Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill

Bill Number 112-1

Regulatory Impact Statements

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Regulatory Impact Statement

Taxation of foreign superannuation

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem addressed in this statement is whether the current tax treatment of interests in, and income from, foreign superannuation schemes is appropriate and, if not, how it should be changed.

Key issues were the complexity of the current rules for taxing foreign superannuation held by New Zealand residents, and a lack of clarity on whether the rules resulted in a fair outcome, particularly for lump sum transfers and withdrawals. The complexity arises from the fact that a number of different regimes may apply in taxing interests in foreign superannuation schemes. This has resulted in significant levels of non-compliance, which has been estimated to be approximately 70%.

The issues were first raised by tax practitioners in 2006, and were included in the Government's tax policy work programme in 2011. The policy review focused on the application of the foreign investment fund (FIF) rules to foreign superannuation, and taxing lump sums received from foreign schemes, including both transfers and withdrawals. As there were no concerns about the current tax treatment of pensions, no changes to pensions are proposed, except insofar as those interests are currently taxed under the FIF rules.

The preferred option for reform will replace a number of different regimes (as they apply to foreign superannuation), simplifying the applicable tax rules and improving clarity. It also aims to maintain equity and consistency of tax treatment. It is expected that compliance costs for individuals will be reduced.

The option proposed involves legislating for two calculation methods for lump sums, in order to determine the amount of foreign superannuation which is assessable income. The calculation methods rely on several key assumptions. In particular, the interest rate and the growth rate in the foreign scheme have been calibrated at 5%. Although some submitters in the consultation process were concerned that the 5% rate was too high and may result in over-taxation, we note that since we are providing an alternative method for taxing actual gains, the 5% will effectively act as a cap where actual gains are higher. This is similar to the operation of the fair dividend rate and comparative value methods in the FIF rules.

Significant consultation was undertaken during the policy development process. Officials met with practitioners from several large accounting firms and the financial services industry, and with pension transfer agents. An issues paper released in July 2012 drew 59 external submissions. Key changes arising from the consultations included: deferring the application date from 1 April 2011 to 1 April 2014 as submitters were generally opposed to retrospective legislation, and providing for an alternative method to tax actual investment gains derived while the taxpayer was New Zealand resident.

The fiscal implications of the preferred approach are very difficult to quantify due to a lack of reliable information, but have been estimated to be broadly fiscally neutral based on migration trends and data on previous transfers provided by some pension transfer companies. The existing policy to tax foreign superannuation is continued under the new rules, which are designed to make the rules easier to comply with, rather than to collect any additional revenue.

Other than those set out in this statement, no significant gaps, assumptions, dependencies, constraints, caveats and uncertainties have been identified. The amendments do not impose additional costs, impair private property rights, reduce market competition, provide disincentives to innovate or override common law principles.

Joanna Clifford
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1 March 2013

STATUS QUO AND PROBLEM DEFINITION

1. New Zealand tax residents with interests in foreign superannuation schemes are liable for tax on those interests. The current rules for taxing foreign superannuation are complex. Foreign superannuation is taxed either annually under the foreign investment fund (FIF) rules, or at the time the person received the income (for example, as a pension, a lump-sum withdrawal, or a transfer to another scheme).

2. The FIF regime is the default method for taxing interests in foreign superannuation, unless a specific statutory exemption applies to an individual's circumstances. The exemptions recognise that there can be practical problems with applying the FIF rules to foreign superannuation. In particular, as superannuation is often locked in[1] until retirement age, the savings may not be accessible, so the FIF tax liability must be satisfied out of other income. The key exemption relevant to foreign superannuation therefore relates to locked-in employment-related schemes. Subjective elements can make this exemption difficult to apply.

3. A summary of the tax treatment of New Zealand residents' interests in domestic and foreign superannuation schemes is provided in the table below:

General treatment of retirement savings	Foreign retirement savings held by New Zealand residents - FIF rules	Foreign retirement savings held by New Zealand residents - FIF exemption
New Zealand taxes savings on a "taxed-taxed-exempt" (TTE) basis (on accrual). This means: • contributions are made out of after-tax income, • any gains are taxed at the time they are earned, and • all withdrawals are tax-free. Many foreign countries tax their residents' retirement savings on an "exempt-exempt-taxed" (EET) basis (on receipt). This means: • contributions are made before income tax is deducted, • any gains are not taxed at the time they are earned, and • any withdrawals made from the account are fully taxed.	This is default method for taxing foreign superannuation interests held by New Zealand residents: • the individual is required to calculate income or loss in respect of the foreign superannuation interest on an annual basis • there are a number of methods for calculating income under the FIF rules[2] • distributions from the scheme are tax-free • this is in line with the treatment of domestic savings: gains are taxed, but withdrawals are tax-free • since many foreign countries tax foreign superannuation on receipt, there may be some effective double taxation as New Zealand does not provide foreign tax credits for tax paid on receipt.	When a FIF exemption applies, the foreign superannuation interest is still taxable, but under different rules: • the individual does not need to calculate tax in respect of this interest on an annual basis • withdrawals, transfers and pensions are taxable on receipt • the amount of tax to be paid on lump sums depends on factors such as the legal structure of the superannuation scheme, for example a company or trust • it can be difficult to identify the correct tax treatment • the ultimate tax liability may be very different from that resulting from the FIF rules.

[1] A locked-in scheme is one where the provider does not permit withdrawals before retirement age or under certain restricted circumstances, for example, KiwiSaver.

[2] For example, the comparative value and fair dividend rate (FDR) methods. The comparative value method taxes the net increase in the value of the investment during the year. The FDR method taxes a deemed return of 5% of the market value of the person's interest.

4. As illustrated in the table above, the rules for taxing New Zealand residents on their foreign superannuation interests are complex and lack consistency and cohesion. There is particular complexity in respect of lump sums. Tax liability can differ substantially based on whether the FIF rules apply or whether – and how – a distribution is taxed under the dividend or trust tax rules. For example, tax on FIF income is likely to be less than or equal to 1.65% per annum of the market value of the interest, whereas tax on a distribution from a trust may equal fully 30% of the lump sum. This creates inequity between people in similar circumstances. These problems serve to make the status quo unsustainable.

5. Furthermore, the complexity and lack of clarity have led to significant levels of non-compliance, some of which was discovered during compliance activity undertaken by Inland Revenue. Some people were incorrectly advised that an exemption from the FIF rules meant that they were exempt from New Zealand tax altogether. Non-compliance is problematic because these individuals may learn they have significant tax liabilities, after they have spent or invested the money. While the exact amount of non-compliance is difficult to quantify due to a lack of reliable information, it has been estimated that the rate of non-compliance for the group to whom these rules apply, is approximately 70%, based on the data that Inland Revenue has been able to obtain. This figure includes people who should be accounting for tax under the FIF rules, as well as those transferring lump sums to New Zealand.

6. Public concerns with the current tax rules were identified in 2006 in submissions on the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill. Submitters considered that the current rules relating to withdrawals from superannuation schemes should be clarified. Officials acknowledged that the tax implications arising from an exemption from the FIF rules were not clear and recommended that further work be undertaken (subject to other Government tax policy priorities). In November 2011, the Minister of Revenue announced a policy review of the taxation of foreign superannuation. An issues paper was released in July 2012[3].

7. The status quo is unsustainable as non-compliance would remain prevalent, which would be inconsistent with Inland Revenue's focus on encouraging voluntary compliance. As noted above non-compliance is estimated to be approximately 70%. This could also pose a risk to the Government's revenue if the tax is not collected. Inland Revenue would also be obliged to resume compliance (i.e. pre-audit) activity on people who have not paid tax with respect to past transfers. The expected imposition of use-of-money interest and late payment penalties may place individuals in financial difficulty.

8. The problem addressed in this statement is whether the current tax treatment of interests in – and lump sum receipts from – foreign superannuation schemes is appropriate and, if not, how it should be changed. As taxation is imposed by legislation, only legislative amendments are sufficient to address these concerns.

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[3] *Taxation of foreign superannuation - an officials' issues paper*

OBJECTIVES

9. The objectives are to establish a coherent set of rules for the taxation of foreign superannuation held by New Zealand residents which have the following characteristics:

- *Equity* – to ensure that the tax treatment does not differ significantly based on a person's individual circumstances, such as whether they have foreign or domestic superannuation assets, or whether the income is received as a lump sum or a pension. For example, domestic savings are taxed on accrual and are exempt on withdrawal.
- *Efficiency* – to not discourage people from migrating to New Zealand or from transferring their superannuation here.
- *Simplicity* – to make the new rules as simple and compliance-friendly as possible, without the complexity that is prevalent in the current framework. This will help to reduce instances of non-compliance.
- *Certainty* – to enable people to determine their expected New Zealand tax liability in advance of transfer or migration, so that they are able to make informed decisions.

REGULATORY IMPACT ANALYSIS

10. To address the concerns regarding tax rules for foreign superannuation, officials identified the following options:

- **Option 1** – extend the accrual regime so that all interests in foreign superannuation schemes are taxed on accrual under the FIF rules. This would require repealing the existing FIF exemptions.

- **Option 2 –** tax all foreign superannuation on a receipts basis (i.e. when the income is received), in a manner which approximates tax payable on accrual. This would apply to both lump sums and pensions.

- **Option 3 (preferred) –** tax lump-sum withdrawals and transfers as per option two, but retain the current tax treatment for pensions[4]. This is, in essence, a hybrid of option two and the existing rules.

11. Retaining the status quo was not an option under explicit consideration. The inequity, complexity and lack of cohesion inherent in the current rules make them both undesirable and unsustainable.

12. The preferred approach is option three, which consists of taxing lump-sum withdrawals and transfers under the inclusion approach, and pensions under the current rules. The inclusion approach taxes lump sums on receipt and approximates the tax that would have been paid on accrual. The mechanics of the inclusion approach are discussed in paragraph 17. This is the framework presented in the officials' issues paper but with some modifications,

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[4] Pensions are taxed on receipt at a person's marginal tax rate.

following the consultation process. Officials consider that this option best addresses the concerns with the current law and is consistent with the stated objectives.

13. The new rules will apply to New Zealand residents who hold interests in foreign superannuation schemes. This group is expected to comprise new migrants and returning New Zealanders who have worked or earned income overseas. In addition, the transitional rules will affect people who transferred or withdrew their foreign superannuation in a prior year and did not properly comply with their tax obligations in respect of that amount. Again, the group of people who have transferred or withdrew their foreign superannuation in a prior year are likely to have worked or earned income overseas.

14. The economic and social implications of the options are outlined in a table on pages 9-11. There are expected to be some compliance cost savings arising from the preferred option, with few administration costs likely. No environmental or cultural costs are expected to arise.

Analysis of options

15. Option one would extend accrual taxation by requiring all interests held by New Zealand residents in foreign superannuation schemes to be taxed under the FIF rules. To ensure this outcome, the FIF exemptions would cease to apply to foreign superannuation and several exemptions would accordingly be repealed. The current FIF methods, as discussed on page three, would continue to apply in the same manner. Any income received from the foreign scheme would not be taxable.

16. The main difference from the status quo is that some foreign superannuation income which is (or should be under the current law), taxable on receipt – pensions in particular – would cease to be and would instead be taxed annually on accrual. Typically, this would alter the amount of tax payable. As illustrated in the table on page three, the tax treatment of FIF and non-FIF treatment can differ significantly, and determining whether an interest falls under the FIF rules or not can be complex. Option one would remove these problems.

17. Option two would also apply accrual taxation to all foreign superannuation (both lump sums and pensions), but instead of this being payable annually under the FIF rules it would be accumulated and payable only on receipt. An interest factor would be incorporated into the calculations to account for the use-of-money benefit that a person receives by not paying tax annually. The eventual tax liability would, therefore, be a function of the length of time that the person holds the interest (as a New Zealand resident) before the income is received. A longer duration implies a greater deferral benefit. This is termed the "inclusion approach", as a portion of the income – calculated as above – would be included in a person's assessable income and the rest would not be taxable.

18. For this option, there are two main differences from the status quo. First, all foreign superannuation interests which are currently taxable under the FIF rules would be excluded from those rules. People would instead be required to return income when the amounts are received. Second, for income which is currently taxed on receipt (especially pensions), the amount of the tax liability would be expected to change. In most cases, except for lump sum amounts which are wholly or largely considered a return of capital, this option would reduce the tax payable.

19. Officials note that some submissions on the issues paper effectively argued for this option: that option three, which was proposed in the issues paper, should be extended to periodic pensions as well. This is not preferred, for reasons which are outlined in the table on pages 9-11.

20. Option three involves the application of option two only to lump-sum withdrawals and transfers, and retaining the current treatment of periodic pensions. The inclusion approach would be applied to lump sums received from foreign superannuation schemes. The inclusion rates will be calculated in the same manner as under option two. It is officials' preferred approach because it removes the complexity of the FIF rules, as well as the cash-flow problems that may arise when individuals have tax to pay on accrual but cannot access the required funds because their scheme is locked. It is also preferred because it recognises that the current tax treatment of periodic pensions is not a problem and therefore will continue to be taxed on receipt at a personal's marginal rate. The officials' issues paper proposed this option. A number of changes have been made following the consultation process (in particular, an alternative method to the inclusion approach to tax actual investment gains), although these do not affect the basic framework of this option.

21. There are some common advantages to all three options. In particular:

- The distinction between foreign superannuation interests that are subject to the FIF rules and those that are not will be removed. Less reliance will be placed on the current FIF exemptions, which can be subjective and difficult to apply. The tax consequences will no longer depend on whether, for example, a scheme is locked-in. This ensures that the rules are simple, fair, efficient, and provide certainty.

- Systematic over-taxation should be avoided by tax being payable to the extent that it would have been paid on accrual (plus an interest factor for the deferral benefit). Full taxation of lump sums, which has the potential to occur under the current rules, was not considered as a viable option. This ensures that the rules are fair.

- The taxation of lump sums will no longer be assessed under the existing rules that apply where there is a FIF exemption. The rules that apply where there is a FIF exemption are highly complex and depend on factors such as whether the distribution is from a company or a trust. This ensures that the rules are simple, which means that it will be easier to apply and less-information intensive for individuals.

- There will not be a disincentive to transfer superannuation to New Zealand compared to leaving savings overseas. This will achieve the objective of efficiency as a neutral policy setting is desirable.

22. The new rules will be implemented within the existing legislative and regulatory framework. A number of provisions have specific relevance to this policy reform. The transitional residents' rules provide an exemption from New Zealand tax (including both the FIF rules and tax on receipt) for most sources of foreign income during the first four or so years of residence. The agreement on trans-Tasman portability of superannuation between New Zealand and Australia will, when it comes into force on 1 July 2013, ensure that

qualifying transfers from certain Australian schemes into KiwiSaver schemes are not taxable. The 2010 double tax agreement between New Zealand and Australia also provides a similar result for lump sums.

23. The preferred option incorporates the existing measures described in paragraph 22. For example, transitional residents receiving lump sums will only be taxed on investment gains that would accrue after the end of their four-year exemption for foreign income. As transfers from Australia are exempt under the above international agreements, the preferred option addresses a revenue risk by providing for tax to be payable on foreign superannuation transfers into either New Zealand or Australian schemes.

24. Several key assumptions underpin these options. The amount of accrued gains and the use-of-money interest charge which are to be payable on receipt, use interest and growth rates of 5%. It is further assumed that the investment gains that accrue in the foreign scheme are not taxed (i.e. the foreign country operates an "EET" regime). These assumptions enable the calculation methods to determine the extent of tax that has not been paid in New Zealand on accrual (as under the FIF rules), which forms the basis for the new rules.

25. Officials consider these assumptions are robust. The 5% rates were chosen to be consistent with the FDR method, and will effectively serve as a cap where investment gains would be higher. (If investment gains are lower, the alternative approach for taxing actual gains may be used instead.) The assumption of an EET regime is valid as the majority of the source countries from which new migrants come, operate an EET regime. The notable exception is Australia; however, transfers of superannuation from Australia will not be taxable under the international agreements discussed in paragraph 22.

26. The fiscal implications of the preferred approach are very difficult to quantify due to a lack of reliable information, but have been estimated to be broadly fiscally neutral. The existing policy is to tax foreign superannuation, and the new rules are simply designed to make the rules easier to comply with rather than to collect any additional revenue.

27. In addition to the advantages listed above, which are common to all three options, officials' analysis is summarised in the following tables. Some terms are explained on page three:

Option	Advantages	Disadvantages	Net impact
One: Extend the accrual regime so that all interests in foreign superannuation schemes are taxed under the FIF rules. **Objectives met:** • Equity (partially) • Efficiency • Certainty	• The FIF exemptions would no longer apply, which would reduce some complexity, and subjectivity (certainty and to an extent simplicity). • Consistent tax treatment between lump sums and pensions (equity). • Consistent with treatment of domestic superannuation and savings (on a "TTE" basis) (equity and efficiency). • Consistent with treatment of other foreign assets held by New Zealanders that are also taxed under FIF rules (equity and efficiency). • Regular collection of tax annually rather than sporadically on receipt (certainty).	• FIF rules may be complex and unintuitive, which leads to additional compliance costs and increases the risk of non-compliance. • Significant practical issues in applying the FIF rules. For example, an individual may encounter cash-flow difficulties when paying tax on accrual in respect of a locked-in scheme as they cannot access the required funds. Individuals with defined benefit schemes may not have access to the required information on the value of their scheme. • Mismatch of foreign tax paid with other countries, which can result in some economic double taxation (when New Zealand tax has been paid on accrual, no foreign tax credit will be available in New Zealand for foreign tax subsequently paid on receipt). • Inconsistent with taxation of domestic pensions and foreign social security pensions. • Sizeable fiscal cost of reducing tax on pensions; ambiguous fiscal implications for lump sums.	Not preferred as it retains significant complexity even though at face value it makes the FIF rules simpler by removing possible exemptions. There are significant practical issues with accrual taxation for people with interests in locked-in and defined benefit schemes, compared with the status quo. There may be cash-flow or valuation difficulties, as such schemes are currently taxed on receipt. Furthermore, it creates inequity between foreign and domestic periodic pensions. There is a continued risk of non-compliance.

Option	Advantages	Disadvantages	Net impact
Two: Tax all foreign superannuation on receipt in a manner which approximates FIF taxation. **Objectives met:** • Equity (partially) • Efficiency • Certainty	• Taxation on receipt is more consistent with people's expectations (certainty). • Resolves practical issues with the FIF rules of liquidity, valuation and lack of information (simplicity, but only in respect of lump sums. See disadvantages). • Less complexity than the FIF rules, so reduced risk of non-compliance (simplicity, but only in respect of lump sums. See disadvtanges). • Consistent tax treatment between lump sums and pensions (equity). • Matching of foreign tax credits with other jurisdictions which helps to prevent double taxation (efficiency). • Preserves residence state's right to tax under a number of New Zealand's double tax agreements (efficiency). • Largely consistent with taxation of other foreign investment (as lump sum taxation approximates accrual), although tax imposed at different times (equity).	• Partial taxation of pensions is not consistent with people's expectations and creates additional complexity compared with the status quo. • Inconsistent with taxation of domestic pensions and foreign social security pensions. • Risk of revenue loss if person moves overseas before receiving the lump sum, as tax would not be collected annually.	Not preferred as it does not meet the simplicity objective, because it creates additional complexity for periodic pensions. Compared to the status quo, it would impose a significant risk of revenue loss due to the partial taxation of pensions. Furthermore, it creates inequity between foreign and domestic periodic pensions.

Option	Advantages	Disadvantages	Net impact
Three: Tax lump sum amounts on receipt in a manner approximating accrual taxation (as per option two) and retain the current tax treatment for pensions. **Objectives met:** • Equity • Efficiency • Simplicity • Certainty	• Targets reform at problem area (lump sums and FIF rules). • Retains current tax treatment of pensions, which is intuitive, simple and well understood (simplicity and certainty). • Resolves practical issues with the FIF rules of liquidity, valuation and lack of information (simplicity). • Less complexity than the FIF rules, so reduced risk of non-compliance (simplicity). • Matching of foreign tax credits with other jurisdictions which helps to prevent double taxation (efficiency). • Preserves residence state's right to tax under a number of New Zealand's double tax agreements (efficiency). • Largely consistent with taxation of other foreign investment (as lump sum taxation approximates accrual), although tax imposed at different times (equity). • Consistent with taxation of domestic pensions and foreign social security pensions (equity).	• Inconsistent tax treatment between taxation of pensions and lump sums, which may create boundary issues (e.g. commutation of pensions). • Pensions will be fully taxable, and so may be taxed on capital amounts and gains derived while non-resident. • Risk of revenue loss if person moves overseas before receiving the lump sum as tax would not be collected annually.	Preferred option as it meets all four objectives. There is a small trade-off of equity (between lump sums and pensions) for simplicity and improved compliance. This inequity exists under the status quo as well. However, it retains equity between domestic and foreign pensions which the other two options do not achieve. On balance, the benefits outweigh the costs. It is an improvement on the status quo as the revenue from periodic pensions is maintained and compliance in respect of lump sums is expected to improve, regardless of the revenue risk identified in the disadvantages column.

CONSULTATION

28. In the first half of 2012, officials consulted with certain tax practitioners and the members of the financial services industry on problems with the current tax rules for foreign superannuation. Their views were incorporated into the policy design, particularly the application of the FIF exemptions and concerns about the taxation of lump sums *vis-à-vis* pensions. An issues paper, *Taxation of foreign superannuation*, was subsequently released by Inland Revenue and the Treasury in July 2012. Fifty-nine external submissions were received, and the main comments from submitters were as follows:

Issues and comments raised in submissions	Response
Support for taxation on receipt There was considerable support for taxing foreign superannuation on receipt, rather than on accrual, under the FIF rules. The proposals were considered pragmatic, and the main advantages were said to be clarity and simplicity.	N/A
Inclusion approach may over-tax The inclusion rates assume growth in the foreign scheme of 5% (after taxes and fees), which was considered to be unrealistic. This may result in over-taxation. Consequently, submitters argued there should be an alternative method whereby tax would be payable on actual investment gains.	An alternative method has been included in the new rules that will tax lump sum amounts on the actual investment gains derived in a foreign defined contribution scheme while the person is a New Zealand resident. An interest factor will be charged on these gains in recognition of the use-of-money benefit from deferral. The grace period, during which no New Zealand tax will be payable on lump sum transfers or withdrawals, has been lengthened from two years to four years. This will provide a longer tax-free window during which people can transfer to New Zealand, and will be consistent with the duration of the transitional residents' exemption. Rather than the inclusion rates being calculated on the basis of years of residence since migration, they will instead be calculated on years of residence since the end of the grace period, or transitional residents' exemption. Gains which accrue during the grace period or transitional residents' exemption will not, therefore, be taxed on receipt.
Application date The proposed general application date of 1 April 2011 was not favoured. Instead, a prospective application date was preferred, with most suggesting 1 April 2013 or 1 April 2014.	The application date has been deferred from 1 April 2011, as initially proposed, to 1 April 2014 in order to provide more certainty to individuals affected by the proposals. Previously, it was proposed that a person must have complied with the FIF rules for the 2011 tax year by the due date for that year in order to continue using the FIF rules. Given that the general application date has

	changed, the criteria for a person to be able to continue to use the FIF rules have also been modified to be less restrictive. The new rules provide that only people who file a tax return including FIF income or loss in respect of a foreign superannuation interest before the introduction of legislation may continue to use the FIF rules for that interest after 1 April 2014. This is not restricted to any particular tax year.
Implementation issue - Low cost option for past transfers As a concessionary measure, the paper proposed an option for people who transferred a lump sum in the past and who did not previously comply to apply a 15% inclusion rate. The majority of submitters argued that the 15% inclusion option for past transfers is unfair, as previous non-compliance was inadvertent. Submitters argued that there should be a full amnesty for transfers made in prior years so there is no further tax to pay.	A full amnesty is not recommended as it would create an unfair advantage for non-compliant people over people who have complied with the law and fulfilled any resulting tax obligations. The 15% inclusion option is necessary to reduce potential tax liabilities facing people who did not comply with the tax rules in respect of past transfers. It does not impose taxation retrospectively The eligibility period for the 15% inclusion option has been extended to also apply to transfers up to 31 March 2014, as proposed in some submissions. In the absence of the 15% inclusion option, Inland Revenue's compliance (i.e. pre-audit) activity – which has been deferred pending this policy review – would recommence. The application of existing law, plus use-of-money interest and late payment penalties, would be expected to result in significantly higher tax burdens for most people. The 15% inclusion option is therefore a concessionary and voluntary alternative to the existing law.

29. The new rules have been developed in consultation with the Treasury. Inland Revenue has also consulted with the Ministry of Social Development and the Ministry of Business, Innovation and Employment.

CONCLUSIONS AND RECOMMENDATIONS

30. Officials have assessed the three options discussed in this Regulatory Impact Statement against the stated objectives. The recommended approach, option three, would establish a new, cohesive set of rules in the Income Tax Act 2007 to replace the current rules applying to interests in – and income from – foreign superannuation schemes. The FIF rules will cease to apply to foreign superannuation interests. Instead, lump sum amounts will be taxed on receipt under one of two new calculation methods. These methods are designed to approximate the tax that would have been paid on accrual under the FIF rules, in conjunction with an interest charge that recognises the deferred payment of tax until receipt. Foreign pensions will continue to be taxable on receipt at a person's marginal tax rate. On balance, the recommended approach achieves all four objectives for taxing interests in foreign superannuation: equity, efficiency, simplicity, and certainty.

IMPLEMENTATION

31. The new rules will apply to lump sum transfers or withdrawals received from a foreign superannuation scheme on or after 1 April 2014. New rules will also apply to transfers made before that date, which will be optional and operate alongside the existing law.

32. A person who receives a lump sum after 1 April 2014 will be required to determine the corresponding amount of assessable income under one of the two calculation methods. The result will be included in the person's income tax return for the tax year in which the lump sum was received.

33. A person who received a lump sum in a prior year, and for which they did not comply with their tax obligations (either under the FIF rules or on receipt) may either apply the law which existed at the time or include 15% of the lump sum in their assessable income. To use the 15% inclusion rate, a person will need to return the income in a tax return on or before 31 March 2016. Where the 15% inclusion rate is used, use-of-money interest and late payment and filing penalties will generally not be applied.

34. There will be transitional provisions in place with regards to the application of the FIF rules. A person will need to self-assess whether they can continue to use the FIF rules after 1 April 2014 according to specified criteria. If they are able to continue to use the FIF rules, they can elect to do so by including their FIF income or loss from a foreign superannuation interest in their income tax returns until their rights in the foreign scheme cease. Alternatively, the person can elect to apply the new rules rather than the FIF rules by not including the FIF income or loss in their tax return. Once this election is made, the person will not be able to subsequently apply the FIF rules in respect of that interest. Any income received from that interest will be taxable on receipt.

35. More guidance on implementation and transition issues will be provided when the new rules have been finalised, closer to the enactment of the amending legislation, for example in a Tax Information Bulletin. There are no significant administrative issues arising from these changes.

MONITORING, EVALUATION AND REVIEW

36. Inland Revenue monitors, evaluates and reviews new legislation under the Generic Tax Policy Process (GTPP). The GTPP 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 GTPP involves reviewing the legislation after implementation and identifying any remedial issues.

37. The levels of voluntary compliance in relation to past transfers of foreign superannuation will be assessed through the uptake of, for example, the 15% inclusion option before 31 March 2016.

38. The effectiveness of the new rules after 1 April 2014 will be monitored under the GTPP. Any further changes that are identified as being necessary for the new legislation to have its intended effect would generally be added to the tax policy work programme, and those proposals would also go through the GTPP. Further consultation would be implicit in this

approach. Extending the new rules to foreign life insurance policies with savings elements, which share a number of characteristics with foreign superannuation, may be considered by officials at a later date.

Regulatory Impact Statement

Specified Mineral Mining – Tax Review

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of:

- whether the current tax rules for specified mineral mining are appropriate; and
- if they are not appropriate, the options to more closely align the rules that operate in respect of specified mineral mining to those that apply to the majority of other taxpayers.

There are approximately 200 specified mineral mining operators in the industry. Most of these are relatively small, with a few major operators being responsible for the bulk of production levels.

Consultation on these issues took place via an officials' issues paper, *Taxation of specified mineral mining*, released in September 2012, which sought feedback on various features of a proposed set of tax rules that would replace the existing concessionary rules. Following review of written submissions, officials from Inland Revenue and Treasury met with a number of interested parties. Submissions were received from accounting firms representing clients, mining firms, and mining industry representatives and were overwhelmingly in favour of the retention of the current rules. In addition to their opposition to any general reform in this area, submissions also raised issues with some of the more detailed proposals in the issues paper. Of particular interest to submitters were, the proposed "claw-back" rule, the concept of the "life of the mine", the proposal to make specified mineral mining companies subject to the general tax rules for grouping and shareholder continuity, and rehabilitation expenditure.

The preferred option would largely replace the existing concessionary tax rules for specified mineral miners, and Inland Revenue recognises this is contrary to the preference of submitters. However, the reasons for replacing them (and removing most of the current concessions) are considered more compelling when broad principles such as minimising economic distortions, fairness across taxpayer groups and the coherence of the tax system are considered. Submissions have been taken into account on the details of the proposals, such as the proposal to allow specified mineral mining company losses to be carried through a breach in shareholder continuity.

There are no other significant gaps, dependencies, constraints or caveats concerning the regulatory analysis undertaken. We do however note that the estimated revenue gain of approximately $30 million per annum associated with these changes is relatively uncertain as it is highly contingent on matters such as relative consistency of production levels and the international price of minerals.

The proposed option does not impair private property rights, reduce market competition, or override common law principles. It does arguably provide less incentive to innovate and invest in the specified mineral mining sector than currently, but only to the extent that it proposes the removal of most of the existing concessionary rules.

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11 March 2013

STATUS QUO AND PROBLEM DEFINITION

1) At present there is a separate set of tax rules that apply to "specified mineral miners". There are approximately 200 specified mineral mining operators in the industry. Most of these are relatively small, with a few major operators being responsible for the bulk of production levels.

2) There are 50 specified minerals, of which gold, silver and iron sands are the most commonly mined. The current tax rules that apply to this group effectively allow a tax deduction for capital expenditure in the year the expenditure is incurred, and, in certain circumstances, allow expenditure to be deducted in anticipation of it being incurred.

3) These immediate deductions for capital expenditure and expenditure yet to be incurred make the tax rules for specified mining very concessionary compared to most sectors, including petroleum mining, which also has concessionary rules.[1]

Example:

Current tax rules for specified mineral mining	Orthodox tax rules
An immediate deduction is available for expenditure that is defined in the Income Tax Act as either "mining exploration expenditure" or "mining development expenditure". These terms effectively cover expenditure incurred in searching for mineral deposits and preparing an area for mining. They include significant items of capital expenditure such as land, buildings and machinery.	Deductions for the same expenditure would either not be permitted or deferred and allowed over the economic life of the asset.

4) Tax concessions to particular industries can have the following effects:
   i) They potentially distort investment decisions and the allocation of capital;
   ii) They can be perceived as being unfair on other taxpayers that do not have concessions.
   iii) They reduce the coherence of tax policy.
   iv) They are also contrary to the Government's objective of a broad-base, low-rate tax system.

5) The benefit of the existing tax rules rests almost entirely with the specified mineral mining sector. Although that sector forms an important part of the New Zealand economy, given the Government's focus on a broad-base, low rate tax policy, it is timely to review whether tax concessions are appropriate given the relative lack of concessions provided to similarly capital-intensive industries.

6) It is also noted that this review is occurring largely simultaneously with a Ministry of Business, Innovation and Employment (MBIE) review of the royalty rates that apply to new

[1] A person's taxable income is determined after taking deductions off assessable income. The ability to access deductions can therefore reduce the person's tax liability.

high-value mineral developments.[2] This review complements the work undertaken by MBIE. Both seek a fair return on the Government's mineral resources consistent with the Government's Business Growth Agenda, by better ensuring that scarce capital and labour is allocated to the most productive areas of the economy.

OBJECTIVES

7) The objective of the current review is to ensure the tax rules that apply to specified mineral miners:

i) Are efficient (that is, they do not distort investment decisions);
ii) Promote equity and fairness across the taxpaying community;
iii) Are coherent in terms of the overall tax system;
iv) Promote revenue integrity;
v) Provide certainty;
vi) Do not impose undue compliance costs on business.

REGULATORY IMPACT ANALYSIS

8) We consider there are three main options for dealing with the over-arching issue of the current concessionary rules:

i) *Status quo:* The current rules be retained.
ii) *Revised rules:* A revised set of rules for specified mineral miners be introduced that brings their tax treatment more closely into alignment with other taxpayers.
iii) *No mining rules:* The current rules could be repealed and not replaced so the general tax rules applied to specified mineral miners.

9) Although options 2 and 3 would arguably be similar in effect, option 2 is based on the assumption that some specific rules would be desirable to perform the following functions:

i) Clarify areas of uncertainty for types of expenditure relatively unique to specified mineral mining.
ii) Provide rules that deviated from the standard tax treatment to cater for relatively unique aspects of mining operations.

10) Officials consider there are strong economic arguments for removing concessions and these apply equally to options 2 and 3. These arguments are summarised below. However, we also consider that, because of its potential to result in higher compliance costs and create greater uncertainty for no discernible benefits over and above those provided by option 2, option 3 is not viable. This option was therefore not consulted on, nor was it raised as a realistic possibility by submitters.

11) "In designing option 2 officials were conscious that there are some unique features to specified mineral mining that may justify special rules. These are:

i) The fact that the costs of mining are generally divided into specific definable phases "prospecting expenditure", "exploration expenditure", "development expenditure", "mining expenditure" and "rehabilitation expenditure". It is arguably unfair to treat all of these expenditure types under ordinary principles because the nature of mining operations means that some items that may generally

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[2] http://www.med.govt.nz/sectors-industries/natural-resources/pdf-docs-library/oil-and-gas/crown-minerals-act-review/consultation-on-the-royalty-regime-for-minerals/discussion-paper.pdf

be regarded as capital warrant different tax treatment. There is also scope in mining to incur significant expenditure after all income-earning activity has ceased (such as "rehabilitation costs" of restoring land to the condition required).

ii) It is not always clear at the outset how long a mine will last. Under general principles of depreciation, capital assets that decline in value should be depreciated over their useful life. To be consistent with this principle, assets with a useful life contingent on the operation of the mine would need to be depreciated over the "life of the mine". However, a fixed life would arguably produce uneconomic outcomes because the life of a mine can be a variable figure depending on mineral reserves and levels of production. It is therefore necessary to define the "life of mine" concept and incorporate the necessary flexibility.

iii) It may be possible for a miner to access tax-free capital gains by disposing of land with the minerals still in place, whereas income from the extraction and sale of those same reserves would be subject to tax. The tax treatment of land should therefore be considered.

iv) There are currently rules allow mining companies to carry losses through a change in shareholding (an option not open to most other companies), but restrictions on who mining companies can group with for tax purposes (effectively they can only group with other mining companies). It is important to consider if there is something sufficiently different about the specified mineral mining sector that justify these rules being retained or whether the standard loss and grouping rules should apply.

v) How "farm-out" arrangements, insurance receipts and bad debts should be treated. There are currently special rules for insurance receipts and writing off of debt by mining holding companies. Again, it is important to consider if these are still appropriate.

12) Officials consider the following sector-specific rules will provide a more orthodox tax treatment to the sector (by removing the concessionary treatment), while still providing certainty and catering for some distinctive features of the sector, as explained above

i) "Prospecting expenditure" and "exploration expenditure" should be immediately deductible, subject to the claw-back rule discussed in point iii), below.

ii) "Development expenditure" should be capitalised and deducted over the life of the mine. [3]

iii) "Exploration expenditure" on items later used for the extraction of minerals should be added back as income in the year the mine becomes operational and deducted over the life of the mine as if it were development expenditure.

iv) The "life of the mine" should be self-assessed by taxpayers based on their expected activities in a particular permit area, but should not be less than the expected life of the mine used for accounting purposes. A mine would have a maximum life for tax purposes of 25 years.

v) "Mining expenditure" should be subject to the ordinary capital/revenue distinction that applies to other businesses.[4]

vi) "Rehabilitation expenditure" should be deductible in the year it is spent, but a refundable credit should be generated if a loss is incurred in that year to provide

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[3] Capitalised expenditure is not immediately deductible. Instead, deductions are generally spread over the estimated useful life of the asset created.

[4] Taxpayers are able to immediately deduct revenue items, while capital items are either non-deductible or deductible over time through depreciation.

for the fact that the expenditure may occur after income-earning activity has ceased.

vii) Land should be treated as revenue account property of a mining company, meaning income or a deduction is accounted for in the year of disposal.[5] As with rehabilitation expenditure, if a loss is incurred in the year of a land sale, a refundable credit should be generated.

viii) The existing loss rules for mining companies should remain. That is they should continue to be able to carry losses forward through a continuity breach, but only be able to offset those losses against income from the same permit area. To prevent this loss continuity rule being manipulated, mineral mining companies should still only be allowed to form tax groups with other mining companies. This is consistent with the current mineral mining rules, but differs from the rules that apply more generally.

ix) The rules that allow mineral miners to appropriate income for future expenditure should be repealed. To account for the fact that the repeal of this rule may result in unexpected tax liabilities for miners, they should be allowed to spread any income tax liability over the two years following effective date.

x) When a "farm-out" of mining rights takes place, the consideration received should be treated as income in the year the rights pass and the consideration paid should be deducted over the expected life of the mine (or be immediately deductible if the mine is still in the prospecting or explorations phases).

xi) The normal tax rules should apply in respect of insurance receipts and bad debt/bad debt recovery.

13) The table on the following pages analyses the 3 options discussed above against the objectives of the review:

[5] Revenue account property is taxable or deductible in the year of sale, meaning that if it is sold for less than it was bought for, a deduction is available. Conversely, if a profit is made, that profit is taxable.

	Objectives (Met/Not met)						Impacts		
	Efficiency	Equity	Coherence	Revenue	Certainty	Compliance	Costs	Benefits	Net economic Impact
Option 1: Status quo – Not preferred	Not met – Industry concessions distort investment decisions and productivity of capital	Not met – By lowering the tax obligations of one sector you must invariably increase the relative burden on others.	Not met – Industry concessions are contrary to the Government's overall broad-base, low-rate tax policy framework.	Not met – Lowering the tax obligations for certain taxpayers not only reduces the revenue from that particular source but also puts the overall tax base at risk.	Met – The rules in their current form have been in place for a number of years and are well understood by industry.	Met – Taxpayers are familiar with the current rules and have systems designed for them.	**Government:** Lower revenue collection and issues associated with concessionary rules, such as lobbying from comparable industries for similar concessions. **Taxpayers:** None for the particular sector, but concessions result in relatively higher burden on other taxpayers and lower levels of investment in other industries.	**Government:** A specified mineral mining sector that is more profitable than it otherwise would be. **Taxpayers:** Higher after-tax profits for the sector.	Negative – the benefits to the industry are outweighed by broader considerations of a lack of efficiency, equity, coherence and revenue gains.

	Objectives (Met/Not met)						Impacts		
	Efficiency	Equity	Coherence	Revenue	Certainty	Compliance	Costs	Benefits	Net economic Impact
Option 2: Revised rules (removing most of the concessions whilst retaining some special rules) – Preferred option	Met – Neutral tax treatment promotes investment decisions based on pre-tax returns	Met – Providing broadly consistent tax treatment across industries, allows different industries to compete on a level footing.	Met – Consistent tax treatment across comparable sectors promotes the overall coherence of the tax system.	Met – Removing tax concessions broadens the tax base and ensures that an appropriate amount of tax is paid by all taxpayers.	Not met – A revised set of rules will create some uncertainty while they are 'bedded in' and both taxpayers and Inland Revenue start applying them in practice.	Not met – A new set of rules would necessarily result in compliance costs being incurred while the new rules were established and systems put in place to ensure the revised obligations could be accurately met.	**Government:** Industry dissatisfaction with change. It is not clear how this dissatisfaction would manifest at a practical level. **Taxpayers:** Higher tax obligations and some compliance costs while new systems were established.	**Government:** Promotes efficiency, equity and coherence across the tax system and raises revenue of approximately $30 million per annum. **Taxpayers:** None for the particular sector, but fairer on broader taxpaying community.	Positive – provides efficiency, equity and coherence across the tax system and raises revenue. Compliance costs will be incurred, but are largely expected to be of a one-off nature.

	Objectives (Met/Not met)						Impacts		
	Efficiency	Equity	Coherence	Revenue	Certainty	Compliance	Costs	Benefits	Net economic impacts
Option 3: No mining rules (general tax rules that apply to other businesses applying to miners) – Not preferred	Met – Neutral tax treatment promotes investment decisions based on pre-tax returns	Met – Providing broadly consistent tax treatment across industries, allows different industries to compete on a level footing.	Met – Consistent tax treatment across comparable sectors promotes the overall coherence of the tax system.	Met – Removing tax concessions broadens the tax base and ensures that an appropriate amount of tax is paid by all taxpayers.	Not met – Not having any special rules would promote considerable uncertainty while the industry and Inland Revenue established which of the 'regular' rules apply to which part of a mining operation.	Not met – Not having special rules would necessarily result in compliance costs being incurred while the application of the general rules was established and systems put in place to ensure the revised obligations could be accurately met.	**Government:** Industry dissatisfaction with change arguably higher under this option because of anticipated higher compliance costs. **Taxpayers:** Higher tax obligations and possibly significant compliance costs while new systems were established.	**Government:** Promotes efficiency, equity and coherence across the tax system and raises revenue of approximately $30 million per annum. **Taxpayers:** None	Probably positive, but expected to result in higher compliance costs and greater industry uncertainty for no benefits over and above those provided by option 2.

Recommended option

14) Inland Revenue considers that option 2 is preferable. At a simplistic level, the choice is between keeping a concessionary set of rules (option 1) or applying more orthodox principles to the sector (options 2 and 3).

15) Tax concessions that favour one particular industry distort investment decisions and the productivity of capital. Distortions arise in this context if a tax concession induces people to invest in a particular sector that, in the absence of the tax, they would not invest in. If businesses are effectively subsidised through the tax system, it also has the potential to distort the domestic labour market through that industry being in a position to offer remuneration that a non-subsidised business could not match.

16) New Zealand's framework for taxing inbound capital is based around applying broadly the same tax rules no matter which area of the economy the capital is invested. This is consistent with our broad-base, low rate tax framework. This is why, for example, the same company tax rate applies to companies across the New Zealand economy. The logical extension of option 1 would be to abandon this framework and apply lower effective tax rates on foreign investment into certain areas of the economy. Not only would such an approach put the company tax base at extreme risk, it would likely result in unfair and inefficient outcomes. In addition, it would strongly encourage industries to lobby Government for industry-specific tax concessions.

17) Further, we consider that, even if tax settings are a consideration when investing into a certain jurisdiction, they will - provided the rules are not actively discriminatory - be relatively insignificant compared to other factors, such as a country's infrastructure, the skill of its labour force and the market price of the mineral in question.

18) However, officials recognise that some unique features of the specified mineral mining sector justify departure from the standard rules. As a result some special rules should still be in place for the sector. It is therefore considered that option 2 is preferable.

CONSULTATION – POLICY FRAMEWORK

19) An officials' issues paper was released by The Treasury and Inland Revenue entitled: *Taxation of specified mineral mining* in October 2012.

20) A total of 39 submissions were received from a mix of accounting firms representing clients, mining firms, and mining industry representatives. Twenty-six of the submissions received were standard form submissions from West Coast alluvial gold miners.

Submissions

21) Submissions were overwhelmingly in favour of retaining the status quo. Most submissions agreed that the current rules were concessionary, but that opposed change on the basis of efficiency. Submitters argued that it is incorrect to look at the distortion of local capital markets in isolation. They consider that there is only a limited capital pool available worldwide for mineral mining and, to the extent that rules in New Zealand change to make it less profitable to operate here, that capital will migrate to a more favourable jurisdiction.

Therefore, they suggest, it is more a question of whether the capital comes to New Zealand at all, rather than its efficient allocation once it is here.

22) Submitters also suggested that adverse changes to the tax rules for specified mineral miners could have particularly detrimental effects on rural areas where mining is prevalent – the West Coast of the South Island in particular.

23) Officials do not agree with submitters on the efficiency point for the reasons set out in the analysis section (recommended option), above.

24) Officials understand submitters' concerns about the impact on rural areas. However, as stated above, the tax system is based on the fundamental premises of a broad base and low rate. To the extent that Government support is provided to particular communities, it is more efficient to have this take place through a targeted system, rather than tax concessions to a particular industry.

CONSULTATION – POLICY DETAIL

25) As mentioned above, submitters disagreed with the overall objectives of the proposals as described in option 2. However, written submissions on the issues paper and later meetings and conversations between submitters and Inland Revenue and Treasury officials also focussed on the detailed policy proposals put forward in the issues paper.

26) Although many of the features of the final proposal are consistent with the issues paper, the following table sets out the specific proposals that attracted the most submissions. For each issue it then restates the final policy proposal and, if the final policy proposals have been altered as a result of consultation, what has changed and why. Where key submission points were not advanced as part of the final proposals, it explains the reasons why they were not considered appropriate:

Issue and proposed rules	Submissions and response
Claw-back rule: Given that exploration expenditure would be immediately deductible and development expenditure would have to be capitalised, there are incentives to recharacterise development expenditure as exploration expenditure in order to access those deductions. The proposal is that any item treated as exploration expenditure that is used for mineral extraction is clawed back and then depreciated over the life of the mine (effectively treating it as development expenditure).	The proposal is consistent with the issues paper. Submissions suggested that the boundary between exploration and development expenditure are almost always clear, so the claw-back rule is unnecessary. However, we consider that this will not always be the case as, for example, a tunnel used for exploration purposes may later be used to extract minerals from the functioning mine. In these cases, the claw-back rule will provide a useful buttress between the two types of expenditure. To the extent that the boundary is clear then taxpayers will be able to account for expenditure in a way that ensures the claw-back rule never operates in practice.

Issue and proposed rules	Submissions and response
Rehabilitation/restoration expenditure: Expenditure necessary to restore the mined land to the condition required by the relevant mining permit. The proposal is that deductions should be allowed in the year that rehabilitation expenditure is actually spent. To recognise the fact that this expenditure may be incurred after income earning activities have ceased, to the extent that such expenditure results in a tax loss, a refundable credit should be generated in the relevant period. This credit would be limited in value to the amount of tax that the miner has paid in respect of mining operations in the relevant permit area. This is the treatment given to similar expenditure under the petroleum mining rules. Under the petroleum rules, such losses can be carried back and offset against previous years' income. The refundable credit is considered to be preferable because it eliminates much of the compliance and administration costs involved in reopening and adjusting prior years' returns.	The issues paper suggested that deductions should be given for rehabilitation expenditure to the extent that a grossed-up sum of money was paid into special Inland Revenue account – similar to environmental restoration account rules in subpart EK of the Income Tax Act 2007. So, for example, if a taxpayer wished to obtain a $100 deduction, they would put $28 into an Inland Revenue account (effectively a pre-payment of tax). Submitters suggested the issues paper proposal would generate real cash-flow concerns for them. Submitters have also argued that mineral miners should be able to use the provisioning allowed by IFRS accounting as a basis for deductions. This would result in deductions being available in the year that the miner committed to incurring the expenditure (being the period when the relevant damage to land took place), discounted and then claimed over the period between that date and actual expenditure. Deductions would therefore be able to be taken earlier than under the proposed rules. Although we can see the force in this argument, we do not consider this is something that should be addressed solely in the mineral mining context, as many industries have expected expenditure that they are able to create reserves for in their accounts. A broad review of the tax treatment of future expenditure would seem more appropriate. In the meantime, we do not consider it would be preferable to introduce a regime more favourable than the one that currently applies to petroleum mining.

Issue and proposed rules	Submissions and response
Land expenditure: Land purchased by a miner for the purposes of their mining operations. Currently these expenses are fully deductible. The proposal is to treat land as revenue account property, with gains being taxable and losses deductible in the year of sale. As with rehabilitation expenditure, to recognise the fact that selling of the land will likely be the final act of a mining project, losses attributable to the sale of land should also be available as a refundable credit, up to the value of tax paid in respect of the relevant permit area.	The issues paper suggested treating land as revenue account property, but not that a refundable credit be generated. Submissions suggested a regime similar to that which exists for forestry should be considered. Under the forestry rules, the land is separated from the standing timber, with the latter being given revenue account treatment. Again, we can see the force in this argument, but consider such a solution unworkable in the mineral mining context. Unlike timber, which is easily identifiable, mineral deposits under the surface are extremely difficult to accurately estimate in advance. In any event, the 'revenue account' rule is designed to be concessionary in that it recognises that mineral miners will likely be paying a substantial premium for land when the existing landowner realises that they have commercially viable mineral deposits. The land being sold at the end of the mining project will have been devalued by the extraction of the minerals, so a deduction for the loss in value should be available to the miner.

Issue and proposed rules	Submissions and response
Life of the mine: The life of the mine is an important concept, because it sets the timeframe for depreciation of all assets that are tied to the life of the mine, including development expenditure. It is proposed that the "life of mine" should be self-assessed, provided the timeframe used for tax purposes is not less than the one used for the purposes of the company's accounts. Some mines, particularly iron sand mines, have very long estimated lives. To create some certainty for these long-life mines, it is proposed that there be a cap on the "life of mine" concept of 25 years. The "mine" in question should be the permit area.	The issues paper suggested that depreciation should be calculated using "proven" plus "probable" reserves, with deductions being based on the proportion of those reserves extracted in any given year. Submissions suggested that the "proven" plus "probable" method would be difficult to operate in practice, particularly for smaller mining operators that may not be required to produce such information for the purposes of their accounts. The proposal therefore aims to simplify the issue for smaller operators while still maintaining some robustness around the life of mine figure actually produced. With regard to what a "mine" is for these purposes, submissions suggested that sometimes several mines exist in one permit area. However, the ability to split permit areas into discrete operations could be used to manipulate the proposed self-assessment regime, and using the entire permit area as a proxy for a "mine" would provide greater certainty.

Issue and proposed rules	Submissions and response
Loss continuity and grouping: Under the current regime, a mining company can carry losses through a breach in shareholder continuity (subject to losses from one permit area being ring-fenced to future profits from the same area), but cannot belong to a group of companies unless all group members are also mining companies. The proposal is that the existing rules remain in place. However, the claw-back rule mentioned above should apply to all relevant expenditure irrespective of whether it was incurred before or after a continuity breach. This is because the benefit of any losses will pass to the new owner, so that owner should account for any resulting income.	The issues paper suggested that the normal tax rules for losses and grouping should apply to specified mineral miners. Although the proposal to retain the current system depart from the general tax principles regarding losses and grouping, we consider they are justified in this instance. Submissions suggested that mineral mining companies were more susceptible to continuity breaches because of the nature of their business. Mining is a capital intensive industry that requires significant upfront investment. This is a level of investment that can be beyond the means of founding shareholders. However, unlike other industries, mining companies do not have the option of debt financing because of the high-risk nature of the business. Therefore, with additional equity financing and the associated change in shareholding, they are more at risk of continuity breaches than companies in other industries. We agree that the nature of the business means that mineral mining is somewhat unique in this regard, which is the primary reason that the existing loss-continuity rules should remain in place. This would mean that losses from a permit area can be carried though a continuity breach, but will always be to be ring-fenced to income derived from the same permit area. It also means that mining companies should only be allowed to form tax groups with other mining companies.

Issue and proposed rules	Submissions and response
Appropriation of income: Under the current rules, a specified mining company can deduct an amount of income appropriated towards mining exploration or development expenditure. The deduction is allowed in the year that the appropriation is made. The proposal is that the normal rules apply and no special appropriation be permitted. Any tax liability that arises as a result of the removal of these rules in the 2014/15 income year should be able to spread evenly over that year and the 2015/16 year.	The issues paper suggested that no appropriation be permitted, but did not allow for any resulting tax liability to be spread. The ability to spread the liability over two years follows submissions that the removal of the appropriation rules would result in a significant "income spike" for affected companies, with adverse cash-flow consequences.

CONCLUSIONS AND RECOMMENDATIONS

27) For the reasons set out in the "Regulatory Impact Analysis" section of this statement, we recommend that a revised set of tax rules for specified mineral mining be enacted that more closely aligns the tax treatment of this sector with orthodox tax principals.

28) We also recommend that the revised rules have the key features set out in paragraph 12 of the "Regulatory Impact Analysis" section.

IMPLEMENTATION

29) It is proposed that the revised rules apply to specified mineral miners from the 2014/15 income year. Given that the rules will largely remove existing concessions, no significant transitional issues are expected. The only transitional rule proposed is to allow the payment of any tax attributable to the removal of the income attribution rule to be spread over two years.

30) It is anticipated that there will be some one-off compliance costs for the relevant taxpayers once the revised rules take effect. These costs are expected to largely be associated with ensuring that taxpayers understand the implications of the rules and changes to accounting/software systems necessary to accommodate them.

31) It is not anticipated the introduction of these rules will have significant systems implications for Inland Revenue as most of the changes will simply alter the self-assessment position adopted by taxpayers. The changes will be communicated to taxpayers though the usual legislative means, including a detailed commentary to the bill when introduced and a summary of the final rules in a Tax Information Bulletin once the enacting legislation has received Royal Assent. We will also consult with the industry as to whether more detailed communication on the changes is required – for example, seminars for effected parties and their advisors.

MONITORING, EVALUATION AND REVIEW

32) 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

Financial arrangements – the treatment of interest-free and reduced-interest loans under IFRS

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options for clarifying the financial arrangements rules, to ensure that notional amounts of interest or one-off adjustments that arise because of the accounting treatment of interest-free or reduced-interest loans are ignored for tax purposes.

There are no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties that have been identified. However, our preferred option will be partly retrospective in that it will affect past positions taken, but from a prospective date. This will ensure that taxpayers who have claimed deductions contrary to the policy intent will be returned to the intended tax position. Taxpayers will be required to pay provisional tax on the basis of the new rule before it is enacted, although the introduction of the bill will give them notice of the required treatment. We believe this is appropriate in these circumstances. Claiming deductions for expenses that are not incurred is clearly inconsistent with the underlying policy and the purpose of the financial arrangements rules.

We engaged in only limited consultation as we did not want to draw undue attention to the issue because wider knowledge of this issue poses a revenue risk. We also expect the number of affected taxpayers to be very small (it is estimated that fewer than 20 taxpayers will be affected) and the proposed solution is straightforward. We have consulted with a senior accountant in a large accounting firm, who supported the proposal. We have also consulted with the Treasury, which agrees with our analysis.

This clarification of the law will be communicated by releasing a commentary explaining the effect of the clarification on the introduction of the bill, and writing a Tax Information Bulletin item once the bill receives Royal assent. Given the small scale of the problem and the nature of those possibly impacted (large businesses) we believe this is sufficient to communicate this clarification of the law.

The proposed change does not impose any new significant compliance costs on affected taxpayers. The proposed rule also does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

Joanna Clifford
Programme Manager, Policy
Inland Revenue

6 March 2013

STATUS QUO AND PROBLEM DEFINITION

1. Interest-free loans are financial arrangements and are thus taxed under the financial arrangements rules. Broadly speaking, the financial arrangements rules require expected income and expenditure to be spread over the life of the financial arrangement using a "spreading method".

2. At present, there is uncertainty as to the correct tax treatment of interest-free (and reduced-interest) loans for taxpayers that comply with the International Financial Reporting Standards (IFRS) accounting rules. No actual interest payments will be made under an interest-free loan. Accordingly, there should be no income or deductions to spread for tax purposes.

3. This is not necessarily the tax treatment that such loans receive. For accounting, IFRS requires that the value of an interest-free or reduced-interest loan be reduced on initial recognition, so the loan is effectively split into two components:

(a) a full-interest loan for a lesser amount; and

(b) a contribution of equity in the case of a related-party loan, or a one-off adjustment in the firm's profit and loss account in the case of unrelated lending.

4. This IFRS accounting treatment therefore gives rise to notional payments in a company's accounts. For example, a company that has an interest-free loan will make book entries for interest payments as if it were a full-interest loan, even though it will make no actual interest payments.

5. Some taxpayers have argued that the current drafting of tax legislation allows these notional payments to have a tax effect (i.e. that they are deductible/ taxable).[1] This is because the legislation containing the detailed rules that provide for what is taxable and what is deductible is capable of being read as allowing for deductions in the situation described above. The counter-argument is that Parliament would not have intended for these notional payments to have a tax effect (i.e. that they should not be deductible/taxable) and the rules should be read consistently with that intention so as to deny deductions where there is an interest-free loan. It is unclear which interpretation would be accepted by the Courts. Therefore, it is appropriate that the legislation be amended to make it clear that deductions are not allowed in this situation.

6. We are not aware of many taxpayers who are arguing that these notional amounts should have a tax effect. The size of the problem is small (it is estimated that fewer than 20 taxpayers will be affected). Nevertheless, we consider it important for the law to be clarified because not only is this inconsistent with the policy intent, the potential ability for taxpayers to claim tax deductions on notional payments carries a fiscal risk.

7. It should be noted that if the argument above (that the notional book entries can have a tax effect) is accepted, the result for a taxpayer can either be an increase or decrease in tax liability; its effect depends on how a taxpayer has structured the loan and whether they are a borrower or lender.

OBJECTIVES

8. The objectives are to:

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[1] These anomalies would eventually be cancelled out when the loan is repaid, but in the interim there could be important timing effects.

(a) Ensure that one-off adjustments to the value of a loan on initial recognition and notional amounts of interest are ignored for tax purposes, consistent with the policy intent; and
(b) Protect the integrity of the tax base by ensuring the fiscal risk associated with the status quo is removed.

REGULATORY IMPACT ANALYSIS

Option one: retain the status quo

9. Under option 1 the ambiguity in the legislation relating to interest-free and reduced interest loans would not be removed. This would mean that taxpayers could continue to argue that tax deductions were available for notional amounts recognised in the IFRS accounts.

Option two: amend the legislation to remove the ambiguity

10. Under option two the ambiguity in the legislation relating to interest-free and reduced-interest loans would be removed by ensuring that one-off adjustments to the value of a loan on initial recognition and notional amounts of interest are ignored for tax purposes, consistent with the policy intent.

11. Options one and two are analysed in the table below:

Options	**Meets objective?**	**Comment**	**Fiscal / economic**	**Social environmental**
Option 1: status quo No change to legislation relating to interest-free and reduced-interest loans.	No. This option does not meet the objective as there would still be an argument that taxpayers could claim tax deductions for notional amounts recognised in the IFRS accounts.	Not viable. As a matter of policy, taxpayers should not be able to claim deductions for expenses not actually incurred (or be taxed on income that is not actually derived). Not addressing the ambiguity results in uncertainty.	Potential fiscal risk as there is an argument that taxpayers can claim tax deduction even though no economic expense has been incurred. While the tax deduction would eventually be clawed back, it would still result in a time value of money advantage for taxpayers.	No impact
Option 2 – remove the ambiguity	Yes. It would ensure that there were no tax deductions	As a matter of policy, taxpayers should not be	Removing the ambiguity removes the fiscal risk.	No impact.

The ambiguity in the legislation relating to interest-free and reduced-interest loans would be removed by ensuring that one-off adjustments to the value of a loan on initial recognition, and notional amounts of interest are ignored for tax purposes, consistent with the policy intent.	or taxable income for amounts unless they were economically incurred or derived.	able to claim deductions for amounts not actually incurred (or taxed on income that is not actually derived). Amending the legislation to remove the ambiguity would remove taxpayers' ability to argue this position. Amending the legislation to remove the ambiguity would increase certainty.	Removing the ambiguity may result in minor adverse provisional tax implications for some taxpayers.	

Conclusion on the options

12. The recommended approach is to amend the legislation in relation to interest-free or reduced-interest loans to ensure that one-off adjustments to the value of a loan on initial recognition are ignored for tax purposes. This will ensure that taxpayers cannot claim tax deductions for amounts not incurred (or are not taxed on income that is not actually derived). Amending the legislation to remove the ambiguity would remove taxpayers' ability to argue this position. The other option – retaining the status quo – is not recommended as it would preserve taxpayers' ability to argue that tax deductions are available for amounts not economically incurred. This would result in a potential fiscal risk and would not remove the current uncertainty.

Date of application

13. In terms of application dates, the two options we considered were:

(a) Applying the amendments from the beginning of the income year that the bill containing the amendment is introduced (the 2013–14 income year), and

(b) Applying the amendments from the beginning of the income year following the enactment of that bill (the 2014-15 year).

14. We prefer option (a). Option (a) will potentially have a back-dated effect: taxpayers will be required to pay provisional tax on the basis of the new rule before it is enacted, although the introduction of the bill will give them notice of the required treatment. Claiming deductions for expenses that are not incurred is clearly inconsistent with the underlying policy

and the purpose of the financial arrangements rules. It is worth noting that only large taxpayers will be affected, who we expect will be well advised and aware that claiming these notional deductions is inconsistent with the purpose of the rules. Option (a) reduces the potential fiscal risks associated with the status quo as early as possible.

15. The later application date, Option (b), carries the risk of making more taxpayers aware of the potential tax advantage of the current situation, increasing the fiscal risk.

16. No social or environmental impacts have been identified for either option.

Existing arrangements

17. In terms of existing arrangements (for example, interest-free loans that were entered into in prior years), we considered:

(a) clawing back any notional deductions previously claimed (and, for those paying tax on notional interest amounts, providing refunds), with the clawed-back amounts being payable (or returned) in the 2014/15 income year; and

(b) not clawing back previously claimed/paid amounts until the loan is repaid.[2]

18. We prefer option (c). Again, this is on the basis that it is inappropriate to claim deductions for expenses that are not incurred. Option (c) returns the taxpayer to the correct position as soon as possible. Option (d) defers (but does not prevent) the adjustment until future income years, which would provide the taxpayer with an ongoing time value of money advantage (or disadvantage in the case of interest income). We therefore consider it appropriate for deductions already claimed to be clawed back; the alternative would be allowing taxpayers to keep an improper advantage and would exacerbate the fiscal impact of the current situation.

19. Option (c) is beneficial for any taxpayers that have had to pay tax on notional amounts arising from the accounting treatment of interest-free or reduced-interest loans.

20. Option (d) will have a slightly negative fiscal impact, but due to the small scale of the problem at present this will not be significant or measurable.

21. No social or environmental impacts have been identified for either option.

CONSULTATION

22. We have engaged in limited consultation with a senior accountant in a large accounting firm. He supported our preferred approach as outlined above. He supported a 1 April 2013 application date for the clarification (effectively the same as the application date we propose) and the clawback being performed in the 2013/14 income year. We prefer a later date for the clawback, as it will ensure the relevant bill will have received Royal assent before taxpayers are required to pay back tax on any notional amounts previously claimed.

23. We engaged in only limited consultation as we did not want to draw undue attention to this issue because wider knowledge of this issue poses a revenue risk. As with a prospective application date, drawing attention to the issue would allow taxpayers time to create arrangements that take advantage of the current situation. In addition, based on the small size of the problem and straight-forward nature of our proposed solution we did not consider wider consultation to be necessary.

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[2] As described above, previously claimed/paid amounts will eventually be clawed back in any event when the loan is repaid (or a base price adjustment is triggered for another reason).

24. We have also consulted with the Treasury, which agrees with our analysis.

CONCLUSIONS AND RECOMMENDATIONS

25. The recommended option is to clarify that notional amounts of interest and one-off adjustments to the value of a loan on initial recognition should be ignored in the IFRS financial reporting spreading method. The application date for this clarification should be the beginning of the 2013/14 income year.

26. We recommend the creation of a rule requiring taxpayers who have been claiming deductions for these notional amounts (or paying tax on them) to repay these deductions (or receive a refund of the tax payments) in their 2014/15 income year tax return.

27. This will effectively clarify how the financial arrangements rule spreading methods should apply to reduced-interest or interest-free loans. It also minimises the fiscal risks associated with the status quo.

IMPLEMENTATION

28. The necessary legislative changes will be included in the scheduled April 2013 tax bill. There are no administrative impacts. Enforcement will carried out through Inland Revenue's standard risk monitoring and audit processes.

29. We will communicate this clarification by releasing a commentary explaining what a change does on the introduction of a bill, and writing a Tax Information Bulletin item once the bill receives Royal assent. Given the small scale of the problem and the nature of those possibly impacted (large businesses), we believe this is sufficient to communicate this clarification of the law.

MONITORING, EVALUATION AND REVIEW

30. The need for this clarification has come from Inland Revenue's standard monitoring of how tax laws are being applied in practice. This monitoring is ongoing and will continue once the clarification is in place.

Regulatory Impact Statement

Over-crediting of imputation credits in excess of foreign investment fund income

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem addressed is a mismatch arising under the tax rules where imputation credits are calculated on the basis of the dividend paid but income tax arises only on the foreign investment fund (FIF) income. This may lead to a resident having excess imputation credits, which they can use to reduce tax on other income, such as salary and wages. Being able to use the imputation credits to offset other income is contrary to the policy behind the imputation rules of alleviating double taxation of New Zealand company profits.

The proposed solution will mean that taxpayers will not be able to use excess imputation credits received from interests in Australian companies to offset their tax liability against other income, e.g. salary and wages (only Australian and New Zealand companies are able to attach imputation credits to dividends paid to New Zealand residents).

The class of taxpayers likely to be affected is limited - namely New Zealanders with investments in unlisted Australian companies which use the trans-Tasman imputation rules or are part of a trans-Tasman imputation group.

No consultation has been undertaken on the proposal. Officials did not wish to draw attention to a gap in the rules which could be taken advantage of, leading to revenue leakage.

There are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken, other than as set out above. 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.

Joanna Clifford
Programme Manager, Policy
Inland Revenue

12 March 2013

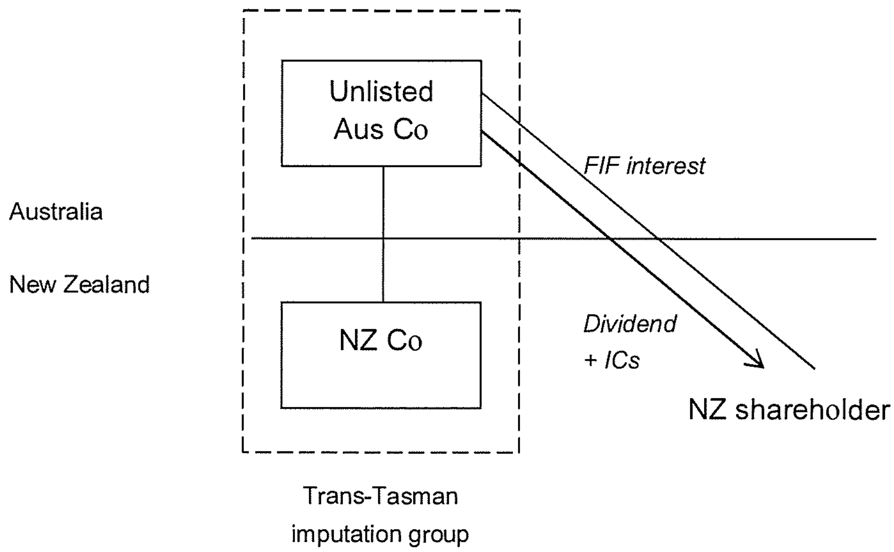
STATUS QUO AND PROBLEM DEFINITION

1. The problem addressed by this RIS is a mismatch arising under the tax rules where imputation credits are calculated on the basis of the dividend paid but income tax arises only on the foreign investment fund (FIF) income. This mismatch means that a resident may have excess imputation credits, which they can use to reduce tax on other income, such as salary and wage income.

2. Under the trans-Tasman imputation rules, an Australian company can maintain an imputation credit account. Any New Zealand tax paid by that company, or by another company in a wholly-owned group comprising Australian and New Zealand companies, will generate imputation credits. These credits can be attached to dividends paid from the Australian company to New Zealand shareholders.

3. The amount of imputation credits that a New Zealand resident receives is calculated on the value of the actual dividend. However, if the Australian company is unlisted, the New Zealand resident will likely be taxed on their shareholding under the FIF rules, which disregard the actual dividend and deem an amount of taxable (FIF) income. If the dividend is of greater value than the amount of FIF income, there may be an over-crediting of imputation credits. That is, the New Zealand shareholder receives imputation credits in excess of the tax liability resulting from their investment in the Australian company. These credits can be used to reduce tax on other income.

4. This is illustrated in the diagram below:



5. The amendment is primarily for base maintenance (i.e. to prevent revenue leakage) so is unlikely to have any implications for fiscal forecasts. It is considered unlikely that many taxpayers will have taken advantage of the loophole in the current rules.

6. If the status quo was retained, excess imputation credits would continue to be used to offset the New Zealand tax liability arising on other income, such as salary and wages. This is contrary to the policy that imputation credits should only alleviate double taxation of company profits.

7. The root cause of the problem is that there is an unintended mismatch between the FIF rules and the trans-Tasman imputation rules, which means New Zealand shareholders may receive excess imputation credits that can offset tax on other income, such as salary and wages.

OBJECTIVES

8. The objectives are to:

a) address a risk to the tax base; and
b) ensure that the legislation aligns more closely with the policy, namely that a person with a FIF interest should only be able to use imputation credits against their tax liability to the extent that there is potential double taxation of an amount and cannot use excess credits to reduce tax on other income.

REGULATORY IMPACT ANALYSIS

9. There are two options that may deal with the problem and achieve the objectives:

a) a change so that the amount of imputation credits - which are attached to a dividend received from an Australian company - that a resident can use to offset their New Zealand tax is calculated on the basis of the resident's FIF income from that company, where the dividend exceeds the amount of FIF income; or
b) a change so that an Australian company can attach imputation credits to a dividend paid to a New Zealand resident shareholder calculated on the basis of the shareholder's FIF income, whether or not the dividend exceeds the amount of FIF income.

Option one (preferred option):

10. This option involves preventing a FIF interest holder from using imputation credits in excess of the tax liability on their taxable FIF income. Accordingly, this option would achieve the policy objective of preventing a FIF interest holder from using excess imputation credits against tax on other income, e.g. salary and wages.

11. The amendment is largely for base maintenance and is not expected to have any revenue implications.

12. The impacts of this option are summarised in the table below.

Option two:

13. This option involves a change so that an Australian company can attach imputation credits to a dividend paid to a New Zealand resident shareholder calculated on the basis of the shareholder's FIF income, whether or not the dividend exceeds the amount of FIF income.

14. This option is not favoured, as it is broader than is strictly necessary for addressing the problem identified and may therefore have unintended consequences. This is because this option would involve fundamentally changing the existing basis on which companies impute dividends paid to shareholders and could involve significant compliance costs. In particular,

an Australian company would need to know details of their shareholders' FIF income to calculate the amount of imputation credits they could attach.

15. The impacts of this option are summarised in the table below.

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	Fiscal risk removed by preventing NZ shareholders in Australian companies from having excess imputation credits.	No administrative costs.	None	Improves status quo by removing fiscal risk and not imposing unnecessary compliance costs.
		Taxpayers	May affect closely-held company situation (i.e. may alter distributions from unlisted Australian companies to NZ shareholders).	Slightly more than status quo, but less than option two.		
Two	Yes	Tax system	Fiscal risk removed by preventing NZ shareholders in Australian companies from having excess imputation credits.	Likely to have administrative costs because involves fundamental changes to imputation rules.	Wider than necessary	Improves status quo by removing fiscal risk but imposes higher compliance and administrative costs.
		Taxpayers	May affect closely-held company situation (i.e. may alter distributions from unlisted Australian companies to NZ shareholders).	Higher compliance costs than option one and status quo.	Unintended consequences because of complexity of redesigning imputation rules.	

Social, environment or cultural impacts of both options

16. There are no social, environment or cultural impacts to the options. The groups affected by the amendments proposed are taxpayers that have attributing FIF interests in unlisted Australian companies which elect to use the trans-Tasman imputation rules.

Net impact of both options

17. The net impact of both options is to remove a significant fiscal risk to the tax base, without causing a negative economic impact for taxpayers.

CONSULTATION

18. No public consultation has been undertaken due to the nature of the issue (being base maintenance). The Generic Tax Policy Process recognises that there are some situations where prior consultation may not be appropriate because it may draw attention to gaps in the tax legislation, which could be exploited and cause significant potential revenue leakage.

19. The Treasury and Inland Revenue were the only agencies involved in developing the proposals and carrying out the analysis.

CONCLUSIONS AND RECOMMENDATIONS

20. Option one is the preferred option because it is an effective and simple solution. It prevents a significant fiscal risk and achieves the objective of ensuring that imputation credits are used to eliminate double taxation of company profits in line with the policy intent of the imputation regime and preventing any excess imputation credits from being used to reduce the New Zealand tax liability arising on other income, such as salary and wages.

21. Option two is not favoured because, while it also achieves the objective, it is likely to involve significant changes to the existing imputation rules and is broader than necessary to eliminate the mischief identified. In addition, it could involve significant compliance costs on companies. In particular, an Australian company would need to know details of their shareholders' FIF income to calculate the amount of imputation credits they could attach.

IMPLEMENTATION

22. The amendment will be implemented through a tax bill this year. The amendment would apply for tax years beginning 1 April 2014.

23. There should be no significant implementation issues with the amendment. Inland Revenue will communicate the change in rules through existing channels, including updating its guides.

MONITORING, EVALUATION AND REVIEW

24. 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.

25. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

26. 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

Bad debt deductions for holders of debt

Agency Disclosure Statement

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

The question addressed in this RIS is whether the tax rules that apply to bad debt deductions for holders of financial arrangements should be changed in order to:

- ensure the tax rules are fair for all taxpayers by allowing them to take bad debt deductions where they would ordinarily be entitled to them on the cessation of the arrangement, but for technical compliance issues; and
- protect the integrity of the revenue base by ensuring that taxpayers can only take bad debt deductions equal to the true economic cost incurred.

Public consultation was targeted at five external parties (including four representative groups and one tax advisor). These parties were consulted because they either have a strong interest in general tax policy amendments, or an interest in the particular issues. All feedback received supported the proposals for change. Several comments were also made on technical matters (such as the scope of the compliance costs change). The proposed legislative draft has been amended where appropriate.

Two specific changes to the tax rules applying to bad debt deductions are recommended. The first change makes the tax rules fairer and reduces compliance costs. This is a taxpayer-friendly change that will make it easier for holders of debt to take deductions in circumstances where they ordinarily should be entitled to them but for technical compliance issues. The second change is a base maintenance measure to ensure that holders of financial arrangements cannot take excessive bad debt deductions. This change aligns the tax rules with the existing policy intent of the bad debt rules and protects the integrity of the revenue base.

We propose that the recommended base maintenance change applies from when the tax bill containing the changes is introduced. This change will be subject to a retrospective claw-back rule that will require taxpayers who have taken excess deductions (that is, deductions for more than the economic cost), to return those amounts as income in the 2014–15 year. The effect of this rule is that the change will be retrospective for financial arrangements that are in existence in the 2014–15 year, but any tax payable will be prospective. This rule is necessary to protect the revenue base.

The Treasury has been consulted and agrees with the contents of this statement.

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

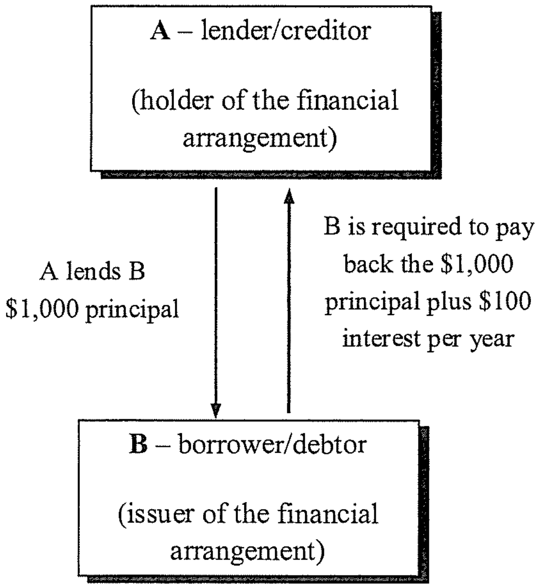
None of the policy options considered impair private property rights, restrict market competition, impose additional compliance costs, or override fundamental common law principles.

Joanna Clifford
Programme Manager, Policy
Inland Revenue

12 March 2013

STATUS QUO AND PROBLEM DEFINITION

1. A financial arrangement is an arrangement under which a person receives money in consideration for providing money to any person at a future time, or on the occurrence or non-occurrence of a future event. A simple example is shown below:



2. In some situations, the original creditor/holder of the financial arrangement (A) can transfer the financial arrangement to a new creditor/holder (referred to as a "subsequent holder" in this RIS). In these situations, the debtor (B) is required to pay the outstanding interest and principal amounts to the subsequent holder.

3. The financial arrangement rules are separate from the rules for bad debt deductions. A bad debt is a debt where there is no reasonable likelihood that it will be received. In certain circumstances, the bad debt rules allow the creditor (either A or a subsequent holder), to take a deduction for a bad debt where that debt has been written off as bad during the same income year.

4. There is a required process for writing off bad debts arising from financial arrangements. Bad debts for amounts owing under a financial arrangement must be written off before the financial arrangement ends (for instance, by liquidation). This means that if a taxpayer fails to take a bad debt deduction before that time, a bad debt deduction cannot later be taken.

5. The bad debt write-off rules ensure that taxpayers are not taxed on amounts which may have been derived and included as assessable income, but are never actually received. If deductions for bad debts were not allowed, taxpayers would pay too much income tax because they would be assessed on income which substantively was not received.

6. The questions addressed in this RIS are whether the tax rules that apply to bad debt deductions for holders of financial arrangements should be changed in order to:

- ensure the tax rules are fair for all taxpayers by allowing them to take bad debt deductions where they would ordinarily be entitled to them on the cessation of the arrangement, but for technical compliance issues; and

- protect the integrity of the revenue base by ensuring that taxpayers can only take bad debt deductions equal to the true economic cost incurred.

Issue 1: Compliance

7. The first issue with the current tax rules is that the strict technical criteria for taking a bad debt deduction are unnecessarily onerous. This gives rise to unfair results and high compliance costs for certain creditors.

8. Currently, the tax rules require that where a borrower (debtor) goes into liquidation or bankruptcy, the creditor can take a bad debt deduction only if the debt was written off as bad in the same income year, and before the liquidation or bankruptcy took place. This requirement can be unnecessarily onerous for certain creditors (particularly small "mum and dad" investors in failed finance companies), as it means they would need to have up-to-date knowledge of the financial state of the debtor in order to take bad debt deduction in time. In some situations, creditors are not informed of upcoming liquidations or bankruptcies and this means they would need to regularly check the companies register or public listings for updates on the financial stability of debtors.

9. The same strict write-off criteria apply to creditors where the debtor company has entered into a composition with them (for example, where the creditor agrees to accept 70 cents for every dollar owed by the debtor). In these cases, the creditor can take a bad debt deduction only if the debt was written off as bad in the same income year and before the composition took place. Again, the write-off requirement can be unnecessarily onerous for creditors because the timeframe to write off the debt can be short (the period between being informed of the financial difficulties of the debtor and the composition itself).

10. Creditors who fail to write off the bad debt in time (before the debtor is liquidated/bankrupted, or before a debtor company enters into a composition with creditors), will have a tax obligation in respect of accrual income they have never received, or remission income that was never written off. This result is unfair and leads to unnecessarily high compliance costs.

11. Following the recent financial crisis, we have become aware that some investors in failed finance companies have not always met the required criteria of writing off the bad debt before the finance company (debtor) was liquidated or entered into a composition with its creditors. Theoretically, these taxpayers would have been denied a bad debt deduction they would ordinarily have been entitled to claim. Therefore, in theory, these taxpayers would be adversely impacted if no legislative action is taken. We are unable to quantify the magnitude of this impact because we do not know who exactly is affected.

12. When the bad debt deduction rules came into force, the likelihood of some creditors (including creditors of liquidated companies and bankrupt individuals) being unable to meet the "write off" requirement and the implications of this were not fully identified.

Issue 2: Base maintenance

13. The second issue with the current tax rules is that holders of debt can take bad debt deductions for amounts owing even where the holder has not suffered an economic loss. This result is not in line with existing policy for bad debt deductions. It also results in an unjustified timing advantage and presents a risk to the integrity of revenue base.

14. For example, it is possible for taxpayers to legitimately carry out a business of buying debts in an attempt to recover as much of the amount owing as possible, and thereby make a profit. Currently, these taxpayers would be able to take a deduction for the amount legally owing under the debt even though the (smaller) amount they paid for the debt reflected the fact that the entire amount was unlikely to be received. These taxpayers are required to return income when the base price adjustment (wash-up calculation) is performed at the end of the financial arrangement. However, we are concerned that taxpayers are able to take bad debt deductions earlier than they should, because it gives them an unjustified timing advantage. To protect the tax base, these inappropriate deductions should not be able to be taken.

15. We are aware of one taxpayer who is currently operating in this area and, under the status quo, there is a risk that other taxpayers will take excess bad debt deductions.

OBJECTIVES

16. The objectives are to:

- ensure the tax rules are fair for all taxpayers by allowing them to take bad debt deductions where they would ordinarily be entitled to them and

- protect the integrity of the revenue base by ensuring taxpayers can only take bad debt deductions equal to the true economic cost incurred.

REGULATORY IMPACT ANALYSIS

17. To achieve the objectives outlined above, a number of options were considered.

Issue 1: Compliance

18. The first issue being considered is that, in some situations, the current strict technical requirements for taking a bad debt deduction are unnecessarily onerous and this gives rise to unfair results (whereby taxpayers are treated as receiving income which was never received). Three options were considered for addressing this issue and these are set out below.

Options	Does it meet the objectives?	Impacts					Risks	Net impact
		Compliance	**Economic**	**Social**	**Costs**	**Environmental and cultural**		
1A Amend the current write-off criteria in the bad debt deduction rules to enable taxpayers to take a bad debt deduction where: - the debt is written off as bad; or - the debt has been remitted by law such as by liquidation or bankruptcy; or - the debtor company entered into a composition with creditors. **(recommended option)**	Yes	Minimises compliance costs – no need for taxpayers to regularly check the companies register or public listings for updates on the financial stability of the debtor. Increases certainty of tax treatment for taxpayers.	None	Fairness – easier for taxpayers to take deductions for economic losses which, under current policy settings, they are entitled to. In particular, it reduces compliance costs for "mum and dad" investors who are less likely to have thorough knowledge of their accounting and tax obligations. The overall result means the taxpayers are not assessed on income which was never received.	Fiscally negative, but the fiscal effect is not expected to be large. No material fiscal effect on baselines. We are not in a position to estimate the precise fiscal effect because we do not know exactly how many creditors would be affected. No significant administrative implications.	None	The amendment is not limited to bad debt deductions arising under financial arrangements – it extends to all bad debts. This could result in unintended impacts on other arrangements (for instance, if it becomes too easy to take deductions where the debt is not truly a bad debt).	Overall, positive. This option improves the status quo because the positive impacts (compliance, economic and social) outweigh the risks. Although there is a theoretical risk that the extended ability to take deductions may span too wide, officials have not identified any situations where this would, realistically, be outside the policy intention

Issue 1 options continued

Options	Does it meet the objective?	Impacts					Risks	Net impact
		Compliance	Economic	Social	Costs	Environmental and cultural		
1B Two new special deductions introduced (base price adjustment deduction and accrual income deduction). Together, these deductions would ensure that where income is required to be returned for tax purposes, a deduction would be allowed for these amounts if the income amounts were never received.	Yes	Minimises compliance costs – no need for taxpayers to regularly check the companies register or public listings for updates on the financial stability of the debtor. Increases certainty of tax treatment for taxpayers.	None	Fairness – easier for taxpayers to take deductions for economic losses which, under current policy settings, they are entitled to. In particular, compliance costs are reduced for "mum and dad" investors who are less likely to have thorough knowledge of their accounting and tax obligations. Overall, taxpayers are not assessed on income which was never received.	Fiscally negative, but the fiscal effect is not expected to be large. No material fiscal effect on baselines. We are not in a position to estimate the precise fiscal effect because we do not know exactly how many creditors would be affected. No significant administrative implications.	None	New deduction provisions will make the legislation more complicated. Given the complexity of the relationship between the current financial arrangement rules and bad debt rules, additional complexity is not desirable.	Overall, neutral. While the ability for taxpayers to take automatic deductions where appropriate is positive from a policy perspective, the risk of unnecessarily complicating the financial arrangement tax rules is considered undesirable.
1C Retain the status quo. Require holders of debt to meet the current criteria so that the debt must be written off as bad before the debt is remitted, and in the same year that the deduction is sought.	No	Does not require legislative change. Feedback suggests taxpayers are not complying with the current strict technical requirements, but are already taking deductions considered appropriately deductible from a policy perspective.	None (other than fairness and compliance).	Fairness – arguably unfair if a bad debt that would ordinarily be deductible is not deductible simply because the write-off criteria were not met in time. If Inland Revenue allows taxpayers to take deductions which are not allowed under current legislation, this could be perceived as unfair.	None	None	The current law requires certain compliance criteria to be met. If the criteria are not amended, there will continue to be uncertainty for taxpayers.	Overall, negative. The objectives are not met. While it is arguable that legislative change is not necessary because taxpayers are already taking deductions (in line with the policy intent), the strict technical requirements that should legally be met, and the uncertainty around the current law, is considered real and significant.

Issue 2: Base maintenance

19. The second issue being considered is that holders of debt can take bad debt deductions for amounts owing even where the holder has not suffered an economic loss. This result is inconsistent with existing policy settings. Three options were considered for addressing this issue:

Options	Does it meet the objective?	Impacts					Risks	Net impact
		Compliance	Economic	Social	Costs	Environmental and cultural		
2A Amend the bad debt deduction tax rules by limiting the deductions that can be taken to the economic loss (amount lent or amount paid to purchase the debt). The current base price adjustment and bad debt deduction rules will continue to work as intended to square up any losses/gains overall. Introduce an anti-avoidance measure to limit the deductions being taken to the real money at risk. **(recommended option)**	Yes	None.	Revenue integrity is maintained because excess deductions are stopped. Coherence – aligns with the tax system as a whole. Efficiency and growth – Limiting the deductions that can be taken may reduce the incentive for businesses to innovate and invest, since the status quo provides an unintended advantage in the form of excessive and unjustified tax deductions. Increases certainty for taxpayers.	Fairness – Addresses the timing advantage that can be obtained under the current bad debt and financial arrangement rules.	Fiscally positive, but insignificant, because it is believed that the majority of taxpayers are correctly applying the law as intended by policy. We are not in a position to estimate the precise fiscal effect because we do not know exactly how many creditors would be affected. There is no material fiscal effect on baselines. No significant administrative implications.	None.	None.	Overall, positive. Option 2A would be an improvement on the status quo and meets the objectives. As noted, option 2A may reduce the incentive for businesses to innovate and invest, however officials consider this is justified because removing this advantage simply aligns the law with the existing policy intent.

Issue 2 options continued

Options	Does it meet the objective?	Impacts					Risks	Net impact
		Compliance	Economic	Social	Costs	Environmental and cultural		
2B Disallow excess bad debt deductions and amend the base price adjustment formula in the financial arrangement tax rules so that the creditor's base price adjustment result does not include the amount remitted by law. The anti-avoidance measure would limit the deductions being taken to the real money at risk.	Yes	Compliance costs would increase. The financial arrangement tax rules are already complicated, and amending them may make them harder to comply with.	Coherence – aligns with the tax system as a whole. Efficiency and growth – Limiting the deductions that can be taken may reduce the incentive for businesses to innovate and invest, since the status quo provides an unintended advantage in the form of excessive and unjustified tax deductions. Maintains revenue integrity.	Fairness – Addresses the timing advantage that can be obtained under the current bad debt and financial arrangement rules. Increases certainty for taxpayers.	Fiscally positive, but insignificant, because it is believed that the majority of taxpayers are correctly applying the law as intended by policy. We are not in a position to estimate the precise fiscal effect because we do not know exactly how many creditors would be affected. There is no material fiscal effect on baselines. No significant administrative implications.	None.	The (complex) financial arrangements rules generally work well. Amending these rules would add complexity to these rules which may unintentionally affect other arrangements.	Overall, neutral. This option is an improvement on the status quo and the objectives are met. However, the complexity of amending the financial arrangement rules is considered a real and significant risk.
2C Retain the status quo The current legislation is unclear, but it may be possible for bad debt deductions to be taken for more than the cash or economic loss incurred to obtain the debt.	No	None.	Efficiency – If excess deductions can be taken, this could distort behaviour (by providing incentives to invest in financial arrangements rather than other forms of investment), which is inefficient.	Fairness – if taxpayers take advantage of the unclear legislation by taking deductions for excess amounts, this would be viewed as unfair, because the deductions are not justified.	There is a risk that if a base maintenance change is not made, and taxpayers take deductions for more than their economic loss, this could result in a potentially significant, fiscal loss and a risk to the revenue base. We are not in a position to estimate the precise fiscal effect because we do not know exactly how many creditors would be affected.	None.	Revenue integrity – if no legislative change is made, there is a risk to the tax base because taxpayers may take deductions that are not justified.	Overall, negative. This option is not an improvement on the status quo and the objectives are not met. It can be argued that legislative change is not required because the majority of taxpayers are already interpreting the legislation purposively, in line with the policy intent. However, this is a base maintenance measure, and if legislative change is not made, there is a potential risk to the revenue base, potentially distortions in behaviour and perceived unfairness.

Application dates

Compliance change

20. We recommend the change which addresses the compliance issue applies from the 2008–09 year. The application date should be retrospective for reasons of fairness, so that investors are not assessed on income which was never received. Taxpayers who will benefit from this change are most likely to be investors in failed finance companies ("mum and dad" investors). The proposed change needs to be retrospective to enable investors to take bad debt deductions for amounts owed following, for example, a finance company going into liquidation or entering into compositions with creditors, otherwise investors would be faced with a tax liability even if they have not received any income. The 2008–09 year was selected on the basis that it would be sufficient to assist affected taxpayers.

Base maintenance change

21. We also recommend that the base maintenance change applies from when the tax bill containing the proposed changes is introduced, and that there be a retrospective claw-back rule to require taxpayers who have taken excess deductions (that is, deductions exceeding the cost of acquisition and any income returned), to return those amounts as income in the 2014–15 year. The effect of the claw-back rule is that the rule is retrospective for financial arrangements that are in existence in the 2014–15 year, and affected taxpayers must return extra income prospectively (in the 2014–15 year). We consider that this is justified because it puts them back in the same position they should be in, in line with the policy intent. There is no concern with financial arrangements that have ended prior to the 2014–15 year, as the base price adjustment (wash-up calculation) that would have been performed should have squared-up any excess deductions taken.

22. The benefit that taxpayers get under the current rules is a timing advantage. If the claw-back rule did not apply, the correct result would be reached when the base price adjustment (wash-up calculation) is performed at the end of the arrangement. However, it is possible for taxpayers to drag out financial arrangements so that a base price adjustment is performed much later than appropriate. This application date ensures that when taxpayers have inappropriately taken excess deductions, unknown to Inland Revenue, the advantage obtained for any existing financial arrangements is reversed by requiring the excess amounts to be returned as income. It is also recommended that a savings provisions apply for taxpayers who are, at the date of introduction of the tax bill, involved in assessments subject to the tax disputes process.

CONSULTATION

23. In September 2012, targeted consultation was undertaken with five external parties; four representative organisations and an external tax advisor. We consulted with these parties because they either have a strong interest in general tax policy amendments, or have an interest in the particular issues.

24. Four of the consulted parties provided feedback, and all four supported the options 1A and 2A.

25. Three parties provided feedback on the application dates of the proposed legislative changes. All three submitted that the compliance change should apply on a retrospective basis, and the base maintenance change should apply on a prospective basis. These submissions were partially accepted, as described below:

- For pragmatic reasons, the compliance costs change is retrospective only to the 2008–09 year.

- The base maintenance change will apply prospectively, but also claw-back excess deductions that have been taken. The effect of the claw back is that the base maintenance rule is retrospective for relevant financial arrangements that are in existence in the 2014–15 year, but any tax payable is prospective. It is not anticipated that a large number of taxpayers will be affected by the claw-back rule; however, it is necessary for base maintenance reasons. The reason for the claw-back rule is that, notwithstanding the current legislative wording, it is not considered reasonable for taxpayers to take deductions for more than their economic loss under the financial arrangement. There will be a savings provision for taxpayers who are involved in assessments that are subject to the disputes process. This will mean that, as at the introduction date of the bill, disputes will continue as per the regular process and will not be subject to the retrospective claw back of excess deductions. The claw-back rule will still apply to excess deductions taken by taxpayers who are not in the disputes process at the date the tax bill is introduced.

26. Three parties provided feedback on the technical detail of the proposed changes. The technical matters raised are discussed below.

Consulted party	Technical comments raised by submitters	Proposed response to technical comments raised
1	Technical change 1: Extend situations where compliance costs change should apply (for Insolvency Act and other jurisdictions). The compliance costs change should extend, not only to debts remitted by law under the Companies Act 1993, but also to debts remitted by law under the Insolvency Act 2006, or the laws of a country or territory other than New Zealand. It appears that the submitters have requested these additional operations of law to reflect the wording of the provision in the financial arrangement rules that deals with debts remitted by law.	This technical change was accepted and the draft legislation will be amended to meet this result. Officials considered it appropriate to align the wording in the two sets of provisions even though they did not consider the change strictly necessary (as creditors of bankrupt individuals should be able to meet the current bad debt criteria).
2	Technical change 2: The compliance costs change should extend to situations where the debt has been remitted when the debtor company is released from making all remaining payments by a deed or agreement of composition with the creditors in the income year (for example, where the creditor agrees to accept 70 cents for every dollar owed).	This technical change was accepted and the draft legislation will be amended to meet this result. Officials agreed that, in certain situations where there has been a composition with creditors, an automatic bad debt deduction should be allowed.
3	Technical change 1, described above. Technical change 3: For tax purposes, capitalised interest (interest which has been added to the original capital), should be separated into interest and principal.	This technical change was accepted and the draft legislation will be amended to meet this result. Technical change 3 was not accepted. Inland Revenue has a longstanding practice of treating capitalised interest as being paid to the investor and reinvested. Officials do not consider it appropriate to

		change this practice because capitalised interest is a close substitute for an investor receiving interest and then reinvesting it themselves. If the tax treatment of capitalised interest was amended this would treat similar transactions differently, which would be inequitable. Further, there would be a fiscal cost in doing so.
4	No technical comments raised.	Noted
5	No feedback received.	

27. As part of accepting technical change 1, a related change should be made for the use of losses after bankruptcy to correct a previous oversight in the tax rules. Currently, when a debtor is released from a financial arrangement debt on discharge from bankruptcy, they can use the losses arising from the financial arrangement debt to offset post-bankruptcy income. From a policy perspective, the debtor should not be entitled to use pre-bankruptcy losses to offset post-bankruptcy income. This correct policy result is the rule that applies to non-financial arrangement debt remitted on discharge from bankruptcy, and the rule for financial arrangement debt should align with this.

28. The Treasury has been consulted in the policy proposals and the preparation of this RIS, and agrees with its contents.

CONCLUSIONS AND RECOMMENDATIONS

29. The recommended options to address the two issues are 1A and 2A. These options involve:

- Amending the current strict technical requirements in the bad debt deduction rules to enable taxpayers to more easily take a bad debt deduction where the debt has been remitted by law, such as by liquidation or bankruptcy; or where the debtor company entered into a composition with creditors. This will remove the strict technical compliance requirements in certain cases and thereby make the tax rules fairer.

  and

- Amending the bad debt deduction tax rules by limiting the deductions that can be taken to the economic loss (subject to an anti-avoidance measure to limit the deductions being taken to the real money at risk). This will protect the integrity of the revenue base by ensuring taxpayers can only take bad debt deductions equal to the true economic cost incurred.

30. Both options meet the objectives and are an improvement on the status quo because the positive impacts identified are considered to outweigh the risks.

IMPLEMENTATION

31. No implementation risks have been identified. We consider that implementation can be managed within existing systems and there would be no other significant administrative issues. The changes will be communicated by updating Inland Revenue publications, and

advising Inland Revenue staff, tax agents, large enterprises and businesses of the changes. A *Tax Information Bulletin* item will be published when the legislation is passed. This will fully explain the new rules for taxpayers.

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. There are no transitional arrangements required. It is proposed that any legislative change would be included in the tax bill expected to be introduced in April 2013.

MONITORING, EVALUATION AND REVIEW

33. There are no plans to monitor, evaluate and review the changes after they become law. This is because the reforms align the current rules with existing policy and the approach generally adopted in practice. If any specific concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process. Also, the Income Tax Act 2007 is subject to regular review by officials. As per the normal process, there will be an opportunity for submissions to be made on the proposed changes during the select committee stage of the tax bill that any legislative change is contained in.