

Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill

Commentary on the Bill

Hon Todd McClay
Minister of Revenue

First published in November 2013 by Policy and Strategy, Inland Revenue, PO Box 2198, Wellington 6140.

Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill; Commentary on the Bill.
ISBN 978-0-478-42401-0

CONTENTS

Employee expenditure payments and employer-provided living accommodation	1
Overview	3
Employee accommodation – out-of-town secondments and projects	5
Employee accommodation – on-going multiple work places	10
Employee accommodation – conferences and training courses	12
Employee accommodation – determining taxable value	13
Payments to cover employee meals	16
Distinctive clothing	18
General rule for determining taxable portion of other expenditure payments	20
Expenditure on account of an employee	22
Minor technical matters	24
Thin capitalisation rules	25
Black hole expenditure	41
Overview	43
Applications for resource consents, patents and plant variety rights	44
Claw-back for subsequent applications or disposals	46
Company administration costs	48
Fixed-life resource consents	49
Foreign account information-sharing agreement	51
Deregistration of charities	61
Overview	63
Clarifying how the general tax rules apply to deregistered charities	65
From which point will a deregistered charity be subject to taxing provisions	67
Requirements for deregistered charities with accumulated assets	69
Consequences of deregistration on eligibility to be a charitable organisation	71
Consequences of deregistration on eligibility to be a donee organisation	72
Tax status of certain community housing entities	73
The taxation of land-related lease payments	79
Overview	81
Lease transfer payments	82
Permanent easements	87
Perpetually renewable leases (“Glasgow” leases)	88
Consecutive leases	89
Retirement village occupation rights	91

Other policy matters	93
Financial arrangements – agreements for the sale and purchase of property or services in foreign currency	95
Income tax rates for 2014–15	98
The acquisition date of land	99
Repeal of substituting debenture rule	101
Withholding tax and inflation-indexed bonds	104
Deductions for underground gas storage facilities	107
Charities with overseas charitable purposes	108
Change of tax residency for GST purposes	109
Zero-rated services supplies to non-residents	111
Classification of mining permits as real property for tax purposes	113
Extending the tax exemption for non-resident offshore oil rig and seismic vessel operators	114
GST remedial matters	117
Overview	119
Scope of the “hire purchase” definition	120
Dwelling definition – retirement accommodation	121
Output tax on the disposal of land	122
Directors’ fees	123
Surrenders and assignments of interests in land	125
Procurement of a lease	126
Non-profit bodies exemption	127
Allowing inputs to registered persons subject to the domestic reverse charge	128
Wash-up rule for taxable or non-taxable use	129
Transitional rule for commercial dwelling accommodation acquisition costs before 1 October 1986	130
Requirement to be registered	131
Minor GST remedial changes	132
CFC remedials	133
CFC and FIF exemptions for Australian unit trusts	135
Repeal of section DB 55	137
Indirect interests in FIFs	138
Active business test for wholly owned groups	139
Negative passive income and accounting standards test for CFCs	140
Foreign exchange gains and losses on liabilities	141
Apportioned funding income	142
Rewrite Advisory Panel remedials	143
Overview	145
Requirement to amend assessments on recovery of dividends from shareholders	146
Option to use foreign tax balance date	147
Foreign company – meaning of direct control interest	148
Comparative value method for calculating FIF income	149
Land transferred to a close relative	150
Liability when company leaves consolidated group	151

Revocation of directors' elections	152
Treatment of foreign trusts when settlor becomes resident	153
Shortfall penalties and groups of companies	154
Minor maintenance items	155
Other remedial matters	157
Spreading of income for income derived from land	159
Mixed-use assets – remedial amendments	162
Loss grouping contingent on group loss company satisfying its liabilities for deductible expenditure	166
Remitted amounts on discharge from bankruptcy	171
Serious hardship	174
Unacceptable tax position	176
Clarification of new due date for payment of tax	178
References to loss attributing qualifying companies	180
Working for Families tax credits	181
Child support remedials	184
Tax Administration Act 1994: cross-references to sections 108 and 109	186
Trusts that are local and public authorities	188

Employee expenditure payments
and employer-provided living
accommodation

OVERVIEW

Over recent years there have been some significant concerns around the tax treatment of employer-provided accommodation, accommodation payments and other allowances and payments by employers to cover employee expenditure. Current tax legislation can lead to impractical outcomes that may differ from how employers apply the rules in practice.

Under current tax law, when an employee expenditure payment is made, provided it is to cover a work expense, it is not taxable. However, when there is a private element linked to the expense, that element is taxable. This is because it is considered to be in effect an alternative to receiving more salary or wages, which would be normally taxed.

An expense is private in nature if it is intended to further some personal purpose or provide a private or domestic benefit. As meals, accommodation and normal clothing are inherently private, the starting position under current tax law is that any employee expenditure payment to cover these sorts of expenses should be taxed.

In many instances, however, the private benefit is either incidental to the business objective or is minimal or hard to measure, and apportionment between the private and employment purpose is not practical, given the compliance costs associated with separating out the relative elements. Accordingly, the proposals in the bill apply the principle that the private amount should be ignored when low in value or hard to measure, and not provided as a substitute for salary or wages.

The proposals also take into account three key policy objectives:

- To improve clarity and certainty, thereby improving compliance. Rules that are relatively easy for employers to understand and apply aid compliance and help to minimise compliance and administration costs.
- To improve fairness by ensuring employees pay their fair share of tax, and that social assistance payments are targeted at those in genuine need. When an employee expenditure payment provides a substitute for labour income or a material private benefit, it ought to be, like salary and wages, taxed and included in income when determining eligibility for social assistance. This ensures that the tax and social assistance outcomes are the same for employees irrespective of the composition of their remuneration.
- To enhance economic efficiency by ensuring that tax rules in this area are not an impediment to business decision-making. The law on employee expenditure payments can affect a broad spectrum of employees who incur expenditure during the course of their work and for which they are reimbursed by their employers. In some cases their employers ultimately bear the additional tax costs. Other than this direct financial implication for the employee or employer, there is the potential for the tax rules to act, where the payment relates to accommodation and meals, as a disincentive to the free movement of labour and, more generally, to normal business activities that require travel. To avoid these economic costs, it is crucial to have rules that are clear and that tax only the private benefit element.

The proposed new rules have been developed after significant consultation, both leading up to the release of the November 2012 issues paper, *Reviewing the tax treatment of employee allowances and other expenditure payments*, and subsequently. A total of 27 submissions were received on the suggestions in the officials' issues paper. Most submissions focussed on the tax treatment of accommodation expenses and establishing a boundary between private and work-related expenditure.

Subsequently, Inland Revenue officials carried out further consultation with key stakeholders, including the Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants and the Canterbury Earthquake Recovery Authority. The main area of concern was that any new rules should encompass not only work-related secondments but also employee involvement in longer-term projects. Those projects included work on the Canterbury earthquake recovery and projects in other locations throughout New Zealand (for example, the ultra-fast broadband roll-out, dam rebuilds and other major water storage projects, and road building projects). The proposals in the bill have taken this various feedback into account.

The proposals include the use of a set of time limits to determine the boundary between when an accommodation benefit is taxable or non-taxable rather than the use of fact-based criteria such as whether the employee still has a house at their previous work location; and valuation rules when it is taxable. A special transitional rule will apply for Canterbury earthquake recovery work.

Potentially, the proposed changes could affect a wide range of employees who are required to work away from their normal place of work for a period of time, as well as on specific groups. However, in most cases the new rules will largely match existing business practice but with the added advantage of providing greater certainty, so the overall effect on employees and employers should be limited.

The merits of the proposed changes are analysed in the Regulatory Impact Statement (available on <http://taxpolicy.ird.govt.nz/publications/type/ris>).

Application dates

Most of the proposed amendments will apply from 1 April 2015. However, there will be a choice of applying the revised accommodation rules to accommodation arrangements put in place on or after 1 January 2011, subject to meeting certain conditions. The changes specific to Canterbury earthquake recovery work will apply from 4 September 2010, the date of the first earthquake.

EMPLOYEE ACCOMMODATION – OUT-OF-TOWN SECONDMENTS AND PROJECTS

(Clauses 20, 33 and 34)

Summary of proposed amendment

When an employer either provides accommodation or an accommodation payment for an employee who is on a secondment or project of limited duration, time limits will apply to determine whether the accommodation or payment is exempt from income tax. An additional transitional exemption is proposed for employees working on Canterbury earthquake recovery projects. (New sections CW 16B, C, E and CZ 29 of the Income Tax Act 2007.)

Application date

The proposed application date for the new rules is 1 April 2015. However, employers and employees will have the choice of applying the new rules retrospectively to accommodation arrangements put in place on or after 1 January 2011, provided they had not taken a tax position before 6 December 2012 (the date of the Commissioner's statement on accommodation) that the amounts involved or accommodation provided were taxable.

In the case of Canterbury earthquake recovery projects, the proposed application date is 4 September 2010, the date of the first earthquake.

Key features

Employer-provided accommodation or an accommodation payment provided because an employee needs to work at a new work location and that location is not within reasonable daily travelling distance of their home, will be tax-exempt provided:

- There is either a reasonable expectation that the employee's secondment to that work location will be for a period of two years or less, in which case the payment will be exempt for up to two years.
- The move is to work on a project of limited duration whose principal purpose is the creation, enhancement or demolition of a capital asset and the employee's involvement in that project is expected to be for no more than three years, in which case the maximum exemption period is three years.
- If the move is to work on Canterbury earthquake recovery projects, the maximum period is extended to five years if the employee starts work in the period starting on 4 September 2010 and ending on 31 March 2015, and to four years if the employee starts work in the period beginning 1 April 2013 and ending 31 March 2016. The maximum period reverts to three years when the employee starts work on or after 1 April 2016.

Background

Employer-provided accommodation and accommodation payments provide an inherently private benefit to an employee and should generally be taxed, particularly if they are provided as part of a salary trade-off. However, sometimes there is little benefit to the employee, largely because the accommodation or payments arise from the requirements of the employer or the job. In these cases there should be no tax liability. A key concern is identifying an appropriate boundary between private and work-related expenditure.

The amendments propose tests based around time limits to determine the boundary. This approach should be easier for employers and employees to apply than tests that use fact-based criteria such as whether an employee has a house in their previous location. It is also the approach used in Australia, Canada, the United Kingdom and the United States. Australia and the United States have a one-year “bright line” tax exemption, while Canada and the United Kingdom have a two-year “bright line” tax exemption.

Detailed analysis

Two-year time limit

Example 1

Adam is an accountant who has worked for his employer in Auckland for 10 years where he lives with his family. He is sent by his employer to New Plymouth for three months to carry out an audit of a large client before returning to the Auckland office. Adam’s employer reimburses his hotel costs in New Plymouth. As Adam’s employer expects him to work in New Plymouth for less than two years, the payment that Adam receives reimbursing him for his accommodation costs in New Plymouth will be exempt income.

Example 2

Bill lives in Wellington. His job is moved permanently to Auckland but he chooses not to move his family and commutes on a weekly basis, returning to Wellington at the weekend. Bill’s employer pays him an accommodation allowance towards his Auckland accommodation costs. Bill and his employer expect he will work at the Auckland workplace for more than two years. The accommodation allowance is not tax exempt under the two year rule.

Accommodation linked to long-term projects of limited duration

The longer maximum exempt time-period of three years allowed for involvement in longer-term projects takes into account business practices, particularly in the construction industry. The workers might be housed at or near the construction site, might share accommodation, and might be employed on a fly in/fly out basis, so would not be relocating. Employees may be recruited specifically from overseas with no intention that they ever relocate to New Zealand.

Example 3

Eddie is seconded by his employer to work on a dam construction project for a client in a remote area of the North Island. Because of the scale of the project, number of workers and remoteness of the location, Eddie's employer sets up an accommodation camp to house its employees. The dam project is expected to take around five years to complete. However, Eddie's employer expects him to work on the project for only the first two and a half years.

Eddie is working on a project involving the construction of a capital asset so the three-year upper time limit applies. His employer expects him to be working at the distant work location for no more than three years so the value of the accommodation is exempt.

While the projects covered by the three-year exemption will often relate to the construction industry, they may also involve upgrades of existing infrastructure and information technology development and implementation, for example. The duration of the project can be longer than three years. The project will also have to satisfy the following requirements:

- Creation of a capital asset – The principal aim of the project must be the creation of a capital asset of some form, whether a new capital asset, a replacement of an existing asset, an upgrade or refurbishment.
- Employment duties specific to the project – The employee must be engaged exclusively on project work (bar incidental activities).
- The project must involve work for a client not related to the employer.

When does the exemption cease?

The payment or employer-provided accommodation will cease to be tax-exempt before the respective maximum period if any of the following occur:

- The employer pays the employee's costs associated with buying a house in or near the new work location, as an eligible relocation expense.
- There is a change in the expectation that the employee will be at the new location for, as relevant, a maximum of two years or three years.
- The employee's involvement in the secondment or project comes to an end before the maximum time is up.

Example 4

Donna works for an employer in Auckland. Her employer sends her to work in Hamilton for an expected 18-month period. After four months, Donna decides that she wants to relocate permanently to Hamilton and her employer agrees to make her job there permanent. Donna's employer has agreed to pay her an accommodation allowance for the first six months after arrival.

Up to the four-month point, Donna's employer's expectation was that she would not be working in Hamilton for more than two years, and payments to cover accommodation up to that point are exempt under the two-year rule. But given the expectation that Donna will now be working in Hamilton for more than two years, payments to cover Donna's accommodation after four months would be taxable.

Anti-avoidance rules

The proposed rules will be subject to certain conditions to protect against abuse:

- The exemption will not apply if accommodation is provided under an explicit salary trade-off arrangement.
- There will be an anti-avoidance rule to prevent behaviour intended simply to restart the respective time limit.

New employees

The above exemptions will apply to accommodation provided to existing employees, and to new employees in specific instances.

New employees will qualify for the three-year exemption subject to the same conditions as existing employees, including that the work is on a project of limited duration and their contract is for a period of three years or less. This will ensure that there is no disparity in the treatment of new and existing employees working on the same project.

New employees will only qualify for the two-year exemption when:

- the employee is newly recruited to work at a particular work location but is then sent to work at another work location temporarily – for example, an individual is recruited to work in Auckland but is then sent to work in Dunedin for a month before returning to Auckland; or
- an employee working for one employer is seconded to work for another employer on a temporary basis, with the expectation that the employee will return to work for the original employer – for example, an individual working for an Australian accountancy firm is sent to work for an affiliated New Zealand firm in Auckland for 18 months.

A more restrictive approach is being taken for new employees in respect of the two-year rule to reduce the likelihood of behavioural changes to the way that new employees are remunerated. The existing rules applying to tax-exempt relocation payments will continue to be available to these new employees.

Exceptional circumstances

There will be a very restricted ability to extend the thresholds in exceptional circumstances. Exceptional circumstances will be confined to those that are outside the control of the employer and employee, such as a natural disaster or medical emergency, that mean the employee has to stay at the work location beyond the maximum tax-free time threshold. The time limit will be extended for as long as the employee is unable to leave the work location because of the exceptional circumstance. Whether exceptional circumstances apply will be determined by self-assessment.

Accommodation linked to Canterbury earthquake reconstruction work

Given the special nature and scale of the Canterbury earthquake reconstruction work, there will be a transitional rule (new section CZ 29) for employer-provided or paid-for accommodation for employees working on Canterbury earthquake reconstruction projects over the period from 4 September 2010 to 31 March 2019.

When the employment duties of the employee require them to work in greater Christchurch on a project or projects for rebuilding or recovery work arising out of the Canterbury earthquakes, the time limit in the definition of “project of limited duration” in proposed section CW 16B(4), is effectively replaced by the following:

- five years when the employee’s date of arrival is in the period from 4 September 2010 to 31 March 2015;
- four years when the employee’s date of arrival is in the period from 1 April 2015 to 31 March 2016; and
- three years when the employee’s date of arrival is in the period from 1 April 2016 onwards, for arrivals up to 31 March 2019. The normal three-year rule will apply to Canterbury rebuild and recovery work from 1 April 2019.

When the date of arrival in “greater Christchurch” (as defined in the Canterbury Earthquake Recovery Act 2011) is in the period from 4 September 2010 (the date of the first earthquake) to 31 March 2015, the time limit will be applied by reference to the time the employee works continuously in greater Christchurch rather than to any expectation. For other periods, the time limits apply based on the employer’s expectation.

Applying time limit in other cases

In the case of other out-of-town secondments and projects, for the period 1 January 2011 to 31 March 2015, the relevant time limit can be assessed by either using the employees actual period of continuous work at the distant work place or the employer’s expectation of how long the employee will be involved in the out-of-town secondment or project (see proposed section CZ 30). For other periods, the time limits apply based on the employer’s expectation.

EMPLOYEE ACCOMMODATION – ON-GOING MULTIPLE WORK PLACES

(Clause 20)

Summary of proposed amendment

The bill proposes that when an employee has to work at more than one workplace on an on-going basis the accommodation or accommodation payment will be tax-exempt without an upper time limit. (New section CW 16F of the Income Tax Act 2007.)

Application dates

The application dates for the proposed new rule are the same as for the previous item.

Key features

There are a number of circumstances in which an employee would have to work at more than one workplace on an on-going basis, because of the nature of their duties, and the additional workplaces are beyond reasonable daily travelling distance from their home. This could be the case, for example, for senior managers of large organisations. In these circumstances there will be an exemption for employer-provided accommodation and accommodation payments, without an upper time limit, given that there will be genuine on-going additional costs in such cases. (If the employee has multiple work places for a limited period, the two or three-year time limit-based exemptions may also apply.)

Detailed analysis

Example 1

Andrew manages two offices, one in Christchurch and one in Dunedin. He works in Christchurch two days a week and in Dunedin for three days a week. His home is in Dunedin. Andrew has more than one on-going work location. When he works in Christchurch, he is beyond reasonable daily travelling distance from his home in Dunedin. An accommodation payment to cover his hotel costs when staying in Christchurch is not taxable. The Christchurch accommodation is exempt under the multiple workplace rule. The Dunedin accommodation is not tax-exempt.

The multiple workplace rule can also apply when an employee is sent on a short-term business trip to another location. In these circumstances the employee will continue to have on-going duties at their normal place of work while they are working at the other work location during the business trip.

Example 2

Carmen is chief executive of a large group of companies based in Auckland. The company has offices in several cities across New Zealand. Each month Carmen visits one of these offices as part of her management duties. Typically these visits can last up to a week and her employer arranges and pays for her accommodation.

When Carmen is visiting the offices away from Auckland she has more than one on-going workplace for the duration of her visit. The accommodation while working at those offices is exempt under the multiple workplace rule.

EMPLOYEE ACCOMMODATION – CONFERENCES AND TRAINING COURSES

(Clause 20)

Summary of proposed amendment

When an employee needs to attend a work-related conference or training course that requires at least an overnight stay, the accommodation or accommodation payment will be tax-exempt without an upper time limit. (New section CW 16D.)

Application dates

The application dates for the new rule are the same as for the previous item.

Key features

While the need for accommodation would normally arise because the work-related conference or training course is beyond reasonable daily travelling distance from the employee's home, this need not be the case. Some courses may be held locally but for reasons, such as networking and team-building, may require employees to stay overnight. Proposed section CW 16D, therefore, covers both local and distant accommodation situations. It is possible, depending on the circumstances, that the multiple work-place exemption or the two or three-year time-based exemption could also apply.

EMPLOYEE ACCOMMODATION – DETERMINING TAXABLE VALUE

(Clauses 11, 12, 24 and 35)

Summary of proposed amendment

When employer-provided accommodation, accommodation allowances and other payments for accommodation are taxable, the proposed revisions to section CE 1B of the Income Tax Act 2007 specify how to determine their taxable value.

In the case of employer-provided accommodation, the taxable value will continue to be linked to market rental value but will be subject to certain adjustments and exceptions.

Application date

The amendments will apply from 1 April 2015. However, the amendments relating to accommodation provided to ministers of religion will apply from 1 July 2013 and those relating to accommodation provided to personnel of the New Zealand Defence Force will apply from 6 December 2012.

Background

When employers make a payment for accommodation, then the market value is just the amount of the payment. However, when an employer directly provides accommodation to its employees, the current approach is to base the taxable amount on its market value. What “market value” means in these circumstances, including what adjustments can be made, is not always clear. The proposed rules endeavour to provide more clarity in this area.

Key features

- The taxable value will be confirmed as market rental value when accommodation is provided by the employer, less any rent paid by the employee and any adjustment for business/work use of the premises.
- There will be a specific valuation rule for accommodation supplied (whether owned or rented) by religious bodies to their ministers (proposed section CW 25B). A long-standing administrative practice has, in certain circumstances, capped the benefit of church-supplied accommodation at 10 percent of ministers’ stipends. This longstanding practice will be incorporated into the legislation, subject to the amount to which this treatment applies being capped at a reasonable rental value that is commensurate with the duties of the minister, and the location in which the minister performs his or her duties. This rule is intended to apply across a wide variety of churches.
- There is also a specific rule to confirm that the market value is discounted in the case of accommodation provided to New Zealand Defence Force personnel to reflect the specific limitations imposed on such properties (proposed section CZ 31).

- The taxable value of employer-funded accommodation provided to employees as part of an overseas posting will be capped at the average or median rental value for accommodation in the vicinity that the employee would live if in New Zealand. This cap, which is of significance to employees who remain tax-resident in New Zealand, recognises that the market rental value of accommodation in overseas locations can be disproportionately high compared with that which an employee might occupy if working in New Zealand.

Detailed analysis

In addition to the above, there will be a rule for when more than one employee shares in the accommodation provided by their employer. In these circumstances, the taxable amount will, for simplicity, be apportioned equally between the employees to ensure the accommodation benefit is taxed only once.

Example

Two employees share a house provided by their employer with a weekly rental value of \$300. They will each be taxed on \$150 per week.

The deduction from the taxable amount when part of the accommodation is used for work purposes (and there is no private benefit) reflects current practice and the amendment is merely intended to clarify and confirm that approach.

Example

An employer provides an employee with accommodation with a market rental value of \$500 a week. One-tenth of the accommodation is used for work purposes. \$50 is deducted from the taxable amount.

Accommodation provided by religious bodies to ministers of religion

The proposed valuation rule based on 10 percent of remuneration for accommodation provided to a minister of religion or member of the clergy by the religious body of which he or she is a minister will apply only to ministers who are performing religious duties. The amount exempted under this rule will be capped based on what is a reasonable rental value commensurate with the duties of the minister and the location in which the minister performs the duties. The proposed valuation rule will apply to a wide range of religious bodies and their ministers. The religious body may own the accommodation or, alternatively, rent the accommodation being provided to the minister. The proposed valuation rule extends to both these situations.

This specific valuation rule will supplement the existing exemption in section CW 25 for board and lodging provided to members of religious societies or orders whose sole occupation is service in a society or order and who are not paid for their service.

Accommodation for employees working overseas

The proposed amendment to use a New Zealand-based value rather than the market value of the overseas accommodation will apply not only to employer-provided accommodation but also when the employer makes an accommodation payment for the employee's accommodation costs at the overseas location.

In establishing the value of the comparable New Zealand property, the work location the employee would be likely to be working in for the employer, and the average or median market rental values at or near that work location would need to be taken into account.

Example

Zoe is seconded by her employer to Brussels for three years and is provided with a flat for the duration of her secondment. The rent paid by the employer is equivalent to \$120,000 a year. Zoe would normally work in Wellington if working in New Zealand, where an average rental value would be \$24,000. Zoe will pay tax on an accommodation benefit of \$24,000.

When there is more than one location in New Zealand where the employee could work for the employer, a New Zealand-wide valuation can be used.

Accommodation provided to Defence Force personnel

The proposed valuation rule for accommodation provided to New Zealand Defence Force personnel is that, up to 31 March 2015, the rent currently being paid will be treated as the market rental value. After that date, the market value will be the lesser of (a) the market rental value for the accommodation and (b) the market rent for the national New Zealand Defence Force benchmark property of that type less a discount. The benchmark properties, their market value and the discount will be determined jointly by the Commissioner of Inland Revenue and the Chief of the Defence Force, following advice from a registered valuer.

Given the compulsion on New Zealand Defence Force personnel to accept a posting anywhere in New Zealand, the New Zealand Defence Force has historically considered it appropriate to take a national approach to considering market rental value of New Zealand Defence Force accommodation. The deployment of personnel is concentrated around the central North Island, and therefore national benchmark properties have previously been assessed by reference to accommodation in the area of Linton Camp. Linton also offers a representative range of NZDF housing stock, reasonable access to amenities and a stable basis for rental comparison purposes.

PAYMENTS TO COVER EMPLOYEE MEALS

(Clause 22)

Summary of proposed amendment

The full amount of meal payments linked to work-related travel will be tax-exempt, subject to a three-month upper time limit at a particular work location. The full amount of meal payments and light refreshments outside of work-related travel, such as at conferences, will be tax-exempt without a time limit. Such payments include reimbursement payments and allowances.

Application date

The amendments will apply from 1 April 2015.

Key features

Proposed section CW 17 CB will introduce two specific exemptions:

- An exemption of up to three months for meal payments if the employee is required to work away from their normal work location because of travelling on business. This may be for a specific short-term, work-related journey or for a longer period such as a secondment to a distant work location.
- Payments to cover working meals and light refreshments when working off the employer's premises will be exempt without any upper time limit.

In both circumstances, when the exemption applies, the full amount of any meal payment will be exempt.

These proposed rules will not affect the existing exemptions in section CW 17C that apply to overtime meal payments and sustenance allowances.

Likewise it is not intended that meals provided directly by the employer should be subject to these rules. Such meals may, however, be subject to the fringe benefit tax rules.

Background

Employers typically meet an employee's meal costs when linked to work-related duties. This recognises that these meal costs may be more expensive than normal meal costs at home for the employee.

When an employer reimburses the cost of a work-related meal, the amount saved by the employee (in other words their normal expenditure on the meal) is arguably taxable. However, it would not be practical to carry out an apportionment each time a meal payment is made. A more practical approach that better matches business practice is needed, given that these meal payments are generally not provided as a substitute for taxable salary.

Detailed analysis

Calculating the three-month time limit

The three-month time limit will run from the date the employee starts working at the workplace and extend for as long as the employee works continuously at that location.

Example

Vernon normally works in Christchurch but is sent by his employer to work in the employer's Nelson office for a period of six months. Vernon's employer pays him a meal allowance for the duration of the secondment. The meal allowance is exempt for the first three months and taxable for the remainder of the secondment.

If the employee does not have a fixed work base, but instead works at a variety of locations and works out of an accommodation base, the time limit will apply from the date at which they arrive at the accommodation base.

Example

An employee is working on an infrastructure project that requires him to work in a variety of locations. Rather than moving to each location, the employee rents a house to use as a base from which he can travel to those locations each day as required. The three-month time limit will apply from the date the employee moves to the rented accommodation.

In determining whether the employee is working continuously at a particular location, periods when away from the location for personal reasons such as leave, weekend breaks and short breaks that are required for work purposes will be disregarded.

The payment will not be exempt when it is paid by way of a salary trade-off.

Working meals and light refreshments at or near the employee's normal work location

Payments to cover meal expenses for a working meal near the employee's work location will be exempt. For example, this will include lunches at conferences or training courses near the employee's normal work location.

The expense will only be exempt if the employee attends the meal because of the nature of the duties of the job. The meal expense will not be exempt if it is provided as a salary trade-off.

The amendments will also introduce an exemption for payments for light refreshments (in the form of tea, coffee, water or similar), when the following criteria are met:

- the employee normally works at least seven hours a day;
- the nature of the employee's employment duties mean he or she has to be away from the employer's premises for most of the day;
- the employer would normally provide the refreshments to the employee on the day; and
- it is not practicable for the employer to provide the refreshments on the day.

DISTINCTIVE CLOTHING

(Clause 23)

Summary of proposed amendments

The amendments propose exemptions for:

- payments provided to cover the costs of purchasing and maintaining distinctive work clothing, such as uniforms, that are clearly related to the employee's job; and
- payments to meet the costs of a plain clothes allowance paid to members of a uniformed service who are required to wear ordinary clothing instead of their uniform.

Application date

The amendments will apply from 1 July 2013.

Key features

The amendment to exempt payments provided to cover the costs of purchasing and maintaining distinctive work clothing, such as uniforms, will ensure that the rules covering employee expenditure payments are better aligned with the equivalent fringe benefit rule.

Background

Under the current general rules used to determine whether a payment or allowance is taxable, expenditure incurred on the purchase and maintenance of clothing is normally a private expense. Case law has confirmed that there is an exception to this general approach when the particular clothing is "necessary and peculiar" to the employee's occupation. This has been taken to include a uniform, or specialist clothing that is not reasonably suitable for private use. Examples include uniforms worn by nursing staff, members of the armed forces and police officers. However, ordinary clothing of a particular style or colour which could reasonably be worn outside the job would not be treated as a uniform. Specialist clothing might include overalls and protective clothing worn for health and safety reasons.

When an employer directly provides or maintains work-related clothing instead of paying an allowance, the fringe benefit tax rules apply. Rather than relying on case law, the Income Tax Act specifically includes a distinctive work clothing exemption (section CX 30). Applying this same approach to clothing allowances would provide consistency in this area.

Detailed analysis

The proposed changes in section CW 17CC will make it clearer that an allowance to cover the cost of buying and maintaining distinctive work clothing will not be taxable income. “Distinctive work clothing” is defined drawing on the fringe benefit tax definition in section CX 30(2) to mean a single item of clothing, that:

- is worn by an employee as, or as part of, a uniform that can be identified with the employer:
 - through the permanent and prominent display of a name, logo, or other identification that the employer regularly uses in carrying on their activity or undertaking; or
 - because of the colour scheme, pattern or style is readily associated with the employer; and
- is worn in the course of, or as an incident of, employment; and
- is not clothing that employees would normally wear for private purposes.

Payments in relation to the purchase and maintenance of other clothing will continue to be subject to the general rules for determining when a payment that does not have its own exemption rules is tax-exempt.

The proposed distinctive clothing exemption will also cover partly taxable plain clothes allowances that were in place as at 1 July 2013 and paid to uniformed personnel who are required to wear plain clothes in order to carry out their duties. This is in line with a long-standing expectation that a portion of the plain clothes allowance paid to police officers is non-taxable, based on the specific circumstances involved. The formal exemption of the non-taxable portion will apply only when:

- the employer provides a uniform to all or almost all of its employees to wear when performing the duties of their employment; and
- despite the fact that the employee has been provided with a uniform, it is a requirement of their current job with the same employer that they do not wear that uniform and, therefore, need to wear plain clothes; and
- the plain clothes allowance was in place at 1 July 2013; and
- part of that allowance was treated as taxable.

GENERAL RULE FOR DETERMINING TAXABLE PORTION OF OTHER EXPENDITURE PAYMENTS

(Clauses 21 and 134)

Summary of proposed amendment

Various legislative changes, including a Commissioner determination-making power, are proposed in relation to the general rule that determines what portion of other payments made to employees are exempt income.

Application date

The amendments will apply from 1 April 2015.

Key features

The amendments add several criteria to the general rule in section CW 17 of the Income Tax Act 2007 for determining the tax treatment of amounts paid to or for the benefit of employees for expenditure in connection with their employment or service. These criteria are intended to clarify when an expense would be an allowable deduction in relation to earning employment income and, therefore, would be non-taxable.

The amendments will also provide the Commissioner of Inland Revenue with the ability to issue determinations on what proportion of a particular type of payment provided to a wide group of employees would be exempt income.

Background

For the most part, beyond the specific payments discussed earlier in relation to accommodation, meals and distinctive clothing, the general rule for establishing the taxable part of an employee expenditure payment works satisfactorily. However, some further clarity about what the rule involves is merited. Furthermore, there is still the possibility that at some time in the future the general rule may not provide an appropriate outcome for another particular type of payment. There are advantages in having a mechanism to handle this other than through specific legislative amendment.

Detailed analysis

Nexus test – clarifying the approach

Under the current approach, expenditure being paid to or on behalf of the employee is exempt income of the employee provided it is incurred in connection with the employee's employment or service, and the employee would be allowed a deduction of that amount if the limitation on employees claiming deductions (the employment limitation) did not exist. This is often referred to as the "nexus test". It effectively means that a payment is exempt provided it is not of a private, domestic or capital nature. Given that these rules generally deal satisfactorily with the vast majority of expenses that do not have their own rule, the proposed changes are simply aimed at providing greater clarity about what the nexus test involves.

Section CW 17 clarifies that to qualify as expenditure that is incurred in connection with an employee's employment or service, it must be because the employee is performing an obligation required by their employment or service, and the employee earns income through the performance of the obligation, and the expenditure is necessary in the performance of the obligation.

Commissioner determination-making power

The amendments introduce a power to enable the Commissioner to issue a determination (under section 91AAT of the Tax Administration Act 1994) in relation to a payment made to a wide group or class of employees. The Commissioner may determine the extent to which on average the amount is exempt income, by setting a percentage that represents the extent to which the payment for the particular type of expense, based on a reasonable estimate, is taxable.

This determination-making power would be discretionary and the Commissioner would need to be satisfied that the payment not only affects a large group or class of employees but also that the average private or capital benefit likely to be received is hard to measure, and that the payment is not paid as a substitute for salary or wages.

Any determination issued will be binding on the Commissioner but not the taxpayer, which means that it will act as a safe harbour. If the employer or employee has evidence to demonstrate that in their particular circumstance some other apportionment is appropriate under the section CW 17 general rule, the taxpayer will still be able to apply that apportionment.

EXPENDITURE ON ACCOUNT OF AN EMPLOYEE

(Clause 13)

Summary of proposed amendment

A minor technical change to the exclusions from the definition of “expenditure on account of an employee” is proposed.

Application date

The amendment will apply from 1 April 2015.

Key features

The amendment changes the general “expenditure on account of an employee” definition to make a clearer distinction between the exclusion in section CE 5(3)(c) and the exclusion in section CE 5(3)(a), and removes any overlap.

Background

When an employer reimburses or otherwise meets a specific employee expense, this is an employee expenditure payment known as “expenditure on account of an employee”. The statutory definition is very widely drawn, so there is a comprehensive list of exclusions from the definition, including two general exclusions that cover employee expenditure payments in general.

The first of these excludes payments to third parties or to employees for expenditure incurred by those employees in deriving their employment income. The second excludes payments made by employers to employees for expenses that an employee had incurred and paid for on their employer’s behalf, when the expenses were the employer’s liability. An example would be when the employee buys a box of photocopying paper on the employer’s behalf on the basis that the employer will reimburse them.

There have been significant changes to the definition of “expenditure on account of an employee” since it was first introduced in 1985. As a result, the general exclusions have been amended and expanded and it is no longer clear how the two exclusions should apply in relation to each other. Arguably, there is now some overlap, which the proposed amendment is designed to remove.

Detailed analysis

The amendment changes the general exclusion in section CE 5(3)(c) of the Income Tax Act 2007 so that it applies subject to:

- the particular payment not falling within section CE 5(3)(a), which should take priority;
- the expense covered by the payment being incurred by or on behalf of the employee's employer; and
- the expense having been paid for by the employee on their employer's behalf.

Provided these criteria are satisfied, the payment will be excluded from being expenditure on account of an employee under section CE 5(3)(c).

MINOR TECHNICAL MATTERS

(Clauses 11, 13, 21, 31 and 32)

Summary of proposed amendment

Several technical amendments are proposed to support the wider changes to the rules governing the tax treatment of employer-provided accommodation, accommodation payments and other allowances and payments by employers to cover employee expenditure.

Application date

The amendments will apply from 1 April 2015.

Key features

The amendments cover changes to definitions, headings and cross-references that are being made to ensure compatibility with the proposed rules.

Thin capitalisation rules

OVERVIEW

The thin capitalisation rules form part of New Zealand's international tax rules and are designed to protect our tax base. The rules place limits on how much debt a non-resident can put into their New Zealand investments. This is important as the use of debt is one method that non-residents can use to move profits out of New Zealand to significantly lower the amount of New Zealand tax they would otherwise pay.

The thin capitalisation rules have generally been operating effectively. However, Inland Revenue's investigators, through their normal audit work, have come across some situations where strengthening the rules would be beneficial.

There are two key concerns with the existing rules. They currently only apply when a single non-resident controls a New Zealand investment. However, investors can often act together in a way that mimics control by a single investor. The rules can also be ineffective when the debt of a worldwide group of companies comes from shareholders rather than third parties.

To respond to these issues, the bill proposes expanding the thin capitalisation rules so they apply when a group of non-residents appear to be acting as a group and own 50 percent or more of a New Zealand investment. The bill also proposes ignoring shareholder debt when taxpayers are calculating their allowable level of New Zealand debt under the rules.

Amendments to three other aspects of the rules are intended to address other areas where the rules appear to be deficient.

These changes were signalled in an issues paper, *Review of the thin capitalisation rules*. The original proposals have been modified, based on feedback received. For example, the definition of shareholders "acting together" in the bill is more certain than that originally proposed, and there is now a limited extension to what is known as the "on-lending concession" for trusts.

The proposed changes will apply from the beginning of the 2015–16 income year.

PROPOSED CHANGES TO THE THIN CAPITALISATION RULES

(Clauses 87 to 98, 123(30) and 123(32))

Summary of proposed amendments

The bill proposes changes to five aspects of the thin capitalisation rules. The most significant change of these extends the rules so they will apply when non-residents who appear to be acting together own 50 percent or more of a company. Non-residents will be treated as acting together if they hold debt in a company in proportion to their equity, have entered into an arrangement setting out how to fund the company, or act on the instructions of another person (such as a private equity manager). The bill will also extend the rules so they apply to all trusts that have been majority settled by non-residents, as well as all companies controlled by the trustees of such trusts.

The bill will change what is known as the “110 percent worldwide debt test”. This test, in essence, compares the amount of debt in a company’s worldwide operations to the debt in the company’s New Zealand operations. The proposed change will mean debt that originates from shareholders will be excluded when calculating the debt level of a company’s worldwide operations.

Increases in asset values following internal company reorganisations will be ignored, unless the increase in asset value would be allowed under generally accepted accounting principles in the absence of the reorganisation, or if the reorganisation is part of the purchase of the company by a third party.

The bill will also make a technical change to ensure that, in the outbound thin capitalisation rules, individuals and trustees must generally exclude their indirect interests in offshore companies if the interest is held through a company they are associated with.

Key features

- Sections FE 2, FE 4, FE 26 and FE 31D extend the inbound thin capitalisation rules to cases in which non-residents act together when investing in New Zealand (they currently apply only when a single non-resident controls the investment).
- Section FE 18 excludes, from the worldwide group debt measure used in the inbound rules, debt linked to shareholders of group entities or to persons associated with shareholders.
- Sections FE 2, FE 3 and FE 26 extend the inbound rules to apply to all resident trustees if 50 percent or more of settlements made on the trust were made by a non-resident, non-residents acting together or other entities subject to the thin capitalisation rules.
- Section FE 13 extends the on-lending concession so that it applies to all financial arrangements held by a trust provided certain criteria are met.
- Section FE 16 ignores increases in asset values that are the result of transactions between associated persons, unless the increase would be allowed by accounting standards in the absence of a transaction.

- Section FE 16, in relation to the outbound thin capitalisation rules, forces consolidation of interests held by individuals or trustees with interests held by companies in which they have a significant interest.

Application date

The amendments will apply from the 2015–16 income year.

Background

An officials' issues paper, *Review of the thin capitalisation rules*,¹ released in January 2013 proposed six changes to the thin capitalisation rules.

The issues paper proposed the following changes:

- that the thin capitalisation rules would apply if a group of non-residents who were “acting together” own 50 percent or more of a company;
- a change to what is known as the “110% worldwide debt test” to exclude debt that originates from shareholders when calculating the debt level of a company’s worldwide operations;
- extending the rules so they apply to all types of trust that have been majority-settled by a non-resident, or a group of non-residents “acting together”;
- excluding capitalised interest from a company’s asset base;
- requiring individuals and trustees to consolidate a trust’s interests with companies they own when determining their New Zealand group;
- ignoring increases in asset values that are the result of an internal sale of assets.

Fifteen submissions were received on the issues paper. Most submitters agreed with the need to reform the thin capitalisation rules but raised several technical concerns, such as the proposed method of defining non-residents “acting together”.

Officials subsequently released a second paper, *Thin capitalisation review: technical issues*,² to address the technical concerns raised by submitters.

Based on feedback in both rounds of consultation, several changes were made to the original proposals. For example, the definition of shareholders “acting together” in the bill is more certain than that originally proposed, and there is now a limited extension to what is known as the “on-lending concession” for trusts.

¹ The paper can be found at <http://taxpolicy.ird.govt.nz/publications/2013-ip-thin-capitalisation/overview>.

² The paper can be found at <http://taxpolicy.ird.govt.nz/publications/2013-ip-thin-capitalisation-technical-issues/overview>.

Detailed analysis

Companies controlled by shareholders acting together

The thin capitalisation rules are designed to apply to companies controlled by shareholders who have the ability to substitute equity with debt. This is clearly the case when a company is controlled by a single non-resident – the controlling non-resident has little constraint on how it can fund the company, and so is free to invest through debt rather than equity. However, this ability to substitute equity with debt is also available to non-residents who are acting together. They are able to coordinate their activities and act in much the same way as a single non-resident yet the current rules do not apply.

The bill proposes to extend the rules so they apply also to companies controlled by a group of shareholders who are acting together. Section FE 2 of the Income Tax Act 2007 will be amended so the thin capitalisation rules apply to a company where a *non-resident owning body* holds 50 percent or more of a company's ownership interests, or has control of a company by any other means.

Consequently, section FE 1 will also be amended to reflect the broader application of the rules.

Non-resident owning body

Proposed amendments to section FE 4 define a non-resident owning body.

To be a non-resident owning body, two or more non-residents will have the following characteristics:

- have, directly or indirectly,³ debt in the company in proportion to their equity;
- have an agreement that sets out how the company should be funded if the company is not *widely held* (a term defined in section YA 1);
- exercise their rights under their ownership interests in a way recommended by a person or persons (such as a private equity manager), or similarly a person or persons act on the members' behalf to exercise their rights.

Member interests will only need to be approximately in proportion. This rule is intended to prevent taxpayers from structuring investment arrangements to avoid exact proportionality.

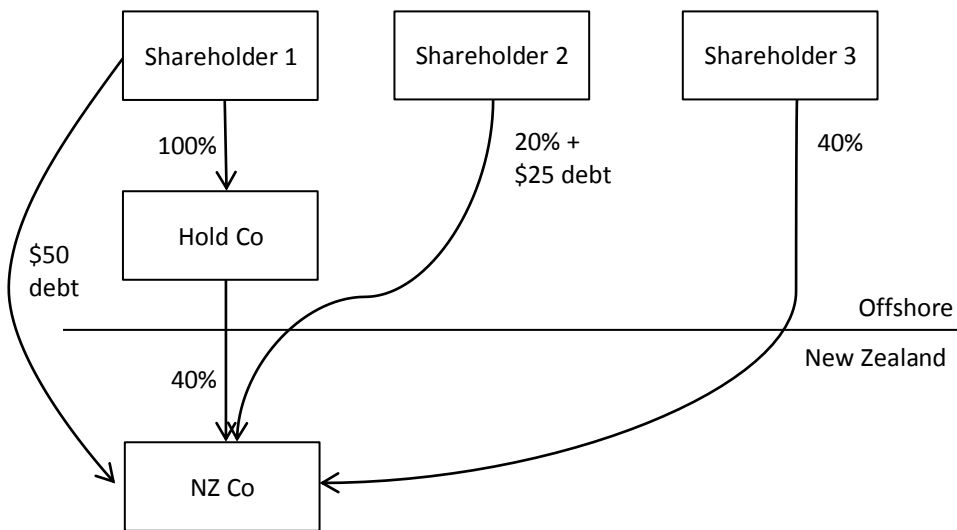
An agreement that sets out how an entity should be funded in the event of a specified event (such as insolvency) will not constitute an agreement that sets out how the company should be funded.

³ Legally, debt cannot be held indirectly. Accordingly, proposed section FE 4(1)(a)(ii) will provide how to determine if debt is held indirectly in proportion to equity.

Example

Resident company NZ Co has three non-resident shareholders: Hold Co, Shareholder 2 and Shareholder 3. Shareholder 1 owns 100 percent of the shares in Hold Co, and is therefore an indirect owner of NZ Co.

Shareholder 1 and Shareholder 2 have also lent money to NZ Co (\$50 and \$25, respectively).



Shareholder 1 (together with its associate Hold Co) and Shareholder 2 will be members of a non-resident owning body. Shareholder 1 has 40 percent of the shares in NZ Co and has lent it \$50 (a ratio of 0.8:1). Shareholder 2 has 20 percent of the shares in NZ Co and has lent it \$25 (also a ratio of 0.8:1).

The thin capitalisation rules will therefore apply to NZ Co as 60 percent of its shares are held by a non-resident owning body.

The ownership interests of a non-resident owning body will be determined as if the members of the body are associates. This means that, as per section FE 41, the ownership interests of the owning body will be calculated by aggregating the ownership interests of the body's members, except to the extent the aggregation would result in double-counting.

Example

Resident company A Co has five non-resident shareholders who have an agreement that specifies how company A should be funded: Mr W (married to Mrs W), Mrs W, Mr X, Mr Y and Mr Z. Each holds 20 percent of the issued shares.

Mr W's ownership interest in A is 40 percent (as his interests are aggregated with Mrs W under section FE 41). Mrs W's ownership interest is similarly 40 percent. The other shareholders (who are not associated with each other or Mr and Mrs W) have an ownership of 20 percent each.

The ownership interests are added together, but with 40 percent removed to correct for double-counting of Mr and Mrs W's interests.

The non-resident owning body made up of Mr W, Mrs W, Mr X, Mr Y and Mr Z therefore has 100 percent of the ownership interests in A Co.

New Zealand groups

Under the proposed new rules, the New Zealand group of a company controlled by a non-resident owning group will be determined much in the same way as companies controlled by a single non-resident.

Proposed new section FE 26(2)(bb) will generally provide that a New Zealand company is a New Zealand parent company if a non-resident owning body has direct ownership interests of 50 percent or more in the company.

A similar amendment is proposed for section FE 26(3)(d), which will generally define a parent of an excess debt entity as the company where the non-resident owning body directly holds 50 percent or more of its ownership interests.

There are two exceptions to these rules. The first is when a non-resident owning body has members that have operations in New Zealand (for example, if some of the members of the group operate through a branch in New Zealand). In this case, the non-resident owning body will be the New Zealand parent as provided by subsection (2)(bc) or (4C), as appropriate.

The second exception is if some members of a non-resident owning body invest into New Zealand through holding companies. The grouping rules will not be able to identify a New Zealand parent for the top-level operating company in New Zealand (Z Co in the example below). Accordingly, section FE 26(6) will deem the top-level operating company as the New Zealand parent. A company controlled by the top-level operating company will identify the operating company as its parent under section FE 26(3). Each holding company will also have a New Zealand group that is just the company.

Example

Non-residents X Co, Y Co and Z Co (who are not associated persons) each own 33 percent of resident company A Co and have proportionate debt and equity. They therefore will form a non-resident owning body.

A Co has three resident subsidiaries.

The New Zealand parent for A Co can only be determined under section FE 26(2)(bb), under which A Co will be treated as the New Zealand parent (the non-resident owning body has direct interests of 100 percent in A Co). Similarly, A Co's subsidiaries will only be able to determine their New Zealand parent (A Co) under section FE 26(3)(d)(ii).

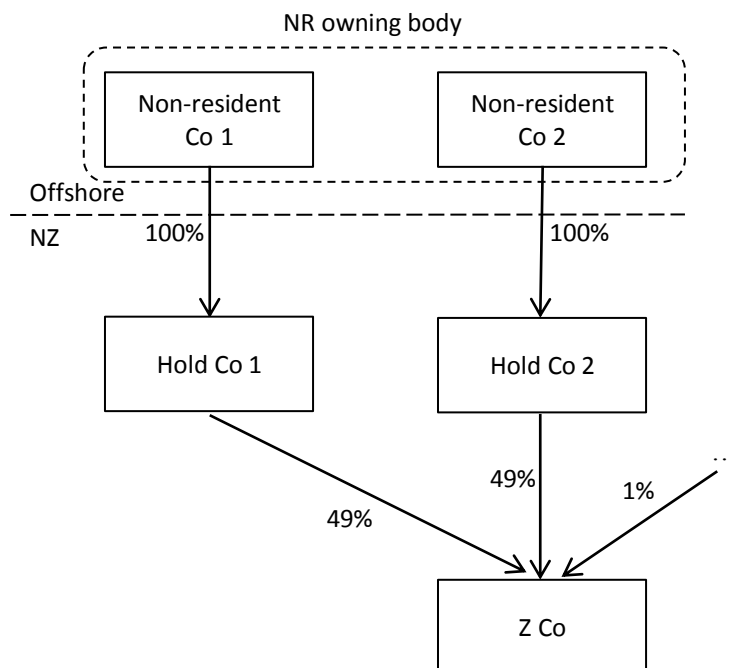
A Co's New Zealand group will comprise A Co and its three subsidiaries.

As A Co's group could only be determined under sections FE 26(2)(bb) and (3)(d)(ii), section FE 31D applies to deem the worldwide group of A Co to be its New Zealand group.

Example

Non-resident Co 1 owns 100 percent of Hold Co 1 and Non-resident Co 2 owns 100 percent of Hold Co 2. Hold Co 1 and Hold Co 2 are therefore subject to the thin capitalisation rules under section FE 2(1)(c).

The non-residents meet the criteria for being a non-resident owning body. Z Co is therefore also subject to the thin capitalisation rules under section FE 2(1)(bb).



Hold Co 1's New Zealand group is Hold Co 1 (as Hold Co does not hold 50 percent or more of Z Co's ownership interests it does not include it in its group under section FE 26). Hold Co 2's New Zealand group is similarly just Hold Co 2.

Z Co's New Zealand group cannot be determined under section FE 26 other than under subsection (6). Z Co is therefore deemed to be its New Zealand parent. As Z Co has no subsidiaries, its New Zealand group comprises only itself.

New grouping rules only apply if existing rules do not

These new grouping rules will only apply if the thin capitalisation rules as they currently stand do not apply – that is, to a company not controlled directly or indirectly by a single non-resident. This means the New Zealand parent of a company controlled by a single non-resident will be unaffected by the proposed changes, even if the company is also controlled by a non-resident owning body. Its New Zealand group will, by extension, also be unaffected.

Example

Non-resident companies Z, X and Y own 50, 25 and 25 percent, respectively, of New Zealand-resident company A Co. Z, X and Y have an agreement that sets out how A Co should be funded. Z, X and Y therefore form a non-resident owning body.

A Co has three resident subsidiaries. Z also owns 100% of an Australian company.

Under the current thin capitalisation rules, the New Zealand group of A Co comprises A Co and its three New Zealand subsidiaries. The worldwide group is the New Zealand group, Z and the Australian company.

There will be no change to the New Zealand or worldwide group of A Co as a single non-resident (Z) owns 50 percent of its shares – even though a non-resident owning body also holds 50 percent or more of A Co's shares.

Worldwide groups

Proposed new section FE 31D will provide that the worldwide group of a company controlled by a non-resident owning body is just its New Zealand group, unless a single non-resident also controls the company.

Rules to ensure matching New Zealand groups

Under the thin capitalisation rules it is important that New Zealand groups of different entities are the same. That is, if Company A includes Company B in its New Zealand group, then Company B should include Company A in its group. It is also important that an entity cannot be included in multiple groups. This is to prevent the double-counting of the entity's debt and assets.

Proposed section FE 3(d) and (f) excludes a company from a group of a trust (or from the group of a *controlling body*) if the company does not include the trust (or body) in its own group. This rule would apply, for example, when a trust owns a subsidiary company. Without the rule a trust could include a company in its group but the company may not include the trust in its group.

A separate rule is proposed in section FE 14(3B) to ensure that an entity cannot include its debt and assets in more than one New Zealand and worldwide group. This might occur, for example, if a member of a *controlling group* controls some companies in its own right.

An ordering rule will apply in some cases when an entity is determining what group it should include its debt and assets in: if the entity is a company that is controlled indirectly or directly by a single non-resident then it must include its debt and assets in the New Zealand group of the single non-resident. If this is not the case then there will be no rule for determining what group the debt and assets should be included in.

Worldwide group debt test

Whether there is any interest denial under the thin capitalisation rules depends on the result of two tests. One of these tests is known as the “worldwide group debt test” and is designed to ensure the amount of debt in a New Zealand company is proportionate to the amount of genuine external debt of the ultimate non-resident parent of that New Zealand company.

In some circumstances, however, the debt of the ultimate parent company may also include debt from the parent’s shareholders or other owners of the group. In such cases the debt level of the worldwide group does not reflect the level of genuine external debt. The worldwide group debt test therefore does not operate as intended.

To address this, proposed new section FE 18(3B) will provide that, when an excess debt entity (other than an outbound excess debt entity⁴) is calculating its worldwide group debt percentage, it must exclude debt that is linked to an owner of the worldwide group.

An “owner” will be a person who has an ownership interest in a member of the group or is a settlor of a trust that is a member of the group.

A financial arrangement will be treated as linked to an owner of the group if the owner, or an associate of the owner (excluding associates who are members of the group):

- is a party to the financial arrangement (for example, by a loan directly from the owner);
- has guaranteed or otherwise provided security for the financial agreement (for example, where an owner has used some of its assets as security for the loan);
- has provided funds or will provide funds, directly or indirectly, to another person who is providing funds under the financial arrangement (such as a back-to-back loan).

Carve-out for minor shareholders’ debt

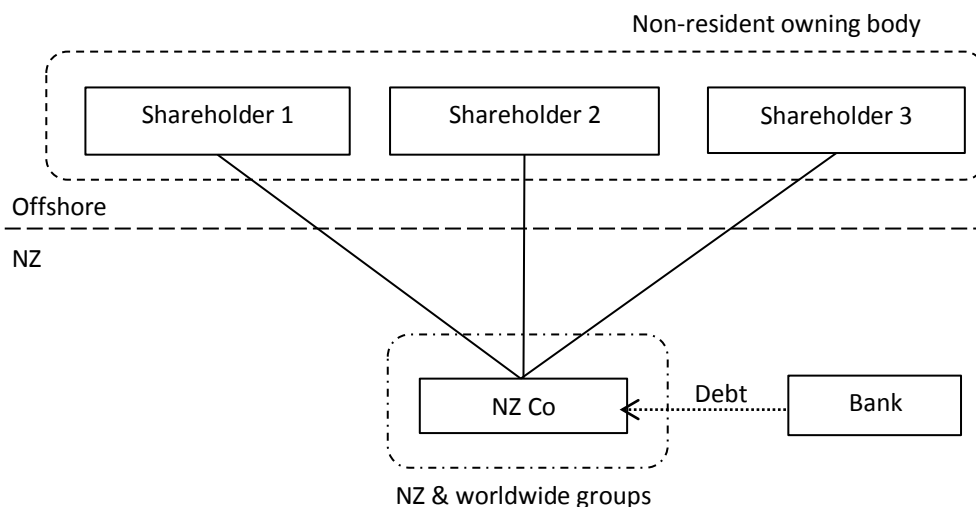
Proposed new section FE 18(3B) will also include a carve-out to the above rule for minor shareholders. An owner’s financial arrangement will not be excluded from the worldwide group debt test if:

- the owner has a 10 percent or less ownership interest in the group; and
- the financial arrangements held by the owner are traded on a public exchange.

⁴ This change applies to the “inbound” thin capitalisation rules, which apply to non-resident investments in New Zealand. The “outbound” thin capitalisation rules, which apply to New Zealand investment abroad, are not affected.

Example

Three shareholders collectively own New Zealand company NZ Co. As NZ Co is controlled by a non-resident owning body, its worldwide group is the same as its New Zealand group.



The three non-resident shareholders will be treated as “owners” of NZ Co as they each have an ownership interest in NZ Co and are outside of its worldwide group. Any debt they extend to NZ Co will not be treated as debt in NZ Co’s worldwide group debt test.

Bank, however, will not be treated as an “owner” of NZ Co as it has no ownership interest in NZ Co and is not associated with any of the shareholders. A loan from Bank will therefore be included as debt in NZ Co’s worldwide group debt test.

Effect of shareholders lending to NZ Co

The three shareholders decide to lend a total of \$500,000 to NZ Co. NZ Co has \$800,000 of assets.

The debt-to-asset ratio of NZ Co’s New Zealand group is $\frac{\$500,000}{\$800,000} = 62.5$ percent.

The debt-to-asset ratio of NZ Co’s worldwide group is $\frac{\$0}{\$800,000} = 0$ percent (as the debt from the owners is excluded).

The debt-to-asset ratio of NZ Co’s New Zealand group exceeds both the 60 percent safe harbour and worldwide group debt test. NZ Co will therefore have income under section CH 9 to cancel out some of its interest deductions.

Effect of Bank lending to NZ Co

Instead of borrowing from its shareholders, NZ Co borrows the \$500,000 from Bank. Again, NZ Co has \$800,000 of assets.

The debt-to-asset ratio of NZ Co’s New Zealand group is $\frac{\$500,000}{\$800,000} = 62.5$ percent.

The debt-to-asset ratio of NZ Co’s worldwide group is $\frac{\$500,000}{\$800,000} = 62.5$ percent.

While the debt-to-asset ratio of NZ Co’s New Zealand group exceeds the 60 percent safe harbour, it does not exceed the worldwide group debt test. NZ Co will not have any income under section CH 9.

Extending the thin capitalisation rules to more trusts

Proposed amendments to section FE 2(1)(d) will extend the thin capitalisation rules to all types of trusts for tax purposes (complying trusts, non-complying trusts and foreign trusts). The proposed new rules will mean a trust is subject to the thin capitalisation rules if the majority of settlements on it come from non-residents, or from persons who are subject to the thin capitalisation rules.

A trust will be subject to the rules if 50 percent or more of the settlements are made by:

- a non-resident or an associated person;⁵
- an entity subject to the inbound thin capitalisation rules (that is, an entity to which section FE 2(a) to (cc) and (db) applies); or
- a group of non-residents or entities subject to the thin capitalisation rules that act together as a group.

As with companies, the thin capitalisation rules will apply to trusts settled by entities acting together as a group (a *controlling group*). This concept of “acting together as a group” will be left undefined. This is because the proposed rules for determining when a group of shareholders are acting as a group (thereby forming a non-resident owning body) cannot be used for trusts. For example, it is not sensible to refer to settlements made in proportion to debt extended to a trust because rights to income from a trust generally do not depend on the amount a person has settled on it.

As with companies, the ownership interests of a controlling group will also be aggregated as if the members were associates.

Proposed new section FE 2(1)(db) will also provide that a trust is subject to the thin capitalisation rules if a person subject to the thin capitalisation rules has the power to appoint or remove a trustee. This is designed as an anti-circumvention measure. It will mean trusts are subject to the rules if they have been settled by a New Zealand resident and then effective control of the trust is transferred to a non-resident by giving the non-resident power to appoint or remove the trustee.

There will be a carve-out from this rule if a person has the power to add or remove a trustee for the purpose of protecting a security interest. This type of security interest is commonly held by banks that have lent to a trust.

Proposed sections FE 2(1)(d) and (db) provide that settlements made by the trustee and powers of removal or appointment of the trustee must be ignored when applying the sections. This is to prevent circularity if two trusts make settlements on each other or each have the ability to appoint the other’s trustee.

⁵ Here, an associate will not include a relative that has not made any settlements on the trust. This is to prevent the rules from applying to a trust settled by a New Zealand resident merely because the resident has a non-resident relation.

To illustrate, say settlements on Trust A are made by a non-resident and Trust B. Settlements made on Trust B are made by Trust A. It is only possible to determine whether Trust B is subject to the thin capitalisation rules if the settlement it has made on Trust A is ignored. Ignoring the settlement means the sole settlor of Trust A is a non-resident; Trust B is therefore subject to the thin capitalisation rules as it has been settled by a trust that is itself subject to the rules. Once Trust B's status is determined, it is then possible to determine that Trust A should also be subject to the rules as it has also been settled by entities that are subject to the rules (a non-resident and Trust B).

Companies controlled by trusts

Proposed new section FE 2(1)(cc) ensures the thin capitalisation rules apply to any resident company that is controlled by a trust that is already subject to the thin capitalisation rules (to which the amended section FE 2(1)(d) or (db) will apply), or controlled by such trusts and other persons acting together as a group.

This proposed amendment is a consequence of extending the thin capitalisation rules to more trusts. If a trust will be subject to the thin capitalisation rules, companies controlled by that trust should also be subject to the rules.

Grouping rules for trusts and companies controlled by trusts

Proposed amendments to section FE 3 will define the New Zealand group of a trust as the trust and all companies controlled by the trust. Whether a trust controls a company will be determined under section FE 27, based on its choice of control threshold under that section.

Similarly, the New Zealand group of a company that is controlled by a trust will be the trust and all other companies controlled by the trust. This will be provided by proposed new section FE 26(4C), which will define the New Zealand parent of a company controlled by a trust (or controlling group) to be the trust (or the group). The other members of the New Zealand group will then be determined under section FE 28.

As with companies controlled by non-resident owning bodies, the worldwide group of a trust, a controlling group and a company controlled by a trust (or controlling group) is the same as its New Zealand group.

Extension of on-lending concession for trusts

Currently, section FE 13 provides what is commonly referred to as the "on-lending concession". It removes financial arrangements that provide funds to a person from the ambit of the thin capitalisation rules.

Proposed amendments to section FE 13 will mean that, for a trust that holds only financial arrangements and does not control any companies, the on-lending concession will apply regardless of whether the arrangement provides funds.

This amendment is designed for securitisation vehicles that hold only financial arrangements, which will become subject to the rules because of the changes relating to trusts described above. This carve-out is proposed on the basis that the on-lending concession would apply to most of the trust's debt in any event.

Exclusion of asset uplift

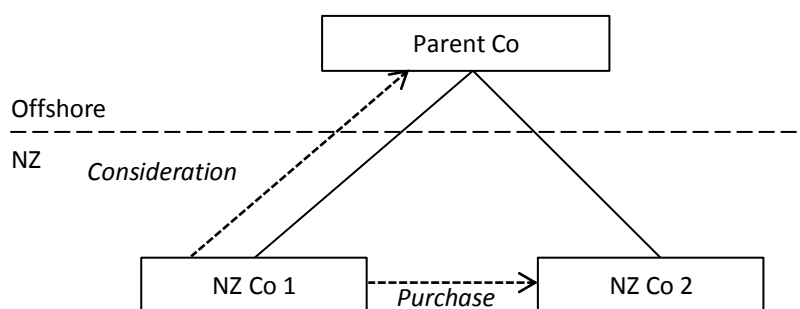
Proposed new sections FE 16(1D) and (1E) will provide that increases in a company's New Zealand group assets that arise from sale or other transfer of assets between a member of the group and a person associated with the group must be ignored. This may or may not be another member of the group. However, the increase in value will be allowed if:

- generally accepted accounting practice would allow the increase in asset values in the absence of the transfer; or
- the transfer is part of a restructure following the purchase of the group by a person not associated with the group.

This is to ensure that increases in asset values that are not recognised under generally accepted accounting practice in the consolidated worldwide accounts of a company cannot nevertheless be recognised in the asset values of the company's New Zealand group.

Example

Parent Co owns two New Zealand subsidiaries, NZ Co 1 and NZ Co 2.



NZ Co 1 purchases the shares in NZ Co 2 from Parent Co. NZ Co 1 will not be able to include any increase in asset values resulting from this purchase for thin capitalisation purposes unless that increase would have been allowed under generally accepted accounting practice in the absence of the purchase.

Excluding individuals' and trustees' interest in a CFC

Proposed new section FE 16(1BA) largely rewrites existing section FE 16(1B) but with a new provision. Individuals or trustees will be required to exclude certain interests in a CFC or FIF they hold indirectly through an associate that is outside of their New Zealand group if the associate is outside of their group by virtue of being an excess debt outbound company or included in the group of such a company.

This provision is necessary as section FE 3(2)(a) excludes from the New Zealand group of an individual or trustee who is an outbound investor, all companies that are excess debt outbound companies or included in the group of such a company. Despite this provision, the person or trustee's indirect interests in the CFC or FIF should be still be excluded from their group assets.

Black hole expenditure

OVERVIEW

This group of amendments deals with the tax treatment of certain items of “black hole” expenditure that were announced as part of the Budget 2013 revenue package. Black hole expenditure is business expenditure of a capital nature that is not immediately deductible for tax purposes and does not give rise to a depreciable asset, so cannot be deducted as tax depreciation over time. These amendments will remove certain distortions against investment arising from current tax settings, while reducing compliance costs and providing greater certainty for taxpayers.

APPLICATIONS FOR RESOURCE CONSENTS, PATENTS AND PLANT VARIETY RIGHTS

(Clauses 39, 41 and 42)

Summary of proposed amendments

Proposed amendments to sections DB 19 and DB 37 and proposed new section DB 40BA of the Income Tax Act 2007 will allow taxpayers an immediate tax deduction for capital expenditure incurred for the purpose of applying for the grant of a resource consent, patent or plant variety rights, when the application is not lodged or is withdrawn, or the grant is refused.

Application date

The amendments will apply from the beginning of the 2014–15 income year.

Key features

The proposed amendment to section DB 19 removes the requirement for a taxpayer to have lodged an application for the grant of a resource consent before capital expenditure incurred on an aborted or unsuccessful resource consent application can be deducted.

The proposed amendment to section DB 37 removes the requirement for a taxpayer to have lodged an application for the grant of a patent before capital expenditure incurred on an aborted or unsuccessful patent application can be deducted.

Proposed new section DB 40BA allows a taxpayer a deduction for capital expenditure they have incurred for the purpose of applying for the grant of plant variety rights, but they do not obtain the plant variety rights because the application is not lodged or is withdrawn, or because the grant is refused. A deduction under the proposed new section will be allocated to the income year in which the taxpayer decides not to lodge the application, withdraws the application or is refused the grant of plant variety rights.

Background

Sections DB 19 and DB 37 currently require a taxpayer to have lodged an application for the grant of a resource consent or a patent in order to obtain a deduction for capital expenditure that has failed to give rise to a depreciable asset. A taxpayer who has incurred capital expenditure for the purpose of applying for the grant of a resource consent or a patent but does not lodge the application is currently unable to receive a deduction for that expenditure.

The proposed amendments to sections DB 19 and DB 37 expand the scope of eligibility for a deduction under these sections to instances when expenditure has been incurred by a taxpayer on an intended application which they decide not to lodge. This removes the need for taxpayers to incur further expenditure in making an application for a grant that is no longer sought in order to access a deduction.

Currently, a taxpayer who incurs capital expenditure for the purpose of applying for the grant of plant variety rights is unable to deduct that expenditure when the plant variety rights are not granted, as there is no equivalent provision to sections DB 19 or DB 37 for plant variety rights. As this expenditure would have been depreciable if the plant variety rights had been obtained, making this expenditure deductible when it fails to give rise to a depreciable asset will improve the symmetry between the tax treatment of successful and unsuccessful expenditure.

CLAW-BACK FOR SUBSEQUENT APPLICATIONS OR DISPOSALS

(Clauses 16, 54 and 55)

Summary of proposed amendments

Under the proposed new rules, deductions that have been taken for an aborted or unsuccessful application for the grant of a resource consent, a patent or plant variety rights, will be clawed back as income if the taxpayer subsequently sells or uses the abandoned application property. In the latter case, the clawed back amount will be included in the cost of the intangible property to be depreciated over the life of the depreciable asset.

Application date

The amendments will apply from the beginning of the 2014–15 income year.

Key features

Proposed new section CG 7B of the Income Tax Act 2007 is a claw-back provision which will apply when a taxpayer:

- has taken a deduction under section DB 19 or DB 37 or proposed new section DB 40BA (for an aborted or unsuccessful resource consent, patent or plant variety rights application), and subsequently derives consideration for the disposal of application property acquired as a result of expenditure on the intended, withdrawn or unsuccessful application; or
- lodges a patent application after having previously taken a deduction under section DB 37 for expenditure on an aborted or unsuccessful application for the grant of a patent, to the extent that this expenditure also relates to the patent application lodged; or
- is granted a resource consent after having previously taken a deduction under section DB 19 for expenditure on an aborted or unsuccessful application, to the extent that this expenditure also relates to the resource consent granted; or
- is granted plant variety rights after having previously taken a deduction under proposed new section DB 40BA for expenditure on an aborted or unsuccessful application for the grant of plant variety rights, to the extent that this expenditure also relates to the plant variety rights granted.

When the taxpayer derives consideration for the disposal, the amount that will be clawed back as income will generally be the lesser of the consideration derived for the disposal and the amount of the deduction that has previously been taken. The exception to this will be when the disposal of the property otherwise gives rise to income under the Income Tax Act 2007, in which case the entire amount of the consideration derived from the disposal will continue to be income.

When the taxpayer subsequently lodges a patent application or is subsequently granted a resource consent or plant variety rights, the amount that will be clawed back as income will be the total amount of deductions taken for the expenditure under sections DB 19 or DB 37, or proposed new section DB 40BA (whichever applies). The clawed-back amount will then be included in the cost base of the resource consent, the patent application (and subsequently the patent if it is granted) or the plant variety rights and can be depreciated over the legal life of the depreciable asset in the usual way.

Proposed amendment to section EE 25 will ensure that any expenditure clawed back as income under proposed new section CG 7B is included in the cost of a subsequent plant variety rights application for the purpose of calculating the pro-rated deduction for the cost of a plant variety rights application that a taxpayer is allowed when they are granted plant variety rights.

The proposed amendment to section EE 57 will ensure that the “base value” used for the purpose of calculating a depreciable asset’s “adjusted tax value” includes any expenditure clawed back as income under proposed new section CG 7B.

Background

It is possible that after taking a deduction for expenditure incurred on an aborted or unsuccessful application for the grant of a resource consent, a patent or plant variety rights, that a taxpayer may use or sell that application property at a later date. In the case of selling application property, the taxpayer has conceptually derived income. A claw-back provision is necessary to preserve a neutral tax treatment because otherwise taxpayers could receive a deduction that is larger than the loss they have suffered.

The tax treatment of expenditure on application property from an aborted or unsuccessful application that is later used in a successful application and expenditure on a first-time successful application should be neutral. In other words, expenditure on a depreciable intangible asset should be depreciated over the estimated useful life of the asset. That certain expenditure did not create a depreciable asset in the first instance does not change the fact that the expenditure has ultimately created depreciable intangible property. Continuing to allow an immediate deduction for such expenditure is not a neutral tax treatment. A claw-back provision will ensure that taxpayers do not receive a timing advantage from immediately deducting expenditure on the initially unsuccessful, but ultimately successful, application property instead of spreading depreciation deductions over the estimated useful life of the depreciable asset created.

COMPANY ADMINISTRATION COSTS

(Clause 44)

Summary of proposed amendments

Proposed new section DB 63 of the Income Tax Act 2007 allows companies a deduction for all direct costs associated with the payment of a dividend. This does not include the amount of the dividend itself.

Proposed new section DB 63B allows listed companies a deduction for expenditure incurred on an annual listing fee to maintain registration on a recognised stock exchange.

Proposed new section DB 63C allows companies a deduction for expenditure incurred to hold an annual general meeting (AGM) of the shareholders of the company, but denies a deduction for expenditure incurred to hold a special or extraordinary meeting of the shareholders of the company.

Application date

The amendments will apply from the beginning of the 2014–15 income year.

Background

The dividend payment process involves authorising, allocating and paying the dividend, as well as addressing any disputes arising over its allocation. Expenditure incurred during this process is a mixture of capital and revenue. However, requiring taxpayers to separately track or apportion this expenditure into its deductible and non-deductible constituent parts could result in disproportionate compliance costs and uncertainty for taxpayers.

Listed companies incur expenditure on an annual listing fee to maintain registration on a recognised stock exchange. Allowing this expenditure to be deductible recognises that its benefit persists for one year only, and is a necessary expense for a listed company.

AGMs are an annual, recurring cost of doing business as a company, while special shareholder meetings are often held to consider a material change in the business of the company. Allowing a deduction for AGM costs while denying a deduction for special shareholder meeting costs ensures that taxpayers are not subject to disproportionate compliance costs or uncertainty over the tax treatment of shareholder meeting costs, and approximates the capital-revenue criteria.

FIXED-LIFE RESOURCE CONSENTS

(Clause 124)

Summary of proposed amendment

This proposed amendment to item 10 in schedule 14 of the Income Tax Act 2007 will ensure that expenditure incurred on resource consents granted under the Resource Management Act 1991 (RMA) to do something that would otherwise contravene sections 15A (Restrictions on dumping and incineration of waste or other matter in coastal marine area) or 15B (Discharge of harmful substances from ships or offshore installations) of the RMA can be depreciated over the life of the resource consent.

Application date

The amendment will apply from the beginning of the 2014–15 income year.

Background

Depreciation is appropriate for resource consents if they have a fixed life after which they have no economic value. Resource consents granted under the RMA to do something that would otherwise contravene sections 15A or 15B of that Act have a fixed life of between five and 35 years. Adding these resource consents to schedule 14, which lists items of depreciable intangible property, brings their tax treatment into line with other fixed-life resource consents.

Foreign account
information-sharing agreement

FOREIGN ACCOUNT INFORMATION-SHARING AGREEMENT

(Clauses 2(23), 5, 6, 37, 128(1), (2), (5), 123(15), 129, 150, 151, 152 and 158)

Summary of proposed amendments

New Zealand has signalled its intentions to negotiate an inter-governmental agreement (IGA) with the United States to clarify the reporting obligations of New Zealand financial institutions under the United States law commonly known as the Foreign Account Tax Compliance Act (FATCA).

Under the terms of this IGA, New Zealand financial institutions would be required to collect information on their customers that are, or are likely to be United States taxpayers. This information must be sent to Inland Revenue, who in turn would transmit it to United States tax authorities under the existing exchange of information mechanism in the double tax agreement between the two countries. The IGA also provides for reciprocal information to be sent from the United States to Inland Revenue.

Amendments to New Zealand's tax legislation are required to bring any agreed IGA into domestic law and allow New Zealand financial institutions to comply with its terms. In particular, there are concerns that, in the absence of any specific change, financial institutions may be unable to provide the relevant information to Inland Revenue without breaching the Privacy Act 1993.

The amendments proposed in the bill therefore seek to explicitly authorise financial institutions to obtain and provide to Inland Revenue the information that New Zealand is obliged to obtain and exchange under the IGA.

The proposed amendments are generally drafted in a broad manner to accommodate the possibility of New Zealand entering into similar agreements with other jurisdictions in the future.

FATCA requirements, with or without an IGA are due to take effect from 1 June 2014. Accordingly, this is the effective date for the new provisions.

Application date

The amendments will apply from 1 June 2014.

Key features

The first foreign account information-sharing agreement that the Government anticipates entering into is the IGA with the United States. A model IGA ("Reciprocal Model 1A Agreement, Pre-existing TIEA or DTC") is available on the United States Treasury website:

<http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx>

This commentary uses the United States' Treasury model agreement to illustrate examples. It uses terms like "financial institution", and other terms defined in that model. In doing so, it is recognised that the relevant provisions and terms may be superseded by the specific terms of any IGA formally agreed between the two countries. Equally, these examples may have limited or no application to other similar agreements that may be entered into in the future.

Status of the agreement

The IGA, and other similar agreements that New Zealand may enter into in the future, are defined as "foreign account information-sharing agreements". The bill introduces this concept as a defined term in section YA 1 of the Income Tax Act 2007. At present, this definition only includes the planned IGA, but it is anticipated that future agreements could be accommodated into the proposed set of rules by simply including them in this definition.

The proposed amendments to sections BB 3(2) and BH 1(4) are intended to clarify that foreign account information-sharing agreements will be "double tax agreements for the purposes of the Income Tax Act". This means that the agreements, like other double tax agreements and tax information exchange agreements, generally override the Inland Revenue Acts, the Official Information Act and the Privacy Act. A new section BH 1(5) states that proposed part 11B of the Tax Administration Act 1994 applies to these agreements. This simply clarifies that Part 11B sets rules for these agreements despite their generally overriding nature.

Operative provisions

Proposed Part 11B of the Tax Administration Act 1994 contains the operative provisions that will govern how foreign account information-sharing agreements are brought into New Zealand law. Clause 152 contains a consequential amendment that moves the definition of "competent authority" from section 173B to section 3.

Part 11B

Part 11B contains provisions that implement foreign account information-sharing agreements. These provisions are important because, for the New Zealand Government to comply with its obligations under such an agreement, it is required to obtain and exchange certain information with a foreign government. It is necessary to have rules that require the relevant New Zealand taxpayers to acquire this information and provide it to the New Zealand Government, so this exchange can take place.

This Part therefore provides the compulsion for New Zealand taxpayers to obtain this information and pass it on to Inland Revenue. It comprises the following proposed sections:

185E – Purpose

This section sets out the purpose of the Part, which is to give effect to and implement foreign account information-sharing agreements.

Section 185F – Permitted choices

The model IGA contemplates that financial institutions may have choices in the way they comply with the agreement. Equally, the agreement may allow the New Zealand Government to make choices that could have consequences for the affected financial institution. The choices a person makes will determine the way the agreement applies to them. Section 185F is designed to recognise these choices, and then authorises a person to make them and treat such choices as being binding for the purposes of the agreement and the person's obligations under the agreement.

Proposed section 185F(1) deals with such choices. Section 185F(2) explicitly authorises a person to make such a choice and anything necessarily incidental to give effect to that choice. Section 185F(3) clarifies that a person's obligations are modified to the extent necessary to give effect to that choice. This is important because financial institutions should not be in a position where they are required to comply with all possible scenarios that an agreement contemplates. An institution that makes a choice should be accountable for the consequences of that choice – but not be punished for failing to take the alternative option.

Example 1

Annex II of the IGA provides a list of entities and products that are exempt from IGA reporting. However, qualification is not always automatic. For instance, a person may qualify as a “financial institution with a local client base” under paragraph III.A only if it has certain “policies and procedures” designed to detect accounts held by United States persons.

Applying these policies and procedures is a choice that the financial institution is entitled to make. However, its choice will have consequences. If it chooses to set up such policies and procedures, it will have the advantage of being non-reporting, but it will need to make sure those policies and procedures continue to meet the requirements set out in the agreement. Equally, if it considers that setting up the policies and procedures represents an unreasonable compliance burden, it can choose not to implement them, but the consequence will be that the exemption will not apply and it must report on relevant accounts in the same way as any other non-exempt institution.

The financial institutions should not be in a position where a customer can claim that it *could* have been exempt and therefore it should have made that choice. The agreement contemplates the existence of this choice, so the proposed legislation attempts to provide the flexibility for financial institutions to make it.

Example 2

In the same exemption in Annex II, a financial institution that wishes to take advantage of the exemption has a choice in respect of taking customers that are United States citizens that are not also New Zealand-resident. The financial institution can either report on such financial account or close the account. Again, this a choice contemplated by the agreement. A US person residing offshore should not have an action against a financial institution that closes their account just because the institution had an alternative course of action (in this case, reporting on the account). The legislation explicitly authorises the choice to be made because it is contemplated in the agreement.

Under the model IGA, New Zealand has a number of choices it can make at government level. Proposed section 185F caters for these choices and allows the Commissioner of Inland Revenue to publish a choice made or revoked in a publication of the Commissioner's choosing (see subsection (4)). The method of publication is broad to allow for the fact that the Commissioner may wish to publish a number of choices in, for example, a *Tax Information Bulletin*, at the time an agreement is signed.

Proposed section 185F(5) clarifies that choices made by the Government or by an affected person are treated as part of the agreement for all aspects of Part 11B and section BH 1 of the Income Tax Act 2007.

Example

Part F of Annex I of the model IGA provides that New Zealand may permit reporting financial institutions to rely on third-party providers to perform due diligence obligations. The "may permit" wording provides New Zealand with a choice about whether it is willing to allow third-party providers. When the Government makes this choice, the Commissioner of Inland Revenue will publish it so that financial institutions are aware of what is acceptable.

If the Government were to allow third-party providers (and published this choice in an appropriate manner), this would then afford financial institutions with a choice of their own: whether to conduct due diligence themselves or outsource to a third party. Again, either of these actions is explicitly sanctioned because it is a legitimate choice that the IGA contemplates financial institutions would have in these circumstances.

There are some choices that the Government may not want people to make. To be as transparent as possible about these choices, the concept of an "excluded choice" is created by proposed section 185F(6) of the Tax Administration Act 1994. A list of excluded choices is contained in section 185F(7). Like the agreements themselves, these choices are defined in accordance with specific agreements so that there is maximum clarity around what the excluded choice is.

In the context of the IGA, the Government is of the view that only accounts that are actually required to be reported on should be submitted to Inland Revenue. In this regard, for example, paragraph II.A of Annex 1 of the model IGA contemplates that a person can elect to report on accounts even if they are below the reporting threshold set out in the IGA. This election can only be made when the implementing rules provide for this election. The effect of section 185F(6) and (7) is that the implementing rules will not provide for such an election – this also applies to other similar "low value threshold" elections contained in the model IGA. Therefore making the choice to report on all accounts below the threshold is not a "permitted choice" for the purposes of the proposed legislation.

Example

A financial institution has nine pre-existing depository accounts held by "US persons" that are individuals. Three of those accounts would be reportable except they have a balance of less than US\$50,000, with the others having balances above that threshold. The financial institution does not have the option of reporting on all nine accounts, it must only report on the six that exceed the minimum threshold set out in the model IGA.

Section 185G of the Tax Administration Act – Registration

The model IGA contemplates that financial institutions that meet certain requirements must register with the United States Internal Revenue Service. Proposed section 185G brings the aspects of this registration requirement relevant to the financial institution into New Zealand law.

Section 185H of the Tax Administration Act – Due diligence

The model IGA also sets out detailed due diligence obligations for affected financial institutions. Proposed section 185H therefore clarifies that a financial institution is required to apply the relevant procedures. It is worth noting that the relevant procedures may depend on permitted choices that the Government and/or the financial institution will have made. A financial institution is only required to perform the due diligence procedures that flow from permitted choices they have made.

Section 185I of the Tax Administration Act – Information for New Zealand competent authority

Proposed section 185I is the central provision for ensuring New Zealand’s compliance with foreign account information-sharing agreements. In essence, it says that, if New Zealand is obliged to obtain and exchange information with a foreign competent authority, the person described or contemplated in the agreement as obtaining and providing the information must obtain and provide it to the New Zealand competent authority. All relevant steps in relation to obtaining and proving that information must be done in accordance with the agreement.

In the IGA context, this means that any information the New Zealand Government is obliged to exchange with the United States must be obtained by New Zealand financial institutions and provided to Inland Revenue.

The section also allows the provision of information if it is not required for exchange purposes, as long as obtaining and providing that information is contemplated in the agreement.

As with the other operative provisions, the relevant information may be dependent on choices that the Government and financial institution have made.

The section also clarifies that the Government may wish to make regulations in this area to spell out any finer details in a person’s reporting obligations.

Example 1

If a financial institution chooses to take advantage of an exemption, this will have a direct bearing on the information that New Zealand is expected to provide in respect of accounts held by that institution. The institution is therefore only required to obtain and provide the information that is consistent with its exempt status.

Example 2

Reporting on accounts below certain thresholds is contemplated by the agreement. However, the fact that reporting on these accounts is an “excluded choice” means that they cannot be reported on by a financial institution.

Section 185J of the Tax Administration Act – Information for third parties

Agreements may contemplate that a financial institution has to provide information to third parties. In the IGA context, these third parties could be foreign competent authorities or other financial institutions. Proposed section 185J authorises obtaining and proving this information, provided it is described or contemplated in the agreement. For foreign competent authorities, the request for information must be valid under the terms of the agreement.

Again, a regulatory power is included to allow obligations to be clarified if necessary.

Example 1

Article 5.1 of the model IGA contemplates a foreign competent authority making an enquiry directly to a financial institution "... where it has reason to believe that administration errors or other minor errors may have led to incorrect or incomplete information reporting...". If a foreign competent authority were to make a request within this framework to a New Zealand financial institution, the institution must provide that information. The institution is not authorised to provide the information if the enquiry is of a substantive nature that is above "administration" or "minor" error.

Example 2

Article 4.1 of the model IGA provides a description of how a financial institution must behave in order to be treated as compliant. One of the requirements (in paragraph (e)) is that, if the institution makes United States sourced payment to a non-participating financial institution, the financial institution must provide information to the immediate payer of that amount (payment intermediary) the information required for withholding and reporting to occur on that payment. A New Zealand financial institution making such a payment to another financial institution is authorised to provide the necessary information to the payment intermediary.

Section 185K of the Tax Administration Act – Prescribed form

Proposed section 185K allows the Commissioner to prescribe the form in which information is received. This is particularly important for foreign account information-sharing agreements because it may be that the form of the information is set by either a foreign competent authority or other international organisation. Some flexibility to set these forms is therefore crucial to the smooth administration of these agreements.

Section 185L of the Tax Administration Act – Anti-avoidance

Proposed section 185L is an anti-avoidance provision that allows an arrangement to be treated as having no effect if the main purpose of entering into the arrangement is to avoid a person's obligations under Part 11B. This provision is recognition of the fact that some people may not want to report on their customers for commercial/compliance costs reasons. However, in entering into foreign account information-sharing agreements, the Government is agreeing to obtain and provide certain information. The ability to unwind arrangements that avoid reporting is a requirement of the IGA. In any event, it is considered an important tool for the Government to be able to comply with the intended effect of these agreements.

Section 185M of the Tax Administration Act – Timeframes

Foreign account information-sharing agreements may not set a specific reporting period. They might be happy with any period, provided it is at least annual. In the New Zealand context, most businesses have systems designed to report on a tax-year basis. Proposed section 18M therefore clarifies that:

- When an agreement or regulation does not specify, or is discretionary as to, a reporting period, that period will be a tax year, from 1 April to 31 March. The model IGA anticipates this period being legitimate for the purposes of that agreement.
- When an agreement or regulation does not specify, or is discretionary about, the time in which a person must provide the information to Inland Revenue, it must be provided within two months of the end of the period. For example, assuming the reporting period ends on 31 March, the information must be provided to Inland Revenue by 31 May of that year.

Other matters

Tax returns

The proposed amendment to the “tax return” definition in section 3 of the Tax Administration Act sets out that information provided in the form set out in section 185K is not a tax return for the purposes of the Act. If the provision of this information was a tax return, various other provisions of the Act, such as the imposition of late filing penalties, would apply. It is not considered necessary to impose late filing penalties because, in many respects, timely filing will be self-policing with inbuilt sanctions for failure.

If a person does not file in time, the information may not be exchanged with the foreign competent authority. In an IGA context, this means that a financial institution runs the risk of being treated as non-compliant. Non-compliant status comes with its own sanctions imposed by the United States. The imposition of a domestic fine of up to \$500 arguably does not provide any real motivation for financial institutions and has the potential to create disproportionately large administration costs for Inland Revenue.

Records

The proposed addition of section 22(2)(1b) sets out that a taxpayer must keep sufficient records to allow the Commissioner to readily ascertain the person’s compliance with Part 11B. This makes it a statutory requirement for an affected person to collect and keep the information necessary for compliance with a foreign account information-sharing agreement. It also ensures that the records must be kept for the statutory record-keeping period set out in section 22.

Failure to keep documents required by this provision will result in a strict liability offence under section 143 or a knowledge offence under section 143A, as applicable.

Penalties

Proposed new sections 143(1)(ab) and 143A(1)(ab) introduce a “strict liability” offence and “knowledge” offence related to a person’s failure to register with a foreign competent authority as required by Part 11B.

These offences are considered necessary to comply with New Zealand’s obligations under the IGA, and possibly future agreements. New Zealand has an obligation under the IGA to rectify what is known as “significant non-compliance” through its domestic law.

It is considered that serious non-compliance will most likely come about in three main ways:

1. A financial institution will fail to register.
2. A financial institution will fail to obtain the required information from its customers.
3. A financial institution will obtain the information but fail to provide it to Inland Revenue.

In cases 2 and 3, it is considered that current legislation gives the Commissioner adequate flexibility to deal with non-compliance. As set out above, if a person does not obtain the required information from its customers, it will have failed to keep documents required by a tax law – resulting in offences being committed under section 143 and (potentially) 143A.

Similarly, if a person obtains records but fails to provide them to Inland Revenue, the Commissioner will have the ability under section 17 of the Act to require their release. If the person does not comply with the section 17 notice, this refusal will also result in offences being committed under section 143 and (potentially) 143A.

However, in case 1, where there has been a failure to register, domestic legislation does not currently have a requirement to register and a sanction for not doing so. As discussed above, proposed section 185G will provide a requirement to register. The proposed changes to sections 143 and 143A will match that requirement with a sanction. By putting this sanction into sections 143 and 143A the changes also mirror the potential outcomes for the other forms of serious non-compliance. However, to recognise the fact that a failure to register may occur for circumstances beyond the control of the person concerned, proposed section 143(2B) provides an exclusion from the absolute liability offence if the relevant failure to register occurred through no fault of the person.

Deductions for withholding

Under section DB 1 of the Income Tax Act, various types of taxes are disallowed as deductions for income tax purposes. Proposed section DB 1(1)(b) clarifies that any FATCA withholding that a person suffers is similarly not available as a deduction, even if the general permissions for deductions are satisfied. It is Inland Revenue’s preliminary view that FATCA withholding will also not be available as a tax credit under subpart LJ of the Income Tax Act. This is because FATCA withholding is more akin to a penalty than a withholding tax.

Deregistration of charities

OVERVIEW

An officials' issues paper, *Clarifying the tax consequences for deregistered charities*, was released in July 2013. The paper discussed problems with the current tax treatment of deregistered charities, and suggested a possible solution for clarifying the tax consequences for these entities by prescribing in legislation rules to deal with their new tax-paying status.

A “deregistered charity” refers to an entity that has been removed from the Charities Register by the Department of Internal Affairs – Charities Services (formerly the Charities Commission).

In general, an entity must be registered with the Charities Services in order to qualify for the income tax exemption for charities in sections CW 41 and 42 of the Income Tax Act 2007. Registered charities are also entitled to an exemption from fringe benefit tax, and are treated as “donee organisations”, which means that donors are entitled to some form of tax relief on donations made to these entities.

Recent high-profile cases involving deregistered charities, particularly when the entity continues in existence, have shown that these entities can face a range of complex tax consequences that can be retrospective, transitional and prospective in nature. These consequences give rise to questions such as when the entity should start its life as a tax-paying entity; how the entity should treat its depreciable property or financial arrangements when it becomes a tax-paying entity, and what tax provisions should apply to the entity going forward.

Currently, the nature and extent of the potential tax consequences ultimately depend on the underlying reason why the entity was deregistered. These consequences may be more onerous (and may involve retrospective tax liabilities) if the deregistered charity is found never to have had a “charitable purpose” or to have ceased being charitable in purpose at some time in the past, compared with the situation when a deregistered charity has simply failed to file the required annual return with Charities Services.

Consultation on the officials' issues paper confirmed that the current tax law as it relates to deregistered charities is neither comprehensive nor robust – that is, it does not adequately deal with the full range of tax consequences involving deregistered charities and, in some cases, does not achieve the desired policy intentions.

Two major policy changes arose from consultation which led to the suggested solution in the issues paper being modified.

- The first change extinguishes any retrospective tax costs for deregistered charities (and their donors) that have acted in good faith and have been compliant.
- The second change imposes an additional tax cost on deregistered charities that have not divested themselves of their assets or income that they had accumulated as a charity, within 12 months of the deregistration date.

Key changes

The new legislative rules proposed in the bill will:

- clarify how the general tax rules (including the income tax, fringe benefit tax and donations tax relief regimes) apply to deregistered charities;
- establish the opening values of assets or consideration for any financial arrangements held by a deregistered charity when it becomes a tax-paying entity;
- prescribe specific timing rules for the application of the taxing provisions; and
- outline new requirements for the treatment of the accumulated assets of deregistered charities.

The new rules are aimed at clarifying the tax law so that deregistered charities and their donors have a greater level of certainty as to their tax obligations, and to protect the integrity of the revenue base by ensuring the tax concessions that apply to charities are well-targeted and policy intentions are met. This includes, for example, ensuring that if an entity has claimed tax exemptions as a charity and has accumulated assets and income, these assets and income should always be destined for a charitable purpose.

For the majority of deregistered charities that have in good faith tried to meet their registration requirements, the proposed new rules should provide them with greater certainty about their tax obligations after deregistration. On the other hand, the very small minority of deregistered charities that have wilfully refused to meet their registration requirements could still face onerous tax consequences (including retrospective tax liabilities) under the new proposed rules.

Application dates

The amendments will generally apply from 14 April 2014. There is one exception to this, which relates to the new requirement for accumulated assets of deregistered charities, for which there is a split application date. This rule will apply from:

- 14 April 2014 for entities which choose to voluntarily deregister; and
- 1 April 2015 for entities which are deregistered by Charities Services.

CLARIFYING HOW THE GENERAL TAX RULES APPLY TO DEREGISTERED CHARITIES

(Clauses 104 and 107)

Summary of proposed amendments

Clause 107 introduces new section HR 11 of the Income Tax Act 2007 which clarifies how a deregistered charity should establish its initial tax base – such as the opening values of its assets and consideration for its financial arrangements.

Clause 104 removes charitable trusts which lose their charitable status from the operation of section HC 31 of the Income Tax Act 2007.

All charities which are removed from the Charities Register from 14 April 2014 will have greater certainty about their income tax obligations when they enter the tax system.

Key features

New section HR 11 sets out how an entity which has ceased to meet the requirements to derive exempt income under sections CW 41 or CW 42 should:

- establish the cost base for its property – specifically premises, plant, equipment and trading stock;
- establish the consideration for any financial arrangements; and
- value prepayments it has made.

These tax base calculations are required to be undertaken on and after the date that a deregistered charity ceases to derive exempt income.

Section HC 31 has been consequentially amended so that it no longer applies to a charitable trust that has lost its charitable status. Instead, new section HR 11 will set out the initial tax base for all charities which come into the tax base.

Background

Currently, section HC 31 of the Income Tax Act 2007 provides for the tax consequences for trusts that enter the tax base, but not corporate entities. Section HC 31 is further limited because it does not cover all assets that may be held by a deregistered charity – for example, prepayments.

New section HR 11 applies on and after the day that a deregistered charity ceases to meet the requirements to derive exempt income under section CW 41 or section CW 42. This point in time is referred to as the “date of cessation”. The date of cessation is used to trigger the tax base calculations in the year the entity becomes a tax-paying entity but may also apply for each subsequent income year that the deregistered charity ceases to meet the requirements to derive exempt income under sections CW 41 or CW 42.

The following examples illustrate how and when the tax base calculations are to be undertaken.

Example: Depreciable property

Charity A was registered as a charitable entity in 2008. That same year, Charity A purchased office furniture for \$50,000 (GST exclusive) during the first month of the 2008 tax year. In 2013, Charity A was deregistered because it was found by Charities Services to have been non-compliant with its constitution since it was registered. Charity A still owns the office furniture at the date of deregistration. The depreciation rate for office furniture is 19.2%.

Charity A must file an income tax return for each year starting from the 2008 year.

Under new section HR 11(2) the cost of premises, plant, equipment, and trading stock is the value that would be used at the “date of cessation” under the general tax rules if section CW 41 or section CW 42 never applied. Under the general tax rules, office furniture must be depreciated each year it is used in the business of Charity A. Therefore, the cost of office furniture for each year from 2008 to the present day is as follows:

Year	2008	2009	2010	2011	2012	2013
Opening value (\$)	50,000	40,400	32,643	26,376	21,312	17,220
Depreciation (\$)	9,600	7,757	6,267	5,064	4,092	3,306
Year-end balance (\$)	40,400	32,643	26,376	21,312	17,220	13,914

Charity A will introduce the asset into the tax base at \$50,000 and recognise a depreciation charge of \$9,600 in its 2008 income tax return.

Example: Financial arrangement

Assuming the deregistration facts as above, Charity A had loaned \$100,000 to person X in 2008. The loan was repayable on demand and interest was 10% per annum compounding. No loan repayments were made.

Under new section HR 11(3), Charity A is required to account for this loan under the financial arrangement rules in each of the years that it had ceased to meet the requirements of sections CW 41 or CW 42. It must also calculate an opening value using the formula in new section HR 11(4). The calculations are as follows:

Year	2008	2009	2010	2011	2012	2013
Opening value (\$)	100,000	110,000	121,000	133,100	146,410	161,051
Interest (\$)	10,000	11,000	12,100	13,310	14,641	16,105
Year-end balance (\$)	110,000	121,000	133,100	146,410	161,051	177,156

In 2008 the opening value would be \$100,000 and the closing value would be \$110,000. Charity A would account for \$10,000 accrued interest income in its 2008 income tax return.

FROM WHICH POINT WILL A DEREGISTERED CHARITY BE SUBJECT TO TAXING PROVISIONS

(Clauses 27 and 123(8))

Summary of proposed amendments

Clause 27 amends section CW 41 of the Income Tax Act 2007.

Clause 123(8) inserts a new definition of “final date of decision” in section YA of the Income Tax Act 2007.

The amendments to section CW 41 ensure that entities which are removed from the charities register will continue to be tax-exempt until the date of “final decision”, so long as they have acted in accordance with their constitution or other information supplied to the Charities Services, since registration.

The amendments should help to ensure that a large majority of deregistered charities do not face retrospective tax consequences.

Key features

The amendments to section CW 41 provide that:

- income derived by a deregistered charity in a specified period is treated as exempt income; and
- a deregistered charity is a “tax charity” (as defined in section CW 41 (5)) for the specified period.

The specified period in question starts from the date the entity is registered on the charities register, and ends with the earlier of two dates. These dates are:

- the day on which the entity fails to act in accordance with its constitution, or other information supplied to Charities Services at the time of applying for charitable status; or
- the day of final decision.

A new definition of “day of final decision” is included in section YA 1. It is the later of two dates, namely:

- the day the entity is removed from the charities register; or
- the day on which that entity exhausts all disputes and appeals its charitable status.

Background

Under current law, tax consequences on deregistration may be quite onerous and may involve retrospective tax liabilities if a deregistered charity is found never to have had a “charitable purpose” or ceased being charitable in purpose at some time in the past. In some cases, however, these entities will have been acting in accordance with their constitutions, but there may simply have been a slight change in jurisprudential interpretation of what is “charitable” and what is not.

The amendments to section CW 41 should afford entities a greater level of certainty that, for tax purposes, they should be able to rely on the decision made by Charities Services to recognise that entity as charitable in purpose. This protection, however, only applies when the deregistered charity has acted in accordance with all the information and evidence that Charities Services used to make its registration decision. If an entity has ceased to act in accordance with the evidence or information provided to Charities Services, then that entity should not be able to take advantage of the decision to register it.

Therefore, entities that have continued to be compliant with their constitutions and other supporting information provided at the time of registration will not be liable for tax in periods before they were deregistered, and if they dispute their deregistration, not before the date their dispute is finally decided.

As under current law, a small number of entities could face a retrospective tax liability when they are deregistered.

REQUIREMENTS FOR DEREGISTERED CHARITIES WITH ACCUMULATED ASSETS

(Clauses 19 and 108)

Summary of proposed amendments

Clause 108 inserts new section HR 12, which is intended to encourage deregistered charities to distribute their accumulated assets and income to charitable purposes within 12 months of being deregistered. If the entity chooses to retain the assets and income it has accumulated, it will be required to include the value of its net assets on hand as an amount of income which will be subject to tax.

Clause 19 inserts new section CV 17, which sets out that any amount of income arising under new section HR 12 will be considered as income of the entity in the income year after the income year in which the entity is deregistered.

Key features

New sections CV 17 and HR 12 provide that an entity has an amount of income equal to the greater of zero or the value of its net assets held at the time that is 12 months after the date of deregistration, subject to some adjustments.

These adjustments carve out certain assets, which reduce the net assets balance that will be subject to tax. The items carved out are:

- any assets distributed to charitable purposes in the 12 months after the entity is deregistered; and
- any assets (not including money) gifted or left to the entity while it was deriving exempt income.

New section HR 12 has a split application date. It generally applies from 1 April 2015, but applies from 14 April 2014 for charities that choose to voluntarily deregister.

Background

Current tax law (legislation and case law) supports the ability of charities to accumulate their income for future use, and no symmetry is required between the income tax exemption and the payments towards charitable purposes, either in amount or timing. Although there is a requirement for deregistered charities which cease to operate to distribute their assets and income to charitable purposes, there is no such requirement when deregistered charities continue to operate.

The Government believes that the assets and income of a charitable entity with tax-exempt status should always be destined for a charitable destination, irrespective of whether the entity ceases to exist or not. However, if a deregistered charity continues in existence, the Government considers that the value of the deregistered charity’s net assets (assets minus liabilities) should be subject to income tax. The imposition of tax in this instance is consistent with the current policy intentions underlying the charities-related tax concessions. In other words, the tax concessions should only be available to *bona fide* charities and deregistered charities should be held to account for the assets and income they have built up while they enjoyed the benefit of the tax concessions.

For reasons of fairness, however, deregistered charities should be given time to apply any assets or income to charitable purposes before the imposition of any tax, and an adjustment should be permitted for any donated assets as these assets were not funded by non-taxed income or through a tax-preferred source.

Example: Taxation of tax-exempt accumulation

Charity A’s date of deregistration is 1 June 2013. The balance sheet for Charity A at 1 June 2013 is shown below.

Assets		Liabilities	
Cash	\$50	Loan	\$200
Inventory	\$300	Equity	
Land (donated)	\$3,000	Shareholders’ equity	\$3,150

The net asset calculation will be \$3,150; less the value of the donated land; less any assets and income distributed for charitable purposes within 12 months of the date of deregistration. The net assets value will be \$150 (\$3,150 less \$3,000). Assume Charity A has a July balance date for tax purposes. Charity A would include \$150 as income in its 2014 income tax return.

CONSEQUENCES OF DEREGISTRATION ON ELIGIBILITY TO BE A CHARITABLE ORGANISATION

(Clause 123(6))

Summary of proposed amendments

Clause 123(6) amends the definition of “charitable organisation” in section YA 1. It widens the definition of “charitable organisation” to include an entity which has been removed from the charities register, so long as it has acted in accordance with its constitution and other supporting information provided at the time of registration.

This amendment clarifies the FBT treatment for deregistered charities and largely mirrors the amendment to section CW 41 in clause 27 discussed earlier.

Key features

The definition of “charitable organisation” in section YA 1 is being amended to ensure that a deregistered entity can still be a charitable organisation for a specified period.

The period in question starts from the date the entity is registered on the charities register, and ends with the earlier of two dates. These dates are:

- the last day of the relevant quarter or income year in which the entity fails to act in accordance with its constitution, or other information supplied at the time of registration; or
- the last day of the relevant quarter or income year in which the final decision on the entity’s charitable status is made.

Background

Despite being deregistered, an entity might still qualify to be a “charitable organisation”, if it is not carried on for the private pecuniary profit of an individual, and applies its funds wholly or mainly to charitable, benevolent, philanthropic or cultural purposes within New Zealand, or is listed in schedule 32 of the Income Tax Act 2007.

If a deregistered charity is no longer eligible for the FBT exemption, the FBT rules will apply to that entity in the same way as for income tax purposes. This means that deregistered charities that have complied with their constitution will lose their FBT exemption from the date of the final decision about their charitable status, and non-compliant entities from the date of non-compliance.

CONSEQUENCES OF DEREGISTRATION ON ELIGIBILITY TO BE A DONEE ORGANISATION

(Clause 110)

Summary of proposed amendments

Clause 110 amends section LD 3(2) of the Income Tax Act 2007 to confer donee status on an entity registered on the register of charitable entities under the Charities Act 2005. The amendment would ensure donors have a greater level of certainty that their donations tax relief will not ordinarily be reversed in circumstances when they have made a *bona fide* monetary gift and the entity they have donated to is later deregistered.

Key features

New section LD 3(2)(ab) ensures that monetary gifts that meet the requirements of a “charitable or other public benefit gift” in section LD 3(1) made to registered charities can still qualify for donations tax relief even if that entity is later deregistered.

Background

A deregistered charity may still qualify for donee organisation status if it meets the other donee organisation requirements.⁶ If, however, the entity no longer qualifies for donee organisation status, donors will no longer be entitled to tax relief on their donations. Under current law, this will happen at the point at which the entity no longer satisfies any of the requirements to be a donee organisation. This could be in the past, which would give rise to retrospective consequences for donors.

Under current law, donors who have made cash donations to an entity after the point at which it no longer qualifies to be a donee organisation are technically not eligible for donations tax relief. In the case of individuals, this relief is in the form of a tax credit; in the case of corporate or Māori authority donors, in the form of a tax deduction. Inland Revenue has the ability to reverse previous tax relief claims that have been claimed incorrectly.

The Government accepts that Inland Revenue should be able to reverse tax relief in certain circumstances, but this power should not be used as a matter of course. In particular, this power should only be available in circumstances when a donor had knowledge at the time of claiming the relief that the entity did not satisfy any of the requirements to be a donee organisation, or when the donor was involved in fraud in relation to the donation and the donee organisation, or when the requirements substantiating that a *bona fide* monetary gift has been made are not met under general law.

The amendment should protect donors who have claimed donations tax relief in good faith, assuming that an organisation was a donee organisation.

⁶ A donee organisation is an organisation that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic or cultural purposes within New Zealand. The Income Tax Act 2007 also lists 108 donee organisations whose charitable purposes are largely carried out overseas.

Tax status of certain community housing entities

TAX STATUS OF CERTAIN COMMUNITY HOUSING ENTITIES

(Clauses 28, 29, 110, 123(7) and 159)

Summary of proposed amendments

Amendments are being made to the Income Tax Act 2007 and the Tax Administration Act 1994 to confer tax-exempt status and donee organisation status on community housing entities who meet specified criteria. The amendments address current tax uncertainties relating to community housing entities who provide affordable home-ownership products to low-income households.

Application date

The majority of amendments will apply from 14 April 2014.

The specific criterion in the proposed income tax exemption that the entity must be a registered community housing entity under the Housing Restructuring and Tenancy Matters Act 1992 will apply from the date the new Regulatory Authority proposed under the Social Housing (Restructuring and Tenancy Matters) Bill comes into existence.

Key features

- New section CW 42B of the Income Tax Act 2007 confers an income tax exemption on community housing entities which meet specified criteria, including only supplying housing products or services to specific classes of recipients which are listed in the new section.
- The specific classes of recipients listed in new section CW 42B include other tax-exempt community housing entities, and people or classes of people, described in regulations to be set under new section 225D of the Tax Administration Act 1994.
- New section LD (3)(1)(ab) of the Income Tax Act 2007 confers donee organisation status on community housing entities which meet the requirements in new section CW 42B, which ensures that donors who give monetary gifts of \$5 or more to one of these entities qualify for donations tax relief.

Background

Currently, the tax-exempt status and donee organisation status of community housing entities involved in the provision of affordable home-ownership products aimed at low-income households with alternative housing options is not certain. This is because the charitable status of these entities is uncertain. Charitable entities that are registered with the Department of Internal Affairs – Charities Services are eligible for the charities-related income tax exemption and donee organisation status.

Charities law recognises the relief of poverty as a charitable purpose, however entities that offer affordable home-ownership products tend to fall outside the charities criteria – the ability to purchase a house is an indication a person is not “in poverty”.

The Government believes that community housing entities should have a range of options in relation to housing products to offer to recipients – for example, rental and home ownership. If an entity provides affordable home-ownership products aimed at low-income households, but in all other ways would be recognised as charitable in purpose, the Government believes that the provision of a home ownership product alone should not disqualify that entity from being entitled to tax-exempt status or donee organisation status.

The proposed amendments are intended to address the current lack of tax certainty, and help to promote home ownership for New Zealanders who would not otherwise be able to afford to buy a house.

Detailed analysis

Income tax exemption (clauses 28, 29, 123(7) and 158)

A community housing entity is eligible for the proposed income tax exemption if it carries on the business of providing housing products or services to the following recipients:

- persons, or classes of persons, described in regulations made under new section 225D of the Tax Administration Act 1994; and
- other community housing entities which are eligible for the proposed income tax exemption.

Classes of recipients' criteria

New section 225D of the Tax Administration Act 1994 permits the Governor-General to make regulations specifying people, or classes of people who may be recipients of housing products or services offered by community housing entities.

The factors which may be used to determine a recipient are:

- the person's geographic location in New Zealand;
- the composition of the household a person lives in;
- the income of the person or household; and
- the person's assets.

These criteria ensure that the proposed exemption is aimed at community housing entities that are involved in the provision of new housing products to people who are on low-incomes and who could not otherwise afford to buy a home without Government assistance.

The Minister for Housing and the Minister of Revenue will be responsible for establishing a framework for determining who can be an eligible recipient of housing assistance for the purposes of the proposed exemption. This framework is currently being developed.

Furthermore, new section 225D contemplates that the regulations may have retrospective effect and could apply from a date before the bill containing these amendments is enacted.

Other exemption criteria

The community housing entity must also ensure that:

- its business is not carried on for the private pecuniary profit of any individual;
- all profit of the business is reinvested into the business; and
- no person with some control over the business may be able to direct or divert an amount derived by the business for their own benefit or advantage.

These criteria are similar to those described in current sections CW 42(5), (6), (7) and (8) of the Income Tax Act 2007. They ensure that only community housing entities that operate under a non-profit model are eligible for the proposed income tax exemption.

Donations tax relief for donations to tax-exempt housing entities (clause 110)

Under current tax law, donors who make cash donations of \$5 or more to donee organisations are entitled to tax relief based on their donation. In the case of individuals this relief is in the form of a tax credit; in the case of corporate or Māori authority donors, in the form of a tax deduction.

The proposed amendment to section LD 3(2) of the Income Tax Act 2007 confers donee organisation status on community housing entities.

The taxation of land-related lease payments

OVERVIEW

Currently, the Income Tax Act 2007 provides for the tax treatment of certain land-related lease payments. For example, lease premiums, lease inducement and lease surrender payments are generally taxable and tax deductible under the Act. In absence of specific provisions, the tax treatment of other land-related lease payments is determined under general provisions and principles.⁷

Since the Act does not provide comprehensive coverage of all land-related lease payments, similar lease payments can be treated differently for income tax purposes, which can have the effect of distorting business decisions.

An officials' issues paper, *The taxation of land-related lease payments*, released in April 2013, sought feedback on proposals to introduce a broad reform to achieve a coherent and consistent tax treatment of all land-related lease payments. In particular, the issues paper suggested making commercial land-related lease payments taxable and deductible by introducing a bright-line rule of 50 years for leases and licences of land. Commercial leases or licences of land lasting less than 50 years would therefore have been put on revenue account. Leases and licences of land lasting 50 years or more would have been put on capital account, which would provide a similar tax treatment to most freehold land.

Following public consultation, the Government decided to introduce a targeted reform to address specific revenue risks with lease transfer payments (that is, received by an exiting tenant for transferring a lease to an incoming tenant).

The bill proposes to tax, from 1 April 2015, certain lease transfer payments, which are substitutable for taxable lease surrender and lease premiums payments. This bill also proposes a number of technical amendments to tax law relating to leases and licences of land to provide consistency and certainty.

⁷ Generally, payments that are revenue in nature, such as receipts or expenditure derived or incurred in the ordinary course of business, are treated as taxable income and tax deductible expenditure. Generally, payments that are capital in nature are treated as non-taxable income and non-deductible expenditure.

LEASE TRANSFER PAYMENTS

(Clauses 9 and 123(23))

Summary of proposed amendment

The proposed amendment taxes certain lease transfer payments that are substitutable for taxable lease surrender payments and lease premiums.

Application date

The amendment will apply from 1 April 2015.

Key features

New section CC 1B extends section CC 1B to include certain lease transfer payments that are substitutable for taxable lease surrender payments in section CC 1C and taxable lease premiums in section CC 1.

A lease transfer payment will be taxable in following situations:

- The lease transfer payment is sourced directly or indirectly from funds provided by the owner of the estate in land from which the land right is granted; such a payment is substitutable for a lease surrender payment.
- The person purchasing the lease is associated with the owner of the estate in land from which the land right is granted; the lease transfer payment is substitutable for a lease surrender payment.
- The vendor of the lease is associated with the owner of the estate in land from which the land right is granted; the lease transfer payment is substitutable for a lease premium.

Background

Lease transfer payments are generally received by an exiting tenant (assignor) from a new incoming tenant (assignee), for the transfer or assignment of a lease. For income tax purposes, the payment is generally non-taxable to the exiting tenant.

The current non-taxable status of lease transfer payments, in tandem with taxable lease surrender payments,⁸ can distort commercial decisions when tenants exit a lease. As lease transfer payments are generally not taxable, it would be tax advantageous for a tenant to exit a lease by transferring the lease to a third party for a tax-free lease transfer payment, rather than surrendering it to a landlord for a taxable lease surrender payment.

⁸ Lease surrender payments are taxable under section CC 1C of the Income Tax Act 2007.

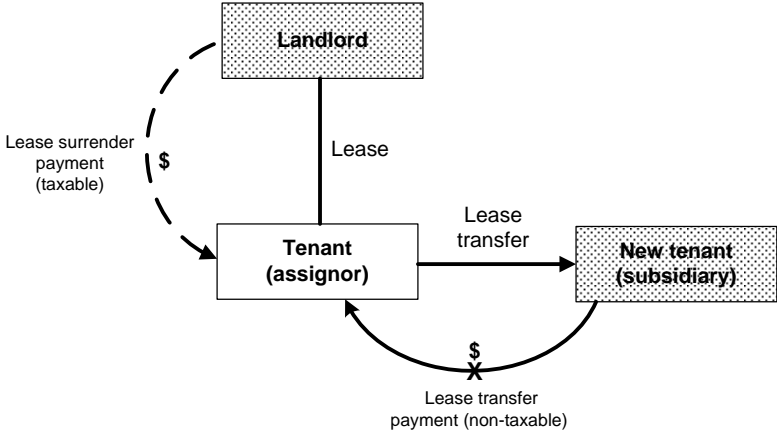
From the exiting tenant’s perspective, there is no economic difference between surrendering the lease to the landlord and transferring it to a third party. The effect is the same – the tenant exits the lease and receives consideration for it. Treating similar payments differently for income tax purposes distorts business decisions and results in economic inefficiency and unfairness.

Example

On 1 April 2015, a landlord and a tenant enter into a 10-year lease. After three years, the landlord expands its business to retail, by setting up a subsidiary company. The landlord wishes the tenant to exit the lease so that the subsidiary company can use the premises to carry on its retail business.

If the landlord pays a lease surrender payment to the tenant, the payment is taxable to the tenant and deductible to the landlord.

A subsidiary company of the landlord and the tenant enter into an agreement to transfer the lease. The subsidiary company pays the tenant \$100,000 for the transfer.



Under the current rules, the lease transfer payment of \$100,000 is deductible to the subsidiary company over the remaining seven years under the depreciation rules. The lease transfer payment is non-taxable to the exiting tenant. The exiting tenant is \$28,000 ($\$100,000 \times 28\%$) better off than receiving a lease surrender payment from the landlord.

The revenue risk increases when the commercial property market tightens – that is, when there is a shortage of business premises in economic upturns. This is because lease transfer payments from new tenants or lease surrender payments from landlords tend to occur more often when leases become valuable in a tight commercial property market. For example, prospective tenants or landlords would be more prepared to pay existing tenants for the transfer or surrender of a lease.

Following public consultation, the Government decided to tax certain lease transfer payments as a base-protection measure – that is, to prevent non-taxable lease transfer payments being substitutable for taxable lease surrender payments or lease premiums.

Detailed analysis

The tax treatment of lease transfer payments

The new rules extend section CC 1B to include certain lease transfer payments. This extension is intended to be a targeted base-maintenance measure.

If a person (the payee) derives an amount, in relation to a land right, as consideration for the transfer of the land right from the holder of the land right to another person, the amount will be taxable to the payee (new sections CC 1B(1)(b) and (2)). The land right must be a right that is a leasehold estate or a licence to use land.

The term “leasehold estate” is defined broadly in section YA 1 to include any estate, however created, other than a freehold estate.⁹ The charging provision, therefore, does not apply to payments for a freehold estate in land, such as the proceeds from the sale of land.

Despite this broad charging provision for lease transfer payments, most lease transfer payments will not be taxable by satisfying the following conditions listed in new section CC 1B(3):

- the payee is the holder of the land right (for example, the exiting tenant);
- the amount is consideration for the transfer of the land right to the person paying the amount (for example, the new tenant);
- the amount is not sourced directly or indirectly from funds provided by the owner of the estate in land from which the land right is granted; and
- each of the payee and the person paying the amount is not associated with the owner of the estate in land from which the land right is granted.

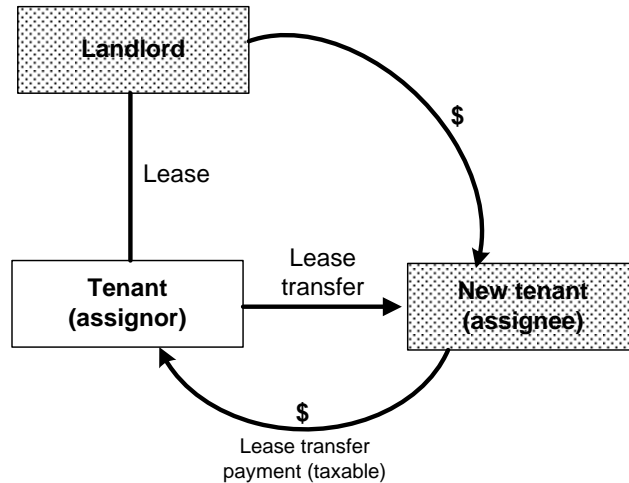
Payments derived in situations when these conditions are not satisfied will be taxable to the payee. If a lease is transferred as part of a business transfer, consideration for goodwill attaching to the land will be taxable to the payee; however, consideration for business or personal goodwill will not be subject to the charging provision.

Situations involving lease transfer payments that are covered by the proposed section CC 1B are payments that are substitutable for taxable lease surrender payments in section CC 1C and taxable lease premiums in section CC 1.

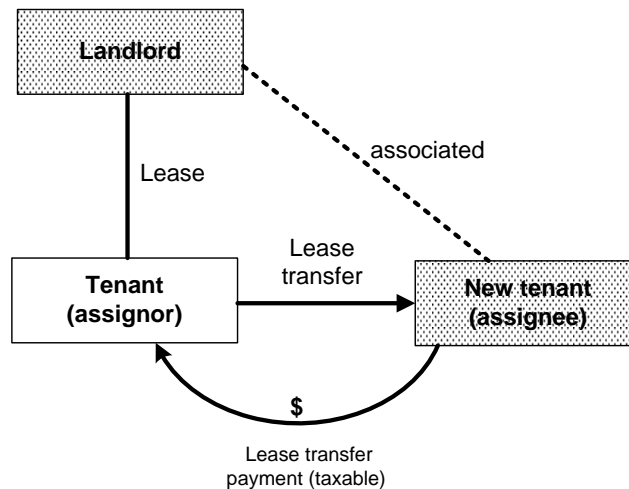
⁹ For income tax purposes, an interest in land has the same meaning as an estate in land.

There are two situations when lease transfer payments that are substitutable for lease surrender payments will be taxable to the payee. They are:

- if the amount is sourced directly or indirectly from funds provided by the owner of the estate in land from which the land right is granted.¹⁰



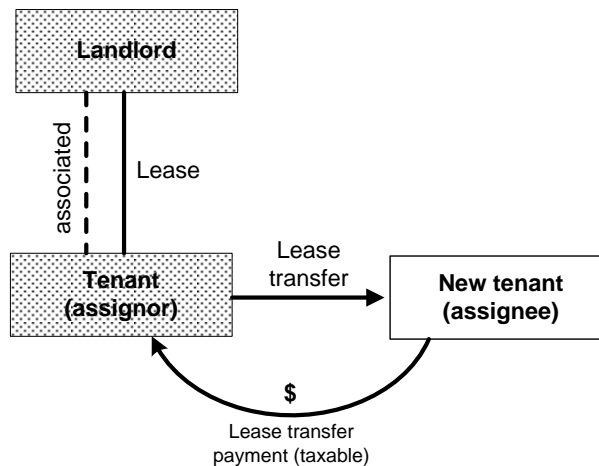
- if the person paying the amount is associated with the owner of the estate in land from which the land right is granted.



An exception for a tenant or a licensee of residential premises will apply to the two situations described above. The amount is not income if the payee is a natural person (individual) and derives the amount as a tenant or licensee of residential premises whose expenditure on the residential premises does not meet the requirements of the general permission (proposed section CC 1B(4)(a)). This exclusion is intended to provide a consistent tax treatment with that for lease surrender payments in section CC 1C.

¹⁰ Note that the payment from the landlord to the new tenant for the lease transfer is deductible to the landlord under section DB 20B and taxable to the new tenant under existing section CC 1B.

Another situation when lease transfer payments will be made taxable is payments that are substitutable for lease premium payments. In particular, if the payee is associated with the owner of the estate in land from which the land right is granted, lease transfer payments will be taxable.



This would prevent a landlord setting up a lease with a low rent with their associate and, as part of this arrangement, the associated tenant transfers the lease to a non-associated tenant and receives a non-taxable lease transfer payment.

Taxing a lease transfer payment in such situation will supplement the existing anti-avoidance provision in section GC 5, which allows the Commissioner to set an adequate level of rent for leases between associates.

Lease transfer payments received for residential premises will also be taxable if the payee (the tenant) is associated with the owner of the estate in land from which the land right is granted (proposed section CC 1B(4)).

The definition of “land provisions” in section YA 1 will be amended so that the definition of “associated person” applying in new section CC 1B is the one applicable to land provisions.

If a person receives a lease transfer payment on behalf of another person, the current nominee rules in section YB 21 apply to treat the amount as derived by that other person.

An amount that is subject to the existing capital contribution rules will not be subject to the charging provision (proposed section CC 1B(5)). A capital contribution will continue to be income under section CG 8 and spread evenly over 10 years unless the payee chooses to reduce the cost base of the depreciable property under section DB 64.

Timing of income

The timing provision in section EI 4B applies to the amount of income under section CC 1B. Under that provision, the allocation of income is affected by when the income is derived in relation to the spreading period.

The exiting tenant (assignor) who receives a lease transfer payment has no remaining period over which to spread the amount of income under section CC 1B. Therefore, the amount of income will be allocated to the income year in which the amount is derived.

PERMANENT EASEMENTS

(Clause 8)

Summary of proposed amendment

The proposed amendment excludes a payment for a permanent easement from being taxable to a landowner under existing section CC 1.

Application date

The amendment will apply from 1 April 2015.

Key features

Proposed section CC 1(2C) provides that if an owner of a fee simple estate in land derives an amount as consideration for the grant, for the duration of the estate, of an easement over the land, the amount will not be income of the owner. The purpose of this specific exclusion is to align the tax treatment of a permanent easement (or a perpetual right of way) with that for freehold land under the existing section CC 1.

Accordingly, a payment for a permanent easement will not be taxable to the owner of land (the grantor) under section CC 1,¹¹ and a payment for a permanent easement will not be deductible to the payer (the grantee) under the depreciation rules.

Background

Section CC 1 applies broadly to tax income from land by providing that amounts derived from land by a landowner are taxable even if the amounts are traditionally categorised as capital in nature – for example, a lease premium. A payment for a permanent easement is currently taxable to a landowner under section CC 1.

On the other hand, a payment for a permanent easement is generally non-deductible to the payer (the grantee) under the depreciation rules. Generally, a permanent easement does not meet the definition of depreciable property under section EE 6; in particular, in normal circumstances, a permanent easement is not reasonably expected to decline in value.

¹¹ Note that the land provisions in sections CB 6 – CB 23B continue to apply to permanent easements.

PERPETUALLY RENEWABLE LEASES (“GLASGOW” LEASES)

(Clause 53)

Summary of proposed amendment

The proposed amendment excludes a perpetually renewable lease from being depreciable property.

Application date

The amendment will apply from 1 April 2015.

Key features

Section EE 7 will be amended to exclude a lease of land with a perpetual right of renewal from being depreciable property. The purpose is to treat a perpetually renewable lease similarly to freehold land under the depreciation rules. Accordingly, depreciation deductions will not be available for a perpetually renewable lease.

Background

Perpetually renewable leases last for a certain duration (for example, 7, 10 or 21 years), but are renewable in perpetuity at the option of tenants. They are commonly known as “Glasgow” leases. They are typically for the bare land only and tenants generally own the improvements on the land. Rents on these leases are reviewed periodically (usually to a market rate).

Under the current rules, “the right to use land” is contained in the list of depreciable intangible property in schedule 14 of the Income Tax Act 2007. Usually, a commercial tenant of a lease can claim depreciation deductions for their cost to acquire the lease (that is, a lease premium or lease transfer payment) over the term of the lease.

However, a tenant under a perpetually renewable lease may not claim depreciation deductions during the term of the lease because these leases have a perpetually renewable lease period. The tenant, however, may be able to claim a depreciation loss when the perpetually renewable lease is sold for less than its adjusted tax value if the lease meets the definition of “depreciable property” in section EE 6 – that is, in normal circumstances, the lease might reasonably be expected to decline in value.

Note that a payment for a perpetually renewable lease continues to be taxable to a landowner under section CC 1. This payment (for example, a lease premium) is easily substitutable for taxable rent payments on a perpetually renewable lease that are periodically reset to market levels.

CONSECUTIVE LEASES

(Clauses 56, 123(23) and 123(24))

Summary of proposed amendment

The proposed amendment treats consecutive leases of land as a single lease for depreciation purposes.

Application date

The amendment will apply from 1 April 2015.

Key features

Section EE 67 will be amended to include consecutive leases in the existing definition of “legal life” for a lease and licence to use land. The definition of “legal life” is used to determine the annual depreciation rate for an item of fixed-life intangible property, such as a lease of land, in section EE 33.

If consecutive leases over the same parcel of land are granted to a person or an associated person at the same time, the term of a lease owned by the person will also include the terms of consecutive leases owned by that person or an associate. This will have an effect of treating consecutive leases as a single lease.

Any genuinely subsequently negotiated leases or licences of land will not be counted towards the legal life of a lease. Consecutive leases would need to be acquired by the person or associated person at the same time to be counted towards the legal life of a lease.

This is intended as an anti-avoidance measure to prevent the timing of depreciation deductions for the cost of acquiring a lease (a lease premium or lease transfer payment), being accelerated by entering into consecutive leases. If consecutive leases are entered into around the same time (such as one day apart), the general anti-avoidance provision in section BG 1 may apply to counter any transactions that attempt to circumvent this measure contrary to the policy intent.

Example

On 1 April 2015, A Ltd and its associates, B Ltd and C Ltd, enter into three separate leases for the same parcel of land to take effect immediately after one terminates. The first lease commences on 1 April 2015. Each lease lasts for 10 years.

Lease	Commencement date	Lease ownership	Term of the lease
1	1 April 2015	A Ltd	10 years
2	1 April 2025	B Ltd	10 years
3	1 April 2035	C Ltd	10 years

A Ltd, B Ltd and C Ltd are associated and they have entered into consecutive leases for the same parcel of land on the same day. Therefore, under the proposed rules:

- A Ltd's interest (owner's interest) in the lease will be treated as lasting for 30 years, which includes both B Ltd and C Ltd's interests in the lease.
- B Ltd's interest (owner's interest) in the lease will be treated as lasting for 20 years, which includes C Ltd's interest in the lease.
- C Ltd's interest (owner's interest) in the lease lasts for 10 years as there is no consecutive lease.

The definition of "land provisions" in section YA 1 will be amended so that the definition of "associated person" applying in section EE 67 is the one applicable to land provisions.

Also, paragraph (d)(v) of the definition of "lease" in section YA 1 will be amended to remove the Commissioner's discretion to determine consecutive leases for the purposes of personal property lease payments. A similar definition to the one that is proposed for depreciation purposes in section EE 67 will be adopted to provide certainty and consistency.

Background

Consecutive leases are multiple leases for the same parcel of land that are granted to a person or an associated person at the same time, and are linked to take effect immediately after one terminates. Under the current rules, depreciation deductions on a lease could be accelerated by entering into consecutive leases, including involving associated persons, rather than a single lease.

RETIREMENT VILLAGE OCCUPATION RIGHTS

(Clause 123(25))

Summary of proposed amendment

The proposed amendment excludes an occupation right agreement as defined in the Retirement Villages Act 2003 from the financial arrangement rules.

Application date

The amendment will apply from 1 April 2015.

Key features

Paragraph (f) of the “lease” definition in section YA 1 will be amended to include an occupation right agreement as defined in the Retirement Villages Act 2003. This way, retirement village occupation rights will be treated as an excepted financial arrangement in section EW 5(9), and accordingly excluded from the financial arrangement rules.

This amendment is intended to align the treatment of retirement village occupation rights with leases of land under the financial arrangement rules, and to provide certainty that retirement village residents are not subject to these rules.

Background

Leases are currently excluded from the financial arrangement rules because they are excepted financial arrangements under section EW 5(9). However, retirement village occupation rights that are licences to occupy are currently regarded as financial arrangements because they are not a lease for the purposes of financial arrangement rules as defined in section YA 1.¹²

Treating certain retirement village occupation rights as financial arrangements is undesirable from a policy perspective. In particular, if certain retirement village occupation rights are subject to the financial arrangement rules, there may be tax consequences for a retirement village resident.¹³

Note that Determination S16, which was issued by the Commissioner of Inland Revenue in 2010, applies to certain retirement village occupation rights that are leases resulting in the financial arrangement rules not applying to such arrangements. However, a legislative amendment in this area would provide greater certainty and ensure that all occupation right agreements under the Retirement Villages Act 2003 are excluded from the financial arrangement rules.

¹² See paragraphs (d) and (f) of the definition of “lease” in section YA 1.

¹³ The existing financial arrangement rules shift financial benefits from the transaction from one party to another. Consequently, under certain retirement village occupation rights arrangements, deductions may be allowed to a retirement village operator and assessable income may arise to the resident. This tax outcome would not generally have been contemplated by the contracting parties at the time of the transaction.

Other policy matters

FINANCIAL ARRANGEMENTS – AGREEMENTS FOR THE SALE AND PURCHASE OF PROPERTY OR SERVICES IN FOREIGN CURRENCY

(Clauses 60 to 67)

Summary of proposed amendments

The taxation rules for financial arrangements which are agreements for the sale and purchase of property or services in foreign currency (the foreign currency arrangements) are being changed to:

- reduce the complexity of calculations and increase overall compliance;
- minimise the volatility of taxable income in comparison to accounting income; and
- ensure that interest calculation for tax purposes reflects the economic reality.

An officials' issues paper released in July 2012 also proposed that the taxation rules for agreements for the sale and purchase of property or services in New Zealand currency be changed for the same reasons. This proposal has been deferred to allow for further consideration of the issues by officials in consultation with taxpayers.

Application dates

The amendments will apply to foreign currency arrangements entered into from the 2014–15 income year. Taxpayers using International financial reporting standards (IFRS) can make a once-and-for-all election to apply the new rules to foreign currency arrangements entered into from the beginning of an income year commencing with the 2011–12 income year.

In addition, tax positions taken consistently for existing foreign currency arrangements which are essentially based on the new rules will be validated.

Key features

The new rules will require IFRS taxpayers to follow their accounting treatment for foreign currency arrangements. This means the value of the property and services and any interest included in foreign currency arrangements will follow the accounting treatment. Compliance costs and complexity for these taxpayers will be considerably reduced compared with the current tax treatment.

Non-IFRS taxpayers will follow similar rules to IFRS taxpayers, based on spot exchange rates. There will be the ability to use forward exchange rates when these taxpayers elect to follow a prescribed foreign currency hedging tax treatment. Again, compliance costs and complexity for these taxpayers will be reduced.

Background

A primary purpose of the financial arrangements rules in the Income Tax Act 2007 is to account for the income or expenditure on a financial arrangement (the “interest” component) over the term of the arrangement. The interest component includes foreign currency gains and losses on financial arrangements.

Agreements for the sale and purchase of property or services have been financial arrangements since the commencement of the financial arrangement rules in 1986. This is because they can include an interest component resulting from prepayments or deferred payments. Any interest component is identified by comparing the value of the property or services with the consideration paid for the property or services.

Foreign currency arrangements have been subject to a complex mandatory tax treatment since 1996 to identify any interest component. This treatment includes the use of forward exchange rates for valuing the property or services and taxing the unrealised gains and losses during the term of the arrangements.

The current rules for foreign currency arrangements have caused significant compliance difficulties and volatility of taxable income (compared with accounting income). The volatility of taxable income is especially significant for IFRS taxpayers. The compliance difficulties are relevant to all taxpayers but are especially significant for non-IFRS taxpayers.

Modern accounting practice has now comprehensively and coherently dealt with this issue, thereby offering an opportunity to consider changes to the relevant tax rules.

Detailed analysis

The proposed new rules will apply from the application dates noted above to new foreign currency arrangements as follows:

IFRS taxpayers:

- This group will use the accounting treatment for the value of property or services in all cases. These values are calculated at spot exchange rates where designated hedging is not applied for accounting purposes. When designated hedging is applied for accounting amounts from the designated hedges are aggregated with the values calculated at the spot exchange rates to get the values of property or services. The accounting values will also be used for other tax purposes for example, the “cost” of property for calculating tax depreciation, and valuing revenue account property etc.

These taxpayers will be taxed on any interest and foreign currency gains and losses from foreign currency arrangements and designated hedges included in the accounting income statement that are not included in the accounting values of property or services. The accounting result is considered to be the correct economic and tax result in these cases.

- This group will also have existing tax positions consistently taken on existing foreign currency arrangements which are essentially based on the new rules validated. This measure is necessary to ensure existing tax positions for existing foreign currency arrangements where spot exchange rates have been applied instead of the mandated forward exchange rates are not subject to future dispute. The use of spot exchange rates instead of forward exchange rates for existing foreign currency arrangements has resulted in tax timing differences which will reverse over time. These differences will have gone both ways and are now locked into the fiscal base. It is not considered productive to have them corrected by use of the disputes process.

Non-IFRS taxpayers:

- These taxpayers will generally value the property or services in foreign currency arrangements at actually realised spot exchange rates. There will be a once-and-for-all ability to elect to include in the value of property or services amounts from specifically identified forward foreign exchange contracts which hedge the foreign currency arrangements. The election criteria will be prescribed in the legislation. This will suit many non-IFRS taxpayers who hedge their foreign currency purchases or sales. Others will simply use the spot exchange rate option.
- This group will not be taxed on any unrealised foreign exchange gains and losses under the stand-alone foreign currency arrangements. (They are presently taxed on the unrealised foreign exchange gains and losses under the current rules.) If they elect to include amounts from specifically identified forward foreign exchange contracts used to hedge the foreign currency arrangements in the value of property or services they will not be taxed on foreign gains and losses on the hedges. If they do not elect to include the hedge amounts in the value of the property or services they will be taxed on foreign currency gains and losses on the hedges. That is the current tax treatment for such stand-alone hedging financial arrangements.
- These taxpayers will be taxed on any interest under foreign currency arrangements arising from prepayments or deferred payments which are made 12 months or more before or after the “rights date” (the possession of the property or performance of the services). These prepayments and deferred payments are considered to be in the nature of loans and have always been taxed under the financial arrangement rules. This rule will not apply to payments for progress made on either making or constructing property, or providing services. These payments are not considered to be in the nature of loans.
- Under the proposed rules, this group will have existing tax positions consistently taken on existing foreign currency arrangements, and which are essentially based on the new rules, validated. This measure is necessary to ensure existing tax positions for foreign currency arrangements where spot exchange rates have been applied, instead of the mandated forward exchange rates, are not subject to future dispute.

INCOME TAX RATES FOR 2014–15

(Clause 3)

Summary of proposed amendment

The bill sets the annual income tax rates that will apply for the 2014–15 tax year and are the same as those that applied for the 2013–14 tax year.

Application date

The provision will apply for the 2014–15 tax year.

Key features

The annual income tax rates for the 2014–15 tax year will be set at the rates specified in schedule 1 of the Income Tax Act 2007.

THE ACQUISITION DATE OF LAND

(Clause 7)

Summary of proposed amendment

The land provisions contained in subpart CB of the Income Tax Act 2007 are being amended to clarify the time at which land is considered to have been acquired for tax purposes. In particular, the amendment clarifies that for the purposes of section CB 6 (land acquired with the intention or purpose of disposal), that the date a person's intention or purpose will be tested is at the beginning of the period when the person has an estate or interest in the land.

Application date

The amendment will apply to disposals of land from the date the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill is introduced.

Key features

New section CB 15B provides that the date a person acquires land for the purposes of subpart CB (income derived from land) is the date that begins a period in which the person has an estate or interest in the land.

Practically, this means that the date the taxpayer's purpose or intention is tested under section CB 6, and the other relevant land provisions, will be the date a binding agreement is entered into.

Indicative characteristics of the date a binding agreement is entered into (that is, the agreement has no conditions precedent, but the vendor and the purchaser intend to be bound by the terms of the contract even if there are conditions subsequent that have to be fulfilled) are:

- the date a binding sale and purchase agreement has been signed and executed by both the vendor or purchaser (including nominees or agents); or
- the "Date" indicated on a binding sale and purchase agreement, which is then subsequently signed by the parties to the agreement; or
- the date a binding oral agreement for the disposal of land was agreed to by the parties, which has then been subsequently acted on by part performance of the agreement and if required later, evidenced by a memorandum.

The definition of "land" in the Income Tax Act 2007 also includes an option to acquire an estate or interest in land. For the purposes of an option under the proposed new rules, the date a binding agreement is entered into will be the date the parties enter into the main contract and the taxpayer acquires the option but has not yet exercised it. Although the option is yet to be exercised and the parties still have to enter into a subsequent agreement for the sale and purchase of the land pertaining to the option, the taxpayer has acquired an equitable interest in the "land" and this date is reflective of the underlying "first interest" policy that underpins the proposed legislative clarification.

Background

The amendment seeks to clarify the acquisition date of land for the purposes of the land disposal provisions in the Income Tax Act 2007, in particular section CB 6, which is causing considerable uncertainty for taxpayers, their agents and Inland Revenue.

Section CB 6 deals with land acquired for the purpose of, or with the intention of disposal, and the taxation of income derived from disposing of the land. If a taxpayer acquires the land with the intention or purpose of disposal and subsequently disposes of the land, any profit made is taxable.

The uncertainty is caused by the timing of when the taxpayer's intention or purpose should be determined. The Courts have held that "intention" or "purpose" should be tested when a taxpayer has acquired the land in question (known as the date of acquisition). However, because the definition of "land" in the Income Tax Act 2007 includes estates and interests in land, and the taxpayer acquires different interests and estates in "land" at different times under a typical sale and purchase agreement (which are then merged when the title is registered), neither the legislation nor common law have provided sufficient clarity over which interest in "land" the date of acquisition should apply to.

To address this uncertainty, as part of Budget 2013 officials released the issues paper *Clarifying the acquisition date of land*. The issues paper discussed two possible interpretations of the provisions. It concluded that the "first interest" interpretation whereby the date of acquisition is the date when the first equitable or legal interest in land arises in a sale and purchase agreement (typically in the early phases of a sale and purchase agreement), would provide greater certainty and be more economically efficient. This interpretation also more closely reflected the policy underlying section CB 6 (which targets property speculators), as it is the initial decision-making that informs how a person intends to use the property. It would be unusual for a property speculator to enter into a sale and purchase agreement unless they thought it very likely that the purchase and its subsequent disposal would be profitable.

REPEAL OF SUBSTITUTING DEBENTURE RULE

(Clauses 38, 40, 51, 83, 84, 105 and 123(13) and (40))

Summary of proposed amendment

The bill proposes the repeal of the substituting debenture rule in section FA 2(5) of the Income Tax Act 2007, and other consequential amendments as the rule is now out-dated.

Currently, the rule recharacterises debt issued by a company to its shareholders by reference to their equity (most commonly debt issued in proportion to shares held) as equity for tax purposes. This means interest paid in respect of a substituting debenture is taxed as a dividend; it is non-deductible to the company and subject to imputation.

Application date

The amendment will apply for the 2015–16 and later income years. This aligns with the application date for the amendments in the bill to the thin capitalisation rules.

Key features

Clause 84 of the bill repeals section FA 2(5) of the Income Tax Act 2007, which defines “substituting debenture”, and section FA 2(7), which quantifies the amount of the debenture.

As well as repealing the substituting debenture rule, the bill also:

- makes certain consequential amendments, primarily to remove references to substituting debentures in other sections of the Income Tax Act 2007 (in clauses 38, 40, 51, 105 and 123(13) and (40) of the bill); and
- introduces a transitional provision for substituting debentures that are already in existence when the rule is repealed.

Clause 83 contains the transitional provision. Its purpose is to ensure that no adverse tax consequences arise on transitioning from treating the debenture as a share for tax purposes, to treating it as a debt for tax purposes.

The transitional provision will treat the taxpayer as having redeemed the substituting debenture for its outstanding principal immediately before the beginning of its 2015–16 income year and re-advanced the redemption proceeds under a new loan equal to the outstanding principal on the first day of its 2015–16 income year.

Any income derived or expenditure incurred in respect of the loan on or after the first day of the taxpayer's 2015–16 income year must be accounted for under the financial arrangements rules. Any income and expenditure arising under the substituting debenture in income years before the 2015–16 income year will not be taken into account under the financial arrangements rules because that income and expenditure will have been dealt with under the tax rules applying to shares.

Background

A number of tax advisers and commentators have recently raised concerns about the substituting debenture rule.

It applies too widely in some circumstances. Arguably any shareholder loan is caught. It is easy for those not taking advice to mistakenly issue substituting debentures. Often the rule applies to fairly common company dealings which are of no policy concern. Taxpayers who inadvertently issue substituting debentures may have consequential problems with past tax years (for example, the company may have paid too little tax by virtue of treating the interest as deductible, the incorrect amount of RWT may have been deducted by the company from the payments, no imputation credits would have been attached by the company to the “dividend”, and there may be penalties and use-of-money interest payable as a result of taking an incorrect tax position in past years).

Conversely, the rule is too narrow in other circumstances, and can be easily circumvented. For example, the rule does not apply where the debt is in the form of a convertible note or where the loan is not made by the direct shareholder, but an indirect shareholder higher in the ownership chain. Taxpayers may also deliberately structure their funding as substituting debentures to take advantage of the equity recharacterisation. The ease with which the substituting debenture rule can be manipulated may facilitate cross-border tax arbitrage, as taxpayers can effectively choose whether a debenture is treated as debt or equity for New Zealand tax purposes.

The scope and the application of the rule are uncertain. This leads to increased compliance costs as taxpayers are inclined to seek advice (and even binding rulings) on fairly straight forward transactions.

Furthermore, in light of the recent tax avoidance cases, taxpayers are becoming increasingly concerned about standard commercial transactions which seemingly circumvent the rule. It is difficult to determine whether Parliament's intention is frustrated when the policy issue Parliament contemplated no longer exists given current policy settings.

The rule was enacted in 1940 as a specific anti-avoidance rule, under very different tax policy settings (in particular, New Zealand did not have an imputation regime).

The rule originally targeted transactions in which companies were swapping their ordinary equity for debt. These transactions were popular at the time because dividends were paid out of post-tax income and were exempt income to the shareholders, whereas interest was deductible to the company and taxable to the recipient, generally at a lower tax rate than the (then) company rate. Ultimately, the tax burden on dividends was often higher than that on interest. It is also possible that the Government was concerned about the collection of tax from ultimate shareholders as the predecessor of resident withholding tax (RWT) was easily circumvented.

In 1958 the dividend exemption was removed. This meant that dividends were subject to double tax, but interest was not (absent the substituting debenture rule). There was a clear tax incentive to structure investments as debt rather than equity, so the substituting debenture rule continued to serve an anti-avoidance purpose at this time.

Since the introduction of imputation in 1988, the original purpose of the substituting debenture rule has ceased to be relevant in many cases (as debt and equity returns are generally subject to the same tax treatment in the hands of a New Zealand-resident in a taxpaying position).

For investors such as non-residents, who still prefer to receive interest rather than dividends for tax reasons there are targeted rules, such as the thin capitalisation and transfer pricing rules, which limit the ability to take undue advantage of the preference.

Accordingly, the rule is now out-dated and the bill proposes its repeal. To mitigate any risk to the tax base as a result of the repeal, the application date of the repeal aligns with the strengthened thin capitalisation rules.

WITHHOLDING TAX AND INFLATION-INDEXED BONDS

(Clauses 119, 121, 122, 123(22), 128(3), 130, 131, 132 and 133)

Summary of proposed amendment

The resident withholding tax (RWT) and the non-resident withholding tax (NRWT) rules in the Income Tax Act 2007 are being amended to deal with technical problems relating to the application of these withholding tax rules to inflation-indexed instruments. The proposed amendments relate to the timing and the amount of withholding tax to be deducted from the inflation-indexed component of such instruments.

To administer the proposed changes, amendments to the record-keeping and filing provisions in the Tax Administration Act 1994 are also proposed.

Application date

The amendments will apply from the date of enactment.

Key features

The proposed changes are:

- Section RE 2(3) is being amended to exclude the inflation-indexed component, which is income that accrues to the bond holder at the end of the tax year, from being interest for the purposes of the general application of the RWT rules.
- New section RE 18B will:
 - limit the RWT payer's obligation to deduct resident withholding tax on both the interest and inflation-indexed amount to the amount of the interest payment; and
 - require RWT to be deducted from the interest and inflation-indexed amount when the bond coupon is paid.
- Section RF 2(1) is being amended to treat the inflation-indexed component as being non-resident passive income at the time the coupon interest is paid. This is to ensure that NRWT is deducted at the same time.
- Section YA 1 is being amended to insert a definition of an inflation-indexed instrument.
- A new paragraph is being inserted in sections 25(6) and 51 (2) of the Tax Administration Act 1994 that will require the bond issuer to notify the recipient of their requirement to file, and the Commissioner of Inland Revenue of any remaining tax liability.
- A new paragraph is being inserted in sections 33A(2) and 33AA(1)(l) of the Tax Administration Act 1994 that will provide an exclusion from non-filing requirements for a bond holder who has an interest payment capped by new section RE 18B.

Background

As part of the 2012 Half Yearly Economic Fiscal Update, the Government announced that it intended to target up to 10–20% of total bonds outstanding over time in an inflation-indexed bonds format. The Government had previously issued inflation-indexed bonds in 1996 but suspended their issue in 1999.

Inflation-indexed bonds are intended to diversify the Crown's investor base, to provide long-term cost-effective funding for the Government and to provide investors with a hedge against inflation as recommended by the Capital Market Development Taskforce in 2009, and in accordance with the 2010 Government Action Plan.

An inflation-indexed bond is a bond in which the nominal capital value invested increases by a measure of inflation in any year. The measure of inflation is generally a price index published by Statistics New Zealand and is actually credited when the bond matures, but is taken into account in calculating the coupon payments.

The coupon paid in any year is paid quarterly on the capital value of the bond. The capital value of the bond is the face value or nominal amount of the bond adjusted for cumulative changes in the Consumer Price Index.

Section EI 2 treats the inflation-indexed component as income having been credited at the end of the year.

Tax treatment of inflation-indexed instruments

The tax treatment of inflation-indexed bonds falls within the relevant RWT, NRWT and inflation-indexed instruments provisions in the Income Tax Act.

RWT is due on most forms of interest for New Zealand residents who do not hold an RWT exemption certificate.

NRWT is also due on most forms of interest for non-residents, unless a 0% NRWT rate applies. In most cases where a 0% NRWT rate applies, approved issuers (or a person on their behalf) must pay a levy on the securities they register with Inland Revenue, known as the approved issuer levy (AIL).

Approved issuers are able to pay interest to non-residents without deducting NRWT. Instead approved issuers are required to pay a levy at the rate of 2% for every dollar of interest paid on the inflation instrument.

If RWT or NRWT has been deducted at the wrong rate, the taxpayer may be obliged to file a tax return at the end of the year and make up the difference (or receive a refund). NRWT for the majority of non-resident holders is a final withholding tax.

The problems the changes seek to address

Two technical tax problems have been identified with the reissuance of these bonds which this bill seeks to address.

The primary problem is the potential for a withholding tax obligation to exceed the coupon amount. In this situation, the issuer of an inflation-indexed bond would have a liability to pay withholding tax, but no administratively workable “payment” to deduct it from.

At present this problem is a potential risk rather than an actual problem. The current coupon rate for the new Government issue of inflation-indexed bonds is 2% per annum, and this low coupon rate increases this potential risk. For example, the following table provides an indication of what the rate of inflation needs to be in order for the potential risk to become a problem.

Tax type and rate	Coupon rate	Annual inflation rate for the coupon payment to be insufficient
RWT at 33%	2%	4.1%
RWT at 30%	2%	4.7%
RWT at 17.5%	2%	9.5%
NRWT at 15%	2%	11.3%

While the risk of withholding tax exceeding the coupon payment is currently perceived to be low, the proposed changes go some way towards mitigating the cashflow and potential tax collection consequences if the inflation risk profile were to change significantly.

The proposed amendments to limit the RWT liability to the amount of the coupon are not extended to NRWT because the risk is considered lower.

The second and related problem stems from a timing issue. The legislation intends that RWT should be deducted annually from the inflation-indexed component. However, the coupon is generally paid quarterly and the administrative practice is to withhold the tax on the inflation-indexed component for the previous quarter, and deduct it from the coupon payment. This can result in an unclear situation where an issuer may be withholding tax from a coupon amount in advance of the bond holder’s legal obligation, because there is some form of cashflow from which to deduct the withholding tax.

So that Inland Revenue can administer these proposed changes, additional record-keeping requirements for the bond issuer and filing requirements for the bond holder have also been included in the bill.

DEDUCTIONS FOR UNDERGROUND GAS STORAGE FACILITIES

(Clauses 17, 18 and 36)

Summary of proposed amendment

The amendment is proposed to remove from the ambit of the petroleum mining tax rules underground facilities that are used to store processed gas. These facilities will instead be covered by the general depreciation tax rules, with deductions for expenditure on these facilities being spread over the estimated economic life of the asset.

Application date

The amendment will apply to expenditure incurred from the date of enactment. However, there is a grand-parenting provision proposed for expenditure incurred by the owner of an existing underground gas storage facility.

Key features

An amendment to section CT 7 carves out underground facilities used to store processed gas from being treated as petroleum mining assets. These underground facilities will be subject to the depreciation rules, rather than the petroleum mining rules.

Proposed section CZ 32 provides a transitional rule for the tax treatment of proceeds from selling an underground gas storage facility constructed before the amendments come into force.

The proceeds received from the sale of an underground gas storage facility are currently treated as being on revenue account under the petroleum mining rules (section CT 1). Under the proposed change, which removes underground storage facilities from the petroleum mining rules and includes them within the depreciation rules, the sale of an underground gas storage facility will be treated as being on capital account.

Consideration received from a disposal will be apportioned to reflect the amount of expenditure that has been incurred under the existing rules. For example, if an underground gas storage facility is sold for \$500 million in 2016, with \$300 million of expenditure incurred before the amendments are enacted and \$100 million incurred after the amendments are enacted, the amount of income from selling the facility would be: $\$300 \text{ million} / \$400 \text{ million} \times \$500 \text{ million} = \$375 \text{ million}$.

Background

Currently, a gap in the petroleum mining tax rules means that underground facilities for storing processed gas are eligible for concessionary treatment as a petroleum mining asset. This means that expenditure on an underground gas storage facility is deductible over seven years, instead of over the economic life of the facility (which would be the treatment under the depreciation rules). This is contrary to the policy intent that only expenditure on petroleum exploration and development should be eligible for concessionary treatment. The underground storage of gas that has already been extracted and processed is not an exploration or development activity.

CHARITIES WITH OVERSEAS CHARITABLE PURPOSES

(Clauses 2(25) and 126)

Summary of proposed amendment

The bill adds two 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:

- Every Home Global Concern Incorporated
- Namibian Educational Trust

Application date

The amendments will apply from 1 April for the income year following enactment.

Background

Donors to organisations listed in schedule 32 are entitled, as individual taxpayers, to a tax credit of 33¹/₃% of the monetary 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 that are 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 two charitable organisations being added to schedule 32 are engaged in the following activities:

- Every Home Global Concern Incorporated: The Trust is involved in a wide range of projects throughout the developing world, with particular emphasis on breaking the cycle of poverty and oppression and giving people the skills to improve their lives. The Trust carries on projects in Bangladesh (microenterprises) and Malawi (agricultural and livestock training, amenities and water pumps, HIV/Aids education), Africa generally (mosquito nets) and South Asia (vocational training, HIV/Aids education and microenterprises).
- Namibian Educational Trust: The Trust is involved in projects directed at improving the health and wellbeing of children in northern Namibia. Its main focus is to resource and provide amenities to schools and villages in the region.

CHANGE OF TAX RESIDENCY FOR GST PURPOSES

(Clause 161(3))

Summary of proposed amendment

The amendment “turns off” the backdating effect of certain residency rules in relation to the Goods and Services Tax Act 1985.

Application date

The amendment will apply from the date of enactment.

Key features

Whether a person is a resident or non-resident for the purposes of the Goods and Services Tax Act 1985 is dependant, in part, on whether the person is present or absent from New Zealand for a certain period of time as determined by the Income Tax Act 2007. Once the time period has been exceeded the person’s residence status is backdated to the beginning of the time period.

Under the current rules, to be considered tax resident a person must be present in New Zealand for more than 183 days in total, over a 12-month period. In these circumstances, a person is treated as being a tax resident from the first of the 183 days.

To be considered non-resident, a person must be outside New Zealand for more than 325 days in a 12-month period. In this case the resident will be regarded as a non-resident from the first of the 325 days.

For the purposes of the Goods and Services Tax Act 1985 only, the proposed amendment “turns off” the retrospective application of the residency rules so a person’s residency status is determined on a prospective basis (starting from the first day after the relevant time period has been exceeded).

Background

The residency status of a person for GST purposes is determined by section YD 1 of the Income Tax Act 2007. The provision contains two rules that determine a person’s tax residence – the permanent place-of-abode rule and the day-count rules.

There are two “day count” rules, the 183-day rule for determining whether a person becomes a tax resident and the 325-day rule for determining when a person ceases to be a tax resident.

A number of provisions in the Goods and Services Tax Act 1985 refer to the residency status of a person, most notably the provision that allows services supplied to non-residents who are offshore at the time of supply to be zero-rated. However, the retrospective application of the day-count rules can result in the GST treatment applied at the time of the transaction, on the facts known at the time, subsequently becoming incorrect.

For example, in a situation when immigration services are zero-rated on the basis of being supplied to a non-resident who is offshore at the time of supply, the GST treatment can become incorrect if the recipient's tax residency status is backdated to a time before the services were performed. This could happen if the recipient visited New Zealand before the services were performed and came back to New Zealand after the services had been performed. The combined time in New Zealand could result in the application of the 183-day rule.

This is not a satisfactory outcome given the fact that the service provider is unlikely to be aware upfront of whether the non-resident will become a resident after the services have been provided. This leads to uncertainty for the supplier who does not know when completing the GST return whether the GST treatment of the services was correct.

The proposed amendment is intended to resolve the above problem by turning off the retrospective application of the income tax residency rules in relation to both the 183-day residence test and, correspondingly, the 325-day absence test. The proposed change follows submissions received on the officials' issues paper, *The GST treatment of immigration and other services*, released in June 2013.

ZERO-RATED SERVICES SUPPLIES TO NON-RESIDENTS

(Clause 166)

Summary of proposed amendment

A new zero-rating rule is being proposed that will allow services to remain exempt from GST when a non-resident receiving services visits New Zealand during the period of service, as long as the non-resident's presence is "not directly connected" with the services being supplied.

Application date

The amendment will apply from the date of enactment.

Key features

Currently, services supplied to a non-resident who is outside New Zealand at the time services are being performed are zero-rated for GST purposes.

The proposed amendment allows "outside New Zealand" to be interpreted (for a natural person) as a presence in New Zealand that is minor and not directly connected with the supply.

Background

New Zealand's GST system is based on the "destination principle" under which supplies of goods and services are taxed in the jurisdiction where the goods and services are consumed. Since services supplied to non-residents who are offshore will not typically be consumed in New Zealand, the services are zero-rated. This ensures GST is not a cost to overseas consumers.

The zero-rating rule requires the supplier to have knowledge of the whereabouts of the non-resident consumer during the period in which the services are performed. However, in some cases the non-resident may visit New Zealand during the period the service is supplied on an unrelated matter. In this situation the supplier may be unaware of the non-resident's presence in New Zealand and may mistakenly zero-rate the service.

The proposed change is intended to resolve this problem by allowing services to remain zero-rated as long as the non-resident's presence is "not directly connected" with the services being supplied. However, to ensure services are only zero-rated when they are performed to a non-resident who is predominantly outside New Zealand, the proposed change also requires the non-residence presence in New Zealand to be minor in nature.

A similar provision applies to non-resident companies and unincorporated bodies that have a minor presence in New Zealand or a presence that is not effectively connected with the supply.

The approach proposed in the amendment has been developed from submissions received from the officials' issues paper, *The GST treatment of immigration and other services*, released in June 2013.

CLASSIFICATION OF MINING PERMITS AS REAL PROPERTY FOR TAX PURPOSES

(Clause 123(35))

Summary of proposed amendment

An amendment is being introduced to clarify that mining permits issued under the Crown Minerals Act 1991 should be treated as “real property” for the purposes of the Income Tax Act 2007.

Application date

The amendment will apply from the date of enactment.

Key features

A definition of “real property” is being included in section YA 1 of the Income Tax Act 2007 to clarify that mining permits issued under the Crown Minerals Act 1991 are treated as “real property” for the purposes of the Income Tax Act 2007.

Currently, there is some uncertainty about the treatment of mining permits for tax purposes because section 91 of the Crown Minerals Act 1991 states that a mining permit is neither real nor personal property.

The proposed change will ensure that New Zealand has source taxing rights over income from these permits under Article 6 of its double tax agreements (DTAs), which applies to income from real property. This is consistent with the approach taken in New Zealand’s newer DTAs (signed since the 1990s) where it is evident that mining permits are included within the definition of “real property” contained in those treaties.

EXTENDING THE TAX EXEMPTION FOR NON-RESIDENT OFFSHORE OIL RIG AND SEISMIC VESSEL OPERATORS

(Clause 30)

Summary of proposed amendments

An amendment is proposed to extend the temporary tax exemption for non-resident offshore oil rig and seismic vessel operators for a further five years, until the end of 2019.

An amendment is also proposed to modify the scope of the non-resident offshore oil rig and seismic vessel exemption by excluding modular drilling rigs.

Application date

The extension of the exemption will apply from 1 January 2015 and expire on 31 December 2019. The amendment modifying the scope of the exemption will apply from 1 January 2015.

Key features

An amendment is proposed to extend the temporary tax exemption for non-resident offshore oil rig and seismic vessel operators, in section CW 57 of the Income Tax Act 2007, for a further five years.

A temporary five-year exemption from tax on the income of non-resident offshore oil rig and seismic vessel operators was introduced in 2004. This exemption was rolled over in 2009 for a further five years and is due to expire on 31 December 2014.

An amendment is also proposed to modify the scope of the non-resident offshore oil rig and seismic vessel exemption by excluding modular drilling rigs. This will be achieved by amending the definition of “exploration and development activities” in section CW 57(2) to exclude a drilling rig that is of modular construction and is installed on an existing platform.

Background

Offshore rigs and seismic vessels owned by non-residents are covered by the current exemption. They are used to drill for oil and gas and gather data on potential oil and gas finds.

Rigs are generally of two types – semi-submersibles and jack-up rigs. There is a worldwide market in rigs and seismic vessels. No New Zealand company owns offshore rigs or seismic vessels, so any company wishing to explore in New Zealand waters needs to use a rig or seismic vessel provided by a non-resident owner.

Section CW 57 was introduced to deal with a problem created by our double tax agreements (DTAs). New Zealand generally taxes non-residents on income that has a source in New Zealand. However, our DTAs provide that non-residents are only taxable on their New Zealand-sourced business profits if they have a “permanent establishment” in New Zealand. Many of our DTAs (such as the New Zealand – United States DTA) have a specific rule providing that a non-resident enterprise involved in exploring for natural resources only has a permanent establishment in New Zealand if they are present for a particular period of time, often 183 days in a year. Once a non-resident has a permanent establishment in New Zealand, they are taxed on all their New Zealand business profits starting from day one.

The issue caused by this DTA provision was that seismic vessels and rigs used in petroleum exploration were leaving New Zealand waters before the 183-day limit was reached so they would not be subject to New Zealand tax. This meant that, in some cases, a rig would leave before 183 days and a different rig was mobilised to complete the exploration programme. This “churning” of rigs increased the cost for companies engaged in exploration and delayed exploration drilling and any subsequent discovery of oil or gas.

Section CW 57 applies broadly to non-resident companies operating seismic vessels and rigs used in drilling wells (see the definition of “exploration and development activities” in section CW 57(2)).

The main rig types used in drilling wells are semi-submersibles and jack-up rigs. However, a type of rig (a modular drilling rig) exists that is of modular construction and designed to be installed on an existing platform. These modular drilling rigs were never intended to be included within the scope of the exemption, which was designed with semi-submersibles and jack-up rigs in mind. In addition, modular drilling rigs do not have the same high mobilisation and demobilisation costs as larger rigs, which means the rationale for the exemption does not apply in relation to these rigs.

GST remedial matters

OVERVIEW

Most of the GST remedial items in the bill relate to issues outlined in the GST issues paper, *GST remedial issues*, released in December 2012. Hence, the majority of the amendments were developed from submissions received on that paper. All section references relate to the Goods and Services Act 1985 unless stated otherwise.

SCOPE OF THE “HIRE PURCHASE” DEFINITION

(Clause 123(19) and (180))

Summary of proposed amendment

The definition of “hire purchase agreement” will be broadened to include any contract where a person has an option to purchase.

Application date

The amendment will apply from 1 April 2005, with a “savings” provision for taxpayers who filed returns under the contrary position up until the date of introduction of the bill.

Key features

The definition of “hire purchase agreement” under section YA 1(a)(i) of the Income Tax Act 2007 and section OB 1(a) of the Income Tax Act 2004 will be amended to explicitly incorporate contracts under which the person has an option to purchase, but that option is not exercised until a later date.

Background

The definition of “hire purchase agreement”, in section YA 1 of the Income Tax Act 2007 is intended to cover two types of agreement. The first is when the goods are let or hired to a person with an option to purchase (an “option to purchase agreement”). The second is when a person has agreed to purchase the goods with a condition (a “conditional contract of sale”). The main difference between the two is whether the person has agreed to purchase the goods at the time the relevant contract is entered into.

An amendment made to the “hire purchase agreement” definition that took effect from 1 April 2005 contained a drafting error, which arguably means a person’s upfront agreement to purchase the goods is required in order for an arrangement to be a hire purchase agreement. This interpretation is inconsistent with the original policy intent, which is to capture both forms of agreement.

The proposed amendment was previously included in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill 2011. However, it was withdrawn for further consultation alongside the proposal for deferred settlement land transactions to be removed from the hire purchase definition (so as to remove the requirement for the up-front payment of GST) and be replaced with an anti-avoidance rule. These issues were further consulted on as part of *GST remedial issues*. After considering submissions, a decision was made to proceed with the more minor change to the hire purchase definition by extending its scope to include “option to purchase” agreements.

DWELLING DEFINITION – RETIREMENT ACCOMMODATION

(Clause 161(1) and (2))

Summary of proposed amendments

Two proposed amendments to the dwelling and commercial dwelling definitions will clarify that residential units in retirement villages and rest homes where the occupants are essentially living independently are treated as GST-exempt “dwellings”.

Application date

The amendments will apply from 1 April 2011. However, in recognition of the transitional costs to taxpayers, the amendments will be subject to a “savings” provision for those who filed their tax returns on the reverse basis up until 31 March 2015.

Key features

The proposed amendment to the “dwelling” definition will create a new subparagraph 2(b)(iii) which states that when the consideration paid or payable for the supply of accommodation in a retirement home or village is for the right to occupy a residential unit, the unit will be treated as a dwelling.

The proposed amendment to the “commercial dwelling” definition will replace section 2(b)(ii) with a cross-reference to the new amendment to the “dwelling” definition. This will ensure that units in retirement villages where the occupants are living independently are excluded from the “commercial dwelling” definition.

Background

GST is imposed on accommodation in “commercial dwellings” such as hotels but not in “dwellings” such as private residences, which are GST-exempt.

The definitions of “dwelling” and “commercial dwelling” were amended on 1 April 2011. The policy intention behind the changes was to clarify the boundary between these definitions, and to narrow the scope of what could be considered a “dwelling” on the basis of economic equivalence with owner-occupied homes.

Concerns have been raised that tenants of residential units in retirement villages may not meet the new dwelling definition requirement of having “quiet enjoyment” (under section 38 of the Residential Tenancies Act 1986) of their properties. As such, despite the previous treatment of these units as GST-exempt dwellings, they could be treated as “commercial dwellings” (subject to GST). This does not align with the policy intention, which was to maintain the pre-April 2011 GST treatment of retirement village accommodation.

OUTPUT TAX ON THE DISPOSAL OF LAND

(Clause 163)

Summary of proposed amendment

The proposed amendment clarifies that when input tax has been claimed in respect of the acquisition of land, output tax must be paid on its disposal.

Application date

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

Key features

The proposed amendment will extend the scope of section 5(16) so that it also applies to all subsequent supplies of land when any input tax credit has been claimed. The amendment will treat such supplies as being in the course or furtherance of a taxable activity and therefore subject to GST.

The extension of section 5(16) will not apply to situations when a registered person has already returned the output tax – for instance, if they have already performed the wash-up calculation in proposed section 21FB or they have paid output tax upon deregistration.

Background

If a registered person claims input tax when they purchase land, the correct policy outcome is for output tax to be paid on its sale. However, it is possible that a person could claim input tax on their land, but fail to pay output tax on its disposal if the disposal is outside the “course and furtherance” of their taxable activity. This situation could potentially arise when the use of the land before sale is solely non-taxable.

Although the issue also exists in relation to other assets, it predominantly occurs in regard to land.

DIRECTORS' FEES

(Clause 164)

Summary of proposed amendments

Two amendments are proposed to section 6 that relate to the GST treatment of fees paid to directors and board members.

The first proposed amendment provides that when an employee is engaged by a third party to be a director or board member, and the employee is required to account to the employer for any payments received, the employer will be treated as supplying services to the third party. The employer will therefore return GST and the third party will be able to claim input tax on the payment for these services.

The second proposed amendment extends the proviso under section 6(3)(b) that deems services performed by directors to be supplied in the course and furtherance of a taxable activity when that director has a broader taxable activity to persons listed in section 6(3)(c)(iii) such as members of boards.

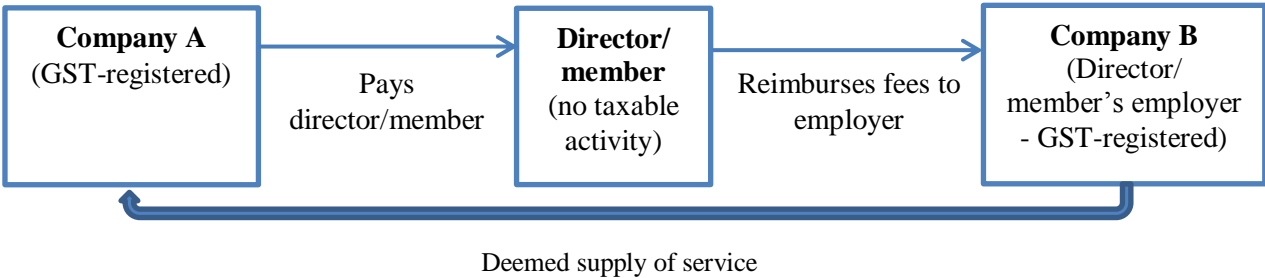
Application date

The amendments will apply from the date of enactment of the bill.

Key features

The first amendment creates a “flow-through” rule (shown below) that deems services to be supplied by an employer (Company B) to a third party (Company A) when an employee is engaged by the third party to be a director or person listed in section 6(3)(c)(iii) (that is, board members) and when the employee is required to account for any fees or other amounts to their employer (Company B). Hence, the rule will require the employer (Company B) to issue a tax invoice for the fees paid and the third party (Company A) will be able to claim the related input tax deduction.

Flow-through rule:



The second amendment extends the provision that deems services performed by directors to be supplied in the course and furtherance of a taxable activity when that director has a broader taxable activity to persons listed in section 6(3)(c)(iii) (Members of boards).

Background

The first amendment relates to an issue identified in an Inland Revenue Public Ruling (BR Pub 05/13) regarding the GST treatment of directors. It occurs when an employee who is not GST-registered is engaged by a third party to be a director and is required to remit fees paid by the third party to their employer.

In this situation, the directors' fees paid to the employee are not subject to GST because the employee is precluded from having a taxable activity. However, when the employee passes these fees on to their employer, the employer is required to account for output tax on the supply.

This result means that the third party will not receive an input tax deduction for the fees paid. The director's employer will, however, have to account for output tax on the amount reimbursed by the employee. Conceptually the same issue could arise in relation to the persons listed in section 6(3)(c)(iii), such as members of boards.

The second issue concerns the exception to the rule that precludes a director from carrying on a taxable activity, under section 6(3)(b). The rule applies when directors have a broader taxable activity, in which case their services as a director are deemed to be supplied in the course and furtherance of that taxable activity. However, members of boards and the other persons listed in section 6(3)(c)(iii) can also have broader taxable activities. For GST purposes the persons listed in section 6(3)(c)(iii) are conceptually the same as directors, therefore they should have the same treatment.

SURRENDERS AND ASSIGNMENTS OF INTERESTS IN LAND

(Clause 165(1) and (3))

Summary of proposed amendment

The proposed amendment to 11(8D) will clarify that assignments and surrenders of interests in land are subject to the zero-rating of land rules.

Application date

This amendment will apply from 1 April 2011.

Key features

The proposed amendment will replace “chargeable with tax at 0%” with “of land” in section 11(8D)(a) and (b) so the GST treatment of assignments and surrenders of interests in land would depend upon meeting the zero-rating of land requirements in section 11(1)(mb).

Background

Section 11(8D) is designed to clarify that assignments and surrenders of interests in land are subject to the zero-rating of land rules. The policy intent of this section is that assignments and surrenders of interests in land can be zero-rated when the requirements for the zero-rating of land rules are met.

However, the current wording of section 11(8D) arguably allows all “surrenders” or “assignments” of interest in land to be zero-rated, even when the other zero-rating land transaction requirements are not met – for instance, when the recipient of the supply is not GST-registered.

PROCUREMENT OF A LEASE

(Clause 165(2))

Summary of proposed amendment

The proposed amendment will ensure payments for the procurement of a lease are subject to the zero-rating of land rules.

Application date

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

Key features

A change to section 11(8D) will be made to ensure new interests in land through a procurement of a lease will be zero-rated, subject to the zero-rating of land requirements of section 11(1)(mb) being met.

Background

The concern is that the procurement of a lease when purchasing a business does not fall under the zero-rating of land rules. This is because an argument can be made that when a new interest has been created in the procurement transaction there is no transfer of an interest in land between the vendor and the purchaser. Therefore, any consideration payable in relation to this supply will not be zero-rated. This outcome does not create the correct policy outcome as lease procurements are arguably economically equivalent to lease assignments which are subject to the zero-rating of land rules.

NON-PROFIT BODIES EXEMPTION

(Clause 167(1) and (3))

Summary of proposed amendment

The proposed amendment will clarify that non-profit bodies can claim all of their GST input deductions other than on inputs that relate to the making of exempt supplies.

Application date

This amendment will apply from 1 April 2011.

Key features

The proposed amendment will ensure that non-profit bodies can claim all of their GST input deductions except those that relate to exempt supplies. It achieves this by extending the application of section 20(3K) so that it applies for the purposes of section 20(3) and (3C), and the definitions of “percentage actual use” and “percentage intended use” in section 21G(1).

Background

Non-profit bodies are able to take advantage of a special input deduction rule that allows them to claim input tax deductions on all supplies received except to the extent that the goods or services in question are used for making exempt supplies. However, an unintended consequence of the introduction of the new GST apportionment rules in April 2011 is that they have created some uncertainty around the application of the special rule.

This is because the definitions of “percentage actual use” and “percentage intended use” only enable input deductions to the extent that goods and services are actually used for making “taxable supplies”. Hence, it is arguable that non-profit bodies may not be able to claim input tax credits for purchases that relate to non-exempt supplies.

The new apportionment rules were not intended to alter the GST input entitlements of non-profit bodies.

ALLOWING INPUTS TO REGISTERED PERSONS SUBJECT TO THE DOMESTIC REVERSE CHARGE

(Clause 167(2) and (3))

Summary of proposed amendment

The proposed amendment will ensure that section 20(4B) does not prevent a person from claiming an input tax credit in cases when they are already registered for GST.

Application date

The amendment will apply from 1 April 2011.

Key features

The proposed amendment will extend the scope of the exclusion in section 20(4B) to cover a person that is already registered. This will mean that if a purchaser was already registered for GST when they incorrectly zero-rated a transaction they will still be able to claim an input tax credit.

The extended exclusion will only apply to the extent that the person uses the goods for making taxable supplies.

Background

The supply of land to registered persons is zero-rated in order to prevent “phoenix fraud”¹⁴ arrangements. However, in limited situations this treatment can enable purchasers to avoid paying GST by intentionally or unintentionally representing that they are GST-registered and making the relevant taxable supplies. The “domestic reverse charge” mitigates this risk by requiring the purchaser in this situation to account for the output tax on the sale of the land, but preventing the purchaser from claiming an input tax deduction in relation to this sale (unless they subsequently become registered).

What is not catered for is a purchaser who is already GST-registered and incorrectly zero-rates a transaction – for example, as a result of a genuine error. Output tax will be payable under section 20 with no corresponding input tax credit.

¹⁴ Phoenix fraud arrangements involve Inland Revenue refunding GST to a purchasing company, but no corresponding payment of output tax being paid to Inland Revenue on a subsequent supply because the company is wound up before making payment.

WASH-UP RULE FOR TAXABLE OR NON-TAXABLE USE

(Clause 168)

Summary of proposed amendment

The proposed amendment will require taxpayers who have applied the apportionment rules to perform a “wash-up” calculation when their use of an asset changes to 100 percent taxable or 100 percent non-taxable use.

Application date

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

Key features

The proposed amendment will, for assets that have been subject to the apportionment rules, require taxpayers to perform a compulsory “wash-up” calculation to account for any unclaimed input tax or pay output tax when the use of the asset changes to solely taxable or non-taxable.

Under the proposed rule:

- Taxpayers that change from mixed-use to 100 percent taxable use of an asset will be able to claim the “full input tax deduction” (definition under section 21D(2)(a)) less the “actual deduction” (definition under section 21F(3)(c)).
- Taxpayers that change from mixed-use to 100 percent non-taxable use of an asset will be required to pay output tax equal to the “actual deduction” already claimed.

Once the wash-up calculation has been performed, taxpayers will no longer be required to make any on-going adjustments.

To qualify for the “wash-up” deduction, the taxpayer would need to sustain the 100 percent taxable or non-taxable use of their asset for the current apportionment adjustment period and the next adjustment period (up to two years).

Background

A taxpayer who purchases an asset in order to use it for taxable and non-taxable purposes must apportion their input deductions to account for the non-taxable use. However, if the taxpayer changes the use of the asset to 100 percent taxable they may still be required to perform on-going input tax adjustments. This poses a compliance cost burden on taxpayers, especially in relation to long-lived assets such as land.

If taxpayers are allowed to claim a 100 percent deduction earlier to avoid this compliance burden, the logical corollary is that a 100 percent change to non-taxable use of an asset (in respect of which a partial input tax deduction has been claimed) should give rise to an offsetting output tax payment.

TRANSITIONAL RULE FOR COMMERCIAL DWELLING ACCOMMODATION ACQUISITION COSTS BEFORE 1 OCTOBER 1986

(Clause 169(1) and (3))

Summary of proposed amendment

The proposed amendment to the transitional rule in section 21HB will ensure that input tax deductions cannot be claimed for accommodation reclassified as a commercial dwelling if it was acquired before 1 October 1986.

Application date

The amendment will apply for tax positions taken after the date of introduction of the bill.

Key features

The proposed amendment to section 21HB(1) will ensure that suppliers who are required to treat their supplies of accommodation as commercial dwellings as a result of the changes to the definitions of “commercial dwelling” and “dwelling” cannot claim input tax for accommodation acquisition costs incurred before 1 October 1986. This will be achieved by replacing the requirement for the costs to be incurred before 1 April 2011, with the requirement that they were incurred between 1 October 1986 and 1 April 2011.

Background

The transitional rule was developed for suppliers of accommodation who were required to start charging GST as a result of the changes to the “dwelling” and “commercial dwelling” definitions. The rule gave these suppliers the ability to claim input tax for the acquisition costs of their newly defined “commercial dwelling” accommodation.

However, an unintended effect of the transitional rule is that suppliers affected by the definition changes can arguably claim input tax for accommodation acquired before the introduction of GST on 1 October 1986. This is contrary to the policy rationale underlying the rule as this outcome would allow suppliers to claim input tax for property acquired when no GST was incurred.

REQUIREMENT TO BE REGISTERED

(Clause 169(2) and (4))

Summary of proposed amendment

The proposed amendment to section 21HB will allow suppliers affected by the changes to the definitions of “commercial dwelling” and “dwelling” to have the option of either including or not including a commercial dwelling as part of their broader taxable activity.

Application date

The amendment will apply from 1 April 2011.

Key features

The proposed amendment to section 21HB will give a person the option to either include or not include a commercial dwelling as part of their other supplies for consideration if the supply of accommodation in the commercial dwelling is under \$60,000 in a 12-month period.

The amendment will only apply to persons:

- affected by the change to the definitions of “dwelling” and “commercial dwelling”; and
- who are required to register because the inclusion of supplies from their newly defined commercial dwelling pushes them over the \$60,000 registration threshold under section 51.

Background

An unintended effect of the change in the definitions of “dwelling” and “commercial dwelling” is that a non-registered person with an activity attributable to newly defined commercial dwelling accommodation (that generates turnover below the GST registration threshold of \$60,000) may now have to incorporate the commercial dwelling into their “taxable activity” which may push their turnover above the registration threshold. However, it may be the case that the person would prefer not to be forced to incorporate their newly defined commercial dwelling into their taxable activity for GST purposes, and therefore have to register for GST.

MINOR GST REMEDIAL CHANGES

Clause	Clarification changes	Reason	Application date
Clause 162	Definition of “life insurance contract” in section 3, <i>Meaning of The Term Financial Services</i> .	Update the cross-reference to Accident Insurance Act (Entitlements arising from fatal injuries).	1 April 2002
Clause 165(1) and 165(3)	Section 11(8D)(b) zero-rating of land.	Clarify that commercial leases under which no contemporaneous or advance payment has been made are subject to the exception to the zero-rating of land rules.	1 April 2011
Clause 170	Section 46(1B) non-resident registration.	Clarify that the extended period to claim refunds only applies to GST registered non-residents.	1 April 2014
Clause 171(1)	Section 54C(3)(a) non-resident registration.	Clarify the effective date of non-resident deregistration.	1 April 2014
Clause 171(2)	Section 54C(3)(b) non-resident registration.	Clarify the scope of the 5-year embargo on non-resident registration.	1 April 2014

CFC remedials

CFC AND FIF EXEMPTIONS FOR AUSTRALIAN UNIT TRUSTS

(Clauses 75 and 76)

Summary of proposed amendments

Under proposed new rules, Australian Unit Trusts that are not taxed as companies under Australian law will be excluded from the exemptions for Australian controlled foreign companies (CFCs) (section EX 22) and interests in foreign investment funds (FIFs) resident in Australia (section EX 35).

Application date

The amendments will apply from the beginning of the 2014–15 income year.

Background

Before the 2009 international tax reforms, taxpayers did not have to return attributed income in respect of their interest in a CFC if the CFC was resident in a “grey list” country. The grey list comprised eight countries that were thought to have broadly comparable tax systems to our own. Income earned in a grey list country was exempt and income earned in other countries was subject to tax.

When the grey list exemption for CFCs was repealed in 2009 it was replaced by an exemption for active income (the active business test) and an exemption for Australian CFCs. Passive income, which included interest, dividends and some types of rent, would be taxable, while active income, primarily business profits, would be exempt. The active business test granted a full tax exemption to CFCs that had only small amounts of passive income.

While the active business test required CFCs to earn less than 5 percent passive income, the Australian exemption was a broader, simpler test. CFCs had to be resident in Australia (and only resident in Australia) and subject to Australian income tax.

A broader exemption was justified in order to reduce compliance costs for SMEs. Many New Zealand firms looking to expand offshore made their first move across the Tasman and the Australian exemption meant these companies did not need to learn or comply with the attribution rules.

The simpler test is buttressed in two ways. First, Inland Revenue and the Australian Tax Office have a close working relationship which makes it easier to monitor and respond to trends and developments. Secondly, the opportunity for mischief is reduced as companies face similar levels of taxation in Australia to those in New Zealand.

A equivalent exemption for non-portfolio FIFs (that is where a taxpayer holds more than a 10 percent interest in a FIF) was introduced when the FIF grey list exemption was repealed in 2012.

Australian Unit Trusts (AUTs) are generally seen as trusts under Australian tax law but are considered companies under New Zealand tax law.

Under the Australian trust regime only a low rate of tax is withheld from passive income; under the New Zealand CFC or non-portfolio FIF regime that income is exempt. In addition, no Australian tax is paid on non-Australian sourced income to which a New Zealand-resident beneficiary is presently entitled.

This outcome is concessionary and contrary to the policy objectives of the Australian exemption for CFCs. AUTs are unlikely to be used by New Zealand SMEs looking to expand offshore and the level of taxation on passive income is significantly lower in Australia than it would be in New Zealand.

REPEAL OF SECTION DB 55

(Clauses 43 and 174)

Summary of proposed amendments

The bill repeals section DB 55 of the Income Tax Act 2007, which allows companies to claim deductions for expenses incurred in deriving exempt foreign dividends. This provision was introduced as exempt foreign dividends were subject to the foreign dividend payment (FDP) rules which were seen as being equivalent to a tax.

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 repealed FDP and section DB 55 no longer served a purpose as exempt foreign dividends were no longer subject to the FDP rules.

A “savings” provision is included to preserve assessments based on the current rules if the returns were filed before the date of introduction for this bill.

A retrospective amendment is proposed to remove a potential conflict between section DB 55, which allows deductions against exempt foreign dividends, and the general permission under section DA 1, which precludes deductions against exempt income.

Application dates

The amendment repealing section DB 55 applies from 30 June 2009.

The amendment to section DB 55, and section DB 44 of the Income Tax Act 2004, will apply from 1 October 2005.

INDIRECT INTERESTS IN FIFS

(Clauses 78 and 80)

Summary of proposed amendment

The bill clarifies the rules that apply to indirectly held interests in FIFs. Additional FIF income is calculated only if the CFC or FIF holds an interest in a FIF that would be an attributable interest if the person had directly held their indirect interest.

Application date

The amendment will apply from the beginning of the 2014–15 income year.

Background

The current rules apply a formula to determine the amount of income that should be attributed when a person holds an interest in a CFC or FIF which itself holds an interest in another FIF.

For example, a person may hold a 50 percent interest in a CFC which holds a 15 percent interest in a FIF.

The intended effect of these rules was that the person should have FIF income attributed to them on the basis of a 7.5 percent indirect interest holding.

The proposed amendment ensures that a person in the above situation is not able to access the exemption for interest in a FIF resident in Australia (section EX 35) as they only hold an indirect interest of 7.5 percent.

ACTIVE BUSINESS TEST FOR WHOLLY OWNED GROUPS

(Clauses 72, 73 and 74(1))

Summary of proposed amendments

Under the current rules, taxpayers determining whether a CFC meets the active business test have the option of grouping multiple CFCs together into a test group and working out the ratio of active to passive income based on the consolidated accounts of that group.

Amendments are being made to allow companies that are part of wholly owned groups to form test groups which include any interest in a CFC held by a member of the wholly owned group. The same-jurisdiction rule will continue to apply.

A further amendment is being made to ensure that wholly owned groups of companies are not able to form over-lapping test groups by including any one CFC in multiple different test groups.

Application date

The amendments will apply for income years beginning on or after 1 July 2009.

Background

Taxpayers determining whether their CFCs meet the active business test have the option of grouping multiple CFCs together into a test group and working out the ratio of active to passive income based on the consolidated accounts of the test group. The CFCs must be resident in the same country and the taxpayer must hold an income interest of more than 50 percent in each CFC.

It is not uncommon for CFC interests to be held by different members of a wholly owned group. The current rules place unnecessary restrictions on how those groups can access the active business test given that the group effectively has control over all of the CFC holdings.

NEGATIVE PASSIVE INCOME AND ACCOUNTING STANDARDS TEST FOR CFCs

(Clauses 74(2), (3) and (4))

Summary of proposed amendments

Under the proposed new rule, a negative numerator in the formula defined in section EX 21E(5) will no longer disqualify a CFC from passing the active business test. Instead the negative numerator will be deemed to be zero.

Application date

The amendments will apply for income years beginning from 1 July 2009.

Background

The formula for the accounting standards active business test is defined in subsection EX 21E(5) as below:

$$\frac{\text{reported passive} + \text{added passive} - \text{removed passive}}{\text{reported revenue} + \text{added revenue} - \text{removed revenue}}$$

Subsection EX 21E(3) provides that if the numerator (the top line of the formula) is negative, the CFC will fail the accounting standards test and will need to perform the default test (EX 21D).

CFCs that are demonstrably active CFCs, that is they receive very little, if any, passive income, may fail the accounting standards if they hold foreign currency (that is, currency other than the currency in their home jurisdiction) and that currency loses value, resulting in a foreign exchange loss.

Requiring these CFCs to undertake the more demanding default test is considered to be an undue compliance burden.

FOREIGN EXCHANGE GAINS AND LOSSES ON LIABILITIES

(Clauses 74(5), (6), (7), (8) and (9))

Summary of proposed amendments

The proposed rules give taxpayers the option to include foreign exchange gains and losses on both financial assets and liabilities when applying the accounting standards test (section EX 21E).

Under the current test, the ratio of passive income to active income takes into account foreign exchange gains and losses from financial assets and not from financial liabilities.

Taxpayers who are unable to readily distinguish the foreign exchange gains and losses on financial assets from those on liabilities will be able to apply the accounting standards test using a combined amount.

Inland Revenue will publish further information in the *Tax Information Bulletin* following enactment of the legislation on how the term “readily distinguishable” will be interpreted.

Application date

The amendments will apply for income years from 1 July 2009.

Background

It is not unusual for companies to produce financial accounts that provide a single rolled up figure of foreign exchange gains and losses from both financial assets and liabilities.

The amendment has been proposed to relieve these companies from the additional compliance costs of separating foreign exchange gains from losses.

APPORTIONED FUNDING INCOME

(Clauses 70 and 71)

Summary of proposed amendments

The bill relocates the provisions relating to apportioned funding income from section EX 20C (Net attributable CFC income or loss) to section EX 20B (Attributable CFC income).

The specific effects of the provisions are unchanged. Taxpayers can exclude a portion of income from financial liabilities (that is, foreign exchange gains on loans taken out by the company) based on the percentage of the company's assets (the asset fraction) used to generate active income.

Moving the provisions into section EX 20B will mean that taxpayers will be able to take this adjustment into account when applying the active business test under section EX 21D.

Application date

The amendments will apply for income years beginning on or after 1 July 2009.

Background

Section EX 20B contains the rules defining how a CFC calculates its attributable CFC amount. This is broadly equivalent to the CFC's gross attributable income.

Section EX 20C contains the rules which define what deductions can be taken against that gross attributable income to derive the CFC's net attributable income or loss.

The current subsection EX 20C(3) includes an adjustment which excludes some of the income that was previously included in the gross attributable income (apportioned funding income).

As this adjustment is an exclusion of income rather than a deduction against income, it is better situated in section EX 20B.

Moving the provision to section EX 20B will also provide more accurate calculations of a CFC's active-to-passive income ratio as the current rules do not take the adjustment for apportioned funding income into account.

Rewrite Advisory Panel remedials

OVERVIEW

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.

REQUIREMENT TO AMEND ASSESSMENTS ON RECOVERY OF DIVIDENDS FROM SHAREHOLDERS

(Clauses 10 and 173)

Summary of proposed amendment

Section CD 40 of the Income Tax Act 2007 and section CD 29 of the Income Tax Act 2004 are being amended to state more clearly that, if a company recovers a dividend from its shareholders, section 113B of the Tax Administration Act requires the Commissioner to amend the following:

- any income tax assessment and foreign dividend payment assessment of a shareholder to ensure that the dividend and any imputation or foreign dividend payment credit previously attached to the now-recovered dividend are disregarded; and
- any assessment of the company made under the imputation rules, the non-resident withholding tax rules, the resident withholding tax rules or under the supplementary dividend rules in subpart LP, again to ensure that the dividend and any imputation or foreign dividend payment credit previously attached to the now-recovered dividend are disregarded.

Application date

The amendment to section CD 40 of the Income Tax Act 2007 will apply from the beginning of the 2008–09 income year.

The amendment to section CD 29 of the Income Tax Act 2004 will apply from the beginning of the 2005–06 income year.

Background

A submission was made to the Rewrite Advisory Panel (the Panel) that the cross-reference from section CD 29 of the Income Tax Act 2004 to section 113B of the Tax Administration Act 1994 contained an unintended change in outcome. The submission was that after enactment of the Income Tax Act 2004, this cross-reference to section 113B no longer requires the Commissioner to amend an assessment of a company's imputation credit account on the company recovering a dividend from its shareholders.

If a company recovers a dividend from its shareholders and notifies the Commissioner that the dividend has been recovered, the policy intention is that the Commissioner is obliged to amend any assessment to disregard that recovered dividend.

The Panel did not agree that an unintended change in the law had occurred because the transitional provisions in section YA 3 of the Income Tax Act 2004 enable the correct outcome to be determined. However, the Panel considered that the drafting clarity could be improved so that it should be unnecessary to rely on the transitional provisions in section YA 3.

This issue also arises in the linkage between section CD 40 of the Income Tax Act 2007 and section 113B of the Tax Administration Act 1994, resulting in a similar amendment being made to section CD 40.

OPTION TO USE FOREIGN TAX BALANCE DATE

(Clauses 57 and 176)

Summary of proposed amendment

Section EG 1 in both the Income Tax Act 2004 and the Income Tax Act 2007 is amended to ensure that New Zealand-resident taxpayers may elect to include foreign-sourced income (apart from interest, dividends and foreign investment fund income) in the tax year in which the taxpayer's balance date in the overseas jurisdiction falls.

Application date

The amendment to section EG 1 of the Income Tax Act 2007 applies from the beginning of the 2008–09 income year.

The amendment to section EG 1 of the Income Tax Act 2004 applies from the beginning of the 2005–06 income year.

Background

The amendment arises from a submission to the Rewrite Advisory Panel that section EG 1 of the Income Tax Act 2004 does not permit a taxpayer to elect to include foreign-sourced income (apart from interest, dividends and foreign investment fund income) in the tax year in which the taxpayer's balance date in the overseas jurisdiction falls.

The submission noted that this election was permitted in the corresponding provision (section EP 1) of the Income Tax Act 1994. The Panel agreed with the submission and recommended that this unintended change should be corrected retrospectively for section EG 1 in both the 2004 and 2007 Acts.

FOREIGN COMPANY – MEANING OF DIRECT CONTROL INTEREST

(Clauses 68, 69, 177 and 178)

Summary of proposed amendment

Section EX 5(1)(c) and (d) in both the Income Tax Act 2004 and the Income Tax Act 2007 is being amended to ensure that a direct control interest does not include interests of a person in a foreign company if that person is not entitled to the income or assets and is prohibited from applying the same for their own benefit or interest.

Consequentially, section EX 9(1)(c) and (d) of both Acts is also being amended.

Application date

The amendment to sections EX 5(1) and EX 9(1) of the Income Tax Act 2007 will apply from the beginning of the 2008–09 income year.

The amendment to sections EX 5(1) and EX 9(1) of the Income Tax Act 2004 will apply from the beginning of the 2005–06 income year.

Background

The Rewrite Advisory Panel received a submission that section EX 5 in both the Income Tax Act 2004 and the Income Tax Act 2007 contained an unintended change concerning the calculation of control interests to determine whether a foreign company is a controlled foreign company under the international tax rules. Control interests include direct control interests and indirect control interests.

Section CG 4(4)(c) and (d) of Income Tax Act 1994 was clear that a direct control interest did not include interests held by a person in a controlled foreign company unless the person would have been entitled to have the income or any value of the net assets dealt with in their interest or on their behalf.

The Panel concluded that the provisions were unclear and that the correct outcomes could be obtained only by applying the transitional provisions in section YA 3 of the Income Tax Act 2004 and section ZA 3 of the Income Tax Act 2007. Therefore the Panel recommended that:

- section EX 5(1) be amended in both the 2004 and 2007 Acts to more clearly reflect the outcome under the corresponding provision in the 1994 Act; and
- this amendment apply retrospectively from the first income year to which the 2004 Act applies.

In reviewing this submission, it was also noted that the wording in section EX 9(1)(c) and (d) in both the Income Tax Act 2004 and the Income Tax Act 2007 mirrored the wording in section EX 5(1)(c) and (d). Therefore, section EX 9 in both Acts is amended in the same manner to ensure the two provisions are consistently worded.

COMPARATIVE VALUE METHOD FOR CALCULATING FIF INCOME

(Clauses 79 and 179)

Summary of proposed amendment

Section EX 51 of the Income Tax Act 2007 and section EX 44 of the Income Tax Act 2004 are being amended to ensure that expenditure incurred for, or on behalf of the person having the foreign investment fund (FIF) interest is included in the meaning of “cost of a FIF interest” for the purpose of calculating FIF income under the comparative value method.

Application date

The amendment to section EX 51 of the Income Tax Act 2007 will apply from the beginning of the 2008–09 income year.

The amendment to section EX 44 of the Income Tax Act 2004 will apply from the beginning of the 2005–06 income year.

Background

A submission made to the Rewrite Advisory Panel identified an unintended change in outcome in the meaning of “cost of a FIF interest” applied for the purpose of calculating FIF income under the comparative value method. The submission was that since the enactment of the Income Tax Act 2004, the term “cost” for the comparative value method of calculating FIF income, does not include expenditure incurred for or on behalf of the person having the FIF interest.

The policy and legislative history of the provisions show that expenditure incurred on behalf of a person holding a FIF interest is included in the meaning of “cost” for the purpose of calculating FIF income under the comparative value method. For example, if the FIF interest is a shareholding in a foreign company, the cost of an increase in the shareholding made on behalf of the owner of the FIF interest should be included in the value of that cost.

The Panel agreed with the submission and recommended that a remedial amendment be made to both the Income Tax Act 2004 and the Income Tax Act 2007, with application from the beginning of the 2005–06 income year.

LAND TRANSFERRED TO A CLOSE RELATIVE

(Clause 86)

Summary of proposed amendment

Section FC 5(3)(b) of the Income Tax Act 2007 is being amended to ensure that if sections CB 9 to CB 11, and CB 14 of the Income Tax Act 2007 apply to the land, costs incurred by the executor or administrator on land within 10 years of acquisition of the land by the deceased person are intended to be included in the cost of land in the estate.

This ensures that the cost of that land allowed as a deduction from the income under the land sales rule can include costs incurred by the executor or administrator

Application date

The amendment to section FC 5(3)(b) will apply from the beginning of the 2008–09 income year.

Background

The Rewrite Advisory Panel considered a submission that in the Income Tax Act 2007, section FC 5 does not include expenditure is incurred by the administrator or executor of the estate as part of the cost of land held in an estate. The submitter states this represents a change from the outcome under the corresponding provisions of the 2004 Act.

Section FI 7(3) of the Income Tax Act 2004 shows that if the transfer of land is subject to the same land sale rules, the cost of land held by an estate is intended to include expenditure incurred on that land by the administrator or executor of that estate if the expenditure is incurred within 10 years of the acquisition of the land by the deceased person.

The Panel agreed with the submission and recommended that the rules for asset transfer on death be retrospectively amended to apply from the beginning of the 2008–09 income year (the first income year to which the 2007 Act applies).

LIABILITY WHEN COMPANY LEAVES CONSOLIDATED GROUP

(Clause 99)

Summary of proposed amendment

Section FM 5 of the Income Tax Act 2007 is being amended to ensure that the joint and several liability imposed on all members of a consolidated group to satisfy income tax obligations of the consolidated group does not apply to a company that has left the group, in relation to an increase in an income tax obligation of the group made:

- for a tax year the exiting company was a member of the group; and
- under an amended assessment for that tax year after the exiting company left the group.

Application date

The amendment will apply from the beginning of the 2008–09 income year.

Background

The Panel has considered a submission that when a company exits from a consolidated group, section FM 5 incorrectly results in the exiting company retaining a joint and several liability for increased income tax obligations of the group assessed after the company has left the group.

Section HB 1(2) of the Income Tax Act 2004 removed this joint and several liability for a company that has left a consolidated group for increases in income tax obligations of the consolidated group made:

- for a tax year the exiting company was a member of the group; and
- under an amended assessment for that tax year after the exiting company left the group.

The Panel agreed with the submission and recommended that section FM 5(1) be amended retrospectively to apply from the beginning of the 2008–09 income year (the first income year to which the 2007 Act applies).

REVOCATION OF DIRECTORS' ELECTIONS

(Clause 101)

Summary of proposed amendment

Section HA 31(2) is being amended to ensure that that the director's notice of revocation should take effect from the later of:

- the year in which the notice is received by the Commissioner; or
- the effective year stated in the notice.

Application date

The amendment will apply from the beginning of the 2008–09 income year.

Background

The Panel has agreed with a submission that the 2007 Act rewrite of the notice of revocation of director's election has permitted retrospective revocation of a director's election for a company to attain qualifying company status.

The correct policy is that the director's notice of revocation should take effect from the later of:

- the year in which the notice is received by the Commissioner; or
- the effective year stated in the notice.

Previously, under the Income Tax Act 2004, the revocation of a qualifying company election was provided for in section HG 3(4) and (5). Section HG 3(5) provided that any revocation took effect on the later of the beginning of the income year the notice of revocation was provided or the beginning of such other income year specified in the notice.

The Panel has recommended that section HA 31 be amended retrospectively to the beginning of the 2008–09 income year to correct this unintended change.

TREATMENT OF FOREIGN TRUSTS WHEN SETTLOR BECOMES RESIDENT

(Clause 103)

Summary of proposed amendment

Section HC 30(4)(a) of the Income Tax Act 2007 is being amended to ensure that if a settlor of a foreign trust becomes resident in New Zealand, and no election is made within 12 months of the settlor becoming resident, the trust continues to be treated as a foreign trust until the end of that 12-month period.

Application date

The amendment to section HC 30(4) will apply from the beginning of the 2008–09 income year.

Background

The Rewrite Advisory Panel considered a submission that relates to the taxation consequences when a settlor of a foreign trust becomes resident in New Zealand under section HC 30(4) of the 2007 Act. For foreign trusts, a settlor, trustee or beneficiary of that trust may choose that the trust becomes a complying trust if the settlor becomes resident in New Zealand. This election must be made within 12 months of the settlor becoming resident in New Zealand.

The unintended change identified (when compared with section HH 2(3) of the Income Tax Act 2004) is that if the election is not made within the 12-month period after the settlor becomes resident in New Zealand, section HC 30(4) does not clearly result in that trust continuing, in relation to distributions from the trust, to be treated as:

- a foreign trust until the end of that 12-month period; and
- as a non-complying trust after the end of that 12-month period.

The Panel agrees that, if the settlor of a foreign trust does not make this election within one year of becoming resident in New Zealand, the legislation does not clearly result in that trust continuing to be treated as a foreign trust until the end of that 12-month period. The Panel recommended that:

- section HC 30(4)(a) of the 2007 Act be clarified to give the same outcome as its corresponding provision in the 2004 Act; and
- the amendment applies retrospectively from the commencement of the 2007 Act.

SHORTFALL PENALTIES AND GROUPS OF COMPANIES

(Clause 109)

Summary of proposed amendment

Section IW 1(3) of the Income Tax Act 2007 is being amended to ensure that a group of companies may elect to use a tax loss of one company in the group of companies to satisfy a shortfall penalty assessed against any company within the same group of companies.

Application date

The amendment will apply from the beginning of the 2008–09 income year.

Background

The Rewrite Advisory Panel considered a submission that section IW 1(3) of the 2007 Act does not allow a wholly owned group to use tax losses of one company in the group to pay the shortfall penalties of another company in the group. The submission is that this differs from the outcome given by the corresponding provision, section IG 10(1A), of the Income Tax Act 2004.

Section IG 10(1A) of the Income Tax Act 2004 provided for a group of companies to elect a tax loss to satisfy a shortfall penalty assessed against any company within that group of companies.

The policy is that a wholly owned group should be able to use tax losses of one company in the group to pay shortfall penalties of another company in the group.

The Panel agreed with the submission and recommended that:

- the provision be corrected to give the same outcome as the corresponding provision in the 2004 Act; and
- this amendment apply retrospectively from the commencement of the 2007 Act.

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 the consistent use of terminology, definitions, and readers' aids – for example, the defined terms lists;
- grammar;
- punctuation;
- spelling; or
- consequential amendments arising from substantive rewrite amendments.

Application dates

In the table below:

- amendments to the Income Tax Act 2007 apply retrospectively from the beginning of the 2008–09 income year;
- amendments to the Income Tax Act 2004 apply retrospectively from the beginning of the 2005–06 income year.

Clause	Section	Act	Amendment
2(9), 53(2)	EE 7	2007 Act	Correct cross-referencing
2(6), 175	EE 7	2004 Act	Correct cross-referencing
2(9), 77	EX 46(11)	2007 Act	Correct terminology
2(9), 100	GB 34	2007 Act	Correct cross-referencing
2(9), 111	LJ 3	2007 Act	Drafting consistency
2(9), 112	LJ 5(3)(c)	2007 Act	Correct cross-referencing
2(9), 120	RE 14(2)	2007 Act	Error in formula corrected

Other remedial matters

SPREADING OF INCOME FOR INCOME DERIVED FROM LAND

(Clauses 58 and 59)

Summary of proposed amendment

Sections EI 7 and EI 8 are being amended to ensure that if a taxpayer chooses to apply these sections to income derived in the 2015–16 or a later income year, the income is spread evenly over the period of time referred to in those sections.

Transitional provisions apply to income derived before the 2015–16 income year if the taxpayer has previously chosen to apply either section EI 7 or section EI 8. The transitional provisions apply to that unallocated income as follows:

- If the period of time referred to in those sections has *not* expired before the start of the 2015–16 income year, that unallocated income is spread evenly over the number of years remaining in that period, beginning with the 2015–16 income year.
- If the period of time referred to in those sections *has* expired before the start of the 2015–16 income year, that unallocated income is allocated to the 2015–16 income year.

Application dates

The amendment applies to income derived in the 2015–16 and later income years if the taxpayer chooses to apply either section EI 7 or section EI 8.

The transitional provisions apply to income derived before the start of the 2015–16 income year if the taxpayer has previously chosen to apply either section EI 7 or section EI 8.

Background

Sections EI 7 and EI 8 of the Income Tax Act 2007 provide relief to taxpayers who derived income from land, either:

- in the nature of fines, premiums or from a payment of goodwill on the grant of a lease (section EI 7); or
- as a result of a compulsory disposal of land to the Crown (section EI 8).

Before self-assessment legislation enacted in 2001, the corresponding provisions to sections EI 7 and EI 8 in the Income Tax Act 1994 required taxpayers to follow the Commissioner's practice and spread that income evenly over the number of years referred to in the relevant sections (sections EB 2 and EN 4 of the Income Tax Act 1994).

Following the enactment of self-assessment legislation and subsequent rewriting of the two provisions into the Income Tax Act 2004, consistent with the self-assessment process, it became arguable that the Commissioner's discretion was replaced with a choice for taxpayers for the spreading of the income. That choice did not require the income to be spread on an even basis. However, the Commissioner's practice has generally been followed.

The proposed amendments to sections EI 7 and EI 8 serve to clarify that the income is to be spread on an even basis over the years referred to in both of those sections.

Detailed analysis

The policy for sections EI 7 and EI 8 is to provide relief for taxpayers who derived income from land in certain circumstances. The relief granted is to permit the taxpayers to spread the income evenly across the current and certain future income years instead of returning the income in the year it is derived. This relief applies to income derived either:

- in the nature of fines, premiums or from a payment of goodwill on the grant of a lease (section EI 7, Income Tax Act 2007); or
- from a compulsory disposal of land to the Crown (section EI 8, Income Tax Act 2007).

The amendments to sections EI 7 and EI 8 of the 2007 Act clarify that the taxpayer may choose between allocating income to which the sections apply on the default basis (section BD 3 of the Income Tax Act 2007 refers), or allocate the income to the number of years referred to in sections EI 7 or EI 8, as appropriate.

If the taxpayer chooses to spread the income forwards:

- income derived from land for payments in the nature of fines, premiums or goodwill on the grant of a lease is allocated evenly over the income year the income is derived in and the five immediately succeeding income years; and
- income derived from a compulsory disposal of land to the Crown is allocated evenly over the income year the income is derived in and the three immediately succeeding income years.

Both of these amendments apply to income derived in the 2015–16 income year and later income years.

Transitional issues

The amendments to sections EI 7 and EI 8 apply to income derived from and including the 2015–16 income year. Therefore, it is necessary to ensure that all income derived before the 2015–16 income year that has not been fully allocated at the end of the 2014–15 income year is:

- allocated evenly to income years from 2015–16 onward, while ensuring that the income spread does not exceed the time period referred to in sections EI 7 or EI 8; and

- if the period of time referred to in the relevant provision has expired before the start of the 2015–16 income year, to allocate that remaining amount of income to the 2015–16 income year.

Transitional provisions apply to sections EI 7 and EI 8 for income derived before the beginning of the 2015–16 income year for which:

- the taxpayer has chosen to apply section EI 7 or section EI 8 (as appropriate); and
- all of that income has not been allocated to an income year before the beginning of the 2015–16 income year.

Example 1: Transitional effect

The taxpayer has chosen to spread the income derived in the 2011–12 income year from land for payments in the nature of fines, premiums or goodwill on the grant of a lease on an even basis. The policy intention is that this would result in all of that income being allocated evenly over the 2011–12 to 2016–17 income years.

The transitional rule provides that the amount of income derived in the 2011–12 income year that remains unallocated at the start of the 2015–16 income year is spread evenly over the 2015–16 and 2016–17 income years.

Example 2: Transitional effect

A taxpayer has derived income from a premium on the grant of a lease in the 2008–09 income year. Under section EI 7 it was arguable that the taxpayer could choose to allocate all or some of the income to an income year of choice, for example the 2018–19 income year. The policy intention is that the income should have been spread evenly over each of the 2008–09 to 2013–14 income years.

The transitional rule provides that the income derived in the 2008–09 income year that remains unallocated at the start of the 2015–16 income year is allocated fully to the 2015–16 income year. This is because the allocation of the income has already been deferred beyond the intended relief period, and therefore should be allocated to the 2015–16 income year.

MIXED-USE ASSETS – REMEDIAL AMENDMENTS

(Clauses 47, 48 and 49)

Summary of proposed amendments

The bill proposes several minor remedial changes to the mixed-use asset rules in subpart DG and section DZ 21 of the Income Tax Act 2007.

Application date

An amendment to the mixed-use asset associated persons rule and amendments to legislative examples apply for the 2013–14 and later income years (that is, the beginning of the mixed-use asset regime).

An amendment to the depreciation rollover relief provision applies generally for the 2013–14 and later income years. However, the amendment does not apply in relation to an asset when a shareholder who acquires the asset disposes of it before the date of the bill's introduction.

Key features

The proposed amendments fall into three categories and are all consistent with the original policy intent of the rules:

- an amendment to the mixed-use asset specific associated persons rule in section DG 6;
- minor corrections to several examples in the legislation; and
- an amendment to the depreciation rollover relief provision that applies when a company distributes its mixed-use asset to one or more shareholders in the 2013–14 income year. The amendment is to ensure that depreciation recovery income is ultimately crystallised if the shareholder sells the asset for more than its adjusted tax value (taking into account depreciation claimed by the company).

Background

The mixed-use asset rules were introduced as new subpart DG and related provisions by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013.

The rules generally apply from the 2013–14 income year to prevent excess deductions where an asset is used partly for business and partly for private purposes.

Mixed-use asset specific associated person rule

The concept of association is key to the mixed-use asset rules. Section DG 6 modifies the general associated persons rules. Specifically, section DG 6(a) deems a shareholder who holds 5 percent or more of the shares in a company to be associated with that company. It was intended to remove this provision from the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill at the Finance and Expenditure Committee stage, however it was not removed before enactment. Accordingly, this bill proposes removing section DG 6(a) with application for the 2013–14 and later income years. Section DG 6(b), which deems a shareholder to be associated with a company if the person's share in the company gives them a right to use a mixed-use asset owned by the company, will remain.

Corrections

Several examples in the legislation contain minor errors that need to be corrected. These are summarised below **with the proposed corrections bolded for emphasis**.

Section	Example and correction	Why correction is needed
DG 11	<p>Example Holiday Home Ltd holds a holiday home with a rateable value of \$200,000. The company has debt of \$40,000, with associated interest expenditure of \$4,000. Since the debt value is less than the asset value, all the interest expenditure must be apportioned (section DG 11(3)). Boat Ltd has a charter boat whose adjusted tax value cost is \$60,000. The company has debt of \$100,000, with associated interest expenditure of \$10,000. Since the debt value is more than the asset value, the company must apportion interest expenditure of \$6,000 (section DG 11(4)-(6)). The formula is $\\$10,000 \times (\\$60,000/\\$100,000) = \\$6,000$.</p>	<p>Under section DG 11(8)(b), the appropriate “asset value” for property other than land is its adjusted tax value, not its cost.</p>
DG 16	<p>Example David has a city apartment with a rateable value of \$300,000. He rents out the apartment and also uses it privately. He receives market rate rental of \$4,000 from non-associates, and \$6,000 from associates. David's total allowable expenditure, under sections DG 7, DG 8 and DG 11, is \$15,000. The income from associates is exempt under section CW 8B, and is ignored. David therefore has asset income of \$4,000 and deductions of \$15,000, giving rise to an excess of expenditure over income of \$11,000. Since David's income from non-associates is less than 2% of the apartment's rateable value, the excess expenditure of \$11,000 \$5,000 is denied as a deduction. The amount denied may be allocated to a later income year under section DG 17.</p>	<p>The excess expenditure in this example is \$11,000 not \$5,000. The proposed amendment also provides additional explanation of the calculations to assist readers.</p>
DG 17	<p>Example, continued from section DG 16 In the following income year, David derives \$10,000 from renting his city apartment at market rates to a non-associate. David's total allowable expenditure, under sections DG 7, DG 8, and DG 11, is \$8,000. He also has expenditure of \$11,000 \$5,000 quarantined from the previous income year. David is able to deduct \$2,000 of that quarantined expenditure. The remaining \$9,000 \$3,000 continues to be quarantined and may be allowed as a deduction for in a later income year.</p>	<p>Carry-through from correction of section DG 16.</p>

Section	Example and correction	Why correction is needed
DG 18	<p>Example Aircraft Ltd owns an aircraft to which the rules in this subpart apply; the income derived from the asset in the current year is less than 2% of the cost of the aircraft. The company has calculated an outstanding profit balance of \$12,000 after the application of section DG 16. Aircraft is 100% owned by Parent Ltd, which has apportioned interest expenditure of \$5,000 calculated under section DG 12. Parent has 2 equal shareholders, Alisa who has apportioned interest expenditure of \$8,000, and Hamish who has apportioned interest expenditure of \$1,000, both calculated under section DG 14. Parent must apply section DG 18 first, and is not required to quarantine any of its interest expenditure; the outstanding profit balance is reduced to \$7,000 (\$12,000 – \$5,000). Alisa’s and Hamish’s share of the outstanding profit balance is \$3,500 each (\$7,000 \$7,500 x 50%). Alisa must quarantine \$4,500 of interest expenditure (\$8,000 – \$3,500); Hamish is not required to quarantine any interest expenditure.</p>	Correction of numeric error.
DG 19	<p>Example, continued from section DG 18 In the following income year, Aircraft has calculated an outstanding profit balance of \$16,000 after the application of section DG 18. Section DG 19 does not apply to Parent or Hamish Alisa because they have no previously quarantined interest expenditure. However, the section does apply to Alisa Hamish because she he has \$4,500 of quarantined interest expenditure from the previous year. Alisa’s Hamish’s current year apportioned interest expenditure is \$7,000, calculated under section DG 14, and her his share of the outstanding profit balance is \$8,000 (\$16,000 x 50%). Alisa Hamish is allowed a deduction for \$1,000 of previously quarantined expenditure (\$8,000 – \$7,000). His Her remaining quarantined expenditure is \$3,500 (\$4,500 – \$1,000).</p>	Correction of names.
DZ 21	<p>Example On 31 March BoatCo has a boat with an acquisition cost of \$85,000. on 31 March 2013 which The boat meets the various requirements set out in subpart DG. All the shares in BoatCo are owned by Michelle. The boat has a market value of \$75,000, and an adjusted tax value of \$55,000. BoatCo transfers the boat to Michelle without payment (which is treated as a dividend of \$75,000). For depreciation purposes, BoatCo is treated as disposing of the boat for \$55,000, and Michelle is treated as acquiring it for \$55,000 \$85,000, and having been allowed a deduction of \$30,000 for depreciation loss in past income years.</p>	Amendments to ensure the example is consistent with the change to section DZ 21 in the bill.

Depreciation recovery income for assets transferred in the 2013–14 income year under section DZ 21

There is a one year transitional period (2013–14 income year) in which companies that own mixed-use assets can transfer those assets to their shareholders without triggering depreciation recovery income (this is referred to as “rollover relief”). The rollover relief provision is contained in section DZ 21. Section DZ 21(2) treats the transfer as if it were a disposal and acquisition for an amount equal to the adjusted tax value of the asset on the date of the transfer.

This means that there is no depreciation recovery income to the company when it transfers the asset to its shareholder(s) because the consideration deemed to have been received is the same as the asset's adjusted tax value.

If the shareholder later sells the asset for more than its adjusted tax value, the policy intention is that depreciation recovery income will be crystallised at this point. To ensure this policy objective is achieved the bill proposes to treat the shareholder as stepping into the shoes of the company for depreciation purposes – that is, by having:

- acquired the asset on the date on which the company acquired it for an amount equal to the amount the company paid to acquire it;
- used the asset for the purposes for which the company used it;
- used the depreciation method used by the company in relation to the asset; and
- been allowed a deduction for an amount of depreciation loss that the company has been allowed since the company's acquisition of the asset.

As well as including all depreciation deductions the company has previously been allowed in the depreciation recovery calculation, this amendment also ensures that any change in use or depreciation method by the shareholder is captured and the shareholder has the correct depreciation cost base.

LOSS GROUPING CONTINGENT ON GROUP LOSS COMPANY SATISFYING ITS LIABILITIES FOR DEDUCTIBLE EXPENDITURE

(Clauses 14, and 15(2), (3))

Summary of proposed amendment

Changes are being made to the loss grouping rules to correct an unintended consequence of the rewrite of the Income Tax Acts. The bill proposes a number of amendments to confirm the correct policy intent.

Key features

Section CG 2 no longer applies to a group loss company if:

- the group loss company has previously made a tax loss available to another company in the same group of companies under the loss grouping rules; and
- the group loss company in the same group of companies as the group profit company has unsatisfied liabilities for deductible expenditure included in those past tax losses made available under the loss grouping rules; and
- the group loss company in the same group of companies is liquidated; or
- either the group profit company or the group loss company has left the group and for both cases, the group loss company is insolvent, in receivership or in liquidation at that time.

Instead, new sections CG 2C and CG 2D will apply in these circumstances. These amendments confirm the long standing policy that the grouping of tax under the loss grouping rules is contingent on the group loss company fully satisfying its liabilities relating to past deductible expenditure included in the group loss company's tax losses. If the sections apply, the group profit company derives income equal to the amount of certain unsatisfied liabilities of the group loss company.

New section CG 2C will apply if the group loss company has been struck off the register of companies.

New section CG 2D will apply if the profit company and the group loss company are no longer part of the same group of companies and:

- the group profit company has received the benefit of group tax losses from the group loss company; and
- at the time either company leaves the group, the group loss company is insolvent, in receivership or has been placed in liquidation (but not yet struck off the register of companies).

Application date

New sections CG 2C and CG 2D will apply from the date of introduction of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill.

Background

Since the enactment of section 191(7B) of the Income Tax Act 1976, the grouping of tax losses has been contingent on the group loss company fully satisfying its liabilities for deductible expenditure included in its tax losses made available to another company in the same group of companies.

This policy was given effect in the Income Tax Act 1994 by the interaction of sections CE 4, IE 1(4) and IG 2(9) which permitted the Commissioner to amend an assessment of a group profit company to reduce the amount of grouped tax losses to the extent the group loss company had not satisfied all liabilities giving rise to deductions included in the grouped tax losses. The effect of the interaction of the predecessors of these three rules was confirmed by the Court of Appeal in the case of *Hotdip Galvanisers (Christchurch) Ltd v CIR* (1999) 19 NZTC 15,337.

These three provisions from the Income Tax Act 1994 were rewritten into section CG 2 of the Income Tax Act 2004, and included a policy change relating to the timing of the recovery of amounts relating to remitted or cancelled debts for past deductible expenditure. Section CG 2 was re-enacted unamended into the Income Tax Act 2007.

Under current section CG 2, a remitted or cancelled debt for past deductible expenditure is treated as income derived in the year the debt is remitted (for example, on the company being struck off or liquidated). This policy change was to better align the adjustment (for remitted or cancelled liabilities relating to past deductible expenditure) with self-assessment by eliminating the need to amend past assessments.

However, this policy change has also resulted in an unintended consequence for the loss grouping rules. The unintended consequence is that section CG 2 does not give effect to the policy that the benefit of the loss grouping rules is contingent upon the group loss company fully satisfying its liabilities for past deductible expenditure included in its tax losses.

Detailed analysis

Reduction in benefit of group tax losses under the Income Tax Act 1994

The interaction of sections IG 2(9), IE 1(4) and CE 4 of the Income Tax Act 1994 permitted the Commissioner to amend an assessment of a group profit company to reduce the amount of losses made available under the loss grouping rules. This amended assessment of a group profit company could be made for any income year – it was not limited by the four-year time bar that normally applies to income tax assessments. However, the reduction in the benefit of grouped tax losses was limited to the amount of remitted or cancelled debts of the group loss company.

The decision of *Hotdip Galvanisers (Christchurch) Ltd v CIR* (1999) 19 NZTC 15,337, the Court of Appeal confirmed that, under the 1976 Act's corresponding provision to section IG 2(9) of the 1994 Act:

- the Commissioner was entitled to amend an assessment of a group profit company in a group that received the benefit of tax losses from a group loss company, if the group loss company's deductible expenditure forming part of the loss offsets was remitted or cancelled; and
- the provision did not require the Commissioner to first re-assess the group loss company for the remission adjustment; and
- the Commissioner was not limited by the four-year time bar that normally applies to income tax assessments.

Policy change in Income Tax Act 2004

In rewriting sections CE 4 and IE 1(4)(d) of the Income Tax Act 1994 into section CG 2 of the Income Tax 2004, it was considered desirable to place the timing of the effect of the remission on a basis consistent with self-assessment. This policy change resulted in the timing the effect of the remission on the income tax liability to the year of remission in contrast to the amendment of previous years' assessments under the former law.

Under the 2004 Act and the 2007 Act, remitted or cancelled debts for past deductible expenditure are treated as income derived in the year the debt is remitted (for example, on the company being struck off or liquidated).

Unintended consequence

The remission income rule in the 2004 and 2007 Acts applies only to the taxpayer that had incurred the debt. While this rule technically applies to a group loss company that has been liquidated, it has no consequence for a company that has been struck off the register of companies. A company struck off the register does not exist, and no valid assessment for tax on income arising under section CG 2 can be made (absent the company being restored to the register).

Under current law, section CG 2 does not apply to a group profit company if a group loss company cannot be assessed for remission income. This has resulted in the unintended consequence that there is no longer a legislative provision to reduce the benefit of past grouped tax losses from group profit companies if debts of the group loss company are remitted or cancelled.

The new sections CG 2C and CG 2D give effect to the policy that the retention of the benefits of loss grouping is contingent on the group loss company:

- fully satisfying its liabilities for deductible expenditure included in a net loss; and
- that net loss has been included in a tax loss subsequently made available under the loss grouping rules to another company in the same group of companies.

Group loss company going into liquidation

Section CG 2C applies to a group profit company in a group of companies if:

- the group profit company has received the benefit of tax losses under the loss grouping rules from a group loss company in the same group of companies;
- the group loss company is removed from the register of companies (and not subsequently restored to the register);
- the group profit company and the group loss company are in the same group of companies immediately prior to the removal of the group loss company from the register of companies;
- at the time the company is removed from the register of companies, the group loss company has unsatisfied liabilities for past deductible expenditure relating to tax losses made available to the group profit company under the loss grouping rules; and
- the removal of the group loss company from the register of companies occurs after the tax loss has been made available to another company under the loss grouping rules.

On removal from the register of companies, there is no longer a company in existence to meet those unpaid unsatisfied debts. In the absence of this amendment section, section CG 2 would treat the group loss company as deriving income equal to the amount of the unsatisfied liability for prior deductible expenditure, but no valid assessment could be made for income tax on this income without restoring the company to the register.

Therefore, section CG 2 does not apply and instead section CG 2C will apply. The section treats the group profit company as deriving income equal to the remitted or cancelled liability (due to the operation of the Companies Act 1993) for deductible expenditure incurred by the group loss company. That income is treated as derived on the day the group loss company is removed from the register of companies.

The amendment in section CG 2C ensures that the 2007 Act will have the same effect as the interaction of sections CE 4, IE 4 and IG 2(9) of the Income Tax Act 1994, provided that the group loss company and the group profit company are in the same group of companies immediately prior to the group loss company being removed from the register of companies.

New section CG 2C will not apply to a debt arising under a financial arrangement, consistent with section CE 4 of the Income Tax Act 1994.

Group loss company or group profit company leaving the group

A number of commercial considerations mitigate against section CG 2C applying to a group profit company if the group profit company and the group loss company are not in the same group of companies when the group loss company is removed from the register of companies.

These considerations include:

- The management of the affairs of the group loss company would differ from the management of the affairs of the group profit company. A decision to remove the group loss company from the register of companies by the new owners need not consider the implications for that group profit company given they are no longer part of the same group of companies.
- A tax obligation for a company arising from the liquidation of a group loss company that is no longer part of the same group as the group profit company (and beyond the management of the group's affairs) can impact adversely on the group profit company's balance sheet, and also potentially affect existing financing arrangements.

However, if a group loss company is insolvent, when either it or a group profit company exits the group, it can be assumed that management would be aware at that time:

- if an insolvent group loss company has not satisfied its debts giving rise to tax losses transferred under the loss grouping rules; and
- there is a strong risk that the insolvent loss group company might not subsequently satisfy its debt obligations for past deductible expenditure included in the tax losses of the group loss company.

Under new section CG 2D the profit company must forfeit the benefit of past grouped tax losses to the extent the insolvent loss group company has unsatisfied liabilities for past deductible expenditure. However, if the group loss company satisfies its unpaid debts for past deductible expenditure before the exit time without giving a preference to one creditor over another, section CG 2D would not apply.

New section CG 2D will not apply to a debt arising under a financial arrangement, consistent with section CE 4 of the Income Tax Act 1994.

Voidable preference

Under new section CG 2D, either the profit company will forfeit some or all of the benefit of past grouped tax losses or the group loss company will repay the relevant debts.

However, because solvency is measured at a point in time, an issue arises under the voidable preference rules in the Companies Act 1993. It is possible for a payment by the group loss company to satisfy an unpaid liability for past deductible expenditure to be a voidable preference under the Companies Act 1993. If the payment is a voidable transaction (a creditor is repaid in preference to other creditors), a liquidator could recover the payment, resulting in the liability being reinstated.

The Commissioner has the discretion to ignore payments of the group loss company if those payments could constitute a voidable transaction under the Companies Act 1993. If the Commissioner exercises this discretion, an amended assessment will be made for the group profit company for income derived under new section CG 2D.

REMITTED AMOUNTS ON DISCHARGE FROM BANKRUPTCY

(Clauses 14 and 15(1))

Summary of proposed amendment

This amendment provides that section CG 2 will not apply to a bankrupt on discharge from bankruptcy. At present, section CG 2 of the Income Tax Act 2007 applies to a person discharged from bankruptcy and can result in a discharged bankrupt deriving assessable income on the full amount of remitted debts on discharge (remission income). This conflicts with the “fresh start” principles of insolvency law on discharge from bankruptcy.

New section CG 2B applies to a person discharged from bankruptcy. This new provision provides for remission income sufficient to reduce the benefit of past deductions to the extent liabilities incurred for those deductions are remitted or cancelled. Instead of section CG 2 applying to debts remitted on discharge from bankruptcy, new section CG 2B will apply to limit the remission income from those debts to the lesser of:

- the total amount of debt remitted on discharge from bankruptcy that relates to past deductible expenditure; and
- the bankrupt’s loss balance at the end of the tax year preceding the discharge from bankruptcy after taking into account any reduction in the loss balance made by the Commissioner under section 177C of the Tax Administration Act 1994.

Application date

The amendment applies from the commencement of the amending Act.

Background

On 3 October 2011, the Minister of Revenue issued a press release calling for submissions on some remedial items. One of those remedial items related to the Commissioner’s powers, under section 177C of the Tax Administration Act 1994, relating to a taxpayer in bankruptcy, to:

- write off uncollectible amounts of tax owing by the bankrupt; and
- make related consequential adjustments to the taxpayer’s tax losses carried forward (“the loss balance”).

Submissions on this remedial item raised two issues relating to the remission of most debts when a bankrupt is discharged from bankruptcy:

- Insolvency law remits most debts of a bankrupt at the time of discharge. One issue was whether it was appropriate for section CG 2 to recover all of the past deductions (as remission income of the taxpayer) if debts incurred for those past deductions:
 - a) remained unpaid on the taxpayer being adjudged bankrupt; and
 - b) were subsequently remitted on discharge from bankruptcy.

- It was unclear whether remission income under section CG 2 is taken into account in the calculation of the bankrupt's taxable income before or after being discharged from bankruptcy. This uncertainty potentially impacts on the Commissioner's powers to write off remission income arising on discharge from bankruptcy against a loss balance of the bankrupt.

Detailed analysis

Section CG 2 of the Income Tax Act 2007 was re-enacted without change from the Income Tax Act 2004. Section CG 2 of the Income Tax Act 2004 corresponded to sections CE 4 and IE 1(4)(d) of the Income Tax Act 1994.

Section CG 2 applies to a person:

- who has been allowed a deduction for an amount the person is liable to pay;
- that liability is later remitted or cancelled (but not if the remission or cancellation is a dividend); and
- the financial arrangement rules do not require a base price adjustment to be made for that remission or cancellation.

The potential application of section CG 2 to a bankrupt on discharge from bankruptcy is an unintended consequence arising from a policy change made in rewriting section CE 4 of the Income Tax Act 1994. This policy change related to the timing of income from debt remissions to make the operation of the debt remission rule more consistent with self-assessment principles.

Effect of law under the Income Tax Act 1994

Before the enactment of the Income Tax Act 2004, a debt remission of this nature would have resulted in the Commissioner amending the income tax assessment for the tax year in which the deduction was incurred (section CE 4 of the Income Tax Act 1994). This amended assessment could be made for any income year – it was not limited by the four-year time-bar that normally applies to the amendment of income tax assessments. However, the amount of the amended assessment to reduce past tax losses was limited to the amount of remitted or cancelled debts of the bankrupt.

Under the Income Tax Act 1994, an amended assessment of the income tax liability for an earlier income year by the Commissioner would have resulted in either:

- a reduction in the person's loss balance at the end of that earlier tax year; or
- an increased income tax liability being assessed for that earlier tax year.

Policy change in Income Tax Act 2004

In rewriting section CE 4 of the Income Tax Act 1994 as section CG 2 of the Income Tax Act 2004, it was considered desirable to place the timing of the effect of the remission on a basis consistent with self-assessment. This policy change resulted in the timing the effect of the remission in the year of remission in contrast to the amendment of previous years' assessments under the former law.

Amendment to section CG 2, and new section CG 2B

The application of section CG 2 to a bankrupt on discharge from bankruptcy conflicts with the “fresh start” policy of insolvency law for a discharged bankrupt. The amendment to section CG 2 ensures that it does not apply on discharge from bankruptcy. Instead, the new section CG 2B is to apply to a person discharged from bankruptcy.

If a person discharged from bankruptcy does not have a loss balance at the end of the tax year preceding the year in which the discharge occurs, that person will not have remission income under either of section CG 2 or section CG 2B.

If a person discharged from bankruptcy has a loss balance at the end of the tax year preceding the year in which the discharge occurs, section CG 2 does not apply but section CG 2B applies to provide that the person has income equal to the lesser of:

- the total amount of debts remitted which relate to past deductions; and
- the person’s loss balance at the end of the tax year preceding the year of discharge (after taking into account any reduction in that loss balance by the Commissioner under section 177C of the Tax Administration Act 1994).

Income derived under section CG 2B is treated as derived on the first day of the income year in which the person is discharged from bankruptcy. This income is included in the calculation of the person’s taxable income for the year of discharge:

- effectively reducing the benefit of the loss balance of the taxpayer brought forward from the previous year; and
- ensuring that a discharged bankrupt does not have an income tax liability for debts discharged in bankruptcy.

SERIOUS HARDSHIP

(Clauses 128(4) and 153 to 157)

Summary of proposed amendments

Amendments are being made to allow the Commissioner, in appropriate circumstances, to bankrupt taxpayers, who are in serious hardship and to ensure the reasons why the debt arose is not a factor in determining whether the taxpayer is in serious hardship. These amendments ensure that the legislation is consistent with Inland Revenue's current operational practice.

Application date

The amendments will apply from the date of enactment.

Key features

The bill will clarify the meaning of "serious hardship" and ensure that factors that give rise to the taxpayer not being able to pay the outstanding tax are not taken into account when determining whether or not the taxpayer is in serious hardship.

The bill also clarifies that the Commissioner of Inland Revenue can, in appropriate circumstances, bankrupt taxpayers, when they are in serious hardship.

Background

In 2003, the debt and hardship rules were introduced. Under the rules the Commissioner must maximise the recovery of outstanding tax from a taxpayer and deal with cases in an efficient manner. However, the Commissioner may not recover to the extent that recovery is an inefficient use of the Commissioner's resources or it would place a taxpayer, who is a natural person (individual), in serious hardship.

The rules provide incentives for taxpayers who are having problems paying their tax to contact Inland Revenue and discuss the options available to them. The best option is always payment of the full amount on or before the due date. If that is not possible, taxpayers can enter an instalment arrangement and pay the debt off over time. If the debt cannot be paid off over time, the Commissioner has a discretion under which she can write off tax. In addition, the Commissioner must write off the tax that is not collected if the taxpayer is bankrupted, liquidated or their estate has been distributed. The Commissioner's practice is to bankrupt taxpayers who cannot pay in appropriate circumstances – for example, when it is considered the write-off would have an adverse effect on taxpayers' perceptions of the integrity of the tax system.

Following a review of the legislation, an alternative view of the rules has been raised which has two related implications.

The first implication is that bankruptcy is a recovery action and at the point that any further recovery action would cause serious hardship, bankruptcy, along with any other recovery action, is prohibited. Therefore, the Commissioner could not bankrupt a taxpayer when the taxpayer is facing serious hardship.

Inland Revenue's current view is that bankruptcy does not place or cause a taxpayer to be in serious hardship. This is consistent with the policy intent; the Official Assignee takes over the bankrupt's affairs and ensures they do not suffer serious hardship.

The second implication arises from the additional view that in determining whether a taxpayer is in serious hardship, Inland Revenue must first consider how the debt arose. For example, if the taxpayer's debt arose from the taxpayer enjoying goods of an expensive nature, the taxpayer would not be in serious hardship and Inland Revenue could recover the debt.

This view is at odds with the way in which Inland Revenue applies the debt and hardship rules and can result in adverse outcomes for taxpayers. The view is also inconsistent with the policy intention of the rules which is to protect taxpayers from being placed in serious hardship as a result of recovery actions taken by Inland Revenue.

Inland Revenue's current approach is that when a taxpayer applies for financial relief, Inland Revenue determines whether the taxpayer can pay the debt, or whether paying part or all of the debt would place the taxpayer in serious hardship. The cause of the outstanding tax is not taken into account in determining serious hardship as the alternative would require. If paying the debt would place the taxpayer in serious hardship, Inland Revenue then considers how best to deal with the debt, and in some cases writes off the debt. In some cases the taxpayer would be bankrupted and in other cases the debt would remain. In deciding which action to take, Inland Revenue will at this step consider how the debt arose and the need to maintain the integrity of the tax system.

UNACCEPTABLE TAX POSITION

(Clause 146)

Summary of proposed amendment

An amendment to the unacceptable tax position penalty will clarify that the penalty does not apply to shortfalls that arise in respect of GST and withholding-type taxes. That is, the unacceptable tax position penalty will only apply to income tax shortfalls. The amendment clarifies an amendment made in 2007.

Application date

The amendment applies retrospectively to tax positions taken on or after 1 April 2008 (the application date of the 2007 amendment).

Key features

The amendment clarifies that the tax types listed in section RA 1 of the Income Tax 2007 are removed from the scope of the unacceptable tax position shortfall penalty so that the penalty will apply only to tax positions relating to income tax.

Background

A tax shortfall is the difference between a taxpayer's correct tax liability calculated under the legislation and the position a taxpayer took in their tax return. There are five categories of shortfall penalty – ranging from not taking reasonable care (when the penalty is 20 percent of the tax shortfall) to evasion or a similar act (when the penalty is 150 percent of the tax shortfall). The appropriate penalty is assessed when a required standard is breached – for example, if the taxpayer does not take reasonable care, the penalty for not taking reasonable care is assessed.

One of the shortfall penalties is the unacceptable tax position penalty. An “unacceptable tax position” is a tax position that, if viewed objectively, fails to meet the standard of being “about as likely as not to be correct”. This does not mean that the taxpayer's tax position must be the better view or be more than likely the correct view, but rather that the position is “about as likely as not to be correct”.

The aim of the shortfall penalty is to encourage taxpayers to take tax positions that are correct in terms of the law. A taxpayer is liable to pay a shortfall penalty of 20% if the taxpayer takes an unacceptable tax position in relation to income tax, and the tax shortfall arising from the taxpayer's tax position is more than both:

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

A change to the legislation in 2003 meant the unacceptable tax position penalty potentially applied to all tax shortfalls over the thresholds, including cases when the tax shortfall arose from a mistake in the facts or when an unacceptable tax position was taken and immediately corrected. Taxpayers and tax agents noted that the penalty was having an adverse effect on taxpayer behaviour, resulting in taxpayers being less inclined to make voluntary disclosures. In 2006 a short-term solution was put in place which gave Inland Revenue a discretion not to impose the penalty in specific circumstances.

In 2007 the discretion was repealed, the threshold for imposition of the penalty was increased and the scope of the penalty was limited to income tax – that is, the penalty was no longer to be imposed on GST or withholding tax shortfalls. At the same time, the reduction given for voluntary disclosures made before a taxpayer is notified of a pending audit or investigation when the shortfall arose from the taxpayer not taking reasonable care, or from an unacceptable tax position, increased from 75% to 100%.

Following a review of the legislation it has been determined that the 2007 amendment does not achieve the desired policy outcome. The 2007 amendment inserted the words “in relation to income tax” in section 141B of the Tax Administration Act 1994. However, section RA 2 of the Income Tax Act 2007 deems the tax types listed in section RA 1 to be income tax and therefore subject to the unacceptable tax position penalty. These taxes include PAYE, fringe benefit tax and non-resident withholding tax.

The intention of the 2007 amendment was clear and taxpayers expected that following the amendment the unacceptable tax position penalty would only apply to tax shortfalls that arose in annual income tax returns. Inland Revenue’s practice to date has been to apply the penalty only to tax shortfalls that arise in annual income tax returns.

CLARIFICATION OF NEW DUE DATE FOR PAYMENT OF TAX

(Clause 149)

Summary of proposed amendment

Amendments clarify that a new due date is not set when the Commissioner makes a systems-generated default assessment, and that when a taxpayer files a return following a systems-generated default assessment, a new due date is set for the resulting tax liability.

Application date

The amendment will apply retrospectively from 6 October 2009 (which was the application date of the 2009 amendment).

Key features

The bill proposes a clarification to section 142A of the Tax Administration Act 1994 to ensure that a new due date is not set when the Commissioner makes a systems generated default assessment. The bill will also clarify that when a taxpayer files a return following a systems generated default assessment, a new due date is set for the resulting tax liability.

Background

If the Commissioner makes an assessment or amends and increases an assessment, a new due date is set for the tax assessed. Before an amendment in 2007 a new due date was only required when the Commissioner increased an assessment. This had the effect of creating an incentive for taxpayers who considered they did not have a tax liability to file a “nil return”. This meant that if the Commissioner determined at a later date that the taxpayer did have a tax liability, a new due date would be set for the tax assessed by the Commissioner. In the absence of the “nil return”, the taxpayer would be liable for use-of-money interest and late payment penalties from the original due date and, when the taxpayer had breached a required standard of behaviour, shortfall penalties.

There was a concern that the penalty rules were discouraging taxpayers from complying voluntarily with their tax obligations, as the imposition of both use-of-money interest and late payment penalties overly penalised taxpayers. Also, the application of late payment penalties when the taxpayer considered they did not have a tax liability could be seen as inappropriate. In some cases the late payment penalty was effectively being used as a penalty for the taxpayer not filing their return on time.

In 2007 an amendment was made under which Inland Revenue is required to set a new due date when it makes an assessment or increases an assessment. In 2009 the provision was again amended. The aim of this amendment was to remove the requirement to set a new due date when Inland Revenue makes a systems-generated default assessment.

More recently, concerns have been raised that the 2009 amendment does not achieve the desired policy outcome. In particular, it has been found that when a taxpayer files a return following a default assessment, a new due date is only set when the tax assessed by the taxpayer is more than the default assessment and the new due date only applies to the difference.

This is contrary to the policy intent which is that the late payment penalty is a penalty imposed when the taxpayer knows they have a tax liability and they do not pay on time. Default assessments are made by the Commissioner under section 106 of the Tax Administration Act 1994. There are a number of different circumstances when the Commissioner can issue a default assessment, for example, when a return has not been made or following an audit or investigation when the Commissioner is not satisfied with the return filed by the taxpayer.

The 2009 amendment which removed the requirement to set a new due date when Inland Revenue makes a default assessment was aimed at systems-generated default assessments, assessments generated by Inland Revenue's FIRST system to encourage the taxpayer to file an outstanding return. It was not aimed at assessments made by the Commissioner following an audit. It was considered appropriate to impose late payment penalties from the original due date because in the case of systems-generated default assessments the assessment is issued because there is a concern about the taxpayer's non-compliance.

REFERENCES TO LOSS ATTRIBUTING QUALIFYING COMPANIES

(Clauses 147 and 148)

Summary of proposed amendment

In 2010 the loss attributing qualifying company rules were repealed and the look-through company rules introduced. The promoter penalty legislation still refers to “loss attributing qualifying companies” when it should refer to “look-through companies”.

The bill proposes that the references in the promoter (section 141EB) penalty legislation which refer to loss attributing qualifying companies be updated to refer to look-through companies, and the penalty relief provision for loss attributing qualifying companies be repealed.

Application date

The amendments will apply from 1 April 2011 (the date from which the look-through company rules apply).

WORKING FOR FAMILIES TAX CREDITS

(Clauses 114 to 116)

Summary of proposed amendments

Additional items are proposed to be added to the list of payments that are excluded from the definition of family scheme income in relation to the Working for Families scheme (WFF) under section MB 13(2) of the Income Tax Act 2007. These items are windfall gains or payments of a capital nature. The change reflects that WFF is income-tested but not asset-tested.

There are also two remedial changes to clarify wording and correct errors in section MB 1(5C) relating to depreciation losses in earlier years, and section MB 7B(2) concerning employment benefits.

Application dates

The amendments to section MB 13(2) apply for the 2015–16 and later income years.
The amendments to section MB 1(5C) apply from 1 April 2011.
The amendments to section MB 7B(2) apply from 1 April 2014.

Key features

Changes to the rules in subpart MB of the Income Tax Act 2007 describing the definition of family scheme income are proposed. The main change will add the following items to the list of payments that are excluded from the “other payments” rule in section MB 13:

- repayment of a loan;
- repayment of a mistaken or misdirected payment;
- refund of a payment (including tax, student loan and child support refunds resulting from an overpayment);
- payment from the person’s ownership of an investment activity or business, where it is received on capital account, and the payment is not a loan and is not a payment by a trustee;
- payment of an inheritance from a deceased person’s estate;
- money won from gambling or a New Zealand lottery.

The other changes in subpart MB will:

- correct a cross-reference error in section MB 1(5C)
- amend section MB 1(5C) to cover depreciation loss for a building in an investment activity, to mirror earlier changes made to section MB 3 to ignore net losses from investment activities; and

- correct a drafting error in section MB 7B(2)(b) to refer to a “benefit” instead of a “fringe benefit”.

Background

WFF tax credits are provided to the principal caregiver of dependent children based, among other things, on their level of family scheme income for a tax year. The tax credits are abated when family scheme income exceeds \$36,350 at a rate of 21.25 cents per dollar. Families that choose instalment payments of tax credits throughout the year are required to estimate their family scheme income and are subject to an end-of-year reconciliation. Alternatively, families can apply for an end-of-year lump sum payment.

The family scheme income provisions have been amended a number of times over the last decade, including as part of the rewrite of the Income Tax Act. The definition of “family scheme income” was broadened as part of Budget 2010, with effect from 1 April 2011. This included a new provision for other payments a family may receive to replace lost income or to meet their usual living expenses. The broader definition is intended to improve the fairness and integrity of Working for Families tax credits by, for example, countering arrangements that have the effect of inflating entitlements beyond what people’s true economic circumstances justify.

In 2012 the Government agreed that employer-provided vouchers and other short-term charge facilities should also be included in family scheme income. This change comes into effect from 1 April 2014.

The definition of “family scheme income” is also used, with some adjustments, for determining eligibility for some people applying for student allowances and the community services card. The income definition will also be the basis for assessing child support in the future. A similar definition is used for student loan repayments.

Detailed analysis

Current sections MB 1 to MB 12 list specific amounts that are included in family scheme income. Section MB 13(1) includes other payments in the definition of family scheme income where the payment is paid or provided to the person from any source and used by the person to:

- replace lost or diminished income of the person or the person’s family; or
- meet usual living expenses of the person or the person’s family.

Current section MB 13(1) is broadly drafted. Section MB 13(2) then excludes payments from MB 13(1) where the payment is not intended to form part of family scheme income. An example is when a payment is already included in family scheme income under sections MB 1 to MB 12, or when it is a government payment and treated as exempt income for tax and welfare purposes.

The WFF tax credits are income-tested on family income. While it has a broad definition of income, it is not the policy intent for the tax credit to be asset-tested. For example, the use of money or cash assets from a person's bank account for usual living expenses is not intended to be included in family scheme income, whereas interest earned on savings is included. Similarly, the family scheme income definition is not intended to capture the realisation of assets into cash, other than the extent to which it is assessable income under the Income Tax Act. Section MB 13(2)(b) excludes a payment where it is the proceeds of the disposal of property and not assessable income of the person disposing of the property. This is intended to prevent, for example, the proceeds from the sale of a car, when the proceeds are used to meet usual living expenses, from being included in family scheme income. The exception is when sales proceeds are assessable income for that person.

There are payments not covered by section MB 13(2)(b) but which are similar in nature to capital or they relate to a change in how assets are held or realised which should be excluded. It has also not been the policy intention to include windfall gains in family scheme income, to the extent that they are not assessable income for the person. For families who estimate their family scheme income upfront, it would not be possible to accurately estimate windfall gains, leading to end-of-year debts. It is also unlikely that the family would rely on windfall gains to meet the family's usual living expenses.

The proposed list of items to be excluded under section MB 13(2) can be technically caught by the wording of section MB 13(1) but do not come within the policy intent of that provision. They are:

- Repayment of a loan – this covers the repayment of the principal of the loan. Interest payable on the loan is assessable income and is already included in family scheme income under another provision.
- Repayment of a mistaken or misdirected payment – this is not additional money for the person or their family.
- Refund of a payment (including tax, student loan and child support refunds resulting from an overpayment).
- Payment of an inheritance from a deceased person's estate.
- Money won from gambling or a New Zealand lottery – these windfall gains are not intended to be caught by the “other payments” rule.

The bill also proposes to include in the list of excluded items a payment from the person's ownership of an investment activity or business, where it is received on capital account, and the payment is not a loan and is not a payment by a trustee.

Dividends, shareholder salary, interest, or rent from a business or investment activity are not received on capital account and are already included under other provisions in subsection MB. A payment from a person's investment or business received on capital account is equivalent to the withdrawal of funds from a savings account and should likewise not be included in family scheme income. The person and their family are not “better off” from receiving the payment, rather they are converting their assets into cash. Often the payment on capital account will be referred to as drawings, although some drawings may be a loan or income that has been incorrectly labelled. A loan from a business or investment to the person will be excluded under section MB 13(2)(a) if it is on the basis of ordinary commercial terms and conditions.

CHILD SUPPORT REMEDIALS

(Clauses 181 to 191)

Summary of proposed amendments

A number of changes are proposed to ensure the policy objectives of the child support reform are achieved. The changes clarify wording, correct errors, make further consequential changes and make minor improvements to simplify the child support scheme.

Application date

The majority of the amendments will apply from 1 April 2014.

One amendment will apply from the day of Royal assent.

Background

Under the Child Support Amendment Act 2013 a number of changes were made concerning child support terms – for example, the “custodial parent” of the qualifying child is now referred to as the “receiving carer”.

The Child Support Amendment Act will also amend, from 1 April 2014, the way a formula assessment of child support is determined and make improvements to the operation of the child support scheme. The amendments include:

- decreasing the threshold for recognised shared care;
- the Commissioner determining who is a liable parent and who is a receiving carer of the qualifying child based on the income and care details of both parents;
- defining who is a non-parent receiving carer;
- changes to how income is measured and estimated for assessment purposes; and
- how child support is distributed.

Key features

The bill proposes the following additional remedial changes to the Child Support Act 1991:

- removing the definition of “election period” in the interpretation section as it has been replaced by a new definition in new section 40AA;
- clarifying in new section 9(1)(c) that a beneficiary is not required to apply for child support if they are already a receiving carer;

- clarify that notices of election in new section 40(1) cannot be given after the end of the child support year to which the election relates;
- correcting the ordering of provisions in new section 44 relating to the end-of-year reconciliation of an estimate of income to ensure the correct policy outcome is achieved;
- consequential changes to section 65 in light of the new rules for determining liable parents and receiving carers, and to prevent a voluntary agreement and a formula assessment for a child being in force simultaneously;
- repealing new section 92(3A) as the provision is no longer required;
- amending section 98 to align with new section 32 on the method for distributing the minimum annual amount of child support when there is more than one receiving carer;
- ensure that a non-parent receiving carer who has been granted a Sole Parent Support payment under the Social Security Act 1964 cannot waive the right to collect child support from a liable parent; and
- further consequential amendments reflecting the changes in child support terminology.

TAX ADMINISTRATION ACT 1994: CROSS-REFERENCES TO SECTIONS 108 AND 109

(Clauses 135 to 145)

Summary of proposed amendment

Sections 93(2)(b), 94(2)(b), (c), 95(2)(b), 97(3)(a), 97B(3)(a), 98(2)(a), 98B(3)(a), 99(2)(a), (b), 100(3)(b), 101(2)(a) and 101B(2)(a) are being amended to confirm that:

- the Commissioner cannot amend an earlier assessment made under any of those provisions outside the time-bar period; and
- section 109 applies in relation to these provisions.

These amendments correct cross-referencing to sections 108 and 109 of the Tax Administration Act 1994.

Application date

The amendments will apply from 1 October 1996.

Background

In a recent court decision (*Vinelight Nominees Limited v CIR* [2012] NZHC 3306), Peters J identified a remedial issue within section 99 of the Tax Administration Act 1994, concerning the relationship of section 99 to section 108 of the Tax Administration Act 1994. Peters J stated:

[100] There is an obvious difficulty with s 99(2)(a), because s 108(1) does not include the words “income tax for any year”.

The judge’s comments in the *Vinelight* decision highlight a technical problem that the time bar may not apply to resident withholding tax (RWT) assessments. The words identified by Peters J, “income tax for any income year”, were repealed in 1996 as part of the reforms of the disputes resolution legislation. Section 99 of the Tax Administration Act 1994 was not updated at that time to reflect the new wording in section 108(1). The same cross-referencing problem arises in a number of provisions from section 93 to section 101B of the Tax Administration Act 1994.

Similar drafting issues arise from the use of the term “taxpayer” in a number of provisions from section 93 to section 101B of the Tax Administration Act 1994 that refer to section 109 of the Tax Administration Act 1994. This is because the term “taxpayer” no longer appears in section 109.

Section 99 of the Tax Administration Act 1994 enables the Commissioner to assess a person for RWT if the Commissioner considers that person has not paid the correct amount of RWT. Under the RWT rules, a person paying resident withholding income is required to withhold RWT and pay to the Commissioner the amount of RWT withheld on a periodic basis.

The reference in section 99(2) of the Tax Administration Act 1994 to section 108(1) of the Tax Administration Act 1994 is necessary to ensure that the Commissioner cannot amend an earlier RWT assessment outside the time-bar period. Peters J's comments in the Vinelight decision highlight a technical problem that the time bar may not apply to RWT assessments.

Section 108(1) imposes a time limit (time bar) on the Commissioner's power to amend an earlier assessment of income tax. That time-bar period is four years after the end of the tax year in which the earlier assessment was made.

Section 109 of the Tax Administration Act 1994 provides that disputable decisions are treated as correct unless a challenge is lodged against that decision, but the provision no longer uses the word "taxpayer". Disputable decisions include assessments by the Commissioner and most decisions of the Commissioner in relation to the application of a tax law to a taxpayer's circumstances.

Again, this drafting issue results from these provisions not being updated correctly in 1996 to reflect the amended wording in section 109.

TRUSTS THAT ARE LOCAL AND PUBLIC AUTHORITIES

(Clauses 25 and 26)

Summary of proposed amendment

Amendments to section CW 38 and CW 39 clarify that an amount derived by a trustee for a local authority or a public authority constituted as a trust:

- does not enjoy the exempt income status under sections CW 38 or CW 39 if that amount is retained and included in trustee income of the trustee; and
- is exempt income if that amount is distributed to a beneficiary that itself is exempt from income tax in relation to that distribution.

Application date

The amendment applies from the commencement of the amending Act.

Background

The Income Tax Act 2007 currently exempts from tax any amount derived by a local authority and a public authority other than “an amount received in trust”. The exact meaning of these words is unclear and their interpretation has caused difficulty for taxpayers and Inland Revenue.

The policy is that this exemption should not extend to amounts that a local authority receives as a trustee. However, if the trustee receives an amount (other than as trustee for a beneficiary which itself enjoys exempt income status).