definition of “salary or wage” in the KiwiSaver Act 2006 includes extra pay (as defined in section YA 1 of the Income Tax Act 2007), unless otherwise excluded.

Therefore, for employees, a voluntary bonding scheme payment would fall within the definition of “salary or wages” for KiwiSaver purposes. If other process requirements are met, it would be possible for a percentage of the voluntary bonding scheme payment to be treated as an employee KiwiSaver contribution, and for the employer to be required to pay a compulsory employer contribution. The employer, under the KiwiSaver Act 2006, is the person making the payment, in this case the relevant Ministry administering the scheme.

This is an unintended consequence of the specific treatment of the payment under the Income Tax Act 2007 and is contrary to the policy intention that the voluntary bonding scheme be a payment towards the applicant’s student loan debt.

The KiwiSaver Act 2006 provides exemptions for specific government payments that are caught under the broad definition of salary and wages in the Income Tax Act 2007 but where there is not an employment relationship between the payer and the recipient. For example, payments of the unemployment benefit and student allowance are not subject to KiwiSaver requirements due to an exemption from the definition of salary or wages. The bill proposes a similar exemption for the voluntary bonding scheme payments.

PROVISIONS RELATING TO OVERSEAS BENEFITS

(Clauses 11, 39, 57 (21, 22, 27) and 108)

Summary of proposed amendment

This bill rationalises some provisions relating to overseas benefits in the Income Tax Act 2007.

Application date

The amendment will apply from the date of enactment.

Key features

This bill proposes to simplify some provisions relating to overseas benefits in the Income Tax Act 2007 particularly the interaction with the Social Security Act 1964. The amendments will not reduce any person's entitlements.

Background

Currently, section CW 28 of the Income Tax Act 2007 exempts an overseas benefit from income tax to the extent that section 70 of the Social Security Act 1964 applies. These tax exemptions are still relevant but their interaction with the Social Security Act 1964 is complex and can be simplified.

Some provisions also need updating as they are now spent. For example, the references to the Social Welfare (Transitional Provisions) Act 1990 (which mostly relates to national superannuation and the veteran's pension) in some provisions in the Income Tax Act 2007 are no longer necessary because most parts of the former Act are now spent.

TAX CONCESSIONS FOR CERTAIN NON-RESIDENT COMPANIES

(Clauses 38, 57 (13) (23) and 109)

Summary of proposed amendment

The bill repeals residual tax concessions for certain non-resident investment companies in the Income Tax Act 2007 as they are now outdated and could pose a risk to the tax base.

Application date

The amendment will apply from the 2013–14 income year.

Key features

The residual tax concessions for certain non-resident investment companies in the Income Tax Act 2007 are being repealed; related Orders in Council are also being revoked. The concessions have outlived their original purpose and are now inconsistent with a broad-base, low-rate tax framework. Moreover, retaining the tax concessions poses a revenue risk.

Background

The Income Tax Act 2007 provides residual tax concessions for certain non-resident companies investing in projects that are specified in four Orders in Council. The main concession relates to interest derived by these non-resident investment companies from specified projects.

The income tax on interest derived by a non-resident investment company from a specified project is limited to the lower of the New Zealand company tax rate and the tax rate imposed in the non-resident company's home country. This is done by providing a tax credit for the amount (if any) by which the New Zealand company tax exceeds the amount of home tax. A similar concession applies for dividends derived by a non-resident investment company from specified projects. The interest paid to the non-resident investment company from these specified projects is also exempt from non-resident withholding tax.

The tax concessions for non-resident investment companies were generally repealed in 1995 as they were considered inconsistent with a broad-base, low-rate tax system, and were considered to be largely redundant in light of international tax reforms at that time. However, the concessionary rules were grandparented for the four Orders in Council then in force. The Orders in Council are:

- Income Tax (Non-resident Investment Companies) Order 1970;
- Income Tax (Non-resident Investment Companies) Order 1972;
- Income Tax (Non-resident Investment Companies) Order (No 2) 1972; and
- Income Tax (Non-resident Investment Companies) Order (No 3) 1974.

AMENDMENT TO STAMP AND CHEQUE DUTIES ACT 1971

(Clause 93)

Summary of proposed amendment

The Taxation (International Investment and Remedial Matters) Act 2012 replaced section 86I of the Stamp and Cheque Duties Act 1971. This change was to accommodate a zero rate of AIL for retail bonds that are traded in New Zealand.

However the replacement of section 86I failed to incorporate a 2010 amendment that clarified that AIL could be paid for the purposes of “an exemption under a double tax agreement”. The bill reinstates this 2010 amendment.

Application date

The proposed amendment will apply from 7 May 2012, the date that the Taxation (International Investment and Remedial Matters) Act replaced section 86I.

TECHNICAL CHANGES

(Clauses 12, 13, 102 and 103)

Summary of proposed amendment

The amendment makes minor technical changes to the Income Tax Acts 2004 and 2007 to correct an unintended change following the rewrite of the Income Tax Act 1994. The amendment restores the rules to the original position so that payments and services provided to Members of Parliament (MPs) so they can carry out their Parliamentary duties are taxed only to the extent of any private benefit, rather than in full.

Application date

The provision will apply from 1 April 2005.

Key features

Sections CW 31 and CX 12 of the Income Tax Act 2007 relating to services for MPs and their predecessors (sections CW 25 and CX 11 of the Income Tax Act 2004) will be amended so that only the private element of any payment provided to MPs under the Civil List Act 1979 will be taxed and not the full amount.

Background

Under the Civil List Act 1979, MPs are provided with certain services and payments so they can carry out their Parliamentary duties. However, an inadvertent consequence of the fringe benefit tax provisions being rewritten is that the full amount of any such payment is treated as a fringe benefit and taxed, not just the amount relating to any private element of the service in question. This would mean that payments and services provided to MPs would be taxed more harshly than other taxpayers.

The anomaly in the tax legislation is already being corrected prospectively through the Members of Parliament (Remuneration and Services) Bill. However, that amendment is prospective only. A retrospective amendment is also required to the Income Tax Acts 2004 and 2007 provisions relating to services for MPs under the Civil List Act 1979, effective from 1 April 2005, the date of the rewritten legislation. Without such an amendment, there would be unintended tax consequences for this earlier period.

REWRITE ADVISORY PANEL AMENDMENTS

The following amendments reflect the recommendations of the Rewrite Advisory Panel following its consideration of submissions on the rewritten Income Tax Acts. The Panel monitors the working of the 2007 Income Tax Act and reviews submissions on what may be unintended changes in the law as a result of its having been rewritten. The Panel recommends legislative action, when necessary, to correct any problems.

Application dates

Unless otherwise stated all the amendments will apply retrospectively, with effect from the beginning of the 2008–09 income year.

Minor maintenance items

The following amendments relate to minor maintenance items referred to the Rewrite Advisory Panel as minor maintenance items and retrospectively correct any of the following:

- ambiguities;
- compilation errors;
- cross-references;
- drafting consistency, including readers' aids – for example, the defined terms lists;
- grammar;
- punctuation;
- spelling;
- consequential amendments arising from substantive rewrite amendments; or
- the consistent use of terminology and definitions.

Application dates

In the table below, amendments to the Income Tax Act 2004 (ITA) apply from the beginning of the 2005–06 income year.

Clause	Section	Act	Amendment
27 105	EC 7 EC 7	ITA 2007 ITA 2004	Clarifying the drafting to resolve ambiguity.
32 106	EE 60 EE 51	ITA 2007 ITA 2004	Clarifying the drafting to resolve ambiguity.
36	HA 33	ITA 2007	Correction of a cross-reference.
37	LK 1	ITA 2007	Clarifying the drafting to resolve ambiguity.
45	RD 60	ITA 2007	Correction of a cross-reference.
58	Schedule 3	ITA 2007	Insert a cross-reference.

REMEDIAL AMENDMENTS FOR INLAND REVENUE'S ACCESS AND SEIZURE POWERS

(Clauses 64, 65, and 110)

Summary of proposed amendments

Inland Revenue's search and seizure powers in the Tax Administration Act 1994 and the Schedule to the Search and Surveillance Act 2012 are to be amended to ensure that the powers are appropriate and harmonised between the two Acts.

Application date

The amendments will apply immediately after the items relating to the Tax Administration Act 1994 in the Schedule of the Search and Surveillance Act 2012 come into force, or on 1 April 2014, whichever is first.

Key features

To ensure that Inland Revenue's access and seizure powers in the Tax Administration Act 1994 fit into the Search and Surveillance Act 2012 framework appropriately, it is proposed to insert some cross-references into the Tax Administration Act 1994. Those provisions need to be reflected in the Schedule of the Search and Surveillance Act 2012. Therefore, amendments are proposed to both the Tax Administration Act 1994 and the Schedule to the Search and Surveillance Act 2012 to ensure that the powers are harmonised between the two Acts, as a remedial matter.