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

Bill Number 176-1

Regulatory Impact Statements (RIS)

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Regulatory Impact Statement

The tax treatment of payments by employers in respect of employee expenditure, and employer-provided accommodation

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options for reforming the rules determining the tax treatment of allowances and other reimbursing payments paid by employers to, or for the benefit of, their employees and the direct provision of accommodation. Inland Revenue has identified a number of issues which have broad implications for the tax treatment of these types of payments. As a result, the Government added the review of this area of tax law to its work programme.

Given that employers and employees do not need to provide separate information to Inland Revenue on these payments, Inland Revenue does not hold detailed information about how much employers pay by way of allowances and other reimbursing payments. We have, however, been advised that businesses generally pay fewer types of allowances than they used to. Nevertheless, there are still a number of payments that are commonly paid by employers, in particular, in relation to accommodation, meals and clothing.

To overcome the lack of comprehensive data in this area and gain a better general understanding of the scope of the issues around employer-provided accommodation, allowances and other reimbursing payments, officials consulted with a wide range of employers, key business representatives and Government agencies, to obtain their views on such payments. There has also been wider public consultation on the options for reform. This consultation has helped to shape the options and our recommendations. Our findings are summarised in this RIS.

The Treasury has worked closely with Inland Revenue in preparing this statement and agrees with the analysis.

A strong message from employers and their representatives has been the desire for certainty over the tax treatment in particular circumstances. This need for certainty has been a key objective in shaping the preferred options.

Although the proposed changes, when broken down into individual issues, may be slightly fiscally positive or negative, the effect of the measures as a whole is likely to be broadly revenue neutral, as originally intended.

Inland Revenue is of the view that there are no significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken, other than as noted above. None of the policy options would restrict market competition, reduce the incentives for businesses to innovate and invest, unduly impair private property rights or override fundamental common law principles.

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17 October 2013

EXECUTIVE SUMMARY

There are a number of significant concerns around the tax treatment of employer provided accommodation, accommodation payments and other allowances and payments by employers to cover employee expenditure. The generality of the current tax legislation has led to impractical outcomes that may differ from how employers apply the rules in practice.

Under current tax law when an employee expenditure payment is made, provided it is to cover a work expense, it is not taxable. However, when there is a private element in the linked expense, that element is taxable irrespective of compliance costs. As meals, accommodation and normal clothing are inherently private, the starting position under current tax law is that any employee expenditure payment to cover these sorts of expenses should be taxed. (This is on the basis that the private benefit is a salary substitute and that, just like salary and wages, should be taxed to ensure that there is no incentive to provide remuneration in ways that are not taxed.)

In many instances, however, the private benefit is either incidental to the business objective or is minimal and/or hard to measure. Accordingly, some more practical rules of thumb are needed to determine where to draw the taxable/ non-taxable line, which means that legislative change is required in this area.

The major areas of concern relate to employer-provided accommodation and accommodation payments, particularly when linked to work-related travel and secondments. There has been a lot of confusion in this area, leading to calls from a range of representative bodies, agents and employers for the law in this area to be made more certain and workable.

Legislative change is also required for meal payments, as the current law does not match practice (for example, the amount that an employee saves because an employer pays for their evening meal while working out of town is in theory taxable under current law), and for work-related clothing allowances.

Officials have undertaken extensive consultation over the past two years on these issues. A range of options have been considered and measured against the objectives of limiting compliance costs, fairness and economic efficiency, leading to the recommendations below. There are no environmental or cultural impacts from these recommended changes.

Potentially these changes could impact on a wide range of employees. However, in the vast majority of cases the new rules will largely match existing business practice but with the added advantage of providing greater certainty, so the overall impact on employees and employers should be limited.

The recommended changes are:

Accommodation

- Employer-provided accommodation or an accommodation payment would be tax exempt when an employee is required by their employer to move to a new work location that is not within reasonable daily travelling distance of their home, and either
    i. the move is not project specific but there is a reasonable expectation that the employee's secondment to that work location will be for a period of two years or less, in which case the tax exemption is for up to two years; or
    ii. the move is to work for a period of three years or less on a project of limited duration, in which case the exemption is for up to three years.

There would also be a special exemption of up to five years for employees working on Canterbury earthquake recovery projects (reverting to the three year time limit by 31 March 2019).

- When an employee has to work at more than one workplace on an on-going basis the accommodation or accommodation payment would be tax exempt without an upper time limit.
- The rules for determining the taxable value of an accommodation benefit when it is not tax exempt would be clarified, including in relation to accommodation provided by churches to ministers of religion.

Meals

- The full amount of meal payments linked to work-related travel would be tax exempt, subject to a three month upper time limit at a particular work location.
- The full amount of meal payments and light refreshments outside work-related travel, such as at conferences, would be tax exempt.

Clothing

- There would be a specific exemption for the costs of purchasing and maintaining distinctive work clothing, such as a uniform, to align with the fringe benefit tax approach when the clothing is provided directly by the employer.
- There would be an exemption for plain clothes allowances paid to members of uniformed services who are required to wear ordinary clothing when performing their duties where those allowances were treated as tax-free as at 1 July 2013.

General rule for other payments

- The general rule for determining when an allowance is or is not taxable would be clarified, including by providing the Commissioner of Inland Revenue with the discretion to issue a determination as to what proportion of a class of payment is non-taxable when the private or capital element is hard to measure and/or low in value.

The recommended application date for most of these changes would be 1 April 2015. However, to ease the transition, some of the changes, including the special rule for Canterbury earthquake recovery projects, have earlier start dates. The general accommodation rule would, at the taxpayer's option, apply from 1 January 2011.

STATUS QUO AND PROBLEM DEFINITION

Background

1. This RIS provides an analysis of options for the reform of the rules affecting the tax treatment of allowances and other payments made by employers to, or for the benefit of, their employees and employer provided accommodation. These reforms arise out of the policy review, as outlined in the November 2012 officials' issues paper, *Reviewing the tax treatment of employee allowances and other expenditure payments*.

2. Businesses have a long history of paying their employees allowances, although we understand that there are fewer allowances today than thirty years ago as many have been incorporated into salaries and wages. The legislated tests have also changed over time from a system where all tax-free allowances had to be sanctioned by the Commissioner of Inland Revenue to one of taxpayer self-assessment.

3. Although the term "allowance" is commonly used in this statement, the review covers a wider range of employer payments. An allowance can be categorised as a payment to an employee which is additional to (and in some cases a substitute for) salary and wages, paid in advance and based on estimated expenditure. An employer can also make a payment to reimburse actual expenditure or on account of an employee to settle the employee's expenditure. These sorts of payments are normally paid in arrears either directly to the employee or to a third party. This variety of payments can more generally be described as "employee expenditure payments". The most common employee expenditure payments relate to accommodation and meals. In addition, accommodation provided directly by an employer has been included as part of the review.

The current legislative approach

4. The tax legislation covering these areas consists of some limited specific rules either, as in the case of accommodation, setting out the basis on which it is taxed or, for certain other payments[1], the basis on which they are exempt from tax, with a general rule setting out when other types of payments are tax exempt.

5. Generally, under the legislation, when an employee expenditure payment is made then, provided it is to meet an expense incurred in earning the employee's employment income, it is not taxable. The exception is when there is a private or capital element in the expense being reimbursed. In such circumstances, the payment may be taxable in part or in full. A taxable employee expenditure payment is taxable income of the employee and subject to PAYE. In the case of employer-provided accommodation, the benefit of the accommodation or accommodation allowance is treated as income of the employee and subject to PAYE to the extent of its market value. These taxable benefits are also taken into account when calculating social assistance entitlements.

6. The framework behind the current legislation is that any benefit that is a salary substitute should be taxed, just like salary and wages, to ensure that there is no incentive to provide remuneration in ways that are not taxed.

[1] Specific exemptions are provided for reimbursement of certain expenses arising from the relocation of employees, for overtime meal payments and for employees' additional transport costs.

Problems with current approach

7. The rule setting out when most types of employer expenditure payments are tax exempt is very general and over the years has been open to a number of different interpretations and practices, leading to taxpayers questioning what is the correct application and intention of the law. Furthermore, there are questions over whether the current law represents the most appropriate policy outcomes. These questions create uncertainty for everyone.

8. In the past, gaps that have arisen from the general rules had to be subsequently filled with either more detailed legislation or interpretive statements by Inland Revenue. For example, changes were made in 2009 specifically to deal with employee relocation payments and overtime meal payments. Since then a number of further concerns with other types of payments have arisen, in particular in relation to accommodation, meals and clothing. As a result the law needs to be clarified to provide greater certainty and better alignment with business practice.

9. To minimise uncertainty and create consistency in the area, while at the same time ensuring that there is not significant salary substitution, the Government included a review of the tax rules in this area in its work programme, with particular focus on accommodation and meals.

10. Some examples of the problems that need to be addressed are:

- *Accommodation*: It has been common practice for employers to adopt a "net benefit" approach in determining whether employer funded or provided accommodation is taxed. Under this approach, when an employee maintains a home elsewhere for their use, it is argued there is no taxable benefit, whatever the circumstances. Inland Revenue does not agree that this approach is supported in law and the Commissioner of Inland Revenue published an interpretation statement in December 2012[2] clarifying her view about the correct approach. Under the statement, the exemption for employer-provided accommodation and accommodation payments depends on the circumstances in each case (as measured against certain fact-related criteria) with a maximum exempt period of 1 year, and only applies to existing employees. This statement has generated widespread comment amongst employers and their representatives that this interpretation produces an unreasonable outcome that does not match what businesses are doing in practice.
- *Meals*: Arguably when an employer reimburses the cost of a work-related meal then the amount saved by the employee (in other words their normal expenditure on the meal) should be taxed. However, it would not be practically possible to comply with or administer a test that requires such an apportionment to be made.

11. Without change, uncertainty in these areas will continue and is likely to remain a significant issue. A strict interpretation and application of the current law could result in significant additional compliance costs for employers, or even non-compliance. The uncertainty can also result in unfairness and economic efficiency issues to the extent that any payment or employer-provided accommodation provides an untaxed private benefit.

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[2] CS 12/01 Commissioner's Statement: Income tax treatment of accommodation payments, employer-provided accommodation and accommodation allowances.

12. It has not been possible to quantify the impact of the problem because Inland Revenue does not hold detailed information about how much employers pay by way of employee expenditure payments. However, discussions with individual businesses and key business representatives indicate that the issue is likely to be significant for a wide range of employers and, potentially, for many thousands of employees. These employees would be in both the public and private sectors and would include manual workers, technicians, executives and other professionals.

OBJECTIVES

13. Given the concerns outlined above, three key policy objectives were identified for the review:

> ***Objective 1****: Improve clarity and certainty, thereby improving compliance.*
>
> The first objective has been to explore options for providing greater clarity and certainty in this area for employers and employees, something employers and their representatives have said is important to them particularly in relation to accommodation. Rules that are relatively easy for employers to understand and apply, aid compliance and help to minimise compliance and administration costs.
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> ***Objective 2****: Fairness – ensure individuals pay their fair share of tax and social assistance payments are targeted at those in genuine need.*
>
> When an employee expenditure payment is a substitute for labour income/provides a material private benefit, the second objective is to tax the payment and include it in income when determining eligibility for social assistance. In this regard, the review attempts to identify a workable boundary between payments that confer a private benefit and those that do not.
>
> As outlined in the policy principles set out in the issues paper, when a payment by an employer is to meet an expense incurred by the employee during the course of and directly because of their employment, there should normally be no tax consequences because there will be no or only incidental private benefit, but when the payment is to meet a purely private purpose then it should be taxed in full. When there is a mixed private and employment purpose, ideally the amount relating to the private purpose should be taxed. However, apportionment may not be practical in all cases due to the compliance costs associated with separating out the relative private and employment elements. In such cases the private amount should be ignored when low in value (and incidental to the work purpose) or hard to measure, and the benefit is not provided as a salary substitute. This approach ensures that when there is a private benefit, the tax and social assistance outcomes are the same for employees irrespective of the composition of their remuneration.

***Objective** 3: Economic efficiency – ensure that tax rules in this area are not an impediment to business decision making.*

The law in this area can impact on a broad spectrum of employees who incur expenditure during the course of their work and for which they are reimbursed by their employers. In some cases their employers ultimately bear the additional tax costs. Other than this direct financial implication for the employee or employer, there is the potential for the tax rules to act, where the payment relates to accommodation and meals, as a disincentive to the free movement of labour and, more generally, to normal businesses activities that require travel. To avoid these economic costs, it is crucial to have rules that are clear and that tax only the private benefit element.

REGULATORY IMPACT ANALYSIS

14. The main options for change considered during the review are summarised in the table below and discussed in the paragraphs following the table. They are assessed against the three objectives outlined in the preceding section (compliance, fairness and economic efficiency). A description and fuller analysis of all options considered is provided in the annex. That annex assesses the options against compliance, economic, social and fiscal impacts. The social impact is considered in terms of fairness. There are no cultural or environmental impacts.

Why the status quo is not an option

15. The option of retaining the status quo was also considered for all issues but was rejected because we did not consider it would address the compliance, equity and economic efficiency problems associated with the current rules identified earlier. The status quo option, therefore, is not an option for the long-term.

16. The key options for change are:

Issue	Option	Net impact and whether objectives are met
Employer-provided & funded accommodation linked to work travel and secondments generally	Net benefit approach (see paragraph 19 for further explanation)	- Likely to involve significant compliance and administrative costs. - Equity issues as employee's tax and social assistance outcomes differ depending on personal living circumstances. - Likely to distort behaviour/encourage salary substitution if applied without any time limit, leading to high fiscal risk. *Not preferred option as is high risk and subjective.*
	Series of upper time limits (two years generally, three years for projects with up to five years for Canterbury recovery projects) (see paragraphs 20-26 for further explanation)	- Is the approach adopted in a number of other countries. - Removes uncertainty around where boundary is drawn so should reduce compliance and administration costs. - Extended upper limits for projects and for Canterbury recovery work provide flexibility to avoid equity issues. - This flexibility should also not impede labour movement and normal business activity. *Preferred option as limits risk and provides flexibility without subjectivity.*
	Upper time limit with Commissioner discretion to extend (see paragraph 27 for further explanation)	- Removes some uncertainty around the boundary of what is/is not taxable, upper limit provides a safe harbour, and discretion allows for special circumstances. - Commissioner discretion would involve more compliance and administration costs. - Application of Commissioner discretion may impact on fairness/consistency.

		- Commissioner discretion provides flexibility to avoid impeding labour movement/normal business practice. *Not preferred option as although limits fiscal risk and provides flexibility, may cause inconsistency.*
Valuation of taxable accommodation benefit	Market value	- Compliance and administration costs minimised as is current valuation approach and therefore well understood. - May not be fair where employee provided high priced accommodation that employee would not normally occupy but for the requirements of the job. May impede labour mobility in such cases.
	Market value with standard adjustment	- Compliance costs dependent on nature of the adjustment. - Standard adjustment difficult to determine and application could be too wide, so raises issues of fairness and economic costs.
	Market value with caps for church-supplied property, for those posted overseas (see paragraph 28 for further explanation), and possibly for New Zealand Defence Force housing	- Generally limits compliance and administration costs. - Targets adjustment to specific cases identified as requiring adjustment. *Preferred option for this reason.*
Meals payments during work travel	Upper time limit – tax after 3 months (see paragraphs 29 and 30 for further explanation)	- Removes uncertainty around where boundary is drawn so should reduce compliance and administration costs. - Should be sufficient for vast majority of journeys away from normal workplace so should not impede normal business activity, while recognising extra costs for employee. - Limits fiscal risk associated with alternative option of having no limit. *Preferred option.*
Clothing payments	Distinctive work clothing exemption (see paragraphs 29 to 31 for further explanation)	- By in effect codifying the outcome of case law and mirroring fringe benefit tax treatment when clothing provided by employer instead of an allowance, it provides greater clarity and therefore reduces compliance costs relative to the status quo of relying on general rule. - Plain clothes exemption for uniformed services reflects long-standing practice recognising specific circumstances.
General rule for other payments	Some minor clarifications and a Commissioner determination power to specify proportion of benefit that is taxable (see paragraphs 32 to 34)	- Improves status quo by providing more clarity and flexibility to handle future questions over what is taxable/not taxable while retaining current rules. - Alternative of a substantial revision would lead to greater uncertainty with no guarantee of improvement.

17. More discussion of these points in the context of each area of employee expenditure payment is provided below.

Employee accommodation

18. Employer provided and funded accommodation provides an inherently private benefit to the employee and should generally be taxed, particularly if provided as part of a salary trade-off. However, in some instances there is little benefit to the employee, largely because the accommodation or payments arise from the requirements of the employer or the job. In such cases there should be no tax liability. The key problem is identifying a workable boundary between private and work-related expenditure so only private expenditure is taxed.

Accommodation linked to work travel (and secondments)

Tax exemption when no net benefit

19. To establish this boundary, as noted earlier, many employers have in the past adopted a "net benefit" approach which takes into account whether an employee maintains a home elsewhere for their use and where this is the case, it is then argued that there is no taxable benefit when the employer provides accommodation. This is on the basis that the value of the accommodation related to the work secondment is wholly linked to the employee's job and is extra to the employee's on-going normal home costs. However, such an approach is highly subjective requiring an evaluation of an employee's personal affairs to determine the right tax outcome which may not be possible at the time of payment. It would also be difficult for Inland Revenue to audit and would result in significant administration costs. Whilst in many instances the employee will be incurring extra costs because of the 'temporary' nature of the 'move', the question is the point at which maintaining a home elsewhere is a matter of personal choice for the employee that ought to be recognised as a taxable benefit. The net benefit approach ignores this key issue.

Tax exemption subject to time limits (recommended option)

20. A test or tests based on objective rules may be easier for employers and employees to understand. Some time limit cut-off would be required to establish a suitable boundary and this would also need to take account of fiscal considerations[3].

21. The issues paper suggested a one year bright line test for accommodation linked to work-related secondments of existing employees. However, feedback suggested that a one year limit would be too short for a significant proportion of temporary shifts such as work-related secondments. Consultation indicated that a two year time limit should cover the vast majority of cases in New Zealand. However, there were still concerns in relation to longer-term projects. Options considered for dealing with these concerns included an increased time limit for projects, including the Canterbury earthquake recovery, or alternatively, a power for the Commissioner to agree to an increase in the two year time limit in particular cases. A variant of this alternative option was for the taxpayer to self-assess whether they qualified for a time extension against a set of fact-related criteria.

22. Accordingly, for the general situation, our preference is for a tax exemption linked to a two year upper time limit.

23. Given that increasing any time limit beyond two years for employees in general would not be necessary for most work-related secondments, our preferred option is to allow a limited extension to three years for major projects of limited duration. To qualify the employer will need to have been contracted by an unrelated third party to supply employees to work specifically on such a project for a duration of no more than three years. (While the employee's contracted work cannot exceed a maximum of three years, the duration of the project could be longer.) Both new and existing employees would be potentially eligible in this case.

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[3] An exemption with an upper time limit is the approach used in Australia, Canada, the United Kingdom and the United States. Australia and the United States have a tax exemption with a one-year upper time limit, while Canada and the United Kingdom have a tax exemption with a two-year upper time limit.

24. This extension would be in recognition of the long-term nature of the engagement in these sorts of projects and that some of the projects are often not located where employees might want to relocate permanently. The employees might be employed on a fly in/fly out basis, so would not be relocating, or recruited specifically from overseas with no intention that they ever relocate to New Zealand.

25. Even a three year time limit might not be a long enough period for many of the individual projects that will be undertaken as part of the Canterbury earthquake recovery. Consequently, the package includes a separate transitional rule specific to accommodation provided to employees working on Canterbury earthquake reconstruction projects, over the period 4 September 2010 to 31 March 2019. The recommended maximum tax-free accommodation period is five years for employees arriving in the period 4 September 2010 - 31 March 2015; four years for arrivals in the period 1 April 2015 – 31 March 2016, and three years thereafter. However, Canterbury recovery work will eventually come to an end, at which point the general rules would apply. Consequently, the specific exemption would cease from April 2019.

26. The advantage of the option of a series of upper time limits is that it provides flexibility to handle a wide range of business situations and should not impede labour mobility. At the same time it balances the equity issues associated with ensuring that a pragmatic boundary is drawn to delineate what is a private, and hence taxable, benefit. Since employers and employees can identify the treatment upfront, it aids in limiting compliance and administration costs.

Commissioner discretion to extend

27. The alternative option of giving the Commissioner of Inland Revenue a discretion to extend the two year time period would also provide additional flexibility for particular cases. However, ideally the factors the Commissioner would take into account would be defined in legislation, along with any upper time limit to the extension. There would be additional compliance and administration costs in applying such an approach. Whilst some employers might welcome this discretionary approach, there is scope for inconsistency in how the power is applied and if the factors can be defined in legislation it is questionable whether there would be much to be gained by requiring employers to apply for, and Inland Revenue to consider, an extension of time. The same concerns would apply if the extension was self-assessed by the taxpayer and could lead to more disputes between Inland Revenue and taxpayers. (Consequently, we prefer a series of upper time limits rather than a Commissioner discretion as in the previous option.)

Employees with more than one workplace

28. There are also a number of circumstances in which an employee has to work at more than one workplace on an on-going basis, because of the nature of their duties, and the additional workplaces are beyond reasonable daily travelling distance from their home. This could be the case, for example, for senior managers of large organisations. In these circumstances, because of the on-going nature of the two workplaces and the associated costs, an upper time limit is not appropriate. Accordingly, our recommendation is to introduce an exemption for employer-provided accommodation and accommodation payments in such circumstances, without an upper time limit.

Value of accommodation benefits

29. When employers provide accommodation to their employees, the current approach is to base the taxable value on market rental value. The recommended approach is to leave this well understood approach unchanged, but to make the position clearer in legislation, including recognition of any contribution made by the employee. However, adjustments to this market value rule are recommended for:

- *Ministers of religion:* A longstanding existing administrative practice has capped the benefit of church-supplied accommodation at 10% of stipend. From a policy perspective this accommodation provides a significant private benefit and should be taxed like salary and wages given that no rent is charged. However, removing the existing practice would place a significant additional cost at relatively short notice on individual churches at a time when they have other significant financial obligations, such as making earthquake strengthening repairs. There is a case therefore for continuing the effect of the longstanding practice in a way that is workable, and across the spectrum of churches. This could be by way of a full exemption or by simply including the current practice in legislation. In either case, it would seem more workable to include both rented as well as owned accommodation provided to ministers as they are largely substitutable. A specific valuation rule is recommended for accommodation supplied (whether owned or rented) by religious bodies to their ministers, subject to a reasonableness test that would cap the exempt amount at a reasonable market rental value.

- *Accommodation for employees working overseas:* The recommendation is to cap the benefit value at the rental value of a property that the employee would be expected to occupy in New Zealand. This would be for fairness reasons, to ensure that the attributed tax value does not exceed the perceived benefit from the accommodation.

- *New Zealand Defence Forces (NZDF):* Historically the NZDF had an administrative arrangement allowing for a discount of up to 40% of market value, meaning in effect there was no taxable benefit when personnel paid below market rents. This arrangement was terminated in December 2012 by the Inland Revenue Commissioner's statement on accommodation. The NZDF was moving incrementally towards market values as part of a wider review of terms and conditions, however, this was subsequently suspended in August 2013. Currently, the main differences between market value and the rental charged by the NZDF arise in Auckland (where rents are on average nearly 20% below market) and, to a lesser extent, Christchurch. The NZDF has argued for a continuation of past practice based on the special nature of the armed forces and the housing provided (such as being on base and subject to certain restrictions).

  Generally, following the principles of a broad-base, low-rate tax system, the full market value should be used to determine whether there is any tax liability. The NZDF could gross up the salaries of the affected personnel to cover the tax (and any social assistance) implications of applying full market value. However, there is debate over what is an appropriate market value for NZDF accommodation that sufficiently takes into account the additional restrictions of military life. Arguably, therefore, there is a case for continuing the past practice of discounting the market value and incorporating it into tax legislation, either temporarily through to 1 April 2016, or permanently.

Employee meals

30. Employers typically meet an employee's meal costs when linked to work-related duties. Arguably the amount of normal expenditure saved by the employee is taxable. In these circumstances any private element is likely to be low in value and difficult to measure. The options considered ranged from exempting the full amount of the cost of meals linked to work-related travel without limitation to limiting the exemption either to where there are overnight stays or a three month upper time limit at a particular work location. A limitation was considered to be necessary to limit the fiscal cost of and incentive for salary substitution. A three month time limit was considered preferable to a limitation based on overnight stays because it would better match when an employee incurred additional expenditure as part of work travel and a cut-off that employers might reasonably apply in paying for employee meals.

31. A further recommended option is to exempt reimbursements for working meals and conferences and light refreshments, provided the payments are not a substitute or trade-off for salary. These recommendations are largely consistent with current business practice and should, therefore, have minimal impact on business behaviour and compliance costs.

Distinctive work clothing

32. A specific exemption for payments provided to cover the costs of buying and maintaining distinctive work clothing, such as uniforms, is recommended on the basis that the payments are clearly related to the employee's job. The provision of such clothing is already specifically exempted from fringe benefit tax. Payments in relation to the purchase and maintenance of other clothing would be subject to the general rules for determining when a payment that does not have its own exemption rules is tax-exempt.

33. The alternative option was to just rely on the general rule and existing case law, but the additional certainty of a specific exemption was considered to be preferable. This exemption would be along the lines of the fringe benefit exemption when employers provide distinctive clothing rather than a cash allowance.

34. This distinctive clothing exemption will also cover partly taxable plain clothes allowances that were in place as at 1 July 2013 and paid to uniformed personnel who are required to wear plain clothes in order to carry out their duties. For example, there has been a longstanding expectation that a portion of the plain clothes allowance paid to police officers is non-taxable, based on the specific circumstances involved. Under normal circumstances, however, the provision of ordinary clothing or an allowance to purchase ordinary clothing would be a taxable benefit.

General rule for determining taxable portion of other expenditure payments

35. Our preferred option is to leave the rules that determine what other benefits are provided tax-free largely unchanged. The general rule requires the expenditure in question to be incurred in connection with earning the employee's employment income and exempts the reimbursing payment from tax to the extent that the expenditure is not a private or capital expense. Although this requires a judgement to be made about the nature and extent of any private benefit, any alternative test would require similar judgements to be made. There would, therefore, be significant administrative and compliance costs in moving to any new general rule, without any guarantee of delivering additional clarity.

36. However, an enhancement can be made without a fundamental alteration by clarifying when an expense would be incurred in connection with earning employment income. Under this recommended option several criteria would be added to the general rule, focusing on whether the expenditure was incurred because of the obligations of the job or as a practical requirement of the job.

37. We also recommend adding a Commissioner's determination making power specifying the proportion of any class of payment that would be taxable or exempt. Such a determination would be binding on the Commissioner but optional for the taxpayer. To limit the need to use this power to determine an exempt proportion, the payment involved would need to affect a large group or class of employees, and the Commissioner would need to be of the view that the private or capital benefit involved was low in value and/or hard to measure, and involved no salary re-characterisation (that is the payment was provided mainly for business purposes). This power would provide flexibility in handling future questions over what is the taxable portion of a type of payment and should be a more efficient process than requiring a law change when issues over apportionment arise.

CONSULTATION

38. Following informal consultation with a number of individual businesses and key business representatives, Inland Revenue published an officials' issues paper in November 2012, *Reviewing the tax treatment of employee allowances and other expenditure payments,* setting out the scope of the issues and its initial thinking in this area about the options for resolving them. Submissions on the issues paper led to further refinement of the options suggested in the paper.

39. Twenty-seven submissions were received. In general, submitters welcomed the review as a positive move to clarify the law in this area and supported the policy principles set out in the paper[4]. However, some submitters took the view that the starting position should be that any payment by an employer to cover an employee expense should not be taxable unless it is specifically a reward for services (or similar).

40. Submitters were also positive about any moves to clarify and make the law more certain. In particular, the proposals to exempt the full amount of any meal payment (rather than the excess over the employee's normal day to day costs) for a three month period, working lunches and light refreshments were welcomed.

41. Most submissions focused on the tax treatment of accommodation expenses linked to work-related travel and establishing a boundary between private and work-related expenditure. There was some focus on costs for employers in complying with any new interpretations or rules, particularly when the types of payments likely to be affected are minor and any tax consequences are relatively small.

42. Given the main areas of concern were around the tax treatment of employer-provided or funded accommodation, substantive further consultation was undertaken to discuss this with a range of employer representatives. A number of submissions favoured the net benefit approach to the tax treatment of accommodation payments or, alternatively, a safe harbour

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[4] See objective 2 in paragraph 13 for an outline of those principles.

time period with the ability to extend beyond that time period if certain fact-based criteria were considered to be met. We did not agree that these options were the best approach, for the reasons explained earlier regarding the consistency question and the compliance and administration costs of such approaches.

43. Our view was that a better approach was to focus solely on a simpler test linked to an upper time limit. Consultation then focussed on the length of any time limit for accommodation linked to work-related travel. Those consulted thought a two year time limit should cover the vast majority of work-related secondments, based on anecdotal evidence. Some even commented that a two year limit would be generous in a number of cases.

44. However, there were concerns that this time limit would not be long enough in all cases and that the exemption should also apply to accommodation for new employees in certain situations. In particular, issues were identified about how well a time limited rule might work for longer-term projects – mainly large-scale construction projects that take longer than two years to complete. These include work on the Canterbury earthquake recovery (where there will be a number of major longer term projects with construction workers moving between different projects), projects in other locations throughout New Zealand (for example, the ultra-fast broadband roll-out, dam rebuilds and other major water storage projects, and road building projects such as Transmission Gully), and international secondments (which often last for two to three years). The recommended rules have taken this into account and included new employees in the 3 year test so as to provide the same tax treatment as existing employees.

45. The Treasury has worked closely with Inland Revenue on this review of employee expenditure payments.

CONCLUSIONS AND RECOMMENDATIONS

46. It is recommended that changes be made to the legislation determining the tax treatment of employee expenditure payments and employer-provided accommodation to improve clarity and certainty.

47. In doing so, the proposed approach would result in the following outcomes for accommodation, meals, clothing and the general rule covering other employee payments:

Accommodation	
Employer provided/funded accommodation linked to work travel	
a)	Employer-provided accommodation or an accommodation payment will be tax exempt when: • An employee is required by their employer to move to a new work location and that location is not within reasonable daily travelling distance of their home; and • Either i. the move is not project specific but there is a reasonable expectation that the employee's secondment to that work location will be for a period of 2 years or less, in which case the payment is exempt for up to 2 years; or ii. the move is to work on a project of limited duration for a period of 3 years or less, in which case the time limit is 3 years.

b)	The accommodation payment will cease to be tax exempt before the respective maximum period if any of the following occurs: • The employer makes a tax-free relocation payment to assist an employee buy a property in the new work location (an indication that the shift is more than temporary); or • The expectation that the employee will be at the new location for, as relevant, a maximum of two years or three years changes.
c)	The rules will also be subject to certain conditions to protect against abuse: • The exemption would not apply if accommodation is provided under a salary trade-off arrangement. • There would be an anti-avoidance rules to prevent behaviour intended simply to restart the relevant time limit.
d)	The above exemptions would apply to accommodation or accommodation payments with existing employers. New employees could also qualify for the three year exemption when they move to work on a particular project of limited duration - for example, when an individual is recruited to work on a project to build a new thermal power station in a remote location. New employees would only qualify for the two year exemption when: • an employee is recruited to work at a particular work location but is then sent to work at another work location temporarily; or • an employee working for one employer is seconded to work for another employer on a temporary basis, with the expectation that the employee will return to work for the original employer.
e)	The upper time limit for Christchurch recovery projects would be: • five years if the date of arrival is in the period 4 September 2010 to 31 March 2015; • four years if the date of arrival is in the period 1 April 2015 to 31 March 2016; and • three years when the date of arrival is in the period from 1 April 2016 to 31 March 2019.
f)	Employers and employees would have the choice of applying these revised rules retrospectively to accommodation arrangements put in place on or after 1 January 2011 (4 September 2010 for Christchurch accommodation). Otherwise, the rules would apply from 1 April 2015.

Accommodation when employee has more than one workplace

There are a number of circumstances when an employee, because of the nature of their duties, has to work at more than one workplace on an on-going basis and these additional workplaces are beyond reasonable daily travelling distance from their home. An exemption for an accommodation payment in such circumstances, without an upper time limit, is recommended.

Value of taxable accommodation benefits

When employer provided accommodation is not tax exempt, a mechanism is required to determine the taxable value. The current approach is to base the taxable value on market rental value. We recommend continuing this approach but with some clarification around what constitutes 'market value' in certain circumstances:

Accommodation benefits linked to a particular job – A specific valuation rule for church-supplied accommodation provided to ministers of religion is recommended given the specific historical tax treatment in their case of valuing the benefit at 10% of stipend. The tax exempt amount would be limited to the extent that the accommodation is a reasonable amount for the area and the nature of the minister's duties. There is also debate over whether the market rental value test adequately takes into account the additional restrictions applied to personnel who rent New Zealand Defence Force accommodation.

Accommodation for employees working overseas – The value of employer provided accommodation in overseas locations can be particularly high – this issue is of relevance to MFAT staff posted to overseas embassies, for example. To address this issue, we recommend the taxable value should be capped at the value of a property the employee might reasonably be expected to occupy in New Zealand.

Payments to cover meals
Work-related travel meals – We recommend exempting the full amount of meal payments linked to work-related travel, subject to a three month upper time limit at a particular work location. ***Other meals*** – We recommend exempting the full amount of meal payments linked to work-related meals outside of work-related travel and the meal arises because of the nature of the work. This would cover meals at conferences, for example. ***Light refreshments*** – We recommend exempting payments to cover the cost of light refreshments, such as basic tea and coffee, away from the employer's premises when the employer provides refreshments on those premises.
Payments to cover distinctive work clothing
We recommend exempting: • payments to cover the cost of purchasing and maintaining distinctive work clothing, such as uniforms; and • that part of a plain clothes allowance that had previously been treated as non-taxable if: the allowance was in effect as at 1 July 2013; it relates to employees who have been issued with a uniform but, because of the nature of their current duties, are required to wear ordinary clothing; and part of the allowance was previous treated as taxable.
General rule for determining the taxable portion of other expenditure payments
We recommend: • Clarifying the current general rule for determining whether an employer payment is taxable by including several criteria that focus on whether the expenditure was incurred because of the obligations of the job or as a practical requirement of the job. • The Commissioner of Inland Revenue be given a power to determine, by way of binding determination, the proportion of a particular type of payment that is taxable when the private or capital benefit is hard to measure, low in value and not a salary substitute. • A minor technical modification to the general exclusions from the definition of "expenditure on account of an employee" to clarify the way the relevant provisions operate.

IMPLEMENTATION

48. To address issues of uncertainty around applying the current rules, employers and employees will have the choice of applying these revised rules retrospectively to accommodation arrangements put in place on or after 1 January 2011 (4 September 2010 for Christchurch accommodation). Otherwise, the rules would apply from 1 April 2015.

49. Any initial compliance costs arising from gaining familiarity with the new rules can be limited by releasing clear guidance on the operation of these new rules through existing Inland Revenue channels. Inland Revenue customer information products would be updated (for example, guides, booklets, fact sheets and website). Inland Revenue is considering the merits of an on-line tool to help individuals when self-assessing how the new rules will apply in particular circumstances.

50. Consistent with existing tax rules, individual taxpayers would be required to comply with the existing individual tax return (IR3 return) and information obligations. Employers would be required to comply with any new PAYE obligations. Generally, taxable employee expenditure payments and the benefit of employer provided accommodation are taxable income of the employee and therefore subject to PAYE. Employees who receive the benefit of such payments or accommodation will also be required to include them in their social assistance calculations.

51. The administrative impacts of the recommended changes are likely to be small as no system changes will be required.

52. Enforcement of the proposed changes will be managed by Inland Revenue as part of its usual business and no specific enforcement strategy will be required.

MONITORING, EVALUATION AND REVIEW

53. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

54. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage. Any necessary changes identified as a result of the review would be recommended for addition to the government's tax policy work programme.

Annex – consideration of options

The key objectives identified for the review were as follows:
(C) Compliance *– improve clarity and certainty, thereby improving compliance.*
(F) Fairness *– ensuring individuals pay their fair share of tax and social assistance payments are targeted at those in genuine need.*
(E) Economic efficiency *– ensure that tax rules are not an impediment to business decision making.*

To achieve the objectives outlined above, a number of options were considered as follows:

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Issue 1: Tax treatment of employer provided or funded accommodation during work travel					
Option 1: Net Benefit test – make a specific adjustment for costs incurred by an employee when they retain a property elsewhere					
Requires on-going assessment of employee's personal circumstances and judgements about personal benefit and intentions, which may change. A retrospective assessment will often be necessary. An upper time limit or detailed criteria to limit permanent secondments might also be warranted which would bring additional costs. Formalising approach in law would require more rigorous application and compliance by employers, and introduce uncertainty/ more compliance and administration costs.	Reflects approach many employers have been taking so may not impact on business decision making. However, likely to overcompensate/ distort behaviour if applied without any time limit or subjective criteria to preclude permanent moves.	Presents significant fairness and equity issues with employees working side by side and incurring similar expenses having different tax and social assistance outcomes depending on personal circumstances.	Fiscal effect not expected to be significant unless it encourages salary trade-off, particularly for longer terms secondments unless it was combined with a time cap and/or salary trade-off exclusion. Does not recognise private benefit to employee of long-term accommodation.	Formalising net benefit approach in law would require greater compliance costs for employers and administrative costs. Risk of incentivising salary substitution.	**C.** No **F.** No **E.** Partly Overall, likely to require significant compliance and administrative costs. Because it only considers availability of a home elsewhere, does not recognise personal choice element of longer term secondments.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Option 2: Full exemption – no time limit – exempt accommodation payment made when working temporarily away from the employee's normal workplace					
Full exemption would remove valuation issues, such as determining what might constitute "additional accommodation costs".	Recognises that in the majority of cases, accommodation costs are work expenses that are wholly additional to the employee's normal day-to-day household costs. Works against the relocation exemption which provides for a 3 month exemption on relocation. Encourages permanent moves to be dressed up as temporary, in other words distorts behaviour.	Employees who are required to work away from home because of their job would not be subject to tax, for however long they were away. Does not recognise that after a period of time, the new work location becomes a "home" location for the employee and means the significant private benefit would not be recognised for tax purposes and social assistance calculations.	Because this option does not set an upper time limit for making a tax-free payment, it presents a long-term significant fiscal risk in allowing a payment to be traded for salary.	There is a very significant fiscal risk from having an exemption that allows a very significant private benefit to be provided without limit. Places considerable strain on a salary substitution rule.	**C.** Yes **F.** No **E.** Yes Although low compliance and administrative costs, this option presents a significant fiscal risk that an income substitute will go untaxed because the exemption is uncapped. It also fails to recognise the significant private benefit to an employee in the longer term.
Option 3: Full exemption with upper time limits **(recommended option)**					
Provides recognised boundary so that outcome is known in advance. Removes any requirement to compare accommodation costs in different locations so relatively easy to measure any taxable amount. Setting a clear boundary provides a safe harbour and removes the uncertainty under the current approach which is linked to the employee's personal circumstances.	Provided the upper time limit is set at an appropriate period it should not act as a barrier to moving employees to work locations for business reasons. However, some employees will find themselves on the wrong side of the boundary.	Depending on where the time limit is set, would impact on social assistance payments of workers on very long-term secondments. However, for the vast majority of employees this should not be an issue.	This is more generous than the current approach as set out in the Commissioner's interpretation statement, and provides clearer boundaries. The vast majority of travelling employees will be unaffected so unlikely to be a significant fiscal impact.	A time limit creates a cliff edge and some employees will inevitably find themselves on the wrong side of it. If the time limit is set too low, it could act as a barrier to employee mobility and if set too high would create a fiscal risk.	**C.** Yes **F.** Yes **E.** Yes Overall, removes a lot of the uncertainty around the boundary of what is and is not taxable. The taxable amount should be easy to measure and unlikely to lead to salary substitution. The 3 year rule for longer-term projects and further time extension for Canterbury earthquake recovery work mean that there should be fewer employees at the margin.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Option 4: Full exemption – upper time limit with power to extend in certain circumstances					
Removes any requirement to compare accommodation costs in different locations so relatively easy to measure any taxable amount. Setting a clear boundary provides a safe harbour and removes the uncertainty under the current approach which is linked to the employee's personal circumstances. Compliance and administration costs associated with any application to Commissioner for an extension of time.	Provided the upper time limit is set at an appropriate period to reflect the upper time limit in most cases, it should not act as a significant additional barrier to moving employees to long-term work locations. A power to extend the time limit would bring additional flexibility allowing the rule to cater for non-standard circumstances where a fixed limit might not be sufficient.	Provides a boundary to recognise the point at which long-term accommodation should be treated as providing a private benefit that should be taken into account in income calculations. Depending on where the time limit is set, would impact on social assistance payments of workers on long-term secondments. However, for the vast majority of employees this would not be an issue. Power to extend provides some additional flexibility around the margins. There would be fairness issues depending on how this was applied.	This broadly reflects the current approach as set out in the Commissioner's interpretation statement, although with a clearer boundary. Therefore, depending on where the upper time limit is set, unlikely to be a significant fiscal impact. Administration costs if leads to significant number of requests for extension. Need to identify criteria for extension in which case why not include in legislation?	A time limit creates a cliff edge and some employees will inevitably find themselves on the wrong side of it. If the time limit is set too low, it could act as a fiscal barrier to employee mobility and if set too high provide a fiscal risk.	**C.** Partly **F.** Yes **E.** Yes Removes some uncertainty around the boundary of what is and is not taxable. Taxable amount should be easy to measure. Having a power to extend the time limit overcomes some of the borderline issues with a fixed upper time limit. However, unless CIR power narrowly drawn, it introduces administrative costs, uncertainty and potential fairness issues if there is an inconsistent approach to applying any extension power.
Issue 2: Tax treatment of employer provided or funded accommodation at or near normal work location (e.g. caretaker)					
Option 1: Tax full market rental value, adjusted for a range of factors					
Difficult to establish adjustment as requires a subjective assessment to be made about a range of factors personal to the employee that will vary on an individual basis; for example perceptions about the drawbacks to living at or near the job.	Would remove or substantially reduce disincentives to labour mobility since if accurate would ensure the employee was only taxed on the perceived benefit rather the market rental value which may not always be reflective of the benefit when the employee would choose to live in cheaper location.	Would mean the employee was only taxed on the perceived benefit, resulting in neither over nor under taxation. However, it is unlikely that an accurate and fair figure could be established as perception of the effect of the factors would vary substantially.	Since the current approach is to tax market rental value, there should be a fiscal cost. However, the value of this is unclear since it is not certain that employers are currently always taxing full market rental value.	Would be likely to lead to significant additional administrative costs in Inland Revenue agreeing taxable values and additional compliance costs for employers in establishing the discounted value.	**C.** No **F.** Partly **E.** Yes Overall, whilst theoretically this option results in the correct value being taxed, this is unlikely to be the case. It would be very difficult to quantify accurately the discounted value which would also depend on the particular factors.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Option 2: Full exemption if employee required to occupy property in order to do job					
Significant issues would arise in identifying the circumstances in which a particular property should be exempt. There would be on-going compliance issues in policing the boundary with self –assessment by an employer being subject to subsequent scrutiny under Inland Revenue audit.	Runs counter to principle that the tax system should be neutral in economic decision making, and broad based with few exemptions.	An employee required to occupy a particular property would not have their social assistance entitlements and obligations affected. However, there would be fairness issues relative to other employees.	Whilst there may be significant drawbacks to "living on the job", an employee will still enjoy a substantial private benefit from employer provided accommodation which would not be taxed or taken into account for social assistance calculations. Once exempted, difficult to change at a later date because of the impact on individual employees and their families.	Introducing a general exemption would introduce significant compliance and administration issues in identifying and policing the boundary. Potentially, it could lead to salary substitution because of the substantial tax-free benefit that would arise and calls for extension of the exemption.	**C.** No **F.** No **E.** No Overall, a general exemption would bring new compliance issues in identifying which housing should be exempt, fairness issues in deciding which employees should have their housing treated as exempt and economic efficiency concerns that those employees were not being taxed on a valuable private benefit.
Option 3: Tax full market rental value, but subject to a specific exemption or cap on value for church-owned accommodation supplied to ministers of religion **(recommended option)**					
This more or less reflects the current position and allows the use of well understood market rental values. Is a simpler rule of thumb than trying to adjust for perceived disadvantages in particular circumstances. By carrying forward an established practice, compliance costs should be kept down. Exemption or valuation cap for church owned properties recognises longstanding administrative practice. Not intended as general tax exemption for ministers of religion. Some argument for capping the value in relation to	Market rental value should broadly reflect the value of a particular property without the need for further complex adjustments. In most cases, it should result in the correct amount being taxed. However, employees are likely to be less willing to move to areas with high property values where they would otherwise rent in a cheaper location but for the job requiring them to be at that location.	Employees required to work in areas with high property values are likely to be less willing to move there given tax and social assistance implications of high rental values. However, high costs of living are often factored into salary and wages (which are taxable) in the alternative scenario of a purely cash package.	Fiscal cost associated with exemption/valuation cap for ministers of religion and for NZDF personnel. Otherwise, fiscal cost should be neutral since this option largely reflects the current position.	Because this approach carries the current practice forward, risks should be low. Potential impact on movement of labour to areas with high property values.	**C.** Yes **F.** Partly **E.** Partly Overall, this reflects the option with the lowest compliance costs and that best reflects the taxable value to the employee given the trade-off between accuracy and simplicity.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
accommodation provided by NZDF to its personnel given the historic practice of discounting market value to reflect the restrictions of military life.					
Option 4: Tax market rental value, but cap at a benchmark value					
Would mix two approaches but market rental value approach is well understood. Comparison with a capped value could be relatively straightforward if benchmarks identified.	This would have to be a fairly broad brush approach but, depending on where the cap is set could overcome the barriers to employee mobility that might arise with a link solely to rental values.	An advantage of this approach is that it avoids large tax charges arising when an employee is obliged to live in a particularly expensive location, where they might not otherwise live, because of the needs of the job.	Depending where the cap is set, the full private value to the employee may not be recognised, which could lead to under taxation and a fiscal cost.	The full private value to the employee may not be recognised, which could lead to under taxation and an incentive for salary substitution.	**C.** No **F.** Yes **E.** Yes A fairly broad brush approach which, because it would have to cater for the whole of the working population, would lead to under-taxation for a group of the population.
Option 5: Tax market rental value, but cap at a proportion of salary					
Would mix two approaches but market rental value approach is well understood. Capping at a proportion of salary could be more complex depending on how this is defined.	Depending on where the cap is set could overcome the barriers to employee mobility that might arise with a link solely to rental values. Linking to salary would be more flexible and provides a better link to taxable income than using a benchmark value.	Avoids large tax charges when an employee is obliged to live in a particularly expensive location where they might not otherwise choose to live.	The full private value to the employee in some cases will not be recognised, leading to under taxation and a fiscal cost.	The full private value to the employee in some cases will not be recognised, which could lead to under taxation and an incentive for salary substitution.	**C.** Partly **F.** No **E.** Yes A fairly broad brush approach which, because it would have to cater for the whole of the working population, would lead overall to more under-taxation of the accommodation benefit.
Issue 3: Tax treatment of accommodation when more than one permanent workplace					
Option 1: Exemption based on employee nomination of which is the permanent workplace					
Potentially low compliance costs if employee simply has to tell employer which accommodation payment should be tax exempt.	Employer can provide tax-free accommodation without there being a barrier to employee mobility.	Avoids tax charges when an employee has to work in multiple work locations away from home and social assistance implications.	Likely to be some fiscal cost because it would allow employees to pick that location that produced the exemption.	Allowing employee nomination could mean selection of the most tax advantageous location to be exempt which could be employee's home.	**C.** Yes **F.** No **E.** Yes Although there are low compliance costs with this option, allowing choice as to which accommodation should be exempt provides significant fiscal risk.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Option 2: Exemption base on main place of work					
Requires a factual assessment to be made of the employee's main place of work – for example, the workplace the employee works from for most of the time. This would require a judgement to be made and reviewed on an on-going basis with some compliance costs for the employer.	Assuming the employee's home is near their main place of work, this approach would mean there was no accommodation barrier to the employee working away on an on-going basis.	Assuming the employee's home is near their main place of work, this approach would mean there was no accommodation barrier to the employee working away on an on-going basis.	Likely to be fiscally neutral.	Relies on an accurate assessment being made of the employee's main place of work. This may not be clear in some cases and require careful consideration. Alternatively it would be difficult to challenge any assessment.	**C.** Partly **F.** Yes **E.** Yes Reduces the fiscal risk that would arise under self-nomination. However, has slightly higher compliance costs in assessing the main place of work.
Option 3: Exemption if type of accommodation is considered temporary, for example a hotel room					
Employer would have to monitor the work accommodation being used to determine the tax treatment.	Subjective judgement on type of accommodation could be incorrect leading to under or over-taxation that drives decisions about form of accommodation offered. Could act as a barrier to the mobility of labour/impede business activity if employer or employee is unable to find the right type of accommodation.	Social assistance implications could be determined by something outside of the control of the employee – the type of accommodation. There are fairness issues around employees doing the same job having different tax treatment just because one employer placed their employee in different type of accommodation.	If limits accommodation options, then could be fiscally positive, but not an objective of the review.	That this could act as a barrier to mobility of labour or distort business behaviour.	**C.** No **F.** No **E.** No Likely to have additional compliance costs since the employer would need to monitor the nature of the accommodation costs being reimbursed and would result in some work-related accommodation being taxed and others under taxed with social assistance consequences.
Option 4: Distance from home **(recommended option) -** This option focuses only on the accommodation being beyond reasonable daily travelling distance from the employee's home (and therefore beyond the usual workplace).					
This should already be a consideration in the employer's decision to pay for accommodation and so should not bring significant additional compliance costs.	Exempts accommodation away from the employee's home so should not act as a barrier to the mobility of labour.	Exempts accommodation costs necessarily incurred from the job so should not bring any excess tax charges.	Should be broadly revenue neutral.	No particular issues identified.	**C.** Yes **F.** Yes **E.** Yes Introduces relatively low compliance costs and broadly exempts additional accommodation costs necessarily incurred because of the job.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Issue 4: Tax treatment of accommodation when posted overseas					
Option 1: Tax market rental value					
Is practical. Assuming the rental market in the overseas location is well developed, it should be relatively easy to identify the taxable value.	Follows the normal model for taxing accommodation. However, since many overseas work locations are in particularly expensive cities and the accommodation may incorporate a work-purpose (e.g. embassy). If taxed to the employee there can be significant over taxation and therefore a disincentive to work overseas when remaining New Zealand tax resident, for example government employees.	If working in a particularly expensive overseas location but retaining NZ residency, this could have a significant impact on social assistance payments.	Reflects the current law so no material cost implications likely.	Can act as a barrier to mobility of labour.	**C.** Yes **F.** Partly **E.** No Maintains the current position of taxing in full.
Option 2: Tax market rental value but cap at a proportion of salary					
Is practical. Assuming the rental market in the overseas location is well developed, it should be relatively easy to identify the taxable value. Ease of compliance determined by identifying correct salary entitlement.	Reduces the addition to taxable income to an amount commensurate with the employee's salary so it is affordable and not a disincentive to working overseas. In some cases it provides a subsidy to employees, depending on salary level chosen.	Reduces the addition to taxable income to an amount commensurate with the employee's salary so it is affordable and this carries across to social assistance implications.	The numbers are likely to be small so unlikely to be significant cost implications.	The numbers are likely to be small so risks are likely to be small.	**C.** Yes **F.** Partly **E.** Yes Caps the taxable amount at a level in line with the employee's remuneration package.
Option 3: Tax market rental value but cap at benchmark New Zealand property value **(recommended option)**					
As above for previous option – but requires knowledge of employee's circumstances in New Zealand.	As above for previous option.	As above for previous option.	As above for previous option.	As above for previous option.	**C.** Yes **F.** Partly **E.** Yes Caps the taxable amount at a level in line with what a NZ employee might expect to pay.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Issue 5: Whether to tax accommodation benefits under income tax or fringe benefit tax (FBT)					
Option 1: Tax under FBT, with inclusion of fringe benefit in income for social assistance/obligation calculation					
Aligns with other fringe benefits but there are compliance costs associated with the change. However, the employer is already currently involved in collecting tax, through PAYE.	Would not alter who ultimately bears the cost of the tax. Would need to ensure benefit continued to be included in income for social assistance purposes. Otherwise, would encourage provision of accommodation benefits.	Neutral, provided benefit included in social assistance calculations.	Potential fiscal gain as would be taxed to employer at a higher rate.	Risk that benefit may not be included when calculating income for social assistance purposes.	**C.** Yes **F.** Yes **E.** Yes This approach would align with other fringe benefits and be taxed to the employer. However, without special rules, it would result in a very significant fundamental benefit being excluded from social assistance considerations.
Option 2: Tax under income tax **(recommended option)**					
Continues the current approach so no new rules for the employer to be concerned about.	Continues the current approach so no new incentives/ barriers to employee mobility.	Ensures that a very substantial personal benefit is taken into account for social assistance purposes.	No costs anticipated.	No particular risks identified.	**C.** Yes **F.** Yes **E.** Yes This option maintains the current approach which has been established for a long time.
Issue 6: Tax treatment of meal payments during work travel					
Option 1: Full exemption – no upper time limit					
Employers and employees would not need to apportion any payments once they establish that meal expenses have been incurred on a work journey which would avoid significant compliance costs.	Ensures no barrier to employee mobility for work purposes.	The additional cost the employee spends on meals linked to work travel is not taxed nor taken into account for social assistance purposes.	There may be a cost if the employee swaps taxable salary for a meal payment since it covers a significant private benefit.	Risk of salary trade-off for meal payments over a prolonged period.	**C.** Yes **F.** No **E.** Yes Over time, could encourage higher allowances and salary substitution.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Option 2: Full exemption – limit to overnight stays					
As above for option 1. However, employers would need to distinguish whether overnight stay involved with employee travel.	Would not recognise that some employees may incur additional costs even when overnight stay is not required.	More limiting than current practice. The additional cost the employee spends on meals linked to work travel without an overnight stay is not taxed nor taken into account for social assistance purposes. May lead to some currently untaxed payments affecting social assistance.	There may be a cost if the employee swaps taxable salary for a meal payment since it covers a significant private benefit.	Risk of salary trade-off for meal payments over a prolonged period, but limited significantly by employee needing to be away.	**C.** Yes **F.** Partly **E.** No Assumes that when a work journey does not involve an overnight stay the employee does not incur significant additional meal costs.
Option 3: Full exemption – subject to upper time limit of three months **(recommended option)**					
As for option 1. However, there would be an upper time limit that employers would have to comply with, although this would set a clear non-taxable/taxable boundary for employers.	Any time limit would need to be sufficiently long so that it covered the vast majority of work journeys away from the normal place of work so it does not act as a barrier to the mobility of labour. Three months is considered appropriate in this context.	The option would mean work related meal expenses would be excluded from an employee's income calculation. Any time limit would inevitably mean some employees find themselves on the wrong side of it, which could result in some employees being taxed on some expenses.	No significant costs anticipated since employers normally only reimburse work-related meals.	Risk of salary trade-off for meal payments, but limited by three month cut-off.	**C.** Yes **F.** Yes **E.** Yes The employer would not have to worry about identifying the notional private/ work split of a meal payment – it would be not taxable at all, or taxable in full. Setting an upper time limit would recognise the additional expenses linked to work-related travel, and that these costs are normalised after a period of time.
Option 4: Exempt amount saved, in other words, the amount taxable under current law					
There would be a significant compliance cost from the employer having to identify the employee's normal meal expenses. This would be very difficult, if not impossible, to do.	There would be an impediment to normal business activity if employers and employees had to undertake complex exercises to identify the taxable element of a meal expense.	The value of the amount saved would need to be taken into account in income for social assistance purposes. Given the relatively small individual amounts this would be difficult to identify and monitor.	Potentially, a small fiscal positive since the amount save is not currently taxed. However, this would be so difficult to identify employers would be reluctant to undertake the calculations.	The calculation required to identify the amount saved could prove to be near impossible to undertake.	**C.** No **F.** Yes **E.** Yes Because of the likely difficulties in identifying the amount saved and hence the taxable amount, this option is not seen as a realistic outcome.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	Economic	Social	Fiscal impact		
Option 5: Exempt a fixed portion or a capped amount					
A broad brush approach that should have relatively low compliance costs. The approach is already adopted by the USA and Canada which exempt 50% of any expenses. However, employers would have to change their processes to tax in part payments that are currently being paid tax-free.	Ensures that a significant element of any meal payment is tax exempt. However, the level of the cap will determine the extent of any impediment to normal business activity and labour mobility.	The taxable portion will be taken into account in income used for social assistance purposes. When an employee works away on a regular basis this could be a material amount. However, it should recognise the significant private benefit to the employee when the employer covers their meal costs.	This option would be fiscally positive since the amount saved by the employee is not currently being taxed. There is little information on the scale here and the amount would be determined by the deemed taxable element.	That the cap is set too high and acts as a barrier to normal business activity.	**C.** Yes **F.** No **E.** Partly Employers would have to change their processes to tax meal payments in part and account for this through PAYE.
Issue 7: Tax treatment of working lunches/ light refreshments					
Option 1: Exempt full amount – subject to upper monetary limit					
It provides a clear boundary. However, would introduce a cliff edge which employers would have to monitor and potentially allocate expenditure between employees, bringing significant compliance costs for relatively small amounts.	The boundary approach could result in employers paying up to the limit and no more. The boundary would require monitoring to maintain the real value or it could start to distort decisions.	No particular issues identified.	Unlikely to be a fiscal cost.	That the compliance costs would impact on business decisions and behaviour.	**C.** No **F.** Yes **E.** No Employers would have to monitor employee expenditure to ensure monetary limits are not exceeded and any excess is taxed. Depending on where the cut-off was set, could curtail normal business behaviour.
Option 2: Exempt full amount **(recommended option)**					
Employers would need to ensure that they satisfy any criteria for making tax-free payments, but otherwise no compliance costs.	No impacts.	No impacts.	No impacts.	Potential for private meal benefits to be paid by way of salary trade-off or otherwise as a tax-free – salary substitution rule for this.	**C.** Yes **F.** Yes **E.** Yes This option would reflect current practice so net impact likely to be minimal.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Issue 8: Tax treatment of clothing payments					
Option 1: Tax in full					
A simple outcome since employers would tax all clothing payments.	Would also cover uniforms and specialist clothing that employees require to do their job, pushing up costs and distorting business decisions.	Assuming employers continue to make such payments, there would be an additional taxable income that would flow through into social assistance entitlements.	Would result in additional revenue since employers would have to continue to provide and service clothing for certain jobs.	That business decisions will be distorted towards providing clothing directly.	**C.** Yes **F.** No **E.** No There would be significant additional tax consequences for uniform and specialist clothing.
Option 2: Exempt distinctive clothing – including police plain clothes allowance **(recommended option)**					
Substantially maintains the current approach for employers. Issues would remain around employers identifying what clothing is covered by the definition of uniform or specialist clothing and is therefore tax exempt.	For the vast majority of employers, there should be no impact on business decision making. Consistent with fringe benefit tax treatment of distinctive clothing.	No significant impacts other than for the few employees who consider they have significant abnormal use of ordinary clothing.	Broadly revenue neutral.	None identified.	**C.** Yes **F.** Yes **E.** Yes Payments relating to uniform and specialist clothing would continue not to be taxed – however, a plain clothes allowance paid to an employee who had been issued with a uniform but was required to wear ordinary clothing because of the nature of their duties would be exempt.
Option 3: Exempt distinctive clothing and abnormal use of ordinary clothing					
Different from current position with respect to abnormal use of ordinary clothing.	Incentive to try to include ordinary clothing tax-free.	Incentive to try to include ordinary clothing tax-free.	Fiscal cost if interpreted to enable more ordinary clothing to be tax-free.	By enshrining law the tax position for ordinary clothing, this could result in additional pressure to widen the very limited current scope.	**C.** Yes **F.** Partly **E.** Partly By enshrining law the tax position for ordinary clothing, this could result in additional pressure to widen the very limited current scope.
Option 4: Apply general rule to clothing					
Retains the existing position in effect.	Retains the existing position in effect.	Retains the existing position in effect.	Retains the existing position in effect.	Retains the existing position in effect.	**C.** Yes **F.** Yes **E.** Yes Retains the existing position in effect.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Issue 9: Clarifying the definition of "expenditure on account of an employee"					
Option: Amend general exclusions to make a clearer distinction between when they should apply **(recommended option)**					
Retains status quo so minimal compliance impact.	Retains the current position.	Retains the current position.	Retains the current position.	That re-drafting the exclusions will have unintended consequence that will not deliver the policy intent.	**C.** Yes **F.** Yes **E.** Yes Retaining the existing position is simpler approach than consolidating the two provisions. Other options also considered but would have either left a gap in the law (if repealed general provision) or lead to a more confused outcome if merged the two exclusions.
Issue 10: Enhancing the general rule that determines taxable/non-taxable portions of other allowances					
Option 1: Amend general rule to reflect policy principles					
Re-writing of the general rules would result in significant compliance costs as employers and their advisers have to come to grips with them and how they should be interpreted and applied. There would be corresponding administrative costs.	Potentially would make it simpler for employers to pay work-related expenses.	Potentially would make it simpler for employees to be refunded work-related expenses.	Potential significant fiscal cost if the change in approach results in a relaxation of the current approach.	That the change in approach merely complicates the existing rules.	**C.** No **F.** Yes **E.** Yes Uncertain whether it would allow employers to make additional payments tax-free in a range of work-related scenarios.
Option 2: Clarify general rule by including general criteria that focus on whether expenditure is incurred because of obligations of the job or as a practical requirement of the job					
Involves minor re-writing of the general rules that should reduce compliance costs over time through providing greater clarity.	No significant economic implications.	No significant social implications.	No significant cost implications.	Limited risk that the revised rules deliver an unintended outcome and create some uncertainty or a relaxation having some fiscal impact.	**C.** Yes **F.** Yes **E.** Yes Limited impact expected.

Impacts				Risks	Net Impact Does option meet objectives?
Compliance	**Economic**	**Social**	**Fiscal impact**		
Option 3: Apply the above change and provide the Commissioner of Inland Revenue with power to determine the proportion of a class of payment that is not taxable when private or capital benefit is hard to measure or low in value and not a salary substitute **(recommended option)**					
Commissioner determination making power is expected to lead to some additional administrative costs. But a determination would reduce compliance costs for employers.	Determination power should make it easier to deal with grey areas that are an impediment to business decisions.	Determination power should make it easier to deal with issues that have an impact on employees.	Fiscal costs should be low since any discretion would be focused on low value apportionment aspects that are currently hard to measure or low in value.	That the determination power is applied inconsistently or too widely, but have public rulings to limit this.	**C.** Yes **F.** Yes **E.** Yes Enables specific apportionment issues to be addressed in a more streamlined way than having to legislate for each case.

Regulatory Impact Statement

Improving the effectiveness of the thin capitalisation rules

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem addressed in this statement is whether the inbound thin capitalisation rules are operating effectively, or whether there are inconsistencies that need to be addressed. Where the thin capitalisation regime is not operating as intended, this statement addresses how it should be changed.

The policy intent of the thin capitalisation rules is to ensure that non-residents pay some New Zealand tax on their New Zealand investments. The thin capitalisation rules protect the New Zealand tax base by denying interest deductions when a non-resident has placed an excessive level of debt in their New Zealand investment.

Key issues with the inbound thin capitalisation rules have been brought to the Department's attention regarding the relative ineffectiveness of the regime. The ineffectiveness arises from the targeted nature of the rules, as they currently only apply to investments controlled by a single non-resident. This means that the thin capitalisation rules are easily able to be avoided, especially in the case of private equity investment and the scenario where a trust is interposed into a corporate structure.

The preferred option is to introduce a package of changes to the inbound thin capitalisation rules to broaden the application of the regime to other types of non-resident investor and tighten the rules around calculating a taxpayer's debt-to-asset ratio and worldwide group. This should increase fairness across different types of non-resident investment and help to ensure that New Zealand collects its fair share of tax.

Time has been a significant constraint in this regulatory analysis, due to the inclusion of the proposed package of changes in Budget 2013. As a result, the technical design of the policy has not yet been finalised but this should not impact the fiscal implications of the preferred approach. Further policy analysis is required to determine the technical detail.

Significant consultation was undertaken with several large accounting and other advisory firms prior to and immediately following the release of an officials' issues paper that was released in January 2013. This issues paper drew 15 external submissions. Submitters were largely supportive of the broad proposals put forward in the issues paper, but raised a number of key issues with regard to the design of the policy. Officials are continuing to work through these design issues with interested parties to ensure that any changes to the thin capitalisation rules do not impose unnecessary uncertainty and complexity.

The officials' issues paper requested that submitters consider the likely compliance costs of the proposals in their submissions. Submitters noted that they were not in a position to quantify the costs. It is important to note that such costs are already faced by those taxpayers that are currently subject to the thin capitalisation rules.

Other than those set out in this statement, no significant gaps, assumptions, dependencies, constraints, caveats and uncertainties have been identified.

The preferred package of changes does not impair private property rights, reduce market competition or override common law principles. Some additional compliance costs may be imposed upon certain taxpayers, and the application of the thin capitalisation rules to certain types of non-resident investment currently not subject to the rules may have the effect of reducing returns on investment. This may have the effect of reducing the relative attractiveness of some investment structures in New Zealand. However, we consider that these issues are not significant and the package of changes is overall beneficial to New Zealand

Carmel Peters

Carmel Peters
Policy Manager
Inland Revenue

19 March 2013

STATUS QUO AND PROBLEM DEFINITION

The thin capitalisation rules

1. New Zealand's "thin capitalisation" rules limit the tax deductions that may be taken for interest expenditure. The basis of the rules is to ensure that non-residents (such as multinational companies) pay some New Zealand tax on their New Zealand investments. One way that non-residents can reduce their New Zealand tax liability is by replacing equity with debt, because they can then take interest deductions in New Zealand. This is shown in the example below.

Example

Australian investor A puts $100m of capital in a New Zealand company as equity. Company earns $10m from sales and pays $2.8m New Zealand tax. Company pays a net dividend (not tax deductible) of $7.2m to A. Total New Zealand tax is $2.8m.

Australian investor B puts $100m of capital into a New Zealand company as debt, with an interest rate of 10%. Company earns $10m from sales but has to pay $10m of tax-deductible interest to B, reducing taxable income to $0. No tax is paid by the company, but a 10% tax on interest is imposed on B (non-resident withholding tax). Total New Zealand tax is $1m.

2. While taxing non-resident investment reduces incentives to invest here, this must be balanced against non-residents paying their fair share of tax – to ensure New Zealand can capture some of the benefits of that investment. Various reviews, such as the Tax Working Group (2009) and McLeod Review (2001), have considered the tax treatment of non-resident investment and concluded that it should be subject to some reasonable level of taxation. The thin capitalisation rules play an important role in achieving this objective.

3. There are general thin capitalisation rules for foreign investors and specific thin capitalisation rules for registered banks. There are also specific rules for New Zealanders investing abroad.[1] The focus of this statement is on the rules for foreign investors. The integrity problems identified below relate only to the general inbound rules; those problems do not arise under the other two sets of thin capitalisation rules.

Structure of the rules

4. The inbound thin capitalisation rules apply to non-residents directly earning New Zealand income, to New Zealand companies controlled by a single non-resident, and to certain trustees.

5. The rules help to protect the New Zealand tax base by denying further interest deductions in cases where a non-resident has placed an excessive level of debt in New Zealand (relative to the size of their New Zealand operations and the levels of debt that they have in other countries).

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[1] A different rationale applies for the outbound thin capitalisation rules. These are to ensure New Zealanders do not allocate debt to their New Zealand operations if that debt should rightly be allocated to their offshore operations.

6. To work out if any interest deductions should be denied, an entity subject to the rules must work out the debt-to-asset ratios of their "New Zealand group" and their "worldwide group". The New Zealand group is, crudely speaking, all the operations of the New Zealand entity. Similarly, the worldwide group is the worldwide operations of the entity's non-resident parent.

7. Interest deductions are not denied if:

- the New Zealand group's debt-to-asset ratio is 110% or less of the worldwide group's ratio; or
- the New Zealand group's debt-to-asset ratio is 60% or less.

8. The intuition of the first condition (the "110% worldwide group test") is that if the New Zealand group is no more indebted than the worldwide group, the debt in New Zealand is a rough but convenient proxy for the group's *external* debt that should be rightly attributable to its New Zealand operations. This condition is also intended to act as a proxy for what a commercially acceptable level of gearing is.[2] If an industry is generally heavily geared, as reflected by high levels of worldwide debt, high levels of New Zealand debt is also acceptable.

9. The second condition (the "60% safe harbour") is provided to reduce compliance costs as it can be difficult and time-consuming to calculate the worldwide group's debt-to-asset ratio. Many companies will have debt-to-asset ratios that are lower than 60% for commercial reasons. Companies below the 60% safe harbour do not need to calculate the worldwide group ratio in order to justify their debt levels.

Scope

10. The focus of the proposals is base maintenance. We have only considered changes to the thin capitalisation rules that ensure the above two tests (the 60% safe harbour and 110% worldwide group test) cannot easily be avoided.

11. We have not considered the thin capitalisation regime more fundamentally – such as whether the current safe harbour levels are appropriate. We received submissions suggesting that we should not proceed with the base maintenance changes to the rules without a more fundamental review of the taxation of non-resident investment. We disagree.

12. As noted above, the basis for taxing non-resident investment has been considered by various tax reviews, most recently the Tax Working Group. These reviews considered that the thin capitalisation rules play an important part in ensuring New Zealand collects its fair share of tax on non-resident investment. We do not consider it necessary to undertake a further review.

13. We have also not considered fundamental changes to treatment of debt held by finance or insurance companies, even though the existing rules appear to be ineffective in both cases.

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[2] Generally speaking, gearing is the relative level of debt to equity held by a company.

This was to keep the size of the review manageable. Consideration may be given to a different set of rules for such entities at a later date and may perhaps be comparable to those for registered banks (the Reserve Bank of New Zealand recently introduced prudential capital requirements for finance and insurance companies, which might be a basis for bank-style thin capitalisation rules).

Problem definition

14. While the thin capitalisation rules generally work well, we are aware of some structures and situations where they do not apply effectively, or at all. This provides a mechanism that allows non-resident investment to avoid paying its fair share of New Zealand tax. This also creates a moderate fiscal risk for New Zealand's tax base and undermines the integrity of the tax system.

15. The methods for planning around the thin capitalisation rules are well known. Under the current rules, New Zealand is relatively more attractive to those who are able to circumvent the thin capitalisation rules and advantages some forms of investment over others. This creates an uneven playing field for non-resident investment due to the fact that some types of non-resident investor, for example private equity investors, are not subject to the thin capitalisation rules and are therefore advantaged over the others.

16. As a result of the status quo providing a mechanism for some foreign investors to shift profits out of New Zealand with little tax being paid, the relative tax burden falls more heavily on other types of taxpayers.

17. It is difficult to quantify the scale of the problem. Private equity, which is highly geared, has been a popular investment vehicle for several years. Although its popularity declined slightly during the global financial crisis, levels of private equity investment are expected to remain steady.

18. Specifically, the key issues that we have identified are summarised in the table below.

Non-residents acting together	At present, the thin capitalisation rules apply only if a single non-resident controls the New Zealand investment. However, there are other cases where a non-resident can arbitrarily determine the level of debt and equity in a company – such as where a private equity manager effectively controls multiple companies that jointly invest into a New Zealand company.
Problems with the 110% worldwide group test	At present, the worldwide debt of a company includes all debt of the group – including shareholder debt. However, to the extent that worldwide debt is shareholder debt, this is not a good reflection of a commercial debt level for the company. Rather, it is likely that shareholders have substituted equity for debt at the worldwide level, which in turn allows them to thinly capitalise their New Zealand operations as well.
Interposition of complying	At present, trusts are only subject to the rules if it is non-

trusts	complying (that is, has not complied with all of its New Zealand tax obligations) and where 50% or more of its settlements have been made by a single non-resident. There are ways around this rule. Most notably, the rules do not apply to complying trusts (i.e. trusts that have complied with New Zealand tax obligations). This allows the trust to borrow from its settlor and fund New Zealand investments without the thin capitalisation rules applying.
Capitalised interest	Whether interest deductions will be denied under the thin capitalisation rules turns on debt-to-asset ratios. Asset values are determined according to generally accepted accounting practice (GAAP). These generally require asset values to include capitalised interest costs. For tax purposes, New Zealand companies are generally allowed a deduction for interest costs even if they have been capitalised. Taxpayers who are capitalising interest costs claim a tax deduction on the expense and can record an increase in their asset values – allowing them to claim even higher interest deductions in later years. This may be inappropriate.
Asset uplifts	Under GAAP, many kinds of intangible property must be valued at cost. Unless the asset is sold to an unrelated party, revaluation of such assets is not permitted because a reliable value cannot be determined. This restriction is being circumvented by some groups who report increased asset values following internal reorganisations. This may allow for inflated asset values. It is not clear that the amount paid by a related party will be a fair reflection of the asset's true value since the transaction is not necessarily at arm's length.

OBJECTIVES

19. The objectives of this reform are to:

- create a level playing field, so all types of non-resident investors that can substitute between debt and equity are caught by the thin capitalisation rules (fairness and efficiency);
- ensure that any changes to the thin capitalisation rules do not add undue complexity and compliance costs for taxpayers (simplicity);
- improve the integrity of the tax system by ensuring that New Zealand collects its fair share of tax on New Zealand investments of non-residents;
- reduce the fiscal risks associated with the thin capitalisation regime; and

- strike a reasonable balance between economic impact (such as incentives to invest into New Zealand) and additional tax revenue.

REGULATORY IMPACT ANALYSIS

20. The key question in this statement is whether the status quo should be retained, or if a package of reforms should be implemented to address the ways taxpayers are able to avoid the thin capitalisation regime.

21. Broadly, the package of reforms features the following:

- applying the thin capitalisation regime to any group of non-residents if they are acting together and have a combined ownership of a New Zealand investment of greater than 50%;
- exclude shareholder debt in calculations of a company's worldwide debt-to-asset ratio;
- extend the thin capitalisation regime broadly so that it also applies to complying trusts; in other words, so the rules generally apply to a resident trustee if 50% or more of the settlements made on the trust have been made by a non-resident (or a group of non-residents acting together), or by an entity already subject to the rules;
- disallow capitalised interest to be included in asset values for thin capitalisation purposes, at least for some purposes; and
- generally disregard asset value increases that arise from internal group restructuring.

22. The focus of this statement is whether, in broad terms, the thin capitalisation reforms, as described above, should proceed. The problems themselves are base maintenance in nature, which constrains the number of practical options available to address them. Aside from the proposal to apply the thin capitalisation rules to groups of non-residents acting together, practical alternatives to the other proposals do not exist.

23. Consider, for example, the proposal to extend the thin capitalisation regime to complying trusts where 50% or more of the settlements made on trust are made by a non-resident, a group of non-residents acting together, or an entity that is subject to the thin capitalisation rules. If it is considered preferable to close this loophole, the only option available is this proposal. Submitters raised the concern that this would capture securitisation vehicles as the on-lending concession does not always work perfectly. We are working through this concern.

24. Further policy analysis is required as technical decisions will need to be made on how each of these reforms should be shaped. These decisions will be informed by the submissions we have received, as well as ongoing discussions with those submitters.

Analysis of the proposed reform package

25. The officials' issues paper that was released in January 2013 identified the problems outlined in the table in paragraph 18 and proposed solutions to these, which are described

above in paragraph 21. Together the problems lead to an overall ineffectiveness of the thin capitalisation rules.

26. Of the proposals described above in paragraph 21, only the proposal to apply the thin capitalisation rules to groups of non-residents acting together had more than one practical option available to achieve the policy intent. These were either an acting together test that was not exhaustively defined in legislation, an acting together test defined using only specific and exhaustive criteria, or applying the thin capitalisation regime to all New Zealand investments where non-residents hold interests that add to 50% or more.

27. These alternative acting together tests are respectively presented as options 2, 3a, and 3b in the tables on pages 9 and 10. These tables are targeted at analysing the impact of a particular acting together test, in conjunction with the other proposals, in relation to the status quo.

28. Officials sought feedback in relation to the proposed package of reforms. Submitters broadly agreed that the problems identified by officials need to be addressed in order to ensure that the thin capitalisation rules operate effectively.

29. A number of submitters provided comments in respect of the technical design of the proposals. For example, some submitters commented that in terms of the definition for 'acting together', an exhaustive list would be preferred over a non-exhaustive definition. The policy intent is to capture private equity regardless of the final definition of 'acting together', in order to improve fairness among different types of non-resident investment and make the thin capitalisation rules more difficult to circumvent.

30. The package of reforms would have a negative impact on the value of some existing non-resident investment, in terms of reduced returns, but overall it is in New Zealand's best interest to subject non-resident investment to some amount of tax, as concluded by a number of reviews.

31. The package of reforms would apply the thin capitalisation rules more broadly, which would create a more level playing field for different types of investment. As a result, it would be harder for these non-residents to avoid paying their fair share of tax. This would have the effect of reducing the relative tax burden placed on other taxpayers.

32. The package of reforms would remove these fiscal risks and would raise revenue of an estimated $10 million per year. This figure is largely based on a sample of existing private equity investment in New Zealand that would be brought into the thin capitalisation rules, as well as some large enterprises already within the rules that would be affected by the exclusion of shareholder debt from the worldwide group ratio.

33. However, it is expected that compliance costs may increase for some taxpayers. For instance, the reform requires that shareholder debt be excluded from a company's worldwide group. We received submissions that stated this would be particularly onerous for companies with large worldwide groups. This particular type of taxpayer is not the focus of the policy concern, so we will work with submitters to try to address these concerns.

34. In the officials' issues paper we requested information on the likely cost of complying with the proposals that would fall onto taxpayers. Ideally, we would like to be able to

quantify transitional as well as on-going compliance costs. Submitters noted that they were not in a position to quantify these costs.

35. The overall policy objective is to balance any additional revenue with the potential economic impact of the proposed reform and to ensure that non-resident investors are paying a reasonable level of tax in New Zealand. However, we will continue to work with affected parties to minimise compliance costs as much as possible when designing the technical aspects of the changes.

36. It is important to note that such compliance costs are already borne by taxpayers currently subject to the thin capitalisation rules.

37. Our preferred option is to reform the thin capitalisation rules by addressing the issues identified in paragraph 18 rather than to retain the status quo. Options 2, 3a, and 3b all go some way in addressing these issues, but at this stage option 2 is our ultimate preference. This is because option 3a carries the risk of the thin capitalisation rules being easily circumvented by those able to plan their corporate structures effectively. Option 3b would have the effect of bringing more taxpayers into the scope of the thin capitalisation rules than intended. Although it would be possible to specifically exclude some types of non-resident investment, there would be the risk

38. In principle, option 2 effectively meets the objectives identified and is specifically designed to address the current problems associated with the thin capitalisation rules: it ensures non-residents pay their fair share of tax, reduces fiscal risks and improves the integrity of the tax system. We also believe it strikes a good balance between the economic impact of taxing non-resident investment and tax revenue raised from that investment. As noted above, appropriate settings for non-resident taxation have been reviewed on a number of occasions. These have concluded that it is in New Zealand's best interest to impose a reasonable amount of tax on non-resident investment. Based on this, it is important the thin capitalisation rules cannot easily be avoided so New Zealand does collect this reasonable level of tax.

39. A summary of our analysis is presented below:

Option 1	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Maintain the status quo **Objectives met:** • Simplicity	• Investing in New Zealand would remain relatively more attractive to those who are able to avoid the thin capitalisation rules, but; • New Zealand would not be collecting its fair share of tax on that investment	• This option has a moderate fiscal risk, because the methods for avoiding the thin capitalisation rules are well known e.g. the use of private equity structures	• Foreign investors would have a mechanism to shift profits out of New Zealand, so New Zealand's tax burden would more heavily on other types of taxpayers, such as New Zealand residents • It would also create an uneven playing field for investments made by non-residents (those are able to avoid the thin capitalisation rules vs. those who are not)	• No additional compliance costs associated with the status quo	Not preferred, as there is significant fiscal risk and there is a large amount of unfairness present in this option. It also undermines the integrity of the tax system as taxpayers are easily able to avoid the thin capitalisation rules, meaning that the rules do not apply and work effectively when they should.

Option 2	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Implement the package of reforms (see paragraph 20), where 'acting together' is *not* exhaustively defined in legislation **Objectives met:** • Fiscal risk • Fairness • Balance between economic impact and tax revenue • Integrity of the tax system	• This option would impact the value of some existing non-resident investment in New Zealand as a result of a reduction in returns. However, the reduction in returns are not considered to be significant • Overall benefit to New Zealand as various reviews have concluded that it is in New Zealand's best interest to impose some tax on non-resident investment	• Fiscal risks associated with the status quo would be closed off • In addition to this, we estimate that this option would raise $10 million per year	• This option would reduce the relative tax burden on other taxpayers • It would also create a more level playing field between non-resident investors	• Some additional compliance costs would fall on taxpayers • This is because some taxpayers may need to determine whether the thin capitalisation rules apply to them • Those already within the thin capitalisation rules may need to change the way they calculate their debt-to-asset ratios. For example, excluding debt linked to shareholders from the worldwide group ratio	Preferred option as it meets the objectives with only minor trade-offs. These trade-offs are the additional compliance costs placed on some taxpayers and the effect on the value of existing non-resident investment. However, it ensures that New Zealand collects its fair share of tax on non-resident investment, increases fairness by reducing the tax burden on other taxpayers and creates a more even playing field between non-resident investors. Overall, the integrity of the tax system is improved as the package of reforms would help to ensure that the thin capitalisation rules are effective in practice.

Option 3a	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Implement package of reforms as in option 2, but with 'acting together' defined using only specific and exhaustive criteria **Objectives met:** The concern is that the thin capitalisation rules could be easily circumvented by a number of taxpayers who should be subject to the regime. This would have the same effect as option 1, but the simplicity objective is not met because of additional compliance costs.	• A test with specific and exhaustive criteria poses a risk as it could be easy to circumvent. • This means that investment in New Zealand would remain relatively attractive to those who can continue to plan their structures to get around the thin capitalisation rules • As per option 1, New Zealand would not be collecting its fair share of tax	• This option poses some fiscal risk as a test with specific and exhaustive criteria could be easy to circumvent • Only a minor proportion of the fiscal risk associated with the status quo would be eliminated as the other proposals would apply to taxpayers already subject to the thin capitalisation rules	• In theory, this option would have a similar impact as option 2 • In reality, this option could have a similar impact as option 1 because those investments able to restructure could do so in order to not be subject to the thin capitalisation rules	• Some additional compliance costs would fall on taxpayers • Some costs would fall on taxpayers in circumventing the rules, however this is already true under the existing rules • Taxpayers already within the scope of the thin capitalisation rules would need to account	At this stage, this option is not preferred because as with the status quo, there is a risk that the thin capitalisation rules could easily be circumvented. However, it is still under consideration as part of finalising the design of the rules. As a result of the discussed risk, there would be a large amount of unfairness and it would undermine the integrity of the tax system. In reality, this option may have the same ultimate effect as not proceeding with the reform.

Option 3b	Impact				Net impact
	Economic	Fiscal	Fairness	Simplicity and compliance	
Implement package of reforms as in option 2, but instead of an acting together test, the thin capitalisation rules would apply to all New Zealand companies in which interests held by non-residents add to 50% or more. **Objectives met:** • Fiscal risk • Fairness **(partially)** • Balance between economic impact and tax revenue • Integrity of the tax system	• This option would impact the value of some existing non-resident investment in New Zealand as a result of a reduction in returns. • Unlike option 2, the reduction in returns may not be insignificant as the rules would apply to more taxpayers than intended. As such, it may not to result in an overall benefit to New Zealand	• As per option 2, fiscal risks associated with the status quo would be closed off	• As per option 2, this option would reduce the relative tax burden on other taxpayers and creates a more level playing field between non-resident investors • Some unfairness is created, as some taxpayers would be brought into the scope of the thin capitalisation rules when it was not intended that the rules would apply to them	• Some additional compliance costs would fall on taxpayers • Compared with options 2 and 3a, this option would make it easier for taxpayers for determine if the thin capitalisation rules apply to them • A greater number of taxpayers would need to comply with the thin capitalisation rules than under option 2	At this stage, this option is not preferred. However, it is still under consideration as part of finalising the design of the rules. Even though it has largely the same impacts as option 2, it brings into the scope of the thin capitalisation rules a number of taxpayers that should not be subject to the rules. The policy intent of these reforms is to capture non-resident investors who co-ordinate their investments in such a way that they mimic a single non-resident controller. This option goes beyond that to an unnecessary extent.

Transitional rules

40. Given our preferred option is for reform, whether any transitional or grandparenting arrangements should be provided needs to be considered. The options we have considered are:

- have the new rules apply from the 2015/16 year – **our preferred option;**
- have the new rules apply from the first income year after the relevant bill receives Royal asset (likely to be the 2015/16 income year);
- delay the application date for all taxpayers, so that the rules apply from the second income year after the relevant bill receives Royal assent (likely to be the 2016/17 income year);
- provide a savings provision for taxpayers who would have had interest denied under the new rules on existing funding arrangements; and
- phase in the new rules for taxpayers who have interest denied under the new rules on existing funding arrangements.

41. Our preferred approach is the first, so the new rules apply from the 2015/16 income year. This provides taxpayers with sufficient time to review their funding structures and make any changes, if necessary.

42. We note that application from the 2015/16 income year is a relatively long lead-in time given that consultation on the reform package and its likely application date began in January 2013. We also note that new rules would continue to allow deductions for genuinely external debt, which is the type of debt that is most difficult to restructure. We consider that this largely eliminates the case for a delayed application date or savings provisions.

43. Compared to the other options, a 2015/16 start date best meets the objectives of creating a level playing field and reducing fiscal risks. The other options would favour existing investments over new investments (at least until the rules applied to existing investments) and could create boundary issues in distinguishing whether some funding was the continuation of an existing investment or a new investment.

44. One risk with a 2015/16 application date is the potential for legislative delays, which could mean the rules begin to apply for some taxpayers before the legislation is enacted. This risk can be managed by reviewing the application date if there looks to be a significant delay. We note that this risk would not arise if the rules applied from the first income year following enactment. However, compared to a fixed application date, this would provide less certainty and consistency of treatment between taxpayers.

CONSULTATION

45. The package of changes has been developed in consultation with the Treasury.

46. To consult on these proposals we released a public Officials' Issues paper in January 2013. We received 15 submissions from industry groups, accounting and law firms, and some taxpayers who might be affected by the proposals.

47. Many, but not all, submitters understood the rationale behind the proposals (to ensure the thin capitalisation rules cannot be easily avoided). They agreed that in many cases non-residents have structured themselves to avoid the thin capitalisation rules and the rules should clearly be expanded to capture them.

48. Other submitters questioned the reforms. They suggested that the thin capitalisation rules should be reviewed more fundamentally before any reforms are implemented. As noted above, we do not believe this is necessary.

49. Submitters also raised specific issues with elements of the package. Some of these are technical, such as what is the best way to determine whether investors are "acting together" to set levels of debt in a New Zealand business, or about compliance costs if shareholder debt must be excluded from the worldwide group of widely-held companies with large international operations. We do not believe any of these issues are insurmountable; we will continue to work with submitters and other interested parties to ensure the package of reforms to the thin capitalisation rules is practicable. These concerns do not give us reason to cease implementing the reform package.

50. Submitters questioned whether certain elements of the package should proceed at all. These are discussed below.

Problems with the 110% worldwide group test

51. Submitters argued that the 110% worldwide group test does not take into account that different industries have different acceptable debt ratios. For example, infrastructure investment is often heavily debt financed. They submitted that given the perceived problem is companies who are excessively debt financed, simply excluding shareholder debt is far too broad. A better approach would be to use an arm's length test, as that can take into account what an acceptable level of external funding is.

52. We do not agree that an arm's length test is a better approach. This was stated in the officials' issues paper and excluded as an option.

53. In our experience, arm's length tests are very difficult to apply. We understand that this is also the case with other countries that have used an arm's length test. We do accept that different industries and businesses have different acceptable levels of gearing but consider that the only reliable way of demonstrating what constitutes an acceptable level of debt is by sourcing that debt from an unrelated party.

54. We note that the proposal to exclude shareholder debt is likely to be consistent with commercial drivers. This is because it would be very unusual for a shareholder in a company

to have a better credit rating than the company itself.[3] As a consequence, it will generally be cheaper for a company to borrow directly from third parties as opposed to borrowing from its shareholders. Shareholder debt can, however, be used in place of equity, in order to reduce the effective tax rate on the investment. For this reason, it is appropriate to deny further interest deductions where the investment is heavily debt financed and there are high levels of shareholder debt.

Capitalised interest

55. Many submitters disagreed with this proposal. They argued that accounting generally requires assets to be recognised at fair value. If asset values have been increased because of capitalised interest, either the increase is a reflection of an increase in the asset's market value, or the increase will have to be written off as an impairment. Submitters also noted that there would be substantial compliance costs involved in backing out capitalised interest that has been added to asset values in prior years.

56. We note these comments but do not consider them grounds to not include this item in the package of reforms. While most taxpayers use fair value accounting, we understand that some do not. In addition, we also understand that some taxpayers may not recognise impairments to asset values in the same group where they recognise capitalised interest. We consider there is still a rationale to continue with this base protection measure, but perhaps with a more limited scope to address the points raised in submissions.

Asset uplifts

57. Many submitters also disagreed with this proposal. Some submitters noted that they cannot see how asset value uplifts can be recognised in an internal reorganisation. More generally, submitters noted the matter should not proceed because asset valuations must, at the end of the day, be justifiable.

58. We understand that whether or not asset uplifts can be recognised in this way is not entirely clear under GAAP. Most accounting firms would not allow asset uplifts to be recognised in this way, but we are aware that some do. This is creating an uneven playing field. Moreover, the fact that most accounting firms would not allow this type of uplift recognition is a good indication that asset values generated by an internal reorganisation may not be a fair reflection of their value. Including this base protection measure in the package of thin capitalisation reforms is therefore justified.

Public Private Partnerships

59. Some submissions raised concerns regarding the potential impact on public private partnerships (PPPs) as these tend to be heavily debt-funded.

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[3] If a non-resident shareholder borrowed against different assets, they might be able to achieve a better credit rating than the New Zealand company they are investing into. However, we still have a policy concern with this situation because the debt in the New Zealand company may not be a commercial level of debt.

60. However, our expectation is that the impact of the new rules on existing or future PPPs should be minimal. This because the actual and potential PPPs that we are aware of have high levels of external debt (which will continue to be deductible in most cases[4]) and relatively low levels of shareholder debt.

61. We therefore do not consider it necessary to provide any special accommodation for PPPs, but will continue to work through any concerns with submitters.

CONCLUSIONS AND RECOMMENDATIONS

62. Officials have assessed the two main options, with possible alternatives, discussed in this Regulatory Impact Statement against the stated objectives. The recommended approach is to implement the package of reforms set out in option 2 which would add to the thin capitalisation rules already established in the Income Tax Act 2007. The inbound thin capitalisation rules would apply more broadly to trusts as well as groups of non-residents acting together. The aim of this is to make the inbound thin capitalisation rules more difficult to circumvent. The package of changes would also limit what can be included when calculating the debt-to-asset ratios of a taxpayer's New Zealand group and worldwide group. The aim of this is to ensure that non-residents do not take excessive interest deductions in New Zealand in order to reduce their New Zealand tax liability. It ensures that New Zealand collects its fair share of tax from non-resident investment in New Zealand.

63. On balance, the recommended approach achieves four of the five objectives set for the reform of the thin capitalisation rules: creating a level playing field, improving the integrity of the tax system, reducing fiscal risks, and striking a reasonable balance between economic impact and additional tax revenue. The fifth objective, to ensure that no undue complexity results from the changes, is in the process of being achieved as officials are continuing to engage with interested parties to resolve the key design issues of the preferred approach.

IMPLEMENTATION

64. It is recommended that the proposed reform package will apply from the start of the 2015/16 income year. Before that date the existing law will apply, such that taxpayers who are not subject to the thin capitalisation rules under existing law will not be required to account for the new amendments until the 2015/16 income year.

65. During this time, taxpayers should evaluate their financing structures and determine whether any changes are necessary in order to comply with thin capitalisation rules once they are in place. Affected taxpayers may include those already subject to the thin capitalisation rules, as well as those who may be brought into the ambit of the rules as a result of the extended application to trusts and those determined to be "acting together". It is proposed that existing structures will become subject to the new rules at the same time as new funding arrangements.

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[4] Deductions on external debt may be denied in some cases where there is a single non-resident controller, but this is already the case under the existing rules, so there is no change under the new rules.

66. More guidance on implementation will be provided when the technical details of the new changes have been finalised and key design issues have been resolved. Further guidance will be provided when the legislation is introduced and considered at select committee. Detailed guidance will be published soon after enactment, in a Tax Information Bulletin. Because the proposed amendments affect existing rules and systems, there are no significant administrative issues arising from the changes.

MONITORING, EVALUATION AND REVIEW

67. Inland Revenue monitors, evaluates and reviews new legislation under the Generic Tax Policy Process (GTTP). The GTTP is a multi-stage tax policy process that has been used for tax policy in New Zealand since 1995. The implementation and review stage of the GTTP involves reviewing the legislation after implementation and identifying any remedial issues.

68. The effectiveness of the new rules after the start of the 2015/16 income year will be monitored under the GTTP through the use of the financing questionnaire undertaken by Inland Revenue involving a number of large taxpayers. Any further changes that are identified as being necessary for the new legislation to have its intended effect could either be included as remedial amendments in future tax bills, or if they involve more complex issues could be added to the tax policy work programme. Further consultation would be implicit in this approach.

69. Inland Revenue officials will continue to make themselves available for discussion with affected taxpayers should any further difficulties arise.

Regulatory Impact Statement

Black hole expenditure items: abandoned research and development, resource consents and company administration costs

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address the following areas where black hole expenditure may occur under current tax rules:

- abandoned research and development (R&D);
- certain fixed-life resource consents;
- unsuccessful resource consents where no application is lodged; and
- company administration costs.

These black hole expenditure items were predominantly brought to the attention of officials through correspondence from the private sector. The abandoned R&D black hole expenditure item was identified by officials during a recent review of tax settings related to innovation.

Black hole expenditure is capital expenditure that is not immediately deductible for tax purposes and also does not give rise to a depreciable asset for tax purposes, and therefore cannot be deducted as depreciation over time. Generally, taxpayers try to reduce their tax liability by deducting their expenditure, wherever possible, against their assessable income. If expenditure is incorrectly ascribed as non-deductible black hole expenditure, a number of problems can arise.

Black hole treatment of expenditure items for tax purposes can produce economic distortions. A taxpayer may choose to invest in an area where they can deduct or depreciate their expenditure instead of investing in a black hole expenditure item where they cannot. If investing in the black hole expenditure item would have been the most efficient choice in a world without tax, the taxpayer's investment decision has been distorted by tax settings.

Other issues that can arise include uncertainty for taxpayers about an item's correct tax treatment, an increase in compliance costs for taxpayers to obtain a deduction, inconsistencies in the tax treatment of similar expenditure items, and an incentive for taxpayers to re-characterise black hole expenditure items in order to access the deduction. It should be noted that due to the nature of such issues, it is not possible to accurately assess the exact scale of these problems.

It is proposed that some expenditure that is currently black hole in nature instead be made immediately deductible or depreciable, with some expenditure of a more capital nature to remain non-deductible. As the size of the problem cannot be quantified with any certainty, there is some uncertainty around the estimated fiscal costs, and the amounts of any expected fiscal gains are unknown.

The proposals have the following estimated fiscal implications:

	$m increase / (decrease)				
Vote Revenue Minister of Revenue	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**
Tax Revenue	-	(0.360)	(1.560)	(2.010)	(2.460)

Estimated tax revenue costs is expected to continue to increase by $450,000 per annum to approximately $9 million per annum over time.

As these proposals were earmarked for potential announcement as part of Budget 2013, officials have not consulted on them with taxpayers, and the analysis undertaken has been subject to time constraints in order to meet Budget 2013 deadlines. However, these proposals are overwhelmingly taxpayer friendly and most were brought to officials' attention as a result of correspondence with the private sector. As the amendments will be included in a bill which will be considered by the Finance and Expenditure Committee, there will be an opportunity for submissions to be made by interested parties. Officials could also engage in direct consultation with submitters on the issues if agreed by the Select Committee. The analysis undertaken on this issue was carried out in conjunction with the Treasury, and they support the conclusions and recommendations made.

None of the policy options would impose additional costs on business, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

Graeme Morrison
Policy Manager
Inland Revenue

19 March 2013

STATUS QUO AND PROBLEM DEFINITION

1. Black hole expenditure is capital expenditure that is not immediately deductible for tax purposes and also does not give rise to a depreciable asset for tax purposes, and therefore cannot be deducted as depreciation over time. A number of areas where black hole expenditure can occur under current tax rules have been brought to the attention of officials. A further area where black hole expenditure may occur was identified by officials during a recent review of tax settings related to innovation.

2. Black hole treatment of expenditure items for tax purposes can produce economic distortions. A taxpayer may choose to invest in an area where they can deduct or depreciate their expenditure instead of investing in a black hole expenditure item where they cannot. If investing in the black hole expenditure item would have been the most efficient choice in a world without tax, the taxpayer's investment decision has been distorted by tax settings.

3. Other issues that can arise include uncertainty for taxpayers about an item's correct tax treatment, an increase in compliance costs for taxpayers to obtain a deduction, inconsistencies in the tax treatment of similar expenditure items, and an incentive for taxpayers to re-characterise black hole expenditure items in order to access a tax deduction. It should be noted that due to the nature of such issues, it is not possible to accurately assess the exact scale of these problems.

4. The black hole expenditure items which are the subject of this Regulatory Impact Statement relate to:

- abandoned research and development (R&D);
- certain fixed-life resource consents;
- unsuccessful resource consents where no application is lodged; and
- company administration costs (dividend payments, listing fees and special shareholder meetings).

Abandoned research and development

5. Under current tax rules, a person is allowed an immediate deduction for expenditure they incur on research or development up until an asset is recognised for accounting purposes. Further development expenditure is capitalised. Development expenditure that has been capitalised can be depreciated only once there is a depreciable asset for tax purposes.[1] In the event that the project does not generate a depreciable asset for tax purposes, this capitalised expenditure will be rendered non-deductible either immediately or over a period of time.[2] This can act as a disincentive to undertake desired levels of R&D.

[1] Note that the depreciable cost base of items of depreciable intangible property will not necessarily equate to the total capitalised expenditure the taxpayer will have incurred from the point of asset recognition.

[2] An immediate deduction is currently allowed under section DB 37 of the Income Tax Act 2007 for capitalised expenditure incurred in relation to a patent application that is refused or withdrawn.

Certain fixed-life resource consents

6. The Income Tax Act 2007 (ITA) lists items of intangible property that are depreciable – this includes certain fixed-life resource consents. In 1998, sections 15A (dumping of waste in coastal areas) and 15B (discharging hazardous substances from ships and offshore installations) were added to the Resource Management Act 1991 (RMA) to regulate dumping activities in the coastal marine area. Resource consents to do something which would otherwise contravene these sections of the RMA have a limited life of between five and thirty-five years. The ITA has not, however, been updated to include reference to these sections of the RMA. Therefore, capital expenditure incurred in obtaining a resource consent to do something which would otherwise contravene section 15A or 15B of the RMA is not currently depreciable. This is inconsistent with the tax treatment for expenditure on other fixed-life resource consents, which are depreciable.

Unsuccessful resource consents where no application is lodged

7. The ITA allows a deduction for expenditure incurred by a person who applies for the grant of a resource consent under the RMA and is refused the grant or withdraws the application. The wording of the relevant section requires that, for the expenditure to be deductible, the resource consent application process must be completed, even though the consent is no longer actually sought. This may result in some taxpayers incurring further expenditure to complete the application simply in order to obtain the tax deduction, which is an inefficient outcome.

Company administration costs: dividends, listing fees and shareholder meeting costs

8. Inland Revenue's view of the law in this area is currently in draft form. This has created some uncertainty in the private sector over the tax treatment of various company administration costs. The costs identified as of most concern are costs associated with the payment of dividends, listing fees and shareholder meeting costs. All of these items straddle the capital-revenue boundary, which creates the uncertainty. When considering the appropriate tax treatment of company administration costs, there is a trade-off between compliance costs and economic distortions; in general, the more accurate and consistent the item's tax treatment, the higher the associated compliance costs. As these expenditure items are usually relatively minor, minimising compliance costs is to be prioritised over minimising economic distortions.

OBJECTIVES

9. The objectives of the proposed changes are to:

(i) improve the efficiency of the tax system by ensuring that investment decisions are not distorted by tax considerations;

(ii) provide certainty about the tax treatment of particular expenditure items;

(iii) reduce compliance costs for taxpayers; and

(iv) improve the coherency, consistency and integrity of the overall tax system.

10. For the abandoned R&D and the resource consent expenditure items, minimising investment distortions has been prioritised over the other three objectives (however, they generally go hand in hand). On the other hand, for company administration costs, which are

usually relatively small, minimising compliance costs has been prioritised over minimising investment distortions where there is a conflict between objectives.

REGULATORY IMPACT ANALYSIS

Abandoned research and development

Status quo

11. Under the status quo, R&D expenditure that has been capitalised cannot be deducted where the project fails to produce a depreciable asset for tax purposes.

Option one (preferred option):

12. Option one is to allow an immediate deduction for failed capitalised R&D expenditure which would have been part of the cost of "depreciable intangible property" if the project had been successful.

Option two

13. Option two is to depreciate failed capitalised R&D expenditure, which would have been part of the cost of "depreciable intangible property" if the project had been successful, over the estimated useful life of the asset the R&D expenditure was aimed at creating.

Option three

14. Option three is to allow an immediate deduction for all capitalised R&D expenditure on failed projects that were aimed at creating an asset listed as depreciable for tax purposes on Schedule 14 of the ITA.

Option four

15. Option four is to depreciate all the capitalised R&D expenditure on failed projects over the estimated useful life of the asset on Schedule 14 of the ITA the R&D expenditure was aimed at creating.

Further information

16. Each of options one to four would also involve the introduction of appropriate claw-back rules (outlined below), which would apply in the event that a failed asset from an abandoned R&D project (which has had capitalised R&D expenditure deducted) becomes useful or is sold.

17. In the event that such a failed asset becomes useful, it is proposed that the capitalised R&D expenditure previously allowed as a deduction would be clawed back. The clawed-back amount would then be able to be depreciated over the estimated useful life of the asset.

18. In the event that such a failed asset is sold, it is proposed that the capitalised R&D expenditure previously allowed as a deduction (or the sale proceeds, if this amount is lower) would be clawed back. The exception to this would be where the sale of the failed asset would otherwise give rise to assessable income. In such instances, it is proposed that the entire sales proceeds would continue to be assessable income.

Summary

19. The impacts of the status quo and options one to four are summarised in the following table:[3]

[3] Neither the status quo nor any of options one to four have any social or environmental impacts.

Table 1: Abandoned research and development

Option	Meets objectives?	Impacts						Net impact
		Economic impact	Coherence / Consistency / Integrity	Certainty	Compliance costs	Fiscal impact	Risk	
Status quo	No	Disincentive to undertake the optimal level of R&D.	Not met, as a deduction for failed capitalised expenditure is usually allowed when it is written off.	Not met, as, if the R&D project fails, expenditure that would have been depreciable if it had succeeded may be neither deductible nor depreciable.	No impact.	No impact.	None.	The level of R&D undertaken may be sub-optimal.
One (preferred option)	Yes	Removes a disincentive to investment in R&D.	Improved, as a deduction is allowed for failed capitalised expenditure that would have been depreciable if it had been successful.	Improved, as businesses will know that if their R&D project fails they will be able to deduct the capitalised R&D expenditure they would have been able to depreciate if it had succeeded.	Reduced, as businesses will not need to incur unnecessary expenditure to access a deduction (where available).	Estimated fiscal cost of $1m per annum.	As this option restricts deductible expenditure to that which would have been part of "depreciable intangible property" if the project had been successful, and deductions are already allowed in the case of failed or withdrawn patent applications, this option may be perceived as being of limited benefit.	Overall, improves upon the status quo, as it reduces economic distortions and is consistent with the tax treatment for other items of failed capital expenditure.
Two	In part	Removes a disincentive to investment in R&D. Economically neutral between successful and unsuccessful projects.	Not met, as this is not the usual treatment of failed capitalised expenditure.	Improved, as businesses will know that if their R&D project fails they will be able to depreciate the capitalised R&D expenditure they would have been able to depreciate if it had succeeded.	Reduced, as businesses will not need to incur unnecessary expenditure to access a deduction (where available).	Estimated fiscal cost would eventually rise to a level similar to option one.	In addition to carrying the same risk as option one, the private sector could complain that this treatment is less favourable than solutions implemented for other black hole expenditure issues.	Reduces economic distortions, but is inconsistent with the tax treatment for other items of failed capital expenditure.

Three	No	Removes a disincentive to investment in R&D. Would give failed R&D projects a more favourable tax treatment than currently exists for successful ones.	Not met, inconsistent treatment between failed and successful projects.	Improved, businesses will know that if their R&D project fails they will be able to deduct all capitalised R&D expenditure.	Reduced, as businesses will not need to incur unnecessary expenditure to access a deduction (where available).	Estimated fiscal cost of $10m per annum.	Would create an asymmetric tax treatment with successful projects, which would distort investment decisions and potentially create tax avoidance risks.	Removes one economic distortion but creates a more serious one.
Four	No	Removes a disincentive to investment in R&D. Would give failed R&D projects a more favourable tax treatment than currently exists for successful ones.	Not met, inconsistent treatment between failed and successful projects. Also not the usual treatment of failed capitalised expenditure.	Improved, businesses will know that if their R&D project fails they will be able to depreciate all capitalised R&D expenditure.	Reduced, as businesses will not need to incur unnecessary expenditure to access a deduction (where available).	Estimated fiscal cost would eventually rise to a level similar to option three.	Would create an asymmetric tax treatment with successful projects, which would distort investment decisions and potentially create tax avoidance risks.	Removes one economic distortion but creates a more serious one. Also inconsistent with the tax treatment for other items of failed capital expenditure.

Certain fixed-life resource consents

Status quo

20. Under the status quo, expenditure incurred in applying for resource consents granted under the RMA to do something that otherwise would contravene section 15A (dumping of waste in coastal areas) or 15B (discharging hazardous substances from ships and offshore installations) cannot be depreciated. This creates investment distortions and is inconsistent with how other assets with a fixed life are depreciated, including other fixed-life resource consents.

Option one (preferred option):

21. Option one is to allow resource consents granted under the RMA to do something that otherwise would contravene section 15A or section 15B to be depreciable over the life of the consent.

22. All resource consents for the coastal marine area granted under the RMA to do something that otherwise would contravene section 15A or 15B of the RMA have a limited life of between five and thirty-five years. This option is consistent with our depreciation framework; fixed-life resource consents should be depreciated as their economic benefits are used up over their lifetime.

23. The impacts of the status quo and option one are summarised in the following table:

Table 2: Certain fixed-life resource consents

Option	Meets objectives?	Impacts							Net impact
		Economic impact	Coherence / Consistency / Integrity	Certainty	Fiscal impact	Compliance costs	Social / environmental impacts	Risk	
Status quo	No	No impact.	Not met, inconsistent with the tax treatment of other fixed-life resource consents.	Not met, likely to be further calls to change the tax treatment.	No impact, as no additional revenue or cost.	No impact, as existing tax treatment remains.	No impact, as existing tax treatment remains.	None.	Economic distortions and inconsistency with the tax treatment of other fixed-life resource consents would persist.
One (preferred option)	Yes	This option would minimise investment distortions and will improve the overall consistency of the tax system.	Improved, would be consistent with the tax treatment of other fixed-life resource consents.	Improved.	Estimated fiscal costs increase by \$0.45m per annum from \$0.11m in 2013/14 to approximately \$9m per annum over time.	A very minor impact as taxpayers incur a small compliance cost to claim the depreciation deduction.	Moving to a more favourable tax treatment will likely, at the margin, increase the number of fixed-life resource consents applied for to carry out coastal dumping. However, the option does not alter the regulatory framework under the RMA for obtaining these consents.	There is some uncertainty about the fiscal cost of this option.	Minimises economic distortions and improves the consistency of the tax system.

Unsuccessful resource consents where no application is lodged

Status quo

24. Under the status quo, expenditure incurred in relation to an application for the grant of a resource consent under the RMA is deductible if the grant is refused or the application is withdrawn. Expenditure incurred in relation to an intended application for the grant of a resource consent, where an application is never lodged, is currently unable to be deducted nor depreciated.

Option one (preferred option):

25. Option one is to allow a deduction for expenditure incurred in relation to an intended resource consent application that is never lodged. The deduction would be allocated to the income year in which it is decided that the application will no longer be pursued.

Option two

26. Option two is to depreciate expenditure incurred in relation to an intended resource consent application that is never lodged over the life of the particular resource consent which would have been obtained if the application had been made and granted.

27. The impacts of the status quo and options one and two are summarised in the following table:

Table 3: Unsuccessful resource consents where no application is lodged

Option	Meets objectives?	Impacts						Net impact
		Economic impact	Coherence / Consistency / Integrity	Certainty	Fiscal impact	Compliance costs	Risk	
Status quo	No	No impact.	Not met, a deduction for failed expenditure is usually allowed when it is written off	Not met, there is likely to be issues with taxpayers trying to interpret the policy intent behind requiring an application to be completed to access the deduction.	No impact.	No impact, but already high because of additional costs incurred by taxpayer to complete the application to access the deduction.	None.	The current settings are inefficient and inconsistent compared with the tax treatment for other items of failed capital expenditure.
One (preferred option)	Yes	Improvement in efficiency, as taxpayers will no longer incur expenditure for no economic reason other than obtaining a tax deduction.	Improved, a deduction for failed expenditure is allowed when it is written off.	Improved.	No impact, as applicants are already likely deducting this expenditure by completing the application process.	Reduction in compliance costs, as businesses will no longer have to incur unnecessary expenditure in completing an application for a resource consent that is no longer sought.	None.	Improves upon the status quo, as allowing a deduction for expenditure is consistent with the tax treatment for other items of failed capital expenditure.
Two	In part	Improvement in efficiency, as taxpayers will no longer incur expenditure for no economic reason other than obtaining a tax deduction.	Not met, this is not the usual treatment of failed expenditure.	Improved.	No impact, as applicants are already likely deducting this expenditure by completing the application process.	Reduction in compliance costs, as businesses will no longer have to incur unnecessary expenditure in completing an application for a resource consent that is no longer sought.	None.	Depreciating expenditure over the life of the resource consent (had it been successful) is inconsistent with the tax treatment for other items of failed capital expenditure

Company administration costs: dividends, listing fees and shareholder meeting costs

28. There are no specific rules governing the tax treatment of these items, and Inland Revenue's view of the law in this area has only ever been released as a draft statement. In practice, there is some evidence to suggest that some taxpayers may not necessarily be deducting these expenses as set out in this draft statement. The analysis below will consider the status quo as Inland Revenue's latest view of the law.

Dividends

Status quo

29. Under the status quo, the capital-revenue test, which determines whether expenditure is revenue and therefore deductible, or capital and therefore not deductible (but possibly depreciable), should be applied to expenditure incurred during the dividend payment process. Inland Revenue's view of the law suggests that expenditure incurred on authorising dividends is deductible, but costs related to the allocation, payment, and disputes over the allocation of dividends are not.

Option one (preferred option):

30. Option one is to allow deductions for all costs associated with the payment of dividends. The payment of dividends is a regular ordinary business expense and despite some of the costs of the process being capital, it would be practical to allow deductions in order to minimise compliance costs and increase certainty for businesses.

31. The impacts of the status quo and option one are summarised in the following table:

Table 4: Dividends

Option	Meets objectives?	Impacts						Net impact
		Economic impact	Coherence / Consistency / Integrity	Certainty	Fiscal impact	Compliance costs	Risk	
Status quo	In part	Minimises investment distortions.	Met, consistent application of the capital-revenue test as usually applied to expenditure to determine deductibility.	No change.	No impact.	High compliance costs as taxpayers required to separate out expenditure incurred on authorising dividends from the other costs associated with the dividend payment process.	Enforcing and monitoring is difficult, with the cost often exceeding the benefit.	It is consistent but likely to maintain uncertainty and high compliance costs.
One (preferred option)	Mostly	Allowing deductions for a capital item incentivises additional spending on that item.	Reduced, allows a deduction for expenditure that is possibly capital.	Improved, would provide certainty of the law.	No significant impact, some evidence to suggest that some taxpayers may already be deducting this expenditure.	Reduced compliance costs as all expenditure associated with the payment of dividends would be deductible.	None.	Minimises compliance costs and increases certainty, but does reduce overall consistency.

Listing fees

Status quo

32. Under the status quo, the capital-revenue test should be applied to expenditure incurred on initial, subsequent and annual listing fees. The Inland Revenue draft statement suggested that all listing fees are capital expenditure and should not be deductible because they are used to raise and maintain equity.

Option one (preferred option):

33. Option one is to allow deductions for annual listing fees but not for the initial listing fee or subsequent listing fees arising from additional share issues. Annual listing fees are a regular expense with a short-term benefit, facts which favour allowing a deduction. Initial listing fees are incurred so a company can list on a stock exchange, and subsequent listing fees help with the acquisition of further equity. These benefits persist indefinitely, and are indicative of capital expenditure.

Option two

34. Option two would involve aligning the tax treatment of equity and debt raising costs. Debt and equity capital are partial substitutes for financing a business, which seems to imply that the respective tax treatments for debt and equity raising costs would need to be similar to prevent a bias towards one or the other. As debt raising costs are deductible, allowing a deduction for listing fees (initial, subsequent and annual) may reduce a bias towards debt financing. However, this needs to be balanced against the difference in the lives of equity (indefinite) and debt (limited).

35. The benefits arising from expenditure that raises equity persist indefinitely, whereas benefits from expenditure that raises debt are used up over the life of the loan. This would suggest that the different tax treatments for debt and equity raising costs are consistent with existing tax frameworks.

Summary

36. The impacts of the status quo and options one and two are summarised in the following table:

Table 5: Listing fees

Option	Meets objectives?	Impacts						Net impact
		Economic impact	Coherence / Consistency / Integrity	Certainty	Fiscal impact	Compliance costs	Risk	
Status quo	Mostly	Minimises investment distortions but may encourage financing with debt over equity.	Met, consistent application of the capital-revenue test as usually applied to expenditure to determine deductibility	Some uncertainty over the current tax treatment.	No impact.	No impact, compliance costs are not a problem here as no expenditure is to be apportioned.	Enforcing and monitoring is difficult, with the cost exceeding the benefit.	Preventing deductions for annual listing fees incentivises taxpayers to finance with debt over equity. Continued uncertainty of the tax treatment will remain.
One (preferred option)	Yes	Slight distortion favouring listing fees, but some evidence to suggest that some taxpayers are already deducting annual listing fees. This means there would be very little economic impact.	In part met, concessionary tax treatment of annual listing fees but the proposed treatment of initial and subsequent fees is consistent.	Met, would provide certainty of the law.	No impact, as applicants are already likely deducting this expenditure in line with the proposed policy.	No impact, compliance costs are not a problem here as no expenditure is to be apportioned.	None.	Provides certainty to businesses on the tax treatment of this item, minimises compliance costs. While it creates a slight economic distortion, this is not of concern.
Two	No	Allowing deductions for capital expenditure incentivises additional investment in that area.	Not met, this is a concessionary tax treatment for all listing fees.	Met, would provide certainty of the law.	Small unknown fiscal cost for allowing initial and subsequent listing fees to be deductible.	No impact.	None.	This is inconsistent with tax deductibility frameworks as it does not take into account the indefinite benefit taxpayers receive from publicly listing on a stock exchange.

Shareholder meeting costs

Status quo

37. Under the status quo, the capital-revenue test should be applied to expenditure incurred on annual shareholder meetings (AGMs) and special shareholder meetings. The Inland Revenue draft statement suggested that all AGM costs are deductible for tax purposes, whereas the deductibility of special shareholder meeting costs depends on the purpose of the meeting. For example, expenditure on a special meeting held to consider a major transaction is revenue and would be deductible, but considering a change to a company's constitution is capital and not deductible.

Option one (preferred option)

38. Option one is to confirm that AGM expenses are deductible, and make special shareholder meeting expenses non-deductible. AGMs are a requirement by law and are a regular business expense, but special shareholder meetings are often held to consider a material change in the business, and therefore are often capital expenditure.

Option two

39. The resolutions considered in a shareholder meeting are the most accurate determinants of deductibility. Option two involves requiring taxpayers to apportion shareholder meeting costs between the deductible (revenue) and non-deductible (capital) resolutions considered at each meeting.

Option three

40. Allow a deduction for all AGM and special shareholder meeting costs.

Summary

41. The impacts of the status quo and options one to three are summarised in the following table:

Table 6: Special shareholder meeting costs

Option	Meets objectives?	Impacts						Net impact
		Economic impact	Coherence / Consistency / Integrity	Certainty	Fiscal impact	Compliance costs	Risk	
Status quo	No	Incentivises taxpayers to consider capital resolutions at AGMs where they are deductible.	Met, consistent application of the capital-revenue test as usually applied to expenditure to determine deductibility.	Not met.	No impact.	High compliance costs as taxpayers have to break down expenditure into smaller categories than are currently accounted for.	Enforcing and monitoring is difficult, with the cost exceeding the benefit. It is often difficult to ascertain the major purpose of the meeting on occasions.	Does not provide certainty or reduce compliance costs for taxpayers while economic distortions persist.
One (preferred option)	Mostly	Incentive for taxpayers to consider capital resolutions at AGMs exaggerated further by disallowing deductions for all special shareholder meetings.	In part, tax treatment approximates the capital-revenue test, but is somewhat concessionary towards AGM costs and harsher towards special shareholder meeting costs.	Improved, would provide certainty of the law.	Small, unknown fiscal gain as some previously deductible shareholder meetings are no longer deductible.	Significant reduction in compliance costs. This option does not require taxpayers to break down expenditure into smaller categories.	None.	Satisfies prioritised objective of reducing compliance costs and provides certainty to taxpayers. However, economic distortions remain, and it is somewhat inconsistent with the overall tax system. Overall, net impact is positive.
Two	No	Least distortionary tax treatment.	Met, uses the most accurate determinant of deductibility (resolutions considered) instead of the current determinant, the meeting's purpose.	Not met, the complex design of this option would make it harder for taxpayers to apply the new tax treatment correctly.	Small, unknown fiscal gain, as some AGM and special shareholder meeting costs (where capital resolutions are considered) would no longer be deductible.	Significant increase in compliance costs with the introduction of apportionment rules.	May encourage taxpayers to artificially inflate the number of revenue resolutions to increase the deductible portion of the meeting cost.	Removes economic distortions to a degree but would increase compliance costs significantly and reduce certainty.
Three	In part	Most distortionary tax treatment.	Not met, concessionary tax treatment of both AGM and special shareholder meeting costs.	Improved, would provide certainty of the law.	Unknown fiscal cost as all shareholder meeting costs would be deductible.	Significant reduction in compliance costs. This option does not require taxpayers to break down expenditure into smaller categories.	Unknown fiscal risk, and allowing this concessionary tax treatment may lead to further calls for similar concessions to be made for other expenses.	Satisfies prioritised objective of reducing compliance costs and provides certainty. However, economic distortions are relatively large, the proposed tax treatment would be inconsistent, and there are identified risks.

CONSULTATION

42. Officials have not consulted with taxpayers on these issues because the proposals are earmarked for announcement in Budget 2013. However, it is expected that these proposals would be generally favourably received by taxpayers, as they are predominantly taxpayer friendly and have arisen partly from correspondence with the private sector.

43. As the amendments will be included in a bill which will be considered by the Finance and Expenditure Committee, there will be an opportunity for submissions to be made by interested parties. Officials could engage in direct consultation with submitters on the issues if agreed by the Committee.

44. The Treasury has been consulted and agrees with the proposals.

CONCLUSIONS AND RECOMMENDATIONS

Abandoned research and development

45. Officials recommend that an immediate deduction be allowed for failed capitalised R&D expenditure which would have been part of the cost of "depreciable intangible property" if the project had been successful (with appropriate claw-back rules which would apply in the event that a failed asset becomes useful or is sold). This reduces economic distortions, without creating an asymmetric treatment with successful R&D projects, which would result in more serious economic distortions. Also, an immediate deduction (rather than depreciation over time) is consistent with the tax treatment for other items of failed capital expenditure.

Certain fixed-life resource consents

46. Officials recommend that sections 15A and 15B of the RMA be added to Schedule 14 (depreciable intangible property) of the ITA. This will mean that expenditure on resource consents granted under the RMA to do something that otherwise would contravene these sections will be depreciable over the life of the resource consent. This policy change fits within Inland Revenue's depreciation framework; resource consents with a fixed-life should be depreciated as their economic benefits are used up over their lifetime to minimise economic distortions. It also improves the consistency of the tax system, as this change would grant these resource consents the same tax treatment as other fixed-life resource consents.

Unsuccessful resource consents where no application is lodged

47. Officials recommend that a deduction be allowed for expenditure relating to a failed resource consent application that has not been lodged. The status quo requires taxpayers to complete the application for a resource consent that is no longer sought, which is an unintended policy outcome that increases their compliance costs.

Company administration costs

Dividends

48. Officials recommend a deduction for costs associated with the payment of dividends. Requiring taxpayers to apply the capital-revenue test to this expenditure creates disproportionate compliance costs. Allowing a deduction will provide certainty about the item's tax treatment, and minimise compliance costs for taxpayers.

Listing fees

49. Officials recommend allowing deductions for annual listing fees but not for the initial listing fee (for listing on a stock exchange), or subsequent listing fees arising from additional share issues. Annual listing fees have short-term benefits that do not persist, whereas the benefits from initial and subsequent listing fees persist indefinitely. The proposed change also provides certainty to taxpayers over the tax treatment of these costs.

Shareholder meeting costs

50. Officials recommend allowing deductions for AGM expenditure but not for expenditure on special shareholder meetings. This will reduce compliance costs for taxpayers as it only requires them to allocate expenditure between the AGM and any other special shareholder meetings (if any), and not to apportion costs to capital and revenue items considered at the same meeting. It also provides certainty to taxpayers about the tax treatment of these costs.

IMPLEMENTATION

51. If approved, these proposals, which require legislative change, will be included in the next available taxation bill after Budget 2013 and will apply from the 2014/15 income year.

52. When introduced to Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a Tax Information Bulletin, which would be released shortly after the bill receives Royal assent.

53. The proposals have no system implications for Inland Revenue but may incur some additional administrative costs. These are expected to be insignificant and would be met within existing baselines.

54. The proposals are not expected to result in any additional compliance costs for taxpayers. The intent of the proposed tax treatment of the company administration expense items is to reduce compliance costs.

MONITORING, EVALUATION AND REVIEW

55. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as

necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.

Regulatory Impact Statement

Legislation to enable compliance with an intergovernmental agreement between the United States and New Zealand

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of:

- Whether it is appropriate for New Zealand to enact legislation that will enable financial institutions to comply with their obligations under any intergovernmental agreement (IGA) with the United States of America. The IGA will be an agreement that sets out how New Zealand is to assist in the implementation of United States law commonly referred to as the Foreign Accounts Tax Compliance Act (FATCA).
- If it is appropriate, what form that should legislation take.

The issues have been consulted on with the relevant Government agencies, including The Treasury, Ministry of Justice and the Office of the Privacy Commissioner. Public consultation on these issues has been limited, but a working group of representative from the financial services sector has been actively engaged and are supportive of New Zealand legislation that reduces the compliance costs imposed by FATCA on the sector.

FATCA and any IGA are also of broader public interest, particularly amongst United States taxpayers that are resident in New Zealand. It is understood this group generally opposes both FATCA and New Zealand entering into an IGA with the United States. However, it is important to differentiate the IGA from the proposal to introduce enabling legislation. The decision to negotiate an IGA has already been taken by Cabinet; this legislation is simply the mechanism by which New Zealand financial institutions will be able to comply with its terms.

The preferred option would allow any IGA to be incorporated into domestic legislation and would require financial institutions to comply with any information gathering and reporting obligations contained in it. It is also designed to allow future agreements of a similar nature to the IGA to be added into domestic legislation with minimal additional legislative amendments.

There are no significant gaps, dependencies, constraints or caveats concerning the regulatory analysis undertaken. We do however note that the economic costs of not enacting the legislation proposed are unable to be accurately estimated. Similarly, any fiscal gains from the reciprocal nature of any IGA cannot currently be estimated because Inland Revenue is not currently aware of the number of unreported US accounts held by New Zealand tax residents. Nevertheless, it is concluded that the benefits of enacting this legislation greatly outweigh the costs. Without the ability to comply with FATCA (i.e. if the necessary enabling legislation is not in place), New Zealand financial institutions may be faced with a choice of:

- not investing in the United States (either directly or indirectly); or
- investing in the United States and facing a 30% withholding penalty on any profits derived.

Because it will require financial institutions to collect data on customers and pass relevant information onto Inland Revenue, the proposed option will impair the privacy rights of the customers concerned. There is also an argument that, because the first people likely to be impacted by the legislation are United States taxpayers, the legislation will enable discrimination against this group. To this end, the proposals have been discussed with the Office of the Privacy Commissioner and the Ministry of Justice, both of whom understand the need for legislation in this instance.

Other than as stated above, the policy options do not impair private property rights, restrict market competition, or override fundamental common law principles.

Peter Frawley
Policy Manager
Inland Revenue

13 September 2013

STATUS QUO AND PROBLEM DEFINITION

1. The United States of America, as part of the Hiring Incentives to Restore Employment Act of 2010, enacted a set of rules commonly referred to as the Foreign Accounts Tax Compliance Act (FATCA). Under FATCA financial institutions, regardless of their location, are required to report on certain United States account-holders (known as "US persons") directly to the Internal Revenue Service (IRS) or face a withholding on United States sourced income of 30%. Financial institution is broadly defined to include (subject to certain exceptions) banks, life insurers and managed funds.

2. As recognition of the fact that compliance with FATCA would impose a significant compliance burden on financial institutions, the United States has developed a system whereby foreign governments can enter into intergovernmental agreements (IGA) with the United States. There are two main types of IGA, known as Model 1 and Model 2.

3. A Model 1 IGA would require financial institutions to supply the relevant information through their own tax authority. That tax authority would then exchange the information with the United States in accordance with existing protocols set out in any double tax agreement between that country and the United States. A Model 2 IGA would require the relevant country to compel its financial institutions to enter into agreements directly with the IRS.

4. Entering into an IGA has a number of benefits, the main ones being:

- Financial institutions in the relevant country would not be required to carry out some of the more compliance-heavy aspects of FATCA.
- In the case of a Model 1 IGA, the financial institutions would not have to enter into separate agreements with the IRS – they would instead be automatically covered by the national agreement.
- Financial institutions would be deemed compliant unless they demonstrated serious non-compliance with the IGA.
- The IGA clarifies a number of exemptions from FATCA reporting for financial institutions considered to be of low-risk from a United States tax perspective.

5. In November 2012, Cabinet agreed to enter into negotiations with the United States with a view to concluding a Model 1 IGA.

6. IGA negotiations with the United States are ongoing. However, this statement is focussed on the desirability of enabling domestic legislation that would require and allow New Zealand financial institutions to comply with the terms of any IGA, on the assumption that one will be agreed in the near future. Financial institutions in New Zealand see significant risk in not having domestic legislation in place.

7. For the purposes of this statement, it is worth noting that the United States is one of the very few countries that taxes individuals on a "citizenship" basis. This means that a United States citizen remains liable to file tax returns (and pay tax if necessary) in the United States irrespective of how long they have been living abroad. In practice, this may mean that a New Zealand resident that is also a United States citizen/taxpayer may be caught by FATCA reporting, even if they have been living in New Zealand for many years and maintain no links to the United States (apart from continuing to be a United States citizen). People in this position that have not consistently complied with their United States reporting and payment obligations are therefore likely to be concerned that being reported on to the IRS may potentially expose them to significant tax and penalty charges.

8. Because they are also New Zealand residents, any impact on this group will be a social impact. The interests of this group are therefore an important consideration in reviewing the alternative options. However, it is also important to note that New Zealand respects the sovereign rights of the United States to impose taxes and penalties as it sees fit.

9. Finally, Inland Revenue notes that the international trends towards countering tax evasion make it likely that other countries may look to adopt FATCA-style reporting at some stage in the future. This means that agreements similar to the IGA may become more commonplace in the international community.

OBJECTIVES

10. The objective of the review is to ensure that:

- New Zealand financial institutions comply with their reporting obligations under any IGA; and
- can do so without violating any domestic law.

REGULATORY IMPACT ANALYSIS

11. Given that approval for IGA negotiations has been provided by Cabinet, this statement proceeds on the assumption that an IGA will be agreed between the United States and New Zealand prior to the date that FATCA information gathering requirements commence on 1 July 2014. We consider there are two main options regarding enabling legislation:

i) *Option 1: Status quo:* No specific legislation be introduced and financial institutions would be required to work within existing legislative frameworks.
ii) *Option 2: Legislation:* Legislation be introduced that would require financial institutions to comply with IGA reporting obligations and explicitly over-ride domestic legislation likely to impede with that.

12. Within option 2, there are two further sub-options:

iii) The legislation could be prescriptive and effectively reproduce any IGA within domestic legislation.
iv) The legislation could be broad, incorporating any IGA by reference only.

13. "Broad", in this context, refers to legislation that applies to any IGA but also any similar agreements that may be entered into in the future with other countries. It would incorporate such agreements by reference and provide a general framework in which they operate by setting out rules that apply to all such agreements.

14. Officials consider there are strong economic arguments for favouring option 2 (introducing legislation) and also consider that legislation should be broad. These options are also favoured by the financial services sector.

15. The table on the following pages analyses the 2 options discussed above against the objectives of the review. It also takes into account the position of United States taxpayers that are likely to be the subject of any reporting.

	Objectives (Met/Not met)		Impacts		
	Require financial institutions to comply with any IGA requirements	Can comply without breaching domestic legislation	Costs	Benefits	Net Impact
Option 1: Status quo – Not preferred	Not met – Although any IGA is likely to be a "double tax agreement" for domestic law purposes, this does not in itself authorise financial institutions to comply with its terms. Compliance with any IGA would therefore be optional for a financial institution.	Not met – It seems likely that any effort to transmit information to Inland Revenue, as contemplated by any IGA, would constitute a breach of the privacy of the persons concerned (under the Privacy Act 1993). It may be possible to circumvent this by obtaining the permission of each customer, but it is unlikely that this permission would ever be obtained for all customers. Taking action against uncooperative customers could open financial institutions to claims of discrimination under the Human Rights Act or the New Zealand Bill of Rights Act.	**Government:** New Zealand's commitment to assisting the fight against tax evasion by entering into an IGA would be contradicted by a lack of legislation authorising compliance with its terms. This could result in broader reputational damage and may also damage the bilateral relationship between New Zealand and the United States. **Financial institutions:** Industry uncertainty as to whether they could comply with the IGA within existing frameworks. Deadweight costs on legal advice are likely to be significant, as would any attempts to get universal consent of customers to collect and share personal information. Failure to comply could expose the institutions to FATCA penalties, which could impact on their broader customer base. The alternative option of not investing into the United States would deny access to the world's largest financial market and would likely result in lower returns for their broader customer base. Would impose a significant compliance cost onto industry. This cost may be reflected in lower returns to the financial services sector and those costs being passed onto consumers. **US persons:** None, other than possible lower returns from investment as a result of financial institutions being subject to FATCA withholding or not investing in the United States. This would be a cost to all New Zealand customers.	**Government:** Existing rights of United States taxpayers that are resident in New Zealand will be protected. **Financial institutions:** None. **US persons:** United States taxpayers would be allowed to challenge the sharing of their information under existing legislation.	Negative – Any benefits to United States persons are outweighed by: (1) the potential reputational impact to New Zealand (2) financial institutions incurring significant deadweight costs (3) financial institutions either suffering FATCA penalties or denying themselves access to the United States financial market.

	Objectives (Met/Not met)		Impacts		
	Require financial institutions to comply with any IGA requirements	Can comply without breaching domestic legislation	Costs	Benefits	Net Impact
Option 2: Specific legislation – Preferred	Met – Legislation would require financial institutions to comply with the requirements of any IGA. Failure to comply would result in penalties, either through becoming subject to the FATCA 30% withholding penalty or through sanctions in domestic legislation or both.	Met – Domestic legislation can over-ride the Privacy Act, Human Rights Act and New Zealand Bill of Rights Act to the extent it is inconsistent with those Acts.	**Government:** Inherent undesirability of promoting legislation that may be contradictory to Privacy, Human Rights and Bill of Rights legislation. **Financial institutions:** None in addition to those that would be incurred under option 1. **US persons:** Any avenues they may have to take action against financial institutions for breaches of the Privacy Act or Bill of Rights Act may be extinguished. For those reported on, there may be the imposition of tax and penalties from the IRS. While the IGA does not alter any substantive taxing rights, it may have the effect of making the IRS aware of existing non-compliance. However, this is consistent with the aims of FATCA.	**Government:** Consistent with the message that the Government will cooperate with international efforts to reduce tax evasion. **Financial institutions:** Provides certainty that they can comply with any IGA reporting obligations, which in turn should mean they can avoid FATCA withholding penalties and can continue to invest in the United States. **US persons:** None.	Positive – Legislation would enhance New Zealand's reputation as an active member of the international community attempting to counter tax evasion. Enabling financial institutions to comply with IGA reporting obligations would allow them means to continue to invest in the United States without penalty. Costs to US persons resident in New Zealand do not appear to outweigh these benefits.

Broad or prescriptive legislation

16. Having established that legislation is desirable, it is necessary to consider whether that legislation should be broad in nature or prescriptive and IGA-specific.

	Advantages	Disadvantages
Option 1: Prescriptive – Not preferred	• It would bring any IGA into domestic legislation in an unambiguous manner. • It would provide a single legislative reference point for interested parties.	• It would be relatively cumbersome to effectively reproduce the requirements of the IGA into domestic legislation. • The legislation would either repeat the IGA (if it were an exact copy) or paraphrase it. There is a risk that paraphrasing would introduce unintended ambiguity between the IGA text and the content of any legislation. • It would be inflexible in that it would only apply to any United States IGA. In the event that New Zealand enters into agreements in the future with other countries which are of similar effect to any IGA, these future agreements would similarly need to be incorporated in a comprehensive manner. • Any future changes to the IGA itself are likely to result in domestic legislation needing to be amended.
Option 2: Broad - Preferred	• It would be simple. It would cross-refer to any IGA and allow interpretation of that document to determine a person's obligations. In doing so, the risk of 'gaps' between any IGA and enabling legislation could be managed and theoretically eliminated. • It could more easily accommodate New Zealand entering into similar agreements in the future. If agreements of this type were their own defined category, future agreement could be included within the regime by amending the relevant definition. Any agreement-specific legislative changes would also be able to be included at that time. • Broad legislation is consistent with the way New Zealand currently legislates for agreements to eliminate double taxation and prevent fiscal evasion (double tax agreements, or DTAs) entered into with other jurisdictions.	The major disadvantage would be that the agreement would not be contained in the same place as other substantive tax laws. Any reader would therefore have to locate both the enabling legislation and the relevant agreement to obtain the full legal picture. People unfamiliar with the workings of DTAs may therefore have trouble locating the relevant legislation. We consider this is mitigated considerably by the ability to search and access legislation online and Inland Revenue will attempt to publically disseminate the relevant legislative references through the FATCA pages on its website.

Fiscal impacts

17. It is not considered that this legislation will have any direct fiscal impacts. Any fiscal effects will instead come from entering into the IGA.

18. Inland Revenue does not consider it is possible to estimate the fiscal costs/benefits of entering into an IGA with the United States. However, it is considered that not entering into an IGA and promoting enabling legislation would have a significant impact on the New Zealand economy. Without the ability to comply with FATCA (i.e. if the necessary enabling legislation is not in place), New Zealand financial institutions may be faced with a choice of:

- not investing in the United States (either directly or indirectly); or
- investing in the United States and facing a 30% withholding penalty on any profits derived.

19. The Model 1 IGA that New Zealand is negotiating is a reciprocal agreement. This means that, in time, Inland Revenue will also receive information from the United States on New Zealand taxpayers with accounts in United States financial institutions. Any financial benefits from this arrangement cannot be estimated at this stage because it is not known how many New Zealand residents have undeclared accounts in United States financial institutions.

Social, environment and cultural impacts

20. The social impacts of the options are largely related to their impact on US persons that are also New Zealand residents. Inland Revenue does not consider there are any environmental or cultural implications for any of the options.

Recommended option

21. Inland Revenue considers that option 2 is preferable and, within the sub-options of broad or prescriptive legislation, broad legislation is also preferable. These choices appear to provide the maximum possible benefits to New Zealand, by clarifying that financial institutions must comply with their IGA obligations and enabling them to do so in a way that avoids unnecessary confusion while also catering for the possibility of future similar agreements being entered into.

Legislation before an IGA

22. It is recognised that recommending legislation be passed before an IGA has been signed is unusual. However, we note that:

- FATCA takes effect from 1 July 2014 irrespective of any action taken by New Zealand. The October 2013 tax bill containing these changes is the last chance that New Zealand will have to implement enabling legislation before that date, unless urgency is used. Urgency would reduce the ability of affected US persons to contribute to the process at the select committee stage.
- As set out above, without enabling legislation, New Zealand financial institutions are unlikely to be able to comply with their FATCA/IGA obligations.

- There is no reason to suspect that an IGA will not be agreed well before 1 July 2014.

CONSULTATION – POLICY FRAMEWORK

Private sector

23. Options for legislation have not been broadly consulted on, on the basis that the decision is simply whether or not specific legislation is required. This is considered to be more of a technical legal question than one that would greatly benefit from public input. However, a working group of representatives from the financial services sector has been actively engaged and are broadly supportive of the aims of the legislation.

24. It is recognised that FATCA is a matter of public interest, particularly amongst New Zealand residents that are likely to be reported on under any IGA. However, public dissatisfaction is likely to be centred around:

- whether an IGA should be agreed in the first place; and
- the United States model of citizenship taxation.

25. The Cabinet decision to enter into IGA negotiations has already been made. The content of any IGA agreed between officials of the United States and New Zealand will be subject to scrutiny in the appropriate manner. Only after this scrutiny has taken place and the IGA brought into force will any domestic enabling legislation take effect.

26. It is recognised that the United States model of individual taxation will result in the application of any IGA being broader than it would have been if New Zealand had entered into a similar agreement with a country that did not adopt this model. However, it is considered inappropriate for New Zealand to comment on this. New Zealand respects the United States' sovereign rights to impose taxes and penalties as it sees fit.

Public sector

27. Inland Revenue has discussed enabling legislation with The Treasury, the Ministry of Business, Innovation and Employment (MBIE), the Office of the Privacy Commissioner, the Ministry of Foreign Affairs and Trade and the Ministry of Justice.

28. MBIE is supportive of enabling legislation on the basis that it will significantly lower compliance costs for financial institutions and enable financial institutions to continue to have access to the United States market.

29. The Office of the Privacy Commissioner considers that New Zealand financial institutions would be unable to comply with FATCA or any IGA without breaching some of the privacy principles set out in the Privacy Act. It has recommended that the only way financial institutions could comply would be through the enactment of legislation that clearly authorises the collection and transmission of the relevant information.

30. The Ministry of Foreign Affairs and Trade is assisting Inland Revenue with any relevant aspects of the IGA negotiations and will further assist in bringing the officials' text of any IGA to Cabinet for approval.

31. The Ministry of Justice has been kept abreast of developments and will vet the proposed legislation for Bill of Rights Act implications in the usual manner.

CONCLUSIONS AND RECOMMENDATIONS

32. For the reasons set out in the "Regulatory Impact Analysis" section of this statement, we recommend specific legislation be introduced to enable and require New Zealand financial institutions to comply with reporting requirements under any IGA (option 2). We also recommend that such legislation be broad, in that it incorporates any IGA (and any other future similar agreements) by reference and provides a broad legislative framework in which such agreements can operate.

IMPLEMENTATION

33. It is proposed that the revised rules apply to affected parties from 1 July 2014. This is the date that the first FATCA information-gathering requirements are due to take effect. As FATCA implementation more generally is driven by the United States, we consider there is little scope to change this application date. To bring it forward may subject affected US persons to unnecessary reporting. To delay it would leave financial institutions in a situation where they were required by the United States to commence FATCA information-gathering but would have no explicit domestic legislative authority to do so.

34. It is anticipated that there will be some compliance costs for financial institutions. These will be necessary to ensure compliance with any IGA, such as systems changes necessary to identify the relevant customers and increased customer contact to establish whether a customer is a US person. However, these will be considerably less than they would be if no enabling legislation were introduced.

35. Receiving information from financial institutions and passing it onto the United States IRS will have systems implications for Inland Revenue. This is particularly due to the volume of information it anticipates receiving as well as catering for the fact that the United States will set the technical specifications for the data exchange. Inland Revenue is currently preparing a single stage better business case for funding of this initiative for consideration by Cabinet. As required by the business case process, a range of options are being considered. These options range in cost, over a five-year whole of life cost, and are currently estimated at between $5.667 million and $8.543 million.

MONITORING, EVALUATION AND REVIEW

36. Monitoring the effect of these changes will fall under Inland Revenue's responsibilities under the generic tax policy process (GTTP). The GTTP is a multi-stage process that has been used to design tax policy in New Zealand since 1995. The final stage of this process is the implementation and review stage, which involves Inland Revenue conducting a post-implementation review and identifying any remedial issues. Opportunities for external consultation are built into this stage.

Regulatory Impact Statement

New tax rules for deregistered charities

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question addressed in this statement is whether the current tax rules adequately deal with the tax consequences facing deregistered charities and their donors and, if not, how these rules should be changed.

A "deregistered charity" refers to an entity that has been removed from the Charities Register by the Department of Internal Affairs – Charities Services and, consequently, is no longer eligible for the charities-related tax concessions in the Income Tax Act 2007.

The key objectives of the proposed reform are to clarify the tax law so that deregistered charities and their donors have a greater level of certainty as to their tax obligations, and to protect the integrity of the revenue base by ensuring the tax concessions that apply to charities are well-targeted and policy intentions are met.

Inland Revenue and the Treasury consulted on the proposed reform in an officials' issues paper, *Clarifying the tax consequences for deregistered charities*, which was released in July 2013. Discussions were also had with a number of key submitter groups from the charitable sector. Two major policy changes arose from consultation, which led to the issues paper's suggested solution being modified.

- The first change is to relieve any retrospective tax costs for deregistered charities and their donors who have acted in good faith and have been compliant with their constitutions.

- The second change is to impose an additional tax cost on the net assets of deregistered charities that have not divested themselves of their assets or income that they had accumulated as a charity, within 12 months of the deregistration date.

The proposals are expected to give rise to a net fiscal cost of up to $28 million, due to relieving the retrospective tax liabilities of charities which are potentially at risk of deregistration in the coming months. This cost is expected to arise across the next two financial years.

Based on recent deregistrations, the fiscal gain from imposing a tax on net assets retained could be as much as $30 million in any one year if no assets are distributed. However, we note that the number of deregistrations is declining, and that a scenario in which no charities distribute is highly unlikely. We consider the fiscal gain is likely to be much lower, reflecting the notion that if this change is successful, deregistered charities would distribute most, if not all of their assets and income to charitable purposes within the 12-month period. As a result, we expect only a very small fiscal gain.

There are caveats on the estimates provided above. Our analysis of this data indicates that deregistrations are decreasing in number since the Charities Register opened and so using historical data to quantify the potential fiscal implications may not be reliable. Furthermore, the available data is not tax data so it is, at best, a proxy. For example, income measures reported in the charities' annual returns could include non-taxable income such as grants, which would tend to overstate the implied tax (or fiscal gain) and understate the implied forgone tax (or fiscal cost). We also do not know how many deregistered charities, when faced with the imposition of a tax, would divest themselves of all their assets and income within the 12-month period to avoid the tax. For these reasons, quantifying the net effect of option 1 has been problematic.

On balance, we believe the net fiscal effect of the combined policy changes is likely to be a fiscal cost of up to $28 million.

There are no other significant constraints, caveats or uncertainties concerning the regulatory analysis undertaken. None of the policy options considered impair private property rights, restrict market competition, or override fundamental common law principles.

Mike Nutsford
Policy Manager, Policy and Strategy
Inland Revenue
15 October 2013

STATUS QUO AND PROBLEM DEFINITION

Charities registration and related tax concessions

1. In New Zealand, the registration of charities began on 1 February 2007. The Department of Internal Affairs – Charities Services is responsible for determining whether an entity can be registered as a "charitable entity" under the Charities Act 2005. Although registration is voluntary, one of the benefits of registration is that a registered charity may be entitled to charities-related tax concessions under the Income Tax Act 2007.

2. The charities-related tax concessions are:

- an income tax exemption.[1] Registered charities are exempt from income tax on their non-business income (e.g. donations and passive investment income such as interest and dividends). Registered charities may also be exempt from income tax on their business income derived directly or indirectly, as long as that income is applied to charitable purposes in New Zealand and no person with some control over the business activities of the charity can direct or divert income derived from the business to their benefit or advantage;

- a fringe benefit tax (FBT) exemption. Registered charities may also be entitled to an exemption from FBT on non-cash benefits paid to their employees who are employed in the non-commercial operations of the charity; and

- recognition as a "donee organisation" for the purposes of the donations tax relief provisions. This means that donors to a registered charity are eligible to receive certain tax benefits on their donations. In the case of individuals, this relief is in the form of a tax credit; in the case of corporate or Māori authority donors, in the form of a tax deduction.

Deregistered charities

3. In July 2008 the tax law was amended to link eligibility to the charities-related income tax exemption to registration with Charities Services. However, there were no consequential amendments made to specifically deal with circumstances when the registration requirement is no longer met. In short, the current tax rules do not deal with the full range of circumstances involving deregistration of charities.

4. A "deregistered charity" is an entity that has been removed from the Charities Register by Charities Services, but which continues in existence. These entities can face a range of complex tax consequences that can be retrospective, transitional or prospective in nature. This is because deregistration means the deregistered charity is no longer eligible for the charities-related income tax exemption – its tax status changes from tax-exempt to taxable. It may also mean the deregistered entity is no longer eligible for the fringe benefit tax exemption and donee organisation status.

[1] Since 1 July 2008, an entity must be registered with Charities Services to be eligible for the income tax exemption for charities. Before this date, a practice developed where an entity would seek Inland Revenue's confirmation that it met the requirements of charitable status and therefore was eligible for the associated exemption.

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

6. Since the Charities Register opened, 4,126 charities have been deregistered. The most common reason for deregistration is a failure to file the required annual return (60%). However, we expect there to be fewer instances of these types of deregistrations in the future. Until recently, Charities Services automatically deregistered charities if they had failed to file one annual return. Under a new approach, registered charities are given more opportunity to file their annual returns. Although not apparent from the data, 24 former charities have been deregistered because they were found not to have a "charitable purpose". This small group is spread across "voluntary deregistrations" and "no longer qualified to be registered".

7. The table below provides statistics on Charities Services' deregistration decisions, as at September 2013.

Deregistration decisions (as at September 2013)	**Number**
Failure to file annual return	2,496
Voluntary deregistrations - 450 entities voluntarily deregistered because they were in the process of winding up or merging with another charity	1,617
No longer qualified to be registered	12
Serious wrong-doing	1

Problem definition

8. There are a number of problems with the current law (status quo). These relate to:

Income Tax

- The current income tax rules provide for the tax consequences for deregistered charities that are trusts but not corporate entities. Therefore, it is unclear how deregistered charities that are corporate entities should transition to the tax base. Furthermore, the tax rules do not take into account the circumstances when a deregistered charity has acted in good faith and in accordance with its constitution since registration in order to limit the potential for retrospective tax liabilities.

FBT

- Similarly, there may be tax consequences for deregistered charities that have previously relied on the FBT exemption. The tax law is unclear as to how and when Inland Revenue would deal with these entities for FBT purposes.

Donors

- Donors who have made cash donations to deregistered charities after the point at which those entities no longer qualify to be a donee organisation should not be eligible for donations tax relief. Although Inland Revenue has the ability to reverse previous donations tax relief that have been claimed incorrectly, the tax law is unclear as to how and when this power would be exercised in relation to deregistered charities and their donors.

Accumulated assets and income

- Although there is a requirement for a deregistered and disestablished charity to distribute its assets and income to charitable purposes, there is no such requirement when a deregistered charity continues its operations. This result is inconsistent with the intended policy that accumulated charitable income and assets should always be destined for a charitable purpose, regardless of whether the entity ceases to exist or not.

9. The officials' issues paper, *Clarifying the tax consequences for deregistered charities,* which was released in July 2013, was written to address the question of whether the current tax law is clear, consistent and coherent in relation to circumstances involving deregistered charities. The paper noted that the current tax law is neither comprehensive nor robust – that is, current tax law does not adequately deal with the full range of tax consequences involving deregistered charities and, in some cases, does not achieve the desired policy outcome.

10. As noted above, the issues with the current law are more minor with deregistrations caused by a failure to file the required annual return, as such entities are likely to face only prospective tax liabilities. However, as this group lost its registration through administrative non-compliance with the Charities Act 2005, they are likely to be even more under-resourced and unsophisticated than the norm. Thus, officials' view is that requiring such a group to comply with complex and unclear tax law is unsustainable. This seems particularly unreasonable as it is likely that this group could still be undertaking charitable activities.

11. For entities that were deregistered because they were never charitable or were involved in serious wrongdoing, although the number of these entities is much smaller (than other deregistered entities), the implications are much larger, as these deregistrations could involve retrospective as well as prospective tax liabilities. This would include any social housing providers that have characteristics similar to the Queenstown Lakes Community Housing Trust, which was the subject of a High Court decision that found that the Trust was not charitable in purpose *[2011] 3 NCLR 50.*

12. For these reasons, and given the significance of the charitable sector in providing social services in New Zealand, and the importance of ensuring that the associated tax concessions are targeted correctly, we do not consider the status quo to be sustainable.

OBJECTIVES

13. The objectives of changing the current rules are to:

- clarify the tax law so that deregistered charities and donors have a greater level of certainty as to their tax obligations after deregistration; and
- protect the integrity of the revenue base by ensuring the tax concessions that apply to charities and their donors are well-targeted and meet policy intentions. This includes, for example, ensuring that if an entity has claimed tax exemption as a charity and has accumulated assets and income, these assets and income should always be destined for a charitable purpose.

REGULATORY IMPACT ANALYSIS

14. Three options have been considered for addressing the current problems and achieving the stated objectives.

Option 1 (preferred solution)

15. A specific set of rules (in legislation) would apply to deregistered charities to:

Income tax

- clarify how the general tax rules apply to all deregistered charities, regardless of their legal form;
- establish the opening values of any depreciable assets and other assets, or consideration for any financial arrangements held by a deregistered charity when it enters the tax base;
- prescribe tax commencement rules for when the general tax rules should apply to deregistered charities. These rules would be linked to whether an entity has complied with its constitution and other supporting information since it registered with Charities Services (or Inland Revenue);

FBT

- clarify the circumstances in which the FBT exemption no longer applies to deregistered charities;

Donors

- clarify the circumstances in which donors who have made cash donations to deregistered charities may be affected; and

Accumulated income and assets

- impose tax on the value of the net assets (with certain adjustments) of the deregistered charity at the expiry of a 12-month period. Adjustments would be made to the net assets calculation to exclude donated assets and any assets or income applied to charitable purposes within the 12-month period.

16. The proposed tax rules for deregistered charities would also apply to entities that have relied on or are relying on the income tax exemption in section CW 42(5)(b) of the Income Tax Act 2007. See further discussion on this matter under "Consultation".

17. The proposed tax rules would also be supported by two amendments to the Charities Act 2005. These changes would provide that a decision to register or deregister a charity can be backdated and, where an entity fails to file an annual return, this would be a separate ground for deregistration.

Option 2 (solution in the officials' issues paper)

18. The solution suggested in the issues paper, which was largely based on current practice, would:

Income Tax

- clarify how the general tax rules apply to all deregistered charities, regardless of their legal form. This involves extending the current tax rules applying to deregistered charities that are trusts to all deregistered charities, regardless of their legal form;

- establish the opening values of any depreciable assets and other assets, or consideration for any financial arrangements held by a deregistered charity when it entered the tax base;

- prescribe detailed timing rules for when the general tax rules should have applied in five distinct deregistration circumstances. In four of the five circumstances, retrospective tax consequences could potentially occur.

19. The issues paper also noted that:

FBT/Donors

- deregistered charities would also require clarification as to their eligibility for the FBT exemption and donee organisation status, after deregistration. There was concern that operational guidance based on the current tax law on these matters might not have been sufficient to achieve the desired policy outcomes.

Accumulated assets and income

- there is no obligation for deregistered charities that continue in existence to apply their income and assets to charitable purposes following deregistration. The issues paper called for submissions on the appropriate treatment to apply to deregistered entities.

Option 3 (status quo)

20. The status quo is set out under "Status quo and problem definition". As noted earlier, officials' view is that the status quo is not sustainable.

Analysis of options

21. Officials' analysis of the two options is summarised in the table below. Each option is assessed according to its additional costs and benefits relative to the status quo.

Options	**Costs**	**Benefits**	**Net impact**
Option 1 provides a comprehensive set of tax rules in legislation to clarify: • what tax rules apply to deregistered charities • when the tax rules apply to deregistered charities • the tax consequences for deregistered charities for FBT purposes where the entity is compliant with its constitution • the tax consequences for donors who believed the deregistered charity was a donee organisation Option 1 also imposes a tax on the net assets of a deregistered charity that continues to operate beyond 12-months, after deregistration	*Taxpayers* New tax cost and additional compliance costs relating to the imposition of tax on the net assets of deregistered charities that remain in operation, 12 months from the date of deregistration *Tax system* Additional administrative costs associated with assessing the imposition of tax on net assets	*Taxpayers* No retrospective tax cost for deregistered charities that have been compliant with their constitutions No retrospective tax cost for donors who have claimed donations tax relief, where they assumed the entity was a bona fide donee organisation Increased fairness overall, as deregistered charities are treated in the same way as charities who cease to exist *Tax system* Improved compliance due to clear, consistent and coherent tax rules for deregistered charities and their donors A fiscal cost of up to $28 million over two years – due to relieving retrospective tax liabilities A fiscal gain of between $0 - $30 million – tax on net assets	Preferred option Overall improvement on option 2 and the status quo in terms of compliance, taxpayer certainty, fairness, and the coherency of the tax system On balance, the net fiscal effect of the proposed changes is likely to be a fiscal cost of up to $28 million.

Option 2 provides a set of income tax rules in legislation to clarify what and when the income tax provisions apply to deregistered charities, with some operational guidance provided on: • when the FBT exemption no longer applies • when donors may be affected	*Taxpayers* Same as status quo *Tax system* Inconsistent treatment of deregistered charities that continue in operation and charities that are wound up	*Taxpayers* Slight improvement in taxpayer compliance associated with clearer income tax rules *Tax system* Fiscally neutral Slight improvement in tax administration associated with clearer income tax rules	An overall improvement on the status quo As the proposed solution was largely based on the current rules and practice, the fiscal cost of this option would be fiscally neutral

22. Option 1 is favoured because it would provide clear, consistent and coherent tax rules for deregistered charities and their donors. It addresses a greater range of tax consequences and gives rise to fairer outcomes for the affected groups, compared with option 2 and the status quo. Additionally, option 1 achieves the desired policy intentions by ensuring that the charities-related tax concessions are properly targeted to bona fide charities, and that deregistered charities are held to account for the assets and income they built up while they enjoyed the benefit of the tax concessions.

23. Option 1 is expected to lead to improved compliance overall, as deregistered charities and donors should benefit from having clear and robust tax rules. Even so, we acknowledge that deregistered charities may face additional tax costs and compliance costs relating to the new tax on net assets. On the other hand, there will be no retrospective tax costs for deregistered charities and their donors that have acted in good faith and have been compliant with their constitutions.

24. Inland Revenue would need to assess the new tax on net assets so there may be a small increase in administrative costs, but this would be offset by the savings resulting from the removal of the need to assess retrospective tax consequences for compliant, deregistered charities and donors.

25. Option 1 is expected to give rise to a net fiscal cost of up to $28 million, due to relieving the retrospective tax liabilities of charities which have been identified as potentially being at risk of deregistration in the coming months. This cost is expected to arise across the next two financial years.

26. There could be a fiscal gain associated with imposing tax on the value of the net assets of deregistered charities that continue to operate beyond the 12-month period, following deregistration. Based on recent deregistrations, the fiscal gain could be as much as $30 million in any one year if no assets are distributed. However, I note that the number of deregistrations is trending downwards, and that a scenario in which no charities distribute is highly unlikely. Officials have advised that the fiscal gain is likely to be much lower, reflecting the notion that if this policy change is successful, deregistered charities would distribute most, if not all of their assets and income to charitable purposes within the 12-month period. As a result, I expect only a small fiscal gain.

27. There are caveats on the fiscal estimates provided above. Analysis of the underlying data indicates that deregistrations are decreasing in number since the Charities Register opened and so using historical data to quantify the potential fiscal implications may not be reliable. Furthermore, the available data is not tax data so it is, at best, a proxy. For example, income measures reported in the charities' annual returns could include non-taxable income such as grants, which would tend to overstate the implied tax (or fiscal gain) and understate the implied forgone tax (or fiscal cost). It is also not known how many deregistered charities, when faced with the imposition of a tax, would divest themselves of all their assets and income within the 12-month period to avoid the tax. For these reasons, quantifying the net effect of the proposal is problematic.

28. On balance, therefore we believe the net fiscal effect of the combined policy changes in option 1 is likely to be a fiscal cost of up to $28 million.

29. Option 2 is not supported because it does not deal with the full range of tax consequences facing deregistered charities and their donors. It also would give rise to unfair outcomes for deregistered charities and their donors who have acted in good faith and had been compliant with their constitutions. Option 2 effectively mirrors current practice, and so is expected to be broadly fiscally neutral and to lead to a slight improvement in both compliance and administration, as deregistered charities and Inland Revenue would benefit from having clearer and more robust income tax rules. However, option 2 did not go far enough.

30. There are no economic, social, environmental or cultural impacts associated with the options considered above.

Application date

31. The application date proposed in the issues paper was 1 April 2014. Officials now recommend that the changes to the Tax Acts should generally apply from 14 April 2014 – that is, deregistered charities whose date of final decision is on or after 14 April 2014 would have to apply the new rules. 14 April 2014 is the date that most of the proposals in the Social Housing Reform Bill are expected to be enacted.

32. With respect to the tax on net assets, however, officials recommend a split application date. It would apply from 1 April 2015 to entities which are deregistered by Charities Services, or which lose their tax charity status. It would, however, apply from 14 April 2014 to entities which choose to voluntarily deregister.

33. The reason for the 1 April 2015 date is to give current and prospective charities and their advisors more time to become familiar with the proposal to impose tax on net assets for deregistered charities that continue to operate beyond the 12-month period after deregistration. Applying the proposal to entities which choose to voluntarily deregister, however, between 14 April 2014 and 1 April 2015 will act as an anti-avoidance measure to ensure that there is not a sudden deluge of entities deregistering during that period in order to avoid the new tax on net assets.

34. The changes to the Charities Act 2005 will apply from 14 April 2014.

CONSULTATION

35. Inland Revenue and the Treasury consulted on the proposed reform in an officials' issues paper, *Clarifying the tax consequences for deregistered charities*, released in July 2013. A total of 15 submissions were received on the issues paper from a range of people including tax specialists, academics and specialist advisors to the charities sector. The submissions confirmed that current tax law does not deal adequately with the full range of tax consequences facing deregistered charities. Submissions also agreed that the suggested solution was a good starting point.

36. Officials also had discussions with a number of key submitter groups. These groups included the Association of Non-Governmental Organisations of Aotearoa, the Fundraising Institute of New Zealand, Volunteering New Zealand, Greenpeace, Social Development Partners, and the New Zealand Institute of Chartered Accountants.

37. Officials also discussed preliminary proposals with officials from the Treasury, the Department of Internal Affairs and the Ministry of Business, Innovation and Employment.

38. The feedback in submissions and discussions with these groups helped to formulate officials' preferred option.

39. The key issues raised in submissions related to:

- the "tax commencement rules" and the potential for retrospective tax liabilities to arise;
- the tax treatment for accumulated assets and income of deregistered charities; and
- donor consequences.

Tax commencement rules

40. Submitters were concerned about income tax applying retrospectively when a deregistered charity had acted in good faith and in accordance with its constitution since registration. Submitters considered that deregistered charities should be able to rely on previous decisions made by Charities Services (or Inland Revenue) to recognise these entities as meeting the legal tests of a charity. In addition, submitters suggested that a time bar apply to deregistered charities that enter the tax base, to limit the potential for retrospective tax liabilities and provide greater certainty. The time bar would limit Inland Revenue's ability to go back more than four years to reassess past tax years, except in cases of fraud, wilful wrongdoing or omission of income.

41. In response to these submissions, we greatly simplified the approach to determining when the general tax rules should apply. If a deregistered entity has acted in good faith and has complied with its constitution since it was registered by Charities Services (or Inland Revenue), income tax obligations should commence from the date of final determination of an entity's charitable status, either through the Charities Services disputes process or through the Courts. This means that an entity would start paying tax only after exhausting all dispute procedures for determining its charitable status. However, if an entity has been found to be non-compliant, the tax rules would apply from the date of non-compliance.

42. Consequently, we have revised the rules to determine the application of the tax rules to reflect the changed approach. The revised rules are:

Deregistration situation	Tax commencement date of tax rules
The deregistered charity has complied with its constitution, rules and any other information supplied to Charities Services (or Inland Revenue before 1 July 2008)	The deregistered charity would be subject to tax on income from the "date of final decision"
The deregistered charity has not complied with its constitution, rules and any other information supplied to Charities Services (or Inland Revenue before 1 July 2008)	The deregistered charity would be subject to tax on income from the "date of non-compliance"

43. We do not support a time bar on the basis that its need is reduced – that is, the revised tax commencement rules should reduce the incidence of retrospective tax liabilities for deregistered charities that have acted in good faith and have been compliant with their constitutions.

44. The tax commencement rules would also apply to determine the continued application of the FBT exemption. This means that compliant entities would lose their FBT exemption from the date of final decision, and non-compliant entities from the date of non-compliance if they no longer meet the requirements of the FBT exemption.

Donor consequences

45. Submitters agreed that Inland Revenue should be able to reverse donations tax relief in certain circumstances. However, they expressed concern about Inland Revenue's ability to reverse donations tax relief when donors have claimed the relief in good faith, assuming that the organisation was a bona fide donee organisation.

46. We share the same concerns as submitters, and consider that Inland Revenue should reverse donations tax relief only if a donor had knowledge, at the time of claiming the tax relief, that the entity did not satisfy any of the requirements to be a donee organisation, or when the donor was involved in fraudulent activities.

Accumulated assets and income

47. Submitters put forward a range of views on the tax treatment of accumulated charitable assets and income, including:

- requiring deregistered charities to distribute their accumulated income and assets to a charitable purpose or to a registered charity (the Australian model);
- requiring deregistered charities to distribute their accumulated income and assets to a charitable purpose or to a registered charity within a specified period, or risk the income and assets being subject to tax (the Canadian model);
- imposing tax on the accumulated assets (i.e. not accumulated income) that have been purchased from untaxed income, and accumulated income that has not been distributed or paid to another charity within a prescribed period (say 12 months); or

- ring-fencing accumulated income, so that it must be applied to a charitable purpose after deregistration. This treatment has been adopted in the Treaty of Waitangi settlements process by some treaty settlement entities that have chosen to receive their treaty redress and manage it under a non-charitable entity structure.

48. Officials' view is that, where an entity has accumulated assets and income as a charitable entity with tax-exempt status, its assets and income should always be destined for a charitable destination, regardless of whether the entity ceases to exist or not. However, if a deregistered charity continues in existence, we consider that the value of its net assets (i.e. assets *minus* liabilities) should be subject to income tax. The imposition of tax in this instance is intended to be a proxy for taxing the deregistered charity as if it had always been a tax-paying entity. This outcome is consistent with the current policy intentions underlying the charities-related tax concessions – that is, the tax concessions should only be available to bona fide charities and deregistered charities should be held to account for the assets and income they have built up while they enjoyed the benefit of the tax concessions.

49. For reasons of fairness, we also consider that deregistered charities should be given time to apply any assets or income to charitable purposes before the imposition of any tax, and an adjustment should be permitted for any donated assets as these assets were not funded by non-taxed income.

50. We believe that the best approach is to tax the deregistered charity on the value of its net assets (with certain adjustments) remaining at the end of a 12-month period from the day the entity became subject to tax. Adjustments should be made to the net assets calculation to exclude donated assets and any assets or income distributed for charitable purposes within the 12-month period. This approach is a simple, low compliance costs option but we acknowledge that it may result in a tax impost for some deregistered charities that is higher than what they would have paid had they always been subject to tax.

51. The example below illustrates how the new tax would operate.

Example

Charity A's date of final decision is 1 June 2015. The balance sheet for Charity A as at 31 May 2016 (12 months after the date of final decision) is shown below.

Assets		**Liabilities**	
Cash	$50	Loan	$200
Inventory	$300	**Equity**	
Land (donated)	$3,000	Shareholder's equity	$3,150

The net asset calculation would be $3,150; *less* the value of the donated land; *less* any assets and income distributed within 12 months of the date of deregistration. The net assets value would be $150 ($3,150 less $3,000). The tax rate would be the rate applicable to the entity. If the deregistered entity were a trust it would be taxed at the trustee rate of 33%.

Other matters raised in submissions

52. A number of other issues were raised in submissions but were not specifically covered in the officials' issues paper. In particular, three further matters have been included in the recommended option as outlined below:

- The proposed tax rules for deregistered charities should also apply to entities that have relied on or are relying on section CW 42 (5)(b) of the Income Tax Act 2007 of the "tax charity" definition. That provision confers the charities-related tax exemption on entities that had started, before 1 July 2008, the process of registering with the former Charities Commission and that intend to complete the process of registration. The provision is a transitional measure intended to give more time for entities that were struggling to meet the 1 July 2008 deadline for registration and continued tax-exempt status. For reasons of certainty and fairness, these entities should be able to take advantage of the tax exemption afforded by the transitional provision, provided they have complied with the requirements of that provision. Officials recommend that entities that rely on section CW 42 (5)(b) of the Income Tax Act 2007 should be able to rely on the proposed new rules for deregistered charities. We are aware of at least one high-profile entity that would benefit from this change.

- To support the proposed tax changes, we propose a consequential amendment to the Charities Act 2005 to give Charities Services more flexibility around the process for determining the date of registration and deregistration. This change would help to support the tax commencement rules for determining the application of the general tax rules. Charities Services advise this flexibility would avoid potentially serious consequences for smaller and less robust charities deregistered for administrative non-compliance, and which may incur a tax liability as a result. This includes charities who may fail to file the required annual return.

- To complement this change, and create a less onerous compliance framework, we also propose a second consequential amendment to the Charities Act to clarify that failure to file an annual return is a separate ground for deregistration. Currently, such administrative non-compliance is considered under the general heads of serious wrongdoing, or a significant and persistent failure of the organisation to meet its obligations under the Charities Act.

CONCLUSIONS AND RECOMMENDATIONS

53. The preferred option (option 1) is to enact specific rules in the Income Tax Act 2007 and the Tax Administration Act 1994 to cater for the full range of tax consequences for circumstances involving deregistered charities. To support the proposed new tax rules, two minor amendments to the Charities Act 2005 are also recommended.

54. The preferred option is the result of consideration of feedback on submissions on the issues paper and further analysis by officials.

IMPLEMENTATION

55. The changes to the Tax Acts will generally apply from 14 April 2014 – that is, deregistered charities whose date of final decision is on or after 14 April 2014 would have to apply the new rules. With respect to the tax on net assets, however, we recommend a split application date. It would apply from 1 April 2015 to entities which are deregistered by Charities Services, or which lose their tax charity status and would apply from 14 April 2014 to entities which choose to voluntarily deregister. The changes to the Charities Act 2005 will apply from 14 April 2014.

56. There are no significant implementation risks arising from the proposed new rules for deregistered charities. Transitional arrangements and enforcement of the proposed changes will be managed by Inland Revenue as business as usual. Current Inland Revenue operational guidelines relevant to charities would be updated to explain the proposed new rules to deregistered charities and their donors. Inland Revenue will also work with Charities Services to help communicate these changes to existing and prospective charities.

57. Overall, we expect there to be an improvement in compliance through having clear, consistent and coherent tax rules for deregistered charities.

MONITORING, EVALUATION AND REVIEW

58. There are no specific plans to monitor, evaluate and review the proposed new rules for deregistered charities. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

59. In general, Inland Revenue monitoring, evaluation and review of new legislation takes placed under the GTPP. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves a post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, changes identified as necessary for the new legislation to have its intended effect would generally be added to the tax policy work programme, and proposals would go through the GTPP.

Regulatory Impact Statement

Tax treatment of community housing providers

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

The question addressed in this statement is whether the current tax treatment of community housing providers (CHPs) which provide affordable home-ownership products aimed at very low-income households is appropriate and, if not, how this can be addressed.

In *Queenstown Lakes Community Housing Trust [2011] 3 NZLR 50*, the High Court found that the Queenstown Lakes Community Housing Trust (QLCHT), which offered an affordable home-ownership scheme to "low-to-moderate income families", was not charitable in purpose. As a consequence, QLCHT was no longer eligible for the income tax exemption as a charity and donee organisation status. There is concern that other CHPs currently registered with Charities Services that are similar to QLCHT might also be affected.

The charitable status of CHPs offering social housing products (such as rental accommodation) where the housing benefit is directed to those who are poor, in need, aged or suffering genuine hardship, and provides actual relief, would seem to be relatively assured. At the other end of the spectrum, CHPs that are "for profit", or accrue private, pecuniary profits for the owners are not charitable in purpose. However, the position of CHPs that offer affordable home-ownership products and that target households on low-incomes with alternative housing options is not certain.

The key objectives are to ensure that the tax treatment of CHPs that offer affordable housing products to low-income households:

- aligns with the current tax policy settings underlying the charities-related tax concessions;
- is consistent with the Government's overall strategy for the tax system of having a broad base with low rates and few exemptions;
- is not a barrier to building a more diverse and sustainable social and affordable housing provider sector.

The class of taxpayers likely to be affected has been narrowly defined – namely, CHPs that provide affordable home-ownership products to low-income households "in poverty" as understood by charities law.

Targeted consultation has been undertaken with housing sector representatives, and their views have helped to inform the problem definition and the formulation of options. The Ministry of Business, Innovation and Employment; the Treasury; and the Department of Internal Affairs have been consulted on the policy discussed in this RIS.

The preferred option to preserve the status quo does not have a fiscal cost. All other options are expected to give rise to a fiscal cost of $2.4 million, due to providing tax relief for the prospective tax costs for the affected CHPs and tax relief for donors who give cash donations to those CHPs. The fiscal cost is calculated based on the CHPs on the Charities Register which retain similar characteristics to those referenced in the QLCHT decision. We also note that it is a question of fact and degree as to whether a CHP meets the charities criteria in the Charities Act 2005 and each provider must be assessed on a case-by-case basis. We will not know which entities are in fact charitable in purpose until Charities Services has undertaken a thorough examination of each CHP.

A further constraint on the fiscal cost is that the underlying data is not tax data so it is, at best, a proxy. For example, income measures reported in the charities' annual returns could include non-taxable income such as grants, which would tend to overstate the implied tax (or fiscal gain) and understate the implied forgone tax (or fiscal cost).

There are no other significant constraints, caveats or uncertainties concerning the regulatory analysis undertaken. None of the policy options considered impair private property rights, restrict market competition, or override fundamental common law principles.

Mike Nutsford
Policy Manager, Policy and Strategy
Inland Revenue
23 October 2013

STATUS QUO AND PROBLEM DEFINITION

Social housing sector

1. At present, the community housing sector comprises a range of social and affordable housing providers offering rental accommodation and/or pathways to home-ownership products. Some are "for profit" while others are not-for-profit. Some are charitable in purpose while others are not. Some of these organisations also receive central or local government grants and/or receive public donations to carry out their housing assistance activities.

2. The Government's Social Housing Reform Programme seeks to encourage a more diverse and contestable social housing market, and the Government's Social Housing Fund aims to increase the supply of more social and affordable housing products for low-to-moderate income households. In particular, the Reform Programme seeks to significantly expand the proportion of social housing provided by the community housing sector over the long-term. The Government has set aside $139 million for this programme.

3. Parliament is considering the Social Housing Reform (Housing Restructuring and Tenancy Matters Amendment) Bill. The bill provides a framework for the future provision of social housing that will promote contestability by increasing the number and diversity of community housing providers (CHPs) operating in the market, and increase the choices available for tenants and prospective tenants.

4. Among other things, the bill will enable the establishment of a Regulatory Authority to register CHPs, with associated objectives, functions, and powers to monitor and enforce compliance with regulatory standards. It will also enable the making of regulations that prescribe eligibility criteria and performance standards to be met by CHPs registered with the Regulatory Authority, and allow for the extension of income-related rent subsidies to those providers. The majority of the bill has a commencement date to be determined by Order in Council, although the expectation is commencement on 14 April 2014.

Tax treatment of community housing providers

5. There are no specific tax rules for CHPs in the Income Tax Act 2007, other than the Housing New Zealand Corporation which is treated as a "state enterprise" subject to full taxation.

6. Entities registered with Charities Services as a charitable entity are entitled to the charities-related income tax exemption in the Income Tax Act 2007. This means that the income earned by registered charities is not subject to tax.

7. In addition, registered charities are recognised by Inland Revenue as meeting the requirements of donee organisation status[1]. Donors who give money to donee organisations are entitled to a tax credit (in the case of individuals) and a tax deduction (in the case of companies and Māori authorities). Although Inland Revenue approval is not required under current tax law, a practice has developed whereby organisations seek Inland Revenue's confirmation of this status for certainty.

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[1] A "donee organisation" is any entity that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic or cultural purposes within New Zealand. A donee organisation also includes any entity that is listed in Schedule 32 of the Income Tax Act 2007.

8. Under current tax policy settings, registration with Charities Services is intended to act as a gateway to the charities-related income tax exemption and donee organisation status. In order to be registered with Charities Services, an entity must meet the legal tests of charity as set out in the Charities Act 2005 – that is, they need to have one of four "charitable purposes" and must be for the "public benefit". A change to the legal test(s) in the Charities Act, and/or a change in the way the courts interpret those tests over time will affect how the Charities Registration Board applies the law. This will in turn affect a registered charity's tax status.

Charitable status of Community Housing Providers

9. In *Queenstown Lakes Community Housing Trust [2011] 3 NZLR 50,* the High Court found that the Queenstown Lakes Community Housing Trust (QLCHT) which offered an affordable home-ownership scheme to "low-to-moderate income" families was not charitable in purpose. This case highlighted the current uncertainty in charities law as it relates to providers that offer affordable home-ownership products including shared-ownership and rent to buy schemes.

10. The charitable status of providers offering social housing products (such as rental accommodation) where the housing benefit is directed to those who are "in poverty", namely those who are poor, in need, aged or suffering genuine hardship and that provides actual relief, would seem to be relatively assured. These providers would be tax-exempt. At the other end of the spectrum, housing providers that are "for profit", or accrue private, pecuniary profits for the owners, are not charitable, and are therefore taxable.

11. However, the position of CHPs involved in the provision of affordable home-ownership products and that target households on low-to-moderate incomes with alternative housing options is not certain. Providers that offer affordable home-ownership products tend to fall outside the Charities criteria – the ability to purchase a house is an indication a person is not "in poverty". The QLCHT's model of providing housing for "key workers" – whose income renders them unable to purchase a house in the region of their work due to local affordability factors – was deemed not to be charitable in purpose. Relevant factors in that case, which included the size of the deposit required ($70,000) and the median income of buyers (140% of national median income), indicated that the workers were not "in poverty".

12. Thus, given the range of social and affordable housing products which are or could be provided in the future by CHPs, and the fact that the intended recipients might not necessarily be considered "in poverty" (as understood by charities law), there is no clear "bright-line" test for determining who is charitable or not. It is a question of fact and degree as to whether a CHP meets the charities criteria and each provider must be assessed on a case-by-case basis either by Charities Services or the Courts.

13. Charities Services can identify existing registered charities where the provision of accommodation and/or housing has been stated as the entity main purpose. Initial high level reviews indicate that a significant majority of these entities will continue to be registered as charities as they provide social housing products to people in identified charitable need. In this high-level review, a small percentage of charities have been identified as having similar activities and practices similar to those identified in the QLCHT decision. This has created risks regarding the on-going eligibility of an entity in this group to be registered as a charity.

A small number (ten) of these providers are currently pre-registered with the Social Housing Unit.

Tax consequences following loss of charitable status

14. When an entity loses its charitable status, it can face a range of complex tax consequences that can be retrospective, transitional or prospective in nature. These consequences give rise to questions such as when the entity should start its life as a tax-paying entity, how the entity should treat its depreciable property or financial arrangements when it becomes a tax-paying entity, whether the entity continues to qualify as a donee organisation, and what tax provisions should apply to the entity going forward.

15. The nature and extent of these tax consequences ultimately depend on the underlying reason for deregistration. For example, if an entity was found never to have had a "charitable purpose" or ceased being charitable in purpose at some time in the past (through mission drift), it could face retrospective tax liabilities. Individuals who have donated to such entities could also be affected, as donation tax benefits might have to be reversed (as housing providers that do not qualify for registration as a charity also might not qualify as a donee organisation).

Problem definition

16. The Minister of Housing and the Minister of Revenue understand that the majority of CHPs who provide social housing products are not at risk of losing their charitable status because they are engaged in the relief of poverty – that is, they direct their housing assistance to people "in poverty". Consequently, their tax-exempt status and donee organisation status seem to be relatively assured. At the other end of the spectrum, Ministers understand that CHPs that are "for profit", or accrue private, pecuniary profits for the owners are not charitable and therefore taxable.

17. However, Ministers are concerned about those CHPs which might possibly be at risk of being deregistered because they offer affordable home-ownership products to low-income households or people who are "in poverty". They believe these providers should continue to be tax-exempt and be recognised as a donee organisation because they benefit people who "would never be able to afford a house". The perceived problem therefore, which Ministers are seeking to address is to support CHPs that offer pathways to home ownership to low-income households but that might no longer be considered charitable in purpose.

18. The community housing sector has raised the following concerns with the loss of tax-exempt status and donee organisation status:

- the requirement to pay tax on the profits from the delivery of affordable home ownership products. There is a concern that to meet tax liabilities, particularly retrospective liabilities, there will be a need to sell existing housing units and prospectively, some may reconsider whether they will continue to remain affordable home-ownership providers;

- it removes money from providers that would otherwise be reinvested into additional affordable housing;

- the compliance costs associated with meeting taxpayer obligations, adding another layer of complexity to their activities, especially the tax rules on land, financial arrangements and Government grants; and

- reduced public donations.

19. The community housing sector also believes that the change in tax status for CHPs might also put at risk the Government's social housing policy as it relates to building a more diverse and sustainable housing provider sector.

20. There are two related areas to consider: the tax liability incurred in the past resulting from the charities deregistration process, and the tax status of the providers in the future.

21. Inland Revenue, the Treasury and the Ministry of Business, Innovation and Employment agree that retrospective tax liabilities arising from deregistration is a problem and should be addressed. The proposed new rules for deregistered charities may provide relief to CHPs that have been compliant with their constitutions since registration. The proposed new rules are discussed in the RIS *New tax rules for deregistered charities.*

22. The Ministry of Business Innovation and Employment and the Treasury do not consider that current tax and charitable status arrangements for CHPs engaged in the provision of rental housing for those in need present a significant risk to the Government's social housing policy in the future. This is because from 14 April 2014, CHPs offering rental housing and registered with the Regulatory Authority will be eligible to receive market rents through the income related rent subsidies.[2] The Ministry and the Treasury's view is that the status quo would be sustainable from 14 April 2014.

23. This RIS is concerned solely with the future tax treatment of CHPs.

OBJECTIVES

24. The key objectives are to ensure that the tax treatment of CHPs that offer affordable home-ownership products to low-income households:

a) aligns with the current tax policy settings underlying the charities-related tax concessions;

b) is consistent with the Government's overall strategy for the tax system of having a broad base with low rates and few exemptions; and

c) is not a barrier to building a more diverse and sustainable social and affordable housing provider sector.

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[2] The income related rent subsidy is a government subsidy which helps people on low incomes with the cost of housing. The government pays the difference between the rent paid by tenants and the current market rent for the area and type of property. Currently, this subsidy is only available to HNZC, but under the Social Housing Reform (Housing Restructuring and Tenancy Matters) Amendment Bill this will be extended to include registered CHPs.

25. We note that there may need to be a trade-off between the objective of ensuring a broad base, low-rate tax system with few exemptions and the objective of building a more diverse housing provider sector, depending on the option that is adopted.

26. A time constraint exists in relation to the legislative vehicle for any of the options requiring legislative amendments. It is preferable that any legislative amendments be included in the tax bill scheduled for introduction in November 2013 so that Ministers can signal to affected CHPs that they are considering the tax issues facing them at the same time as the Social Housing Reform bill is ushering in the new housing sector reforms.

REGULATORY IMPACT ANALYSIS

27. Three broad options and the status quo (option 4) have been considered for addressing the problems and achieving the stated objectives. These options are:

- ***Option one:*** direct funding for eligible CHPs and conferring donee organisation status
- ***Option two:*** specific income tax exemption for eligible CHPs and conferring donee organisation status
- ***Option three:*** confer charitable status on eligible CHPs

28. Options one and three can be achieved in two ways. A detailed description of each option (and its variations) is set out below.

Eligible CHPs

29. "Eligible CHPs" in options one, two and three would be those that meet the following criteria:

- CHPs must be registered with the proposed Regulatory Authority under the Social Housing Reform Bill
- the affordable home-ownership products offered by these CHPs must be aimed at low-income households. Two options were considered for determining that is a "low income household" namely; explicit income thresholds set by reference to regional household income and asset testing; and an "in poverty" test (which does not have an income threshold)
- CHPs must ensure that no part of their funds is used or is available to be used for the private pecuniary profit of a member, proprietor, shareholder, or associate of any of those classes of people
- CHPs must ensure that no person (or their associate) is able to direct or divert amounts from the business to their own benefit or advantage
- the affordable home-ownership product must be aimed at increasing the supply of affordable housing

- CHPs must re-invest all surpluses back into its affordable home-ownership activities

- on winding up, the assets of the provider must be distributed to another CHP registered with the Regulatory Authority.

30. The criteria above ensure certainty about the scope of the options and consistency between those options.

31. Two options were considered for setting the criterion for determining whether the recipient of housing assistance is a low-income household:

- an "in poverty" test

- an income and assets threshold test

"In poverty"

32. Under the first criterion, the recipient must be "in poverty" as understood by charities law.

33. We accept that there is no single, fixed criterion of what constitutes "in poverty" for the purposes of charities law. The High Court in the QLCHT case observed there cannot be a single, fixed criterion, and the case law does not support a "bright-line" test for poverty.[3] However, charities case law provides some guidance in this area.

34. In particular, poverty includes being unable to meet all that is necessary, not only for a bare existence, but for a modest standard of living. People who are in need, aged, or who are suffering genuine financial hardship from a temporary or long-term change in their circumstances are likely to qualify for assistance. However, alleviating poverty does not mean that a person should be supplied with all that one should have for one's own good. Relieving poverty has the connotation of relieving financial needs, but financial disadvantage is not the same as being poor.

35. In the QLCHT case, the Court recognised that assisting the poor to buy housing through shared ownership or other direct financial aid can be charitable but held that the QLCHT's scheme was open to individuals who were not impoverished in the relevant sense. Participation in the scheme was open to individuals with incomes over the New Zealand median income; and, in point of fact, QLCHT was assisting beneficiaries who could have met their housing needs, by renting or purchasing in an alternative location.

36. It may be difficult for a person to assess whether they are "in poverty", and so this criterion could provide less certainty than an income and assets threshold test, which can be assessed more readily. However, this uncertainty can be alleviated by Inland Revenue providing guidelines on the interpretation of what is meant by "in poverty".

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[3] *Queenstown Lakes Community Housing Trust* [2011] 3 NZLR 50 at [40].

Income and assets tests

37. Under the second criterion the recipient must meet both an income test and an assets test. The income test prescribes an income threshold aligned to the lower quartile of household income – which is currently about $35,700 per annum. The main benefit of using an income threshold is that it is objective and can easily be applied in a self-assessment environment. It can also be set by reference to household composition and by geographical region.

38. However, there is a risk with using an income threshold alone, as it may include people who are not "in poverty", such as cash-poor, asset-rich individuals. To address this concern, we feel that if this option is chosen, an asset test should form part of the exemption. An assets test could be designed to be similar to the transitional assistance support[4].

39. Even with an asset test, there are concerns with this approach. These include:

- The test requires comprehensive definitions of "income" and "assets", which could be quite complex;
- There is potential for people who are not "in poverty" to be included, as their low level of income and assets is only temporary;
- The test may exclude current registered charities who offer affordable home-ownership products;
- The approach may set an unintended benchmark for what the Government regards as a "low-income household";
- There are issues relating to future-proofing the thresholds such as indexing the thresholds to ensure that they are inflation-adjusted or pressure on the Government to increase the thresholds in the future;
- The test creates a "cliff". The income and asset thresholds do not provide any flexibility for either safe-harbouring people who are close to the thresholds and inadvertently cross the thresholds, or for dealing with people who structure their affairs to maintain their eligibility.

Option one

40. Under this option, the eligible CHPs would be subject to tax but they would be compensated for their future tax costs by:

- additional Government grants. It would be very difficult to make additional Government grants to providers to accurately reflect the amount of their tax liability; or

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[4] A temporary grant to support people when their basic expenses exceed their income, administered by Work and Income.

- a tax indemnity provided by the Minister of Finance under section 65ZD of the Public Finance Act. A tax indemnity involves CHPs quantifying their tax liability, and the Government compensating them for this amount.

41. The Government may choose to issue tax indemnities until the proposed housing reforms have bedded in and then move to additional direct grant funding. Alternatively, the Government could offer direct grant funding from the outset.

42. In addition, this option would include a legislative amendment to the Tax Acts to preserve the donee organisation status of the affected CHPs (see paragraphs 49 to 50).

Option two – specific income tax exemption

43. A specific income tax exemption would apply to eligible CHPs that offer affordable home-ownership products to low-income households or people "in poverty".

44. The exemption would be administered by Inland Revenue on a self-assessment basis, which is consistent with how tax law applies to all entities. In general, the criteria contain objective tests which should enable CHPs to self-assess if the exemption applies or not, and Inland Revenue would provide guidance on how the exemption applies. If absolute certainty is required, CHPs can apply for a binding ruling to confirm their status at a cost to them. Further, the proposed Regulatory Authority and Inland Revenue would consider how the exemption could be administered, once the Authority is established and housing guidelines are determined.

45. In addition, this option would include a legislative amendment to the Tax Acts to preserve the donee organisation status of eligible CHPs (see paragraphs 49 to 50).

Option three – confer charitable status on eligible CHPs

46. Under this option charitable status would be conferred on eligible CHPs by amending the definition of "charitable purpose" in the Charities At 2005 to:

- deem CHPs to be charities; or

- recognise that the provision of affordable home ownership does not automatically disqualify CHPs from having a charitable purpose, provided that all the other requirements of "charitable purpose" are met.

47. Deeming CHPs to be charities is intended to provide absolute certainty CHPs will not be subject to tax. The effect on CHP's costs if the Charities Services Board is required to register them as charities is uncertain because CHPs may incur compliance costs under more than one piece of legislation. Simply amending the definition of "charitable purpose" in the Charities Act 2005 would not provide absolute certainty for affordable home-ownership providers because an application to register as a charity would remain subject to a case by case consideration by the Charities Registration Board (or the courts).

Option 4 – Status quo

48. If the status quo is maintained, the current tax policy settings for CHPs continue to apply. If a CHP is registered with Charities Services it is eligible for the charities-related income tax exemption and is recognised as a donee organisation. Deregistered CHPs are subject to tax.

Donee organisation status

49. The eligibility criteria could also be used as the basis for establishing criteria for donee status specifically for CHPs. CHPs meeting the criteria would automatically qualify for donee status. In practice, it is likely that CHPs would confirm this status with Inland Revenue.

50. A specific provision conferring donee status could be included in options one and two. Option three confers donee status on CHPs by virtue of it conferring charitable status, but that status would remain subject to confirmation of registration by the Charities Registration Board. Thus, all options would preserve the donee status that existed for CHPs before the High Court decision in the QLCHT case. There is a fiscal cost associated with preserving donee status for the eligible CHPs, this is tentatively estimated at $0.1 million.

Impact analysis of the options

51. The impacts of options one to three and the status quo option, and whether they meet the objectives in paragraph 24, are summarised in the table below.

52. Summary of impacts of options one, two and three and the status quo.

Option	*Meets objectives a, b, or c?*	*Impacts*				*Net impact*
			Fiscal/economic impact	*Administrative and compliance impacts*	*Risks*	
One *Direct funding for eligible CHPs and donee status*	b, c	Tax system	Fiscal cost of $2.4 million pa Transparent about fiscal cost	Additional administrative costs associated with administering the direct funding mechanism	May create a precedent for direct funding of a broader range of CHPs' tax liabilities in the future	Addresses the problem definition as identified by Ministers and most of the objectives
		CHPs	Extinguishes future tax costs for eligible CHPs	No additional compliance costs, as CHPs will still need to determine their tax liabilities		
Two *Specific tax exemption for eligible CHPs and donee status*	c	Tax system	Fiscal cost of $2.4 million pa but the true cost may never be known because it is not clear who will actually be deregistered Creates a tax preference for home ownership over other forms of housing	Administrative savings from not having to assess future tax liabilities but there is a cost associated with administering the exemption	May create a precedent for tax exemptions for a broader range of CHPs in the future	Addresses the problem definition but does not meet two objectives
		CHPs	Extinguishes future tax costs for eligible CHPs	Tax compliance cost savings for eligible CHPs as they will not need to determine their tax liabilities Improved taxpayer certainty		

Option	*Meets objectives a, b, or c?*	*Impacts*				*Net impact*
			Fiscal/economic impact	*Administrative and compliance impacts*	*Risks*	
Three *Conferring charitable status on CHPs*	c	Tax system	Same as option two	Additional administration required by Charities Services Administrative cost savings for IRD as there is no need to assess the tax liabilities of eligible CHPs	May create a precedent for other groups to lobby for similar treatment Undermines the integrity of the charities registration process, and the statutory independence of the Charities Registration Board May not improve CHP taxpayer certainty	Addresses the problem definition but does not meet two objectives
		CHPs	Extinguishes future tax costs for CHPs	Same as option two Potential additional compliance costs for eligible CHPs under more than one piece of legislation		
Four *Status quo*	a, b, and c	Tax system	No fiscal cost Does not create a tax preference for home ownership over other forms of housing	Potential additional administrative costs as some previously charitable CHPs enter the tax base	Does not fully resolve uncertainty in the tax status of CHPs arising from their eligibility for charitable status	Achieves all objectives but does not address the problem definition identified by Ministers
		CHPs	Future tax costs for CHPs	Tax and compliance costs for previously-charitable CHPs		

Fiscal cost

53. Options one, two and three have a fiscal cost which has been estimated at $2.4 million per annum. The fiscal cost of relieving the prospective tax costs for eligible CHPs is calculated based on the CHPs on the Charities Register, which retain similar characteristics to those referenced in the QLCHT decision. The fiscal cost will ultimately depend on how rapidly the affordable housing market grows. The fiscal cost of donee status is based on reported public donations received by eligible CHPs. We also note that the fiscal cost is based on reported financial information that is not tax data so it is, at best, a proxy. For example, income measures reported in the charities' annual returns could include non-taxable income such as grants, which would tend to overstate the implied tax (or fiscal gain) and understate the implied forgone tax (or fiscal cost).

54. This fiscal cost would be counted against the tax policy work programme scorecard.

Social, environment or cultural impacts of all options

55. Providing support to affordable home-ownership providers could have the following social benefits:

- reduces pressure on the rental market;
- households achieve more permanent housing solutions – households that are assisted may have been very transient in their quest to find suitable rental accommodation options. Increased stability through home ownership could mean households are more inclined to become active members of their community, have more permanent access to education and employment options; and
- depending on eligibility requirements of the CHP, it supports households who are able to sustain a mortgage long-term but are unable to save enough for a deposit.

56. There are no environmental or cultural impacts associated with the options considered above.

Net impact of all options

57. The preferred option of the status quo (option four) does not address the specific problem raised by Ministers but it does achieve all of the stated objectives: aligning with the current tax policy settings, consistency with the Government's strategy for the tax system and not creating a barrier to building a more diverse and sustainable housing provider sector. At present it is not absolutely clear that the current law would not address the problem definition as articulated by Ministers, but until Charities Services has reviewed each eligible CHP involved in an affordable home-ownership provision, it is not possible to provide Ministers with the requisite level of certainty about who is affected.

58. The net impact of option one ensures that the specific problem definition is addressed, aligns with current tax policy settings, and is consistent with the Government's overall tax strategy for the tax system.

59. Options two and three address the problem definition and do not present a barrier to building a more diverse and sustainable social and affordable housing provider sector.

CONSULTATION

60. Inland Revenue has had several discussions with QLCHT and the Community Housing Association of Aotearoa to understand the impact of the loss of tax-exempt status on CHPs. In addition, the Community Housing Association of Aotearoa (a representative body in the community housing sector) provided a submission on the July 2013 officials' issues paper on *Clarifying the tax consequences for deregistered* charities, in which it outlined its views on the tax issues facing CHPs. The Association suggested that CHPs should be recognised as charitable in purpose and therefore eligible for tax exemption and donee organisation status (option 3).

61. Inland Revenue also conducted in-depth discussions with officials from the Ministry of Business, Innovation and Employment; the Treasury and the Department of Internal Affairs.

Ministry of Business, Innovation and Employment's view

62. The Ministry supports option four – the status quo because it meets the stated objectives and is consistent with the Government's longer term goal of creating a level playing field for social rental housing providers. From this perspective, it is appropriate that a consistent tax approach should apply to all classes of social rental housing providers (Government and non-Government; for-profit and not-for-profit). Within this general approach, providers that consider their purpose to be charitable should be free to apply for charitable status (as at present).

63. If the Government wishes to provide support to a tightly-defined group of eligible CHPs, the Ministry supports option one – direct funding, on the basis that it is fiscally more transparent than options two and three. They do not see any significant risk to the future social rental housing market if the support is limited to providers of home-ownership products to low-income families, as proposed.

The Treasury's view

64. The Treasury supports and endorses the views of the Ministry of Business Innovation and Employment. Like the Ministry, the Treasury supports option four – status quo with a second preference of option one. The Treasury does not support a tax exemption for the reasons outlined by Inland Revenue below. However, if a tax exemption becomes the preferred option, the Treasury's preference is for a tax exemption with objective income thresholds rather than one based on the more uncertain concept of "in poverty".

Department of Internal Affairs' view

65. The Department of Internal Affairs (Charities Services) does not support option three, which undermines the Charities Registration Board's statutory independence from ministerial direction. A loss of public confidence in the integrity of the charities registration process could have unintended consequences for charities that currently meet all registration requirements, and which are heavily reliant on donations. Option three does not offer any advantages over option two in terms of the objectives achieved, but it is likely to have a number of additional negative impacts. In the Department's view, option three raises similar issues to Option two in terms of what criteria would be used to "qualify" a CHP as a "deemed charity".

66. The Department does not support an alternative to an amendment to the definition of "charitable purpose" in the Charities Act 2005 that would require the Charities Registration Board to assess a CHP's eligibility for registration against criteria (including "deemed charitable status) specified in the Tax Acts.

67. Option three is inconsistent with Cabinet's November 2012 decision not to review the Charities Act 2005. At the same time, Cabinet decided it was not appropriate to conduct a separate review of the definition of "charitable purpose" [SOC Min (12) 24/3].

CONCLUSIONS AND RECOMMENDATIONS

68. Inland Revenue's preferred option is option four – the status quo because it best achieves the stated objectives. We consider that current tax policy settings underlying the charities-related tax concessions are appropriate. Linking eligibility to the tax concessions for charities to charities registration ensures that the tax concessions are appropriately targeted and policy intentions are met. Although we accept that eligible CHPs can face difficulties in readily determining whether they meet the legal tests for charitable status, this problem is temporary as Charities Services will eventually provide the requisite certainty when it carries out a thorough examination of each eligible CHP.

69. If the Government does wish to intervene to provide support to eligible CHPs, we support option one – direct funding on the basis that it is fiscally more transparent than options two and three. Options two and three are not supported as they are inconsistent with the Government's overall strategy for the tax system of having a broad base with low rates and few exemptions. Exemptions create boundaries between taxable and tax-exempt activities or entities, which creates complexity and compliance costs as people transition from one to another. Also, an exemption may give CHPs an incentive to focus on providing home-ownership products over other forms of housing products. Exemptions also present a risk to maintaining the revenue base, as other groups will seek to lobby the Government for similar treatment.

70. Inland Revenue supports the use of an "in poverty" test to define eligible CHPs for the reasons outlined in paragraph 39 and because the test would provide more flexibility to determine who should be a tax-exempt provider.

IMPLEMENTATION

71. The status quo and option one do not require legislation to implement. Option two would require changes to the Tax Acts and option three would require changes to the Charities Act 2005. Conferring specific donee status on CHPs would require a change to the Tax Acts.

72. The amendments to the Tax Acts could be included in the tax bill scheduled for introduction in November 2013. Amendments to the Charities Act 2005 would not be within the scope of the tax bill or the Social Housing Reform bill and so they will have needed to be included in a Charities Amendment bill. Ideally, any legislative amendments should apply from 14 April 2014, the date on which most of the proposals in the Social Housing Reform bill take effect.

73. Inland Revenue will communicate any legislative tax changes to CHPs and their advisors through its existing channels, such as the *Tax Information Bulletin* and by updating its guides.

74. Inland Revenue, Charities Services and the Ministry of Business, Innovation and Employment could work together to provide general guidance on charities law, tax law and housing to help CHPs transition to the new housing regime.

75. There are no significant implementation risks arising from the preferred option. Inland Revenue will assess any tax liabilities of CHPs as part of its business as usual.

MONITORING, EVALUATION AND REVIEW

76. There are no specific plans to monitor, evaluate and review the changes to the Tax Acts to give effect to the specific tax exemption or the donee organisation change (if adopted). If any detailed concerns are raised in relation to these changes, Inland Revenue will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

77. In general, Inland Revenue's monitoring, evaluating and reviewing of new legislation takes place takes under the GTPP. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.

Regulatory Impact Statement

Financial arrangements – agreements for the sale and purchase of property or services

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

The question in this RIS is whether the tax rules that apply to taxpayers for returning income and expenditure on agreements for the sale and purchase of property or services (the "arrangements") should be changed in order to:

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

Public consultation was targeted at business taxpayers, since non-business taxpayers do not generally have any significant arrangements of this type. The submissions received influenced the design of the options, particularly for the application dates and the rules recommended for taxpayers who do not use full accounting standards. Although the consultation pointed to the significant impact of the compliance costs and volatility, we are unable to quantify this impact and are not aware of any significant risk to the revenue base. Also, we assume that the overall net tax base effect across all affected taxpayers is fiscally neutral.

The analysis is based on the existing policy that the arrangements are treated as financial arrangements for tax purposes. The analysis also assumes that existing alternative methods in tax legislation for returning income and expenditure on financial arrangements are appropriate for the arrangements.

There are no other key gaps, assumptions, dependencies, significant constraints, caveats or uncertainties concerning the analysis.

None of the recommended options impair private property rights, reduce the incentives for businesses to innovate and invest, impose additional compliance costs, restrict market competition, or override fundamental common law principles.

Dr Craig Latham
Group Manager, Policy
Inland Revenue

5 December 2012

STATUS QUO AND PROBLEM DEFINITION

1. For tax purposes, agreements (other than short term agreements) for the sale and purchase of property and services (the "arrangements") are financial arrangements and are therefore subject to the financial arrangements (accruals) rules.

2. The arrangements are treated as financial arrangements because they can include interest due either to prepayments or to the deferral of payments for the property or services. The accruals rules were designed to include all arrangements that may include an interest component.

3. An example is an arrangement for the deferred settlement in six months' time for a commercial property where the parties agree that the property is worth $1 million when possession passes (ie. at the current time). However, due to the deferred settlement in six months, the purchaser will pay $1,025,000. The accruals rules treat $25,000 of the amount paid as interest paid/received by the purchaser/seller for the six-month deferral period.

4. The accruals rules also apply to the foreign currency ("FX") component of financial arrangements. In the above example, if the price of the property was denominated in US dollars, the accruals rules would capture the US$25,000 as interest. They would also capture any FX gains or losses on the US$1,025,000 from the possession date to the date of payment six months later.

5. The question in this RIS is whether to change the tax rules that apply to taxpayers for returning income and expenditure on agreements for the sale and purchase of property or services in order to:

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

Compliance

6. For many business taxpayers there are ongoing and unnecessary compliance problems and significant compliance costs with using the current tax rules. Although these tax rules apply to many imports and exports of goods (trading stock etc.) and services, New Zealand is generally an importer of capital equipment and the compliance problems and costs are mostly in this area. Most businesses that are affected will be larger companies, and generally they will use International Financial Reporting Standards (IFRS) for financial reporting (IFRS taxpayers).

7. IFRS taxpayers have sophisticated accounting systems which give an appropriate, but different, treatment of the arrangements for accounting purposes, including the FX and interest components. These taxpayers then have to maintain separate complex work papers and spread-sheets to calculate taxable income and expenditure for the arrangements. In many cases, taxpayers have to engage external accountants and tax agents to complete these tasks.

8. At present, a number of taxpayers, for various reasons, do not fully comply with the detail required by the tax rules. We have evidence of technical non-compliance by at least one taxpayer, although, to date, this has not affected the tax take. During consultation we became anecdotally aware that a few other taxpayers might not be complying with the detail of the

rules (for example, the Corporate Taxpayer Group acknowledged certain technical non-compliance).

9. We are aware that there are significant compliance costs caused by the current rules. While this is not a formal estimate, after informal discussions with the two major submitters we believe that the compliance cost savings would be in the order of $3 million to $5 million per annum. This would be because separate tax calculations by most importers of capital equipment (the IFRS taxpayers) would not be required if the proposals in this paper are adopted. As is noted below, the major IFRS submitters explicitly noted this compliance cost reduction.

Tax volatility (and revenue fluctuations)

10. The rules can result in volatile taxable income or expenditure. As a consequence, the revenue collected also suffers from this volatility. The tax volatility is the result of using forward exchange rates for the arrangements when matching hedging arrangements are not used to offset the FX risks. Although this is not the case for the majority of taxpayers, the impact on the taxable income of those who are affected can be very significant in any income year.

11. A simple FX volatility example might concern an unhedged contract to buy a depreciable asset for delivery in twelve months. The forward rate at the date the contract is entered into is .8, at the intervening balance date it is .72. The ten percent movement, when multiplied by the contract cost of the asset results in a deductible loss for the year to the balance date. Where the asset is large (as is frequently the case for fixed assets) the volatility can be significant.

12. Then suppose the loss reverses and the currency to settle is purchased at .8. The previously reported book loss totally reverses in the next year. If the cost of the asset is $100 million, then the volatility is $10 million for each of the years, even though, in this case it is net nil over both years. Further, IFRS accounting will completely ignore both of these movements.

13. Although we are unable to quantify the level of volatility across the tax base, we are aware that, for some taxpayers, the volatility can be very significant when compared to their core taxable income.

Inappropriate tax outcomes where no economic interest income or expenditure

14. The rules allow interest income or expenditure to be imputed in some cases where it does not exist economically. This conflicts with the tax policy for financial arrangements which seeks to tax only the final economic income or expenditure over the life of the arrangement. Any advantages resulting from the imputation of non-economic interest into arrangements are counter to the policy intent of the accruals rules, and are therefore inappropriate tax outcomes.

15. The deductions for imputed interest could give significant timing advantages to taxpayers, and taxable income could be artificially reduced (although the impact of the deductions should reverse on maturity of the arrangements). For example, where plant and equipment are imported, deals may be structured to convert some of the capital cost of depreciable assets into a notional interest charge. The consequent timing advantage would not reverse until the assets are fully depreciated. As New Zealand taxpayers are significant

importers of plant and equipment there is, at least conceptually, scope to structure arrangements to obtain this timing advantage.

16. At present, we are not aware of any significant risk to the revenue base of this.

OBJECTIVES

17. The objectives are to:

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

REGULATORY IMPACT ANALYSIS

18. There are four options considered for the FX component of the arrangements (FX in the table below) and three options for the interest component (INT in the table below) that wholly or partly achieve the desired objectives. These options (some of which are co-recommendations as noted) are highly technical in nature and we have sought to summarise the options in the table, which also outlines the economic and compliance implications. Otherwise, no fiscal, social environmental or cultural costs are expected to arise under the recommended options.

19. Although the recommended option(s) reduce compliance costs significantly, all of the potential changes alter the timing of tax obligations rather than the amount of tax payable. The timing outcomes for different transactions and different taxpayers will differ: for some taxpayers the changes will result in a bring-forward of tax whilst for others they will give a delay. Because of the wide range of taxpayer specific circumstances and the interaction of these circumstances with foreign exchange movements, the overall net effect is assumed to be fiscally neutral.

Options	Costs	Benefits	Recommendation & impact (compared to *status quo*)
FX 1: use spot FX rates without hedge accounting	- No overall reduction of compliance costs for IFRS taxpayers who hedge the arrangements. - No reduction in volatility of taxable income for taxpayers who hedge the arrangements. - May not increase voluntary compliance.	- Non-IFRS taxpayers would have reduced compliance costs.	**Not recommended.** **Net impact:** marginally positive.

FX 2: use forward FX rates with an expected value alternative (which does not tax unrealised FX gains/losses)	- May increase planning opportunities in some circumstances.	- Reduced compliance costs for taxpayers with unhedged arrangements. - Reduced volatility of taxable income for taxpayers with unhedged arrangements.	**Not recommended.** **Net impact:** marginally positive.
FX 3: use spot FX rates with hedging (giving IFRS accounting equivalent results)	- At the margin planning risks may be increased for IFRS taxpayers.	- Taxpayers would have reduced compliance costs. - Non-IFRS taxpayers would have less volatile taxable income.	**Recommended** for non-IFRS taxpayers who consistently include FX hedging amounts in values for trading stock and depreciable assets in their accounting systems. **Net impact:** marginally positive.
FX 4: follow accounting treatment, especially for IFRS taxpayers and non-IFRS taxpayers who elect to use IFRS accounting	- At the margin non-IFRS taxpayers may be able to adopt inappropriate tax treatments/increase planning risks.	- Significant compliance cost savings for the IFRS taxpayers. - Significantly reduces volatile taxable income for the IFRS taxpayers.	**Recommended** for IFRS taxpayers and non-IFRS taxpayers who have adopted IFRS GAAP accounting. **Net impact:** significantly positive.
INT 1: interest for tax when the parties explicitly agree it (all taxpayers)	- May not discourage planning opportunities for arrangements between NZ and overseas-related parties.	- Significantly reduces compliance costs for all taxpayers. - Reduces planning risks. - Accords with commercial reality and may therefore encourage voluntary compliance.	**Not recommended.** **Net impact:** positive, but not the most beneficial option.
INT 2: current general rules but only in very restricted circumstances	N/A	- Reduces compliance costs. - Reduces planning risks.	**Recommended** for non-IFRS taxpayers. **Net impact:** positive, but not the most positive for IFRS taxpayers.
INT 3: follow accounting treatment	- Not available for non-IFRS taxpayers, so they would use option INT 2 above.	- Significantly reduces compliance costs for IFRS taxpayers. - Reduces planning risks for IFRS taxpayers.	**Recommended** for IFRS taxpayers, with option INT 2 for non-IFRS taxpayers. **Net impact:** the most positive option overall.

CONSULTATION

20. The full Generic Tax Policy Process GTPP) was followed for consultation. An issues paper was released in July 2012, seeking consultation on the tax treatment of these arrangements. Seven submissions were received in response to the issues paper. The submissions reflect the views of the Corporate Taxpayer Group (33 IFRS taxpayers); two individual IFRS taxpayers (members of the Corporate Taxpayer Group); three of the large accounting practices; and the New Zealand Institute of Chartered Accountants. As a result,

alternative solutions for the tax treatment of the arrangements were considered and are covered in this RIS for options FX 3, FX 4 and INT 2 above.

21. All the submissions support the general direction of the suggested changes to the tax rules for these arrangements. The submissions made by the Corporate Taxpayer Group and the two individual IFRS taxpayers were explicit and unanimous that the proposals for IFRS taxpayers provide compliance costs savings and eliminate the volatility between accounting and tax positions. Naturally submitters were more reticent on the present non-compliance with the technical detail of the rules, but the Corporate Taxpayer Group's submission did acknowledge this technical non-compliance.

22. The Corporate Taxpayer Group's submission agreed with all the substantive suggestions about the IFRS accounting treatment for tax, except the suggestion for the imputation of IFRS interest in arrangements when the parties have not agreed that there is interest. This matter has been discussed with the submitters and the outcome of those discussions (and other discussions) is reflected in the summary of the submissions in the table below:

	Submission	**Officials' comments**	**Impact on proposals**
1.	IFRS treatment of interest should not override lowest price clauses or interest agreed commercially.	IFRS should reflect the commercial reality of most arrangements and therefore is appropriate.	No change to proposed IFRS treatment of interest.
2.	An expected value method which does not tax unrealised FX gains/losses should apply to the current FX forward rate treatment.	This may allow some taxpayers to eliminate the volatility of taxable income but does not have any advantages over using spot rates or following the accounting treatment.	No change to the proposed treatment of the FX component.
3.	The FX component proposed spot exchange rate treatment should be further considered for non-IFRS taxpayers	We agree with the submission and propose more flexibility.	Some hedging treatment is to be allowed for trading stock and depreciable assets where it is used in accounting systems, and IFRS accounting would be allowed for non-IFRS taxpayers who choose to adopt IFRS accounting.
4.	Interest should not be imputed into arrangements for non-IFRS taxpayers where it has not been agreed commercially.	The rules for non-IFRS taxpayers are mirroring the IFRS treatment and are appropriate. Significant complexity has been removed for non-IFRS taxpayers.	No change to the proposed changes for the interest component for non-IFRS taxpayers.
5.	For existing arrangements transitional rules – a case-by-case transitional approach under care and management should apply, rather than the proposed legislative approach.	The proposed legislative approach for transition is compliance friendly and poses no fiscal risk. The submission is not considered workable and would cause compliance difficulties.	One change to the original suggestions is proposed for IFRS taxpayers who would be allowed to use the IFRS treatment of new forward exchange contracts designated as hedges of existing arrangements.
6.	The mandatory application of the proposed new rules should not apply from the 2012-13 income year as most taxpayers are already well into that year.	We agree with the submission.	We now propose that the new rules should apply from the 2013-14 income year. However, IFRS taxpayers would be able to elect to apply them from the 2011-12 income year.

CONCLUSIONS AND RECOMMENDATIONS

23. Based on the above analysis our conclusions and recommendations are set out below.

IFRS taxpayers – FX and interest components

24. The IFRS treatment would be mandatory for taxation purposes for IFRS taxpayers (option **FX 4** above and option **INT 3** above). The suggested IFRS treatment would not extend to any capitalisation of interest paid (e.g. bank interest) into the cost of the underlying item.

25. There are significant compliance benefits for IFRS taxpayers to use the IFRS accounting treatment for both the FX and interest components for returning income and expenditure for tax on these arrangements. Following the IFRS treatment for tax also reduces the volatility between accounting income and taxable income, which is a primary concern for some IFRS taxpayers.

26. The submission of the Corporate Taxpayer Group (representing the 33 corporate IFRS taxpayers) agrees with the mandatory IFRS treatment. The submission does raise a question about overriding any contractual interest in these arrangements with the IFRS imputation of interest. However, after discussion and consideration, we conclude that the IFRS treatment of interest would reflect the contractual position in most, but not all, cases.

Non-IFRS taxpayers

27. ***FX component*** – the general rule to value the property or services denominated in foreign currency would be the aggregate of the NZ dollar amounts using actual spot exchange rates at payment dates/recognition dates (including an appropriate accounting treatment in some cases, which can be the IFRS treatment where it is adopted for financial reporting) (option **FX 3** above). There would be two exceptions:

- for trading stock and consumables, any FX variations from hedges would be included in the value of the stock where they are included in the stock values in the taxpayer's stock system; and
- for depreciable property, FX variations from "qualifying" hedges would be included in the value of the property where it is also included for tax depreciation calculations.

28. ***Interest component*** – interest would only be imputed in the agreements on a future value or discounted value basis in limited circumstances (option **INT 2** above).

29. Non-IFRS taxpayers would continue to have some compliance issues with the proposed treatment of these arrangements. This is inevitable, given the wide range of businesses that do not use IFRS or do not have to prepare general purpose financial reports at all. The proposed new rules for these taxpayers are designed to be as compliance-friendly as possible, and allow some pragmatic choices to be made. They will still be simpler than the present rules.

IMPLEMENTATION

30. We propose that the new rules generally be made effective for new agreements from the 2013–14 income year. We consider that this would be the least disruptive application date for

the majority of taxpayers, and will not impact on provisional tax payments for current income years.

31. However, we propose that IFRS taxpayers can make a once-and-for-all election to apply the IFRS accounting treatment to new arrangements from the 2011-12 income year. This would include any designated hedges, the cost of the underlying item and any interest component. Officials consider that there is no risk to the revenue base from allowing this treatment from the 2011-12 income year.

32. We also propose that the tax treatment for any existing agreements, associated hedges and the underlying property or services for income years before 2013–14, where the methods used are the proposed new rules, be validated retrospectively. We understand that many IFRS taxpayers are effectively using the IFRS treatment for tax, especially where the arrangements are hedged for accounting purposes. We also understand that many non-IFRS taxpayers will be basing the tax treatment on their hedge accounting treatment of trading stock and depreciable assets. The past tax treatment of the arrangements in foreign currency, and the valuation of the underlying property or services in those arrangements based on spot exchange rates at payment and/or rights dates, would also be validated.

33. We consider that existing positions should be confirmed to prevent unnecessary disputes, as those treatments cause only some timing differences compared to the current rules. Existing agreements would continue to use the treatment they adopted in returns before the 2013–14 income year until they mature – that is, agreements would not be allowed to change to another current or new alternative method. This would prevent the rules from being cherry picked and would also prevent risks to the revenue base. However, there would be one exception whereby IFRS taxpayers can elect that forward exchange contracts entered into from the 2011–12 income year, which are designated as hedges of the FX risks on existing arrangements, can follow the IFRS accounting treatment for tax.

34. The new rules would be administered by Inland Revenue through existing channels. There are no systems or design matters specifically catering for the arrangements which need to be addressed for the new rules. Taxpayers would continue to make any calculations for the arrangements not already included in the financial accounts and include the appropriate amounts in their tax returns. A Tax Information Bulletin item would be published, fully explaining the new rules for taxpayers and Inland Revenue employees when the legislation is passed.

MONITORING, EVALUATION AND REVIEW

35. Officials would informally monitor the introduction and transition to the proposed new rules to ensure consistency with the underlying policy framework.

36. Given the impact of the proposals on a relatively small number of taxpayers and the involvement of a number of key representative bodies, where any issues are raised officials would determine whether there are substantive grounds for review under the GTPP.

37. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the GTPP. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves a post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, changes identified as necessary for the

new legislation to have its intended effect would generally be added to the tax policy work programme, and proposals would go through the GTPP.

Regulatory Impact Statement

The taxation of land-related lease payments

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

The problem addressed in this statement is whether the different tax treatment of similar land-related lease payments is appropriate and, if not, how it should be changed.

The current tax treatment of land-related lease payments can produce inconsistent and incoherent outcomes for taxpayers. One of the main problems identified in this RIS is the inconsistent treatment of lease surrender payments and lease transfer payments. The current non-taxable status of lease transfer payments, in tandem with taxable lease surrender payments, can distort business decisions when leases are sold.

This RIS provides an analysis of options that provide a fair and efficient tax treatment of land-related lease payments by:

(i) removing a tax advantage associated with lease transfer payments that has an effect of distorting business decisions on leases and licences of land.

(ii) aligning the tax treatment of similar leases and licences of land for consistency and certainty.

The preferred approach would have additional costs for certain businesses, in particular, certain circumstances in which commercial tenants sell their lease to a third party. Residential tenants would not be affected by the reform targeting lease transfer payments made in substitution for lease surrender payments. The reform would address a risk to the tax base by preventing non-taxable lease transfer payments being substituted for taxable lease payments, such as lease surrender payments and lease premiums. The reform would also affect taxpayers (landlords and tenants) with certain rights to use land, in particular, Glasgow leases (perpetually renewable leases), permanent easements (perpetual rights of way), consecutive leases (multiple leases granted to a person or their associates), and licences to occupy land.

Revenue estimates for the targeted reform have not been quantified because the identified revenue risk arises from lease surrender payments only becoming taxable from 1 April 2013. Previously, lease surrender payments were non-taxable to the exiting tenant. However, we expect that the identified revenue risk would increase over time if the status quo is retained.

No significant administrative or compliance implications arise from the targeted reform. Except as noted in this statement, none of the policy options impair private property rights, provide disincentives to innovate, or override common law principles.

Peter Frawley
Policy Manager, Policy and Strategy
Inland Revenue

24 July 2013

STATUS QUO AND PROBLEM DEFINITION

Status quo

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

2. Notwithstanding this general principle, the Income Tax Act 2007 (the Act) specifically provides for the tax treatment of certain land-related lease payments. The table below summarises the tax treatment of certain commercial land-related lease payments that are covered in the Act.[1]

Payment type	Income	Deductions
Payments relating to a lease or licence to use land, such as rents, fines, premiums or other revenues	Taxable	Generally deductible
Payments for non-compliance with covenant to repair	Taxable	Generally deductible
Contributions for fit-out costs[2]	Taxable	Generally deductible
Lease inducement payments	Taxable	Generally deductible
Lease surrender payments	Taxable	Generally deductible

3. The Act does not provide comprehensive coverage of all land-related lease payments. The tax treatment of other land-related lease payments, which are not specifically covered under the Act, is determined under general principles as described in paragraph 1.

Problem definition

4. The Act's treatment of land-related lease payments can produce inconsistent and incoherent outcomes for taxpayers. The Act treats similar lease payments differently for income tax purposes, which can result in a tax advantage that has the effect of distorting business decisions on leases and licences of land.

Inconsistent tax treatment between lease surrender payments and lease transfer payments

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

6. The current non-taxable status of lease transfer payments, in tandem with taxable lease surrender payments, can distort the commercial decisions of the exiting tenant. As lease transfer payments are generally not taxable, it would be tax advantageous for a tenant to exit a

[1] The recently enacted Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 includes land-related lease inducement payments and lease surrender payments amendments.

[2] These payments are generally paid by landlords to prospective tenants to enter into a commercial lease with a specific contractual requirement to spend the amount on fit-out.

lease by transferring the lease to a third party for a tax-free lease transfer payment, rather than surrendering it to a landlord for a taxable lease surrender payment.

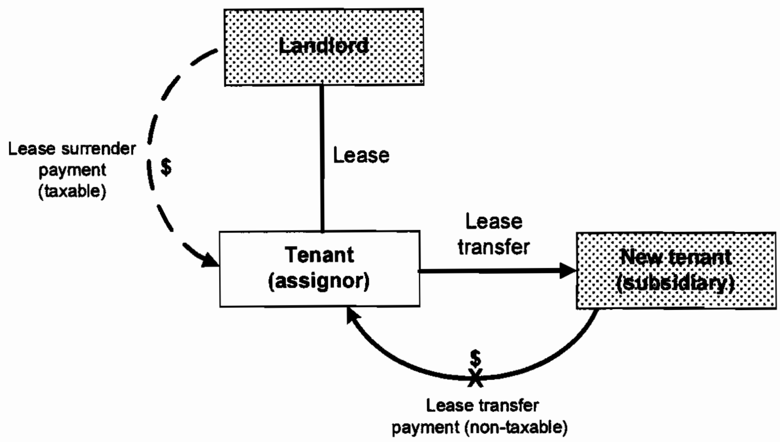
7. From the outgoing tenant's perspective, there is no economic difference (putting tax aside) between surrendering the lease to the landlord and transferring it to a third party. The effect is the same – the tenant exits the lease and receives consideration for it. Treating similar payments differently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

Example

On 1 April 2014, a landlord and a tenant enter into a 10-year lease. After three years, the landlord expands their business to retail, by setting up a subsidiary company. The landlord wishes the tenant to exit the lease so that the subsidiary company can use the premises to carry on its retail business.

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

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



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

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

9. The size of the risk is not quantifiable because the problem arises from lease surrender payments only becoming taxable to the exiting tenant from 1 April 2013. Previously, lease surrender payments were non-taxable to the exiting tenant. We expect that the identified risk would increase over time if the status quo is retained.

Problems with other land-related lease payments

10. Other problems include the following:

A. *Treatment of similar leases and licences of land:* Similar leases and licences of land can be treated differently for income tax purposes. For example, Glasgow leases (perpetually renewable leases) and permanent easements (perpetual rights of way) are similar to freehold land, but they are treated as leases. Also, consecutive leases (multiple leases granted to a person or their associates) are, in substance, similar to holding a single lease, but they are treated as separate leases under the depreciation rules. Lastly, certain licences to occupy land are subject to the financial arrangement rules, whereas leases of land are excluded from such rules.

B. *Treatment of overall land-related lease payments:*

   a. *Income and deductions:* The rules can produce gaps, which mean that similar payments can be treated differently. For example, payments for the grant of a lease (lease premium payments) are generally deductible to a tenant, but payments to modify or waive terms of a lease (lease modification payments) are generally non-deductible to the tenant. Also, payments for the transfer of a lease (lease transfer payments) are generally non-taxable to an exiting tenant. but payments to induce the transfer of a lease (lease inducement payments) are taxable to an incoming tenant.

   b. *Timing rules:* The existing timing rules provided for different types of payments vary because they were developed separately over the years. For example, a landowner receiving lease premium payments may spread the income over six years but a tenant receiving lease inducement payments spreads the income over the term of the lease.

11. The problem addressed in this statement is whether the different tax treatment for similar land-related lease payments is appropriate and, if not, how it should be changed.

OBJECTIVES

12. The objective is to provide a fair and efficient tax treatment of land-related lease payments by:

(i) removing a tax advantage associated with lease transfer payments that has an effect of distorting business decisions on leases and licences of land.

(ii) aligning the tax treatment of similar leases and licences of land for consistency and certainty.

REGULATORY IMPACT ANALYSIS

Policy options

13. Three options have been considered on the tax treatment of land-related lease payments, particularly lease transfer payments:

- **Option 1 (preferred approach)**: introduce a targeted reform that would address revenue risk by making lease transfer payments taxable, and provide consistency and certainty for certain leases and licences of land. In particular, the reform would:

  (i) amend the tax treatment of certain lease transfer payments to prevent them being substitutable for taxable lease surrender payments or lease premiums.

  (ii) amend the tax treatment of certain leases and licences of land so that:

    - "Glasgow" leases (perpetually renewable leases) are treated similarly to freehold land for depreciation deduction purposes
    - permanent easements (perpetual rights of way) are treated similarly to freehold land for income tax purposes
    - consecutive leases (multiple leases granted to a person or their associates) are treated as a single lease for depreciation deduction purposes
    - certain licences to occupy land are excluded from the financial arrangement rules.

- **Option 2**: introduce a broad reform that would provide a consistent treatment for all leases and licences of land. In particular, the reform would treat all commercial land-related lease payments as taxable and deductible by introducing a bright-line rule of 50 years for leases and licences of land. As result, leases or licences of land lasting less than 50 years would be put on revenue account, which would cover most commercial leases and licences of land. Leases or licences of land lasting 50 years or more would be put on capital account, which would provide a similar tax treatment to most freehold land.

- **Option 3:** retain the status quo.

14. Option two (broad reform) was suggested by officials in the issues paper, *The taxation of land-related lease payments*, released for consultation in April 2013. Option one (targeted reform) arose from consultation on that issues paper.

15. Officials' analysis of the options is summarised in the following table.

Options	Disadvantages	Advantages	Net impact
One: introduce a targeted reform that would: • address revenue risk with lease transfer payments by making them taxable; and • provide consistency and certainty for certain leases and licences of land *(targeted reform)*	• Retains various tax rules relating to leases and licences of land • Increased tax costs to certain businesses over time, mainly from making certain lease transfer payments taxable	• Targeted base maintenance measure with minimal disruptions to the tax landscape • Limits tax arbitrage opportunities when commercial leases are sold, preventing future revenue loss • Ensures substitutable payments are treated the same • Provides consistency and certainty for certain leases and licences of land • Revenue gain over time, mainly from making certain lease transfer payments taxable	Preferred option Improvement on the status quo and addresses disadvantages under option two – this option prevents future revenue risk, provides consistency and certainty for certain leases and licences of land, and minimises disruptions to the tax landscape
Two: introduce a broad reform by introducing a bright-line test of 50 years for all leases and licences of land. *(broad reform)*	• May increase compliance costs from uncertainties and boundary issues • Creates new distortions (e.g., with the 50-year threshold) • Inconsistent tax treatment between land rules and lease rules • Increased tax costs to businesses over time, mainly from making lease transfer payments taxable	• Consistent tax treatment of leases and licences of land • Removes tax arbitrage opportunities – e.g., removes distortions between taxable and non-taxable lease payments – preventing future revenue loss • Provides certainty of tax treatment for commercial lease payments, increasing efficiency • Removes non-deductible business expenditure ("black hole expenditure") • Revenue gain over time, mainly from making lease transfer payments taxable	Not preferred Improvement on the status quo, but may disrupt the existing tax landscape by introducing new distortions
Three: retain status quo	• Potential future revenue loss – does not address tax arbitrage opportunities • Existing tax advantage distorts business decisions when leases are sold • Less consistency on tax treatment of similar rights to use land • Less consistency on tax treatment of land-related lease payments	• Tax benefits to commercial tenants who are exiting leases – may encourage using non-taxable lease transfer payments in substitution for taxable lease payments, such as lease surrender payments	Not preferred Maintains the status quo (tax arbitrage opportunities, inconsistent outcome)

Impacts of all options

16. The economic and fiscal implications of the options are outlined in the table above. There are no significant compliance and administrative implications arising from the options. No social, environmental or cultural impacts are expected to arise under the options.

CONCLUSION AND RECOMMENDATIONS

17. Our preferred approach is the targeted reform in option one. By introducing a targeted reform, this option would sufficiently address the specific revenue risk with lease transfer payments. This option would also provide consistency and certainty for certain land rights such as Glasgow leases and permanent easements.

18. We do not prefer the broad reform in option two, which was suggested in the April 2013 issues paper. By putting leases and licences of land lasting less than 50 years on revenue account, new distortions and uncertainties may arise, disrupting the existing tax landscape. It would also increase compliance costs. Therefore, our preferred option is the targeted reform in option one because it minimises disruptions to the tax landscape (as highlighted in submissions), while addressing revenue risk concerns.

19. Option three is not preferred because it does not meet any of the objectives – the current tax treatment of lease transfer payments poses a risk to the tax base, which is a result of an existing tax advantage distorting business decisions on leases. Although the size of the risk is not quantified because it has only recently arisen, the risk is expected to be realised when the leasing market tightens. The objectives cannot be resolved without legislatively modifying the capital-revenue boundary for certain lease transfer payments.

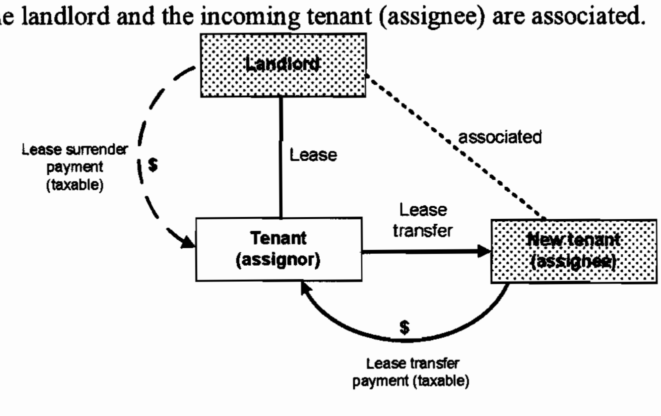
20. The recommended option would involve enacting specific legislative provisions in the Income Tax Act 2007 to treat certain lease transfer payments as taxable to prevent them being substitutable for taxable lease premiums ("key money") or lease surrender payments. This would remove the risk of existing business decisions being distorted by the tax benefits of non-taxable lease transfer payments.

Example of lease transfer payments that would become taxable under the targeted reform

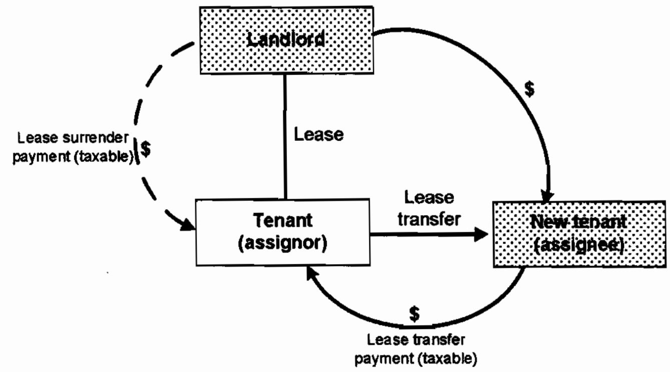
Disguised lease surrender payments

A lease transfer payment received by an outgoing tenant (assignor) would be made taxable if:

(1) The landlord and the incoming tenant (assignee) are associated.

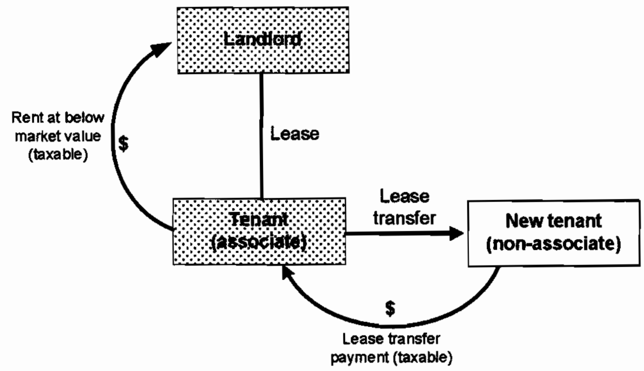


(2) The landlord and the incoming tenant (assignee) are not associated, but the lease transfer payment to the outgoing tenant is fully or partially funded by the landlord.[3]



Disguised lease premiums

A lease transfer payment received by an outgoing tenant (assignor) would be taxable if a landlord and the outgoing tenant are associated. This would supplement an existing anti-avoidance provision in section GC 5 of the Income Tax Act 2007, which allows the Commissioner to set an adequate level of rent for leases between associates.



21. Also, the recommended option would involve making the following amendments to the Income Tax Act 2007. These amendments would provide consistency and certainty of the tax treatment of certain leases and licences of land.

- Permanent easements would be treated akin to freehold land for income tax purposes because of their permanent nature. Accordingly, a payment for a permanent easement would not be treated as taxable income to the grantor under the existing lease rules (section CC 1)[4] and a payment for a permanent easement would not be deductible to the grantee under the depreciation rules.

- Glasgow leases would be treated akin to freehold land for depreciation deduction purposes because they are perpetually renewable. A payment for a Glasgow lease would be non-deductible because these leases would be treated as non-depreciable property. This would prevent tenants of Glasgow leases claiming depreciation loss when these leases are sold.[5] Note that lease premiums for Glasgow leases will

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[3] Note that the payment from the landlord to the new tenant is taxable to the new tenant and deductible to the landlord under sections CC 1B, DB 20B and EI 4B of the Income Tax Act 2007.

[4] Note that permanent easements continue to be subject to the existing land sale rules and may be taxable in certain circumstances.

[5] Under the current tax rules, "the right to use land", which includes Glasgow leases, is contained in the list of depreciable intangible property in schedule 14 of the Income Tax Act 2007. Usually, a commercial tenant of a lease can claim depreciation deductions for their cost to acquire the lease (i.e. a lease premium or lease transfer payment) over the term of the lease. However, a tenant under a Glasgow lease cannot claim depreciation deductions during the term of the lease because these leases have a perpetually renewable lease period, and

continue to be taxable income to the landlord under the existing lease rules (section CC 1), because they are easily substitutable for periodically reviewed taxable rent payments on the ground lease.

- Consecutive leases, which are multiple leases that are granted to the same person or an associated person, would be treated as one lease for depreciation deduction purposes. This is a base maintenance measure that would prevent taxpayers entering into consecutive leases to accelerate depreciation deductions for a lease.

- Certain licences to occupy land, which are an "occupation right agreement" as defined in the Retirement Villages Act 2003, would be excluded from the financial arrangement rules. This would ensure that licences to occupy land are treated similarly to leases of land under the financial arrangement rules and provide certainty that retirement village residents are not subject to these rules.

22. Inland Revenue has consulted with the Treasury, which agrees with the analysis and recommended option.

CONSULTATION

23. The reform to leases and licences of land was consulted on in an officials' issues paper, *The taxation of land-related lease payments*, released in April 2013. A broad reform to leases and licences of land was suggested by putting all leases and licences of land lasting 50 years on revenue account. Nine submissions were received from taxpayers, tax advisors, New Zealand Law Society and New Zealand Institute of Chartered Accountants.

24. On the policy rationale for the broad reform, the majority of the submissions opposed the broad scope of the land-related lease payments reform as suggested in the paper. One of the main criticisms was that shifting the capital-revenue boundary to make lease transfer payments taxable amounted to a type of capital gains tax. Some submissions suggested that the identified revenue risk could be addressed by introducing a more targeted rule.

25. Also, concerns were raised about introducing a bright-line test for putting leases or licences of land lasting less than 50 years on revenue account. Some suggested that the reform in this area would not provide a more consistent and coherent income tax treatment because it would remove one distortion (lease transfer payments and lease surrender payments), but introduce another (the 50-year threshold).

26. Some believed that the broad reform would introduce new anomalies and distortions into the tax system, which would not achieve the objective of the reform and would increase compliance costs. A number of examples were given where boundary issues and uncertainties would arise, particularly regarding the scope of the reform and the bright-line test. Also, there were questions as to how the new rules would interact with other parts of the Income Tax Act 2007.

27. Officials considered the submissions in light of the main base-maintenance policy rationale of the reform, and modified the proposals. The proposals target specific revenue concerns and provide consistency and certainty of the tax treatment for certain land rights.

therefore there is no finite period that the lease can depreciate over as required in the tax depreciation rules. However, the tenant may be able to claim a depreciation loss when the Glasgow lease is sold, if they are expected to decline in value.

The targeted approach is preferable to a broad reform approach, as suggested in the issues paper, because it minimises disruptions to the tax landscape.

28. Specific submissions were received on the technical details of the proposals in the issues paper, if the broad reform went ahead. The table below outlines key concerns and suggestions raised in submissions and officials' response.

Key concerns raised	Officials' response
The cost of finite leases should continue to be depreciable. If the lease that lasts 50 years or more is sold with less than 50 years remaining, the lease should not be on capital account.	The concerns raised in submissions with the broad reform are addressed by recommending the targeted reform. The issues raised do not arise under the targeted reform.
No imputed or deemed income should apply to lease transfers between associates.	Same as above.
Not clear why the fit-out contribution change was not contemplated as part of the lease inducement changes.	The fit-out contribution change did not form part of the lease inducement reform because that reform covered inducement payments that are not already covered in the Income Tax Act 2007. The existing capital contribution rule provides a specific treatment for fit-out contribution income.
All land rights relating to residential premises could be excluded instead of the proposed residential tenant exclusion.	The existing residential tenant exclusion in the lease surrender payments rules would be introduced for lease transfer payments that are in substitution for taxable lease surrender payments.
The deductibility of lease payments should be determined solely by reference to the payer of a payment to provide symmetry with the income provision. Also, the deductibility of all expenses related to land rights should be made explicit as a consequence of categorising certain land rights as revenue account property.	The concerns raised in submissions with the broad reform are addressed by recommending the targeted reform. The issues raised do not arise under the targeted reform.
Glasgow leases should not be treated as leases because they are akin to holding freehold land.	We agree. Given the unique feature of Glasgow leases, they should be treated similarly to freehold land. Accordingly, Glasgow leases should be excluded from being depreciable property under the tax depreciation rules.
A permanent easement should form part of the cost base of a depreciable asset because they are inextricably linked to the asset.	We disagree. Given the permanent nature of these easements, they are akin to freehold land and should be treated similarly for tax purposes.
The proposed definition of consecutive leases would result in uncertainties.	Treating consecutive leases as one lease is necessary to prevent acceleration of deductions on leases or licences of land. Uncertainty concerns raised in this submission will be considered further when developing draft legislation.
Not clear whether it is necessary to deem licence to occupy as an excepted financial arrangement given the Commissioner's Determination S16.	It is necessary to exclude certain licences to occupy land from the financial arrangement rules. To ensure that licences to occupy land are treated similarly to leases of land under the financial arrangement rules, and provide certainty that retirement village residents are not subject to these rules.
Under the proposed transitional rule, there is a possibility of unintended consequences if "the right to use land" is removed from the depreciation rules. Also, the "right to use land" acquired before the application date should continue to be treated as depreciable property.	The concerns raised in submissions with the broad reform are addressed by recommending the targeted reform. The issues raised do not arise under the targeted reform.
Compliance costs would increase for taxpayers because there will be valuation and apportionment issues when leases are transferred as part of business sales. Also, various uncertainties and boundary issues would add to compliance costs.	Concerns regarding compliance costs are largely addressed by introducing a targeted reform.

IMPLEMENTATION

29. The necessary legislative change would apply from 1 April following the enactment of the amending legislation.

30. There are no significant compliance issues arising from the amendment. The following taxpayers would be affected as follows:

- The recipients of certain lease transfer payments would be required to pay tax on the payments.
- The grantors of permanent easements would not be required to pay tax on the payments for these easements.
- Tenants with Glasgow leases would not be able to claim a depreciation loss when these leases are sold.
- The tenants of consecutive leases would be required to treat these leases as one lease for depreciation deduction purposes.

Individual residents with certain licences to occupy retirement villages would not be affected by the financial arrangement rules.

31. The changes will be communicated to taxpayers and tax advisors when the Minister of Revenue makes an announcement on the contents of the relevant tax bill when it is introduced into the House. Inland Revenue will also publish details of the changes in a *Tax Information Bulletin* once the tax bill containing the amendments is enacted.

32. There are no significant administrative issues arising from the amendment.

MONITORING, EVALUATION AND REVIEW

33. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007. If any specific concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

34. In general, Inland Revenue monitors, evaluates and reviews new legislation under the GTPP. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and identifies any remedial issues. Opportunities for external consultation are also built into this stage. In practice, changes identified as necessary for the new legislation to have its intended effect would generally be added to the tax policy work programme, and specific proposals would go through the GTPP.

Regulatory Impact Statement

Review of the substituting debenture rule

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address concerns with the substituting debenture rule (the "rule"). The concerns have been raised largely by taxpayers and relate to uncertainty as to how and when the rule is intended to apply. The rule has the effect of recharacterising shareholders' debt in a company as equity in that company where the debt is issued to shareholders in the same proportion as the level of equity the shareholders have in the company. As a consequence, the company is denied a deduction for interest paid on the shareholder debt and the interest payments are treated as dividends paid to shareholders for tax purposes.

Concerns with the rule have been raised by a number of external parties. In response to these concerns, Inland Revenue has undertaken a full review of the legislative history of the rule (dating back to 1940).

Officials have concluded that the rule is redundant and therefore recommend its repeal. The rule does not fit within the current policy framework (in particular, our imputation system), it is causing problems in practice and there are more targeted rules governing the tax treatment of debt and equity. It is also imposing unnecessary compliance costs.

Officials considered anecdotal evidence of the problems the rule is causing and a selection of taxpayers' cases. Officials do not know how many taxpayers this measure will affect because there is no quantitative data available on these instruments. There should be no fiscal implications for the repeal of the rule because it is so easily circumvented and there is likely to be some non-compliance from lack of awareness of the rule. Other than this, there are no key gaps or dependencies, assumptions, significant constraints, caveats or uncertainties concerning the analysis.

There has been targeted consultation on this measure with a number of taxpayers and their advisors. There is widespread support for the repeal of the rule.

The recommended policy option will not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles. In fact, repeal of the rule should reduce compliance costs for businesses and administrative costs for the government. It should also enhance the simplicity, integrity and coherence of the tax system.

Emma Grigg
Policy Director, Policy and Strategy
Inland Revenue

16 September 2013

STATUS QUO AND PROBLEM DEFINITION

Status quo

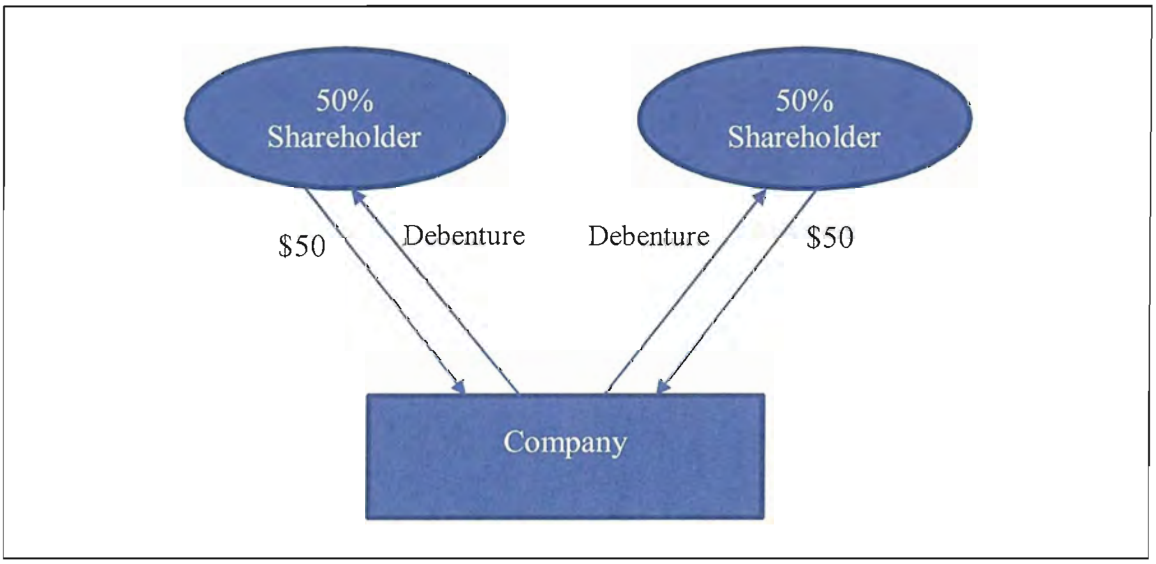
1. The Income Tax Act 2007 (Act) generally relies on the legal form of an investment (as debt or equity) to determine whether the returns are taxed in the shareholders' hands as dividends or interest and whether the company paying the return on the investment claims an interest deduction or not if it is a dividend. However, there are certain circumstances where it is appropriate or necessary for the tax treatment to depart from its legal form and rely instead on the economic substance of an arrangement. Rules that deem interest to be a dividend for tax purposes (or vice versa) are called 'recharacterisation' provisions.

2. The Act has three debt recharacterisation provisions (i.e. where investments that are in legal form debt are treated as equity for tax purposes):

- the substituting debenture rule;
- the profit-related debenture rule; and
- the stapled stock rule.

These were each introduced to protect the tax base in response to particular financing structures.

3. A number of tax commentators and advisers have raised concerns with the substituting debenture rule in section FA 2(5) of the Act.[1] This rule treats debt issued by a company to its shareholders by reference to their equity (most commonly debt issued in proportion to shares held) as equity for tax purposes. This means interest paid in respect of a substituting debenture is taxed as a dividend; it is non-deductible to the company and subject to imputation. A very basic example of this is shown below. In this example, the debentures would be recharacterised as shares in the company. Such debt is arguably economically equivalent to equity for the existing shareholders and this is, broadly speaking, the policy rationale for the recharacterisation.



[1] See for example, "The Substituting Debenture Rule - A compelling case for legislative euthanasia" by Casey Plunket and Kyle Rainsford in Taxation Today (April 2012) and "Shareholder loans rule shows age" by Greg Harris in the Waikato Times (1 July 2013).

Legislative history of the substituting debenture rule

4. The original substituting debenture rule was enacted in 1940 as an anti-avoidance measure to target transactions by companies who had converted (or planned to convert) some or all of their shares into debt. At this time, dividends were exempt and interest was taxable to the recipient, but it appears generally at a lower rate. It is also possible that the Government was concerned about the collection of tax from ultimate shareholders as the predecessor of resident withholding tax (RWT) was easily circumvented. Hansard is unclear on the exact nature of the 'avoidance' effected by the transactions.

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

6. In 1960 an exemption from the substituting debenture rule was introduced for debts that were able to be converted into shares (referred to as "convertible notes"). This exemption was introduced because, at this point in time, convertible notes were covered by a separate provision in the Land and Income Tax Act 1954 that deemed them to be equity.

7. In 1987 specific financial arrangement rules were introduced (the effect of these rules is to require the spreading of income and expenditure under financial arrangements). At this time convertible notes were treated as debt again. The substituting debenture rule was not amended at this time. Arguably the rationale for the convertible note exclusion in the current substituting debenture rule ceased to exist at this stage.

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

Problem definition

9. The root cause of the problems arising from the substituting debenture rule is that it does not fit comfortably within our current policy settings. There have been many changes to our tax system since the rule was introduced and given current tax settings (in particular the imputation regime), the rule no longer serves its original specific anti-avoidance purpose. There are a number of other, more targeted, rules that govern the tax treatment of debt and equity that have come in over time and overlap with this rule. This overlap is problematic as it reduces the coherence of our tax system.

10. In a practical sense, the provision in its current form has a number of flaws:

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

b) It is too narrow in other circumstances, and is easily circumvented and manipulated. For example, the rule does not apply where the debt is in the form of a convertible note[2] or where the loan is not made by the direct shareholder, but an indirect shareholder higher in the ownership chain. Taxpayers may also deliberately structure their funding as substituting debentures to take advantage of the equity recharacterisation. The ease with which the substituting debenture rule is manipulated may facilitate cross-border arbitrage, as taxpayers can effectively choose whether a debenture is treated as debt or equity for New Zealand tax purposes.

c) The policy rationale for excluding convertible notes from the ambit of the rule expired with the introduction of the accrual rules because at this time convertible notes were not covered by another section of the Income Tax Act 1976. The continued existence of the exclusion is anomalous and counterintuitive as a convertible note is perhaps one of the most equity-like debt instruments, yet is excluded from the recharacterisation rule.

d) The scope and the application of the rule are uncertain. This leads to increased compliance costs as taxpayers are inclined to seek advice (and even binding rulings[3]) on fairly straight forward transactions.

e) Furthermore, in light of the recent tax avoidance cases, taxpayers are becoming increasingly concerned about standard commercial transactions which seemingly circumvent the rule. It is difficult to determine whether Parliament's intention is frustrated when the policy issue the 1940 Parliament contemplated no longer exists given current policy settings.

11. Officials considered anecdotal evidence of the problems the rule is causing and a selection of taxpayers' cases. Officials do not know how many taxpayers this measure will affect because there is no quantitative data available on these instruments.

OBJECTIVES

12. The objectives of any amendments to the substituting debenture rule are to:

a) make it easier for businesses to operate and comply with their tax obligations, by ensuring that tax rules are clear, easily understood and certain;
b) reduce unnecessary compliance costs;
c) protect the integrity of the revenue base; and
d) promote the overall coherence of the tax system.

REGULATORY IMPACT ANALYSIS

13. The status quo and three other options for addressing this problem and achieving the objective are set out and analysed below. These options are:

a) maintain the status quo;
b) amend section FA 2(5) to fix its flaws;
c) repeal section FA 2(5) in its entirety (preferred option);
d) repeal section FA 2(5) and strengthen other rules.

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2 Convertible notes are debt instruments that can be converted into shares at either option of the lender or the borrower.

3 A taxpayer can apply to the Office of the Chief Tax Counsel within Inland Revenue for a binding legal opinion as to the tax treatment of a specific transaction. The Inland Revenue is bound by this view and therefore obtaining a binding ruling gives taxpayers a high degree of certainty when undertaking a transaction.

Option one – maintain the status quo

14. The status quo is currently causing problems in practice. The rule is unclear and difficult to apply. There is an element of uncertainty associated with structuring around the rule in the context of the general anti-avoidance rule (GAAR) in section BG 1 of the Act e.g. if a taxpayer issues a convertible note specifically to avoid the rule applying, is this tax avoidance under section BG 1?

15. This uncertainty results in increased compliance costs in the form of advisers' fees and (potentially) the cost of obtaining a binding ruling from the Inland Revenue.

16. Officials are aware that taxpayers are able to deliberately structure into the rule to take advantage of cross-border arbitrage opportunities. Use of a specific anti-avoidance rule in aggressive tax structures reduces the integrity of the New Zealand tax system and potentially erodes the revenue base.

17. The rule also does not fit well within the current tax policy framework, given that there is an imputation regime (which makes most domestic taxpayers indifferent between debt and equity) and a transfer pricing and thin capitalisation regime (which limits excess debt deduction in the international context). Therefore, the continuing existence of the rule reduces the overall coherence of the tax system.

18. Officials therefore believe that the status quo is not a viable option.

Option two – amend section FA 2(5) to fix flaws

19. There are a number of specific problems with the rule:

a) the carve-out for convertible notes does not make sense given current settings and it is easily used to the turn the rule on and off at will;

b) the rule only applies where a company issues debentures to its own shareholders, it does not apply where debentures are issued by a related party (e.g. a wholly-owned subsidiary of the company) or to a related party (e.g. a trust settled by a shareholder). It is easy enough for a company to incorporate a special purpose subsidiary to issue debentures to its indirect shareholders – so-called "wrap-around debt" or for a shareholder to settle a trust to hold the debentures. These structures achieve broadly the same economic outcome as direct lending, but in a way that circumvents the rule; and

c) the rule is too wide – it arguably applies any time a shareholder lends money to a company. This is relatively common place and not offensive in and of itself.

20. One option would be to amend the rule to address these concerns. While this would improve certainty (thus reducing compliance costs associated with the rule) and reduce the ability to manipulate the rules (thus increasing integrity), the fundamental question remains whether the rule itself is still appropriate given the current tax framework.

21. For the reasons outlined in paragraph 17, officials believe the rule does not fit well within our current tax system. Therefore, merely amending the drafting of the rule does not improve the coherence of the tax system. In fact, strengthening an inappropriate rule arguably reduces the coherence of the system. For this reason, amending the rule to fix its flaws is not officials' preferred option.

Option three – repeal section FA 2(5) in its entirety (preferred option)

22. Option three – repealing the rule in its entirety – is officials' preferred option. It has all the benefits of option two (fixing the flaws in the rule), but it also increases the coherence of the tax system as it removes a rule that no longer fits with our current policy settings.

23. The only potential disadvantages to repealing the rule are that:

a) it arguably buttresses some of our targeted international base protection rules[4] (in some cases it will limit the ability to take excess debt deductions in New Zealand where the other specific rules have been circumvented); and

b) there is still a subset of New Zealand residents who would prefer to receive interest rather than dividends from a tax perspective, so it may provide some limit to the extent to which these entities excessively debt fund.

24. Officials do not see these factors as compelling reasons to retain the rule. First, the thin capitalisation rules (which prevent excess debt deductions by New Zealand companies owned by non-residents) are being strengthened, so they do not require a buttress in the form of the substituting debenture rule. Second, it is very easy to circumvent the application of the rule, so in reality the rule is unlikely to be providing any buttress to the international tax rules or preventing New Zealand residents structuring to receive interest rather than dividend returns where this would be advantageous from a tax perspective.

25. However, if the repeal of the rule results in an increase in aggressive tax structuring, then officials will consider recommending strengthening existing rules or introducing another more targeted measure.

Option four – repeal section FA 2(5) and strengthen other rules

26. The final option considered by officials was a full repeal of section FA 2(5), combined with strengthening other related debt recharacterisation rules to address any gaps left by the absence of the substituting debenture rule.

27. The most appropriate candidate for strengthening is the stapled stock rule,[5] as this rule covers similar arrangements. Officials have identified a number of areas where this rule could be improved; in particular whether it is appropriate to retain the current exclusion from the stapled stock rule for debt and shares stapled using a shareholder's agreement in a company that is not widely held.

28. At this stage, officials do not recommend strengthening the stapled stock rule. This is because:

a) we doubt the repeal of the substituting debenture rule will leave any gaps because it is currently so easy to circumvent;

b) as a separate project, the thin capitalisation rules are being strengthened[6] at the same time as the rule is to be repealed so there is already an element of gap filling in the international context; and

c) we are not aware of the stapled stock rule being abused currently; and if it is being abused the general anti-avoidance rule could potentially apply.

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[4] Such as the thin capitalisation rules, the transfer pricing rules and non-resident withholding tax rules.

[5] The stapled stock rule applies where a company issues shares which are "stapled" to debt. This means they cannot be traded separately and are, in substance, completely interchangeable with equity.

[6] See http://taxpolicy.ird.govt.nz/publications/2013-ip-thin-capitalisation/overview.

29. However, as stated above, it the repeal of the rule results in an increase in aggressive tax structuring, then officials will reconsider this option.

30. The table below summarises the analysis of each option.

Options	Does it meet the objectives?	Impacts				Net impact
			Fiscal/economic impact	Compliance and administrative costs	Risks	
1. Maintain status quo	No	Taxpayer	If the rule applies, interest deductions denied which results in more tax being paid by the company. However because the rule is easily avoided the real economic costs are probably low.	Unnecessary compliance costs for taxpayers.	Unnecessary compliance costs, administrative costs and lack of confidence in a coherent tax system by taxpayers. This may erode voluntary compliance.	No change as maintains the status quo. This is negative for the tax system and taxpayers because of unnecessary compliance costs and uncertainty.
		Tax system	It is unlikely that the rule currently raises any revenue because it can be so easily circumvented and there is likely to be some non-compliance from lack of awareness of the rule.	There are administrative costs in providing binding rulings and ensuring compliance with legislation.	The rule is potentially being used in aggressive tax structures. This reduces the integrity of the tax system.	
2. Amend section FA 2(5) to fix flaws	Partially	Taxpayer	There will be an economic cost to taxpayers as the rule will deny interest deductions in more cases because it will not be able to be circumvented.	Compliance costs would be reduced. The rule would be clear, easily understood, and certain.	Common transactions will still be caught and small/ unsophisticated taxpayers are likely to still be inadvertently caught. Transactions that seek to avoid the section are more likely to be subject to the GAAR.	Improves on the status quo slightly because the rules will be much clearer, but not the preferred option because the underlying problem with the section remains.
		Tax system	May result in an economic/fiscal gain to the government as more interest deductions will be denied and more tax collected.	Administrative costs are likely to be reduced as fewer rulings would be needed and audit activity would be simpler.	Taxpayer perception of the fairness of the system may be eroded.	
3. Repeal section FA 2(5) (official's preferred option)	Yes	Taxpayer	Economic gain for taxpayers as potentially more interest deduction allowed with less need for structuring.	Reduced compliance costs. The rule would be clear, easily understood, and certain. No chance of inadvertently falling into the rule.	Taxpayers who have structured into the rule will need to unwind their transactions.	Improves on the status quo by increasing coherence of the tax system, reducing compliance and administrative costs and improving the integrity of the system.
		Tax system	As it is unlikely that the rule currently raises any revenue, the fiscal consequences of repeal are expected to be negligible.	Administrative costs reduced as fewer rulings would be needed and audit activity would be simpler.	May be increased aggressive tax structuring.	
4. Repeal section FA 2(5) and strengthen other rules	Yes	Taxpayer	This may result in an economic cost for business as it replaces a rule that is easy to avoid with tougher rules that will potentially deny more interest deductions and result in more tax.	Compliance costs would be reduced.	Transactions that previously did not fall within the strengthed rules may be subject to the strengthened rules.	Improves the status quo by providing more certainty and reducing compliance costs. It improves the coherence of the tax system. May impose new stricter rules on taxpayers unnecessarily. For this reason this is not the preferred option.
		Tax system	Protects the tax base from any transactions that seek to take advantage of the tax difference between debt and equity.	Overall administrative costs would be reduced.	No identified risks	

Social, environmental and cultural impacts of all options

31. There are no social, environmental or cultural impacts associated with any of the identified options.

Net impacts of all options

32. All identified options would be an improvement on the status quo as they provide more certainty and reduce compliance costs for taxpayers. The lack of data makes it difficult to quantify the net impacts, however anecdotal evidence suggests that the rule is causing problems in practice.

CONSULTATION

33. There has been targeted consultation on this measure. This has been through a number of taxpayers and their advisors raising the issue directly with officials and officials have fully considered their submissions.

34. The New Zealand Law Society has recently recommended that the rule be repealed in the context of the thin capitalisation project[7]. Thus far, no submissions have argued that the rule should be retained.

35. Consultation has been limited because:

a) Officials have already considered a number of unsolicited submissions;
b) The amendment is broadly remedial in nature, and the repeal of the rule will largely benefit the private sector. There appears to be unanimous support for the repeal (officials' preferred option) as it is widely acknowledged that the rule no longer serves its original policy purpose; and
c) Taxpayers are able to make submissions at select committee stage and these submissions with be taken into account before the bill is enacted.

CONCLUSIONS AND RECOMMENDATIONS

36. Official recommend option 3 – repealing the substituting debenture rule in its entirety. There has been unanimous support for this approach from the private sector so far. Officials do not see a need to retain any element of the rule, as any residual function it serves is not deliberate and is a blunt instrument at best. However, if the repeal of the rule results in an increase in aggressive tax structuring, then official will consider strengthening the stapled stock rules or introducing some other more targeted measure.

37. Officials recommend the application date of the repeal should be 1 April 2015 to coincide with the strengthened thin capitalisation rules.

38. The strengthening of the thin capitalisation rules addresses some of the concerns officials had in the cross-border area. Domestically, there is only a small group who, from a tax perspective, generally prefer debt over equity. We do not believe this justifies keeping any part of the rule.

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[7] See the letter dated 4 July 2013 "Thin Capitalisation Review: Technical Issues" at: http://www.lawsociety.org.nz/__data/assets/pdf_file/0003/69213/l-IRD-Thin-Capitalisation-Review-Technical-Issues-040713.pdf.

IMPLEMENTATION

39. Officials will seek Cabinet approval to include the necessary legislative changes in the Taxation (Annual Rates, Employee Allowances and Remedial Matters) Bill. These changes will apply for the 2015-16 and later income years.

40. The legislation will contain a transitional provision for taxpayers who have been treating substituting debentures as shares in past income years. The intention of the transitional provision is to ensure that no adverse tax consequences arise on transitioning from treating the debt as a share for tax purposes, to treating is a debt for tax purposes. The transitional provision will deem the taxpayer to have redeemed the substituting debenture for its face value immediately before the beginning of its 2015-16 income year and re-advanced the redemption proceeds under a new loan equal to the face value on the first day of its 2015-16 income year. Any income derived or expenditure incurred in respect of the loan on or after the first day of the taxpayer's 2015-16 income year must be accounted for under the financial arrangements rules. Any income and expenditure arising under the substituting debenture in income years before the 2015-16 income year will not be taken into account under the financial arrangements rules because that income and expenditure will have been dealt with under the share rules.

41. When introduced to Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a *Tax Information Bulletin* which would be released shortly after the bill receives Royal assent. Officials note that there are no specific implementation risks associated with the recommendations.

MONITORING, EVALUATION AND REVIEW

42. The Inland Revenue will monitor the repeal of the rule to ensure that it does not result in an increase in aggressive tax structuring. However, if the repeal of the rule has this result, then officials will consider recommending strengthening existing rules or introducing another more targeted measure.

43. In general, Inland Revenue monitors, evaluates and reviews new legislation under the Generic Tax Policy Process ("GTPP").

44. The GTPP is a multi-stage process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage.

Regulatory Impact Statement

The withholding tax treatment of inflation-indexed bonds.

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question addressed in this Statement is whether the withholding tax rules that apply to inflation-indexed bonds in the Income Tax Act 2007 should minimise, where appropriate, potential inefficiency that these tax rules may cause the inflation-indexed bonds market. This Statement also questions whether the tax rules should be aligned more closely with the current commercial practice in relation to the timing of the deduction of the withholding tax on the inflation-indexed component.

The key policy objectives are to ensure that there is an appropriate tax treatment for inflation-indexed bonds that reflects as closely as possible the current commercial practice and to minimise the impact of the withholding tax rules on the efficiency of the inflation-indexed bond market.

There are no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties that have been identified.

Targeted consultation has been undertaken with current and past issuers of inflation indexed bonds and the Rewrite Advisory Panel (an independent panel established by the Minister of Revenue in 1995). This consultation helped define the problem, and develop the options and analysis summarised in this statement.

The Treasury has been consulted and agrees with our analysis.

The preferred options have no fiscal implications and are to maintain the revenue base.

There is a very small likelihood that the proposed changes may increase the compliance costs for bond issuers in relation to their record keeping obligations and the return filing obligations of bond holders if the inflation rate were to increase significantly. The proposed change does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

Mike Nutsford
Policy Manager, Policy and Strategy
Inland Revenue

16 September 2013

STATUS QUO AND PROBLEM DEFINITION

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

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

3. Two tax technical issues have been identified with the reissuance of these bonds:

Issue one: withholding tax exceeding the coupon payment

4. The withholding tax rules in the Income Tax Act 2007 (the Act) oblige any person who makes a payment of resident passive income or non-resident passive income (or a payment that includes such income) to deduct tax from the payment unless an exemption applies. In the case of an inflation-indexed bond, the bond issuer is obliged to withhold resident withholding tax (RWT) or non-resident withholding tax (NRWT) from the bond holder's coupon (interest) payment and the inflation-indexed component.

5. In general terms, RWT is withholding tax deducted and paid by New Zealand issuers on interest and dividends paid to New Zealand resident taxpayers. Generally the income is returned in the taxpayer's annual tax return and credit is given for tax withheld.

6. NRWT is a withholding tax deducted and paid by New Zealand based payers of interest, dividends or royalties to non-residents. Generally it is a final income tax on such payments for New Zealand tax purposes.

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

8. Generally if an incorrect amount of withholding tax has been deducted, the withholding tax rules allows a payer of RWT or NRWT to make up the difference by deducting the tax from subsequent payments made during the same tax year. If there is insufficient cash-flow to cover the underpayment, potentially the bond issuer could reduce the capital value of the bond.

9. However this would result in the bonds being non-fungible, as the bonds would reduce in value by different amounts based on the varying withholding rates across bond holders. Over time, multiple categories of otherwise identical bonds would be created and would reduce the trading market for such bonds. In turn, this reduces the attractiveness to holders of the bond and potential investors, as a liquid market is one of the benefits of such bonds.

10. The root cause of the problem is that the current withholding tax rules are inclined towards ensuring that the withholding tax obligations are met rather than minimising, where appropriate, potential inefficiency that these tax rules may create for the inflation-indexed bonds market by reducing the fungibility of bonds.

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

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

12. While the risk of withholding tax exceeding the coupon payment is currently perceived to be low, if the inflation rate were to increase significantly there may be cash flow issues for bond issuers, and potentially tax collection consequences if bond issuers are unable to absorb the underpayment of withholding tax, if the inflation rate were to increase significantly.

13. The other factor mitigating the potential risk of the withholding tax exceeding the coupon payment is if the non-resident is subject to approved issuer levy (AIL) rather than NRWT. Approved issuers are able to pay interest to non-residents without deducting NRWT. Instead approved issuers are required to pay a levy at the rate of 2% for every dollar of interest paid on the bond. The new issue of indexed-inflation bonds will provide that a non-resident investor will be subject to approved issue levy unless an election is made for NRWT to apply therefore the group of non-residents who are actually applicable for NRWT is likely to be very small.

Issue two: timing of the withholding tax deduction

14. The second and related problem stems from a timing issue. The Act intends that withholding tax should be deducted annually from the inflation-indexed component. However, the coupon is generally paid quarterly and the administrative practice of bond issuers is to withhold the tax on the inflation-indexed component for the previous quarter, and deduct it from the coupon payment.

15. There is no explicit permission in the Act to withhold the tax obligation quarterly, and this can result in an unclear situation where an issuer may be withholding tax from a coupon amount in advance of the bond holder's legal obligation, because there is some form of cash-flow from which to deduct the withholding tax. The root cause of this problem is a misalignment between the Act and commercial practice.

16. Because of the misalignment and the cash-flow considerations to meet the withholding tax obligations, issuers of bonds have (to date) inserted a clause in their agreement with bond holders to authorise withholding the tax on the inflation-index component amounts from the coupon payment when they are paid (credited to the account of the holder).

OBJECTIVES

17. A fundamental consideration of a coherent, broad-base, low-rate tax system is that taxes should be efficient through minimising distortions and impediments to economic growth, while still maintaining the tax revenue and encouraging voluntary compliance (the integrity of

the tax system). The key policy objectives are to ensure that there is an appropriate tax treatment for inflation-indexed bonds that reflects as closely as possible the current commercial practice and to minimise the impact of the withholding tax rules on the efficiency of the inflation-indexed bond market.

18. There are no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties that have been identified.

REGULATORY IMPACT ANALYSIS

19. To achieve the objectives outlined above, a number of options to address issues one and two were considered.

Issue one: withholding tax exceeding the coupon payment

20. There are three options that may deal with issue one and achieve the objective of minimising the impact of the withholding tax rules on the inflation indexed bonds market:

1A limiting the bond issuer's obligation to resident withholding tax to the amount of the coupon, with corresponding record keeping amendments so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability (preferred option).

1B limiting the bond issuer's obligation to resident and non-resident withholding tax to the amount of the coupon, with corresponding record keeping amendments so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability.

1C making the bond issuer liable for the resident and non-resident withholding tax underpayment.

21. The status quo is unsatisfactory because it has the potential to create an inefficient inflation-indexed bonds market because bonds may become non-fungible due to the withholding tax rules, and it does not reflect current commercial practice.

Option 1A (preferred option)

22. This option limits the bond issuer's obligation to resident withholding tax to the amount of the coupon, but does not limit NRWT to the amount of the coupon. Therefore where a coupon payment is less than the amount of tax for both or either payments, the liability for payment of any RWT underpayment is met by the bond holder through a "wash-up" payment initiated by filing an income tax return. This ensures that the correct amount of income tax is paid on the income earned from the inflation-indexed bonds.

23. In order for Inland Revenue to administer this proposed solution, additional record keeping and information amendments to the Tax Administration Act 1994 will be needed, so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability.

24. This option achieves the policy objective of minimising the impact of the tax treatment of inflation-indexed bonds on the bonds market, as the bond holder will not have to deduct the remaining tax liability from the face value of the bond therefore creating non-fungible and different classes of bonds. The integrity of the tax system is also maintained by not extending

the coupon limitation to NRWT, as it will ensure that non-residents satisfy their New Zealand tax obligations.

25. The table on page 3 also shows that the annual rate of inflation would need to be 11.3% in relation to NRWT, therefore showing that the potential risk is more heightened for RWT than NRWT.

26. Furthermore as noted in the status quo, AIL will apply in most circumstances, therefore mitigating the risk of issue one occurring to a certain extent.

27. This amendment will maintain the revenue base, and is not expected to have any fiscal impact.

Option 1B

28. Similar to option 1A, this option limits the bond issuer's obligation to RWT to the amount of the coupon. However this option is more extensive in that it would also apply to NRWT. There would also need to be corresponding amendments to the record keeping provisions in the Tax Administration Act 1994 so that Inland Revenue can administer these changes as per option 1A. This option is further mitigated by AIL as noted in option 1A.

29. Like option 1A, this option will achieve the policy objective of minimising the impact of the tax treatment of inflation-indexed bonds on the bonds market, as the bond holder will not have to deduct the remaining tax liability from the face value of the bond therefore creating non-fungible and different classes of bonds. This option will have some administrative impacts as bond holders who are not residents of New Zealand (and are therefore subject to NRWT), will have to file a tax return, whereas generally they do not as NRWT is a final tax for New Zealand tax purposes.

30. This option may also have a fiscal risk if there is non-compliance, as Inland Revenue will have to monitor and collect any underpayments of NRWT. It is difficult to quantify what the fiscal risk may be, but it is likely to be low, due to the number of non-residents bond holders who are more likely to be subject to AIL than NRWT.

Option 1C

31. This option involves the bond issuer of the inflation-indexed bond carrying the shortfall of the tax liability.

32. This amendment will maintain the revenue base, but will have a fiscal cost to the bond issuers, including the Government. It is difficult to quantify what exactly the fiscal cost may be, as it will vary according to the volume of the bonds that are issued, the coupon rate and the rate of inflation.

Issue two: timing of the withholding tax deduction

33. There are two options that may deal with issue two and achieve the objective of reflecting as closely as possible the current commercial practice:

- 2A withhold the tax from each coupon payment when it is paid.
- 2B retain the status quo.

Option 2A (preferred option)

34. This option allows the withholding tax deduction to be withheld from the coupon payment when it is paid to the bond issuer. This option aligns the Income Tax Act 2007 with the current commercial practice that is either currently exercised by bond holders or agreed to by bond holders and bond issuers under the bond memoranda (contract).

35. The amendment provides timing options for bond holders and therefore encourages voluntary compliance by giving more choice as to when the deduction occurs.

Option 2B

36. This option retains the status quo, whereby the timing of the tax deduction is a matter (whether contractual or not) between the bond issuer and the bond holder.

TABLE A *Issue one:* *withholding tax exceeding the coupon payment*

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	*Administrative/ compliance costs*	*Risks*	
1A Limiting the bond issuer's obligation to resident withholding tax to the amount of the coupon, but not NRWT, with corresponding amendments to the record keeping provisions. (preferred option)	Yes	Tax system	No fiscal impact, as maintaining the revenue base.	None, changes will be implanted using current administrative systems.	None	Improves status quo by ensuring tax rules do not create inefficiencies in the inflation-indexed bonds market and maintains the integrity of the tax system by ensuring that non-residents comply with their New Zealand tax obligations.
		Bond issuers	No economic impact as bonds remain fungible.	In the event the problem does eventuate due to the inflation profile changing significantly, there may be some transitional compliance costs due to additional record keeping and notification provisions.		
		Bond holders	No economic impact as bonds remain fungible.	If the inflation profile changes significantly, there is likely to be additional compliance costs due to additional filing requirements.		
1B Limiting the bond issuer's obligation to	Yes	Tax system	May be fiscal impact if there is non-compliance but likelihood is low.	Will create administrative costs, as Inland Revenue will be required to monitor non-resident compliance and administer any enforcement. Likely to be	The filing requirements for non-residents may create disincentives to invest in inflation-indexed bonds due to the additional filing	Improves status quo slightly by ensuring tax rules do not create inefficiencies in the inflation-indexed bonds market, however the additional compliance costs for non-residents who are now required to

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	*Administrative/ compliance costs*	*Risks*	
resident and non-resident withholding tax to the amount of the coupon with corresponding amendments to the record keeping provisions.				administratively intensive with minimal result, as only a small group of taxpayers have deductions under NRWT, as the majority of non-residents who invest in bonds are taxed using the approved issuer's levy not NRWT .	requirements for non-residents.	file may dis-incentivise any investment in inflation-indexed bonds and may increase non-compliance by this group.
		Bond issuers	No economic impact as bonds remain fungible.	May be some transitional compliance costs due to additional record keeping provisions.		
		Bond holders	No economic impact as bonds remain fungible.	Likely to be compliance costs due to additional filing requirements for residents. Likely to be greater compliance costs for non-residents, as generally NRWT is a final withholding tax and the non-resident will now be required to file.		
1C Bond issuer of the inflation	No	Tax system	Likely to be a fiscal impact as the Government is an issuer of inflation indexed bonds, and will be liable for any tax	No administrative costs.	Non-government bond issuers may not have fiscal ability to absorb any underpayments of	Maintains the status quo, as although bonds maintain their fungibility, there is a disincentive for any non-Government bond issuers to issue such bonds as they

Option	***Meets Objective?***	***Impacts***				***Net Impact***
			Fiscal/economic impact	***Administrative/ compliance costs***	***Risks***	
indexed bond to carry the shortfall of the RWT and NRWT tax liability			liability shortfall. Difficult to quantify the fiscal cost as it will depend on the volume of bonds issued, the rate of the coupon and the rate of inflation.		withholding tax.	may not have the fiscal ability to absorb any underpayments of withholding tax, therefore creating inefficiencies, as there are less bond issuers in the market. The bond issuers may also incur costs of finding alternative borrowing.
		Bond issuers	Non-Government bond issuers may not have the fiscal ability to absorb any underpayment of withholding tax and therefore will create economic disincentive to offer inflation indexed bonds.	No additional compliance costs.		
		Bond holders	No economic impact as bonds remain fungible.	No additional compliance costs.		

TABLE B ***Issue two:*** ***timing of the withholding tax deduction***

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	***Administrative/ compliance costs***	***Risks***	
2A Withhold the tax from each coupon payment when it is paid.	Yes	Tax system	No fiscal impact.	Encourages compliance as better alignment between commercial practice and the Income Tax Act 2007.	None	Improvement in the status quo as this option aligns the Income Tax Act 2007 with the current commercial practice, and does not impact on the current policy settings as the tax is still being withheld. The difference is when it is withheld, and this option gives more timing options for bond issuers, therefore encouraging compliance.
		Bond issuers	No economic impact.	No change but greater certainty as law is aligned with current commercial practice.		
		Bond holders	No economic impact.	No change but greater certainty as law is aligned with current commercial practice.		
2B Retain the status quo.	Yes	Tax system	No change.	No change.	None	The status quo remains whereby there is an element of uncertainty where bond issuers are deducting tax before the legal requirement to do so.
		Bond issuers	No change.	If no clause in Bond Memoranda, the tax is being deducted earlier than the Income Tax Act 2007 requires. This may be problematic for the bond issuer if this is challenged by the bond holder, and may incur administrative costs if the bond issuer needs to change timing of the tax deduction from quarterly to annually as per the law.	None	
		Bond holders	No change.	No change.	The bond holder can challenge	

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	***Administrative/ compliance costs***	***Risks***	
					the bond issuer's timing of the tax deduction if it is not contracted for in the Bond memoranda, or not annually as required by the Income Tax Act 2007.	

Social, environment or cultural impacts of all options

37. There are no social, environmental or cultural impacts to any of the options. The groups affected by the amendments are bond issuers and bond holders who invest or issue inflation indexed bonds.

CONSULTATION

38. Targeted consultation has been undertaken on the problems and possible solutions with interested parties and a tax advisory panel.

39. Discussions were held with the only current bond issuer - the Government (managed through Treasury's New Zealand Debt Management Office) and a previous issuer of inflation-indexed bonds. The Treasury's tax strategy team and Treasury's New Zealand Debt Management Office brought these issues to Inland Revenue's officials' attention and worked with Inland Revenue through the possible options including what administrative issues may arise from a bond issuer's and tax administration perspective.

40. Treasury officials discussed the problems and proposed options with a previous bond issuer. This company was relaxed about the proposals as they noted the risk was relatively minor, and given their current coupon rate of 4%, inflation would need to be at 12% for these problems to eventuate. This company noted that the additional record-keeping and information requirements were possible through their current systems therefore the operational impact from these changes on their organisation was likely to be minimal.

41. The Rewrite Advisory Panel (RAP) was also consulted as part of these proposals and recognised that the issue in relation to RWT is a matter of priority and suggested the same legislative amendments. However RAP also noted that similar issues arise in relation to NRWT and suggested that the obligation to withhold NRWT should also be limited to the amount of the coupon.

42. Officials disagreed with RAP for the reasons summarised in Table A. That is, the rationale for recommending a limit for RWT only is that workable mechanisms can be adopted to collect any shortfall in RWT as part of the annual return filing process. With respect to NRWT, while the same mechanisms can be provided to collect any shortfall, collection of any NRWT shortfall (either through a payment or tax return filing mechanism) is often administratively intensive with minimal result. NRWT for the majority of non-resident holders is also a final withholding tax. Not extending the coupon limitation to NRWT is to maintain the integrity of the tax system and ensure that non-residents satisfy their New Zealand obligations. Furthermore non-residents can be subject to AIL.

CONCLUSIONS AND RECOMMENDATIONS

43. The recommended options to address the problems are:

Issue one: withholding tax exceeding the coupon payment

Option 1A (amend the Income tax Act 2007 to limit the obligation to withhold resident withholding tax up to the amount of coupon with corresponding record keeping amendments so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability), as this option achieves the policy objective with less impact on compliance, administrative and fiscal costs than the other two options for this issue.

Issue two: timing of the withholding tax deduction

Option 2A (amend the Income Tax Act 2007 to allow the issuer of an inflation-indexed bond to withhold resident and non-resident withholding tax from both the coupon and the inflation-indexation payment, when the coupon is paid), as this option achieves the policy objective and encourages compliance by providing more choices for the timing deduction for bond issuers.

44. Overall for both issue one and issue two, the proposed amendments will ensure that where practicable the tax law is aligned with the commercial practice adopted by inflation-indexed bond issuers, in aligning the withholding tax deduction on the inflation-indexed component to when the coupon is paid and tax withheld from that amount. Also the proposed amendments ensure that by limiting the RWT withholding obligation to the amount of the coupon payment, that tax will not be a possible impediment to and efficient inflation-indexed bond market.

45. However, officials do not consider that this limitation proposal should be afforded to NRWT because of the tax compliance risk that non-residents may not meet any tax underpayment obligations.

IMPLEMENTATION

46. The necessary legislative changes would be included in the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill which is scheduled to be introduced in late October 2013, with application from date of enactment. There is no need for transitional provisions.

47. There should be no significant implementation issues with the amendments. Inland Revenue will communicate the changes to taxpayers and their agents through existing channels, such as the *Tax Information Bulletin* and through updating its guides.

48. The additional information regarding any RWT underpayment may increase compliance costs for bond issuers. However it is likely that the increase will be negligible as it can be easily incorporated into existing record-keeping requirements already imposed on the bond issuers.

49. The proposed amendments do not provide any opportunity to reduce or remove any existing regulations.

50. No additional enforcement strategy is required to achieve the policy outcomes being sought.

MONITORING, EVALUATION AND REVIEW

51. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following the changes, given that this issue is to help prevent any risk to the tax base.

52. Officials would expect that if any concerns are identified with the application of the proposed options, the Treasury's New Zealand Debt Management Office and the Treasury would raise it with Inland Revenue officials.

53. In general, Inland Revenue monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.

Regulatory Impact Statement

Amendment to the tax treatment of underground gas storage facilities

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address a gap in the petroleum mining tax rules – this gap currently allows expenditure on constructing an underground natural gas storage facility to be deducted over a concessionary seven year period, as petroleum development or exploration activity. This is contrary to the policy intent, as the storage of processed gas is not a petroleum development or exploration activity.

The key policy objective is ensuring that expenditure on underground natural gas storage facilities is deductible over the economic life of the asset, in line with policy intent.

The class of taxpayers likely to be affected is limited – namely, those taxpayers in the petroleum industry who seek to store gas underground, after production.

There are no significant constraints, caveats or uncertainties concerning the regulatory analysis undertaken. The recommended approaches to the various issues raised do not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

Targeted consultation has been undertaken with the industry representative body and interested parties. The Treasury and the Ministry of Business, Innovation and Employment have also been consulted.

There are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken. The recommended approaches to the various issues raised do not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

Peter Frawley
Manager, Policy and Strategy
Inland Revenue

19 July 2013

STATUS QUO AND PROBLEM DEFINITION

1. The current petroleum mining tax rules provide concessions to encourage the exploration for, and subsequent development of, petroleum reserves in New Zealand. The policy issue is that a gap in the rules allows for expenditure on underground natural gas storage facilities to be deducted over a concessionary seven-year period. This is contrary to the policy intent that only expenditure on petroleum exploration or development should be deductible over a seven year period. This is because the underground storage of gas that has already been extracted and processed is not an exploration or development activity.

2. An underground gas storage facility enables processed gas to be injected into the storage facility during periods when demand is low or when renewable energy is abundant. This increases flexibility in supplying gas for electricity generation. The gas has been extracted (a royalty being paid to the Crown on extraction), and processed before being injected into the storage facility.

3. Underground facilities are commonly used in other countries to store gas, as they are more economical than alternative storage options. At present, there is only one underground gas storage facility in New Zealand. However, we understand that at least one other energy company may possibly be interested in using depleted fields in New Zealand (onshore or offshore) for storing natural gas.

4. If the status quo was retained, expenditure on underground gas storage facilities would continue to be deductible over a concessionary seven year period, contrary to the policy intent.

5. The root cause of the problem is that there is a gap in the tax rules which means that underground gas storage facilities fall within the concessionary petroleum mining rules instead of under the depreciation rules (which allow deductions to be spread over the economic life of an asset).

OBJECTIVES

6. The objective is to ensure that expenditure on an underground gas storage facility is spread over the economic life of the facility, in accordance with the policy intent.

7. The outcomes are not subject to any constraints, with the exception that, in considering the application date for the amendment, the circumstances of the one existing underground gas storage facility in New Zealand have been taken into account.

REGULATORY IMPACT ANALYSIS

8. There are two options that may deal with the problem and achieve the objectives:

a) Exclude underground facilities that store processed gas from the petroleum mining rules and include these within the depreciation rules, with an economic life determined by the Commissioner of Inland Revenue. *(preferred option)*

b) Exclude underground facilities that store processed gas from the petroleum mining rules and include these within the depreciation rules, with a set economic life of 40 years.

Option one (preferred option)

9. This option involves excluding underground facilities that store processed gas from the petroleum mining rules, and including these facilities within the depreciation rules. The economic life of the asset (over which deductions for expenditure would be spread) would be set by the Commissioner of Inland Revenue under the tax rules for determining depreciation rates applicable to items of depreciable property. As part of this, taxpayers could also apply to the Commissioner for a special rate. This option achieves the policy objective of ensuring deductions for expenditure on an underground gas storage facility are spread over the economic life of the asset.

10. The amendment is largely for base maintenance and is not expected to have any fiscal impact.

Option two

11. This option involves excluding underground facilities that store processed gas from the petroleum mining rules and including these within the depreciation rules, with a set economic life of 40 years. This economic life is based on the Australian tax rules for underground gas storage facilities, which treat such facilities as depreciable assets with an estimated life of 40 years.

12. The amendment is largely to protect the revenue base going forward and is not expected to have any fiscal impact.

Summary of impacts of options one and two

Option	***Meets Objective?***	***Impacts***				***Net Impact***
			Fiscal/economic impact	***Administrative/ compliance costs***	***Risks***	
One	Yes	Tax system	No fiscal impact, as protecting revenue base going forward.	No administrative costs.	None	Improves status quo by ensuring tax rules align with policy intent.
		Taxpayers	Taxpayers incurring expenditure on underground gas storage facilities must spread deductions over the economic life of the asset, instead of over concessionary 7 years.	May be some transitional compliance costs.		
Two	Yes	Tax system	No fiscal impact, as protecting revenue base going forward.	No administrative costs.	Insufficient flexibility to allow a taxpayer to apply for a special rate (taking into account that the economic life may vary for different underground gas storage facilities).	Improves status quo by ensuring tax rules align with policy intent.
		Taxpayers	Taxpayers incurring expenditure on underground gas storage facilities must spread deductions over 40 years, instead of over concessionary 7 years.	May be some transitional compliance costs.		

Social, environment or cultural impacts of both options

13. There are no social, environment or cultural impacts to the options. The groups affected by the amendments proposed are energy companies seeking to store gas underground post-production.

Net impact of both options

14. The net impact of both options is to ensure that expenditure on underground gas storage facilities is correctly treated under the tax rules, without causing a negative economic impact for taxpayers.

CONSULTATION

15. Targeted consultation has been undertaken with interested parties and the industry representative body, seeking feedback on the proposed approach and what an appropriate economic life for an underground gas storage facility would be. In addition, consultation covered transitional issues in shifting from the current treatment to the proposed treatment, and the application date for the amendment.

16. There was recognition of the policy rationale for spreading deductions for expenditure on underground gas storage facilities over the economic life of these assets. Concerns were raised about the possibility of the legislation specifying one period over which deductions could be spread – the concern was that this approach would not take into account the specific features of each underground gas storage facility. Therefore, submitters preferred an approach which would allow taxpayers to apply to the Commissioner of Inland Revenue for a special rate.

17. Consultation on the application date also resulted in grandparenting for the owner of the one existing natural gas storage facility in New Zealand. The owner has an existing underground storage facility for which it has already incurred expenditure, and it already has a mining permit identifying future expenditure to be incurred on the facility.

CONCLUSIONS AND RECOMMENDATIONS

18. Option one is the preferred option because it achieves the policy objective in a simple and effective manner. Option two is not preferred because it does not provide sufficient flexibility to allow taxpayers to apply to the Commissioner for a special rate, based on the specific features of their underground gas storage facility.

IMPLEMENTATION

19. There is one transitional issue regarding the treatment of proceeds received from the sale of an underground gas storage facility. Such proceeds are currently treated as being on revenue account (taxable) under the petroleum mining rules. Under the proposal, which seeks to remove underground gas storage facilities from the petroleum mining rules, the sale of an underground gas storage facility will change to being on capital account but with claw-back of past depreciation deductions.

20. Accordingly, we consider there should be a rule providing for apportioning proceeds received from the sale of an underground gas storage facility, to reflect the change in treatment of the asset. For example, if $250m was incurred under the old rules, and $50m is

incurred under the new rules, the amount of taxable income from selling a gas storage facility would be: 250/300 multiplied by the sales proceeds.

21. The amendment will be implemented through a tax bill introduced this year. The amendment would apply from the date of enactment, with a grandparenting provision for planned expenditure incurred in relation to the one existing underground gas storage facility in New Zealand.

22. There should be no significant implementation issues with the amendment. Inland Revenue will communicate the change in rules to tax agents through existing channels, such as the *Tax Information Bulletin* and through updating its guides.

MONITORING, EVALUATION AND REVIEW

23. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following the changes, given that this is an isolated base maintenance issue.

24. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

25. In general, Inland Revenue monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.

Regulatory Impact Statement

Extending the tax exemption for non-resident offshore oil rig and seismic vessel operators

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of whether an existing temporary five-year exemption from tax on the income of non-resident offshore oil rig and seismic vessel operators should be extended or left to expire.

The key policy objectives are to ensure that:

- the tax rules do not unnecessarily distort the decisions of non-resident offshore oil rig and seismic vessel operators
- the tax rules do not discourage the offshore exploration for oil and gas in New Zealand
- the scope of the exemption aligns with the policy intent.

The class of taxpayers likely to be affected is limited – namely, those taxpayers involved in offshore oil and gas exploration in New Zealand.

A constraint affecting the consideration of the options is that of time – the existing tax exemption expires at the end of 2014. Accordingly, any extension of the exemption should be enacted before the end of next year. A caveat concerning the analysis is that there is some degree of uncertainty regarding the behaviour of rig operators if the exemption were to be removed. However, the Ministry of Business, Innovation and Employment's best judgement (based on the rig operators' behaviour prior to the introduction of the exemption) is that if the exemption was removed, rig operators are likely to modify their behaviour.

Targeted consultation has been undertaken with the industry representative body. The Treasury and the Ministry of Business, Innovation and Employment have also been consulted.

The recommended approaches to the various issues raised do not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

Peter Frawley
Policy Manager, Policy and Strategy
Inland Revenue

10 October 2013

STATUS QUO AND PROBLEM DEFINITION

1. At present, the Income Tax Act 2007 contains a temporary five-year exemption from tax on the income of non-resident offshore oil rig and seismic vessel operators. The exemption was introduced in 2004 and extended in 2009. The exemption is due to expire on 31 December 2014. The measure was introduced as part of a package of temporary measures designed to encourage offshore oil and gas exploration.

Rigs and seismic vessels

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

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

Current tax settings

4. The exemption was introduced to address an issue created by our double tax agreements (DTAs), under which such operators are only taxable in New Zealand if they are present here for at least 183 days.

5. Ordinarily, a broad-base, low-rate framework applies to the tax system. A consistent application of this framework will normally minimise any distortions caused by tax rules. However, with seismic vessels and rigs used for exploration work, there is a question about whether the normal tax rules provide the right outcome.

6. New Zealand generally taxes non-residents on income that has a source in New Zealand. However, our DTAs provide that non-residents are only taxable on their New Zealand-sourced business profits if they have a "permanent establishment" in New Zealand. Many of our DTAs (such as the New Zealand/United States DTA) have a specific rule providing that a non-resident enterprise involved in exploring for natural resources only has a permanent establishment in New Zealand if they are present for a particular period of time, often 183 days in a year. Once a non-resident has a permanent establishment in New Zealand, they are taxed on all their New Zealand business profits starting from day one. Non-resident rig and seismic vessel operators generally have tax indemnity clauses in their contracts with New Zealand exploration companies. This means that the incidence of any tax imposed on a non-resident rig operator is borne by the exploration company operating in New Zealand which engages the rig operator's services.

7. The exemption was introduced to address an issue caused by this DTA provision – seismic vessels and rigs used in petroleum exploration were leaving New Zealand waters before the 183 day limit was reached so they would not be subject to New Zealand tax. This meant that in some cases a rig would leave before 183 days and a different rig was mobilised to complete the exploration programme. This "churning" of rigs within the 183 day period where income is exempt under many of our DTAs increased the cost for companies engaged in exploration; it also delayed exploration drilling and any subsequent discovery of oil or gas. It also meant that there was no revenue collected from seismic vessels and rigs. Because of

the limited supply of offshore drilling rigs, it could also result in exploration activity not taking place when it otherwise would.

Evidence of the effect of the exemption on offshore drilling activity provided by the Ministry of Business, Innovation and Employment

8. Comparing the period since the exemption has been in place (2005-2012) with the 2000-2004 period suggests that the exemption has extended the period that offshore rigs and seismic vessels are staying in New Zealand waters. Between 2009 and 2012, there have been three non-resident offshore rigs operating in New Zealand, with an average length of stay of around eight months. By contrast, between 2000 and 2005 (before the exemption was introduced), no rigs stayed in New Zealand waters beyond six months. There are three rigs confirmed to arrive in New Zealand this summer.

9. The average length of stay for seismic vessels has also extended from four months pre-2005 to eight months post-2005.

10. There have been 17 offshore wells drilled between 1 January 2009 and 30 June 2012. Only one well, the Manaia extended reach well drilled from the Maari platform, has resulted in new reserves being brought to market. The Manaia well was drilled from the Ensco 107 jack-up which had been in New Zealand waters for well over six months when drilling at Manaia commenced (drilling commenced on 1 August 2009 but the Ensco 107 had been in New Zealand waters since October 2007). The well produced 2.3 million barrels of crude oil between 2009 and 2012, generating an estimated royalty take of $4.9 million and corporate tax of $5.5 million over the period. It is unlikely that this Crown revenue would have been generated as soon as it was without the existing tax exemption. In the absence of the exemption, it is likely that this revenue would have been generated at a later time, because of the impact of rig churning delaying exploration and production activity.

11. A major drilling campaign is being prepared for the 2013/14 drilling season with 20 confirmed wells and a further seven wells being classed as contingent, probable or possible. Of the 20 confirmed wells, approximately four to five wells will be drilled by rigs that will have been in New Zealand for over six months. It is likely that these wells would not be drilled in 2014 if the existing tax exemption was not in place. It is likely that there would be a delay in the drilling of these wells if the existing tax exemption was not in place. It is also possible that some wells may not be drilled. If they were drilled at a later date and the exemption removed, it is likely that there would be additional costs relating to mobilising and demobilising churning rigs. The mobilisation and demobilisation costs for an offshore rig are approximately US$10-15 million. The cost of drilling a well is between US$10-150 million.

Modular drilling rigs

12. The current exemption applies broadly to non-resident companies operating seismic vessels and rigs used in drilling wells. As noted above the main rig types are semi-submersibles and jack-up rigs. However, a type of rig (a modular drilling rig) exists that is relatively small, of modular construction and designed to be installed on an existing platform. There is only one such rig in New Zealand. The other platforms on existing fields in New Zealand are too small to accommodate this type of rig. A modular drilling rig does not have the same high mobilisation and demobilisation costs as other rigs.

13. We consider that modular drilling rigs should be excluded from the scope of the current exemption for non-resident oil rig operators. This is because such rigs were never intended to be within the scope of the amendment (which was designed with large rigs, such as semi-submersibles and jack-up rigs, in mind). In addition, as modular drilling rigs do not have the same high mobilisation and demobilisation costs as semi-submersibles and jack-up rigs, the issue of rig churning is not as significant. Accordingly, the rationale for the exemption does not really apply to this type of rig.

Maintaining the status quo

14. If the status quo is maintained (i.e. the temporary exemption is left to lapse at the end of 2014), it is likely that rigs would resume staying in New Zealand waters for less than 183 days, so that the operators are not subject to tax. This would mean that the cost of offshore exploration activity would increase for New Zealand companies that engage offshore rig and seismic vessel services, as a new rig would have to be engaged to continue exploration work. Mobilising and demobilising such rigs has a cost of around $10-$15 million per rig. This would have flow-on effects for the tax base, as the cost would be deductible to the New Zealand company. The churn would also cause a delay in any potential revenue from successful exploration activity. However, this would be offset by the delay in the deductions associated with that additional exploration activity.

15. The root cause of the problem is that the normal tax rules increase costs for business by creating an incentive for seismic vessels and rigs to "churn", that is, move in and out of New Zealand waters within a 183-day period where income is exempt under many of our DTAs.

OBJECTIVES

16. The objectives are to:

1. ensure the tax rules do not unnecessarily distort the decisions of non-resident offshore rig and seismic vessel operators
2. ensure the tax rules do not discourage the offshore exploration for oil and gas in New Zealand
3. ensure that the scope of the exemption aligns with the policy intent.

17. The outcomes are subject to a time constraint. In considering the legislative vehicle and the application date for the amendment, officials have taken into account that the current temporary exemption expires on 31 December 2014. If the exemption is extended, it is preferable for the legislation to be enacted before the current exemption expires.

REGULATORY IMPACT ANALYSIS

18. There are two options that may deal with the problem and achieve the objectives:

1. Make permanent the current tax exemption for offshore non-resident rig and seismic vessel operators and amend the scope of the exemption to carve out modular drilling rigs. *(preferred option)*

2. Extend the current tax exemption for offshore non-resident rig and seismic vessel operators for a further five years and amend the scope of the exemption to carve out modular drilling rigs.

19. *Summary of impacts of options one and two*

Option	***Meets Objective?***	***Impacts***				***Net Impact***
			Fiscal/economic impact	***Administrative/ compliance costs***	***Risks***	
One (making exemption permanent – preferred option)	Yes	Tax system	No fiscal impact, as continuing current exemption. While not directly consistent with broad-base, low-rate tax framework, addresses churning issue caused by 183 day rule in our DTAs, meaning that exploration programmes are less likely to be delayed. No fiscal impact from amending scope as it will protect tax base going forward.	No administrative costs.	May create a precedent for other tax exemptions in the future.	Improves status quo by addressing issue caused by our DTAs, provides certainty to taxpayers and ensures scope of exemption aligns with policy intent.
		Taxpayers	Improves on the status quo by ensuring that costs of rig "churning" are minimised.	No compliance costs.		
Two (extending exemption by five years)	Yes	Tax system	As above	Some administrative costs from reviewing exemption at end of five year period.	As above.	As above but only for a further five years.
		Taxpayers	As above	No compliance costs but less certainty than option one.		
Three (status quo, i.e. let exemption lapse)	No	Tax system	May have negative fiscal impact. If the exemption were removed, rig operators are likely to resume churning. In this case, no extra revenue would be collected from oil rig operators, while firms purchasing their services could pay less tax. This is because the cost of these services (deductible to the New Zealand purchaser) could increase as a result of rigs being churned. Based on the information provided above on the 2013/14 drilling season, letting the exemption lapse could cost the New Zealand purchaser of rig services approximately US$36 million, with flow-on effects for the tax base.[1]	No administrative costs.		Rigs likely to resume churning because of the 183 day DTA rule, with resulting increased cost of offshore rig and seismic vessel services. Delay in Crown revenue collected from royalties and corporate tax on oil and gas production because drilling likely to be delayed.
		Taxpayers	Likely to be an increase in the cost of offshore rig services, which may delay or reduce offshore exploration activity.	Increased compliance costs.		

[1] This is based on the 3 rigs present in New Zealand for the 2013/14 drilling season and the estimated $10-15 million mobilisation and demobilisation costs per rig.

Social, environment or cultural impacts of all options

20. There are no social, environment or cultural impacts to the options. The groups affected by the amendments proposed are non-resident operators of offshore oil rigs and seismic vessels and oil and gas exploration companies which engage such operators.

Net impact of all options

21. The net impact of options 1 and 2 is to ensure that the tax rules do not unnecessarily distort the decisions of non-resident offshore rig and seismic vessel operators and do not discourage the offshore exploration for oil and gas in New Zealand. Options 1 and 2 also ensure that the scope of the exemption aligns better with the policy intent.

22. The net impact of option 3 (the status quo) is likely to be a return to the situation that existed before the exemption was put in place in 2005, which is that rig operators are likely to resume churning, with a resulting increased cost to companies engaged in exploration in New Zealand, with flow-on effects for the tax base.

CONSULTATION

23. Targeted consultation has been undertaken with the oil and gas industry representative body, the Petroleum Exploration and Production Association of New Zealand (PEPANZ), which supports making the exemption permanent.

24. The Ministry of Business, Employment and Innovation (MBIE) was also consulted; it supports option 1, as it aligns with the Government's policy of encouraging offshore oil and gas exploration in New Zealand.

25. The Treasury was also consulted and favours option 3 (the status quo of letting the exemption lapse). This is because they consider option 3 is more consistent with the Government's broad-base, low-rate tax strategy. Treasury was also concerned about the precedential effect of extending the exemption. However, it supports modifying the scope of the exemption to exclude modular drilling rigs.

26. Targeted consultation was also undertaken with the sole purchaser of modular drilling rig services in New Zealand, who accepts the rationale for excluding modular drilling rigs from the scope of the exemption, in the context of the exemption being made permanent. Consultation was limited because of the time constraint of ensuring legislation is enacted before the current exemption expires. There will be opportunities for other interested parties to submit on the amendments at the Select Committee stage of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill.

CONCLUSIONS AND RECOMMENDATIONS

27. Option 1 is the preferred option because it best achieves the policy objectives of ensuring that the tax rules do not unnecessarily distort the decisions of non-resident offshore rig operators and do not discourage the offshore exploration for oil and gas in New Zealand. Option 1 also ensures that the scope of the exemption better aligns with the policy intent.

28. Option 2 is not favoured because, while it achieves the policy objectives and ensures that the scope of the exemption better aligns with the policy intent, we consider that option 1

is preferable as the exemption has already been rolled over once and it will provide more certainty to exploration companies. In addition, there would be administrative costs from reviewing the exemption again in five years.

29. Option 3 is not favoured because it does not achieve the policy objectives.

IMPLEMENTATION

30. The amendments will be implemented through the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill, expected to be introduced in November this year. The amendments would have an application date of 1 January 2015, being the date that the existing temporary exemption ceases to apply.

31. There should be no significant implementation issues with the amendment. Inland Revenue will communicate the change in rules to taxpayers and tax agents through existing channels, such as the *Tax Information Bulletin* and through updating its guides.

32. Enforcement of the proposed changes will be managed by Inland Revenue as business as usual and there will be no specific enforcement strategy required.

MONITORING, EVALUATION AND REVIEW

33. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following the changes.

34. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

35. In general, Inland Revenue monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.