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

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

March 2013

Prepared by the Policy Advice Division of Inland Revenue and the Treasury

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Livestock valuation

IRREVOCABILITY OF HERD SCHEME LIVESTOCK ELECTION

Clauses 28 and 29(1)

As part of the Budget 2012 legislation, section EC 8 of the Income Tax Act 2007 was amended so that, from 18 August 2011 (the date the officials' issues paper, *Herd scheme elections*, was released) elections by farmers to use the herd scheme could not be revoked. As a consequential to other livestock valuation amendments proposed in this bill, that legislation has been rewritten.

Submission
(New Zealand Institute of Chartered Accountants, WHK)

The application date of this amendment should be 24 May 2012 when the Budget 2012 amendments were introduced, instead of the retrospective date of 18 August 2011.

Comment

WHK argues that retrospective legislation is inappropriate unless there are exceptional circumstances or a high revenue risk. The Ministers of Finance and Revenue, when they announced this amendment on 28 March 2012, advised that the change was to prevent an estimated $275 million loss in the tax base over the next few years. Any change to the application date would not be appropriate.

Recommendation

That the submission be declined.

CESSATION OF FARMING – GENERAL RULE

Clause 30

The bill proposes that section EC 20 of the Income Tax Act 2007 be amended so that when a farmer sells up and retires, they should be required to use the herd values nearest to the date of sale to calculate their final livestock tax liability. Presently, when they sell up before 31 January and cease deriving farming income they have a choice of whether to use last year's or the current year's herd values to calculate this final tax liability. This choice results in a systemic fiscal tax opportunity against the revenue base for farmers, who will always choose the most tax advantageous result.

Submission

(New Zealand Institute of Chartered Accountants, WHK)

Retiring farmers should still have an option about which herd value to use.

Comment

NZICA states in its submission:

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

The quote from NZICA's submission answers the submission. Officials agree – farmers should not be left with a potentially fiscally expensive systemic tax opportunity in this situation. The proposed amendment in the bill prevents that.

Recommendation

That the submission be declined.

Submission

(WHK, Brandt Segedin LP)

The application date of this provision should be deferred from 28 March 2012 to the commencement of the 2013–14 income year (*WHK*), or the 2012–13 income year (*Brandt Segedin LP*).

Comment

The WHK submission effectively asks for the deferral of the switching of the rules that used to offer retiring farmers a potential tax advantage. The 28 March 2012 announcement was unequivocal. While the baseline effect of extending this may not be very significant, most farmers and their accountants would have acted through 2012–13 as if it had been repealed, and would not have made elections. Farmers who did make elections were presumably hoping for a windfall gain.

Both submissions suggest that the 28 March 2012 application date would cause confusion because the commentary to the bill suggests that the effective application date is the 2012–13 income year. Officials doubt that this will result in any real confusion, but there is no reason why the application date could not be the start of the 2012–13 income year. This is not a substantive change.

Recommendation

That the submissions be accepted in part, and apply from the commencement of the 2012–13 income year.

Submission

(Chapman Tripp)

The pre-1993 version of the "cease farming" election should effectively be re-instated. This referred to the farmer ceasing farming, whereas the 1993 version (still current) refers to the farmer ceasing to derive farming income.

Comment

The cease farming election as introduced in 1989 had no explicit requirement that the farmer cease deriving income from farming. All the farmer had to do was cease farming to qualify for the election. The objective of the election was to allow farmers to finalise their farming tax affairs if they ceased farming before the end of their income year. This implies that they must cease deriving income from farming otherwise, how could they be said to have ceased farming and be in a position to finalise their farming tax affairs.

The requirement to cease deriving income from farming was inserted as part of the 1993 rewrite of the livestock valuation provisions. Because this was a very small part of a much larger rewrite, no specific detail on the rationale behind the change is available, but it logically follows from the objective of the provision.

The rule is unambiguous and has been unchanged for almost 20 years. The submission arises because dairy farmers typically recognise their bonuses from their dairy companies on more of a cash basis, and the last of these bonuses is paid out in July or August, which is in the retired farmer's next income year. Thus it is clear that the farmer cannot finalise their affairs for the year in which they sold their livestock and thus there is no need (or capability) to finalise their farming tax affairs in the year in which they sold their livestock.

Recommendation

That the submission be declined.

DISPOSAL OF LIVESTOCK TO AN ASSOCIATED PERSON

The bill contains provisions to prevent associated persons transactions (say a sale by a farmer to a family trust of which he or she is a beneficiary) from being used to avoid the compulsory nature of the herd scheme. The purchaser has to assume any herd scheme election and base herd scheme numbers of the vendor. In effect this means that both parties use the same herd scheme values for tax purposes for their closing values in the year of the transfer and as a result one party's taxable income is the other party's taxable loss to the extent the transfer values differ from the herd scheme values.

Submission
(New Zealand Institute of Chartered Accountants – supplementary submission)

That NZICA understands the tenor of this proposal.

Recommendation

Noted.

Submission
(KPMG)

Requiring associated parties to also use the herd scheme goes too far.

Comment

Inland Revenue is currently reviewing the 2009 tax returns of about 400 dairy farmers who conducted associated persons transactions. Some of these may be found to be tax avoidance, and, if so, the average tax avoided is about $100,000 per farmer. If avoidance is found, the issue is about using associated party transactions to exit from the herd scheme.

The submission suggests this goes too far without putting up an alternative. During consultation there was agreement that the associated persons issue should be addressed, No satisfactory alternative mechanisms have been found.

Recommendation

That the submission be declined

Submission
(New Zealand Institute of Chartered Accountants – supplementary submission)

The 31 October date that applies to determine whether to use opening or closing herd scheme values for non-associated party sales when there is a cessation from farming should also apply to associated persons transactions.

Comment

The associated persons tax position on a transfer of herd scheme livestock is a mirror image – one party's gain will be the other party's loss. The submission notes that the closer we get to herd scheme values the less volatile the tax impact will be. Further, as NZICA points out, this is consistent with the treatment of non-associated persons sales where the volatility objective is the same.

However, this can only easily work in situations when the vendor sells all of their specified livestock. When there is a partial sale the vendor still has to calculate an opening herd scheme adjustment and it would be inappropriate to require this to be partially turned off. However, the underlying point is addressed by the next submission.

Recommendation

That the submission be declined.

Submission
(New Zealand Institute of Chartered Accountants – supplementary submission, WHK)

Solely for tax purposes, the associated persons transaction should be deemed to take place at herd scheme values.

Comment

The submission suggests that total tax neutrality can be achieved if, solely for tax purposes, the transaction is deemed to take place at herd scheme values. NZICA points out that this would be an appropriate extension of "the unique features of the herd scheme's capital adjustments that distinguish herd scheme livestock from more ordinary trading stock".

Officials believe the submission has merit. The bill forces the associated person to step into the shoes of the vendor for some herd scheme reasons – herd scheme elections and the herd scheme base number calculations. This merely extends that concept.

Recommendation

That the submission be accepted.

Submission
(New Zealand Institute of Chartered Accountants – supplementary submission)

The purchaser should be deemed, for income tax purposes, to acquire the herd scheme livestock in the same year the vendor sold it.

Comment

NZICA points out that the objective of this submission is to achieve symmetry between the two associated parties in the unusual situation when the parties have different balance dates.

Officials agree that when the person acquiring the herd scheme livestock does so in a different income year to the income year that the vendor sold the livestock, the herd scheme adjustment does not work properly for the purchaser.

Recommendation

That the submission be accepted.

Submission
(Ernst & Young)

Proposed section EC 4B should be amended to make it clear which parties to an associated persons transaction its various subsections are referring to.

Comment

Officials agree that further clarity can be provided.

Recommendation

That the submission be accepted.

EXCEPTIONS TO THE ASSOCIATED PERSONS RULE

The bill proposes an exception to the proposed associated persons rule when there is a genuine inter-generational transfer of an ownership interest in livestock to children or grandchildren. The suggested grounds for this are very limited, and essentially require the children or grandchildren to have no direct or indirect ownership interest in the livestock before the transfer and the parents or grandparents to have no direct or indirect ownership interest in the livestock after the transfer. This is to ensure that the inter-generational transfer is genuine.

Submission
(New Zealand Institute of Chartered Accountants)

NZICA supports the concept of this exception.

Recommendation

Noted.

Submission
(New Zealand Institute of Chartered Accountants)

The exception should be extended to beneficiaries of a trust (whether the trust owns the livestock directly or indirectly) where they only have a beneficial interest in the trust.

Comment

Given the modern discretionary trust, a "beneficial interest" could amount to almost all the privileges of ownership (for example, receipt of all the farming income). In this case it is not viable to suggest that the beneficiary is not already, at least economically, an owner of the livestock.

Further, it would be very difficult to distinguish this "full ownership" beneficial interest from beneficial interests that were considerably less than this. Further, from a tax policy perspective, this seems inappropriate – if the children or grandchildren have an direct or indirect interest in the income from the sale of livestock then they have, at least in an economic sense, an interest in the livestock.

Recommendation

That the submission be declined.

Submission
(New Zealand Institute of Chartered Accountants)

The exception should be extended to situations when the children or grandchildren receive their direct or indirect interest in livestock by way of a testamentary bequest.

Comment

When the older generation has ceased farming and the younger generation has begun farming as a result of the death of the famer the policy parameters for inter-generational relief apply. The present drafting of this relief does not look beyond the testamentary trust in deciding association and therefore “tainting”. Thus, as the bill was introduced, relief would not be available.

Recommendation

That the submission be accepted.

Submission
(WHK)

Inland Revenue should be given a discretion in determining which associated persons’ transactions the exception applies to.

Comment

In the last 10 years Parliament has removed most of the discretions that used to apply. In their place the legislation has been amended to provide more certainty. Inland Revenue would not have the resources to review applications on a taxpayer-by-taxpayer basis.

Recommendation

That the submission be declined.

Submission
(New Zealand Institute of Chartered Accountants)

The farming structure should not dictate whether or not the exemption applies.

Comment

We have discussed this with NZICA and they now agree that this submission has been addressed.

Recommendation

That the submission be noted.

Submission
(Ernst & Young)

The definition of "associated persons" should be revisited as it seems that siblings of either generation, or grandparents, who are operating independently could "taint" the transaction and inappropriately limit the conceptually correct application of the exception.

Comment

Officials agree that associated party farmers that are completely independent could limit the application of the exception. This would further and inappropriately limit what is already, by intent, a relatively narrow exception.

Recommendation

That the submission be accepted.

Submission
(New Zealand Institute of Chartered Accountants, WHK)

Use of the term "in the ordinary course of business" as a limitation to the more general associated persons rule should be clarified.

Comment

WHK submits that the bill should be amended to provide further clarity. We have discussed this issue with the other submitter, NZICA, which agrees that any clarification should be by way of example in the *Tax Information Bulletin*. The *Tax Information Bulletin* is published by Inland Revenue when the legislation is enacted.

Recommendation

That the submission be accepted, and an example be provided in the relevant *Tax Information Bulletin*.

Submission
(Matter raised by officials)

The limitation that requires the vendor to cease deriving income from specified livestock should be marginally widened.

Comment

The concern is that the vendor might retire to a lifestyle block and keep a few animals. This should not disqualify the parties from accessing the exception to the associated persons rule. An amendment to insert a business requirement into the cessation rule would address this.

Recommendation

That the submission be accepted.

LIVESTOCK CLASSES

Clause 59

The bill proposes that, from the tax year ended 31 March 2013, the Friesian and Jersey beef cattle classes, and the Red and Wapiti deer classes, be combined as at the margin it can be difficult to determine which class a particular line of stock should be in. Further, there are anecdotal suggestions that some advisors view this as an opportunity for tax planning.

Submission
(New Zealand Institute of Chartered Accountants, WHK)

This should be deferred as the legislation will not be passed by May 2013 when the 2013 herd values will be announced.

Comment

The submission is correct. However, in the circumstances it is appropriate to deal with the underlying dilemma and suggested opportunity. This could be done by requiring that, for the purposes of calculating minimum herd scheme numbers for the 2012–13 income year, these classes are combined.

Recommendation

That the submission be accepted and instead, for the 2012–13 year, the classes of Friesian and Jersey dairy cattle, and Red and Wapiti deer, be combined for the purposes of calculating minimum herd scheme numbers.

LIVESTOCK VALUATION ELECTIONS

Submission
(WHK)

The present requirement for farmers to make a separate written election to use the herd scheme should be repealed.

Comment

This requirement has existed since the herd scheme was introduced in 1997. The need for it has been well illustrated over the last few years when the various herd scheme rules have been pushed to the boundary, and, in some cases, potentially over the boundary. Inland Revenue's use of this written notice has been a part of ensuring that farmers have complied with the various technical rules over this period.

While the amendments proposed in the bill should limit opportunities for farmers and their accountants to push the boundaries, this has yet to be proven. In the meantime, officials believe that the information gained from this notice is still necessary.

Recommendation

That the submission be declined.

Assets expenditure

OVERVIEW

Background

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

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

Generally, under current law, owners will claim that their asset is available for income-earning use when the asset is not being used privately. This provides them with a basis for claiming tax deductions for expenses relating to this period. However, if the asset is primarily a private asset, or the income-earning and private use are relatively equal, the level of deductions owners can claim will not be aligned with the actual income-earning use of the asset.

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

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

Key concepts in the bill

The bill proposes new rules that prescribe the amount of deductions that owners of certain assets can claim. Generally, the rules will apply to assets which are used to earn income, are used privately, and are unused for more than 62 days in an income year.

There are three possible ways to deal with the deductibility of expenditure incurred in relation to a mixed-use asset which does not relate directly to income-earning or private use – such as mortgage interest or rates which relate to periods when the asset was unused:

- Allow deductions for all such expenditure, on the basis that the asset is available for income-earning use when empty (the present rule).
- Deny deductions for all such expenditure, on the basis that the asset is essentially a private asset.
- Allow deductions for some proportion of those costs, on the basis that the asset has a dual purpose.

These proposals choose the proportionate deduction approach. This allows a deduction for general expenditure on the basis of actual income-earning use divided by the total actual use of the asset. So, if an asset is used privately for 30 days, and used to earn income for 30 days, 50 percent of most expenditure will be an allowable deduction.

Specific rules for companies

The new rules apply to assets held by individuals, partnerships and certain companies. Proposed rules for companies override the general rule for companies that interest incurred by companies is always deductible (subject only to the thin capitalisation rules), regardless of the use of the borrowed funds. The special interest deductibility rules in companies also extend to other companies in the same group as the company that owns the mixed-use asset and to shareholders.

Deduction quarantining

Under the proposed changes in the bill, asset owners who generate a loss from their asset and earn less than a 2% rate of return are not able to offset that loss against other income, but can carry it forward to use against future income from the mixed-use asset. This rule is designed to address situations when use is low and the chosen apportionment rule does not deliver a sensible outcome.

Application dates

The proposals in the bill as introduced apply from the commencement of the 2013 income year.

Fiscal implications

It is forecast that this measure will have a revenue gain of approximately $50 million a year.

General theme of the submissions received

Submissions were received from 11 submitters on the mixed-use asset proposals. Submitters ranged from the New Zealand Institute of Chartered Accountants and the New Zealand Law Society to professional firms and businesses involved in renting mixed-use assets. No submissions were received from actual owners of mixed-use assets.

Most submitters stated that they supported the approach of apportioning expenditure based on the use of the asset as set out in the bill. No submitters opposed it.

Matters raised by submitters were:

- concern about the degree of complexity of the rules applying to companies, in particular; and
- concern about the proposed loss quarantining rules.

A number of other comments, including many technical comments, were also raised.

MAIN POLICY ISSUES RAISED IN SUBMISSIONS

Issue: The proposed commencement date of the 2013–14 income year is effectively retrospective

Submissions

(New Zealand Institute of Chartered Accountants, Deloitte, Bell Gully, KPMG)

The bill is likely to become law in the second half of 2013 calendar year, but applies from the commencement of the 2013–14 income year. The 2013–14 income year starts on 1 April 2013 for most taxpayers, and even earlier for some. This means the legislation is effectively retrospective, and does not provide an opportunity for taxpayers to plan for it. It should be deferred by a year, and take effect from the beginning of the 2014–15 income year.

Submitters also suggested that "transitional rules" should be provided to allow companies to transfer assets to other entities.

Comment

The policy objective of these measures is to achieve a better balance of fairness between those who own mixed-use assets and those who do not. It is obviously desirable to achieve fairness sooner than later.

The Government's intention to reform this area was first announced in the Budget of May 2011, followed by an issues paper released in August 2011. Taxpayers have therefore had some prior warning that change was likely in this area. While those earlier statements did not include detail about the interest rules for companies in particular, the bill was introduced in September 2012 which gave six months for a risk-averse taxpayer with the standard 31 March balance date to restructure their affairs.

There are two transitional rules requested by submitters:

- a rule dealing with the tax consequences of depreciation recovery, when an asset is transferred for more than its tax book value; and
- a rule dealing with the deemed dividend implications of the transfer of an asset from a company to a shareholder or associate for less than its market value.

These changes have been requested to enable assets to be transferred out of companies without "adverse" tax consequences.

Officials consider that these concerns have some merit, and make the following recommendations.

The bulk of mixed-use assets will be short-term holiday accommodation. Discussions with external parties lead officials to understand that most baches will be held in simple ownership structures, where the concerns raised by submitters are less. Officials therefore recommend that the 2013–14 income year commencement date should continue to apply to these assets.

Other assets – boats and aircraft – make up a small percentage of the pool of mixed-use assets. Due to difficulties ascertaining the number of these assets which potentially fall within the mixed-use asset rules, and the mix of their income-earning and private use, they have not been included in the fiscal estimate of these proposals. Given the smaller number and lower values of these assets compared with baches, we expect the revenue raised from them to be a relatively small proportion of the total revenue raised.

Some of these assets, in particular aircraft, will possibly be held in more complex structures for commercial (rather than tax) reasons.

For these reasons, officials therefore consider that it would be reasonable to defer the implementation date of the mixed-use asset rules to assets other than land until the commencement of the 2014–15 income year. While the revenue collected from them will be a relatively small proportion of the total revenue raised, it is important that they are included in due course from a fairness perspective.

The interest-stacking rules which apply to companies can have some adverse effect on the tax positions of those companies, and those who control those companies may choose to transfer the assets out of companies into other ownership structures where different interest allocation rules apply. Where those assets have been depreciated to a value below their market value, depreciation recovery will be triggered.

Submitters have proposed that a transitional rule be introduced under which assets can be transferred out of companies without triggering depreciation recovery. Officials consider that it is reasonable to allow assets to be transferred on this basis, provided that assets are transferred to shareholders in proportion to their shareholding, and the shareholders acquire the assets at the same tax book values as the company which transferred them. This means that a tax liability for depreciation recovery will arise if the shareholders subsequently dispose of the asset for an amount greater than the asset's tax book value.

Officials consider that this rule need only be made available until the end of the 2013–14 income year, and that it should only be available to companies which hold mixed-use assets at 31 March 2013.

In light of the above approach to dealing with assets held in companies, officials do not consider that an exemption from the dividend rules as requested by some submitters is necessary.

Recommendation

That the submissions be accepted, in part.

Issue: The rules are unduly complex

Submissions
(Ernst & Young, Chapman Tripp, New Zealand Institute of Chartered Accountants, New Zealand Law Society, Deloitte, Bell Gully)

Submitters' concerns about complexity took a number of forms:

- The rules should either not proceed or be revised and redrafted to provide a much simpler approach.
- The rules need to be simple, because they are to be applied by relatively small and unsophisticated taxpayers.
- The complexity creates a risk of non-compliance.
- Rather than enacting such complex rules, it would be better to focus on the enforcement of apportionment rules already contained in the Income Tax Act 2007.
- The entry criteria should be high and focused on situations when the current outcomes are inappropriate.

Comment

The bill as introduced contained two main areas of complex legislation:

- the rules which deal with interest deductions in corporate groups; and
- the rules which deal with deduction quarantining in corporate groups.

The main issue which arises is the ability for an interest deduction, which relates to the holding of the mixed-use asset, to be incurred in another entity in a corporate group. It is necessary to look beyond the company that owns the assets to other companies and shareholders which incur interest costs to ensure the arrangements which already exist now are treated fairly. Further, without rules addressing interest deductibility in complex structures, officials expect that the number of assets held in such structures would increase. These rules are therefore necessary and unavoidably complex.

However, these complex rules only need to be considered by taxpayers when the structure in which the mixed-use asset is held is itself complex. The rules are relatively straightforward to apply when, as will be almost always the case, the asset is not held in a complex structure.

However, officials understand that a relatively small proportion of mixed-use assets are held in companies, and of those, a much smaller proportion are held in complex corporate groups. Officials suggest that the Committee consider the proportion (and circumstances) of mixed-use assets these complex rules will apply to, rather than the number of pages of the bill they occupy. Detailed recommendations later in this report do, however, seek to streamline these rules where possible.

The majority of mixed-use asset owners, which are individuals, partnerships, qualifying companies, look-through companies and trusts, will be primarily concerned with the core apportionment rule, which officials do not consider to be complex, and which has been broadly accepted by submitters. A number of detailed recommendations have been made later in this report to streamline this and other rules which apply to these asset owners.

The deduction quarantining rule is required to deal with the consequences of the application of the simple apportionment formula to expenses. This is explained in more detail later in this report.

We do not agree with the submission that the policy objective can be achieved by enforcement of existing legislation. The approach that a full deduction can be claimed for "empty but available for use days" is made under current law and an attempt by the Commissioner to enforce a different approach is very likely to be unsuccessful. Even if the Commissioner were to be successful, current law would effectively permit sheltering of interest in structures involving companies, and these structures would soon become ubiquitous. The fairness objectives of these proposals would not be achieved by this approach.

Finally, Inland Revenue hopes to be able to make an on-line tool available for asset owners and tax agents to help them to make the calculations required by this legislation.

Recommendation

That the submissions be declined.

Issue: The rules applying to companies are too complex

Submission
(BusinessNZ)

Some amendments to the fringe benefit tax (FBT) and deemed dividend rules would meet concerns in this area.

Comment

The policy objective of the mixed-use asset rules is to better align deductions that are claimed with the taxable income that is earned. This is achieved by limiting the deductions which can be claimed for periods when the asset is not in use.

FBT and the deemed dividend rules take a different approach, which is to impose a tax liability on the private use of a company's assets. For the FBT or the deemed dividend rules to address the policy issue here, it would be necessary for an FBT liability or a deemed dividend to arise when the asset was unused.

This would give rise to a number of concerns:

- It would be conceptually difficult for people to understand why a tax obligation would arise when their asset was available for use, even though they did not use it.
- It would be necessary to ascribe a value to unused days. This would be difficult because it would not be appropriate to ascribe the same value as a day of actual use. Therefore the question would arise over what value would be appropriate – for example, would it be 90 percent, 30 percent or 25 percent of the value of an actual day of use?
- It would inevitably generate entirely different outcomes from a deduction apportionment rule. Incentives would be created for people to move assets into, or out of, company structures to reduce their tax liabilities.

Recommendation

That the submission be declined.

Issue: Interaction between these rules and other provisions which deal with personal use of assets

Submission
(New Zealand Institute of Chartered Accountants, KPMG, PricewaterhouseCoopers, Ernst & Young)

Under current law, FBT and deemed dividend rules apply to tax private use of company assets. The mixed-use asset proposals do not explain their relationship with these rules, and there is a concern that a form of double taxation would arise if both the mixed-use asset and the FBT or deemed dividend rules were to apply.

Comment

The FBT and the deemed dividend rules work well where a shareholder or an associate uses an asset owned by a company, but they do not deal with the time the asset is not used but available for use. As a general principle, the policy objective of the proposals of matching deductions to income-earning use is therefore more likely to be achieved by the mixed-use asset rules applying rather than the FBT or deemed dividend rules. This is also more likely to create an entity-neutral outcome, under which the incentive to move assets in or out of companies to achieve a more favourable tax outcome is minimised.

However, this is subject to several important caveats.

Officials have recommended later in this report an amendment to the definition of “assets to which these rules apply”. Certain assets where the private use is incidental and subject to FBT or the deemed dividend rules are recommended to be excluded from the proposed mixed-use asset rules.

Officials agree that, where the mixed-use asset rules apply, FBT should not also apply, and that a new provision should be included to this effect. Officials also note that, where the benefit provided is in the form of accommodation, an income tax liability may arise to the recipient. Officials recommend that where the mixed-use asset rules apply, the provision of accommodation not give rise to an income tax liability. In any circumstances where FBT does apply, or the provision of accommodation gives rise to an income tax liability, the use should be treated as an income-earning day under the apportionment formula.

This is subject to an additional change in the area of shareholder-employees, who can choose whether the use of an asset is subject to the FBT or dividend rules. The use ought always to be subject to the deemed dividend rules, so that the mixed-use asset rules apply. This amendment is necessary because, where use is relatively low and expenses high, FBT will generally give a more favourable outcome than the mixed-use asset rules and to allow a choice would provide a tax planning opportunity.

However, officials do not agree that where the mixed-use asset rules apply, the deemed dividend rules should not also apply. A simple comparison can be made with a cash dividend. A cash dividend is not deductible to the company which pays it, but is income to an individual who receives it. Imputation credits may be available to meet the tax liability on that income. This is exactly the same result that would be achieved by having both the mixed-use asset and the deemed dividend rules apply to an asset.

Recommendation

That the submission be accepted, in part (see later recommendation).

Issue: The interest rules which apply to companies unfairly treat debt as applying to the mixed-use asset first

Submission
(KPMG, Bell Gully, New Zealand Institute of Chartered Accountants, New Zealand Law Society, Chapman Tripp, PricewaterhouseCoopers, Ernst & Young)

The debt-stacking rule which applies to corporate groups is unfair because it is based on an assumption that any borrowings firstly relate to the mixed-use asset. A number of submitters suggested that a debt-tracing rule be available instead, and some submitters suggested that a gross assets / gross debt formula be used instead.

Comment

The policy objective of the proposed rules is to ensure that only an appropriate proportion of the expenditure which relates to a mixed-use asset is deductible.

Since 2001, a rule has existed under which all debt incurred by most companies is deductible (subject only to the thin capitalisation rules). This rule overrides the tracing rule that would otherwise apply, which requires identification of the application of each amount borrowed by a company to determine whether the interest was deductible or not. The rule that all debt was deductible was introduced to address the compliance costs which companies were incurring in ensuring that all of the interest they did incur was deductible. The 2001 rules are based on two related assumptions:

- all money is fungible; and therefore
- tracing is essentially impossible in corporate groups.

Submissions stating that debt relating to a mixed-use asset can somehow be traced inside a corporate group runs counter to the basis on which the 2001 rules operate. Officials' view is that it would be conceptually inconsistent to operate two sets of rules, one assuming companies could trace debt and the other assuming they could not, at the same time. Corporate groups would eventually structure their affairs to ensure that no debt was able to be traced to the mixed-use asset and so avoid apportionment of any interest expenditure.

Other submitters suggested a gross assets / gross debt formula. This approach requires first ascertaining the value of all of the assets held by the group, the value of assets held by other corporate shareholders that have an interest in the company which holds the asset, and the value of the shares in the group held by natural (individual) persons. All of the debt held by all of the members of the group, other corporate shareholders and the relevant debt held by natural persons then needs to be identified. A ratio is then calculated which is the value of the mixed-use asset divided by the total asset value calculated earlier. This ratio is then applied to the interest expenditure of every member of the group and the relevant interest expenditure of any corporate and individual shareholders to calculate the part attributable to the mixed-use asset. The apportionment ratio is then applied to deny a deduction for a part of that interest expenditure by each group company and each shareholder.

Officials consider that the requirement to collect information from every group member and every shareholder, and for each to be denied a proportion of their interest deduction, makes this an extremely compliance-heavy approach compared with the interest-stacking rule. Under the interest-stacking rule, once sufficient debt has been identified (which may well be in the asset-owning company or its immediate parent) interest deductions in other companies and shareholders are unaffected by the mixed-use asset rules.

Recommendation

That the submission be declined.

Issue: Interest rules set a dangerous principle for denying deductions for other interest costs not incurred in generating assessable income and should not proceed

Submission
(BusinessNZ)

These rules set a dangerous precedent for unprincipled, wide-ranging and complex interest allocation and ring-fencing rules. The rationale is that no deduction should be allowed for interest costs which are not incurred in generating income. This reasoning could also be applied to interest incurred to generate untaxed offshore income or assets which do not produce income (such as land which is land-banked).

Comment

The submission is understandable, but it misinterprets the purpose of the proposals. The concern with an element of mixed-use asset expenditure is not that it is not incurred in generating income, but that it is incurred to deliver a private benefit.

Recommendation

That the submission be declined.

Issue: Interest rules are too complex, unprincipled and a deemed income solution would be preferred

Submission
(PricewaterhouseCoopers)

Interest rules are complex and there is concern about the interest allocation proposal. A deemed income solution would be preferable.

Comment

The policy objective of the rules is to appropriately match deductions for expenditure incurred in relation to an asset with the balance of its income-earning and private use. A further important objective is to do this in a way which is relatively neutral across entities, to minimise the incentive for people to shift assets from one entity type to another to reduce their tax liability.

Using a deemed income rule for companies instead of applying the apportionment rule to interest would create the following problems:

- Different tax outcomes would arise between companies subject to the deemed income rules, and other entities which would presumably not be.

- Setting the appropriate rate of return would be difficult, highly subjective and extremely controversial.
- A deemed income approach would effectively set a base-line, which would mean that those who actually earned less than the prescribed level of income would be over-taxed (and those who earned more would be under-taxed).

Recommendation

That the submission be declined.

Issue: Apportionment of interest deductions should only apply to the company which owns the asset

Submission
(Ernst & Young, KPMG)

Only the company which holds the asset should be subject to apportionment-of-interest deductions. KPMG suggests that if debt is deliberately structured elsewhere the anti-avoidance rules can be applied.

Comment

The policy objective of the rules is to ensure that deductions for expenditure align with the income-earning use of the underlying asset. It is extremely easy to ensure that interest deductions arise in a different entity than the one which holds the asset by having the asset owned in a company which purchases it with cash. The cash in the company comes from the allotment of fully paid-up share capital. The funds to purchase the share capital are borrowed by the shareholder (corporate or otherwise) who subscribes for the shares. Since the money was borrowed to purchase shares in a company, a deduction is generally allowed in full for any interest incurred.

This is the reason it is necessary to apply the rules on interest deductions beyond the company which owns the asset. If this was not done it is conceivable that the transfer of mixed-use assets into company structures as described above would become commonplace, defeating the policy intention of the rules.

Officials consider that relying on the application of anti-avoidance rules to address such transactions would be inappropriate, inefficient, and would give rise to considerable uncertainty. Further, this would be an unusual use of these rules.

Recommendation

That the submission be declined.

Issue: Regulatory impact statement

Submission
(New Zealand Institute of Chartered Accountants)

The regulatory impact statement understates the level of compliance costs arising from interest-stacking rules on companies and shareholders.

Comment

The regulatory impact statement acknowledges that compliance costs for asset owners would be likely to increase, particularly in the short term, as owners will be unfamiliar with the new rules. It went on to state that the additional compliance costs would be expected to reduce in the long-term as owners become more comfortable with the new rules.

We acknowledge the submitter's concern.

The interest-stacking rules only become complex to apply when the structure in which the mixed-use asset is held is complex. Officials consider, having discussed this issue with external stakeholders, that a very small minority of mixed-use assets will be held in complex structures, and often they will be there for tax reasons.

Recommendation

That the submission be noted.

Issue: No justification for deduction quarantining rules

Submission
(New Zealand Institute of Chartered Accountants, New Zealand Law Society, KPMG, PricewaterhouseCoopers, Ernst & Young, Bell Gully)

The deduction quarantining rules are unnecessary and should be removed as the apportionment rules already provide equitable outcomes.

Comment

There were a number of alternative approaches to determining the deduction entitlement arising from days a mixed-use asset is unused. The principal options were:

Approach one: allowing full deductions for expenditure relating to unused days, on the basis that the asset was available for income-earning use on all of those days (the present rule);

Approach two: disallowing a deduction for the expenditure relating to unused days, on the basis that these are essentially private assets (the tightest rule); and

Approach three: allowing a deduction for a proportion of the expenditure relating to unused days, recognising that there is validity in both of the above approaches.

The different outcomes that each approach delivers can be demonstrated with a simple example:

Example

A bach has annual expenses of $20,000 and is rented for 30 nights per year at $200 per night, and used by its owners for 30 nights per year.

	Apportionment equation	Allowable deductions	Profit (loss)
Approach one	(335/365) x $20,000	$18,356	($12,356)
Approach two	(30/365) x $20,000	$1,644	$4,356
Approach three	(30/60) x $20,000	$10,000	($4,000)

The third approach – a middle ground – is the key component of these proposals. The apportionment formula is applied regardless of the level of total use, or income-earning use, of the asset. This is in contrast to the approach suggested in the issues paper, which suggested a mixture of the three approaches discussed above, applying different approaches at different levels of income-earning use. This approach was not pursued in response to submissions that suggested that it was too arbitrary.

However, as demonstrated in the above example, when income-earning use is low, this middle ground is arguably too generous. This is because an asset with low levels of total use, and low levels of income-earning use, relative to its total expenses, will often generate persistent tax losses. If approach two had been taken, the taxable income would have been $4,356 and a quarantining rule would not have been necessary.

A loss of this nature might genuinely arise on a one-off or occasional basis, as a consequence of a poor rental season due to external or unforeseen factors. However, if a loss of this type is persistently generated, it suggests that the rules have allowed excessive deductions. This is because the tax outcome under the mixed-use asset rules is supposed to be a commercially realistic one, and it is not commercially realistic to have continual tax losses. Continual losses are likely to arise because tax deductions are being given for private expenditure.

In the income year in which the loss arises, it is not possible to know whether the loss is a consequence of unforeseen events, or is a consequence of excessive deductions being allowed. This can, however, be known over a number of years, because a loss due to unforseen events is unlikely to be repeated, whereas a loss due to excessive deductions being allowed under the apportionment formula will be.

The deduction quarantining rules therefore take a “wait and see” approach as a loss in a single year will be allowed against profits in future years, whereas long-term losses will effectively be permanently denied.

Officials consider this approach to be preferable to a “threshold” test which would deny deductions to those with low levels of income-earning use, because a threshold test would permanently deprive the asset owner who suffered unforeseen circumstances of the benefit of the deductions.

Recommendation

That the submission be declined.

Issue: Concepts of private use

Submissions
(Chapman Tripp, New Zealand Law Society, Bell Gully, Ernst & Young, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants, BDO)

The rules should use the derivation of market value consideration as the test for whether there is private use or not. *(Chapman Tripp)*

The concepts of private use in the “gateway” tests and the apportionment test should be the same; having different tests complicates the rules and increases compliance risks. *(New Zealand Law Society, Bell Gully, Ernst & Young, PricewaterhouseCoopers, Chapman Tripp)*

Where market value is received from an associate, use should not be treated as private use. *(Chapman Tripp, Ernst & Young, New Zealand Law Society, New Zealand Institute of Chartered Accountants)*

Where market value consideration is received for all use by owners or associates, the use should be considered income-earning use and the related expenditure fully deductible. *(New Zealand Institute of Chartered Accountants, Deloitte)*

Where less than market value is received, it is inequitable to tax the income but treat the days as private days, thereby denying any deduction. The income should be exempt, and the New Zealand Law Society and Bell Gully suggest an alternative of taxing the income but allowing a pro-rated deduction based on the proportion of market value the income represents. *(New Zealand Institute of Chartered Accountants, New Zealand Law Society, Bell Gully, Ernst & Young, BDO)*

Comment

The proposals set out two different concepts of private use – one which applies to determine whether an asset is subject to the rules or not (referred to as “private use”), and the other which is used in the apportionment formula to determine the extent to which certain expenditure will be deductible (referred to as “private days”).

An asset will be subject to the rules if it is used by the person who holds it or an associate, or the person who holds the asset derives less than market value income from its use.

However, for the apportionment formula, private days do not include days when the asset is used by an associate of the person who has the asset, provided the person pays market value.

The reason for this distinction was to prevent owners avoiding the application of the rules (particularly the deduction quarantining rules) merely by the owner or associates paying market value for the use of the asset.

Officials accept that the difference between the various concepts introduced in the bill is potentially confusing, and recommend the adoption of a single concept of private use:

- when the asset is used by a natural person who holds the asset, or an associate of that person (who is also a natural person), regardless of the amount received for the use; or
- when the amount received from the asset is less than 80 percent of the market value of the asset.

The suggested definition is simpler than two private-use concepts and still satisfies the policy concern around the avoidance of the rule. Further, it is suggested that when either of these two rules apply, any income received should be treated as exempt income. This aligns the treatment of income and expenditure, another issue raised by several submitters.

Officials do not agree that when market value is received from the owner or associate, relevant expenditure should be fully deductible. This would allow an asset which was used substantially by its owners to be treated as fully deductible if the owners made arrangements to somehow pay themselves for the use. This would defeat the purpose of the rules. A better approach seems to be, as outlined above, for the expenditure to be non-deductible (by treating the use as a private day) but the income as non-assessable.

Officials accept that it is inequitable to tax the income received from a below-market value transaction but deny any deduction by treating the days as a private day. It would be possible, but complex, to allow a pro-rated deduction, and a simpler alternative seems to be to treat both the income and the relevant deductions as outside the tax base. However, a person should not be able to elect to be outside the tax base by renting their asset for an amount slightly less than market value, as this would potentially enable them to derive untaxed profits. Officials therefore recommend a threshold of 80 percent – so that where an amount which is 80 percent of market value or greater is received, the income will be taxable and a full deduction will be allowed, and where the amount received is less than 80 percent, the income will be outside the tax base and no deduction will be allowed.

Recommendation

That the submissions that the private use and apportionment test be the same, and that receipt of amounts less than market value (where the amount is less than 80 per cent) be accepted, and other submissions be dealt with in the manner noted above.

Issue: Restriction of use of quarantined deductions

Submission
(New Zealand Law Society)

If the deduction quarantining rules are not to be removed, they should be relaxed to allow quarantined losses to be offset against income for other mixed-use assets.

Comment

As explained earlier, the purpose of the deduction quarantining rule is to address situations in which the apportionment rule has effectively allowed a deduction for private expenditure. The rule therefore needs to be applied on an asset-by-asset basis, and it is not compatible with the "wait and see" concept which underlies the rule to allow losses from one asset to be offset against profits from another in the year in which they are incurred.

Recommendation

That the submission be declined.

Issue: Deduction quarantining is a permanent denial of a deduction for business expenditure

Submission
(New Zealand Institute of Chartered Accountants)

The submitter is concerned that when a quarantined deduction arises in one year, and in a subsequent year the asset is not a mixed-use asset and generates a profit, the quarantined deduction will not be able to be offset against any subsequent profits.

Comment

As noted above, the purpose of the deduction quarantining rules is to address situations in which the apportionment rule has effectively allowed a deduction for private expenditure. When that situation has arisen, the amount quarantined is not business expenditure at all, but excess private expenditure. However, when the asset has been affected by an unforeseen event, the amount is arguably business expenditure.

Officials believe that almost all of the situations which fall within the deduction quarantining rules will be when deductions have previously been allowed for private expenditure, and that any permanent denial is appropriate.

However, a matter which the Committee's advisor has raised with officials is the application of this rule where an asset is damaged, written off by the insurance company, and replaced with another asset. In this instance, officials agree that it would be reasonable for quarantined losses to continue to be available where the replacement asset is substantially identical.

Recommendation

That the submission be declined, but that the Committee advisor's point be accepted.

Issue: Application of opt-out rules to companies

Submission
(Matter raised by officials)

The opt-out provisions in the proposals have unintended consequences when applied to companies, and should be restricted to other entities.

Comment

The proposals allow the owner of a mixed-used asset to treat any income arising from it as exempt income but not claim any deductions for expenditure relating to the asset. The owner can choose to do this in two situations:

- when the income from the asset is below a threshold of $1,000; or
- when the asset produces quarantined deductions in the income year.

The opt-out rules are designed to reduce compliance costs when assets have either low levels of income-earning use or no revenue is lost by taking the asset out of the tax system (because it is in loss anyway).

However, they have an unintended consequence when applied to assets owned by companies, which is that the disapplication of the mixed-use asset rules would allow a corporate group to claim all of its interest deductions. This is most obviously the wrong result when the asset was opted out because income from it was less than $1,000, but is also wrong when the proposals produce quarantined losses.

There would therefore be significant advantages to an asset owner of an asset which qualified under the opt-out provisions to move that asset into a company structure. This would be inefficient as well as defeating the policy intention of the rules.

Recommendation

That the submission be accepted.

OTHER POLICY ISSUES RAISED IN SUBMISSIONS

Issue: Relationship between the core provisions and mixed-use asset rules

Submission
(New Zealand Law Society, Chapman Tripp)

The relationship between the core provisions and subpart DG needs to be clarified. There is a concern that expenditure which is apportioned by the mixed-use asset rules will already have been apportioned by the core provisions. The motor vehicle logbook provisions provide a good model.

Comment

The policy intention of the mixed-use asset rules is that they provide an elaboration of the concept of apportionment which appears in the core provisions. There is certainly no intention that two "layers" of apportionment apply and officials are happy to recommend clarification of the legislation.

Recommendation

That the submission be accepted.

Issue: Treatment of capital expenditure

Submission
(New Zealand Institute of Chartered Accountants, Deloitte)

In some instances, a mixed-use asset may be used in a way which is neither private nor income-earning. An example would be when a helicopter was used to view a property which the owner was considering purchasing. This kind of capital use is already non-deductible and should be excluded from the apportionment formula.

Comment

There are two issues at stake here.

First, deductions for the actual use of the helicopter should be denied only once – having the capital component denied by the core provisions and then again by the mixed-use asset rules is not the correct outcome. This will be remedied by addressing the relationship between the core provisions and the mixed-use asset rules, as outlined above.

The second issue is the impact that this kind of non-deductible use has on the apportionment formula, which addresses expenditure which is not directly attributable to use. Much of this expenditure relates to periods when the asset is unused.

Officials consider it is reasonable for non-deductible capital use to be treated under the apportionment formula in the same way as non-deductible private use.

Recommendation

That the submission be accepted, subject to the comments above.

Issue: Application of rules to companies other than close companies

Submissions
(Ernst & Young, New Zealand Law Society)

Section DG 2(4) provides that the proposals only apply to companies which are close companies, but it is unclear whether this restriction is intended to apply just to the company which owns the asset or to all companies to which the rules might apply (such as companies which are shareholders of companies which own the asset). The application of this rule should be clarified. *(Ernst & Young)*

The current drafting of the rules would include within them a company which is a wholly owned subsidiary of a widely held company. This was presumably not intended. *(New Zealand Law Society)*

Comment

The mixed-use asset rules should only apply to a subsidiary company when any parent companies are also close companies. However, they should also apply to appropriate companies held by trusts and trustees. The rules should be redrafted to clearly achieve these objectives.

Recommendation

That the submissions be accepted.

Issue: Application of rules to look-through companies

Submission
(Ernst & Young)

The general definition of "company" excludes look-through companies (LTCs) so it is assumed that the proposed interest expenditure rules do not apply to them or where LTCs are shareholders in other companies which own mixed-use assets. The position of LTCs should be clarified expressly.

Comment

The policy intention of the rules is to capture assets which are held by individuals or in structures which are under the control of a small number of individuals. LTCs ought to be subject to these rules and an amendment is required. Limited partnerships and qualifying companies should also be explicitly dealt with.

Recommendation

That the submission be accepted.

Issue: Definition of "close company"

Submission
(BDO)

This bill would be an ideal opportunity to clarify paragraph (a) in the definition of "close company" to make it clear whether or not a "natural person" can include a natural person trustee.

Comment

This matter is being considered by officials as part of a separate project, but is not part of this bill.

Recommendation

That the submission be declined.

Issue: Guidance on what is expected to support positions taken on private use

Submission
(KPMG)

Inland Revenue should give some guidance on what is expected to support positions taken on private use.

Comment

Inland Revenue will publish information on the new rules once enacted. That information will include guidance on the records required to be kept of private use.

Recommendation

That the submission be noted.

Issue: Assets rented to associates, or for less than market value

Submission
(KPMG, Ernst & Young)

When an asset is used purely by associates, even when they pay market value, all of the use of the asset will be private use, so the mixed-use asset rules will not apply.

Ernst & Young note that this will also arise if the asset is always rented for less than market value.

Comment

Recommendations made elsewhere in this report propose to treat use by associates and use for which less than 80 percent of market value is paid as private use and as giving rise to exempt income. Officials agree that the application of the rules could be made clearer if the reference to earning "income" was changed to refer to "income (including exempt income)".

Recommendation

That the submission be accepted.

Issue: Range of assets subject to rules

Submissions
(WHK, New Zealand Law Society)

Assets used predominantly for business purposes or acquired predominantly for business purposes should be excluded from the rules. *(WHK)*

The provisions include within their ambit assets which are not made available for rental use, but which are used within a business. It is unclear whether they are intended to be subject to the rules, and how the apportionment rules should apply to them. *(New Zealand Law Society)*

Comment

Officials propose to refine the scope of the rules to more precisely capture the key assets where the policy concern arises. This could be done by an additional provision that the rules will only apply to:

- land (including buildings on land);
- boats; and
- aircraft.

This will mean that the rules will not apply to assets like bulldozers which are unlikely to deliver significant private benefit in their use.

While assets used in a business for non-rental use are not the predominant focus of these proposals, there will be some assets held in a business when private use is material, such as a helicopter which is used by a farmer and also to take the farmer and his friends heli-skiing. It is appropriate that the mixed-use asset rules apply to this kind of asset in the same way that they would apply if the helicopter was rented out and used by the owner for heli-skiing. However, an asset which is used inside a business is more likely to be acquired for the purposes of that business, rather than for private purposes. We recommend a new exemption from the rules for assets where:

- the principal use in the income year has been as part of a business, which is not a rental business; and
- the private or non-business use is minor; and
- when the asset is owned by a trust or company, the FBT or deemed dividend rules apply.

Officials prefer a test based on use in the income year, rather than "purpose of acquisition". A "purpose of acquisition" test is highly subjective and does not reflect that the use of an asset might change over time.

Recommendation

That the submissions be accepted, subject to officials' comments.

Issue: Application of rules to assets which change in use during the year

Submissions
(KPMG, New Zealand Institute of Chartered Accountants)

The rules will apply to assets which change in use during the year, such as a house which is occupied by the owner, empty for a period of time, and then rented to a long-term tenant. *(KPMG, New Zealand Institute of Chartered Accountants)*

A rental property which is rented and used privately for the entire year should not fall within the rules just because the tenant is away on holiday or working elsewhere for 62 or more days. *(New Zealand Institute of Chartered Accountants)*

Comment

Officials agree that these circumstances should not bring an asset within the rules. Two amendments are proposed to address these concerns:

- a new exclusion for residential property which is rented on a long-term basis (existing concepts used for GST will be relied on); and
- a rule that provides that when an asset changes use during the year, the mixed-use asset rules will only apply to the part of the year for which the asset is used on a short-term rental basis.

This second rule is necessary to deal with situations such as when an owner lives in a property for the first part of the year, and then uses it as a bach for their own use and for short-term rental for the second part of the year.

Recommendation

That the submissions be accepted.

Issue: Application of rules to leased assets

Submission
(New Zealand Institute of Chartered Accountants)

It is unclear whether the rules will apply to assets which are leased from an independent third party, or if they do, how the $50,000 threshold should apply. It is suggested that the threshold should apply to the lease payments made each year.

Comment

The proposals are intended to apply to leased assets. This is necessary both to reflect commercial reality and to ensure that mixed use asset owners are not able to structure around the application of the rules using lease arrangements.

The $50,000 threshold is part of the existing gateway test and provides that an asset which is not land is not subject to the rules unless it has a cost to the person of $50,000 or more. It would clearly not be sensible, and would provide a tax planning opportunity, if people were able to enter into long-term leases and not be subject to the rules because the $50,000 applied to the amount of the annual lease payments.

Officials recommend that when an asset is leased on a long-term basis, the $50,000 threshold apply to the market value of the asset when the person first leased it.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Application of $50,000 threshold to land

Submission
(New Zealand Institute of Chartered Accountants)

There is no need to refer separately to land in the gateway test – land will have a cost of more than $50,000 anyway so the $50,000 threshold on its own is sufficient.

Comment

The current gateway test provides that assets will be subject to the mixed-use asset rules if they (amongst other things) are either land or have a cost of more than $50,000.

Given land is an appreciating asset it seems possible that some taxpayers will own land which has been held for a long time and has a cost of less than $50,000.

Recommendation

That the submission be declined.

Issue: $50,000 threshold should be raised to $250,000

Submission
(PricewaterhouseCoopers)

Given the objective of the proposals is to target high-value assets, the threshold of $50,000 is too low, and should be increased to $250,000.

Comment

The objective of the proposals is not to target high-value assets; it is to increase fairness by ensuring that the owners of assets used privately and to earn income claim a fair proportion of their expenditure as deductible. The purpose of the $50,000 threshold is to exclude from the rules assets where the expenditure claimed is likely to be less significant, and the compliance costs are arguably not justified. This is inevitably arbitrary, but it is important to note that the boats and aircraft to which this rule applies can have significant maintenance costs.

Officials do not support increasing this threshold.

Recommendation

That this submission be declined.

Issue: Risk of an asset being subdivided into a number of assets to fall below the $50,000 threshold

Submission
(New Zealand Institute of Chartered Accountants)

There is a risk that people will seek to divide what is a single asset from a user perspective into a number of separate assets to fall below the $50,000 threshold. We recommend that the definition should be supplemented with a requirement that the item of property be a unit against which the extent of repairs and maintenance would be measured.

Comment

This seems a reasonable concern for assets such as power boats, where it might be argued that the motor and the hull could be treated as separate assets with one or both below the $50,000 threshold. This would defeat the policy objective of the rules. A definition which aggregates assets which are effectively used as a single asset would address this concern.

Recommendation

That the submission be accepted.

Issue: Concept of cost when a deduction is allowed elsewhere in the Act

Submission
(New Zealand Institute of Chartered Accountants)

When a deduction is allowed elsewhere under the Act in relation to the acquisition of an asset, its cost could be reduced or even zero, which may not be appropriate in some cases.

Comment

Officials agree that it would be undesirable for assets to fall below the $50,000 threshold test just because an argument could be made that their cost was reduced or even zero. This should be clarified.

Recommendation

That the submission be accepted.

Issue: Application of $50,000 threshold to partnerships and look-through companies

Submission
(Matter raised by officials)

Partners in a partnership and shareholders in look-through companies (LTCs) complete tax returns based on their share of the income and deductions. It would be unsatisfactory if applying the $50,000 threshold on an individual basis could see an asset with a total cost of more than $50,000 falling outside the rules.

Comment

It would defeat the fairness objectives of the rules if an asset which had a cost of $50,000 or more fell outside the rules just because it was owned in a partnership or LTC structure. This should be clarified.

Recommendation

That the submission be accepted.

Issue: The expression "motor vehicle" is not defined

Submission
(Ernst & Young)

Motor vehicles are excluded from the mixed-use asset rules, but the expression "motor vehicle" is not defined for these purposes.

Comment

The policy intention of the legislation is that "motor vehicle" should have its ordinary meaning in this context, so no definition is required.

Recommendation

That the submission be declined.

Issue: Single asset used for multiple purposes

Submission
(New Zealand Institute of Chartered Accountants)

The legislation does not provide for assets that can have multiple concurrent uses, and this should be amended. For example, a strata title of a building may be divided into a number of apartments used in different ways.

Comment

The intention of the legislation is that taxpayers take sensible rather than unduly technical approaches to the expression "item of property" when in instances like this the logical approach would be to apply the gateway tests to each apartment.

It is not clear how this approach could be detailed in legislation, but some examples of this approach could be provided by Inland Revenue.

Recommendation

That the submission be declined.

Issue: Exclusion for assets when "area apportionment" basis is too wide

Submission
(New Zealand Law Society)

An asset where all or part of the expenditure is apportioned on an area or other similar basis is excluded from the rules. This exclusion is too wide for an asset which has multiple uses, such as a bach which has a doctor's surgery at the front of it, and the exclusion should be made on an expenditure basis.

Comment

The general policy intention is that the mixed-use asset rules do not apply when existing similar apportionment methods apply, such as the rules under which apportionment by area is carried out.

When an asset has multiple uses as described, the mixed-use asset rules should still apply to the expenditure which relates to mixed use.

Recommendation

That the submission be accepted.

Issue: Concept of "active use"

Submissions
(New Zealand Institute of Chartered Accountants, Ernst & Young)

The concept of "use" for income-earning purposes should include periods when an amount is paid for the use of the asset which prevents any other use, but the asset is not actually used – for example, a bach is booked and paid for but the person does not show up. *(New Zealand Institute of Chartered Accountants)*

The concept of "use" does not accord with the normal position under income tax law as use for income-earning purposes – the focus of the rules should be on periods for which no income is earned from any source. *(Ernst & Young)*

Comment

The primary purpose of the concept of "active use" is to distinguish from periods when the asset is "available for use". Officials agree that the kind of time periods described above by NZICA should be treated as income-earning periods.

The issue with the approach suggested by Ernst & Young is that the issue that these proposals are seeking to address is the concept that time periods when a mixed-use asset is not being physically used to earn income, but is available and being marketed for income earning use, can be treated as use for income-earning purposes.

Recommendation

That the submissions be accepted in part, subject to officials' comments.

Issue: The concept of "private use" is too wide

Submissions
(New Zealand Law Society, New Zealand Institute of Chartered Accountants)

The concept of "private use" captures all use by the person or any associate, whether income earning or not. This is much too wide. *(New Zealand Law Society)*

It should be made clear that when the person using the asset is not the owner and is not associated with the owner – such as an employee – the use is not private use. *(New Zealand Institute of Chartered Accountants)*

Comment

The intention of this provision is to capture all situations where the asset is used by the person who holds the asset, or an associate of that person, where that person is a natural person (individual). Officials agree that the rules should be clarified to make this intention clear. The example given by NZICA is not intended to be captured by the rules.

Recommendation

That the submissions be accepted.

Issue: Market value, discounts and compliance costs

Submission
(Bell Gully, KPMG, Ernst & Young)

The definition of "market value" should be amended to provide for customary use such as volume discounts. *(Bell Gully)*

Inland Revenue should provide some guidance on what is required to establish market value, especially in circumstances when a discount has been provided because, for example, the property has proved hard to let. *(KPMG)*

Because of the compliance costs and risks of dispute, it is unreasonable to require taxpayers to establish that all income derived, even from unrelated parties, is at market value. For example, a taxpayer starting out in business may rent an asset at a reduced price for marketing purposes. *(Ernst & Young)*

Comment

The concept of market value used in the legislation is defined in the legislation and follows the fringe benefit tax definition. It refers to transactions made in the open market, freely offered, on ordinary terms, and to a member of the public at arm's length. Officials consider that the examples raised by submitters would all fall within this definition.

However, guidance material published when the legislation is enacted could confirm this point.

Recommendation

That the submissions about amending the definition of market value be declined, but the submission about Inland Revenue providing guidance be accepted.

Issue: Exclusion from private use

Submission
(New Zealand Institute of Chartered Accountants, Ernst & Young, New Zealand Law Society)

Where an asset is used as part of a business for deriving indirect income this use should not constitute private use. *(New Zealand Institute of Chartered Accountants)*

Where income is derived indirectly, it is too difficult to determine whether the income from the use of the asset is a market value amount. *(New Zealand Institute of Chartered Accountants, Ernst & Young)*

The requirement that the income derived directly or indirectly from the use of the asset is a market value amount should be removed as it is too difficult to apply. *(New Zealand Institute of Chartered Accountants)*

The only requirement for use to be excluded from private use is that a market value amount is derived from direct or indirect use, and all other provisions should be deleted. *(New Zealand Law Society)*

The requirement that the amount paid includes an amount for the services of the person should be removed, as it is too difficult to ascertain where the asset is used in the person's own business. *(Ernst & Young, New Zealand Institute of Chartered Accountants)*

Comment

The submissions refer to an exception to the definition of "private use". The purpose of the exception is to exclude ordinary business and commercial use by the owner from the definition of private use. However, officials understand that as presently drafted the exclusion may not cover all business and commercial use arrangements.

Two amendments are proposed in response to other submissions which ought to reduce the frequency with which this exemption needs to be relied upon. Use will not be treated as private use when either:

- in the income year the asset has been principally used in a business which is not a business of renting out the asset, the private use is minor and (when owned by a company or trust) that private use has been subject to FBT or the deemed dividend rules; or
- at least 80 percent of market value has been paid for the use of the asset.

However, submitters had a concern that when an asset was used in a business in a way which generated income indirectly, it was impossible to know whether the requirement that the "income derived indirectly from the use of the asset is a market value amount" was satisfied. The example was given of a farmer who used his helicopter to check on his stock. In a bad year – such as a year of drought – the farmer may make a loss. The connection between the income he derives from selling sheep and the use of the helicopter are too remote.

Officials agree that there may be a better way to address these kinds of situations, such as an exclusion from the concept of private use where the asset is used in a person's own business as part of the ordinary income earning process of that business.

Recommendation

That the submissions be accepted in part, subject to officials' comments above.

Issue: Associated persons test

Submission
(KPMG)

The associated persons test should not be varied from 25 percent to 5 percent. This creates additional complexity and compliance issues because people who are not normally treated as associated will be for the purpose of these rules.

Comment

The original intention of this amendment was to refine the targeting of the rules to companies controlled by 10 or fewer shareholders. However, the amendment is ineffective to do that, and officials recommend that it be removed.

Recommendation

That the submission be accepted.

Issue: Application of rules where reimbursement payments are received

Submission
(BDO)

It is unclear how the rules apply when a person uses an asset owned by another person and reimburses the owner for their expenditure.

Comment

Under the recommendations in this report, a payment which is less than 80 percent of the market value of the use of the asset would be treated as private use, and the income would be exempt. An amount which is 80 percent or more of market value would be an income-earning day and the income would be taxable.

Recommendation

That the submission be noted.

Issue: Treatment of time spent maintaining the asset

Submissions
(PricewaterhouseCoopers, KPMG, Bachcare, TradeMe)

Time spent by the owner preparing or maintaining the asset for income-earning purposes should not be private use. KPMG suggests an integrity measure could be to limit this to days when the property is not suitable for ordinary use. *(PricewaterhouseCoopers, KPMG)*

Owners should be allowed to stay in the property to carry out maintenance at the beginning and end of each holiday season – two days for every six-month period when the bach is rented out for 30 days in each six-month period is suggested. *(Bachcare)*

Owners should be able to stay in the property to carry out maintenance. This should not be treated as private use – staying in the property will be a practical necessity if they live some distance away. *(TradeMe)*

Comment

Careful consideration when developing these proposals was given to the concept of excluding "maintenance days" when the owner works on the asset. The following factors count against allowing maintenance days to be excluded from the private use calculation:

- The inherent difficulties with defining a "maintenance day". For example, would the person be required to spend some, all, or a substantial part of the day working on the asset? How would this be enforced?
- Allowing maintenance days to be excluded from private use would provide an opportunity for some asset owners to combine their private use with maintenance to achieve greater levels of deduction. For example, there would be a risk that bach owners could claim what is essentially a private day as a maintenance day because they mowed the lawns every two weeks or so.
- The likelihood that many owners do combine private use and maintenance.

The submissions about people needing to travel some distance to carry out maintenance are useful. Different people will value their time in different ways, but it seems likely that if people really did need to travel a considerable distance to reach their bach, and received no private benefit from being there, then they would pay for someone else to carry out the maintenance rather than incur the travel time and costs.

For these reasons, officials do not consider that a blanket exemption for "maintenance days" should be allowed.

However, there may be circumstances when the owner of an asset – typically a bach – needs to repair damage caused by a renter. Officials recommend elsewhere in this report that a deduction is allowed for these costs without apportionment. When the owner of the bach needs to stay in the bach to carry out this kind of repair, it would be reasonable not to treat that as private use.

Recommendation

That the submissions be accepted in part, subject to officials' comments above.

Issue: Treatment of periods when the owner is relocating the asset to enable income-earning use

Submission
(KPMG)

When the owner spends time moving the asset (such as a boat or a helicopter) to enable income-earning use, this should not count as private use.

Comment

This raises many of the same questions as the owner staying at a bach for maintenance purposes. The private benefit derived from an asset like a boat or an aircraft is typically the enjoyment of using – sailing or flying – it. It is not clear to officials that this enjoyment is eliminated simply because that use is to be followed or preceded by a rental use.

However, there may be instances when the costs of the relocation of the asset are explicitly or implicitly incorporated in the amount charged for the asset. Where additional income is derived in this way, it is reasonable that the period the owner spends relocating the asset not be treated as private use.

Recommendation

That the submission be accepted subject to officials' comments.

Issue: Treatment of periods when the property is unavailable due to external contractors' work

Submission
(Bachcare)

Periods when the property is unavailable due to it being repaired by external contractors should not be included in any private use.

Comment

Periods when the property is unavailable due to it being repaired by external contractors is not included in any private use under either the proposals as introduced or as recommended to be amended in this report. Officials have discussed this with the submitter, and the submitter has accepted this point.

Recommendation

That the submission be noted.

Issue: Treatment of periods when the asset is unavailable due to income-earning process

Submission
(New Zealand Institute of Chartered Accountants)

Income earning days should include days when the asset is unavailable for private use, even if it is not actively used to earn income on those days. An example would be a plane which is rented to fly to Sydney, and then rented to fly back one week later. It is not economic to return the plane to New Zealand between rentals, so it remains in Sydney where it is unavailable for private use.

Comment

The situation described above seems reasonable, although the plane being in Sydney does not render it unavailable for private use if the owners or associates happened to be in Sydney at that time.

However, introducing such an exemption into the proposals would risk the policy intention of ensuring that a fair proportion of expenditure is deductible. An exemption would give the wrong result in the following example:

- A boat owner lives in Wellington.
- He places his boat with a Marlborough Sounds yacht charter business.
- A number of bookings are made throughout the summer.
- The yacht is moored in the Marlborough Sounds for the entire summer because that is where each charter begins and ends.

An exemption would allow the owner to claim that the entire summer was an income-earning period. It is not clear how a fair distinction could be drawn between this kind of situation and the charter plane described above, and in either case the asset is available for private use in the "between hire" periods anyway.

Recommendation

That the submission be declined.

Issue: Definition of "interest expenditure" is too broad

Submission
(KPMG, Ernst & Young)

The proposals include in the definition of "interest" amounts paid on fixed-rate foreign equity or fixed-rate shares, and stapled debt securities. These are currently not deductible for companies, but the effect of this proposal is to allow a deduction for a proportion of them. This component should be removed from the proposals.

Comment

There are two implications in the submission:

- amounts paid on fixed-rate foreign equity or fixed-rate shares and stapled debt securities do not need to be brought into the apportionment rules, because they are not deductible;
- a further consequence of the rules is that a part of these amounts are made deductible.

Neither of these outcomes are sensible and officials agree with the submissions that these provisions ought to be removed.

Recommendation

That the submission be accepted.

Issue: Financial arrangement deductions are not matched by financial arrangement income

Submission
(New Zealand Law Society, Bell Gully)

Expenditure under a financial arrangement is subject to apportionment under the rules, but income amounts will be taxable in full. The rules should be clarified and where expenditure is apportioned, income should also be apportioned. *(New Zealand Law Society, Bell Gully)*

It is not clear that a loss in respect of a foreign currency arrangement would satisfy the requirement for being deductible in full. This creates a mismatch, as the income will be taxable in full. *(Bell Gully)*

Comment

Financial arrangement income is taxable even if the financial arrangement is held entirely for private purposes. There is no inconsistency with allowing a deduction for only a part of the expenditure but taxing all income amounts.

Recommendation

That the submission be declined.

Issue: Interest expenditure incurred by individuals who are trustees

Submission
(Ernst & Young)

Interest deductions for individuals are only subject to apportionment when the interest is incurred in relation to the asset. It is unclear whether this rule also applies when the individual is acting as a trustee.

Comment

The policy intention is that interest expenditure incurred by individuals is only subject to apportionment when the underlying debt was incurred to acquire the mixed-use asset (or shares in a company or group of companies which holds a mixed-use asset). This is the "tracing rule".

This approach is even more relevant when the individual is a trustee, as it would be inappropriate for that person to have apportionment apply to debts incurred in their personal capacity.

Officials consider that the legislation – which simply requires that "the person is not a company" – is sufficiently clear to ensure that the tracing rule applies to individuals who are trustees, as they are clearly not companies.

Recommendation

That the submission be declined.

Issue: Interest deductions incurred by partners in partnerships

Submission
(Matter raised by officials)

Additional rules are needed to ensure that the apportionment rules apply to partners in both ordinary partnerships and limited partnerships.

Comment

The proposals contain "look-through" rules to ensure that shareholders in companies will be subject to limitations on their deductions if the company which owns the asset does not have sufficient debt.

Similar rules are required for partners in ordinary and limited partnerships, to ensure that, when partners borrow to acquire their interest in an ordinary or limited partnership, interest deductions on those borrowings are potentially subject to apportionment.

Recommendation

That the submission be accepted.

Issue: Application of mixed-use asset rules to qualifying companies and look-through companies

Submissions
(Ernst & Young, Matter raised by officials)

The general definition of "company" excludes look-through companies (LTCs) so it is assumed that the proposed interest expenditure rules do not apply to them or where LTCs are shareholders in other companies which own mixed-use assets. The position of LTCs should be clarified expressly. *(Ernst & Young)*

The proposals need to be amended to deal with interest incurred by qualifying companies, look-through companies and their shareholders, which have different treatment under current law than ordinary companies. *(Matter raised by officials)*

Comment

The proposals deal with interest in companies in the following way:

- Apportionment is first applied to interest incurred (on debt up to the value of the asset) by the company which owns the asset.
- It is then applied to group companies and other corporate shareholders (if necessary), applying the stacking rule.
- It is then applied to any non-corporate shareholders (if necessary) applying the tracing rule.

A number of problems arise applying this standard framework to qualifying companies:

- Qualifying companies are not subject to the rule under which all interest they incur is deductible, which makes it unreasonable to apply the stacking rule to them. Interest apportionment inside qualifying companies should therefore be on a tracing basis.
- For the rules to operate fairly, it still remains necessary to consider interest incurred by shareholders to acquire his or her shares in the qualifying company, and potentially apply apportionment to it.

In the case of LTCs, the stacking rules will not apply because they are excluded from the legislative definition of "companies", and so the tracing rules will automatically apply. However, as with LTCs, it remains necessary for the rules to operate fairly, and to consider interest incurred by shareholders to acquire their interest in the company, and potentially apply apportionment to it.

Recommendation

That the submissions be accepted.

Issue: Expenditure which relates to both mixed-use assets and other assets

Submission
(Bell Gully)

The rules should provide guidance on how to deal with expenditure which relates to both mixed-use assets and assets which are not subject to the mixed-use asset rules.

Comment

The objective of the proposals is to ensure that an appropriate proportion of expenditure on mixed-use assets is subject to the rules. Expenditure which does not relate to mixed-use assets should be entirely outside the rules.

There will be some instances when a single item of expenditure relates to both mixed use and other assets – for example, rates on an aircraft hangar that is used to house two aircraft, one of which is a mixed-use asset and the other which is solely used privately.

Officials consider that the current form of the legislation is sufficient for taxpayers to be able to make the kind of sensible apportionment that this example would require. For example, the expenditure which is subject to the apportionment formula is "… the total expenditure or loss that is incurred by the person for an income year in relation to the asset".

Recommendation

That the submission be declined.

Issue: Rule for expenditure related to income-earning use

Submission
(Ernst & Young)

It is unclear whether expenditure such as rates, insurance and utilities can satisfy the requirement for expenditure to be solely attributable to the income-earning process.

Comment

The proposals divide expenditure into three categories – expenditure which relates solely to income earning (full deductions can be claimed), solely to private use (no deductions can be claimed), and the remainder (deductions are apportioned).

The "solely incurred" test is necessary to ensure that taxpayers can only claim full deductions for expenditure which delivers no private benefit.

Periodic charges like rates and insurance are more likely to be suited to the third category (apportionment) as they relate to both income earning and private use, and it could be difficult to divide the expenditure into the three separate categories.

However, these kinds of periodic charges could be divided into the three categories described above and this would produce the same outcome.

Other expenditure such as for utilities, which may vary between periods of use and non-use, and between different users, may give a slightly different outcome if entirely apportioned or separated into the three categories. However, because of the compliance cost of splitting the expenditure between each category, apportioning the entire item of expenditure is an acceptable outcome.

Given this approach, officials are therefore unconcerned that some items of expenditure might not satisfy the "solely" test, which is otherwise necessary to ensure the rules are robust.

Recommendation

That the submission be declined.

Issue: Companies and the rule for expenditure on income-earning use

Submission
(New Zealand Institute of Chartered Accountants)

The requirement that "the person not reasonably expect to receive a personal benefit" makes no sense when the person who holds the asset is a company.

Comment

The submitter is correct and the legislation should be amended to include situations where no benefit is received by a natural person who is associated with the person who incurs the expenditure.

Recommendation

That the submission be accepted.

Issue: Requirement that all repair and maintenance expenditure be apportioned

Submission
(New Zealand Institute of Chartered Accountants, KPMG)

The requirement that all repairs and maintenance expenditure be apportioned is an unfair outcome when the expenditure was incurred to remedy damage caused by a renter. NZICA notes that it is also the wrong outcome when the expenditure is incurred to remedy damage caused during private use.

Comment

Officials agree that when the expenditure is incurred to remedy a specific instance of damage caused by a renter – such as a hole in a wall –the cost of the repair should be entirely deductible.

However, officials are not convinced that maintenance expenditure falls within the same category. Maintenance is the remedying of gradual deterioration or wear and tear, rather than something attributable to a specific instance. It will therefore result from either the passage of time or use over time – in which case apportionment seems to be the right approach.

Officials recommend that asset owners be allowed a deduction for repairs which are carried out solely to repair damage caused by a renter, and similarly, that repairs which are carried out solely to repair damage caused by a private user be non-deductible.

Officials recommend no change to the proposal that maintenance expenditure be required to be apportioned.

Recommendation

That the submission be accepted in part, subject to officials' comments above.

Issue: Reference to "rating" in the interest and deduction quarantining provisions

Submission
(Ernst & Young)

The reference to the "amount given by rating" in the provision dealing with the asset value for interest deduction purposes should be amended to make it clear that it is the rateable value of the relevant land plus improvements. This same issue also arises in the deduction quarantining provisions.

Comments

The interest deduction provisions which apply to companies which hold a land-based mixed-use asset require companies to compare the value of that asset to the company's debt. The rateable value of that asset is used as a proxy for market value.

Similar language is used in the deduction quarantining provisions – deduction quarantining only applies to land-based assets when the gross income derived from the asset is less than 2 percent of the amount given by its most recent rating.

The legislative references could usefully be clarified, perhaps by reference to the concepts of annual value, capital value and land value in section 13(3) of the Local Government (Rating) Act 2002.

Recommendation

That the submission be accepted.

Issue: Value of land in the interest provisions should be cost

Submission
(New Zealand Institute of Chartered Accountants, New Zealand Law Society)

The cost of land, rather than its rateable value, should be used as the value against which debt is assessed.

Comment

The interest provisions assess the current debt position of the company. It therefore makes sense that this is assessed against the current asset value of the company.

Officials therefore do not agree that the cost of land should be used in this provision.

However, it is inconsistent with this approach to use cost as the basis for assets which decline in value, as the legislation does now. Officials therefore recommend that the provision which deals with non-land assets be amended to use the tax book value for depreciation purposes as a reasonable proxy for the current value of these assets.

Recommendation

That the submission be declined.

Issue: Use of word "complex" in heading of interest provisions

Submission
(New Zealand Law Society)

The word "complex" should not be used in the heading of the interest provisions because it suggests something inappropriate about such matters. The word should be replaced with "corporate".

Comment

The purpose of the heading was to distinguish between the provisions which come before it, which deal with the deductions for individual asset owners, and the provisions which come after it, which provide additional rules when assets are held in companies. The implication which the submitter draws was not intended, and officials do not think it is a necessary inference of the language used.

However, officials are indifferent between the words "complex" and "corporate" and are happy to recommend the submission be accepted.

Recommendation

That the submission be accepted.

Issue: Use of expression "voting interest" in relation to companies

Submission
(New Zealand Law Society, Ernst & Young)

The mixed-use asset proposals use the expression "voting interests" to refer to the shareholding a company has in another company. However, general legislation provides that the voting interest that a company would otherwise have in another company is to be attributed to its shareholders. This provision needs to be disabled, as it is elsewhere in the Act.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Requirement for companies to provide statements to shareholders

Submission
(Chapman Tripp)

The requirement for companies to provide statements to their shareholders to enable shareholders to take interest apportionment calculations seems problematic given the possibility of different balance dates and return filing obligations. More work should be undertaken to identify a sensible and workable basis for interest apportionment, and in the meantime the proposals should not proceed.

Comment

While some entities and individuals may have different balance dates, those balance dates all relate to the same income year, and return filing dates do not differ for the income year regardless of when the balance date is in that income year.

Accordingly, officials do not agree that significant issues will arise where companies and shareholders have different balance dates.

Recommendation

That the submission be declined.

Issue: Need for information to be provided by group companies and shareholders

Submission
(Ernst & Young)

The Tax Administration Act provision which requires the person who holds the asset to provide information to shareholders needs to be amended to require other group companies and shareholders to provide information to the person who holds the asset. This will enable sequential application of the interest expenditure and deduction quarantining rules.

The provisions assume that the same person will be preparing returns for all parties and able to use all information. This may not accord with professional responsibilities.

Comment

The rules for both interest expenditure and deduction quarantining have been carefully designed to minimise the requirements for two-way information flows. In the case of interest expenditure, companies within the group will need to provide information to whoever is making the interest apportionment calculations. However, it does not seem necessary to legislate for that within a group of companies. This is especially the case given the recommendation elsewhere in this report to exclude certain group companies with minority shareholders from interest apportionment.

No two-way supply of information is necessary for the apportionment of interest by shareholders. The group of companies simply needs to advise the shareholders of their proportion of the net asset balance and the apportionment ratio.

Recommendation

That the submission be declined.

Issue: Taxpayer has more than one mixed-use asset

Submission
(New Zealand Institute of Chartered Accountants, KPMG, Ernst & Young)

The interest apportionment proposals do not work if a company has more than one mixed-use asset. They can result in the reversal of all interest expenditure, and even the creation of additional income.

Comment

Officials agree with the submission, and that an amendment is required.

Recommendation

That the submission be accepted.

Issue: Applying interest apportionment rules to group companies that are not wholly owned

Submission
(New Zealand Law Society, Chapman Tripp)

An ordering rule is required to determine which group company is the first to have its interest apportioned. Issues will arise when group companies are not wholly owned.

Comment

The proposals currently:

- deem all group companies to be 100 percent commonly owned; and
- allow the members of the group to determine amongst themselves in which order to apply the interest apportionment rule.

This second rule in particular is designed to lower compliance costs. Rather than groups needing to apply the interest apportionment calculation in a prescribed order, they may be able to identify a single company which has sufficient debt and apply interest apportionment only to that company.

Officials accept that concerns may arise when non-wholly owned companies are included within the group. The minority shareholders of those companies may be reluctant to have the interest deductions of "their" company apportioned.

Accordingly, officials propose the following amendment.

When a company is not a wholly owned member of the same group as the mixed-use asset company, it can be excluded from the interest apportionment rules entirely if:

- no minority shareholder of the company, or person associated with them, has had private use of the asset; and
- there has been no loss offset with, or no loss subvention payments from, the company.

While these amendments do not create an ordering rule, officials consider that they deal with the bulk of the concerns around non-wholly owned group companies at source, while preserving the compliance cost benefits of groups to determine which companies should have interest allocated to them first.

Recommendation

That the submission be declined, but an amendment be made to clarify the legislation.

Issue: Technical application of interest apportionment formula to group companies

Submission
(Ernst & Young)

It is not clear that when a group company applies the interest apportionment formula, it should use the numbers generated by the mixed-use asset company's application of the formula.

Comment

Officials consider that the drafting is reasonably clear here, but it would be straightforward to add further clarification to avoid any possible confusion.

Recommendation

That the submission be accepted.

Issue: Interaction with depreciation rules

Submission
(Ernst & Young)

The provision dealing with depreciation recovery on sale should be clarified to ensure that the reference to "deductions allowed" in the depreciation rules is to the net depreciation loss deductions actually allowed after taking account of any part-use or subpart DG apportionments.

Comment

The policy intention behind the relevant depreciation rule is that only a proportion of the depreciation recovered will be taxable, reflecting that only a proportion of the depreciation allowed was deductible. The relevant provision in the depreciation legislation refers to:

> all amounts of depreciation loss for which the person has been allowed a deduction for the item in each of the income years in which the person has owned the item.

In officials' view, this clearly means the amounts which are deductible after any apportionment – the amount prior to apportionment is not an amount "for which the person has been allowed a deduction". Officials do not consider that any amendment is required.

Recommendation

That the submission be declined.

Issue: Cost should be used as the benchmark for the 2% deduction quarantining test

Submission

(New Zealand Institute of Chartered Accountants, New Zealand Law Society, KPMG, Ernst & Young)

Cost, rather than rateable value, should be the benchmark against which the 2% threshold for the application of deduction quarantining is assessed. It is unclear why the 2% threshold was selected, and it is too high.

Comment

The deduction quarantining rules prevent a person who owns a mixed-use asset from offsetting a loss from the mixed-use asset against other income. As set out earlier in this report, it is a "wait and see" rule designed to deal with the issue that the apportionment formula does not prevent an asset which has a low level of use and a high level of expenditure from producing perennial losses. Such losses cannot be genuine business losses, and arise because in these circumstances the apportionment formula essentially allows deductions for private expenditure.

To reduce the number of instances where the deduction quarantining applies to genuine losses, the rules will only apply where the gross income derived from the asset is 2% or less of its value. With the Official Cash Rate at 2.5% and bank deposits returning around 4%, 2% was seen as a fairly low level that someone with a reasonable focus on earning income ought to be able to achieve.

The ability of an asset to earn income is related to its current value, not its historic cost. To put it another way, two identical properties would have the same ability to earn income even if one was bought in 1960 and the other in 2007.

However, this logic also means that the value for non-land assets should be their current tax book value, as a reasonable approximation of their market value, and officials recommend an amendment be made.

This creates the same valuation rules as are used in the interest apportionment rules.

Recommendation

That the submissions of the external submitters be declined.

That the officials' recommendation be accepted.

Issue: 2% threshold is not realistic for many properties

Submission
(Bachcare)

The 2% threshold is not realistic for many properties; those outside areas of key demand or basic baches on high-value land. A 1.75% would be a better level.

Comment

The 2% threshold has been set to reduce the likelihood of the deduction quarantining rules applying to asset owners who have a genuine short-term business loss, who under our tax system ought to be able to offset their loss in the year in which it arises, regardless of the level of income which generates it. Arguments can be made that the threshold should be set higher, or that quarantining should apply regardless of the income earned, because a loss on a mixed-use asset which is a perennial loss should always be denied, regardless of the level of income which generates it.

The 2% threshold seeks to balance these two competing objectives, and on balance officials' preference is that it remains where it is.

Recommendation

That the submission be declined.

Issue: Potential disparity between rateable value and market value

Submission
(TradeMe)

Rateable value may not always be the same as market value, so owners should be able to get a valuation from a registered valuer to use as an alternative.

Comment

As noted above, the 2% threshold has been chosen to strike a balance between those who make genuine short-term business losses and those who the apportionment formula allows to make perennial losses, but arguments can be made for a higher or no threshold at all.

As the submitter implies, the rateable value of the property is used as a proxy for market value, and was chosen because it is already available to all property owners and can be obtained without incurring compliance costs.

Officials are reluctant to allow registered valuations to be used as an alternative to the valuation given for rating purposes because allowing these kinds of choices allows taxpayers to "game" the rules. Taxpayers will choose the rateable value if it is less than the market value, and have a registered valuer give a valuation if it is more. The only way this can be avoided (and even then only partially) is to require an asset which has been valued by a registered valuer to continue to be valued in this way each year. This would impose an undesirable level of compliance costs.

Officials consider that using the rateable value at all times provides the best balance of even-handedness and compliance costs.

Recommendation

That the submission be declined.

Issue: Deduction quarantining rules exclude income from associated persons

Submission
(Ernst & Young)

The exclusion of income from associated persons from the 2% gross income threshold below which deduction quarantining applies is confusing.

Comment

The proposals as introduced excluded income from associated persons from the test to determine whether the deduction quarantining rules should apply. This was to prevent asset owners from avoiding the application of the deduction quarantining rules by creating income from associated persons to exceed the 2% threshold.

Officials recommend elsewhere in this report that income from associated persons be treated as excluded income and not subject to tax. An amendment will be required to make it clear that excluded income is not included in the 2% deduction quarantining threshold.

Recommendation

That the submission be accepted.

Issue: Application of quarantined deductions to profits in future years

Submission
(Matter raised by officials)

The proposals should be amended to make it clear that quarantined deductions from one asset can only be offset against future profits from that same asset.

Comment

As noted earlier in this report, the policy intention is that quarantined deductions which arise from an asset can only be offset against future profits from that same asset. There is a slight ambiguity in the current drafting which can be read as allowing quarantined deductions from one asset to be offset against future profits from another asset.

Recommendation

That the submission be accepted.

Issue: Clarity of, and inconsistencies within, deduction quarantining rules

Submission
(Ernst & Young)

- There seems to be an inherent inconsistency between the company which owns the asset having excess expenditure subject to quarantining and having an outstanding profit balance.
- It is not clear what amounts need to be taken into account by group companies, and whether they involve amounts based on the group company's own income and expenditure or those of the company which owns the asset.
- If it is intended that the group company's calculations should be based on the asset-owning company's income and expenditure, there may be information and compliance issues.

Comment

When a mixed-use asset is held in a group of companies, the deduction quarantining rules require a group-wide approach to expenditure. This is because, to determine whether a loss has actually arisen to be quarantined, it is necessary to look at expenditure incurred not only by the company which owns the asset but also relevant expenditure incurred by other group companies. The legislation makes it clear that relevant expenditure is only interest which has already been identified under the apportionment rules.

This means that while the company which owns the asset may appear to be in profit – thereby having an outstanding profit balance – the mixed-use asset activity overall is in loss, once interest expenditure incurred by other group companies has also been deducted.

An example of the operation of these provisions is included at the end of sections DG 18 and DG 19.

Recommendation

That the submission be declined.

Issue: Application of quarantining rules to group companies

Submission
(New Zealand Law Society)

The same issues arise with the application of the quarantining rules to group companies as apply in the interest rules, which is that the rules do not set out the order of companies that the rules should be applied to.

Comment

As with the interest rules, groups of companies may choose which companies, and in which order, to apply the deduction quarantining rules to. This choice has been deliberately left to taxpayers so they can organise this in a way which gives rise to the least compliance costs, or meets whatever other objectives they might have.

The main issue arises with group companies which are not wholly owned. The modification to the interest rules under which certain companies which are not wholly owned will be excluded from the rules and will flow through to the deduction quarantining rules. This will lessen, although not entirely eliminate, the concern the submitters have.

Officials consider it preferable to continue to allow groups of companies to make their own decisions about these matters.

Recommendation

That the submission be declined.

Issue: No quarantining where income cannot be separately attributed

Submission
(New Zealand Institute of Chartered Accountants)

The submitter supports the proposal that deduction quarantining should not apply where a person owns a mixed-use asset to which income cannot be separately attributed.

Comment

Most of the assets to which the mixed-use asset proposals apply will be assets which are rented out. It is then straightforward to apply the test of whether the gross income from the asset is 2% or more of its value.

However, the rules can also apply when the asset is used in the person's own business. In these instances, it will be difficult to apply the gross income test, because no income will be directly attributable to the use of the asset. Assets of this type are excluded, unless there is also a substantial proportion of rental use so that the 2% gross income test could be meaningfully applied.

Recommendation

That the submission be noted.

Issue: Level at which opt-out threshold is set

Submissions
(New Zealand Institute of Chartered Accountants, KPMG, PricewaterhouseCoopers)

The threshold of $1,000 of gross income for opting out is too low and should be:

- 2% of the asset value. *(KPMG)*
- The higher of $5,000 or 2% of the asset value. *(PricewaterhouseCoopers)*
- $10,000. *(New Zealand Institute of Chartered Accountants)*
- Net income without applying the mixed-use asset rules. *(New Zealand Institute of Chartered Accountants)*

Comment

The proposals include two options under which a person who has a mixed-use asset can "opt out" of the tax system. The consequence of opting out is that the income from the asset is not taxable, and no deductions can be claimed. There are two grounds on which a person can opt out:

- when the gross income from the asset for the income year is less than $1,000; and
- when the result of the application of the mixed-use asset rules is that quarantined deductions arise.

Elsewhere in this report are recommendations that income from associated persons, and income which is less than 80 percent of the market value of the use of the asset be treated as exempt income. These recommendations will exclude further mixed-use asset owners from the rules, and make it easier for others to qualify for the opt-out thresholds above (because only market value income from non-associates will be counted).

The submissions focus on the first exemption set out above. The policy objective of this exemption is to reduce taxpayer compliance costs. If only a small amount of revenue will be produced from taxing the income from the asset, it is not worth taxpayers incurring compliance costs or Inland Revenue incurring administrative costs.

The appropriate measure for this exemption is a dollar amount, because compliance costs do not vary directly in proportion with asset value. Other things being equal, the compliance costs of a $400,000 bach will be the same as those for an $800,000 bach. Officials therefore do not agree with submissions that a threshold based on asset value should be used.

Nor do officials agree with a substantial increase in the dollar amount of the threshold, because to do so would be a disproportionate response to the compliance costs involved.

NZICA suggests as an alternative a threshold based on the net income arising from an asset, without application of the mixed-use asset rules. Officials note that a similar provision does exist, which allows a taxpayer to opt out if a quarantined deduction arises – essentially if net income after applying the mixed-use asset rules is nil or less, and gross income is less than 2 percent of the asset's value.

However, officials consider that the threshold could be increased to further reduce compliance costs without raising any material issues of unfairness. This is especially the case as asset owners with low levels of income would be likely to be in loss after the application of the apportionment rules.

Officials recommend that the gross income threshold be increased to $4,000.

Recommendation

That the submission be accepted in part, subject to officials' comments above.

TECHNICAL ISSUES

The following matters deal with technical issues.

Issue: The word "active" is not required in the definition of "private days"

Submission
(New Zealand Law Society)

The word "active" is not required in the definition of "private days" because section DG 3(3) already defines "use" as "active use" for the purposes of subpart DG.

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

Issue: Apportionment of costs of borrowing

Submission
(Matter raised by officials)

The mixed-use asset rules override the provision under which borrowing costs are deductible, but incorrectly refers to them as interest costs.

Recommendation

That the submission be accepted.

Issue: Assets acquired and disposed of in the same year

Submission
(Raised informally with officials)

The proposals include rules which pro-rate thresholds where the asset is acquired or disposed of during the year. These rules need to be amended to deal with situations when the asset is acquired and disposed of in the same year.

Recommendation

That the submission be accepted.

Issue: Early reference to "outstanding profit balance" unnecessary in the deduction quarantining rules

Submission
(Ernst & Young)

Given the expression "outstanding profit balance" is used in section DG 18, why is it necessary to refer to it in section DG 16?

Comment

"Outstanding profit balance" is a term used to refer to an excess of income over expenditure under the deduction quarantining rules. It is calculated under section DG 16 and subsequently referred to in section DG 18. Officials consider this to be a logical form of drafting these provisions.

Recommendation

That the submission be declined.

Issue: Use of outstanding profit balance

Submission
(Ernst & Young)

The reference in section DG 16 to the outstanding profit balance being used under section DG 18 should be a reference to it being used under section DG 19.

Comment

"Outstanding profit balance" is used in a formula in section DG 18, so officials prefer the cross-reference to remain as currently drafted.

Recommendation

That the submission be declined.

Issue: "Company A" and "Company B" concepts undefined

Submission
(New Zealand Law Society)

Section DG 18 uses the concepts of "Company A" and "Company B", but they are not defined for the purposes of this section.

Comment

Company A and Company B are introduced in the interest apportionment rules to refer to the company which owns the mixed-use asset and other companies which are in the same group as the company which owns the mixed-use asset respectively.

Officials agree that they are not defined for the purpose of their subsequent use, but they should be.

Recommendation

That the submission be accepted.

Issue: Cross-reference in deduction quarantining provisions

Submission
(Ernst & Young)

Section DG 19(1) should include a cross-reference to section DG 16.

Comment

Section DG 16 deals with the deduction quarantining of the person who has the mixed-use asset. Section DG 17 provides rules for using that quarantined deduction in a subsequent year.

Section DG 19 deals with the subsequent use of quarantined deductions of group companies and shareholders. These quarantined deductions arise under section DG 18, not section DG 16.

Recommendation

That the submission be declined.

ASSET EXPENDITURE – GOODS AND SERVICES TAX

Clauses 84–87

Issue: The changes should not go ahead

Submission
(Ernst & Young)

The GST changes should not go ahead. Instead, the general apportionment rules should apply. If they do go ahead, they should be deferred to allow people the chance to exclude the assets from the GST base, as proposed by an officials' issues paper released in December 2012.

Comments

Officials note that there are differing views on how the existing rules should apply to mixed-use assets. One view is that input tax in respect of non-use time should be claimable on the basis that the asset is, at such times, available for use. Another view is that no claims should be able to be made in respect of this non-use time because the apportionment rules (section 21G(1)(a)) refer to the extent to which the goods and services "are actually used for making taxable supplies".

Bringing some clarity to this area by providing a specific formula is considered desirable.

With respect to the submission that some registered persons should be able to exclude their assets from the tax base (as outlined in the December 2012 issues paper), this is a narrow proposal that would only affect people that hold assets in the same vehicle that also carries out some other taxable activity. This proposal was put forward as a concession to people that may inadvertently be caught in the GST net, not those that voluntarily registered in respect of entities that hold mixed-use assets.

Officials consider it would be unnecessary to delay these changes, which potentially have a broad application, to cater for a remedial amendment designed to relieve a GST burden on a small group.

Recommendation

That the submission be declined.

Issue: Transitional provisions and effective date of the new rules

Submissions

(New Zealand Law Society, Bell Gully, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

There should be a transitional rule to clarify the interaction between the existing apportionment rules and the proposed rules. *(New Zealand Law Society)*

There should be a new transitional rule for assets acquired between 1 April 2011 and 1 April 2013. *(Bell Gully)*

Guidance should be provided as to what happens to assets already subject to apportionment. *(New Zealand Institute of Chartered Accountants)*

The proposed GST rules should apply from 1 April 2014. *(Bell Gully)*

Changes should only apply to assets acquired after 1 April 2013. *(PricewaterhosueCoopers)*

Comment

Submitters are concerned that the overlay of the proposed apportionment rules for mixed-use assets will cause confusion and additional compliance costs for registered persons with assets currently in the tax base. Of particular concern is that the proposed GST rules could result in output tax liabilities for some people who would be forced to adjust input tax claimed under the current rules.

Officials accept that overlap is undesirable. This is why transitional provisions were introduced when the new apportionment rules were introduced in 2011. However, rather than having another transitional provision for mixed-use assets, officials consider it would be simpler to have the proposed rules for mixed-use assets only apply to relevant goods and services acquired after the date of Royal assent of this bill. This means if a person purchased a bach in 2012 and has apportioned their input tax claims under the existing rules, the mixed-use asset rules would not apply to that bach, but would apply to goods and services (such as rates, insurance and furnishings) acquired after the bill is enacted. This will provide certainty to effected taxpayers, while still ensuring the new rules will apply appropriately.

Recommendation

That the submission regarding the changes only applying to assets acquired after the bill is enacted be accepted. This will address the concerns of other submitters.

Issue: When the rules apply

Submission
(New Zealand Institute of Chartered Accountants)

The GST apportionment rules should not apply when a person takes advantage of the exemption option for income tax purposes.

Comments

The exemption for income tax purposes is only available in a limited set of circumstances, and is generally related to assets that earn under a certain level of income. Although one of these criteria is linked to the value of the asset, it is anticipated that most people that qualify for the income tax exemption will do so because they derive significantly less than $60,000 a year in income from the asset.

If GST has to be charged on a supply when the turnover from the asset is less than $60,000 per annum, the person is either voluntarily registered, has deliberately included the asset in the same structure as a larger taxable activity, or is self-employed and owns the asset in their personal name. In any case, their involvement with the GST system, or their inclusion of the asset in the tax base will, in many cases, have been based on a conscious decision. Officials consider that, as the mixed-use asset rules are now recommended to apply only to assets acquired after the date of Royal assent of this bill, most will make this decision on the understanding that these rules will apply to them.

Further, GST returns are filed more regularly that income tax returns. It would be unusual to create rules that required people to return amounts of output tax for a mid-year return but then exempt the same supply once the end-of-year calculations had been performed.

Recommendation

That the submission be declined.

Issue: Private use days and output tax

Submissions
(Bell Gully, New Zealand Law Society)

An asset owner should be:

- relieved from accounting for output tax on below market rental days; or
- allowed a scaled-back input claim for such days based on discount to market rates. *(Bell Gully)*

The definition of private use should exclude use where market value is paid, or the output tax liability of the owner should be reduced to the extent of the consideration provided for the use. *(New Zealand Law Society)*

Comment

Officials agree that it is not optimal to have output tax charged on a supply while simultaneously denying input tax for that supply.

The proposal that input tax should be able to be apportioned on the basis of the proportion that the rent actually charged relates to the market rent would be problematic. Given submissions that the assets rules more generally are too complicated, to require a registered person to work out percentages of claims for individual days could add significant compliance costs for very little difference in the overall figures produced.

On balance, officials consider that, for the purposes of the GST mixed-use asset rules, any day (or other period) where the asset in question is supplied for consideration should be treated as a business day. In practice, this would mean:

- A period when the asset is leased to an associated person should be subject to the rules that treat supplies between associated persons as taking place at market value. This would mean the owner would have to return output tax on a market value rate even if some lesser consideration (or no consideration) was paid.
- On a day the asset is leased to a non-associate for less than market value (but more than zero), the owner should return output tax on that lesser value. Although this allows supplies to be made to people for lower rates while still claiming input deductions, this is an existing feature of the GST system that registered persons and Inland Revenue will be familiar with.

Officials accept that this will cause the formula for GST purposes to diverge from that used for income tax in some cases. Although this is not necessarily desirable, it is anticipated that this will not be a problem for most taxpayers. The alternative would be to introduce exemptions into the GST system or otherwise change relatively fundamental aspects of the GST system – such as the ability of the supplier to set their own consideration for supplies to non-associates.

Officials therefore consider having differences in the formula for the two tax types simply reflects the nature of the two taxes and the reality that what is a desirable outcome for one tax type (in this case exempt income being derived) will not always be suitable for another.

Recommendation

That the submissions be declined, but the proposed rules be amended in line with officials' comments.

Issue: Guidance on specific terms

Submissions
(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

Inland Revenue should provide guidance on the following matters:

- What a "fair and reasonable result" is for an alternative time measurement under proposed section 20G(3). In particular, is no adjustment for GST when an income tax adjustment is made "fair and reasonable"?

(New Zealand Institute of Chartered Accountants)

- Whether the exclusion for motor vehicles and apportioned assets applies for GST.
- Whether section 20G applies to all GST-registered companies or just close companies.
- Does "input tax" cover secondhand goods or GST under section 20(3J).

(PricewaterhouseCoopers)

Comment

Officials confirm that the policy intentions behind the issues raised are, respectively:

- Matters such as "fair and reasonable" do not lend themselves to prescriptive and exhaustive definition and are generally determined on a case-by-case basis. However, given there are minimum thresholds built into the GST rules and the changes to the GST formula recommended above, perfect tracking with the income tax rules is not anticipated in every instance.
- GST has a set of "standard" apportionment rules that apply to assets that are not described in proposed section BG 3. It is expected that those apportionment rules will apply to most assets, with only assets described in section DG 3 having to be apportioned using proposed section 20G.
- Officials agree that the wording in proposed section 20G is not very clear on this point. Given the intention is to align the GST rules as closely as possible to the income tax rules, to reduce compliance costs, it is arguable that widely held companies should be excluded from the ambit of section 20G.
- The definition of "input tax" in section 3A of the GST Act should apply to proposed section 20G. This would include secondhand goods input credits. Officials agree that the relationship between the proposed section 20G and section 20(3J) should be clarified so that output tax calculated under that section is referable to the inputs that would be able to be claimed under section 20G.

Recommendation

That the submissions be noted, but also that the bill be clarified to confirm that:

- the GST apportionment rules do not apply to widely held companies; and
- the relationship between proposed section 20G and current section 20(3J) be clarified.

Salary trade-offs

OVERVIEW

The bill proposes various changes to bring a wider range of salary substitutes into the definition of “income” for tax and social assistance purposes.

In the bill as introduced, these changes included proposals to tax a wider set of car parks through the FBT rules, largely applying to car parks provided to employees in the central business districts of Auckland and Wellington.

The Minister of Revenue has invited the Committee to withdraw the proposals relating to car parks from the bill.

CLARIFYING THAT VOUCHERS ARE A "SHORT-TERM CHARGE FACILITY"

Issue: Vouchers should not be included in the definition of "short-term charge facility"

Submission
(Maxxia, KPMG, Wilson Parking)

Vouchers simply enable employers to provide employees with goods and services in a more cost-effective manner. If the provision of the underlying good is not subject to fringe benefit tax, there is no policy reason for provision of a voucher to be either. The removal of an efficient mechanism to administer the fringe benefit tax exemption is counterproductive and harmful to the charitable sector. *(Maxxia)*

Officials should look at the Australian model where not-for-profit organisations enjoy the continued support of the Government through a fringe benefit tax exemption, with "per-employee" limits. *(Maxxia)*

While we understand the tax and social policy rationales for the inclusion of vouchers in family scheme income, this may impose an additional cost on a charity from having to fund the tax on behalf of employees. This appears inconsistent with the Government's other public policy objectives. *(KPMG)*

Charitable organisations should not have to pay FBT on the value of vouchers provided to employees. Vouchers given to employees of charitable organisations recognise the efforts of individuals helping the less well off. The new rules also impose significant administrative burdens on charitable organisations. *(Wilson Parking)*

Comment

Although the exemption from fringe benefit tax afforded to charitable organisations means that charitable organisations are not generally required to pay fringe benefit tax on goods and services provided to employees, there is a long-standing exclusion for benefits provided by way of short-term charge facilities when those benefits exceed 5 percent of an employee's salary or wages for the tax year. The bill proposes that this cap be amended to the lower of $1,200 or 5 percent of salary or wages.

In recent years, various arrangements which aim to expand the intended scope of the FBT exemption for non-cash benefits provided to employees of charitable organisations have been marketed to some charitable organisations. The arrangements, such as the provision of vouchers, have aimed to cover an employee's normal everyday living expenses such as groceries and petrol. In these circumstances, vouchers can provide a readily substitutable alternative to salary and wages.

A key principle of tax policy is horizontal equity – ideally a tax should apply equally to people on the same effective income. Not requiring charitable organisations to pay FBT on vouchers (or other short-term charge facilities) provided to employees, could encourage structuring such that employees received minimal monetary remuneration, and received a large portion of their salary package as non-monetary remuneration, including by way of vouchers.

Officials note that these arrangements could be avoidance in some situations. Officials are of the view that it is appropriate to clarify the definition of "short-term charge facility" to express that vouchers are a form of short-term charge facility, and so are subject to the modified cap.

Recommendation

That the submissions be declined.

Issue: The current cap on FBT-exempt short term charge facility benefits of up to 5 percent of salary or wages should not be amended

Submission
(Simpson Grierson)

We oppose the proposal to change the cap on the FBT exemption in respect of the provision of short-term charge facilities to the lesser of $1,200 or 5 percent of the employee's salary or wages.

The proposed $1,200 cap is very low. It does not give sufficient weight to the positive assistance that the more generous, existing cap gives to charitable organisations, in terms of enabling them to attract and retain staff by providing a mixture of monetary and non-monetary remuneration to employees.

Alternatively, if it is considered necessary to supplement the cap with a specific value threshold, that threshold should be more generous, for example $3,000 rather than $1,200.

Comment

As noted earlier, a key principle of tax policy is horizontal equity – ideally a tax should apply equally to people on the same effective income. By allowing employees of charitable organisations to receive valuable salary substitutes, such as vouchers, without their being taxed, employees would receive a tax saving over employees of other entities. This would create inequity between employees of different types of entities. A $1,200 cap is equivalent to 5 percent of income at $24,000, which officials consider provides charitable organisations with sufficient flexibility while precluding salary substitution.

Recommendation

That the submission be declined.

Issue: The wording of section CX 25 should be clarified

Submissions

(Corporate Taxpayers Group, Ernst & Young, Simpson Grierson, Deloitte)

These submissions consider it is unclear how vouchers are included in the definition of "short-term charge facility" by the proposed wording changes to section CX 25.

It's not intuitive that there is a "liability" on the employer when they have provided a voucher, as required by the wording of the section. *(Corporate Taxpayers Group, Deloitte)*

It should be clarified whether this definition includes electronic cards which are given to employees with money pre-loaded onto them, as the employer will have provided payment before the liability to pay for goods and services obtained by an employee arises. *(Ernst & Young)*

Instead, a separate limb should be included in the definition of "short-term charge facility" specifically referencing the provision of vouchers (or equivalent benefit) to an employee that can be redeemed by the employee to acquire any goods or services. *(Simpson Grierson)*

Comment

The issue hinges on whether the employer has a liability to pay for the goods or services at the same time as the voucher or other short-term charge facility is used by the employee. The policy intent is that these two events need not happen concurrently. For example, the liability could occur beforehand, which would cover electronic cards with money preloaded onto them. Officials will instruct the drafter to consider if the wording could be clearer in this area.

Recommendation

That the submissions be noted.

REQUIREMENT TO PROVIDE A STATEMENT ABOUT SHORT-TERM CHARGE FACILITIES

Submissions
(BusinessNZ, Deloitte, Simpson Grierson, Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants, Westpac, KPMG)

Employers should not be required to provide a statement to employees – this requirement would create an excessive amount of paperwork that would serve little to no purpose and would impose significant compliance costs on employers. *(BusinessNZ, Deloitte, Simpson Grierson)*

The requirement to provide this statement should be limited to employers in the charitable sector. *(Corporate Taxpayers Group, BusinessNZ, New Zealand Institute of Chartered Accountants)*

We do not believe that employers would typically enter salary trade-off arrangements involving short-term charge facilities outside of the charitable sector. *(BusinessNZ)*

The requirement to provide a statement should be limited to employers that provide vouchers as salary substitutes. *(Westpac)*

This requirement will impose significant compliance costs on employers who will need to track every single voucher provided during the year. This will not be practical. There should be a minimum amount, under which statements do not need to be provided. This could be $100 per voucher. *(KPMG)*

Employers should only need to provide a statement to employees who receive a significant amount of remuneration through short-term charge facilities. This amount could be $1,200, or the lesser of $1,200 or 5 percent of income. *(Corporate Taxpayers Group, Deloitte, New Zealand Institute of Chartered Accountants)*

The $300 per quarter FBT threshold should apply to the requirement to disclose information on short-term charge facilities. *(Wilson Parking)*

Comment

Clause 67B proposes that all employers who have provided short-term charge facilities, such as vouchers, will be required to provide a statement to each employee who received the short-term charge facility setting out the total value of facilities they received during the income year. The reason for this requirement is to assist employees in calculating their income for social assistance purposes.

Employees are unlikely to keep a record of all short-term charge facilities they receive from their employer. When an employee receives short-term charge facilities from multiple employers, it will be difficult for them to calculate their income for social assistance purposes if they do not have information about the benefits they received during the year from all their employers. The amount a person receives from each employer may be below the threshold, but when combined may exceed the threshold for including this amount in their social assistance calculations.

Officials accept that this disclosure requirement would increase compliance costs for businesses which provide benefits to employees by way of short-term charge facilities. Officials also accept that many businesses which provide these types of benefits to employees do not provide substantial sums under these short-term charge facilities. Accordingly, on balance, officials recommend the removal of this requirement from the bill. Businesses which provide short-term charge facility benefits could still provide information about these benefits to employees if employees request this information. However, this is contingent on their keeping sufficiently detailed records.

Recommendation

That the submissions to remove from the bill the requirement for an employer statement be accepted.

INCLUDING CERTAIN BENEFITS IN FAMILY SCHEME INCOME

Issue: Appropriate year for recognising benefits in income

Submission

(New Zealand Institute of Chartered Accountants)

The amount included in "family scheme income" for the income year should be the value of the benefits received in the previous income year.

This will reduce compliance costs and the likelihood of unrecoverable debts arising if the employee is remiss in advising Inland Revenue about the receipt of those benefits. The timing of receipt of benefits may not always coincide with the time when the person must inform Inland Revenue of their family scheme income.

Comment

The bill requires employees to include short-term charge facility benefits (above the cap) and explicit salary trade-offs involving cars in "family scheme income".

"Family scheme income" is the definition of income used for Working for Families (WFF) tax credits. It is basically taxable income with a range of adjustments, such as the inclusion of trust income and the adding back of rental property losses.

WFF tax credits are calculated at the end of the tax year using the person's family scheme income for that income year. While claimants who apply for interim instalments of WFF tax credits during the year, based on their estimated income, may have trouble estimating the proposed additional benefits likely to be received during the year, this process is subject to a square-up at the end of the tax year. Furthermore, similar estimation difficulties already exist in respect of other types of family scheme income, such as the fringe benefits for shareholder-employees who control 50 percent or more of a company, and extra pays. Claimants are encouraged to update estimated income amounts when changes occur during the year, to minimise any difference at square-up.

In these circumstances, officials see no reason why using the income year in which the benefit was received would not work when including short-term charge facilities and explicit salary trade-offs involving cars in family scheme income.

Recommendation

That the submission be declined.

Issue: The inclusion of short-term charge facilities in family scheme income should be limited to benefits provided by charitable organisations

Submission

(New Zealand Institute of Chartered Accountants, Wilson Parking)

The proposal will require all employers to keep records of short-term charge facilities provided to employees. This is not currently required of employers who are not charitable organisations, and it will impose excessive compliance costs. *(New Zealand Institute of Chartered Accountants)*

Note that they currently do not keep records of vouchers provided given the $300 per quarter FBT threshold. *(Wilson Parking)*

Comment

Officials consider that this requirement should not apply solely to employees of charitable organisations as this would create inequity between employees of different types of entities. The WFF entitlement of an employee of a non-charitable organisation should be the same as that of an employee of a charitable organisation on an equivalent remuneration package.

To reduce employer compliance costs, officials have recommended removing the requirement that employers provide a statement to each employee who has received a short-term charge facility benefit during the year. Instead, it will be left up to employees to ask their employer for this information if they need it. It does not seem unreasonable to expect that employers will have some record, as part of their normal accounting records, of who they are providing vouchers to.

Recommendation

That the submission be declined.

Policy matters

LEASE INDUCEMENT AND LEASE SURRENDER PAYMENTS

Clauses 4B, 17B, 25B, 32B and 57(19B)

Issue: Policy considerations

Submission
(New Zealand Law Society)

Tax asymmetry is inherent and inevitable in a tax system that distinguishes between capital and revenue items. If the proposed amendments do proceed, it is important that the intended symmetry relied on to justify the proposed amendments is in fact achieved, and that the proposed amendments, once enacted, have a logical and reasonably certain application.

Comment

The current tax treatment of generally deductible but non-taxable lease inducement payments poses a risk to the tax base because it creates an opportunity for taxpayers to substitute tax-deductible rent payments with non-taxable cash lease inducement payments. Also, compared with other forms of lease inducements such as a rent-free holiday or a contribution for fit-out costs, these payments provide a tax advantage which distorts business decisions on leases.

To remove this distortion, it is necessary to modify the capital-revenue boundary for lease inducement payments to make them taxable to the recipient. This is in line with several measures in tax legislation where the judicially delineated capital/revenue boundary has been modified to counter arrangements based on converting revenue receipts into capital receipts. Past examples include redundancy payments, payments received for restrictive covenants and exit inducements.

The reforms included in this bill are limited to lease inducement and lease surrender payments, and are the result of the lease inducement payments review undertaken in July 2012. The proposed changes address the revenue risk associated with lease inducement payments and the "black hole" expenditure problem associated with lease surrender payments. They provide a consistent tax treatment of lease inducement and lease surrender payments by treating them as taxable to the recipient and deductible to the payer.

As announced by the Minister of Revenue on 11 December 2012, a wider review of the tax treatment of land-related lease payments is currently underway to rationalise the rules into a coherent regime. It is expected that an officials' issues paper will be released for public consultation this year seeking feedback on the review.

Recommendation

That the submission be noted.

Submission
(KPMG, Corporate Taxpayers Group, Deloitte)

The submitters generally support the reforms.

Recommendation

That the submission be noted.

Issue: Application date

Submission
(PricewaterhouseCoopers, Deloitte, Ernst & Young, Corporate Taxpayers Group)

The application date should reflect the Minister of Revenue's media statement. *(PricewaterhouseCoopers)*

The application date should be made clearer, in particular the words "an amount that is…not derived as consideration for the agreement, before 1 April 2013, to a lease of land or a licence to use land". *(PricewaterhouseCoopers, Deloitte, Corporate Taxpayers Group)*

The term "agreement" should be clarified as to what level of completion is necessary for the relevant lease agreement to be considered in existence before 1 April 2013. *(Ernst & Young, Deloitte, Corporate Taxpayers Group)*

Comment

The proposed wording of the application date is intended to reflect the Minister of Revenue's media statement of 27 September 2012. It stated that the reforms will apply to lease inducement payments on commercial leases entered into on or after 1 April 2013.

This is a form of "savings" provision for taxpayers. It is intended to provide more business certainty for those who have entered into a lease (i.e. completed a binding lease agreement) before 1 April 2013, but who derive or incur lease inducement payments on or after 1 April 2013.

An alternative wording for the application date including the term "agreement" will be considered to better reflect the policy intent. Additional guidance on the application date will also be provided in a *Tax Information Bulletin* article following enactment of the bill.

Recommendation

That the submission be accepted, subject to officials' comments.

Submission
(Ernst & Young)

That the application date for an amount derived or incurred for an agreement to a lease or licence to use land seems redundant for the lease surrender payments amendments in proposed sections CC 1C and DB 20C.

Comment

Officials recommend that the application date for lease inducement payment and lease surrender payment amendments be separated.

Recommendation

That the submission be accepted.

Issue: Deductions for lease inducement payments

Submission
(KPMG)

Consideration should be given to allowing an immediate deduction for lease inducement payments.

Comment

The proposed timing rules spread income and deductions over the term of a lease. This approach, which is consistent with the method used for accounting purposes, recognises that lease inducement payments are all part of the price paid for the lease. Moreover, these payments relate to the securing of an asset – the lease with the tenant – and, in principle, the expenditure on an asset should be spread over its income-producing life. For these reasons, allowing an immediate deduction of these payments is not supported.

Recommendation

That the submission be declined.

Issue: Timing of income and deductions for lease inducement payments

Submission
(PricewaterhouseCoopers, Deloitte, Chapman Tripp, Ernst & Young)

The term "spreading period" in proposed section EI 4B(1) should clarify the beginning and end of the spreading period. *(Ernst & Young, PricewaterhouseCoopers, Chapman Tripp, Deloitte)*

Express definition should be included as to the relevant period over which income and deductions should be allocated for situations such as those when there is an initial fixed term but the land right contains rights to renew or extend which may, or may not, be exercised in due course. *(Ernst & Young)*

Comment

The timing rule spreads income or deductions for lease inducement payments evenly over the term of a land right (for example, a lease). The "spreading period" in the rule determines the term of the relevant land right over which income or deductions are allocated.

The spreading period is intended to recognise a fixed period set either at the grant, renewal or extension of the land right. This approach is taken to avoid complexities around modifying the spreading period (and relevant income and deduction allocations) when the initial fixed period is later renewed or extended. Under the proposed rule, if there is a payment for a renewal or extension of the land right, the fixed period of the renewal or extension would be regarded as a separate spreading period.

Officials will consider an alternative wording for the timing rule, in particular, the term "spreading period" to better reflect the policy intent. Additional guidance on the timing rule will also be provided in a *Tax Information Bulletin* article following enactment of the bill.

Recommendation

That the submission be accepted, subject to officials' comments.

Submission
(Ernst & Young)

A straight-line allocation method (similar to the approach applied for depreciation purposes for fixed life intangible property) for spreading income or deductions seems more straightforward and appropriate compared with the proposed spreading rule, which allocates income or deductions in equal portions to each income year.

Comment

Under the current approach, the amount of income or deductions may not be allocated consistently for taxpayers with the same duration of lease. This is because the allocation of income or deductions depends on the number of income years in the spreading period for a lease. For example, a lesser amount of income or deductions would be spread in each income year for a lease that begins half-way through an income year compared with a lease that begins at the start of the income year.

Example

A tenant receives a lease inducement payment of $100,000 from a landlord on 1 April 2013 for a 10-year lease (the lease ends on 31 March 2023). The lease begins on the same day. The tenant has a 31 March balance date.

Under the proposed timing rule, $10,000 of income ($100,000/10) would be allocated over 10 income years.

However, if a tenant receives the payment on 1 July 2013 for a 10-year lease that begins on the same day and ends on 30 June 2023, $9,091 of income ($100,000/11) would be allocated over 11 income years.

Officials accept that allocating income or deductions in equal portions to each income year may not allocate income or deductions proportionately to the actual number of months or days of the spreading period in an income year.

To better allocate income or deductions without requiring a complex set of rules, officials prefer the amount to be allocated proportionately to the number of months rather than the number of days. Officials consider this is a balanced approach of providing a simple, yet reasonably accurate allocation rule. This approach is also consistent with the suggested straight-line method in the depreciation rules.

Recommendation

That the submission be accepted, subject to officials' comments.

Submission
(Corporate Taxpayers Group)

Transfers to associated persons should be treated consistently for income and deductions purposes to ensure that related entities are able to restructure their holdings of land rights or estates in land without adverse income tax consequences.

Comment

Under the proposed timing rule, a "wash-up" calculation of income or deductions is generally required in certain situations – for example, when a landlord transfers the reversion (i.e. the estate in land from which the land right is granted) or a tenant transfers their lease to a third party before the lease expires.

However, the "wash-up" calculation for deductions is not allowed if the landlord transfers the reversion to an associated person. In this case, the remaining deductions would continue to be spread over the remaining term of the lease. This is intended as a specific anti-avoidance measure to target situations when a lease inducement payment is made by a landlord who subsequently transfers the reversion to an associated person (a new landlord) to accelerate their deductions.

Officials do not agree that the tenant should continue to spread income over the remaining term of the lease if the transfer is between associates. Officials do not consider there is a need to treat transfers between associates differently from transfers between non-associates in relation to the timing of income.

Recommendation

That the submission be declined.

Issue: Timing mismatch

Submissions
(New Zealand Law Society, Corporate Taxpayers Group)

There is a possible mismatch with the timing of capital contribution income (10 years) and deductions (spread over the term of a land right under the proposed timing rule). *(New Zealand Law Society)*

Income from lease premiums that is subject to section EI 7 (which spreads income over six years) should be subject to the proposed timing rule to ensure symmetry. *(New Zealand Law Society)*

Spreading of income and deductions for lease premiums should be consistent. (*Corporate Taxpayers Group)*

Comment

Officials accept there are some inconsistencies between the existing timing rule for lease premiums and capital contributions, and the proposed timing rule for lease inducement payments. These inconsistencies can be partly explained by the fact that the timing rules have been developed separately for particular payments over a long period of time.

As announced by the Minister of Revenue on 11 December 2012, the tax treatment of land-related lease payments is currently being looked at, with a view to providing a coherent and consistent tax treatment of these payments. The timing rules for these payments will be part of the review. It is expected that an officials' issues paper will be released for public consultation this year seeking feedback on the review.

Recommendation

That the submissions be declined.

Issue: Lease surrender payments

Submission
(New Zealand Law Society)

Drafting proposed income and deduction provisions for lease surrender payments (sections CC 1C and DB 20C) in the same way seems desirable.

Comment

Officials do not consider the same drafting format for income and deductions provisions for lease surrender payments is necessary or desirable. There is no general requirement that income and deductions provisions be structured in the same way. The current drafting achieves the policy intent of treating lease surrender payments as income to the recipient and deductible to the payer whether they are a landlord or tenant.

The income provision is drafted differently from the deductions provision – for example, the income provision specifies the recipient only, whereas the deductions provision specifies both the recipient and the payer. This is intended to sufficiently protect the tax base.

Recommendation

That the submission be declined.

Submission
(KPMG)

Proposed section DB 20C needs to be corrected because for lease surrender payments, the payer is the tenant, not the owner of a lease.

Comment

Lease surrender payments are generally made by a tenant to a landlord to surrender an existing lease before its expiry date. However, these payments can also be made by a landlord to a tenant. Hence, provisions relating to lease surrender payments are intended to cover both situations: proposed section DB 20C confirms deductibility of lease surrender payments for both landlords and tenants.

Recommendation

That the submission be declined.

Issue: Definitions of "residential premises" and "tenant"

Submissions
(Ernst & Young, New Zealand Institute of Chartered Accountants)

The policy intent and drafting of the term "residential premises" should be clarified. *(Ernst & Young)*

The term "residential premises" should be defined. *(New Zealand Institute of Chartered Accountants)*

The term "tenant" should be defined. *(Ernst & Young)*

Comment

Under the proposal, lease inducement and lease surrender payments derived by a tenant of residential premises are not income of the tenant. The policy rationale for this exclusion is to provide symmetry of income and deductions for a tenant of residential premises. The tenant would not able to deduct these payments or rent because they do not meet the general permission in section DA 1 and the private limitation in section DA 2(2) would also apply.

Officials accept that some uncertainty may arise over what "residential premises" or "tenant" refer to. Having considered a number of Acts that define these terms, officials are not convinced that providing a specific definition for these terms would be helpful.

Alternative wording will be considered to better reflect the policy intent. It is expected that the exclusion would apply in a very limited circumstance because lease inducement and lease surrender payments are generally incurred or derived in a commercial context (i.e. between landlords and commercial tenants).

Recommendation

That the submissions to clarify the residential tenant exclusion in proposed sections CC 1B(4) and CC 1C(3) be accepted.

Issue: Deductions for landlords of residential premises

Submission
(New Zealand Institute of Chartered Accountants)

The bill should be amended to allow deductions for lease inducement and lease surrender payments by landlords of residential premises.

Comment

Proposed sections DB 20B and DB 20C already allow deductions to a landlord of residential premises who makes lease inducement and lease surrender payments. The exception for tenants of residential premises is relevant for income purposes only.

Recommendation

That the submission be declined.

Issue: Lease premiums and lease inducement payments

Submission
(Chapman Tripp)

The definition of "lease inducement payments" should be clarified as provisions relating to lease inducement payments are drafted very broadly and are not clear how these provisions interact with existing provisions.

Comment

Officials do not consider clarifying the term "lease inducement payments" is necessary. The current provisions sufficiently identify the type of lease inducement payments that are currently not taxable under the Income Tax Act 2007.

The income provision (proposed section CC 1B) is broadly drafted so that it includes both lease premiums (such as "key money" paid by incoming tenants to landlords) and lease inducement payments (paid by landlords to incoming tenants). Although lease premiums are already covered under section CC 1, the amount of income would be allocated to a person once because of the existing single income allocation rule in section BD 3(6).

The deduction provision (proposed section DB 20B) allows deductions for landlords who make lease inducement payments to an incoming tenant. The existing depreciation rules allow deductions for tenants who make lease premium payments to landlords.

Officials accept that these similar payments are covered under various regimes. The scheduled review of the tax treatment of land-related lease payments will seek to rationalise the various rules relating to lease payments. An officials' issues paper is expected to be released for public consultation this year.

Recommendation

That the submission be declined.

Submission
(Corporate Taxpayers Group)

Proposed section DB 20B should be amended to allow deductions for "key money" paid by tenants to landlords. This would ensure that the existing asymmetry does not arise.

Comment

Proposed section DB 20B covers deductions for lease inducement payments only – deductions are allowed to landlords who make lease inducement payments to incoming tenants. Deductions for lease premium payments or "key money" made by incoming tenants to landlords are already covered under the existing depreciation rules.

Having two different deductions mechanisms for lease premiums and lease inducement payments that are similar in substance (i.e. payments to enter into a lease) is undesirable. In practice, it may create some inconsistencies and confusions over which mechanism applies to these payments. The scheduled review of the tax treatment of land-related lease payments will seek to rationalise the various rules relating to lease payments.

Recommendation

That the submission be declined.

Issue: Rationalisation of provisions relating to lease payments

Submission
(New Zealand Law Society)

When a further review of lease payments is being contemplated, consideration should be given to how all provisions should fit together.

Comment

Officials agree there is a need to rationalise existing provisions and new provisions relating to lease inducement and lease surrender payments. The scheduled review of the tax treatment of land-related lease payments will seek to rationalise the various rules relating to lease payments. An officials' issues paper is expected to be released for public consultation this year.

Recommendation

That the submission be noted.

Issue: GST treatment

Submission
(New Zealand Institute of Chartered Accountants)

The GST treatment of lease inducement and lease surrender payments should be clarified.

Comment

The reforms included in this bill are intended to cover the income tax aspects only of lease inducement and lease surrender payments only.

Recommendation

That the submission be declined.

Issue: Minor technical drafting issues

Submissions

(Deloitte, New Zealand Law Society, New Zealand Institute of Chartered Accountants, Corporate Taxpayers Group)

Submitters have made a number of technical suggestions to improve the provisions that are consistent with the policy intent. Officials agree with these submissions. These are outlined below:

- Certain amendments should be made to exclude capital contribution payments (such as contribution for fit-out costs) being subject to the proposed rules, in line with the policy intent. *(Deloitte, New Zealand Law Society, New Zealand Institute of Chartered Accountants, Corporate Taxpayers Group)*
- Proposed sections CC 1B(4) and CC 1C(3) should be amended to refer to a tenant or licensee of residential premises because these provisions would apply to both a leasehold estate and a licence to use land. *(New Zealand Law Society, Corporate Taxpayers Group)*

Recommendation

That the submissions be accepted.

GST: CROSS-BORDER BUSINESS-TO-BUSINESS NEUTRALITY

Clauses 91 and 92

Issue: Grouping

Submissions
(Corporate Taxpayers Group, CTC Aviation, Deloitte, Ernst & Young, KPMG, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

The proposal to prevent residents from forming GST groups with non-residents should not go ahead. *(Corporate Taxpayers Group, CTC Aviation, Deloitte, Ernst & Young, KPMG, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)*

As an alternative, non-residents that are required to be registered should be allowed to group. *(CTC Aviation)*

The proposed rule that allows the disbanding of current groups should be clarified so that it only applies to groups formed after introduction. *(CTC Aviation)*

Comment

The bill proposes to prevent the establishment of cross-border groups to allow Inland Revenue to accurately assess the level of refunds paid to non-residents. If cross-border groups were allowed, when a representative member filed a GST return on behalf of the group, it would be possible for what are effectively GST refunds to non-residents to be "masked" by the activities of a broader group that included New Zealand residents. Grouping with a New Zealand resident could also be used by non-residents as a method of accounting for GST on an invoice basis – a basis that is more susceptible to fraud because GST refunds are provided on invoices issued, rather than cash paid.

However, there are sometimes legitimate reasons for forming cross-border groups and officials accept that the changes should not impose undue barriers in the way of standard business arrangements.

Officials consider there is a solution that will allow for the formation of cross-border groups but still provide an adequate degree of protection to the revenue base. The suggested changes should affect not only cross-border grouping, but provide more clarity around the scope of the rules more generally.

Officials therefore recommend that clauses 91 and 92 be amended so that:

- Only non-residents that make *no* taxable supplies in New Zealand can register for GST under proposed section 54B.
- Non-residents that make taxable supplies in New Zealand under the compulsory registration threshold would not be able to use section 54B but would be able to voluntarily register under the existing registration provisions. This voluntary registration option would also apply to a non-resident that either did or did not make taxable supplies and wished to form a group with companies that made taxable supplies.

- If a non-resident registered under section 54B starts making taxable supplies, they will be treated as being registered under the existing "domestic" rules.

This would give a non-resident the option of either registering under section 54B or joining a group with a New Zealand resident and that group would be subject to the "standard" rules. The advantage of this solution is that non-residents that chose to group-register with a New Zealand company would have to show that any input deductions claimed were linked to taxable supplies made in New Zealand (rather than their worldwide business) in order to access refunds. This is consistent with the current situation and officials do not consider there is a significant revenue risk attached to it. On the flip side, the solution still allows non-residents in a "pure" refund position to register under the proposed rules and claim input deductions based on their worldwide supplies.

Non-residents registered under proposed section 54B would still only be able to group-register with other companies registered under that section (in other words, form wholly non-resident groups).

This solution has been discussed with representatives of Deloitte and the Corporate Taxpayers Group. Both agree it strikes a reasonable balance.

By recommending the main submission be accepted, the concerns raised by the secondary submissions are also addressed.

Recommendation

That the submissions be accepted.

Issue: Registration rules as a code

Submission
(Ernst & Young)

The word "only" in proposed section 54B(1) should be deleted because it reads as a code for all voluntary registrations of non-residents.

Comment

Officials consider the registration criteria rules should be a code, subject to officials' recommendation on the previous issue. The consequence of the recommendation is that a non-resident that makes no taxable supplies in New Zealand should only be able to register under the proposed rules. Non-residents making taxable supplies will be able to continue to voluntarily register.

Recommendation

That the submission be declined on the basis that, if previous officials' recommendations are accepted, having the rules act as a code provides the right outcome.

Issue: Relationship with current rules

Submission
(PricewaterhouseCoopers)

Further consideration should be given to how the existing GST rules and proposed registration rules should work in tandem. In particular, an exclusion similar to that in proposed section 54B(1)(c) should be introduced in relation to goods.

Comment

If the Committee accepts the recommendation to clarify the scope of the proposed rules, those changes would address the concerns in this submission. By applying different rules to non-residents making taxable supplies in New Zealand and those not making taxable supplies, it should be apparent where the dividing line between the two sets of rules is drawn. That being the case, no exclusion such as that suggested in the submission would be necessary.

Recommendation

That the submission be declined on the basis that, if officials' previous recommendations are accepted, the right outcome should be achieved.

Issue: Cessation of registration

Clause 75

Submission
(Ernst & Young)

1. Proposed section 5(3B) should not go ahead.

2. Proposed paragraph 5(3B)(b) should be revised to apply only to services "forming part of the assets" or deleted.

3. Section 10(7A) should refer to section 5(3B) so that market value rules apply.

Comment

Proposed section 5(3B) is intended to be concessionary. Without it, officials consider there is an argument that a non-resident that registered for GST and then deregistered would need to account for output tax on the value of all its worldwide assets. Clearly this would be an inequitable outcome. The purpose of proposed section 5(3B) is therefore to limit New Zealand's taxing right to goods and services that logically form part of the non-resident's New Zealand activities (if there are any).

However, officials agree there is scope for uncertainty regarding the proposed wording of paragraph (b). Output tax on services that have already been supplied in accordance with the time of supply rules should be returned, even though the non-resident will only be registered on a payments basis. We therefore consider that the services caught by this provision should be the services performed in New Zealand prior to deregistration.

Officials also agree that applying the market value rule in section 10(7A) to supplies treated as being made under proposed section 5(3B) is appropriate.

Recommendation

That submission 1 be declined, submission 2 be accepted in part, subject to officials' comments, and submission 3 be accepted.

Issue: On-supply of services

Clause 91

Submission
(Ernst & Young)

Proposed section 54B(1)(c) should be clarified in its scope so that it refers to "the performance of services", rather that the "a supply of services". This would make it consistent with section 11A(2).

Comment

Officials agree that consistency between proposed section 54B(1)(c) and current section 11A(2) is desirable.

Recommendation

That the submission be accepted.

Issue: Input tax ratio

Clause 83

Submissions
(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)

Allowing input claims only to the extent of its taxable supplies is not practical in the case of larger businesses. *(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

Either the restriction should not be introduced or the bill should include a safe-harbour recovery ratio of, say, 25%, which would apply unless the taxpayer can demonstrate that a higher ratio is appropriate. *(New Zealand Institute of Chartered Accountants)*

GST deductions should be calculated under the existing rules for GST recovery and based on actual supplies made by the non-resident business in New Zealand. *(PricewaterhouseCoopers)*

Comment

Claiming input deductions on the basis of worldwide supplies, as if all supplies were made and received in New Zealand, provides an appropriate outcome. Given the broad base of New Zealand's GST system, it is anticipated that almost all industries outside the financial services sector would be entitled to claim on a near 100 percent basis. For those within the financial services sector, officials accept that compliance costs will be incurred. However, it is considered preferable to require estimates to be made, given any alternative may result in a non-resident financial services provider being in a more favourable position than a comparable New Zealand-resident business.

One way of providing some parity between resident and non-resident financial services providers would be to allow a rule that permitted a non-resident to agree a fair and reasonable apportionment method with the Commissioner of Inland Revenue. Resident financial service providers can make the type of arrangement under section 20(3E) of the GST Act, and officials consider that compliance costs for a non-resident financial service provider could be lowered by allowing a similar rule to be made available to them.

Although officials can see the attraction of a safe-harbour recover ratio, as suggested by NZICA, this has the potential to impose compliance costs on the vast majority of businesses that would have to displace the onus of proof to claim a higher ratio.

Basing input claims on the actual New Zealand supplies made would, in officials' view, defeat the purpose of these rules. If claims could only be made on the basis of New Zealand supplies, a non-resident that made no supplies in New Zealand would not be able to access GST refunds.

Recommendation

That the submissions be accepted to the extent that a rule be introduced allowing non-resident financial service providers to agree an input ratio with the Commissioner.

Issue: Time period for refunds

Clause 89

Submission
(New Zealand Institute of Chartered Accountants)

The time period under proposed section 46(1B) should be reduced to 63 working days.

Comment

Officials consider the 90-day period to be appropriate. There is an increased fraud risk associated with providing refunds to non-residents. This risk exists because, unlike residents, Inland Revenue has limited ability to accurately track down and recover money from non-residents when a refund is released in error.

Having a longer timeframe for releasing refunds is considered preferable to having a shorter timeframe that the Commissioner may be more inclined to extend if doubts exist over the legitimacy of a claim. Officials consider that 90 days is a more realistic timeframe to allow the Commissioner to adopt a considered opinion on whether a refund will be released.

Recommendation

That the submission be declined.

Issue: Registration criteria

Clause 91

Submission
(New Zealand Law Society, Russell McVeagh)

There is a potential unintended gap in the registration criteria because it assumes all consumption taxes are as broad based as our GST. The words "if the country or territory in which the person is resident does not have a consumption tax", should be removed from proposed subparagraph 54B(1)(ii) so the registration criteria in paragraph (1) operate on an either/or basis.

Comment

Officials do not agree that the two alternatives set out in proposed section 54B(1) should be on an either/or basis. The purpose behind the registration criteria more generally is that only legitimate businesses should be able to register for GST in New Zealand. Officials consider that a good proxy for "legitimacy" in this instance is the fact that the person has satisfied their "home" government that they should be registered for a comparable tax in that jurisdiction.

However, officials agree with the submission to the extent that there is a potential unintended gap in the wording. The issue is that the person may live in a jurisdiction that has a consumption tax, but not be required to register for that tax because their activities are outside the tax base. On this basis, officials consider the wording should be amended so that paragraph (ii) applies to a person that is resident in a jurisdiction that does not have a consumption tax, or has a consumption tax that does not apply to the activities of the person.

Recommendation

That the submission be accepted to the extent it refers to "an unintended gap between proposed paragraphs (i) and (ii)", but otherwise declined.

Issue: Cancellation of registration

Clause 91

Submission
(New Zealand Law Society)

Proposed section 54C(3)(b) is too inflexible. It should either not proceed or, in the alternative, should provide for some flexibility by incorporating an Inland Revenue discretion.

Comment

Proposed section 54C is included to provide a disincentive for non-residents that fail to comply with their filing obligations. It does this by providing that a person who fails to file or files late returns for three consecutive periods is deregistered and cannot re-register for a period of five years. This five-year period also applies to non-resident associates of the person to prevent the rules being easily circumvented.

The submitter considers this would be inequitable in situations such as when the non-resident company is bought by another non-resident (the prohibition on registration would attach to the new owner), or if the management of the affected non-resident changed.

Officials consider that providing a Commissioner discretion on these matters could lead to uncertainty over how and if that discretion will be exercised, and requests for detailed guidance. Officials do not consider the potential inequities raised outweigh the desirability of having clear rules in this area that are difficult to avoid.

Recommendation

That the submission be declined.

Issue: Direct refund scheme

Submission
(PricewaterhouseCoopers)

The proposed system to allow non-resident businesses to register for GST should be replaced with a direct refund scheme.

Comment

The options for enhancing cross-border business-to-business neutrality were canvassed in a Government discussion document released in August 2011: *GST: Business-to-business neutrality across borders*. In that document, one of the options discussed was a direct refund model. However, one clear disadvantage of that approach was the need for a new electronic system to manage the refunds. The Government therefore stated a preference for the system this bill seeks to implement – whereby non-resident businesses can register for New Zealand GST and claim input tax deductions in a way broadly comparable with a similar New Zealand-resident business. Submissions on the discussion document overwhelmingly agreed with the Government's preference.

Recommendation

That the submission be declined.

Issue: GST on "tooling costs"

Clause 78

Submissions
(BusinessNZ, Deloitte, PricewaterhouseCoopers, Corporate Taxpayers Group)

1. This initiative should proceed. *(BusinessNZ, Deloitte, PricewaterhouseCoopers, Corporate Taxpayers Group)*

2. The rule should be effective from date of enactment, rather than 1 April 2014. *(Deloitte, PricewaterhouseCoopers, Corporate Taxpayers Group)*

Comment

Officials consider these changes form a "package" of cross-border initiatives with the proposed registration system for non-residents mentioned above. For that reason, it is considered desirable for both rules to be effective from the same date.

Recommendation

That submission 1 be noted and submission 2 be declined.

TREATMENT OF EXCEPTED FINANCIAL ARRANGEMENTS UNDER THE FINANCIAL ARRANGEMENTS RULES

Clause 33B

The bill introduces an amendment to the tax rules that allows a taxpayer to elect to treat excepted financial arrangements as financial arrangements. The change will remove an overreach problem caused by the election rule, while still preserving the original policy intent behind the rule. The policy behind the rule is to reduce compliance costs to taxpayers who have debts outstanding relating to goods or services supplied in the ordinary course of their business, valued in a foreign currency.

Issue: Amendment to treatment of short-term agreements for sale and purchase

Submission
(Corporate Taxpayers Group)

The submitter supports the rationale behind the amendment, ensuring the financial arrangements rules work as intended.

Recommendation

That the submission be noted.

Issue: Clarification of drafting

Submission
(Ernst & Young, Corporate Taxpayers Group)

The drafting should be clarified to better reflect the policy intent.

It is not clear whether the modification applies to the underlying short-term agreement that is transferred or to the transfer agreement itself. *(Ernst & Young)*

Comment

Officials agree that the drafting could be clarified to better reflect the policy intent.

The policy intent behind allowing taxpayers to elect to treat certain excepted financial arrangements as financial arrangements was to reduce compliance costs when short-term trade credits denominated in a foreign currency were valued at balance date spot rates for financial reporting purposes, and at transaction date spot rates for tax purposes. Further, when the short-term trade credit was hedged, there was a mismatch.

The excepted financial arrangements that can be treated as financial arrangements are:

- agreements for the sale and purchase of property or services;
- short-term agreements for sale and purchase;
- short-term options;
- travellers' cheques; and
- certain variable principal debt instruments.

Officials consider that removing the ability to elect to treat these excepted financial arrangements as financial arrangements will reduce the potential "overreach" of the current election rule.

However, it is still necessary to address the issue of the mismatch between the tax valuation of excepted financial arrangements denominated in a foreign currency (the tax rules require taxpayers to value these excepted financial arrangements at the spot rate applicable at the date of sale or purchase) and the accounting valuation.

Therefore, officials recommend that a provision in the bill (clause 33B) be re-drafted to address this mismatch. Accordingly, the bill proposes that, for the five excepted financial arrangements listed above, taxpayers be allowed to use the valuations they use for their financial statements for tax purposes, if they are denominated in a foreign currency. More specifically, taxpayers who, for their financial statements, determine foreign exchange values at balance date for such debts (that are excepted financial arrangements) would be allowed to use this balance date foreign exchange value for tax purposes. This should address the compliance cost concern that underpinned the introduction of the election rule (section EW 8 of the Income Tax Act 2007).

The rule is optional. However, once a taxpayer elects into the rule for an excepted financial arrangement, they will not be allowed to revoke the election. A taxpayer's decision to elect into the rule will be reflected in the tax position they take in their return of income for each tax year – no prior notice of election is required.

The new approach therefore means that taxpayers will no longer be able to elect to treat the five excepted financial arrangements outlined above as financial arrangements.

The bill proposes a transitional rule that will operate for taxpayers who have previously elected to treat an excepted financial arrangement as a financial arrangement under section EW 8. These taxpayers will be treated as having valued their foreign currency-denominated excepted financial arrangements at the spot date used for their financial statements, on the date that the new rules come into force.

There will be no change to the application date for the amendment (see next submission).

Recommendation

That the submission be accepted.

Issue: Amendment should be limited in scope or, alternatively, addressed as part of a wider review of the financial arrangements rules

Submission

(Ernst & Young)

The submitter states that the proposed amendment should be deleted or alternatively re-worded to limit its scope. The submitter is concerned that the amendment may have broader application than intended. Taxpayers may elect to treat short-term agreements for sale and purchase, such as their trade receivables or payables as financial arrangements in the ordinary course of business (for example, if they are denominated in a foreign currency). On a literal reading of the proposed new section EW 32B, it is possible that it might apply to such taxpayers.

It is further submitted that any changes to the financial arrangements rules should be addressed as part of a comprehensive review of the rules, rather than on an ad hoc basis.

Comment

The amendment addresses a specific concern with the election to treat excepted financial arrangements as financial arrangements in a targeted manner.

The rationale behind allowing a taxpayer to elect to treat a short-term agreement for sale and purchase as a financial arrangement was to reduce compliance costs by allowing any short-term debt under the agreement to be treated for tax purposes as it is for accounting purposes – for example, in the situation outlined by the submitter. However, the rule has unanticipated overreach – for example, taxpayers being able to convert what would otherwise be capital sums into deductible amounts.

The change proposed above addresses the compliance cost issue raised by the submitter by allowing taxpayers with trade receivables or payable denominated in a foreign currency to use their financial reporting valuations for tax purposes.

The issue required addressing as soon as practicable because it presented a potential fiscal risk. Accordingly, officials did not consider it appropriate to wait for a review of the overall financial arrangements rules before amending the rules. No review is planned. In proposing the change, officials have taken into consideration the overall scheme of the financial arrangements rules.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(Ernst & Young)

The application date should be changed so that the amendment only applies to transactions occurring after the date the bill is enacted.

Comment

The revised amendment outlined above applies to all excepted financial arrangements that a taxpayer elects to treat as a financial arrangement from 27 September 2012. However, there is a "savings" provision for short-term agreements when the taxpayer has taken a tax position or obtained a binding ruling before 27 September 2012 (the date the proposed change was announced by the Minister of Revenue).

Officials consider the application date is justifiable because of the potential fiscal risk from the loophole in the existing rules.

Recommendation

That the submission be declined.

TIME PERIOD FOR REFUNDS UNDER THE INCOME TAX ACT 2007

Issue: Agree with proposal in principle

Submission
(New Zealand Institute of Chartered Accountants)

Subject to our submissions on the application date and section 113, set out below, we accept the broad principle underlying the proposed change to limit the time period for claiming tax refunds and charitable tax credits, being to align the refund period with the time bar for reassessment.

Recommendation

That the submission be noted.

Issue: Application date

Submissions
(Ernst & Young, New Zealand Institute of Chartered Accountants)

The repeal of section RM 6 of the Income Tax Act 2007 should be clarified to apply in relation to refunds of income tax for a person's 2013–14 or later income year. *(Ernst & Young)*

The wording of proposed new section 41A(6) of the Tax Administration Act 1994 should be revised to clarify when the refund application must be made and definition of the four-year period. Clarification should also be provided on how the amendment to section 41A may apply in relation to any delayed claims for housekeeping payment credits up to the 2011–12 income year. *(Ernst & Young)*

The application date of the amendment should be delayed so that it applies from the 2016–17 and later tax years. This would align the proposed amendment with the changes to the tax return filing rules enacted in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012. *(New Zealand Institute of Chartered Accountants)*

Comment

The proposal means that from the 2013–14 tax year the time period for refunds under the Income Tax Act is reduced to four years from the end of the year in which the assessment is made. The amendment applies to all refunds including those where the refund is for a tax year before 2013–14. A submission suggests that the proposal should apply to assessments only to refunds for a person's 2013–14 or later tax year. Officials disagree and consider that it would be much simpler for only one refund time period to apply in all cases. To have different time periods apply depending on when tax was assessed would create confusion.

For donations tax credits the bill proposes that the refund must be made within four years from the end of the tax year in which the donation is made. A submission suggests that the proposal apply to gifts made after 1 April 2013. Currently for the many individual taxpayers who are not required to file returns, there is no assessment of tax, the time period in section 108 does not start and therefore there is no time limit for claiming tax credits. As with the submission on the application date for the refund time period under the Income Tax Act above, officials consider it would be much simpler for only one rule to apply in all cases. To have different time periods in perpetuity depending on when the gift was made would create confusion.

One submission suggested that the proposal be delayed to align with the recent amendment to the return filing rules. The proposal to amend the time period for refunds under the Income Tax Act applies more widely than the recent amendments to the return filing rules. Officials consider that these proposals, which affect all taxpayers, should not be delayed.

Recommendation

That the submissions be declined.

Issue: Commissioner amending assessments

Submission
(New Zealand Institute of Chartered Accountants)

The four-year time limit should also apply to amended assessments issued by the Commissioner under section 113 of the Tax Administration Act 1994.

Section 113 should specifically proscribe the Commissioner's practice of refusing to amend an assessment under section 113 when the taxpayer wishes to change from one valid treatment available under the Revenue Acts to another valid treatment (the so called "regretted choice" approach).

Comment

Section 113 gives the Commissioner the discretion to amend assessments in order to ensure their correctness. While there is specifically no time limit in section 113 on the Commissioner amending an assessment, there are time limits on the Commissioner increasing the amount of an assessment and refunding overpaid tax. Standard practice statement *07/03 Requests to amend assessments* sets out the Commissioner's practice for exercising the section 113 discretion. It clearly refers to the time limits on increasing assessments (paragraph 55) and the time limits on income tax refunds (paragraph 56).

The application of the time bar to the Commissioner's power to amend assessments was confirmed in *Miller v Commissioner of Inland Revenue*, (1998) 18 NZTC 13,961 (CA):

> The Act confers on the Commissioner the power to make tax assessments (s 19) [of the Income Tax Act 1976 which became section 92 of the Tax Administration Act 1994, since amended] and from time to time to make alterations or amendments to an assessment in order to ensure its correctness (s 23)[now section 113]. But the Commissioner may not exercise that power of amendment after four years from the end of the year in which the original assessment was made except where the taxpayer's return was fraudulent or wilfully misleading or omitted all mention of the income in question or all mention of income from a particular source (s 25)[now section 108]. Except in objection proceedings, an assessment may not be disputed and is conclusively deemed and taken to be correct (s 27) [now section 109]. …

When a taxpayer has two or more options available to them, takes one option and at a later date requests a change to another valid option, there is no error to correct – the position taken is correct. The Commissioner does not have unlimited resources and as noted in the standard practice statement *07/03 Requests to amend assessments*:

> … the Commissioner does not consider it appropriate to devote resources to correcting optional positions if the preferred positions could have been taken when the taxpayers made the original self-assessments by filing the tax returns. Arguably, to do so would not promote the integrity of the tax system pursuant to section 6(1).

Amending section 113 to proscribe the Commissioner's practice of "regretted choice" would involve a major change to tax administration. The proposal in the bill concerns the time limit for refunds and is not concerned with amending a long standing core provision such as section 113.

Recommendation

That the submission be declined.

Issue: The amendment does not lead to symmetry

Submissions
(Corporate Taxpayers Group, Deloitte, KPMG, New Zealand Law Society)

The time period for refunds should remain at eight years. While it is correct to say that assessments cannot generally be increased after four years, there is actually a long list of exceptions to this rule which are not mentioned in the commentary to the bill or the associated regulatory impact statement. For example, there is no time limit on the Commissioner if there is a view that a return is fraudulent or wilfully misleading or does not mention income of a particular nature or derived from a particular source. This means there is the potential to nullify the time bar in situations when there is no intended mischief by a taxpayer and therefore can potentially apply to a taxpayer who has made what is essentially a simple mistake or oversight. *(Corporate Taxpayers Group, Deloitte)*

While this change seems reasonable, we note that the statute bar period can be waived in some circumstances. *(KPMG)*

The proposal to limit a taxpayer's right to a refund after the four-year period should not proceed. The playing field is already substantially tilted in the Commissioner's favour. Whereas the Commissioner can amend a assessment at any time during the four-year period in section 108 of the Tax Administration Act, taxpayers have no right to have an assessment amended once four months have passed since the date they made their assessment (note that in the case of a Commissioner assessment, the period is two months). There are many situations when the Commissioner is able to amend an assessment beyond the four-year period. If the proposal does proceed, it should be subject to appropriate exceptions – for example, relatively large claims. *(New Zealand Law Society)*

Comment

Officials agree with the comments in submissions that in particular circumstances there is no time limit on the Commissioner for increasing an assessment – for example, when a return is fraudulent or omits income from a particular source.

The limited exceptions to the four-year time bar rule should be seen in the context that the Commissioner is responsible for administering the entire tax system. Matters concerning tax positions taken by a taxpayer are primarily within the knowledge of the taxpayer. One of the principles underlying self-assessment is that taxpayers have more information about their tax liabilities and are therefore in a better position to assess their own tax liability than the Commissioner. The Commissioner audits taxpayers to determine whether their self-assessments are correct or incorrect.

As noted earlier, taxpayers can request that adjustments be made to assessments under section 113 of the Tax Administration Act to ensure their correctness.

Recommendation

That the submissions be declined.

Issue: Specific loss offset and refund rules

Submissions
(Corporate Taxpayers Group, Deloitte)

The loss offset and refund rules need to be revised to ensure that their operation is consistent with the operative provisions in the Act, particularly the petroleum mining rules. *(Corporate Taxpayers Group)*

There are also a number of circumstances where amended assessments are possible outside the general four-year rule and therefore amending the rules to prevent refunds after a four-year period would not result in symmetry of outcomes for taxpayers and Inland Revenue. *(Corporate Taxpayers Group, Deloitte)*

Comment

This proposal generally aligns the time period for taxpayers requesting refunds with the time period for the Commissioner increasing an assessment. As noted in one of the submissions:

> Regardless of whether this proposal proceeds, arguably sections RM 2, 4 and 6 do not currently work with a large number of provisions in the Act that can require tax adjustments to be made outside of the time bar.

Officials note that this submission raises issues that would require further analysis as part of the Government's tax policy work programme.

Recommendation

That the submissions be declined.

Issue: Double taxation example

Submissions

(Corporate Taxpayers Group, KPMG)

Inland Revenue could amend a taxpayer's assessment to correct an underpayment of tax but not allow the overpayment of tax in an earlier year to be corrected to offset the underpayment. *(Corporate Taxpayers Group)*

It is important that a timing mismatch does not arise. For example, a timing difference that is amended on audit, if Inland Revenue increases the income in a tax year that is inside the four-year limit, and there is a corresponding decrease in income in a tax year that is outside the four-year limit, the refund resulting from the reduced income should not be disallowed. *(KPMG)*

Comment

One of the submissions contained an example where a taxpayer returned income early in year 1 – the income should have been returned in year 3. When Inland Revenue audited the taxpayer in year 7 the assessment for year 3 was amended but a corresponding adjustment was not made to the year 1 assessment, resulting in the taxpayer being taxed twice on the same income.

Officials consider that such an outcome is inconsistent with the Commissioner's duty under section 6 of the Tax Administration Act to maintain the integrity of the tax system. In exercising her powers the Commissioner should seek to avoid this outcome by, for example, making appropriate consequential amendments.

The Commissioner has issued an internal instruction to this effect. This internal instruction will be noted in the *Tax Information Bulletin* article for this reform.

Officials have discussed the issue with the Committee's independent advisor. Officials will monitor this issue and if such double taxation cases occur will propose an amendment in a future bill.

Recommendation

That the submissions be noted.

Issue: Extend the time period to claim input tax credits

Submission
(Corporate Taxpayers Group)

The time period for claiming input tax credits should be lengthened to four years.

Comment

For GST purposes, the current time period to claim input tax credits is two years as set out in the proviso to section 20(3) of the Goods and Services Tax Act 1985. The issue of the time period for claiming input tax credits raises considerations which are particular and special to GST. These would require quite separate analysis to the proposal in the bill to reduce the time period for refunds under the Income Tax Act to four years.

Recommendation

That the submission be declined.

Issue: Application to foreign tax credits

Submission
(BDO Wellington Limited)

It is unclear how the amendments will affect the application of section 78B of the Tax Administration Act 1994.

Comment

Under section 78B(1) of the Tax Administration 1994, a taxpayer who has a tax credit under section LJ 2 (tax credits for foreign income tax) or section LK 1 (tax credits relating to attributed CFC income) of the Income Tax Act must apply for the credit within four years after the end of the tax year in which the taxpayer would have the credit. The Commissioner has a discretion to extend this period by another two years.

Officials agree with the submission and recommend that the time period for the refund be extended if the Commissioner has exercised her discretion under section 78B and the taxpayer would not otherwise be within the refund period.

Recommendation

That the submission be accepted.

Issue: Overpayment of tax

Submission
(New Zealand Law Society)

When a taxpayer has paid more tax than they were procedurally required to do so, there should be no time limit on the right to a refund. The time limitation in section 108 of the Tax Administration Act on the Commissioner's power to amend an assessment does not prevent the Commissioner from collecting tax which the taxpayer has admitted it owes, but which it has not paid. Accordingly, there should be no limit on refunds which arise without the need for an amended assessment.

Comment

This proposal in the bill generally aligns the time period for taxpayers requesting refunds with the time period for the Commissioner increasing an assessment. It means that all taxpayers requesting refunds would be treated similarly, as the refund period for personal tax summary taxpayers is currently four years.

The submission is correct in that there is no time limit on the Commissioner collecting tax which the taxpayer has been assessed for but which has not been paid. The time limit is on the Commissioner amending an assessment so as to increase the amount assessed.

This submission raises an existing issue which the proposed amendment does not affect.

Recommendation

That the submission be declined.

Issue: Time bar and extension of time

Submission
(Deloitte)

For taxpayers with an extension of time, tax returns are due by 31 March following the end of the tax year. However, 31 March 2013 falls on Easter Sunday. An Inland Revenue publication has noted that returns can be filed on 2 April 2013. However, it does not mention the impact of doing so, which is that returns filed on 2 April 2013 would be filed in the 2014 tax year and remain open for the Commissioner to amend the assessment for an additional year beyond what the taxpayer may have expected.

Comment

This issue concerns the current application of the time bar and is therefore separate to the proposed amendments which would reduce the time period for income tax refunds to four years.

Recommendation

That the submission be noted.

Issue: Clarification of the application of the time bar to some taxes

Submission
(Deloitte)

There are a number of issues with the application of section 108 of the Tax Administration Act which prevent its clear application to some taxes – for example, an incorrect reference in section 99(2) to the wording in section 108 and the assessment provisions for FBT, ESCT and NRWT not referring to section 108.

Comment

Officials note that this submission raises issues that would require further analysis as part of the Government's tax policy work programme.

Recommendation

That the submission be noted.

Issue: Refund period under the Stamp and Cheque Duties Act 1971

Submission
(Matter raised by officials)

The time period for refunds in the Stamp and Cheque Duties Act 1971 should also be amended to be consistent with the proposed four-year period in the Income Tax Act 2007.

Comment

Section 86L of the Stamp and Cheque Duties Act 1971 sets out the time period for refunds of overpaid levies or levies paid in error. Currently a person can apply for the refund within eight years of the date of payment.

The time period should be reduced to four years consistent with the proposals in the bill to reduce the time period for refunds under the Income Tax Act.

Recommendation

That the submission be accepted.

Issue: Remedial amendment to section RM 4(1)(c)

Submission
(Matter raised by officials)

Section RM 4(1)(c) of the Income Tax Act 2007 should be amended to refer to "tax year" rather than "income year".

Comment

Section RM 4(1)(c) of the Income Tax Act 2007 refers to the four-year period "under section 108 of the Tax Administration Act 1994 beginning at the end of the income year in which the assessment was amended has not ended". Section 108(1)(b) refers to four years that "have passed from the end of the tax year in which the taxpayer provides the tax return". Section RM 4(1)(c) should be amended to refer to "tax year" rather than "income year", consistent with section 108.

Recommendation

That the submission be accepted.

FAIR DIVIDEND RATE (FDR) FOREIGN CURRENCY HEDGES

Issue: Create a FDR hedging fund

Submission
(Financial Services Council, AMP Capital)

A "FDR hedging fund" should be introduced that would have all its hedges taxed on the same basis as the fair dividend rate (FDR) method. Many funds are single-sector funds, investing in only one type of asset (such as international equities taxed under FDR). A FDR hedging fund approach would be easier for such funds.

Comment

In developing these rules, officials were concerned about the possible revenue risk if they could be misused. As such, the rules require certain calculations to ensure that they can only be used as intended. These rules were developed with significant consultation with the industry and officials are confident they are workable.

Nevertheless, this submission suggests that, for certain types of funds (those that invest only into FDR assets and that only enter into foreign exchange derivatives for the purpose of hedging) the rules could be redesigned to be simpler yet still provide the necessary comfort that they cannot be misused.

Officials understand the submitters' point. However, this would require a redesign of aspects of the rules and development of technical details, such as how to define a fund that only enters into foreign exchange derivatives for the purpose of hedging. As noted above, there is a risk that these rules could potentially be misused, so a cautious approach is justified.

Such a change could, however, potentially be considered for inclusion in the Government's tax policy work programme.

Recommendation

That the submission be declined.

Issue: Out of fund hedging

Submission
(Financial Services Council, AMP Capital, Ernst & Young)

The rules should be modified to also cater for funds that do not invest directly, but rather invest through other managed funds.

Comment

In theory, funds that do not invest directly into FDR assets should be able to "look through" wholesale funds they invest into and access the rules on the basis of those wholesale funds' investments.

However, in order to prevent misuse, there are a number of detailed factors that officials consider would need to be worked through before such a change is considered. For example, a restriction would need to be put in place to ensure that if a wholesale fund were to use this look-through rule it would not be able to arbitrarily start and stop doing so. Questions also arise over which types of funds would be able to benefit from such a modification, in what specific circumstances, and where the onus of proof would lie.

As with the issue of creating an FDR hedging fund noted above, this is a complex area and there are risks that the rules could potentially be misused, so a cautious approach is justified. For these reasons, officials' preference is that the issue of out of fund hedging instead be potentially considered for the Government's tax policy work programme.

Recommendation

That the submission be declined.

Issue: Associated persons and fair value requirements

Submission
(Financial Services Council, Ernst & Young)

For a hedge to be eligible for the new rules, it must not be entered into with an associated person and the hedge must have a fair value of zero when it is first entered into.

These two criteria should be replaced with a requirement that a hedge must be entered into on arm's-length terms.

Comment

Officials' concerns with an "arm's-length" test is that they are difficult to apply in practice. It can be very hard to prove that a transaction was not carried out at arm's length.

Officials do not agree that the rules should apply to hedges that have a fair value not equal to zero, even if that hedge was entered into on commercial terms. It would then be possible for taxpayers to select when to use these new rules in order to minimise their tax liability.

Recommendation

That the submission be declined.

Issue: Closing hedges out early

Submission
(Financial Services Council)

The rules should be amended to allow hedges to be closed out early by entering into an equal and opposite hedge transaction.

Comment

Officials agree, provided that the foreign currency contract used for this also meets the definition of a “hedge” under section EM 3. For example, it must begin with a fair value of zero.

Recommendation

That the submission be accepted.

Issue: Ability to make generic elections

Submission
(Financial Services Council, KPMG, AMP Capital)

Elections for the FDR hedging rules to apply to a hedge should be able to be done on a generic or portfolio basis.

Comment

Officials agree. It is noted, however, that an election for a hedge to be covered under the FDR hedging rules includes an election of a “FDR hedge portion” – that is, the extent to which the hedge should be covered by the rules.

Recommendation

That the submission be accepted.

Issue: Treatment of mistaken elections

Submission
(Financial Services Council, KPMG)

An election for the FDR hedging rules to apply is currently irrevocable. An exception should be made for genuine errors.

Comment

Officials disagree. The rationale for the up-front election is to ensure that taxpayers cannot choose which tax treatment to apply to a hedge based on what would give the most favourable tax treatment. It would be difficult to legislate a sufficiently strong definition of what constitutes a "genuine error", as taxpayers may have incentives to characterise some elections as an "error" for tax reasons.

Recommendation

That the submission be declined.

Issue: Apply calculations on a portfolio basis

Submission
(Financial Services Council)

The calculations in section EM 5 should be able to be performed on a portfolio of hedges, as opposed to a hedge-by-hedge basis.

Comment

Officials agree, subject to being able to adequately establish a reasonable and workable method of measuring assets at the time a hedge is entered into.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Proxy hedge rules

Submission
(Financial Services Council)

It is impractical for a fund to hedge every currency it is exposed to. Funds therefore enter into "proxy hedges", hedging exposure to less common currencies (such as the Brazilian Real) with hedges for more common currencies (such as the US dollar). The current FDR hedging rules allow this but the following minor changes are required:

- In the calculation, the value of "proxied currency asset" must be zero if the fund has a hedge denominated in the "proxy currency". This restriction should be removed.
- Some funds will hedge an uncommon currency with hedges in multiple common currencies (for example, hedge an exposure to the Brazilian Real with hedges in both the US dollar and British pound). The rules should be amended to allow this.

Comment

On the first matter, this restriction is not intended. Officials recommend that, to the extent possible, the legislation be amended to reflect this.

On the second matter, the use of proxy hedges is complex. Nevertheless, the rules do allow some amount of proxy hedging. Officials accept that some funds will attempt to "proxy hedge" with a portfolio of currencies. However, given the complexity of the area, the difficulty in amending the legislation, and the fiscal risks associated with misuse, this issue should potentially be considered further. Officials' preference, therefore, is that this issue is potentially considered for the Government's tax policy work programme.

Recommendation

That the submission be accepted, subject to officials' comments on the second matter.

Issue: New Zealand shares listed on AUX

Submission
(Financial Services Council, AMP Capital)

The FDR hedging regime should extend to New Zealand shares that are acquired on the Australian stock exchange (AUX) and denominated in Australian dollars.

Comment

Officials disagree. It is considered that a New Zealand company listed on the AUX and denominated in Australian dollars (AUD) will largely be "naturally hedged" back to New Zealand dollars (NZD) because the assets and profits of the New Zealand company will largely be denominated in NZD. As an example, say the AUD strengthens. The value of the company to Australians should fall, as its NZD-denominated assets and profits are now worth less when converted to AUD. However, the strengthening AUD also means the NZD-value of the shares on the AUX will be higher than they were before. These two effects should largely cancel out.

Recommendation

That the submission be declined.

Issue: Time limit for adjustment

Submission
(Financial Services Council, AMP Capital)

The reference to days in section EM 7(4) should be changed to "working days".

Comment

Officials agree.

Recommendation

That the submission be accepted.

Issue: Allow profit participation policies (PPPs)

Submission
(Financial Services Council)

For a life insurer, the current rules will only apply to separately identifiable funds where the benefits are directly linked to the value of investments held in the fund. For insurers who hold their investment assets within the life insurer, this will mean that the new rules will apply only to their unit linked savings products. It will not apply to profit participation policies (PPPs).

Comment

It is not clear to officials at this stage whether PPPs are, in fact, consistent with the underlying approach taken in respect of life insurers or, if so, whether the proposed rule under section EM 2 adequately deals with such a situation already. Further work would need to be undertaken to establish this. Officials' preference, therefore, is that this issue is instead potentially considered for the Government' tax policy work programme.

Recommendation

That the submission be declined.

Issue: Allow longer unit valuation periods

Submission
(Financial Services Council, PricewaterhouseCoopers, KPMG)

The FDR hedging rules are currently restricted to taxpayers that perform daily unit valuations. This should be extended to taxpayers that calculate unit prices less frequently.

Comment

Officials agree, provided every hedge is subjected to the tax calculation in section EM 6 at least once. In practice, this means that a fund's unit valuation period must be shorter than the contract period of the hedges the fund enters into.

Hedge contracts can also be cancelled before they are due to expire. This means if a fund has a unit valuation period of greater than a day, a tax calculation under EM 6 will also need to be performed when a hedge contract is cancelled.

Recommendation

That the submission be accepted.

Issue: Rolling hedges

Submission
(PricewaterhouseCoopers)

The FDR hedge portions should be set when a hedge is taken out but not re-set when hedges are rolled.

Comment

Officials disagree. The purpose of calculating FDR hedge portions is to ensure that foreign currency derivative contracts are, in fact, hedges for FDR assets – that is, they must protect against currency risk a person is exposed to. The purpose of the required calculations is to ensure that this is the case.

When a hedge is rolled, how much currency risk a person is exposed to may be different from when they first entered into the hedge. For example, they may have purchased new FDR assets (or sold old ones), or the values of their assets may have changed. It is therefore important for FDR hedge portions to be set when hedges are rolled.

Recommendation

That the submission be declined.

Issue: Extension to other portfolio investors

Submission
(Law Society, KPMG)

The FDR hedging regime as currently drafted is available only to managed funds and other widely held investment vehicles. However, the problem that the regime is designed to resolve – the mismatch in tax treatment between certain offshore assets and hedges for those assets – is not unique to managed funds. The regime should be extended to other portfolio investors.

Comment

Officials disagree. In developing these rules, officials were concerned about the possible revenue risk if they could be misused. It is believed that a restriction to widely held investment vehicles would help mitigate this risk. Such funds are not controlled by any investor, disclose their hedging strategy, and should have systems in place to comply with the requirements of these new rules (such as the need to make an up-front election). It is also generally difficult for a managed fund to take an aggressive tax position due to investor equity issues. Investors can leave and join funds, so the investors who benefit from the tax position may be different to the investors who would have to bear the consequences of any subsequent audit.

It is also noted that other portfolio investors have a method, albeit an imperfect one, of solving the tax mismatch between hedges and FDR assets (grossing up the amount hedged). This method is much less effective for managed funds.

Recommendation

That the submission be declined.

Issue: Clarify interaction with the financial arrangement rules

Submission
(KPMG, Ernst & Young)

The interaction between the FDR hedging rules and the financial arrangement rules needs clarification.

Comment

Officials agree. The intention is that, to the extent the FDR hedging rules apply to a hedge, the financial rules should not apply. Conversely, to the extent the FDR hedging rules do not apply to a hedge the financial arrangement rules do apply.

This means that if a fund is required to adjust its FDR hedge portions under the quarterly test of section EM 7, the adjusted portion should be taxed under the financial arrangement rules from the date of the quarterly test.

Officials recommend clarifying these points in the legislation.

Recommendation

That the submission be accepted.

Issue: Consequences of breach/quarterly calculation

Submission
(KPMG, Ernst & Young)

Given the volatility of international capital markets and foreign currency fluctuations, it is quite possible that a taxpayer will inadvertently breach the quarterly test in two consecutive quarters. As currently drafted, this will result in the taxpayer being excluded from the FDR hedging regime for up to 18 months. This is too penal. The taxpayer should only be excluded from the regime in the following two quarters.

Comment

Officials agree. The taxpayer should only be excluded from the regime for the following two quarters.

Recommendation

That the submission be accepted.

Issue: Overhedging rule in section EM 5(9)

Submission
(KPMG)

Section EM 5(9) provides an unfair result in certain circumstances. If a new hedge pushes the result of the formula to above 1.05 the FDR hedging regime cannot be used for that hedge. This would be particularly unfair if a taxpayer was previously well below the 1.05 threshold and entered into a single large hedge that only subsequently pushed them over the limit.

Instead, the extent to which the FDR hedging rules can apply to the new hedge should be reduced so that the result of the formula in section EM 5(9) is 1.05.

Comment

Officials agree. It is noted that the same result to what is requested could in fact be achieved by entering into two separate hedges: one that results in the formula in section EM 5(9) being equal to 1.05 (which would be eligible for the rules).

Recommendation

That the submission be accepted.

Issue: Minor drafting amendments

Submission
(KPMG)

There are two minor drafting errors that should be fixed:

- section EM 1(1)(a)(i) should refer to "excluded income" rather than "exempt income"; and
- the formula in section EM 5(9) is inverted.

Comment

Officials agree.

Recommendation

That the submission be accepted.

Issue: Application to existing hedges

Submission
(Ernst & Young)

The new rules should be able to be applied to hedges that were entered into before the application of the regime.

Comment

Officials disagree. There needs to be an election in place when hedges are entered into – this prevents selective election to minimise tax payments.

Recommendation

That the submission be declined.

Issue: Application date

Submission

(Matter raised by officials)

The application date of the FDR hedging regime should be changed to the date of Royal assent.

Comment

Due to delays in the planned timeframes of this bill, the planned date of application for these rules (the beginning of the 2013–14 income year) has already passed. Officials therefore recommend the application date be changed to the date the bill receives Royal assent.

Recommendation

That the submission be accepted.

Remedial matters

CLARIFICATION OF THE "DIVIDEND" DEFINITION

Issue: General support for changes

Submission
(Corporate Taxpayers Group, Russell McVeagh, Deloitte, KPMG, New Zealand Institute of Chartered Accountants, New Zealand Law Society)

The submitters support the proposal to clarify the dividend definition so that share splits involving subdivisions, rights issues[1] and premiums paid under bookbuild arrangements[2] do not constitute dividends.

The submitter agrees that share splits should be included in the definition of "bonus issue" rather than being explicitly excluded from being a dividend. This approach preserves a company's ability to elect to treat a share split as a dividend, by virtue of it being a taxable bonus issue. *(New Zealand Law Society)*

Comment

Support for clarification noted.

Recommendation

That the submission be noted.

Issue: Change to wider dividend definition

Submission
(Corporate Taxpayers Group, Russell McVeagh, Deloitte)

Rather than making ad hoc changes to the dividend definition, the current problem can be overcome by amending section CD 5(1) of the Income Tax Act 2007 (the section entitled "What is a transfer of value?") by replacing the word "provides" with "transfers" or "distributes".

[1] A rights issue is where a company offers its shareholders rights either to buy new shares at a discount to the market value, or sell existing shares at a premium.
[2] Following a rights issue, a bookbuild can take place. A bookbuild involves the rights of non-participating shareholders (who chose not to participate or were not entitled to participate) being offered to other investors who pay a premium for them. The original shareholder is paid all or part of this premium for giving up their rights.

Comment

As noted in the regulatory impact statement, *Clarification of dividend definition*, to deal with the current uncertainty officials considered amending the general dividend definition in section CD 5. The key issue with amending the general dividend definition is that there may be unintended effects (for instance, arrangements that should be taxed as a dividend may be unintentionally excluded).

Replacing the word "provides" with "transfers" or "distributes" as suggested by submitters does not necessarily address the current uncertainty relating to the issue of shares. While it is arguable that the issue of a share by a company is not a transfer or distribution (and therefore in line with policy) the opposite is also arguable. This is because the company creates the share and then transfers or distributes it to the new owner. It is this uncertainty which is the source of the problem that officials are trying to deal with. Overall, we consider it is unlikely that replacing "provide" with "transfer" or "distribute" will be decisive. It will merely draw attention to the problem without solving it.

In addition, the term "provide" may, in some situations not involving an issue of shares, be more appropriate than "transfer" or "distribute". For instance, the use by a shareholder of the company's property is also intended to be a dividend. If the ordinary meaning of the word "transfer" or "distribute" is adopted there is an argument that the company does not transfer or distribute the property, or the use of the property, to the shareholder. Therefore in this case "provide" may be a more appropriate term (because the use of the property is provided to the shareholder). It is important not to risk excluding from the general definition of "dividend" these situations in which a shareholder receives a private benefit from the use of a company's resources.

Recommendation

That the submission be declined.

Issue: Confirmation that changes are for clarification only

Submission
(Corporate Taxpayers Group, Deloitte)

If the overarching definition is not amended, it should be made clear that the exclusions are being enacted for clarification only and not because these arrangements or similar arrangements necessarily involve a transfer of value.

Comment

Officials confirm by way of this officials' report, that the changes to the dividend definition are to clarify that rights issues, premiums paid under bookbuild arrangements and share splits are not dividends. This is not a change in policy and the change, in itself, does not imply that other arrangements fall within the dividend definition. A similar statement confirming the clarifying nature of these changes will be made in the *Tax Information Bulletin* article that is published after the tax bill is enacted.

Recommendation

That the submission be accepted.

Issue: Income under ordinary concepts

Submission

(*Corporate Taxpayers Group, Russell McVeagh, Deloitte, New Zealand Institute of Chartered Accountants, Ernst & Young)*

The bill should clarify that no income arises under ordinary concepts in respect of the particular transactions. The main area of taxpayer uncertainty in the case of rights issues is not whether a dividend arises but whether income arises under ordinary concepts, as was held to be so by the High Court of Australia, *Commissioner of Taxation v McNeil*. If this clarification is not made, there is a potential to create greater uncertainty than currently exists.

Comment

The proposed amendments to clarify the dividend definition so that certain transactions are not dividends arose because the rewritten definition of "dividend" (from the Income Tax Act 1994 to the Income Tax Act 2004) unintentionally broadened the dividend definition. The amendment was not made in response to the McNeil decision in Australia. Therefore officials do not consider the proposed changes infer that the particular transactions would be income under ordinary concepts. That is, the proposed amendments are not relevant to the scope of section CA 1(2) (the provision which states that an amount is income for a person if it is income under ordinary concepts).

In general, whether something is income under ordinary concepts is, and should continue to be, a matter of interpretation dependent on the facts of any particular case. "Income under ordinary concepts" has been a feature of the law since income tax was introduced and officials do not consider it is necessary to amend this longstanding core feature of income tax law.

Furthermore, there are considerable differences between the Australian and New Zealand tax legislation (such as the existence of a comprehensive capital gains tax in Australia). It is important to note that Australian case law is not binding on New Zealand courts, and there have been tax cases when the two jurisdictions have reached different conclusions.

Recommendation

That the submission be declined.

Issue: Clarification of the transactions to which subsection CD 29B(2) applies

Submission
(Corporate Taxpayers Group, Russell McVeagh)

Proposed subsection CD 29B(2) should be clarified, as it could be read as being limited to rights issues where the rights relate to shares in the same class as those held by the shareholder to whom the right was issued. If this is intended, there is no clear rationale provided for this limitation.

Comment

It is not intended that the scope of proposed subsection CD 29B(2) be limited by the class of the share being issued. Officials agree that the drafting should be amended to ensure the intended result is achieved.

Recommendation

That the submission be accepted.

Issue: Scope of proposed subsection CD 29B(2)

Submission
(New Zealand Law Society)

Where a person subscribes for shares for less than their market value, there is no loss to the company. There is only a loss to the other shareholders. Accordingly, this transaction should not give rise to a dividend in any circumstance. To address this, paragraphs (a) and (b) of proposed subsection CD 29B(2) should be deleted. Currently section CD 29B(2) reads:

> "*Issue of shares under rights to subscribe for shares*
> "(2) The issue by a company of a share to a person for consideration less than the market value, immediately before the issue, of a share in the same class of shares, is not a dividend if—
>
> > "(a) the person subscribes for the share under a right (a **subscription right**) issued by the company to a shareholder holding shares in the share class before the issue of the right; and
> > "(b) the company does not, as part of the issue of the subscription right, give the person a right to dispose of the share to the company.

Comment

Deleting paragraphs (a) and (b) would mean subsection CD 29B(2) reads "The issue by a company of a share to a person for consideration less than the market value, immediately before the issue, of a share in the same class of shares, is not a dividend".

Paragraphs (a) and (b) of proposed subsection CD 29B(2) are necessary because they ensure that the dividend exclusion only applies to particular rights issues and deleting these paragraphs could lead to the wrong result. For example, under current policy settings bonus shares issued under an arrangement where shareholders can elect whether to receive bonus shares or money or money's worth (bonus issues in lieu), are taxable. There are good policy reasons for treating a bonus issue in lieu as taxable and as part of the current changes we do not propose to review this treatment. If this submission was accepted, a bonus issue in lieu may fall within the section CD 29B dividend exclusion and not be taxable.

Recommendation

That the submission be declined.

Issue: Premiums paid under bookbuild arrangements can be a payment for the right

Submission
(Corporate Taxpayers Group)

As drafted, proposed subsection CD 29B(3) applies to situations when the premium under a bookbuild directly relates to the share (that is, the premium is paid as an additional amount to subscribe for the share). When a person participates in a bookbuild of unexercised rights, the person will generally pay the same amount to subscribe for the share but the "premium" component will generally be attributable to the right itself rather than the share (that is, the right to subscribe for the share). Subsection CD 29B(3) should be amended so that when the premium relates to the right to subscribe for shares, this is also excluded from being a dividend.

Comment

Officials agree that where a premium is paid for the right to purchase a share or to dispose of a share, the premium should not be treated as a dividend. In this case the premium should not be treated as part of the subscription price. This aligns with the policy intent and is consistent with the proposed change for rights issues.

Recommendation

That the submission be accepted.

Issue: Premiums paid in relation to unexercised rights to dispose of shares

Submission
(Russell McVeagh, Corporate Taxpayers Group)

Proposed subsection CD 29B(3) should be expanded to cover premiums paid in relation to unexercised rights to dispose of shares. If premiums paid in relation to unexercised rights to dispose of shares are not excluded from the dividend definition, this could potentially imply that they are considered dividends.

Comment

The bookbuild arrangements officials have come across involve rights to subscribe for shares because bookbuilds are, in nature, equity-raising schemes. However, from a policy perspective, officials agree that when there is an arrangement involving rights to dispose of shares, premiums paid for these under such an arrangement should be excluded from the dividend definition if the company does not give up anything of value and the premium is effectively paid by other shareholders who purchase the rights. Officials also agree that not including such premiums in subsection CD 29B(3) may create uncertainty.

Recommendation

That the submission be accepted.

Issue: Limitation of subsection CD 29B(3) where premium gives rise to available subscribed capital

Submission
(New Zealand Law Society)

In some cases, the excess of the "clearing price" over the "subscription price" may be paid to the company in its own right (rather than to the shareholder who did not subscribe). In that case, it might give rise to available subscribed capital, and should not be excluded from the dividend definition.

Comment

Officials agree that proposed subsection CD 29B(3) should not apply if the premium amount gives rise to available subscribed capital.

Recommendation

That the submission be accepted.

Issue: Retrospective application

Submission
(Corporate Taxpayers Group)

The submitter supports the retrospective nature of the proposed amendments, given that the amendments are intended to remedy particular uncertainty created by what appears to be an unintended broadening of the dividend definition as a result of the rewrite process. However, it is worth emphasising the basis on which the proposed changes are being made retrospective.

Comment

The changes to clarify the dividend definition, so that share splits involving subdivisions, rights issues and premiums paid under bookbuild arrangements do not constitute dividends, apply from the 2005–06 year. This was the commencement date of the rewritten legislation (Income Tax Act 2004) which contained the new (rewritten) dividend definition.

Recommendation

That the submission be noted.

Issue: Change application dates to a fixed date rather than a tax year

Submission
(Ernst & Young)

The amendments should be expressed as applying from 1 April 2005 (for the Income Tax Act 2004 amendments) and from 1 April 2008 (for the Income Tax Act 2007 amendments), rather than for specified tax years. References to "tax years" could cause confusion for shareholders with non-standard balance dates.

Comment

The proposed changes apply to both the Income Tax Act 2007, and its predecessor, the Income Tax Act 2004. The application date of these changes is intended to mirror the application date of both these statutes so that, in effect, the changes apply from the date that the Income Tax Act 2004 (which first contained the rewritten dividend definition) applied from. We do not expect this to cause problems for taxpayers with non-standard balance dates.

Recommendation

That the submission be declined.

FARMERS’ RIPARIAN PLANTING

Clauses 20 and 21

The bill proposes that the present practice, farmers’ riparian planting for conservation planting, should be immediately deductible.

Submission
(WHK)

The submitter supports the bill’s proposal.

Recommendation

That the submission be noted.

CAPITAL CONTRIBUTIONS TO AMORTISABLE PRIMARY SECTOR EXPENDITURE

Clauses 18, and 57(7)

The bill contains a proposal that the rules concerning third-party contributions to capital expenditure should be extended to cover primary sector amortisable expenditure of the sort dealt with in subpart DO.

Submission
(Ernst & Young)

It is arguable that the definition of “capital contribution property” and the use of that definition in clause 18 could restrict the application of the proposed capital contribution rule to revenue account property.

Comment

Officials believe that the drafting as it is presently stated is clear and unambiguous.

Recommendation

That the submission be declined.

Submission
(Ernst & Young)

That the definition of “capital account property” be further clarified by referencing it to “capital contribution”.

Comment

Officials suggest that this could make the definition circular and therefore it would not add anything.

Recommendation

That the submission be declined

PRIMARY SECTOR ASSET AMORTISATION – SUBPART DO

Clauses 18, 23

The bill contains specific generic proposals to better align the primary sector amortisation rules in subpart DO of the Income Tax Act 2007 with the ordinary depreciation rules. The amendments are a result of a more detailed analysis of this subpart as a result of the kiwifruit PSA virus outbreak that has decimated the main Kiwifruit Gold variety and has potentially affected other kiwifruit.

Submission
(New Zealand Institute of Chartered Accountants, Ernst & Young)

To remove doubt, the proposed amendment should explicitly state that the rendering useless of the kiwifruit as a consequence of the kiwifruit PSA virus is not an action of the taxpayer.

Comment

The submission concerns the scope of the proposed amendment. As introduced, the amendment is prescriptive and may be interpreted as not allowing a deduction when the orchardist has removed the kiwifruit as a precautionary measure. In the circumstances this is not intended.

Recommendation

That the submission be accepted, subject to the matter being able to be explicitly drafted.

Submission
(New Zealand Institute of Chartered Accountants)

The tenor of the amendments should be extended into subpart DO generally, to even better replicate the depreciation rules.

Comment

Officials understand the direction of this submission. However, it potentially has wider implications and in the context of this bill officials have not had time to fully analyse it.

Recommendation

That the submission be declined, but when the Government's tax policy work programme allows, it should be further considered.

GENERAL INSURANCE CLAIMS RESERVES AND EVENTS THAT OCCURRED BEFORE JULY 1993

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

Issue: Support for proposed amendment

Submission
(New Zealand Institute of Chartered Accountants)

The technical amendment is logical.

Comment

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

Transitional rules deny insurers a deduction for any pre-1993 claims under section DZ 10.

The rules for calculating the outstanding claims reserve under the Income Tax Act 2007 do not explicitly exclude amounts relating to pre-1993 events and arguably tracks claims when an entitlement to a tax deduction for the claim does not exist under section DZ 10. This outcome was not envisaged and appears to impose an unnecessary requirement on taxpayers to track insurance events when under the transitional rules no deduction would be allowed for a claim that is connected with a pre-July 1993 event.

The proposed amendment explicitly excludes from the calculation of a general insurer's outstanding claims reserve – sections CR 4 and DW 4 – certain insurance events that occurred before 1 July 1993.

Recommendation

That the submission be noted.

TRANSITIONAL IMPUTATION PENALTY TAX

Clause 71

The bill proposes that the transitional imputation penalty tax, which ensures that dividends are not over-imputed following the company tax rate change from 30% to 28%, should not apply to dividends paid out before the earlier of the 2010–11 tax return being filed or 31 March 2012 (the deadline for filing 2010–11 tax returns).

Submissions
(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

1. The 10% (of 30%) penalty should be reduced as it is unnecessary and gives arise to punitive and unintended results. *(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)*

2. Where a dividend for a listed company was declared in the period of the earlier of the 2010–11 tax return being filed or 31 March 2012, the penalty should not apply. This is on the basis that once dividends are declared under the stock exchange rules, a listed company is committed. *(PricewaterhouseCoopers)*

3. The penalty, which was always intended to prevent deliberate over-imputing of dividends, can now be repealed because its usefulness is at an end as from 1 April 2013 dividends cannot be over-imputed. *(PricewaterhouseCoopers)*

Comment

After the recent company tax rate change from 30% to 28%, taxpayers may have paid out dividends at the old ratio of 30/70 (instead of the new ratio of 28/72) before they filed their 2010–11 tax return without fully appreciating the details of that tax return. The return may not have yielded sufficient 30% tax to cover the 30/70 imputation credits attached to the dividends. A one-off penalty tax at 10% (of 30%) would then apply on 31 March 2013.

We agree with submitters that the penalty at 10% is currently overstated, especially when the core imputation penalty ensures that companies do not overdraw their imputation accounts.

The penalty was intended to be a preventative device, to ensure that companies do not deliberately over-impute dividends at 30% during the transitional period (from the 2011–12 income year to 31 March 2013) when they had not paid underlying tax at 30% or more. In the previous transitional period, when the company tax rate decreased from 33% to 30%, the same penalty applied. Around 65 taxpayers were penalised, resulting in $550,000 of penalties being imposed.

Officials considered the option of reducing the penalty to better reflect the potential loss to the tax base. However, this option is not desirable as adjusting the penalty at this late stage will not be easy, particularly given that it will be due before this tax bill is enacted.

A better option at this stage is repealing the penalty. The administrative implications to correct the penalty are significant when compared with the potential loss to the tax base in this situation. The potential revenue risk reflected in the previous transitional period is immaterial. Also, the core imputation penalty is already in place to ensure that companies do not overdraw their imputation accounts.

Recommendation

That submission 3 be accepted, which will also deal with submissions 1 and 2.

DEDUCTIBILITY OF REPAIRS AND MAINTENANCE FOR COMMERCIAL FIT-OUT

Clause 14

Issue: Clarifying the application of proposed section DA 5

Submissions
(PricewaterhouseCoopers, Deloitte, KPMG, Argosy Property Limited)

The application of section DA 5 should be clarified to ensure that it only applies to previously separately depreciated items of commercial fit-out.
(PricewaterhouseCoopers, Deloitte, KPMG)

The drafting of the proposed section is inconsistent with, and overrides, existing case law because it addresses what asset (the commercial fit-out item) the repairs and maintenance expenditure relates to. Instead, it should state that the expenditure does not relate to the building. *(Argosy Property Limited)*

The drafting of the proposed section creates ambiguity by referring to "a building's commercial fit-out" as the "item". It could be interpreted as relating to the whole of the building's commercial fit-out rather than each separate item of commercial fit-out. *(PricewaterhouseCoopers, Argosy Property Limited)*

Comment

The policy intent behind this change is to prevent taxpayers from claiming that capital expenditure is immediately deductible because it is repairs and maintenance on the building. Officials agree that clarifying the wording of proposed section DA 5 would better align the legislation with the intended policy outcome.

Recommendation

That the submissions be accepted.

Issue: Application date of proposed amendment

Submission

(Corporate Taxpayers Group)

The application date of the proposed section DA 5 should be changed from 1 April 2011 to the commencement of the 2012 income year in order to be consistent with recent changes to depreciation settings.

Comment

Officials agree that it would be desirable for this amendment to be consistent with previous changes to depreciation settings and to take effect from the start of the 2011–12 income year.

Recommendation

That the submission be accepted.

Issue: Request for Inland Revenue guidance

Submission

(*PricewaterhouseCoopers*)

Guidance on the interaction of proposed sections DA 5 and DB 65 would be of assistance to taxpayers. Section DB 65 provides an allowance to taxpayers who previously depreciated commercial fit-out items as part of the building, rather than separately. Specifically, guidance on whether or not section DA 5 will apply when a taxpayer is already utilising section DB 65 is requested.

Comment

If practical difficulties arise on the interaction of proposed section DA 5 and section DB 65, Inland Revenue would assist taxpayers through the usual channels for interpretive issues. Policy officials will alert the relevant unit that this is an area of interpretation taxpayers are interested in.

Recommendation

That the submission be noted.

Issue: Review of changes to building depreciation settings

Submission

(*Deloitte*)

The removal of depreciation on buildings fundamentally changed the depreciation environment for building owners. It would be worthwhile to carry out a post-implementation review of a number of prominent boundary issues that have been identified since the removal of depreciation on buildings.

Comment

The final stage of the Generic Tax Policy Process (GTPP), which governs the tax policy development process in New Zealand, involves a post-implementation review of new legislation, and identification of remedial issues required for the legislation to have its intended effect. Officials will continue to consider issues associated with the removal of depreciation on buildings as and when they arise.

Recommendation

That the submission be noted.

LOCAL AUTHORITIES' CHANGE OF ACCOUNTING BASIS

Issue: Support for the transitional provisions for local authorities

Submission
(TaxTeam)

The submission supports the introduction of the transitional provision which mitigates the effects of the local authorities' change to an invoice basis of accounting for GST.

Recommendation

That the submission be noted.

Issue: Bad debt write-offs

Submission
(Far North District Council, New Zealand Institute of Chartered Accountants)

Inland Revenue should alter the current policy for bad debt write-offs in relation to the eight local authorities referred to in the Goods and Services Tax (Local Authorities Accounting on Payments Basis) Order 2009. A full provision for the purpose of the bad debt recognition should be sufficient, in place of a bad debt write-off. *(Far North District Council)*

Local authorities should be able to write off rates related to Māori freehold land when there is a history of non-payment. *(New Zealand Institute of Chartered Accountants)*

Comment

Officials have concerns about changing the bad debt write-off rules for a very small group of taxpayers and the possible precedent it would create. The bad debt rules for tax purposes need a relatively high threshold for write-off to ensure that deductions can only be taken once all appropriate avenues have been explored.

The issue of a local authority's inability to write off unpaid rates as a bad debt for six years would, in our view, be better addressed through consultation with the Department of Internal Affairs, or Te Puni Kokiri who have the expertise in the areas of rating and Māori land. Officials are happy to refer the submissions to those departments.

Recommendation

That the submission be noted.

AGENTS' "OPT-OUT" PROVISION

Issue: Support the provision to allow principals and agents to "opt out" of the current rules

Submissions

(Ernst & Young, Farmlands, PricewaterhouseCoopers, KPMG)

The proposal is welcomed. *(Ernst & Young)*

The proposal to allow principals and agents to opt out of the agency rules in the GST Act is supported. *(Farmlands)*

This proposal is welcomed as it is business-friendly and reflects common commercial practice in relation to agency arrangements. *(PricewaterhouseCoopers)*

We agree with the changes to the agency rules as this will alleviate the compliance costs of the principal and agent and align the GST Act with current commercial practices. *(KPMG)*

Recommendation

That the submissions be noted.

Issue: Extra requirements for people who use the opt-out provisions

Submissions

(Ernst & Young, Chapman Tripp, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

Use of the provision should not be restricted to registered persons. *(Ernst & Young)*

The provision should be clarified as to determine whether there needs to be an express written agreement per supply, or whether an identification of the types or kinds of supplies subject to the provision is sufficient. The Commissioner should be able to make determinations that the provision should apply to supplies of a specified kind. *(Chapman Tripp)*

The requirement that the principal account on an invoice basis for this supply should not be retained. It does not seem like a practical solution to a practical problem. *(New Zealand Institute of Chartered Accountants)*

The principal should be allowed to claim a bad debt deduction if the agent does not pay them. *(PricewaterhouseCoopers)*

Comment

Although the GST Act does not allow a principal to issue a tax invoice in relation to a supply if the agent has issued a tax invoice in relation to that supply, officials now understand that in practice, multiple invoices are commonly issued in agency situations. This is wider than the problem which prompted this amendment, namely large computer systems automatically issuing invoices when goods are sent out, and therefore technically being in breach of the one-invoice requirement. This situation could equally also arise where smaller taxpayers use agents to sell items for them.

In light of submission received on this amendment, officials are of the view that some of these additional requirements could be impractical for some principals and agents. The requirement for the principal to account for the supply on an invoice basis, and the inability of the principal to claim a bad debt deduction if the customer paid the agent were included in the bill as a GST protection measure. Otherwise a GST liability could be avoided by interposing an agent into a transaction, and then having the agent disappear before meeting their GST obligation.

Officials do not, however, recommend removing the amendment which limits the principal's ability to claim a bad debt deduction. This requirement is an important protection against taxpayers creating agency relationships in order to take advantage of this section.

Recommendation

That the first three submissions be accepted.

That the submission relating to bad debt deductions be declined.

Issue: Application of the section to an "agent"

Submission
(KPMG, Chapman Tripp)

There is currently no definition of an "agent" in the GST Act. It is uncertain whether this provision will only apply to persons acting as agents in supplying goods and services, or also to those merely acting in the capacity of a paying or collecting agent. *(KPMG)*

The GST Act should follow the Australian GST legislation and define the role of an intermediary. *(KPMG)*

As currently drafted, the section only applies to parties in a full agency relationship. The provision should be extended to apply to situations where an intermediary facilitates supplies to a third party on behalf of a principal. *(Chapman Tripp)*

Comment

This matter was not raised during the policy development process, and would need further research and analysis before being implemented.

Recommendation

That the submission be noted.

Issue: Purchases by agents

Submission
(KPMG)

The section should be amended to also include any purchases by the agent to be treated in the same manner for GST purposes.

Comment

This matter was not raised during the policy development process, and would need further research and analysis before being implemented.

Recommendation

That the submission be noted.

Issue: Treatment of a commission paid to an agent

Submission
(KPMG, Farmlands, Chapman Tripp)

As currently drafted, the legislation does not refer to the treatment of a commission derived by the agent.

It should be considered whether this provision should include wording to deal with the GST treatment of a commission paid to an agent. *(Chapman Tripp)*

The consideration for the commission services should be overlooked for GST purposes, which would allow the principal to account for GST on its supply on a net of commission basis. *(Farmlands)*

Comment

Officials would generally expect commission derived by a New Zealand-resident agent to be subject to GST. There is not, in our view, a sufficient case for further clarification.

Recommendation

That the submission be noted.

Issue: Scope of the amendment

Submission
(Ernst & Young)

Existing subsection 60(7) should be extended to allow agents to return GST in respect of services provided by non-registered non-residents.

Comment

This submission is outside the scope of the current proposals in the bill.

Recommendation

That the submission be declined.

Issue: Definition of "prize competition"

Submission
(KPMG)

The definition of "prize competition" should be amended to read "for which direct or indirect consideration is paid to the person for conducting the prize competition".

Comment

Changing the wording of the amendment as suggested above would slightly widen the definition of a "prize competition". It would mean that a competition whose organiser receives funding to run that competition from a person other than a participant could meet the definition of a prize competition. This could, for example, happen if funding for the competition was received from advertisers, or sponsors. Officials see no policy reason to deny people in this situation of the benefit of the proposed change.

Recommendation

That the submission be accepted.

GST RECORD-KEEPING REQUIREMENTS

Submission
(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

1. The proposed amendment is supported. *(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)*

2. The amendment should be accompanied by commentary that clarifies:

   - The Commissioner's position on what "reasonable conditions" may be imposed. *(Corporate Taxpayers Group)*
   - What constitutes "reasonable notice" for withdrawing of an authorisation to keep records offshore. *(New Zealand Institute of Chartered Accountants)*

3. The GST registration form for non-residents should incorporate an option to apply for approval to store records offshore. *(PricewaterhouseCoopers)*

4. The legislation should state that Guidelines released by the Commissioner should contain terms that are no more stringent than would be expected from a New Zealand-based server, except where those terms are needed to combat identified flight risks. *(New Zealand Institute of Chartered Accountants)*

Comment

The first three submissions all raise points related to the administration and implementation of the proposed rule. Policy officials will pass the submissions onto the relevant units within Inland Revenue for their consideration.

Officials consider that the NZICA submission on guidelines not being stricter than that expected of New Zealand-based server is a matter for the guidelines themselves, rather than being set down in legislation. The proposed GST rule is designed to mirror a provision that applies to income tax records, which was recently inserted into the Tax Administration Act 1994. To avoid confusion, it is important to keep the two provisions consistent to the greatest extent possible. That way, when guidance is provided for one provision, it should be equally applicable to the other.

Recommendation

That the NZICA submission on legislation imposing conditions on the guidelines should be declined, and that all other submissions be noted.

REMOVAL OF THE REMNANTS OF DEPRECIATION LOADING

Clauses 22, 60

As part of Budget 2010 the general 20% depreciation loading was removed. However, for subpart DO, which deals with primary sector amortisable assets, this was not removed as a result of oversight. The bill proposes to correct this with, in general, application from 13 September 2012, the date of the announcement.

Submission
(New Zealand Institute of Chartered Accountants)

The measure should apply from the commencement of taxpayers' 2013–14 income year.

Comment

The concern is that if given advance notice, taxpayers might accelerate their expenditure in order to gain larger deductions. NZICA submits that this concern is overstated and that it would be cleaner from a compliance perspective to make this amendment on an "income year" basis.

There is a risk that late balance-date farmers (and for sheep and beef farmers, typically balance at 30 June) will have a window between when this bill is reported back to the House (and therefore this amendment would become public) and their balance date to accelerate some development expenditure to attract the loading. Officials judge this risk as being immaterial and accept the compliance point.

We note that because of the particular way this measure has been forecast, there are no fiscal implications.

Recommendation

That the submission be accepted.

TAX CONCESSIONS FOR CERTAIN NON-RESIDENT COMPANIES

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

Submission
(New Zealand Institute of Chartered Accountants)

The submitter supports the reform unless affected taxpayers raise concerns.

Comment

As part of the policy development process, officials have consulted with affected taxpayers. No particular concerns were raised during the policy development process or at the Committee stage.

Recommendation

That the submission be noted.

TECHNICAL CHANGES: TAX TREATMENT OF PAYMENTS AND SERVICES PROVIDED TO MEMBERS OF PARLIAMENT

Clauses 12, 13, 102 and 103

Issue: Expiry date for the application of the Income Tax Act 2007 amendments

Submissions
(Ernst & Young, New Zealand Institute of Chartered Accountants, Parliamentary Service)

There should be no expiry date for the application of the Income Tax Act 2007 amendments. *(Ernst & Young)*

We support the amendment. *(New Zealand Institute of Chartered Accountants)*

The period of application of the amendments should be extended. *(Parliamentary Service)*

Comment

A retrospective amendment is being made to correct an anomaly that has arisen in the tax legislation following the rewrite of the fringe benefit tax provisions. The amendment will ensure that only the private element of any payments provided to MPs under the Civil List Act 1979 is taxed, as was always the intention.

The expiry date for the application of these amendments needs to tie in with the commencement date for the prospective correction which is being made through the Members of Parliament (Remuneration and Services) Bill. The commencement date for the measure in that bill is currently uncertain and it is likely that the expiry date for the retrospective amendments will have to change in order to tie in.

Recommendation

That Inland Revenue continue to liaise with officials working on the Members of Parliament (Remuneration and Service) Bill over the appropriate date for expiry of the amendments.

Issue: Taxation of the value of accommodation provided to members of Parliament

Submissions

(Ernst & Young, New Zealand Institute of Chartered Accountants, Parliamentary Service)

The proposed amendments may not achieve the stated objective where accommodation is provided, as distinct from a monetary accommodation allowance. *(Ernst & Young)*

An amendment should be made to section CE 1(1B) to clarify that only the private element of accommodation allowances or an accommodation benefit is taxable to an employee. *(New Zealand Institute of Chartered Accountants)*

The anomaly which taxes the full value of accommodation provided to members of Parliament should be corrected. *(Parliamentary Service)*

Comment

The proposed amendment is a technical change to correct an anomaly that has arisen in the tax legislation. The submissions go beyond that and would make changes to the tax treatment of provided accommodation and accommodation allowances.

The tax treatment of accommodation allowances and accommodation provided to employees is being considered as part of a more general review of employee allowances and other employee expenditure payments. Consultation on an officials' paper, *Reviewing the tax treatment of employee allowances and other expenditure payments*, closed in February and submissions are currently being considered. That would be the appropriate arena for considering any matters relating to the taxation of the valuation of accommodation or accommodation allowances provided to members of Parliament.

Recommendation

That the submissions be declined.

Issue: The taxation of the private element of services provided to members of Parliament

Submission
(Parliamentary Service)

The legislation should be amended to allow for reasonable estimates of any private element of services provided to members of Parliament.

Comment

The proposed amendment would correct a further anomaly in the tax legislation affecting the fringe benefit tax treatment of services provided under the Civil List Act 1979. The administrative practice to date has been to make an apportionment of services between private and work-related services based upon a reasonable estimate. It has recently become apparent that this practice is not supported in law. The proposed amendment would allow this apportionment method to continue.

Recommendation

That the submission be accepted.

Issue: Power of appointment or removal

Submission
(New Zealand Law Society)

Section YB 11 of the Income Tax Act 2007 should be amended to ensure that a person who receives a power of appointment or removal of a trustee in their professional capacity (for example, a lawyer) is not associated with that trustee.

Comment

Section YB 11 treats a trustee of a trust and a person who has a power of appointment or of removal of that trustee as associated persons. This section is intended to supplement the trustee-settlor associated persons test in section YB 8 – that is, to treat a person who has the power to appoint or remove trustees similar to a settlor of a trust who usually retains the power.

However, section YB 11 currently includes the relationship between professional advisors and their clients. This outcome is not intended as professional advisors generally do not benefit under the trust. The rule associating the settlor of a trust with its trustee also does not apply to persons acting in their professional capacity only.

Officials agree with the submission that section YB 11 should be amended to ensure that a trustee is not associated with a person who holds the power of appointment or removal in their professional capacity only and who is not eligible to benefit under the trust. A person who is acting in their professional capacity would be defined as a person who is a member of an “approved organisation” defined in section 3(1) of the Tax Administration Act 1994.

The proposed remedial amendment should apply from the 2010–11 income year, which is the date when the current associated persons definition came into force.

Recommendation

That the submission be accepted.

Issue: Limited partnerships and tripartite test

Submission

(New Zealand Law Society)

Section YB 14 of the Income Tax Act 2007 should be amended so that a company is not associated with another company in which it has an effective 6.25 percent interest – where a company holds 25 percent of a limited partnership which holds 25 percent of the second company.

Comment

Officials agree with the New Zealand Law Society that there is currently overreach of the tripartite test in section YB 14 when a limited partnership is interposed between two companies. A company that has an effective 6.25 percent interest in another company should not be associated with the second company.

Officials consider that the overreach involving limited partnerships is not limited to the case raised by the submission. When a person other than a company holds 25 percent of a company and 25 percent of a limited partnership, the company and the limited partnership are associated under the tripartite test. If the limited partnership was a company, the two companies would not be associated under section YB 14 because the two companies are associated with the person under the same associated persons test. Therefore, they do not meet the different associated persons test requirement in the tripartite test (that is, the requirement that two persons have to be associated with the same third person under different associated persons tests).

Officials consider the tripartite test applies more widely than is necessary to protect the tax base in such situations. This is because the different associated persons requirement in the tripartite test – designed to prevent overreach – does not work effectively if a taxpayer's structure involves a limited partnership. In particular, a limited partner and a limited partnership are associated under a different test (section YB 12(2)) to the company-related tests in sections YB 2 and YB 3.

To prevent this unintended overreach, officials recommend a generic amendment to treat a limited partnership as a company for the purposes of applying the tripartite test.

The proposed remedial amendment should apply from the 2010–11 income year, which is the date when the current associated persons definition came into force.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Changing the notified investor rate

Submission
(KPMG)

The rules should be amended to clarify that a portfolio investment entity (PIE) can apply a change to an investor's notified investor rate either from the first day of that year (retrospectively) or from the day the new tax rate is provided (prospectively).

Comment

The prescribed investor rate (PIR) is the tax rate for an investor in a PIE which the PIE uses to calculate the tax on that investor's income.

When an investor provides the PIE with an updated PIR, the PIE should have the flexibility to apply the correct PIR either from the beginning of that year/quarter/calculation period or as soon as practicable after receipt. This accommodates differences in PIEs' systems and PIE return filing options. This amendment would clarify the legislation to be in line with current practices.

Recommendation

That the submission be accepted. As the change clarifies the original intent of the legislation, it should apply from 1 October 2007. This will provide certainty for transactions that have occurred during this period.

Issue: Allocation of expenses to a PIE

Submission
(KPMG)

The rules should be amended to clarify that expenses incurred in deriving income in which no investor has an interest are also not attributable.

Comment

A PIE is able to treat income in which no investor has a beneficial interest as relating to a separate investor class (in which the PIE is the sole investor). The net income (or loss) is then taxable at the PIE rate of 28%.

The submitter proposes that the legislation be amended to make it clear that expenses relating to this unattributed income are also not attributable.

This is in line with current policy. When clarifying the law, however, it should also be made clear that expenses are not attributable for resident investors only and not to non-resident investors.

Recommendation

That the submission be accepted, subject to the comment above and that this change apply from the 2012–2013 income year to provide certainty for transactions that have occurred in that year.

Issue: Refundability of PIE tax credits

Submission
(BDO Wellington Limited)

The rules should be amended to make it clear when PIE tax credits are refundable to investors.

Comment

In situations when an investor has to square up their PIE tax obligations at the end of the year, the investor gets a tax credit for the amount of tax that has already been paid on their behalf by the PIE.

For most types of investors, these PIE tax credits should be refundable. However, they should be non-refundable for natural (individual) investors that are not trusts. This would ensure that these investors are not incentivised to elect PIRs that are too low for them, as this is the only instance when PIE tax is not a final tax for individuals.

The submission is consistent with current policy settings.

Recommendation

That the submission be accepted.

Issue: Disposal of certain shares by PIEs

Submission
(PricewaterhouseCoopers)

Section CB 26 should be "turned off" for investors who issue dividends as long as they are received by the same investors.

Comment

A taxable dividend is deemed to arise to the seller of certain shares for which a dividend has been declared but not yet paid. The actual dividend is also taxable to its recipient. This is an anti-avoidance provision to ensure that the otherwise taxable dividends are not converted into a non-taxable disposal of shares.

This double taxation should be removed where the seller and the recipient of the shares comprise the same investors. In practice, this can arise as a result of the restructuring.

Recommendation

That the submission be accepted, and that this change apply from the 2012–13 income year to provide certainty for transactions that occurred in that year.

Issue: Management fee rebates

Submission
(Matter raised by officials)

Management fee rebates should be included in the types of income a PIE can derive.

Comment

At least 90 percent of a PIE's income must be passive income, such as dividends, interest and rent.

A PIE can receive management fee rebates in situations when a retail PIE pays a wholesale PIE for the wholesale PIE's expenses but the wholesale PIE partially refunds these fees.

Particularly in periods of a market downturn, a PIE could be either in a loss situation, or its income could be reduced, so that the percentage of income from the fee rebate causes it to breach the PIE eligibility criteria. This would cause the entity to lose its PIE status. This breach of the PIE rules was not intended.

Fee rebates are not active income of the PIE and should be added to the types of income a PIE can earn.

Recommendation

That the submission be accepted, and that this change apply from 2012–13 income year. This would provide certainty for transactions that occurred in that year.

Issue: Notification requirements

Submission
(Matter raised by officials)

PIEs should be allowed to provide notices to their investors electronically, provided either the investor or an authorised person has consented to this.

Comment

Section 31C of the Tax Administration Act 1994 requires PIEs to provide their investors with notices setting out certain information relating to their investment. Officials recommend that the language of the section should be amended to allow these notices to be provided electronically, provided the investor or their authorised person has consented to this.

Recommendation

That the submission be accepted.

Issue: Heading of a section

Submission
(Matter raised by officials)

The heading of section DB 54 should be changed from "Treatment of credits for investment fees" to "Treatment of certain fees charged by multi-rate PIEs".

Comment

The proposed heading would more accurately reflect the content of the section.

Recommendation

That the submission be accepted.

EMISSIONS TRADING SCHEME: TAX TREATMENT OF SURRENDERED UNITS

Submission
(KPMG)

The provisions which deal with the tax consequences of transactions under the Emissions Trading Scheme (ETS) should be amended. It would be desirable for the surrender of emissions units by a post-1989 forester who wishes to leave the ETS to have the same tax treatment as the surrender of units on harvest.

Comment

Current income tax legislation sets out the tax consequences of the acquisition and disposal of emissions units under the emissions trading scheme.

Included in those rules are specific rules which deal with foresters who elect to participate in the ETS – under which they will receive units for the capture of carbon in their growing forests, and be required to surrender units when they harvest their timber. The tax rules provide that income arises when emissions units received are sold, and a deduction arises when emissions units are surrendered.

However, a forest owner who has participated in the ETS and received emissions units may choose to exit from the ETS. A forester who does this will be required to surrender to the Government a number of emissions units equivalent to the number previously received. This transaction was not envisaged when the current tax provisions were drafted. The correct outcome is that these surrenders ought to give rise to a deduction.

This submission addresses a matter in legislation which does not appear in the current bill. However, officials' view is that the requested amendment should be made promptly, so they recommend it be added to the current bill.

The amendment is taxpayer-friendly, so officials recommend it take effect from 1 July 2010, the date the original legislation took effect.

Recommendation

That the submission be accepted.

TAXATION OF EMPLOYER-PROVIDED ACCOMMODATION/ACCOMMODATION ALLOWANCES

New clause

Issue: Remedial amendment – taxation of employer-provided accommodation and accommodation allowances

Submissions
(KPMG)

There should be an urgent remedial amendment to section CE 1(1B) of the Income Tax Act 2007, to ensure that accommodation provided by an employer to an employee (or accommodation allowance) is only taxable when there is a private benefit to the employee. Where an employee is temporarily relocated to a different city or country, but incurs costs maintaining their regular home, there is no private benefit from accommodation provided by their employer in the other country or city.

Comment

The tax treatment of accommodation allowances and accommodation provided to employees is being considered as part of a more general review of employee allowances and other employee expenditure payments. Consultation on an officials' paper, *Reviewing the tax treatment of employee allowances and other expenditure payments*, closed in February and submissions are currently being considered. That would be the appropriate arena for considering any issues relating to the taxation of accommodation or accommodation allowances provided to employees.

Recommendation

That the submission be declined.

Matters raised by officials

INTERNATIONAL TAX REMEDIAL MATTERS

In 2012 new rules were introduced for taxpayers with significant (but non-controlling) shareholdings in foreign companies as part of the Taxation (International Investment and Remedial Matters) Act 2012. As taxpayers have begun to apply the new rules some minor problems have been identified through correspondence with tax practitioners.

The proposed amendments are intended to correct these problems.

The first two amendments are taxpayer-friendly. The third addresses a potentially problematic interpretation but is likely to be consistent with how most taxpayers would apply the rules. It is therefore recommended that all three remedial amendments apply retrospectively, to the date of the relevant reforms.

Issue: Allowing taxpayers to continue to use certain foreign losses

Submission

(Matter raised by officials)

A small number of taxpayers have losses under the branch equivalent method that they are not able to access under the new foreign investment fund (FIF) rules (as the branch equivalent method has been replaced by another method which they cannot use). A transitional rule is required to enable such losses to be used to offset future income derived from these foreign companies.

Comment

The problem has arisen because the Taxation (International Investment and Remedial Matters) Act 2012 replaced the branch equivalent method for calculating FIF income with the attributable FIF income method (which exempts active income earned through foreign companies). Under the branch equivalent method, if a taxpayer invests in a foreign company which made losses, the losses could be carried forward to offset income from the foreign company in future years. These losses are not extinguished by the new rules, but can only be used when the taxpayer is able to apply the new attributable FIF income method. A small number of taxpayers who were previously using the branch equivalent method are unable to use the new attributable FIF income method (as they hold a less than 10% shareholding), and so cannot effectively access their losses. The amendment seeks to address this problem.

Recommendation

That the submission be accepted.

Issue: Ensuring the inter-group payment exemption is available when the Australian exemption also applies

Submission

(Matter raised by officials)

A remedial amendment is required to allow an inter-group payment exemption to apply when the paying company would have satisfied the requirements for the inter-group payment exemption, in the absence of the exemption for companies based in Australia.

Comment

Under the new rules introduced by the Taxation (International Investment, and Remedial Matters) Act 2012, an exemption is provided for companies that are resident and subject to tax in Australia. Payments of interest, rent and royalties from an "active" foreign company to a related foreign company are also exempt if both of the foreign companies are located in the same country.

These exemptions can disrupt each other in one case. That is, the exemption for certain payments between related companies does not work if the paying company qualifies for the Australian exemption. This is because the Australian exemption prevents the paying company from qualifying as an "active" business, even though it could qualify if the Australian exemption was ignored.

Recommendation

That the submission be accepted.

Issue: Clarifying that taxpayers who switch to the FDR method have FIF income in the first year that they use FDR

Submission

(Matter raised by officials)

An amendment is needed to clarify that there is an opening market value in the year that a taxpayer first uses the fair dividend rate (FDR) for a FIF, if they used a different method for that FIF in the preceding year. This amendment is likely to be consistent with how most taxpayers would apply the rules.

Comment

The new rules removed the branch equivalent and accounting profits methods. As a result, some taxpayers will switch to the FDR method. In such cases the rules require the taxpayer to calculate an opening market value by treating their shares to be sold and reacquired "immediately after the start" of the new income year.

The phrasing of this sale and reacquisition provision could possibly be interpreted as meaning the person does not have an opening market value for the purpose of the FDR at the beginning of the year. If this interpretation was correct, it would be contrary to the policy intent and would mean that the taxpayer would not have FIF income in the first year that they used the FDR method (although they would still have FIF income in subsequent years).

Recommendation

That the submission be accepted.

REMEDIAL AMENDMENT TO TAX EXEMPTION

Submission
(Matter raised by officials)

Section CW 55BB of the Income Tax Act 2007 should be amended so that the limited tax exemption for children effectively covers children's income that is not taxed at source.

Comment

As part of Budget 2012, a limited tax exemption for children replaced an out-dated tax credit for the active income of children. Section CW 55BB exempts up to $2,340 of income earned by a school child from tax if the income is not taxed at source.

Income from casual domestic work that is not taxed at source may not be exempt. This is because such income is covered by the PAYE income payment definition that is used in current section CW 55BB to identify income that is not tax-exempt. It means that a child who earns income from their casual domestic work (such as babysitting or mowing lawns) does not get the benefit of the exemption. This is inconsistent with the policy of introducing the limited tax exemption.

To correct this error, section CW 55BB should be amended to refer to an amount for which there is a withholding requirement by the payer under the PAYE rules. This would ensure that a child's casual domestic work is covered by the limited exemption.

The proposed change should apply from the 2012–13 tax year, which is the date when the limited tax exemption came into force.

Recommendation

That the submission be accepted.

UPDATE TO CROSS-REFERENCES

Submission
(Matter raised by officials)

Officials have identified two out-of-date references in existing legislation.

Goods and Services Tax Act 1985

Section 291 of the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006 amended section 15 of the Goods and Services Tax Act, by removing the classification of registered persons into specified categories.

A consequential amendment is required to remove the reference to a “category C” registered person in section 53(1)(c) of that same Act.

KiwiSaver Act 2006

Section 11 of the Taxation (Canterbury Earthquake Measures) Act 2011 removed the definition of “redundancy payment” from section YA 1 of the Income Tax Act 2007.

A consequential amendment is required to the term “redundancy payment” in section 4 of the KiwiSaver Act, to remove the cross-reference to the definition at section YA 1 of the Income Tax Act 2007.

Comment

These out-dated references should be amended.

Recommendation

That the submission be accepted.