Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill

*Commentary on the Bill*

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Minister of Revenue

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Closely held companies

# Overview

In September 2015 Inland Revenue released the officials’ issues paper, *Closely held company taxation issues*, which sought feedbackon a package of possible changes to deal with concerns about the workability of certain aspects of the tax rules that apply to closely held companies.

Subsequent to public feedback, the Government made decisions on the package and these have been incorporated into this tax bill. The proposed amendments aim to simplify the rules and reduce compliance costs, while ensuring that the rules remain robust and in line with intended policy.

Closely held companies typically have only a few shareholders but can have widely varying net worth and business focus. They also make up a significant proportion of the total number of companies in New Zealand. Many use the standard company tax rules but there are also specific tax rules available for very closely held companies, in particular the look-through company (LTC) rules and their predecessor, the qualifying company (QC) rules.[[1]](#footnote-1)

The LTC and QC rules recognise that companies are taxed differently from individuals and it is important that this tax difference does not influence business decisions on whether to incorporate as this may impede growth. For example, a business may start off as a sole trader and as it grows it decides to become a company, given such legal benefits as limited liability. The LTC rules in effect enable individual tax treatment to continue to apply to owners’ LTC interests even though the LTC is legally a company for other than tax purposes. On the other hand, it is important that these rules be available only to those that could have genuinely alternatively operated through direct ownership.

The proposals in this bill make a number of changes to the LTC rules. They also affect QCs and, through a number of proposed changes to the dividend rules, other types of companies.

The key changes relate to the following:

***LTCs***

* Eligibility criteria
* Entry tax
* Deduction limitation rule
* Debt remission

***QCs***

* Continuity of ownership

***Other companies***

* Tainted capital gains
* Resident withholding tax on dividends
* Taxation of shareholder-employees’ employment income.

**Application date**

Most of the proposed changes apply from the beginning of the 2017–18 income year, although some, such as those relating to debt remission, have been backdated where appropriate.

# Look-through company eligibility criteria

### (Clause 262)

## Summary of proposed amendments

Several amendments are proposed to tighten the LTC eligibility criteria to ensure that LTCs operate as closely controlled companies, as originally intended. They relate in particular to who can have an interest in a LTC and how the five or fewer “counted owners” test applies. These proposed changes are as follows:

* The way that beneficiaries are counted when determining whether the counted owner test is met is to be broadened.
* Charities and Māori authorities will be precluded from being LTC owners, directly or indirectly, subject to certain exemptions and grandparenting.
* Trusts that own LTCs will be precluded from making distributions to corporate beneficiaries.
* The foreign income that a foreign-owned LTC can earn annually will be limited.
* The restriction that requires a LTC to have only one class of shares will be relaxed.

## Application date

These amendments will come into force on 1 April 2017, except for the Māori authorities’ grandparenting arrangements, which will apply to Māori authorities’ interests in LTCs entered into before the date of introduction of this bill.

## Key features

The definition of “look-through counted owner” in section YA 1 provides the mechanism for counting owners when testing the “five or fewer counted owners” requirement for a company to qualify to become a LTC. The proposed amendments introduce a new limb to the definition with respect to LTCs owned by trusts to broaden the way that beneficiaries are counted, by including any beneficiary who receives any distribution from any source from the trust.

The definition of “look-through company” will also be amended to preclude charities and Māori authorities from becoming LTC owners (either directly or indirectly through a trust). The proposed new restrictions will not apply to Māori authorities that currently have ownership interests in LTCs, in effect grandparenting current structures. Further, to ensure these prohibitions do not inadvertently discourage charitable giving, a new rule is proposed to allow trusts that own LTCs to continue making distributions to beneficiaries that are charities, so long as the distribution is akin to a donation or is received by the charity as a residual beneficiary of the trust.

To bolster the current legislative prohibition on direct corporate ownership of LTCs, the definition of “look-through company” will be further amended to prohibit a trust that owns a LTC from making any distributions to any corporate beneficiaries.

To restrict the use of LTCs as conduit vehicles for international investment, the foreign income that can be earned by a LTC whose ownership interests are held more than 50 percent by foreign LTC holders will be limited to the greater of $10,000 and 20 percent of the LTC’s gross income in the relevant income year. A new definition of “foreign LTC holder” provides the rule for determining how the foreign ownership of LTCs is tested when applying the new foreign income restriction.

An amendment to the definition of “look-through interest” is proposed, to enable LTCs to have more than one class of shares. This amendment will enable LTCs to have shares carrying different voting rights, provided all shares have uniform entitlements to all distributions.

## Background

The eligibility criteria limit the type of entity that can elect to become, and continue to be, a LTC as well as the type of owner that can hold LTC interests. They serve to ensure that the use of the LTC rules is appropriately targeted according to the policy intent underlying their design, which is that the rules should only be available to those that could have genuinely alternatively operated through direct ownership.

LTCs are not designed to be widely held investment entities. This concern covers not only direct ownership but also indirect ownership through benefiting from a distribution from a trust that has an ownership interest in a LTC. For example, the current rules allow for charities and Māori authorities to hold LTC interests, either directly or indirectly through a trust. Both charities and Māori authorities have potentially wide pools of beneficiaries and are therefore, conceptually, not part of the LTC target audience.

The proposed amendments primarily focus on strengthening the rules supporting the requirement for a LTC to have no more than five counted owners, which is to ensure that the company is “closely controlled” by individuals. Corporate ownership is precluded given the scope that it would allow for widely held ownership. Another LTC can be an owner but is looked through to its owners for the purposes of the counted owners test. Family trusts can be owners but specific rules determine the extent to which the trustee(s) and beneficiaries are counted owners.

No change is planned to the rule that states that if a LTC fails to satisfy the eligibility criteria during an income year it loses its LTC status from the beginning of that income year.

## Detailed analysis

### Definition of “look-through counted owner”

#### Shareholding trusts

For LTCs owned by trusts, when determining the number of look-through owners, the rules count the trustee (grouping multiple trustees as one) when the LTC income earned by the trust is not fully distributed to beneficiaries, as well as all beneficiaries who have received LTC income from the trust as “beneficiary income” in the current and preceding three years. This is too narrow.

The definition of “look-through counted owner” will be amended to count all distributions to beneficiaries, irrespective of whether they are from the LTC or from other sources, or whether they are received by the beneficiary as beneficiary income, trustee income, trust capital or corpus. The amendment is necessary to ensure the test counts all persons who, though they may not receive beneficiary income, nevertheless benefit from the trust owning LTC shares. Including all distributions is necessary to also ensure the rule is not undermined by the fungibility of money, which makes the result from tracing the source of a distribution arbitrary.

To ensure this rule applies only prospectively, given that the counted owner test looks back to the current and preceding three income years, the strengthened test will apply only to income earned from the beginning of the 2017–18 income year. Income earned and distributed to beneficiaries or retained by the trust prior to the 2017–18 income year will be counted under current rules.

Similarly, to ensure the strengthened test incorporating all distributions to beneficiaries does not result in double counting of owners, amendments are being made to the way trustees are counted, to ensure that the test is phased out as the strengthened test is brought in.

For example, the current test counts a trustee that retains LTC income and ignores the future distribution of that income as “trustee income” to beneficiaries; whereas the proposed test will count all distributions in the hands of the beneficiary, including the receipt of trustee income. To prevent the test from counting the trustee and the beneficiary in relation to the same income when it has been retained by the trustee in one year and distributed to beneficiaries in the following year, the proposal restricts the current trustee count test to apply only to income earned prior to the 2017–18 income year. This means that for 2017–18 onwards, trustee income retained by the trust will not be counted until it is distributed to the beneficiaries, and receipts by beneficiaries of trustee income earned prior to 2017–18 will be ignored for the purposes of counting the beneficiary as an owner. In effect, by 2021–22 only the strengthened test should be applicable.

### Definition of “look-through interest”

#### Voting rights

Currently, in order to simplify the attribution of a LTC’s income and expenditure to its underlying owners, LTCs can only have one class of share. This rule is overly restrictive as it can limit legitimate commercial structuring or generational planning and inhibit some companies from becoming LTCs.

The proposed revision to the definition of “look-through interest” relaxes the requirement that a LTC can only have one class of share by allowing LTCs tohave shares that carry different voting rights provided that all shares still have the same rights to distributions.

### Definition of “look-through company”

#### Corporate beneficiaries

Currently, a trust that owns a LTC interest can have a corporate beneficiary but direct ownership by companies, other than other LTCs, is expressly prohibited. The trust is looked through and the shareholders of the corporate beneficiary are counted if it receives any beneficiary income. This, coupled with the way that the number of owners is determined for trusts, unintentionally provides widely held non-LTC corporates with a way to circumvent the prohibition on direct ownership.

The definition of “look-through company” will be amended to expressly prohibit trusts which own LTCs from making distributions to corporate beneficiaries. This approach in effect allows for grandparenting of current structures involving corporate beneficiaries, by not expressly prohibiting LTC owning trusts from having corporate beneficiaries while strengthening the present prohibition on ownership of LTCs by standard companies.

#### Charities and Māori authorities

To ensure that the LTC rules are reserved for closely controlled entities, the proposals will extend the trust approach of looking through to the ultimate beneficiaries to LTCs owned by tax charities (as defined in the Income Tax Act) and Māori authorities. The proposals will effectively preclude direct ownership by charities and direct or indirect ownership by Māori authorities. There will be, however, some exceptions:

* Given that many LTC-owning trusts are likely to have charitable beneficiaries and may want to make charitable distributions, the proposed revised definition of “look-through company” will expressly allow for distributions to charities that have no influence over the LTC or trust from which they receive the distribution. In this case the distribution is truly a gift equivalent to a donation or received by the charity as the residual beneficiary upon the wind up of the trust.
* To prevent Māori authorities incurring the compliance cost of converting their LTC interests to limited partnerships, another look-through vehicle that is often used to achieve the same outcome as a LTC, it is proposed to grandparent current Māori authorities that had interests in LTCs before the introduction of this bill. A definition of “grandparented Māori authority” will be added to section YA 1, which includes not only direct ownership interests but also a Māori authority beneficiary of a trust that is an owner in a LTC, and a Māori authority which has entered into an arrangement to become a LTC owner before the date of introduction of the bill.

#### Foreign income restrictions

Although LTCs are envisaged primarily as a structure for domestically focussed companies, there are no restrictions on either foreign investment by LTCs or on LTCs having non-resident owners. This combination unintentionally allows for LTCs to be used as conduit investment vehicles – that is, vehicles used by non-residents to invest in foreign markets generating income that is generally not taxable in New Zealand. This gives rise to reputational risks for New Zealand.

To address these risks, the revised definition of “look-through company” includes a proposed rule for a foreign-controlled LTC (a LTC that is more than 50 percent held by non-residents) that will restrict it to deriving foreign income annually that is no more than the greater of $10,000 or 20 percent of the LTC’s gross income for the year. Breach of this requirement will lead to loss of LTC status.

The rule tests foreign control by looking at the direct and indirect ownership of the LTC, and testing the tax residence of the owners. Standard tests of residency will apply to determine the residency of individuals. The definition of “foreign LTC holder” will include a trustee of a trust if the trust has a non-resident settlor or a person that is non-resident who has power to appoint or remove a trustee of the trust. The current source rules are relied on when determining foreign income for the purposes of this new rule.

The thresholds are intended to provide flexibility for some degree of combined non-resident shareholding and foreign income, and should prevent a domestic family business inadvertently falling outside the rules through an owner emigrating. On the other hand, the proposal is intended to prohibit LTCs being used by non-residents purely as conduit investment vehicles.

# Look-through company entry tax

***(Clauses 14, 106, 178, 239 and 262)***

## Summary of proposed amendments

The proposed amendments to section CB 32C modify the income adjustment calculation (commonly known as the entry tax) done when a company converts to a LTC to ensure that:

* the taxable income that arises to LTC owners as a result of the calculation is taxed at each shareholder’s personal tax rate; and
* for QCs converting to LTCs, that the entry tax formula does not tax owners of QCs any more than they would be if they liquidated before the conversion.

An associated amendment to section HB 13 will clarify that a company that elects to become a LTC effectively steps into the shoes of the superseded company and must, therefore, use the tax book values of the company at the time of entry for all purposes under the LTC rules.

**Application date**

The amendments to section CB 32C will apply to the 2017–18 and subsequent income years.

The amendment to section HB 13 will apply from the start of the LTC rules on 1 April 2011.

## Key features

The proposed revised formula treats the resulting income that flows through to the LTC owners as a dividend, with imputation credits attached where available, thereby ensuring that the income is taxed at the owners’ personal tax rates in all cases.

This overcomes a problem with the current formula, which bases the calculation on the company tax rate and can lead to under- or over-taxation, depending on an owner’s marginal tax rate.

A further formula is proposed for situations when a QC has insufficient tax credits to cover distributions of all reserves.

The amendment to clarify that the tax book value of assets and liabilities of a company that elects into the LTC regime become the opening book values for the LTC, is for the avoidance of doubt. For example, revenue account property transfers at tax book value, and not market value, meaning that unrealised gains and losses are not recognised at that point.

## Background

The LTC entry tax adjustment applies when a company elects to become a LTC. It triggers a tax liability on un-imputed retained earnings by deeming the company to have been liquidated immediately prior to conversion. This adjustment is intended to ensure that reserves that would generate taxable income for shareholders if distributed before entering the LTC regime and that would be able to be distributed tax-free once the company becomes a LTC, are taxed to owners at the time of entry.

The tax rate used in the current formula is 28%, which means that no further tax is paid on the company’s retained earnings. It is only the untaxed reserves that are taxed at the shareholders’ personal tax rates. The 28% rate was used in the formula to reduce compliance costs, but this can provide a tax advantage for shareholders whose top personal tax rate exceeds 28% (that is, those on the 30% or 33% marginal tax rate) as well as a disadvantage for shareholders whose personal tax rates are below 28%.

Further, the entry tax formula currently applies to tax all un-imputed retained earnings except eligible capital profits. For QCs that elect into the LTC rules, this means that tax is charged to the extent that the earnings are not eligible capital profits. This is inconsistent with the QC rules, which allow for tax-free distribution of un-imputed earnings as exempt dividends to QC shareholders. As a result, the current entry tax formula can over-charge tax on the un-imputed reserves, which may be deterring some QCs from converting to LTCs.

**Detailed analysis**

The current formula in section CB 32C(5) is:

*dividends + balances – assessable income – balances – exit exemption*

*tax rate*

where:

*dividends* is the sum of the amounts that would be dividends if immediately before becoming a LTC the property of the company, other than cash, were disposed of at market value and the company met all its liabilities at market value and it was liquidated and the net cash amount was distributed to shareholders without imputation credits or foreign dividend payment credits attached. In other words a liquidation took place;

*balances* is the sum of the balances in the imputation credit account and foreign dividend payment credit account immediately before becoming a LTC, plus amounts of income tax payable for an earlier income year but not paid before the relevant date, less refunds due for the earlier income year but paid after the relevant date;

*assessable income* is the amount of income that would arise as a result of liquidation less any deductions that the company would have as a result of liquidating. This includes depreciation gains or losses, bad debts and disposals of revenue account property;

*tax rate* is the company tax rate in the income year before the income year in which the company becomes a LTC;

*exit exemption* is the exit dividends that, if the company had previously been a LTC and is now re-entering the LTC rules, would be attributed to any retained reserves from the previous LTC period that have not since been distributed.

The proposed new formula in section CB 32C(4) is:

*(untaxed reserves + reserves imputation credit)* x *effective interest*

where:

*reserves imputation credit* is the total amount of credits in the company’s imputation account, up to the maximum permitted ratio for the untaxed reserves under section OA 18 (Calculation of maximum permitted ratios) and is treated as an attached imputation credit included in the dividend calculated;

*effective interest* is the person’s effective look-through interest for the look-through company on the relevant day; and

*untaxed reserves* is calculated using the following formula:

*dividends – assessable income – exit exemption*

where:

*dividends* is the sum of the amounts that would be dividends if the following events occurred for the company or the amalgamating company, immediately before it became a look-through company or amalgamated with a look-through company:

1. it disposed of all of its property, other than cash, to an unrelated person at market value for cash; and
2. it met all of its liabilities at market value, excluding income tax payable through disposing of the property or meeting the liabilities; and
3. it was liquidated, with the amount of cash remaining being distributed to shareholders without imputation credits attached;

*assessable income* is the total assessable income that the company would derive by taking the actions described in subparagraphs (i) and (ii) above; less the amount of any deduction that the company would have for taking those actions;

*exit exemption* is the amount given by the formula in section CX 63(2) (Dividends derived after ceasing to be look-through company), treating the amount as a dividend paid by the company for the purposes of section CX 63(1), if section CX 63 would apply to a dividend paid by the company.

The terms “dividends, “assessable income” and “exit exemption” are therefore the same as in the current formula.

This proposed formula will treat the retained income and imputation credits that would arise on liquidation of the company as being distributed to the individual LTC owners who will need to include the income and imputation credits in their return of income. This approach leaves it to each individual shareholder to determine what tax rate applies to their share of the income, and results in a fairer tax outcome.

The formula will apply to companies converting to LTCs, including QCs with sufficient imputation credits to fully impute the dividend, as well as companies that amalgamate with LTCs. However, it will not apply to those QCs converting to LTCs for which the entry tax formula would result in a dividend which is not fully imputed.

### Qualifying companies with limited imputation credits

Instead the proposed additional formula in section CB 32C(8) is to be used to calculate the entry tax payable when a dividend by a QC on liquidation would be only partially imputed and, therefore, only partially a taxable distribution. The proposed formula in this case is:

*(balances – balances) + balances imputation credit) × effective interest*

*tax rate*

where:

*balances* is the sum of the following amounts:

1. the balance in the company’s imputation credit account;
2. an amount of income tax payable for an earlier income year but not paid before the relevant date, less refunds due for the earlier income year but paid after the relevant date;

*tax rate* is the basic tax rate for the income year of the company that contains the relevant day;

*balances imputation credit* is the same as the amount of the item balances, and is treated as an attached imputation credit included in the dividend calculated;

*effective interest* is the person’s effective look-through interest for a look-through company on the relevant day.

### Benchmark dividends

An amendment to section section OB 61 (ICA benchmark dividend rules) ensures that the dividend which results from the entry tax formula is disregarded for the purposes of the benchmark dividend rules. This amendment is for the avoidance of doubt that the level of imputation attaching to the entry tax deemed dividend does not require a benchmark dividend ratio change declaration as the company is not an imputation credit account (ICA) company as defined in section OB 1 of the Income Tax Act at the time that the dividend arises.

# Deduction limitation rule

### (Clauses 97 and 105)

## Summary of proposed amendments

The coverage of the deduction limitation rule, which limits a LTC owner’s LTC deductions to the amount that they have economically at risk, will be restricted to LTCs in partnership or joint venture.

To bolster the other rules in the Income Tax Act that help to stop LTC owners claiming excessive deductions, the existing anti-avoidance rule that deems a partner’s transactions to be at market value will be extended to owners of LTCs.

## Application date

The amendments will apply from the beginning of the 2017–18 income year.

## Key features

The first proposed change will mean that the deduction limitation rule in section HB 11 will not apply for most LTCs. The provision will be changed to specifically cover only LTCs that are in partnership or joint venture. The formula determining the “owner’s basis” in section HB 11 will otherwise be unchanged, although officials are continuing to explore options for simplifying and clarifying the formula.

For those no longer covered by the rule, deductions previously restricted and carried-forward by the rule will be automatically freed up from the 2017–18 income year, and will be available for offsetting against their income from that year onwards.

The specific anti-avoidance rule in section GB 50 will be extended to LTCs and their owners. The rule is designed to ensure that transactions between partners and their partnerships that have the effect of defeating the rules in sub-part HG (joint ventures, partners and partnerships) are treated as taking place at market value.

## Background

The deduction limitation rule was designed to ensure that LTCs cannot be used to generate deductions in excess of the money that owners have at risk in the company. It was based on a comparable rule that applies to limited partnerships. It works by restricting an owner’s ability to use LTC deductions against their other income when the deductions are greater than the owner’s economic contribution to the LTC (referred as “owner’s basis”).

The rule results in undue compliance costs in many cases, as it requires each LTC owner to calculate their “owner’s basis” annually, which requires owners to keep track of what they have invested in and withdrawn from the business, and all income and expenditure attributed to them while they have been an owner. Over time this would require LTC owners to maintain records well beyond the standard record-keeping period for tax information. Furthermore, each owner must complete the calculation even though most will not have their deductions constrained by it because their share of expenditure is less than their owner’s basis.

There are some technical issues with the rule and officials are continuing to work on these.

Overall, given that this rule results in compliance costs that appear to outweigh the benefits provided from the operation of the rule, the rule is largely unnecessary in the LTC context. However, for LTCs working together in partnership or as a joint venture, the rule has relevance. This is because partnerships and joint ventures of LTCs are in many respects an alternative to limited partnerships where a deduction limitation rule is appropriate. They can also be potentially widely held investments.

The removal of the rule for other LTCs appears appropriate given that the risk of LTCs being used to generate excessive deductions is ameliorated by other rules in the Income Tax Act, including the general and specific anti-avoidance provisions, and the debt remission amendments discussed in the following item.

# Debt remission

***(Clauses 13, 56, 104 and 119)***

**Summary of proposed amendments**

Amendments to the debt remission rules are proposed to deal with specific concerns about the way the rules work in relation to LTCs and partnerships.

**Application date**

The amendments will apply from the start of the LTC rules on 1 April 2011.

**Key features**

The first amendment ensures that remission income does not arise to either a LTC owner or a partner who remits a debt owed to them by the LTC or partnership, including a limited partnership (referred to in the proposed amendment as “self-remission”).

The second clarifies that in respect of a debt owed by a LTC to a third party, the market value of the debtor’s interest in the debt is adjusted for any credit impairment. While this was always the intention, some practitioners have argued otherwise.

Both amendments are necessary to ensure that the debt remission rules operate as intended.

Any refunds of overpaid tax as a result of the retrospective application can be claimed by taxpayers reopening past returns, but we do not anticipate many will need to do this. Any additional income that may arise as a result of retrospective application will only need to be brought to account in the 2017–18 income year (a transitional amendment achieves this).

**Background**

***Debt arrangements with owners***

Debt remission, being the extinguishing of a debtor’s liability by operation of law or forgiveness by the creditor, gives rise to debt remission income to the debtor under the financial arrangement rules. Under current tax law, debt remission produces taxable income to the debtor.

Problems arise from the interaction of the LTC (and partnership) rules with the financial arrangement rules that produce remission income in circumstances when, as a result of the transparency of the LTC or partnership, the debt is effectively self-remitted. When an owner of a LTC remits debt owed to them by the LTC, all the LTC owners derive debt remission income given the look-through nature of a LTC. This includes the owner that remitted the debt who is required to pay tax on their share of the remission income despite making an economic loss (to the extent of the portion that is attributed to the other shareholders). Generally, they are unable to claim a deduction for the bad debt. Overall, this results in over-taxation of the owner who remitted the debt, which is not an appropriate policy outcome.

***Market value of debts***

The other proposed change involves amending the LTC rules to clarify that when calculating the market value of an owner’s interest as debtor in a financial arrangement with a third party, the amount of any adjustment for credit impairment must be taken into account. This clarification is necessary as Inland Revenue officials have become aware of certain interpretations being taken to the contrary.

The amendment will ensure that the debt remission rules apply as intended so that debt remission income arises when a LTC is either liquidated or elects out of the LTC rules. This is important given the proposed limiting of the scope of the deduction limitation rules, as the debt remission rules are one of the backstops in the Income Tax Act that help to preclude excessive deductions.

**Detailed analysis**

To prevent debt remission income arising to a LTC owner or partner for debt remitted by them, a new concept of “self-remission” is being added to the base price adjustment formula in section EW 31 of the Income Tax Act. Specifically, the definition of “amount remitted” in section EW 31(11) is being amended to exclude “self-remission”. “Self-remission” is defined as an amount of remission for a person and a financial arrangement under which, and to the extent to which, because of the operation of sections HB 1 or HG 2 (which relate to LTCs and partnerships), the person is also liable as debtor in their capacity of owner or partner.

**Example**

As a result of the proposed amendment, if a LTC owes an amount to owner A, who owns 60 percent of the LTCs shares and is unable to pay, when owner A remits the debt, no debt remission income will arise to owner A. Remission income will still arise for the other shareholders to the value of 40 percent of the debt remitted but this is appropriate as it ensures that the economic benefit of not having to repay the debt to owner A is recognised in the hands of the remaining owners.

The clarification that when calculating the market value of an owner’s interest as debtor in a financial arrangement, the amount of any adjustment for credit impairment must be taken into account, involves amending section HB 4.

A transitional rule will ensure that any income that would have arisen in earlier income years through the retrospective application of this remedial clarification will be recognised prospectively in the 2017–18 tax year. This will reduce the consequences for taxpayers who should have had income arise in line with the intended operation of the disposal rules but who took a different tax interpretation.

Specifically, the formula under the proposed transitional rule in section HZ 8 is:

*retrospective amount – current amount*

where:

*retrospective amount*is the amount of income, for the person’s owner’s interest in financial arrangements as debtor, that would result from the application of section HB 4 for income years before the 2017–18 income year, treating that section as amended by the clarification that the market value of the interest must take into account the amount of any adjustment for credit impairment, for those income years;

*current amount*is the amount of income, for the person’s owner’s interest in financial arrangements as debtor from the application of section HB 4 that the person returned for income years before the 2017–18 income year.

# Qualifying companies – continuity of ownership

### (Clauses 98 and 262)

## Summary of proposed amendment

The bill proposes that qualifying company (QC) status will cease if there is a change in control of the company.

## Application date

The amendment will apply for the 2017–18 and later income years.

## Key features

A change of control will be measured using a continuity test. The proposed new shareholder continuity limitation in section HA 6 of the Income Tax Act requires a “minimum continuity interest” of at least 50 percent for the “QC continuity period”. The continuity period will extend from the date the bill receives Royal assent to the last day in the relevant income year. The “minimum QC interest” is defined to mean the lowest voting interest or market value interest during the continuity period.

A breach of this requirement will trigger the loss of QC status under the standard QC rules.

For the purposes of the shareholder continuity measurement, changes to shareholding resulting from property relationship settlements or the death of a shareholder will be ignored when measuring a change of control.

To ease compliance, the proposed continuity test will apply prospectively to changes in shareholding from the date of enactment.

## Background

Qualifying companies are partial look-through vehicles that allow for the profits of the company to be taxed in the same way as a standard company but, unlike a standard company, capital gains and un-imputed dividends can be distributed tax-free to shareholders during the course of business. QCs in place when the new LTC regime came into force on 1 April 2011 were allowed to continue, pending an ultimate decision on the future of QCs. There are still around 70,000 QCs.

As part of the Government’s decisions from the review of closely held company taxation, it was confirmed that these QCs could continue. Requiring all remaining QCs to convert to LTCs, or failing that to ordinary companies, would not only impose significant compliance costs on those businesses but would also not be practical as the LTC requirements might not be suitable for many QCs.

This meant that while no new QCs could be created, existing QCs could continue until they are either liquidated, elect out of the QC regime or fail to meet the QC eligibility criteria. In effect, this provides the grandparented QCs with some degree of permanent tax advantage, due primarily to the opportunity for tax deferral on income through the taxing of the income in the first instance at the company rate, which differs from (and is often lower than) the top personal rate, or the favourable treatment of capital gains relative to ordinary companies.

The effective limitation on trading of QCs by ensuring that QC status is lost if there is a change in control of the company, supports the 2010 decision to grandparent QCs. This outcome ensures that existing QC owners are able to make some shareholder changes without sacrificing QC status while preventing the current owners from trading any tax advantage.

# Tainted capital gains

### (Clause 23)

## Summary of proposed amendments

The scope of the “tainted capital gains” rule is being narrowed to address the current overreach of the rule, and make it much more targeted.

Specifically, the rule will only apply to asset sales between companies that have at least 85 percent common ownership, with the original owners still retaining at least 85 percent interest in the asset at the time of liquidation. The rule currently applies to associated party transactions.

## Application date

The amendments will come into force on the date of enactment and apply to distributions made on or after that date.

## Key features

The current rule and exception relating to capital gains (and capital losses) made on asset sales between associated companies (sections CD 44(10B) and (10C)) will be replaced with a rule that measures commonality of ownership interest both at the time the asset is sold and at the time of the liquidation distribution.

A capital gain or capital loss amount will not arise (in other words, the amount is tainted) if:

(i) at the time of disposal, a group of persons holds, in relation to the seller company (company A) and the buyer company, common voting interests or common market value interests of at least 85 percent; and

(ii) at the time of liquidation of company A, the company that owns the asset is company A or, if it is not company A, the percentage given by the following formula is 85 percent or more:

*commonality interest × ownership interest*

where:

*commonality interest* is the percentage of common holding by a group of persons, for the owning company and company A, of common voting interests or common market value interests (if they are greater than the common voting interests);

*ownership interest* is the percentage of ownership of the asset, by market value, for the owning company.

For example, an asset of a company (company A) may be sold to another company (company B) in the same wholly owned group for a capital gain and at a later stage be on-sold to a non-associated company for a further capital gain, with both companies being liquidated. Both gains will be non-taxable as the outcome of the series of transactions is that by the time of the liquidation distribution the asset has been sold to a company that has no common ownership with companies A and B.

If the owner at the time of liquidation is a non-corporate, (ii) above is not relevant (as that leg of the test requires some portion of the asset to be owned by a company). The gain or loss will, therefore, not be tainted.

The proposed threshold is set at 85 percent because a change of ownership to an unrelated third party of more than 15 percent provides sufficient assurance that the transaction is genuine and involves a real transfer of the underlying assets rather than, say being in lieu of a dividend.

## Background

Capital gains derived at the company level cannot be distributed tax free by ordinary companies, except upon liquidation. The current tainted capital gain rule (in section CD 44(10B) of the Income Tax Act) taints a capital profit if it is realised through a sale of a capital asset to an associated person, making the gain taxable when distributed to shareholders in a liquidation. There is one exception to the rule which applies to gains derived by a close company (as defined in section YA 1) that arise during the course of liquidation.

The policy rationale for this rule is that sales of assets between associated persons (for example, sales within a group of companies) can be for the purposes of creating additional amounts of capital reserves for tax-free distribution, rather than for general commercial reasons. This would allow a company to distribute “capital profits” tax free in lieu of dividends, which would have been taxable.

The rule that governs which gains become tainted has its origins in the mid-1980s when some companies sold assets to associated companies to generate capital gains that they could use to pay out tax-free dividends. Major changes to tax settings since that time, in particular the introduction of the imputation regime and a comprehensive definition of what is a “dividend”, have made the rule less relevant.

In practice, the rule can capture genuine transactions when the sale is not tax driven – for example, the transfer of an asset as part of a genuine commercial restructure. The restriction, therefore, extends beyond its intended ambit and currently applies to gains made on sales to any associated party, not just an associated company. Companies can often be inadvertently caught by the rule, resulting in their being unable to be subsequently liquidated without a tax impost.

The rule still has a role in the case of sales between companies that have significant commonality of ownership, where it provides protection against arrangements that are in effect in lieu of a taxable dividend. The rule should, therefore, be confined to such instances.

# RWT on dividends

### (Clauses 20, 239, 240, 241 and 242)

## Summary of proposed amendments

Two amendments are proposed to deal with the current over-taxation of certain dividends under the resident withholding tax (RWT) rules:

* The first will allow a company to opt out of deducting RWT from a fully imputed dividend paid to corporate shareholders.
* The second provides a new formula for determining the RWT obligation when cash and non-cash dividends are paid contemporaneously.

A third proposed amendment deals with an unintended restriction, because of the need to deduct RWT, on the rule which allows a dividend to be backdated to clear a shareholder’s current account.

## Application date

The first two amendments will come into force on the date of enactment. The third applies from 1 April 2008 for the 2008–09 and subsequent income years.

## Key features

### RWT on dividends between companies

The proposed amendment will limit the definition of “resident passive income” in section RE 2(5) to exclude fully imputed dividends paid to a corporate shareholder if the paying company chooses to exclude the dividend from the definition.

In effect this allows a company to opt out of withholding RWT on a fully imputed dividend paid to another company. This proposal reflects the fact that the obligation to withhold RWT on a fully imputed dividend paid to another company over-taxes the dividend.

The ability not to withhold has been made optional because for some companies (particularly those that are widely held) an outright requirement not to withhold RWT on fully imputed dividends may raise compliance costs. This is because they will need first to establish which shareholders are corporates and those that are not, and differentiate between these two groups within their systems.

### RWT on concurrent cash and non-cash dividends

To deal with the current potential over-taxation of cash and non-cash dividends paid contemporaneously, proposed new section RE 14B will streamline the RWT obligations by treating the two dividends as a single dividend. The amendment introduces a new calculation formula to calculate the amount of RWT owing on the dividends, which applies only if the cash dividend is equal to or greater than the amount of RWT payable under the formula.

Further amendments are proposed to sections RE 13 (Dividends other than non-cash dividends) and RE 14 (Non-cash dividends other than certain non-share issues) to exclude concurrent cash and non-cash dividends (to be covered by proposed new section RE 14B) from their application.

### RWT impact on backdating a dividend

An amendment to section CD 39(9) is proposed to ensure the rule operates as intended. The intention of the provision is to allow for a dividend that had no further tax owing (that is, it is fully imputed) to be backdated, to expunge, or at least reduce, an overdrawn current account balance. This avoids, or limits, the deemed dividend arising and reduces compliance costs. However, a requirement is that there has to be no RWT obligation.

Taxpayers have continued to use the rule but due to an oversight at the time the company tax rate was changed, it technically does not work given the need to deduct RWT. The amendment provides certainty by clarifying that the rule should apply to dividends that are fully imputed, irrespective of any RWT obligation.

## Background

### RWT on dividends between companies

The payment of passive income, such as dividends and interest to resident recipients is subject to an obligation to account for RWT, which is withheld by the company at the time of payment and paid to Inland Revenue in the month following payment. For dividends, a flat rate of 33% applies (less any imputation credits) and for interest, the RWT rate varies according to the recipient’s personal marginal tax rate.

As a result of the lowering of the company tax rate to 28%,[[2]](#footnote-2) even when a company pays a fully imputed dividend the dividend is still subject to an additional 5% RWT. For dividends paid to corporate shareholders (who will be subject to the company tax rate of 28%) this obligation to withhold RWT results in an initial over-taxation of these dividends.[[3]](#footnote-3) This over-taxation may give rise to additional compliance costs for both the paying company, which must account for the additional RWT to Inland Revenue, and the recipient company, which is required to seek a refund when the RWT credit cannot be used.

### RWT on concurrent cash and non-cash dividends

When a company pays a non-cash dividend, such as a taxable bonus issue, the dividend is still subject to RWT. The non-cash dividend is required to be grossed up because the RWT cannot practically be withheld from the non-cash amount.

When a company pays a non-cash dividend concurrently with a cash dividend, both dividends are subject to RWT. The two dividends are treated as separate dividends meaning that the non-cash dividend is still subject to the gross-up even when the concurrent cash dividend is sufficient to cover the RWT obligation on both dividends. This can result in the RWT obligation across both dividends being higher than it should be.

### RWT impact on backdating a dividend

Under the dividend rules, shareholders who have overdrawn current accounts at year end are treated as having received a deemed dividend based on the interest that they would have had to pay had the overdrawn account been a loan. To simplify matters for taxpayers, the rule in section CD 39(5) was introduced, which allows a company to pay a backdated fully imputed dividend to clear, or at least reduce, an overdrawn current account. For dividends to qualify for backdating there must be no further tax owing, including RWT.

The application of this rule was unintentionally limited as a result of the corporate tax rate change. It technically does not work, as a dividend can only be backdated if there is no RWT obligation on the dividend and, in practice, any dividend will have a RWT obligation, even a fully imputed dividend (which has a 5% RWT obligation).

## Detailed analysis

Sections RE 13 and RE 14 calculate the RWT required to be withheld on cash and non-cash dividend respectively. When cash and non-cash dividends are paid contemporaneously, with the objective of the cash dividend being used to account for the RWT owing on the non-cash dividend, there is potential over-taxation because the two dividends are treated separately under these two sections.

New section RE 14B will provide the payer with the option of combining cash and non-cash dividend payments and accounting for RWT as though they were a single dividend. The proposed new section will only apply when the cash dividend alone is sufficient to cover the total RWT owing, meaning that RWT will be paid by deduction rather than gross-up, and the payer has elected for the section to apply.

The amount of RWT that the payer must withhold is calculated using the following formula:

*(tax rate × (dividends + tax paid or credit attached)) − tax paid or credit attached*

where:

*tax rate* is the basic rate set out in schedule 1, part D, clause 5 (Basic tax rates: income tax, ESCT, RSCT, RWT, and attributed fringe benefits);

*dividends* is the total amount of the cash dividend and the non-cash dividend paid before the amount of tax is determined;

*tax paid or credit attached* is the total of the following amounts:

1. if a dividend is paid in relation to shares issued by an ICA company, the total amount of imputation credits attached to the dividends;
2. if a dividend is paid in relation to shares issued by a company not resident in New Zealand, the amount of foreign withholding tax paid or payable on the total amount of the dividends.

To ensure there is no overlap of the rules, neither section RE 13 nor section RE 14 will apply to the dividends if the payer chooses to apply proposed section RE 14B.

# PAYE on shareholder-employee salaries

### (Clauses 234, 235, 236 and 262)

**Summary of proposed amendment**

The amendment proposes that shareholder-employees of close companies who receive both regular salary or wages throughout the year and variable amounts of other employment income will be able to elect to split their income so that the base salary is subject to PAYE and the variable amount is paid out before tax.

## Application date

The amendment will come into force from the date of enactment.

## Key features

New section RD 3C allows for a shareholder-employee of a close company to choose to split their earnings so that the base salary is subject to PAYE and the variable amount is paid out pre-tax, and is therefore likely to be subject to provisional tax instead.

The proposal would allow additional flexibility for shareholder-employees who may be unduly constrained by the current rules.

To ensure that the ability to switch between provisional tax and the PAYE system is not used inappropriately, if a choice is made to apply either provisional tax to all of the earnings (section RD 3B) or the new split method (section RD 3C), the other option becomes unavailable, and the choice is irrevocable. The approach must be applied consistently from year to year.

The provisional tax option in proposed section RD 3B is available under the present rules but has been amended to accommodate the new option in proposed section RD 3C.

The PAYE rules will also be amended to ensure there is no overlap with the new options.

The opportunity has been taken to make some minor technical amendments to reorganise section RD 3 and its associated definitions, in particular, the definitions of “close company” and “shareholder-employee”. These do not alter the scope of section RD 3.

## Background

Shareholder-employees of close companies often do not derive regular amounts of salary or wages, or do not get paid in regular periods throughout the income year. For smaller companies, the remuneration of shareholder-employees also often depends on the performance of the business and, therefore, the annual salary will not be known until well after year end. This can make compliance with the PAYE rules difficult because the rules are designed for circumstances when employees’ salaries are known at the start of the income year and payments are made regularly (monthly, fortnightly or weekly) throughout the year.

To alleviate this problem, the current rules allow for shareholder-employees who do not derive regular amounts of salary or wages or who do not get paid for regular periods, to treat all amounts of income they receive through the year as not subject to PAYE, subject to certain conditions (section RD 3). As a result, the amounts received are taxable in the employee’s tax return and may give rise to provisional tax obligations.

The current rules, however, may not adequately relieve the compliance costs incurred by shareholder-employees as it may not suit the myriad of shareholder-employee circumstances when paying a combination of PAYE and provisional tax might be preferable. There is no option currently to pay a combination of PAYE and provisional tax, the rule is all or nothing.

NRWT: Related party and branch lending

# Overview

New Zealand imposes non-resident withholding tax (NRWT) on New Zealand-sourced interest paid to foreign lenders. The rate is 15%, usually reduced to 10% if the lender is resident in a country with which New Zealand has a double tax agreement. The obligation to withhold falls on the New Zealand borrower. NRWT is still a tax on the foreign investor and they will usually get a credit for the New Zealand tax against the tax they pay on the interest in their home jurisdiction.

A New Zealand borrower can elect to pay the 2% approved issuer levy (AIL) instead of withholding NRWT but only if they are borrowing from an unrelated lender – such as a foreign bank. Foreign lenders cannot claim a credit for AIL against home jurisdiction tax. This means it can be more efficient for NRWT to be paid rather than AIL.

Broadly speaking, there are three parts to the reform package in the bill:

* changes to the NRWT rules to ensure they apply as intended to related party debt;
* changes to the AIL registration process to reduce the risk that AIL is paid on loans from associated lenders; and
* changes to the NRWT/AIL rules which particularly affect branch structures.

The proposed NRWT reform is about correcting anomalies in the current rules to level the playing field for taxpayers to whom the NRWT rules apply (or are intended to apply). The proposed changes focus on ensuring that an NRWT liability arises on interest on related party debt at approximately the same time that an income tax deduction is available to the borrower for that interest. Under the existing rules a number of structures delay or remove the liability for NRWT or replace it with AIL. Changes are also proposed for related party lending by New Zealand banks.

The proposed AIL registration changes will reduce the risk that borrowers will pay AIL (rather than NRWT) on interest payments to non-residents that they are associated with.

The branch proposals are aimed at levelling the playing field between certain borrowers who can step around AIL and NRWT by operating an onshore or offshore branch, and other borrowers who cannot and are therefore subject to NRWT or AIL on interest paid to non-resident lenders. Much of the interest on funding that currently flows through a branch structure is ultimately paid to unrelated parties and will become subject to AIL although NRWT will continue to be available. One kind of structure involving related party lending and onshore branches will become subject to NRWT.

# Interest on related party lending proposals

### (Clauses 5, 15, 55, 246 to 248, 252, 253, 261 and 262)

## Summary of proposed amendments

In broad terms, the approach taken in the bill addresses “holes” in the NRWT base to ensure that the tax applies evenly to economically similar and easily substitutable transactions. It does not attempt to expand the NRWT base beyond its target of associated party interest, or debt which is logically indistinguishable from associated party interest.

At present, differences in the legal form of a loan from a non-resident parent company to its New Zealand subsidiary can result in very different NRWT outcomes. For example, on an ordinary interest-paying loan, NRWT is payable every time interest is paid. However, for a zero-coupon bond, NRWT is not payable until the bond matures. This difference in the NRWT treatment is not mirrored in the income tax treatment for the borrower. The deduction for the borrower in an interest-bearing loan is similar to the deduction for the borrower in a zero-coupon bond. The deferral of the NRWT impost compared with the income tax benefit provides a significant timing benefit.

Another issue arises with the boundary between NRWT and AIL. While AIL is unavailable when the New Zealand borrower is controlled by the non-resident lender, it is available when a group of lenders are acting together and control the New Zealand borrower (typically a joint venture or private equity situations). This situation is difficult to distinguish economically from the case of a single non-resident controller – the group of shareholders are able to act as if they were a single controlling shareholder – yet the availability of AIL differs.

The effect of these (and certain other) issues is that non-resident investors who are able to take advantage of them face a lower effective tax rate in New Zealand than other investors. This is not appropriate.

To address these issues the bill proposes the following:

* to require NRWT to be paid at approximately the same time as interest is deducted by the New Zealand borrower, if the borrower and lender are associated. This will mean that the NRWT consequence of economically similar loan structures will be similar; and
* to adjust the boundary between NRWT and AIL, so AIL is no longer available when a third party is interposed into what would otherwise be a related party loan or where a group of shareholders are acting together as one to control and fund the New Zealand borrower.

These changes will bring the NRWT treatment of substantially similar transactions into line.

## Application date

The amendments will apply to existing arrangements on and after the first day of the borrower’s income year that starts after the date of enactment. For all other arrangements the amendments will come into force on the date of enactment.

## Key features

### Broadening arrangements giving rise to non-resident passive income

### (Clauses 253 and 262(65) and (91))

Non-resident passive income (NRPI) only arises when there is “money lent”. Although the definition of “money lent” is broad it, does not apply in all situations when there is funding provided under a financial arrangement. This can result in a New Zealand borrower incurring financial arrangement expenditure when the non-resident lender has no NRPI.

The bill extends the definition of “money lent” to include any amount provided to a New Zealand resident (or New Zealand branch of a non-resident) by an associated non-resident under a financial arrangement that provides funding to the resident, and under which the borrower incurs financial arrangement expenditure. As “money lent” is a term used in other places in the Income Tax Act 2007, this change is limited to the NRWT rules.

### Reducing quantum mismatches between NRPI and financial arrangement expenditure

### (Clauses 253 and 262(52), (76) and (91))

To reduce mismatches between the NRWT and financial arrangement rules, when the new rules apply, the definition of “interest” will include a payment (whether of money or money’s worth) received by a non-resident from an associated New Zealand resident (or New Zealand branch of a non-resident), to the extent that the payment gives rise to expenditure to the borrower under the financial arrangement rules.

### Related party debt

### (Clauses 253 and 262(91))

“Related party debt” is a new defined term in the proposed rules. It means all financial arrangements where a non-resident provides funds to an associated New Zealand resident (or New Zealand branch of an associated non-resident) and the borrower is allowed a deduction under the financial arrangement rules. To prevent this being structured around, it also includes funding provided through an indirect associated funding arrangement or by a member of a non-resident owning body – these terms are explained below.

A consequence of this definition is that money lent to exempt borrowers (such as charities) will not meet the “related party debt” definition. This is appropriate as no asymmetry can arise between income tax deductions and a lack of NRWT when there is no income tax deduction. Exempt borrowers will continue to be required to withhold NRWT under the existing payment rules, provided the other requirements are met.

Members of a banking group that are registered by the Reserve Bank are also carved out of having related party debt. This is because proposed amendments to section RF 12(1)(a)(ii) recognise that interest payments by New Zealand banks are directly or indirectly equivalent to third-party debt on which AIL can be paid. Although NRWT will continue to be available on interest payments by banks this can be eliminated by paying AIL instead and there is no proposal to apply AIL on an accrual basis. Accordingly, financial arrangements by banks and members of their groups will not meet the definition of related party debt.

### Calculating whether non-financial arrangement income arises

### (Clauses 248 and 262(69), (71), (76) and (91))

One of the principal concerns this bill addresses is where interest payments (and therefore NRWT) significantly lag accrued deductions. Although deductions can be accrued on a daily basis, interest is usually paid in arrears, frequently up to 12 months after the start of the interest period. These rules are not intended to apply to arrangements when interest is accrued up to balance date but paid shortly thereafter; they are instead intended to cover more substantial deferrals.

To achieve this, taxpayers, for each related party debt will be required to complete a deferral calculation, at the end of the second and subsequent years following issue of a financial arrangement, to determine whether non-resident financial arrangement income (NRFAI) arises.

Where the deferral calculation below is satisfied, NRFAI does not arise and the related party debt continues to be taxed under the current NRWT rules. The calculation should be undertaken separately for each related party debt. The calculation that must be made for each financial arrangement at the end of each income year is:

*accumulated payments ÷ accumulated accruals ≥ 90%*

where:

*accumulated payments* is the total interest paid since the financial arrangement became a related party debt until the due date for filing the NRWT return for the second month after the end of the income year.

*accumulated accruals* is the total expenditure the borrower incurs (excluding the effect of foreign exchange) while the arrangement is a related party debt until the end of the year preceding the income year.

The period for the two variables is different, with “accumulated payments” covering payments made up to and somewhat beyond the end of the most recent completed income year while “accumulated accruals” excludes the most recently completed year. There are two reasons for this difference:

* This approach ensures NRFAI does not arise simply because interest is paid annually in arrears.
* “Accumulated payments” only requires knowing what interest has been paid whereas “accumulated accruals” requires a calculation under the financial arrangement rules, which might often not be calculated until shortly before the income tax return is filed. Using “accumulated accruals”, excluding the current year means the majority of the necessary calculations will have already been completed in the ordinary course of business (that is, whether or not these rules were introduced).

Applying a 90% threshold rather than a 100% threshold provides an additional buffer, so that the proposed rules do not need to be applied when the majority of interest payments are paid on a 12-month or less deferral basis, but there is a limited amount of accrued interest, for example, when a bond is issued at a slight discount. This 90% discount also partially equalises the effect on arrangements that are entered into at different points prior to a balance date and before the first interest payment is made.

Once NRFAI arises in a year, NRWT will continue to apply on an accrual basis so long as the financial arrangement is related party debt. This means it will not be necessary for a taxpayer to repeat the above deferral calculation once the 90% threshold has been breached.

### Related party de minimis threshold

### (Clause 248)

If a New Zealand borrower has only a small amount of related party financial arrangement expenditure, the amount of the NRWT deferral, compared with income tax deductions, may not be sufficiently large to justify the additional compliance costs of having to apply the NRFAI rules.

A borrower (and their related party lenders) will not be required to apply the NRFAI rules, except in relation to arrangements already subject to NRFAI, if their expenditure on related party debt in the previous year is less than $40,000. Unlike the rest of the NRFAI rules, to minimise compliance costs, this threshold includes foreign exchange movements on those financial arrangements so that a separate calculation is not required to be undertaken. The threshold also includes expenditure incurred by entities with a common ownership (66%) of the borrower, to prevent taxpayers avoiding the NRFAI rules by borrowing through multiple entities.

### Timing of calculations and payment

### (Clauses 247, 253 and 262(71) and (76))

The above deferral calculation should be completed as part of the preparation of the NRWT return for the second month after the borrower’s balance date. This NRWT return is due on the 20th of the third month after balance date. This date is defined as the “NRFAI due date”. Once NRFAI arises for a year, it is deemed to be paid to the non-resident recipient on the final day of that second month.

The exception to this timing is when a related party debt ceases during a year (the cessation date) in which case the income arising from the start of that year until the cessation date is treated as paid on the final day of the second month following the cessation date.

### Voluntary election into NRFAI

### (Clause 253)

The one year deferral test above means that NRFAI cannot arise for an arrangement, including one with no regular interest payments, before the end of the second year of the arrangement. However, in some cases (for example, a zero coupon bond) it is self-evident that the instrument will give rise to NRFAI and a borrower may find it easier to apply NRFAI treatment from the inception of the arrangement. Taxpayers can therefore elect to apply NRFAI from the first year the arrangement becomes a related party debt.

Taxpayers can also elect to disregard the application of the related party de minimis threshold. One reason they may choose to do this is when they expect to be above the de minimis threshold in future years.

### First-year adjustment

### (Clause 253)

The first year that a non-resident derives NRFAI on a related party debt, the borrower will need to calculate the non-resident’s income from the debt for that year using the financial arrangement rules. The non-resident is also treated as deriving an additional amount of income, which removes the income deferral from that debt for all prior years, including any years the arrangement existed before enactment of the proposals.

Including in income amounts deferred in years before enactment significantly reduces complexity by removing the need for a separate wash-up calculation upon maturity of the arrangement, and a number of transitional provisions.

Taxpayers who wish to avoid paying NRWT on pre-enactment deferral can prevent this by making sufficient interest payments after the enactment of the proposals so that NRFAI does not arise.

### Examples

The following examples illustrate the main features of the new rules proposed by the bill.

**Example 1: Zero coupon bond**

Company A has a 31 March balance date and issues a zero-coupon five-year bond to an associated non-resident on 1 August 2017. Company A receives $700 on 1 August 2017 and will repay $1,000 upon maturity on 30 September 2022. Deductions are calculated on a YTM basis with a 243/365ths apportionment between years.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **#** | **Date** | **Event** | **Payments** | **Deductions** | **Deduction Payment** | **Cash NRWT** | **NRFAI NRWT** |
| 1 | 1 Aug 2017 | Arrangement commences | -700 |  |  |  |  |
| 2 | 31 Mar 2018 | Balance date |  | 34.46 |  |  |  |
| 3 | 20 Jun 2018 | NRFAI calculation date |  |  | N/A – First year |  |  |
| 4 | 31 Mar 2019 | Balance date |  | 54.31 |  |  |  |
| 5 | 20 Jun 2019 | NRFAI calculation date |  |  | 0 ÷ 34.46 = 0% =  NRFAI triggered |  | (34.36 + 54.31) x  10% - 0 =  8.87 |
| 6 | 31 Mar 2020 | Balance date |  | 58.32 |  |  |  |
| 7 | 20 Jun 2020 | NRFAI calculation date |  |  | Not required |  | 5.83 |
| 8 | 31 Mar 2021 | Balance date |  | 62.63 |  |  |  |
| 9 | 20 Jun 2021 | NRFAI calculation date |  |  | Not required |  | 6.26 |
| 10 | 31 Mar 2022 | Balance date |  | 67.27 |  |  |  |
| 11 | 20 Jun 2022 | NRFAI calculation date |  |  | Not required |  | 6.72 |
| 12 | 30 Sep 2022 | Maturity | 1,000 |  |  | 0 |  |
| 13 | 20 Dec 2022 | Maturity NRFAI calculation |  |  |  |  | 2.30 |
| 14 | 31 Mar 2023 | Balance date |  | 23.01 |  |  |  |
|  | Total | | 300 | 300 |  | 30 | |

The balance date entries in #2, 4, 6, 8, 10 and 14 represent income tax deductions available for the return period ending on that date. These may not be calculated until after this date, though the requirement to calculate and pay provisional tax may mean that the company does in fact calculate them earlier than the balance date. The same also applies for the later examples.

The maturity NRFAI calculation in #13 is due on the due date for the NRWT return for the period two months after maturity even though the income tax deduction may not be calculated until sometime after balance date.

As this arrangement has no regular interest payments, Company A would be aware from the outset that NRFAI would eventually arise. Therefore, it may elect to apply NRFAI from the commencement date which would result in an NRWT payment of $3.45 at #3 and the NRWT payment at #5 reducing to $5.43. Although this would be cashflow negative it may reduce compliance costs.

**Example 2: Interest paid less than interest accruing**

Company B has a 31 March balance date and borrows NZ$1,000 from an associated non-resident on 2 April 2017. Company B will pay $60 of interest on 1 April each year and $1,300 upon maturity on 1 April 2022. Deductions are calculated on a YTM basis with a 364/365ths apportionment between years.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **#** | **Date** | **Event** | **Payments** | **Deductions** | **Deduction Payment** | **Cash NRWT** | **NRFAI NRWT** |
| 1 | 2 Apr 2017 | Arrangement commences | -1,000 |  |  |  |  |
| 2 | 31 Mar 2018 | Balance date |  | 108.03 |  |  |  |
| 3 | 1 Apr 2018 | Coupon date | 60 |  |  | 6 |  |
| 4 | 20 Jun 2018 | NRFAI calculation date |  |  | N/A – First year |  |  |
| 5 | 31 Mar 2019 | Balance date |  | 113.55 |  |  |  |
| 6 | 1 Apr 2019 | Coupon date | 60 |  |  | 6 |  |
| 7 | 20 Jun 2019 | NRFAI calculation date |  |  | 120 ÷ 108.03 = 111.1% |  |  |
| 8 | 31 Mar 2020 | Balance date |  | 119.35 |  |  |  |
| 9 | 1 Apr 2020 | Coupon date | 60 |  |  | 6 |  |
| 10 | 20 Jun 2020 | NRFAI calculation date |  |  | 180 ÷ 221.58 = 81.2% = NRFAI triggered |  | (108.03 + 113.55 + 119.35) x 10% - 18 = 16.09 |
| 11 | 31 Mar 2020 | Balance date |  | 125.78 |  |  |  |
| 12 | 1 Apr 2021 | Coupon date | 60 |  |  | Not required |  |
| 13 | 20 Jun 2021 | NRFAI calculation date |  |  | Not required |  | 12.58 |
| 14 | 31 Mar 2022 | Balance date |  | 132.91 |  |  |  |
| 15 | 1 Apr 2022 | Maturity | 1,360 |  |  | Not required |  |
| 16 | 20 Jun 2022 | NRFAI calculation date |  |  | Not required |  | 13.29 |
| 17 | 20 Jul 2022 | Maturity NRFAI calculation |  |  |  |  | 0.04 |
| 18 | 31 Mar 2023 | Balance date |  | 0.36 |  |  |  |
|  | Total | | 600 | 600 |  | 60 | |

Although the interest payment at #9 is paid after the end of the March 2020 tax year, which is the first one NRFAI arises in, it is not expected the NRFAI 90% calculation will have been completed by this date as it is not yet due. This is the reason NRWT on a payments basis is still required; however credit is given for this in the 90% calculation.

**Example 3: Interest accruing but not credited to account**

Company C has a 30 June balance date and a loan facility from an associated non-resident with an interest rate of 10% pa on the outstanding balance, payable at the demand of the lender. Company C draws down $1,000 from this facility on 1 July 2017. Company C makes annual interest payments to the lender of $100 for the first four years. Company C then stops making interest payments and does not credit them to the lender’s account, although interest continues to accrue on an annually compounding basis. Company C calculates its expenditure from the facility under the IFRS financial reporting method.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **#** | **Date** | **Event** | **Payments** | **Accrued interest** | **Deductions** | **Deduction Payment** | **Cash NRWT** | **NRFAI NRWT** |
| 1 | 1 Jul 2017 | Facility draw-down | -1,000 |  |  |  |  |  |
| 2 | 30 Jun 2018 | Balance date | 100 |  | 100 |  | 10 |  |
| 3 | 20 Sep 2018 | NRFAI calculation date |  |  |  | N/A – First year |  |  |
| 4 | 30 Jun 2019 | Balance date | 100 |  | 100 |  | 10 |  |
| 5 | 20 Sep 2019 | NRFAI calculation date |  |  |  | 200 ÷ 100 = 200% |  |  |
| 6 | 30 Jun 2020 | Balance date | 100 |  | 100 |  | 10 |  |
| 7 | 20 Sep 2020 | NRFAI calculation date |  |  |  | 300 ÷ 200 = 150% |  |  |
| 8 | 30 Jun 2021 | Balance date | 100 |  | 100 |  | 10 |  |
| 9 | 20 Sep 2021 | NRFAI calculation date |  |  |  | 400 ÷ 300 = 133.3% |  |  |
| 10 | 30 Jun 2022 | Balance date |  | 100 | 100 |  |  |  |
| 11 | 20 Sep 2022 | NRFAI calculation date |  |  |  | 400 ÷ 400 = 100% |  |  |
| 12 | 30 Jun 2023 | Balance date |  | 110 | 110 |  |  |  |
| 13 | 20 Sep 2023 | NRFAI calculation date |  |  |  | 400 ÷ 510 = 78.4% = NRFAI triggered |  | 610 x 10% - 40 = 21 |
| 14 | 30 Jun 2024 | Balance date |  | 111 | 111 |  | Not required |  |
| 15 | 20 Sep 2024 | Maturity NRFAI calculation date |  |  |  | Not required |  | 11.10 |
|  | Total | | 400 (excluding principal) | 321 | 721 |  | 72.10 | |

Even if Company C started paying interest again, this arrangement would stay in NRFAI. If it wanted to eliminate NRFAI it would need to repay the loan and replace it with a new one.

**Example 4: Arrangements entered into before application date**

Company D has three separate loans from its non-resident parent. All three loans were for $2,000 and were drawn down on 1 April 2015 with no periodic interest payments and a single repayment amount of $2,500 on 31 March 2020. Due to their 31 March balance date, the NRFAI rules apply to Company D from 1 April 2017. On 1 April 2017 Loan 1 continues as originally intended, Loan 2 is repaid at the amount accrued on that date and replaced by a new loan that has annual interest payments and is repaid on 31 March 2020 and Loan 3 is restructured to have annual interest payments on 31 March each year for interest accrued after 1 April 2017 with the balance repaid upon maturity.

***Loan 1:***

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **#** | **Date** | **Event** | **Payments** | **Deductions** | **Deduction Payment** | **Cash NRWT** | **NRFAI NRWT** |
| 1 | 1 Apr 2015 | Arrangement commences | -2,000 |  |  |  |  |
| 2 | 31 Mar 2016 | Balance date | 0 | 91.28 |  |  |  |
| 3 | 31 Mar 2017 | Balance date | 0 | 95.45 |  | 0 |  |
| 4 | 1 Apr 2017 | NRFAI rules apply |  |  |  |  |  |
| 5 | 31 Mar 2018 | Balance date | 0 | 99.80 |  |  |  |
| 6 | 20 Jun 2018 | NRFAI calculation date |  |  | N/A – First year | 0 |  |
| 7 | 31 Mar 2019 | Balance date | 0 | 104.36 |  |  |  |
| 8 | 20 Jun 2019 | NRFAI calculation date |  |  | 0 ÷ 99.80 = 0% = NRFAI triggered |  | (91.28 + 95.45 + 99.80 + 104.36) x 10% = 39.09 |
| 9 | 31 Mar 2020 | Maturity | 2,500 | 109.12 |  | 0 |  |
| 10 | 20 Jun 2020 | Maturity NRFAI calculation date |  |  | Not required |  | 10.91 |
|  | Total | | 500 | 500 |  | 50.00 | |

***Loan 2 & new loan:***

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **#** | **Date** | **Event** | **Payments** | **Deductions** | **Deduction Payment** | **Cash NRWT** | **NRFAI NRWT** |
| 1 | 1 Apr 2015 | Arrangement commences | -2,000 |  |  |  |  |
| 2 | 31 Mar 2016 | Balance date | 0 | 91.28 |  | 0 |  |
| 3 | 31 Mar 2017 | Balance date | 0 | 95.45 |  | 0 |  |
| 4a | 1 Apr 2017 | NRFAI rules apply – loan 2 repaid | 2,186.72 |  |  | 18.67 |  |
| 4b | 1 Apr 2017 | NRFAI rules apply – new loan drawn | -2,186.72 |  |  |  |  |
| 5 | 31 Mar 2018 | Balance date | 99.80 | 99.80 |  | 9.98 |  |
| 6 | 20 Jun 2018 | NRFAI calculation date |  |  | N/A – First year |  |  |
| 7 | 31 Mar 2019 | Balance date | 99.80 | 99.80 |  | 9.98 |  |
| 8 | 20 Jun 2019 | NRFAI calculation date |  |  | (99.80 + 99.80) ÷ 99.80 = 200% |  |  |
| 9 | 31 Mar 2020 | Maturity new loan | 2,286.52 | 99.80 |  | 9.98 |  |
| 10 | 20 Jun 2020 | Maturity NRFAI calculation date |  |  |  |  |  |
|  | Total | | 486.13 | 486.13 |  | 48.61 | |

***Loan 3:***

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **#** | **Date** | **Event** | **Payments** | **Deductions** | **Deduction Payment** | **Cash NRWT** | **NRFAI NRWT** |
| 1 | 1 Apr 2015 | Arrangement commences | -2,000 |  |  |  |  |
| 2 | 31 Mar 2016 | Balance date | 0 | 91.28 |  | 0 |  |
| 3 | 31 Mar 2017 | Balance date | 0 | 95.45 |  | 0 |  |
| 4 | 1 Apr 2017 | NRFAI rules apply |  |  |  |  |  |
| 5 | 31 Mar 2018 | Balance date | 99.80 | 99.80 |  | 9.98 |  |
| 6 | 20 Jun 2018 | NRFAI calculation date |  |  | N/A – First year |  |  |
| 7 | 31 Mar 2019 | Balance date | 99.80 | 99.80 |  | 9.98 |  |
| 8 | 20 Jun 2019 | NRFAI calculation date |  |  | (99.80 + 99.80) ÷ 99.80 = 200% |  |  |
| 9 | 31 Mar 2020 | Maturity | 2,286.52 | 99.80 |  | 28.65 |  |
| 10 | 20 Jun 2020 | Maturity NRFAI calculation date |  |  |  |  |  |
|  | Total | | 486.13 | 486.13 |  | 48.61 | |

### Defining when payments are to a related person

### (Clause 253)

The requirements of section RF 12(1)(a) include that the borrower is not associated with the lender.

New Zealand borrowers that meet the requirements of section RF 12(1)(a) can pay AIL on a payment of interest that is NRPI. When AIL is paid, this NRPI qualifies for a zero-rate of NRWT.

#### Back-to-back loans and multi-party arrangements

Unlike some other areas of New Zealand’s tax legislation, the AIL rules do not “look through” to the ultimate lender to a New Zealand borrower. Leaving aside the possible application of the general anti-avoidance provision, this allows a New Zealand borrower to interpose one or more third parties into what would otherwise be a loan from an associated person. An example of this type of arrangement is a back-to-back loan.

Arrangements have also been entered into that are not back-to-back loans in the conventional sense but which also involve indirect funding by a non-resident lender to a resident associated borrower without the imposition of NRWT, while maintaining an income tax deduction calculated under the financial arrangement rules.

These back-to-back loans and multi-party arrangements are defined as “indirect associated funding”. Interest payments on indirect associated funding will be ineligible for AIL and New Zealand-resident (or New Zealand branches of a non-resident) borrowers will have to consider whether NRFAI arises if interest payments on indirect associated funding have an inappropriate amount of deferral compared with income tax deductions.

Indirect associated funding arises when a non-resident associate of a New Zealand borrower provides funding, directly or indirectly, to a third party so it can be provided to the New Zealand borrower or to reimburse the third party for funds provided to the New Zealand borrower. This is also intended to apply to arrangements where part of the funding is provided by an associated non-resident and part is provided by the third party. This is achieved by treating any amount lent by or repaid to the associate as being lent directly to the New Zealand borrower rather than the third party. Any interest payments made by the New Zealand borrower to the third party are treated as being made by the New Zealand borrower to the third party as agent for the associate, to the extent they are attributable to money lent by the associate.

The proposals in the bill are intended to capture all arrangements involving a New Zealand borrower, third party and an associated non-resident if there is some linkage between the two amounts of funding provided, but not arrangements where there is no linkage, other than the existence of a common third party.

**Example: Commercial arrangement**

Foreign Parent Ltd has $1,000,000 on deposit with Australian Bank Ltd while its subsidiary, NZ Sub Ltd, has a $500,000 loan from Australian Bank Ltd NZ Branch. Both the deposit and loan are on commercial arm’s length terms so Foreign Parent is not considered to have provided this deposit so that Australian Bank could lend it to NZ Sub Ltd. Therefore, this is not indirect associated funding.

**Example: Back-to-back loan**

NZ Co Ltd has a $1,000,000 loan from NZ Bank Ltd on which it pays 5% interest. NZ Co Ltd’s parent, Aus Hold Co has a $700,000 deposit with NZ Bank Ltd on which it receives 4.9% interest. Bank lending documents show NZ Co Ltd pays this interest rate, instead of 6% charged to other borrowers, due to Aus Hold Co’s deposit. This arrangement is treated as a $700,000 loan from Aus Hold Co to NZ Co Ltd and a $300,000 loan from NZ Bank Ltd to NZ Co Ltd. NZ Co Ltd makes $50,000 annual interest payments to NZ Bank Ltd and NZ Bank Ltd makes $34,300 annual interest payments to Aus Hold Co. The first interest payment is treated as a $34,300 interest payment from NZ Co Ltd to NZ Bank Ltd as agent for Aus Hold Co on which NZ Co Ltd must withhold NRWT (and NZ Bank Ltd will be required to if NZ Co Ltd does not) and a $15,700 interest payment from NZ Co Ltd to NZ Bank Ltd which is treated in the standard manner (NZ Bank Ltd has an RWT exemption certificate so no RWT is withheld; however, this is assessable income to NZ Bank Ltd). The second interest payment from NZ Bank Ltd to Aus Hold Co is treated as not occurring so no NRWT or AIL is required.

**Example: Back-to-back loan through a cash pooling arrangement**

US Parent Ltd has a $10,000,000 loan to NZ Subsidiary Ltd on which the interest payments are subject to NRWT. NZ Subsidiary Ltd repays this loan by withdrawing from an account with US Bank Ltd. This account is part of a cash pooling arrangement with other members of US Parent Ltd’s group. US Parent Ltd uses the $10,000,000 repaid by NZ Subsidiary Ltd to put on deposit with US Bank Ltd in an account that is also part of the cash pooling arrangement. Because these amounts offset each other US Parent Ltd does not receive any interest from US Bank Ltd but neither does NZ Subsidiary Ltd pay interest to US Bank Ltd. NZ Subsidiary Ltd pays $100,000 per month to US Parent Ltd as part of a transfer pricing agreement which is a deductible funding cost to NZ Subsidiary Ltd. Currently this is not interest as US Parent has not lent money to NZ Subsidiary Ltd; section RF 12I will however treat this arrangement as a loan from US Parent Ltd to NZ Subsidiary Ltd and the $100,000 per month payment as an interest payment to US Bank Ltd as agent for US Parent Ltd from which NRWT must be withheld.

**Example: Multi-party arrangement**

NZ Company Ltd borrows $1,000 from NZ Bank Ltd with $100 annual interest payments and the $1,000 repaid in five years. Immediately after this, NZ Bank Ltd sells the principal repayment to Aus Parent Company, the ultimate owner of NZ Company Ltd for $600. Under the proposals in the bill, this is treated as two separate financial arrangements, a 5-year $400 amortising loan from NZ Bank Ltd to NZ Company Ltd and a 5-year $600 bullet loan from Aus Parent Company to NZ Company Ltd as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **From** | **To** | **Arrangement commences** | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** | **Total interest** |
| NZ Bank | NZ Company | -400 | 100 | 100 | 100 | 100 | 100 | 100 |
| Aus Parent Company | NZ Company | -600 |  |  |  |  | 1,000 | 400 |

There is no equivalent amount paid by NZ Bank Ltd to Aus Parent Company so the $100 interest payments by NZ Company Ltd to NZ Bank Ltd are treated as payments of principal and interest between two New Zealand residents under the financial arrangements rules. The $1,000 final payment, whether paid directly to Aus Parent Company or paid to NZ Bank Ltd as agent for Aus Parent Company is treated as a $600 principal repayment and a $400 interest payment from NZ Company Ltd to Aus Parent Company, therefore NZ Company Ltd must withhold NRWT. However, as NZ Company Ltd is claiming financial arrangement deductions for funding provided by an associated non-resident, this arrangement will trigger NRFAI on which NRWT will be required to be paid over the term of the arrangement.

#### Acting together

The current non-association tests for accessing the AIL rules rely on the associated persons definition in subpart YB. One of the tests in the associated persons definition states that two companies are associated if a group of persons exists whose total voting interests in each company are 50 percent or more.

This means that where two or more companies each have ownership interests of less than 50 percent in a New Zealand borrower, these companies will not be associated with that borrower unless they are themselves associated.

Transactions have been identified where two or more non-associated persons (investors), each with less than 50 percent of ownership interests in a New Zealand borrower, together provide debt funding to that borrower under an arrangement. Even though these investors may be genuinely not associated (for example, three pension funds for quite different groups of employees) they may make decisions about the borrower collectively, and in economic substance, operate in a similar manner as if they were a single owner.

By operating in this manner, the investors can make decisions in a similar manner to a single owner such as inserting high levels of debt (subject to thin capitalisation requirements) in proportion to their ownership interests and thereby receive a return on their total (equity + debt) investment with a large proportion of this being deductible in New Zealand.

This problem is not unique to the NRWT/AIL rules. Until recently, the same structure meant the thin capitalisation rules did not restrict the New Zealand borrower’s interest deductions.

It is proposed that related party debt will include funding provided by a member of a non-resident owning body. This means

* interest payments on this funding would be ineligible for AIL; and
* where interest payments are inappropriately deferred compared with deductions, the arrangement may generate NRFAI.

A non-resident owning body is an existing concept within the thin capitalisation rules. This was explained in greater detail in *Tax Information Bulletin* Volume 26, No 7, August 2014. In short, a non-resident owning body is a group of non-residents or entities described in section FE 2(1)(cc) to (db) (such as trusts settled by non-residents), that have one or more characteristics indicating they are acting together to debt-fund a New Zealand company. These characteristics include:

* having proportionate levels of debt and equity among the group;
* an agreement that sets out how the company should be funded with member-linked funding if the company is not widely held (a term defined in section YA 1);
* member-linked debt in the company in a way recommended by a person (such as a private equity manager), or implemented by a person on behalf of the members.

Proportionality is a characteristic of acting together as it generally requires a degree of coordination to achieve. More generally, proportionality is also a situation where shareholders are able to substitute debt for equity. This is because, where there is proportionality, the level of debt in a company does not change shareholders’ exposure to the risk of holding equity in the company or shareholders’ overall return. Due to the ability to structure an arrangement to achieve this outcome without explicit proportionate debt, the test is structured to cover transactions that may not have proportionate debt but can still be considered the result of acting together.

***Prepayments of interest***

### (Clauses 261 and 330)

A proposed transitional prepayment rule will prevent a company effectively continuing the current non-imposition of NRWT beyond application of the new rules by prepaying interest on a financial arrangement before the new rules take effect. This situation may arise when a borrower will be required to withhold NRWT on interest on an arrangement that will be a related-party debt after the new rules come into force but is not currently paying non-resident passive income (for example, because of the onshore branch exemption) or is paying AIL on interest to an unassociated party (for example, as part of an arrangement that will be treated as a loan from persons who are associated with the borrower because they are acting together). The prepayment rule will compare the amount of interest paid with any financial arrangement deductions taken to the date the new rules apply. Any excess interest paid will be treated as being paid on the first day the new rules apply and will therefore be liable for NRWT. Any AIL previously withheld on these interest payments will be refundable.

**Example**

NZ Co is owned 25 percent each by four non-resident private equity funds. NZ Co has been making interest payments to each fund of $100,000 per year and paying $2,000 of AIL on each interest payment. As NZ Co knows its owners will be treated as acting together when the new rules apply to their interest payments after 1 April 2017 they agree that on 1 January 2017 NZ Co will make a one off interest payment to each fund of $800,000 with no further interest payments until after 1 April 2027. NZ Co pays $16,000 of AIL on each of these payments in its January 2017 AIL return. On 1 April 2017 it is calculated that interest payments exceed deductions by $700,000 for each fund; therefore, NZ Co is treated as paying $700,000 to each fund on 1 April 2017 and only $100,000 to each fund on 1 January 2017. $70,000 of NRWT is required to be paid on behalf of each fund. NZ Co can apply to the Commissioner to have $14,000 of AIL refunded for the interest payment to each fund that is no longer treated as being paid on 1 January 2017.

### Interest payments by a member of a registered banking group

### (Clause 252)

For a New Zealand bank that is part of a wider worldwide banking operation, there are commercial reasons why the New Zealand bank may borrow from its parent or another associated entity. This can include the better credit rating held by the larger parent, economies of scale of a single funding operation and/or better name recognition of the parent, which allows funding to be raised more cheaply.

It can reasonably be considered that funding on-lent to a New Zealand bank by its parent is ultimately largely borrowed from an unrelated third party and not generally provided by the parent bank’s shareholders as a substitute for equity.

By restricting the offshore and onshore branch exemptions, as covered by this bill, New Zealand banks will no longer be able to rely on these structures to remove their NRWT liability.

In the absence of further changes, New Zealand banks would have a tax incentive to raise all funding from third parties so that AIL could be paid instead of NRWT even when, in the absence of tax, it would be economically efficient to borrow through an associated party.

Proposed changes to section RF 12(1)(a)(ii) will allow a member of a banking group to pay AIL on interest payments to an associated non-resident. These changes will not be extended to non-banks, including other businesses operating in the financial sector. This is because, unlike other industries, banks already have a clear definition which removes boundary issues and provides confidence that related-party funding is not an economic substitute for equity investment. This is consistent with the current legislation where New Zealand-registered banks are subject to more rigorous thin capitalisation requirements and greater regulatory oversight by the Reserve Bank of New Zealand, than other financial sector taxpayers.

# AIL registration proposals

### (Clauses 246, 294 and 330 to 332)

## Summary of proposed amendments

Proposed changes to the Stamp and Cheque Duties Act 1971 will restrict securities an approved issuer will be able to register and therefore pay AIL on. These restrictions focus on the borrower, the lender and/or the size of the borrower’s interest payments to non-residents, to ensure that borrowers registering a security for AIL are highly likely to treat payments to associated non-residents correctly. These proposals will increase the integrity of the AIL rules while minimising additional compliance costs on compliant borrowers.

## Application date

The proposed amendment will apply to securities registered on or after 1 April 2017. Securities registered before this date will apply the proposed rules on 1 April 2018.

## Key features

To access the AIL rules, a New Zealand borrower must be an approved issuer, and must make a payment of NRPI to a non-associated person on a registered security.

There are currently very few requirements for a person to become an approved issuer or to register a security. There is no legislative requirement that an approved issuer cannot register a security that is issued to an associated party, or pay AIL on such a security. It is simply that the payment of AIL will not prevent NRWT applying to the interest paid to an associated person.

This means that it is relatively easy for New Zealand taxpayers to borrow from non-resident associates and claim NRWT zero rating. While this approach is not in accordance with current law it can only be prevented after being detected by Inland Revenue.

Amendments to the Stamp and Cheque Duties Act 1971 will restrict who can register a security for AIL, with the aim of reducing the possibilities for deliberate non-compliance. Three categories under which a security can be registered are proposed. The first two categories would comprise lenders and borrowers who are highly unlikely to treat, incorrectly for tax purposes, a payment of interest as made to an associated person. The third category would comprise borrowers with sufficient scale that it would be more cost-effective for the transaction to be audited to confirm that the parties are not associated.

The first two categories are New Zealand borrowers and non-resident lenders respectively who have not been observed to be treating associated party transactions incorrectly and where it is reasonably straightforward for Inland Revenue to independently verify that they are not associated with each other. The third category covers New Zealand borrowers who make, or expect to make, interest payments of at least $500,000 per year to non-residents.

### Restructuring a registered security

Under new section 86I of the Stamp and Cheque Duties Act 1971, securities registered under the first two categories may become ineligible for AIL. This will occur if, at the time the interest is paid, the directors of the borrower know or could reasonably be expected to know (without making enquiries specifically for the purpose of applying the section) that the security could not be registered if registration was sought on the date the interest was paid.

It is possible that a registered security becomes ineligible for AIL through the operation of this provision and a further change (for example, in the identity of the holder of the financial arrangement) means registration would be possible if sought at that later date. In that case, the security will automatically become re-eligible for AIL on interest payments after that later date.

This section is intended to prevent a borrower entering into a temporary structure to register a security, then restructuring it as soon as, or shortly after, registration is obtained. It is not intended to cover changes in the commercial structure of a lender that are beyond the control of, and frequently unknown to, a New Zealand borrower.

**Example**

Property Development Ltd, a closely held New Zealand company, with less than $500,000 of expected interest payments to non-residents, borrows $1m in each of three separate loan transactions.

Loan 1 is $1m from Singapore Finance Ltd. Singapore Finance confirms that it lends to more than 100 customers so this security is registered. The day after the security is registered, Singapore Finance sells the loan to one of the directors of Singapore Finance and advises Property Development that future payments should be made to that director. Although Property Development and the director are not associated, neither party would meet the requirements in section 86G(2) or (3) so this security is no longer eligible to have AIL paid and NRWT must instead be withheld from any interest payments.

Loan 2 is $1m from United Kingdom Finance Ltd. United Kingdom Finance confirms that it lends to more than 100 customers so this security is registered. The day after the security is registered, United Kingdom Finance sells the loan to a UK SPV, a company wholly owned by one of the directors of Property Development. UK SPV is not associated with Property Development. Even if UK SPV and United Kingdom Finance do not tell Property Development of the sale – for example, by United Kingdom Finance collecting payments as agent for UK SPV, it is reasonable to expect that Property Development should have known about this sale, so this security is no longer eligible to have AIL paid and NRWT must instead be withheld from any interest payments.

Loan 3 is $1m from Australia Finance Ltd. Australia Finance confirms it lends to more than 100 customers so this security is registered. Six months after the security is registered, a number of Australia Finance’s borrowers have repaid their loans so that Australia Finance now only lends to 95 people. Property Development has not been notified of this, and could not be reasonably expected to know, so they can continue to pay AIL on this security.

This section does not apply to a security that is registered under the third category. Securities registered under the third category will continue to be eligible for AIL, even when the borrower’s interest payments to non-residents drops below $500,000 per year, provided the test was met at the time of registration.

### $500,000 interest category

To qualify to register a security under this category, a borrower must have paid, or expect to pay, at least $500,000 interest to non-residents in the previous year, the current year or the next year. This test includes the next year to cover situations when new borrowing occurs near the end of the current year so that the next year may be the first one with a full year of interest expense.

Registrations under this category may include relatively new businesses where there will be limited records available to confirm whether an expectation of over $500,000 of interest expense to non-residents is realistic. To prevent a borrower claiming they expect to pay over $500,000 of interest when they do not genuinely expect to, new section 86G(5) of the Stamp and Cheque Duties Act 1971 gives the Commissioner the ability to cancel a registration from the date of registration if the original claim was not reasonable.

**Example**

NZ Borrower 1 Ltd borrows from an unassociated non-resident during the year ended 31 March 2018. None of the criteria in section 86G(2) or (3) are satisfied. NZ Borrower 1, however, claims they will pay over $500,000 in the year ended 31 March 2019 so the security is registered. In the year ended 31 March 2019, the interest rate NZ Borrower 1 pays falls from 8% to 5% so it makes interest payments of only $450,000. NZ Borrower 1 could not have predicted this fall in interest rates would reduce its interest expense to non-residents below $500,000 so this security continues to be registered and AIL is available on any interest payments.

NZ Borrower 2 Ltd borrows from an unassociated non-resident during the year ended 31 March 2018. None of the criteria in section 86G(2) or (3) are satisfied. NZ Borrower 2, however, claims it will pay over $500,000 in the year ended 31 March 2019 so the security is registered. In the year ended 31 March 2019 NZ Borrower 2 pays interest to non-residents of $85,000. An Inland Revenue audit ascertains that NZ Borrower 2 had agreed to borrow $2m from the non-resident so could not have reasonably expected to pay over $500,000 of interest in the year ended 31 March 2019. The registration is cancelled at the date of registration and NZ Borrower 2’s NRWT returns are reassessed to include the interest payments to the non-resident.

### Transitional rules

These rules are proposed to apply to all new registrations made on or after 1 April 2017. Any securities registered before this date will continue to be registered, so that AIL can still be paid on interest payments, consistent with the existing rules.

However, on 1 April 2018, a borrower will have to consider whether their existing security would meet one or more of the new categories.

If the security does meet one or more of these categories it will follow the same new rules as a security registered under the new rules. This means that a new registration is not required but the borrower will be subject to the same restriction on paying AIL in section 86I if they know, or could reasonably be expected to know, that the registration requirements would not be met at the date of an interest payment.

If the security does not meet one or more of the new categories it is treated as having its registration cancelled on 1 April 2018 and any interest payments after that date (whether or not to an associated person) would require NRWT to be withheld.

### Determinations

New section 91AAU of the Tax Administration Act 1994 proposes to allow the Commissioner to issue determinations for certain categories of borrower, lender or transaction that will mean a security is eligible to be a registered security.

The purpose of these determinations is so that additional categories can be added in a timely manner. These determinations are intended to cover categories that would have been included in the legislation at the time of its enactment, had those categories been considered and/or existed at that time. It is anticipated that, from time to time remedial legislation would be introduced to bring a category covered by a determination within section 86G. Taxpayer-specific determinations will not be given.

**Example**

Steve borrows $2m from a friend living in Island X. Steve is not a person described in section 86G(2), and the transaction is not within the categories in section 86G(3). Steve does not expect to pay more than $500,000 of interest to non-residents so cannot meet section 86G(4). However, Steve knows he is not associated with his friend and considers that all lenders from tax havens are likely to be equally trustworthy. Steve applies to the Commissioner for a determination that all securities with interest payments to a lender from a country listed in the former schedule 26 of the Income Tax Act 2007 should be eligible to register under section 86G(3(v). The Commissioner considers Steve’s request for a determination but considers that lending from residents of these countries is not highly unlikely to involve associated persons. The Commissioner does not issue a determination so Steve cannot register the security and is required to withhold NRWT on interest payments.

# Branch lending proposals

### (Clauses 5, 83, 246, 247, 269, 270, 279, 329, 332 and 333)

## Summary of proposed amendments

The bill proposes a number of amendments to the NRWT rules and the source rules that will ensure that interest payments from a New Zealand resident (or a New Zealand branch of a non-resident) to a non-resident will be subject to NRWT or AIL irrespective of whether that funding is channelled through a branch or an entity that has a branch. This will ensure that funding transactions that are economically equivalent will have a consistent tax treatment.

#### **Offshore branch exemption**

Changes to the source rules will apply NRWT or AIL to an interest payment from the offshore branch of a New Zealand resident to a non-resident to the extent that the offshore branch lends money to New Zealand residents.

#### **Onshore branch exemption**

Changes to the NRWT rules will apply NRWT or AIL to an interest payment from a New Zealand resident (or New Zealand branch of a non-resident) to a non-resident if that non-resident has a New Zealand branch, unless the interest is derived by the New Zealand branch. These changes will not apply to a New Zealand resident (or New Zealand branch of a non-resident) that pays interest to a non-resident that they are not associated with and that has a New Zealand branch that holds a banking licence.

#### **Onshore notional loans**

New subpart FG and changes to the NRWT rules will apply NRWT or AIL (to the extent it is not already) to a notional interest payment from a New Zealand branch of a bank to its head office. This interest payment will be equal to the amount already included in the branch’s financial statements and claimed as a deduction against New Zealand income of the branch.

## Application date

For existing arrangements, the branch amendments will apply to interest payments on or after the date shown in the table below. For all other arrangements, the branch amendments will apply to interest payments on or after the day the bill is enacted.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Scenario** | **Borrower** | **Lender** | **Application date** | **Clause** | **Intended regime** |
| **Onshore branches** | | | | | |
| Related party | NZ Corporate | Foreign associate with NZ Branch | Royal assent | 5(5) | NRWT |
| Intra-bank Group | NZ Bank Sub | Foreign parent with NZ Branch | 5 years | 5(4)(b) | NRWT or AIL |
| Intra-bank Entity | NZ Bank Branch | Foreign head office | 2 years | 83(2) | NRWT or AIL |
| Corporate | NZ Corporate including NZ Bank | Third Party with NZ Branch | 5 years | 5(4)(a) | NRWT or AIL |
| Third party bank | NZ borrower | Foreign bank with NZ Branch | No change | 247(1) - RF 2(1)(d) | Net income tax |
| **Offshore branches** | | | | | |
| Wholesale funding | NZ Bank Sub branch | Third parties or Foreign parent | 5 years | 5(6) | NRWT or AIL |

The ability for a member of a banking group to pay AIL on an interest payment to an associated party will apply from the date of enactment.

Further detail is provided on application dates under *Key features* below.

## Key features

### Offshore branch exemption

***(Clauses 5, 269, 270, 279 and 333)***

NRPI includes only income that has a New Zealand source. One of the exclusions from having a New Zealand source is the offshore branch exemption. This applies when the interest is derived from money lent outside New Zealand to a New Zealand resident that uses that money for the purposes of a business it carries on through a fixed establishment offshore.

This exemption is intended to apply to a New Zealand resident operating an active business through a branch in another country. If that offshore branch borrows money to fund its offshore operations, the interest on this funding should not be subject to NRWT. This treatment ensures that the offshore branch of a New Zealand company does not have to pay NRWT when a foreign incorporated subsidiary borrowing for an equivalent business would not have to.

However, this exemption also applies when a New Zealand company sets up an offshore branch that borrows money for the purpose of providing funding to New Zealand borrowers, who may be associated or unassociated with the New Zealand company.

The following diagrams illustrate the current and proposed rules for the offshore branch exemption.

**Current application of offshore branch exemption**



The proposed amendments will result in an interest payment by an offshore branch of a New Zealand resident to a non-resident having a New Zealand source to the extent that the branch lends to New Zealand residents.

**Proposed application of offshore branch exemption**



It is possible for an offshore branch of a New Zealand resident to have a business that includes lending to New Zealand residents and other business conducted outside New Zealand. In this instance, any interest payments by the branch will be apportioned based on the proportion of branch assets that are financial arrangements producing New Zealand-sourced income. *De minimis* provisions apply where assets deriving New Zealand-sourced income are less than 5% or more than 95% of a branch’s assets.

To ensure that interest payments by an offshore branch are appropriately subject to New Zealand tax, the payment of AIL will be mandatory on relevant interest payments unless NRWT is withheld.

#### Grandparenting of the onshore branch exemption proposals

The changes to the offshore branch exemption will apply to interest payments on arrangements entered into before the enactment of the bill after a grandparenting period of five complete income years post enactment. This reflects that these offshore branches have entered into commercial arrangements, frequently with unassociated parties, for terms that usually do not exceed five years, and that have been ultimately used to fund New Zealand borrowing, which is also often at fixed interest rates.

All other interest payments by offshore branches will apply the new rules from the date of enactment.

### Onshore branch exemption

### (Clauses 5 and 247)

New Zealand-sourced interest income derived by a non-resident is not currently NRPI when the non-resident lender is engaged in business in New Zealand through a fixed establishment in New Zealand. This exemption from NRPI is known as the “onshore branch exemption”.

This exemption applies irrespective of whether the lending is made through the New Zealand branch. As with the New Zealand branch income, this non-branch (but New Zealand-sourced) income is subject to New Zealand net income tax. This means it is possible for a non-resident parent to lend money to its New Zealand subsidiary with no tax payable on the interest (other than income tax on a very slim margin). The parent can simply lend the money to the head office of a non-New Zealand group company which has a New Zealand branch. The head office of that company can then lend the money to a New Zealand group company.

The following diagrams illustrate the current and proposed rules.

**Current application of onshore branch exemption**



The onshore branch exemption is proposed to be narrowed so that it will only apply to interest payments derived by the New Zealand branch of a non-resident.

**Proposed application of onshore branch exemption**



One exception to this is the onshore branch exemption will continue to apply if the non-resident lender has a New Zealand branch that holds a banking licence and is not associated with the borrower. This is predominantly to minimise compliance costs for individual borrowers who are not currently, but would otherwise under the proposal, be required to withhold NRWT or pay AIL on interest payments to foreign banks for mortgages over foreign properties.

**Proposed application of onshore branch exemption to borrowing from foreign banks**



#### Grandparenting of the onshore branch exemption proposals

When a New Zealand resident is borrowing from an associated non-resident that has a New Zealand branch, these proposals will apply from the date of enactment. These are related party transactions and the parties have ample time and ability to structure out of them if they wish to do so.

When the New Zealand resident is borrowing from an unassociated non-resident that has a New Zealand branch, or when the borrower is a bank, these proposals will apply after a grandparenting period of five years. This is because these are, directly or indirectly, with unrelated parties and reflect arm’s-length transactions that are frequently entered into for longer terms.

### Onshore notional loans

### (Clauses 83, 279, 329, 332(2) and 333)

The proposed amendments aim to equalise the tax treatment between foreign banks that channel offshore funding through their New Zealand subsidiaries and foreign banks that channel offshore funding through their New Zealand branches. In both cases the subsidiary and the branch can claim a deduction for an interest expense on funding provided by their foreign operations (specifically, a notional interest expense in the case of the branch). But whereas the subsidiary has to pay NRWT (or AIL going forward under other proposed amendments in the bill) on its interest payment, the branch pays neither because there is no actual interest flow to the extent that its payment is to head office rather than to a separate company (because it is not possible for one part of an entity to make a legally recognised payment to another – the “payment” is merely a movement of funds).

The following diagram illustrates the current rule once changes in the onshore branch exemption discussed above are incorporated.

**Current treatment of deemed loans**



This is an inconsistent result and has the potential to distort behaviour. Australia has rules which are similar, in substance, to this proposal. The Australian rules apply a 5% withholding tax to a notional interest payment by a branch to its head office. The bill therefore proposes applying 2% AIL to the notional interest payment to ensure the effectiveness of the other proposed branch reforms.

The bill proposes that an amount that the head office makes available to the branch, that is recorded in the branch’s accounting records, is a notional loan from the head office to the branch. When the branch is allowed a deduction as an interest payment on that notional loan it will be a notional interest payment that can be subject to NRWT or AIL.

Like the offshore branch proposals discussed above, these notional interest payments will require AIL to be paid if NRWT is not withheld.

#### Grandparenting of the notional loan proposals

A degree of grandparenting is appropriate as these notional loans have been used to provide funding at fixed rates to New Zealand borrowers. However, unlike the offshore branch exemption and onshore branch exemption proposals discussed above, funding allocated to the New Zealand branch cannot be identified from a specific loan that may have a fixed maturity date (otherwise it would already be subject to NRWT/AIL). These rules will therefore apply to existing arrangements after a grandparenting period of two years.

GST current issues

# Overview

The proposed amendments make a number of changes to the Goods and Services Tax Act 1985. The changes will help ensure that GST continues to function as a tax on consumption in New Zealand, and cover matters where the legislation does not fully give effect to the policy intention or where technical changes could improve the way the system operates.

The proposed amendments contain four key amendments, and relate to the following issues:

* the deductibility of GST associated with the costs of raising capital;
* the eligibility of large, partially exempt, businesses to agree an alternative method of apportionment;
* the ability to take a deduction for secondhand goods, for goods composed partially of gold, silver and platinum; and
* the ability to zero-rate services provided in connection with land in New Zealand.

In addition, a number of other technical and remedial amendments are proposed. The majority of the proposals were included in the officials’ issues paper *GST - Current issues*, which was released for public consultation on 17 September 2015. The submissions received on the items were generally supportive of the suggested changes.

In addition to the matters consulted on in *GST - Current issues*, amendments are also proposed to align the rules of accounting for GST in relation to prize competitions with the practice of the bloodstock industry.

Finally, a number of minor, remedial changes are also proposed, which will address obvious errors or other situations where the legislation does not give effect to the intended policy.

# GST and capital raising costs

### (Clause 311(4))

## Summary of proposed amendment

The proposed amendment will allow businesses to recover GST incurred on goods and services used to raise capital, to the extent that the capital funds their taxable activity.

## Application date

The amendment will come into force on 1 April 2017.

## Key features

The proposed amendment will enable businesses to recover costs incurred in raising capital to fund their taxable activities.

New section 11A(1)(rb) will allow deductions for capital raising costs by treating certain supplies of financial services as zero-rated. These supplies will be zero-rated to the extent the funds raised are expended in an activity of making taxable supplies. The supply would not be zero-rated to the extent that the funds were put to other uses (for example, in capitalising an activity making exempt supplies).

#### **Apportionment of deductions**

Treating the supply of the financial service as partly or wholly zero-rated will result in an input tax deduction being available for part or all of the GST incurred on the goods and services used to make the supply. Some apportionment of deductions may be necessary under the apportionment rules where, for example, the funds will not be raised only for expenditure in a taxable activity, or where goods and services are used for other, non-taxable, purposes (such as making exempt supplies as well as taxable supplies).

#### **Subsequent adjustment of deductions**

These apportioned deductions may also need to be adjusted. As the financial services are zero-rated to the extent that they are *used* to capitalise a taxable activity, the adjustment is expected to follow the actual use. This may require adjustment of the apportioned input tax deductions claimed.

For example, when the activity funded has a different taxable/exempt make-up to that expected, an adjustment to the initially apportioned deduction may be required, so that the deduction reflects the actual proportion of funds used in the taxable activity.

#### **Financial services and persons covered**

The section applies to the following supplies, which are financial services under section 3(1):

* the issue or allotment of a debt or equity security;
* the renewal of a debt or equity security;
* the payment of an amount of interest, principal or dividend under a debt or equity security; and
* the provision or variation of a guarantee of the performance of obligations to do one of the above.

The amendment will not apply when the registered person principally makes supplies of financial services, or to the extent that they have made an election to zero-rate business-to-business supplies of financial services, and a deduction is already available as a result of these rules.

**Example 1**

ACo is a GST-registered company that owns and leases out residential and commercial land. As part of an expansion, it decides to acquire new residential and commercial properties. This will be funded by bond and share issues.

It incurs $10,000 GST in purchasing goods and services to issue the bonds and shares.

Eighty percent of the funds raised will be used to acquire properties, which will be used to make taxable supplies. Twenty percent of the funds will be used to acquire residential properties that will only be used to make exempt supplies of accommodation.

ACo claims an input tax deduction of $8,000.

One of the costs incurred by ACo was for a supply of printed material that was used to advertise the bond and share issue to potential investors. The value of this supply was $6,900 (inc $900 GST). ACo claimed an input tax deduction for $720 (80 percent of the GST incurred). As the estimated use differed from the actual use, ACo may need to make an adjustment to the claimed GST.

## Background

When businesses raise capital, such as by issuing shares or bonds, they will generally make a number of exempt supplies. The business issuing the shares or bonds will consequently not be able to recover GST incurred in raising the capital.

Exempting financial services helps ensure that their consumption is taxed. However, in certain situations, exemption does not lead to the right policy outcome.

This is because exempting financial services arguably leads to tax cascades where the unrecoverable GST is embedded in the cost of the supplies.

The case of capital raising costs for businesses which generally make taxable supplies presents a similar situation, when there is a strong argument that the costs incurred in raising the capital (and associated unrecoverable GST) must be passed on in the cost of the supplies to customers, and or be borne by the business raising the capital, and thereby effectively taxed twice.

# Agreed methods of apportionment and adjustment

### (Clauses 314(3), (4), (5), 315(2))

## Summary of proposed amendment

The proposed amendment will enable businesses to apply alternative methods of apportioning and making adjustments to input tax deductions, to address high compliance costs some businesses experience in applying the legislated approach.

## Application date

The proposed amendment will come into force on the date of enactment.

## Key features

The proposed amendment will enable businesses to apply alternative methods of apportioning and making adjustments to input tax deductions. The method will either be agreed with the Commissioner of Inland Revenue by the business, if the business has a turnover exceeding $24 million, or by an industry association.

Agreed methods must be fair and reasonable, and take into consideration the outcomes that could be reached if the existing apportionment and adjustment rules were applied.

## Background

While most supplies of goods and services in New Zealand are subject to GST, some are exempt. Exempt supplies are instead effectively taxed by denying deductions for the GST incurred by the business making the supply.

In some cases, a business may incur GST on goods and services that it uses to make both taxable supplies and exempt supplies. The business will generally need to apportion the GST it incurs. The rules dealing with apportionment of GST and, if applicable, subsequent adjustment of apportioned deductions, allow GST to be deducted to the extent that the goods and services are used for making taxable supplies.

Businesses make an apportionment upon acquisition of goods and services, generally with limited further adjustments. However, when the use of the goods or services differs from that estimated upon acquisition, the business may be required to adjust the claimed deduction. It may then be required to repay an amount of claimed deduction, or be able to claim a further deduction.

In some cases, businesses may be required to perform a greater number of adjustments to apportioned input tax deductions, and may incur greater difficulty in applying these rules.

For example, retirement village operators may make both taxable and exempt supplies of accommodation in their villages, and the same unit may be used to make both kinds of supplies over its lifespan. As a consequence, the usage of a large number of goods and services acquired by the village may need to be individually tracked and adjustments made. This can give rise to high compliance costs.

## Detailed analysis

The new provisions are intended to address the high compliance costs by providing an alternative method to the apportionment and adjustment rules, which provides a simpler alternative but reaches a similar outcome to that under the current legislation.

New sections 20(3EB) and 21(4B) allow a registered person to use an alternative method of apportionment and adjustment. The method is required to have regard to the outcomes that would be reached if the apportionment and adjustment rules were applied. In some cases there may be a change in the timing of a deduction, and it is expected that the agreement would take account of the time value (for example, by reducing the deduction slightly to reflect this advantage).

While the legislation does not provide a list of factors that an agreed method must take into account, it is expected that agreements would usually contain information such as the following:

* all relevant business activities of the applicant;
* the methodology proposed (for example, calculation based on turnover, floor space, time spent, number of transactions or cost allocations);
* categories of costs that can be directly attributed to either taxable or non-taxable supplies, and categories of costs that relate to both taxable and non-taxable supplies;
* the methodology proposed for significant one-off acquisitions such as land;
* the method by which disposals of assets will be dealt with (for example, what input tax adjustments will be made);
* any adjustments that will be made in relation to goods and services that have already been acquired, including those that are subject to the current apportionment rules, transitional rules or old apportionment rules;
* details of any proposed variations to the minimum number of adjustment periods for which adjustments will be made;
* details of any proposed variations to the period in which adjustments will be returned; and
* an explanation of why the proposed methodology is fair and reasonable, and how it reflects the outcomes that could be reached under the apportionment rules.

#### **Eligibility**

The proposed amendments allow two groups to agree an alternative method of apportionment and adjustment with the Commissioner of Inland Revenue:

* businesses with a turnover exceeding or expected to exceed $24 million in a 12-month period; and
* industry associations.

Businesses exceeding the turnover threshold would be able to agree a method with the Commissioner, which would apply to their own activities. Industry associations would be able to agree methods that could be applied by persons in that industry. The Commissioner and association would need to agree, as part of the agreement, the persons or class of persons that are eligible to apply the method (with any necessary adaptations).

The turnover threshold is intended to help ensure that the administration costs of the scheme are managed, by restricting the number of potential applicants. The amendments will also help ensure that businesses participating within an industry have access to a similar method.

#### **Incidental changes**

Clause 315(3) and (5) make incidental amendments to the provisions, updating cross-references to other sections.

# Secondhand goods, and gold, silver and platinum

### (Clause 304(3), (5) and (6))

## Summary of proposed amendment

The proposed amendment will allow deductions to be claimed under the rules applying to secondhand goods, for goods composed of gold, silver and platinum, and of a kind manufactured for sale to the public.

This will be achieved by expanding the definition of “secondhand goods”, by narrowing the exception that applies to goods composed of gold, silver or platinum.

## Application date

The proposed amendment will come into force on the date of enactment. It also enables businesses to claim deductions for goods acquired in the four years preceding the date of enactment.

## Key features

The proposed amendment expands the definition of “secondhand goods”, to include goods composed of gold, silver or platinum, and of a kind manufactured for sale to the public. It achieves this by narrowing the exception for goods composed of gold, silver or platinum. The new definition continues to exclude goods which are, or to the extent they are, manufactured from these metals, but inserts an additional requirement. The exception will now be restricted to goods that are not of a kind manufactured for sale to the public.

This will allow deductions to be claimed for the gold, silver or platinum content of a variety of goods, such as jewellery.

The proposed amendment also includes an application clause so that deductions can be claimed for goods acquired in the four years preceding the date of enactment, or from an earlier period when the period was reassessed within that four-year period.

The proposed amendment applies from the date of enactment, but also contains an application provision, so that the rule will apply to goods acquired in the four years before the date of enactment, or to goods that were subject to a reassessment within this time period (including a consequential override to section 89DA of the Tax Administration Act 1994, so that the reassessment can be effectively undone).

This recognises that industry practice has been mixed, and ensures that businesses that have claimed the deductions are not subject to reassessments but also that compliant businesses are not disadvantaged.

## Background

Registered persons who acquire a supply of secondhand goods may claim an input tax deduction even when GST is not charged on the supply (for example, because the goods are acquired from a consumer). This deduction recognises that GST will have been incurred by the supplier, and that this is embedded in the cost of the secondhand goods to the registered person.

One of the exceptions to this is for gold, silver and platinum. Goods composed of gold, silver and platinum are excluded from these rules in two circumstances:

* when the good is a “fine metal”; and
* to the extent that the good is composed of gold, silver or platinum.

This first exception recognises that the GST system is designed so that goods that are “fine metal” should not generally be taxed. Gold, silver or platinum are “fine metal” when they are of a fineness of 99.5% and 99.0%, respectively.

The second exception is due to an historic concern that the treatment of fine metal could give rise to a fiscal risk from the conversion of fine gold, silver or platinum into a lower purity, non-fine form, by a non-registered person. Allowing a deduction for the non-fine form under the secondhand goods rules would potentially provide a credit for untaxed gold, and could produce a fiscal risk.

While the exception to the secondhand goods rules for gold, silver and platinum should avoid this risk, it also may affect persons dealing in other goods, which pose a lower risk of this kind of fraud. This potentially leads to the consumption of these goods being taxed multiple times, contrary to GST’s purpose.

The level of compliance with the technical requirements of these rules is also understood to be relatively low, and that a number of persons may already have claimed and be claiming deductions for secondhand goods composed of gold, silver or platinum.

# Services connected with land

### (Clause 311(1) and (3))

## Summary of proposed amendment

The amendment will ensure that a wider range of services, and in particular professional services that closely relate to land in New Zealand, are subject to GST.

The amendment will similarly ensure that, when these services are provided in relation to land outside New Zealand, they are not charged GST.

## Application date

The amendment will come into force on 1 April 2017.

## Key features

The proposed amendment will expand the range of services that are subject to GST when they relate to land in New Zealand and are supplied to non-residents, or that are zero-rated where they relate to land outside New Zealand.

This expands the existing rules which apply to services that are “directly in connection” with land. The amendment supplements this existing rule by adding an alternative test – when the services are supplied in connection with land and are intended to enable or assist a change in the physical nature, or ownership or other legal status of the land.

Services with such a close connection to land are better seen as consumed where the land is located. The amendment ensures that the GST-treatment stems from the location of the land, rather than the location (or residence status) of the recipient of the services.

#### **Services relating to land in New Zealand**

Currently, section 11A(1)(k) applies to zero-rate services supplied to non-residents who are outside New Zealand at the time the services are supplied. This is subject to certain exceptions, which exclude situations where the services will be consumed in New Zealand. Section 11A(1)(k)(i)(A) excludes services that are “directly in connection” with land situated in New Zealand.

Clause 311(3) amends this requirement, by expanding the services that will not be zero-rated under section 11A(1)(k). Under the amended test, the services will not be able to be zero-rated under this section, when:

* they are directly in connection with land or an improvement to the land, that is located in New Zealand (the current test); and
* when they are in connection with land or an improvement to the land, that is located in New Zealand, and are intended to enable or assist a change in the physical condition, ownership or other legal status of the land or improvement.

#### **Services relating to land outside New Zealand**

Currently, section 11A(1)(e) applies to zero-rate supplies of services that are directly in connection with land outside New Zealand. Clause 311(1) amends this section so that the broader test applies. As well as maintaining the existing test, services supplied in connection with land outside New Zealand will also be zero-rated under this section when they are intended to enable or assist a change in physical condition, ownership or other legal status of the land.

#### **Application of the new test**

The requirement that the services be supplied in connection with land (as described under the amendments) is intended to discriminate between supplies that have a close connection with specific land (such as relating to the purchase of a specific property) and can therefore be regarded as consumed in New Zealand, and those that only relate to land more generally (such as seeking general advice on land law or the housing market in New Zealand).

Under the proposed test, the services must be intended to enable or assist a change in the physical condition, ownership or other legal status of the land or improvement. The reference to “services intended to enable or assist a change in physical condition” ensures that services that form an integral part of a process of physically changing the land, but do not do so themselves, are captured.

The inclusion of services intended to “enable or assist a change in the… ownership or other legal status of the land” is expected to apply to a variety of professional services such as legal or real estate agents’ services as part of a land transaction, where the ultimate outcome is to change the legal nature of the land but the services do not involve any physical change or connection to the land.

The following examples illustrate the proposed change, assuming all providers are GST-registered.

*Services connected with land in New Zealand*

Yasmine is a non-resident who intends to purchase land in New Zealand. She hires Blake to act as her agent in bidding or tendering for various open homes.

One tender submitted by Blake is successful, so Yasmine engages Ralph, a lawyer, to act for her in the transaction.

Ralph’s services are intended to enable or assist a change in the legal nature of the land – that is, for the land to be acquired by Yasmine. The services are therefore not zero-rated.

Blake’s services are also intended to enable or assist a change in the ownership of specific land (albeit unsuccessfully in a number of cases). His services are therefore not zero-rated.

*Services connected with land outside New Zealand*

Marama is a New Zealand-resident lawyer who is engaged by Wiremu in relation to the purchase of a condo in Hawaii.

Marama’s services are in connection with the land and are intended to enable a change in the legal nature of the land. Her services are therefore zero-rated, as the land is outside New Zealand.

Wiremu’s residency status or location does not affect the application of the rule for services connected with land outside New Zealand.

*Services not connected with land*

Felix is a photographer based in New Zealand, who is hired by Stella to take photographs of historic sites and places of natural beauty. Stella is a non-resident who is outside New Zealand, and who will use the photographs for a book being compiled.

While the services do relate to specific land, they are not intended to affect the physical or legal nature of the land, and the new rule will not apply.

Felix must therefore zero-rate the supplies.

## Background

New Zealand’s GST system is based on the destination principle, under which supplies of goods and services are taxed in the jurisdiction where the goods and services are consumed. This means services supplied to non-residents who are outside New Zealand will generally be zero-rated, as the services will be regarded as consumed overseas.

An exception is when the service supplied is so closely connected with land that the location of the land is the most appropriate place of taxation. Services supplied to non-residents who are outside New Zealand are not zero-rated when the services are directly in connection with land situated in New Zealand. Similarly, services that are supplied directly in connection with land situated outside New Zealand will be zero-rated (charged with GST at 0%).

These rules for taxing land-related services are consistent with the “place of supply” rules set out in the OECD’s International VAT/GST *Guidelines*. The *Guidelines* suggest that taxing rights over certain services connected with land may be allocated to the jurisdiction where the property is located. In particular, the *Guidelines* suggest that this treatment may be appropriate for:

* supplies of immovable property itself or the right to use that property;
* supplies of services physically provided to the immovable property itself; and
* other supplies of services with a very close, clear and obvious link or association with the property.

However, the interpretation of the current “directly in connection” legislative test potentially results in a number of services in the third category above failing to satisfy the test. This results in the GST treatment of these services instead being determined by other rules, despite their very close connection with the land. This may result in the non-taxation of services that are consumed in New Zealand or the taxation of services consumed outside New Zealand.

In particular, this may apply to professional services such as architectural, real estate or legal services, which are supplied with the intention of facilitating a change in the legal or physical nature of the land, but do not involve a more physical intervention with the land.

In addition, the New Zealand rules are not aligned with the international approach, and this lack of alignment gives rise to a risk of the services being taxed in more than one jurisdiction, or not being taxed in any jurisdiction at all.

# Supplies of land leases

### (Clauses 311(3) to (6) and 315(7))

## Summary of proposed amendments

The proposed amendments address technical issues with the current rules that determine when commercial leases are excluded from the compulsory zero-rating of land rules or when certain other supplies are zero-rated. In addition, the new rules will be extended to supplies of land to GST-registered non-profit bodies, so that the supply is zero-rated in circumstances when the non-profit body would ordinarily be able to deduct GST incurred.

## Application date

The amendments apply on and from 1 April 2011, except the amendment extending the rules to non-profit bodies, which will come into force on the date of enactment.

## Key features

The proposed amendments comprise four changes:

* ensuring that a supply from landlord to tenant, as part of a lease surrender arrangement, is zero-rated;
* reworking the test for whether an arrangement is a commercial lease, and therefore not a supply of land under the compulsory zero-rating of land rules, so that:
* it applies to a supply under an agreement that provides for periodic payments, rather than when the land is supplied periodically; and
* the position is retained so that when payments under the lease (other than regular lease payments) are anticipated not to exceed 25 percent of total consideration payable under the lease, the supply is not a supply of land under section 11(1)(mb). However, when this threshold is exceeded (for example, because the payment is higher than anticipated), the treatment of past payments is not affected;
* ensuring that the procurement by a third party of a lease by way of novation (substituting a new lease with a new tenant for an existing lease, with the agreement of all the parties) is standard rated; and
* where land is supplied to a non-profit body, for use other than in making exempt supplies, the supply may be zero-rated under section 11(1)(mb).

The amendments ensure that the rules operate consistently with the policy intent to zero-rate commercial land transactions, by clarifying that certain transactions fall within the rules or correcting technical issues with the way the rules capture certain transactions.

The original policy intent was that the surrender of a lease would be a zero-rated supply of land. While the surrender of the lease is caught by existing section 11(8D)(a), the section does not zero-rate the landlord’s surrender of their contractual right to payment. New section 11(8D)(ab) provides that this is treated as a supply of land for the purpose of the compulsory zero-rating of land rules.

New section 11(8D)(b) addresses two shortcomings of the current provision which ensures that certain supplies are not supplies of land for the purpose of the compulsory zero-rating of land rules.

First, the current provision applies if the supply is made periodically. This has been replaced with a requirement that the supply is made under an agreement that provides for periodic payments. Leases may be subject to various rules around the time of supply, and when the lease provided for periodic payments to be made it was arguable that each payment was in relation to a separate supply, and therefore the supply of land was not made periodically.

Secondly, new section 11(8D)(b) excludes a lease from the compulsory zero-rating of land rules if payments under the lease that are not regular rent payments are anticipated to not exceed 25 percent of the total consideration payable under the lease. If a payment does in fact exceed this amount (for example, if it is a contingent payment, or an un-quantified payment), then the payment and future payments under the lease are zero-rated. This replaces the current test, which arguably changed the treatment of past supplies to be zero-rated.

New section 11(8D)(c) clarifies the GST treatment of agreements to procure a lease. The current rule is intended to apply to arrangements when a lease is novated – where, by agreement of all the parties, an existing lease between landlord and tenant is replaced with a new lease between the landlord and a new tenant – and the incoming tenant provides consideration to the outgoing tenant. This may occur because the lease could not be assigned. The existing section may not achieve this outcome.

Under proposed new section 11(8D)(d) a GST-registered non-profit body would be treated as acquiring the land for the purpose of making taxable supplies, except to the extent it is acquiring it for making exempt supplies, for the purpose of the compulsory zero-rating land rules. This means that the non-profit body can provide a section 78F statement, and the supply may be zero-rated. Where the non-profit body is using the land partially to make exempt supplies, it may be required to account for output tax under section 20(3J) for the amount of GST it would have incurred, that it could not have deducted.

Consistent with the general rule allowing non-profit bodies to recover GST, the rule only applies to GST-registered non-profit bodies that are resident in New Zealand.

## Background

#### **Compulsory zero-rating of land**

The compulsory zero-rating of land rules treat certain supplies of land as zero-rated rather than taxable. The rules were introduced to help combat phoenix fraud whereby a supplier of land, generally supplied to a related-party, absconds or is wound up without returning GST, but the purchaser is still entitled to a deduction.

Most transactions that are, economically, a supply of commercial land are captured by the rules. An exception is a commercial lease, which, to reduce compliance costs, is excluded unless it possesses the less usual feature of irregular large lump sum payments, which could suggest it could be substitutable for a transfer of land.

#### **Non-profit bodies**

Non-profit bodies are generally able to recover all GST they incur, except to the extent they incur the GST in making exempt supplies. This enables them to recover GST that relates to a non-profit activity that is not a taxable activity. However, the compulsory zero-rating of land rules do not apply in this way, and a non-profit body acquiring land outside the course of their taxable activity would instead be required recover the GST it incurred.

# Time of supply when consideration is unknown

### (Clause 308)

## Summary of proposed amendment

The proposed amendment provides a method for suppliers to account for GST on supplies of goods and services when the consideration payable (and therefore the amount of GST that must be accounted for) is not known at the time of supply.

It will enable the supplier to account for GST to the extent that payment is made or an invoice for a payment is issued. This extends an existing rule and provides a practical way of accounting for GST.

## Application date

The amendment will come into force on the date of enactment, and also applies to supplies before that date, when a business has previously accounted for GST consistently with the amendment.

## Key features

The amendment proposes to treat a supply where the total consideration is not known at the time of supply, as more than one supply. A supply is treated as being made when payment is made or an invoice is issued. This will enable the supplier to account for GST to the extent that the consideration is or becomes known.

It is understood that some registered persons may have accounted for GST in this way in the past. While an existing rule applies in some circumstances, it may have been applied to supplies of goods or services that were not technically covered, as a practical way of dealing with the situation. The amendment will therefore apply to past supplies when a person has taken that approach.

## Background

The “time of supply” determines when a registered person must account for GST on a supply of goods and services. The time of supply will generally be when any payment is made, or when an invoice is issued in relation to the supply, whichever is earlier.

In certain situations, a special rule may apply instead to determine the time of supply. One situation is when goods are supplied under an agreement, and the consideration payable is not known at the time goods are appropriated under the agreement. An example could be when the consideration payable depends on a subsequent event, such as the quality of the goods being ascertained and the value determined.

When this exception applies, the supplier can instead treat the supply as multiple supplies, in relation to any payment made or invoice issued. This enables a person to return GST or issue a tax invoice, to the extent the payment is known.

The current provision is relatively limited, and does not apply to all supplies of goods or to any supply of services. However, similar issues could arise in these cases, which could give rise to difficulties in correctly returning GST or providing tax invoices.

# Goods and services connected with exported boats and aircraft

### (Clauses 310(1), (2) and 311(2))

## Summary of proposed amendment

The proposed amendment will align the tax treatment of goods and services provided in relation to newly purchased boats and aircraft that are to be exported under their own power, with those provided for temporarily imported boats or aircraft.

Goods that are incorporated into, or consumed as part of a process of modifying to-be-exported boats or aircraft, will not be subject to GST. Similarly, services provided directly in connection with these boats or aircraft will also be zero-rated.

## Application date

The amendment will apply from the date of the bill’s introduction.

## Key features

The amendment comprises two key features.

The supply of a boat or aircraft that is exported under its own power within 60 days is a zero-rated supply. The first amendment will likewise zero-rate goods and services that are provided in close connection with these boats and aircraft.

This will effectively align the treatment of goods and services supplied in close connection with newly supplied boats and aircraft with similar goods and services supplied in close connection to temporarily imported boats and aircraft.

The second amendment will enable persons who cannot export the boat or aircraft within the prescribed 60-day time period, due to the acquisition of these goods or services, to apply for an extension to the time period.

Clause 310(1) amends section 11(1)(k) to provide that a supply of goods is zero-rated when the goods are supplied closely in connection with goods that are:

* imported under a temporary import entry; or
* that are supplied from outside New Zealand, destined for outside New Zealand and do not leave the craft on which they are embarked.

To qualify for zero-rating, the goods must be incorporated into the boat or aircraft, or be used up or become worthless as part of servicing the boat or aircraft.

Clause 311(2) inserts new section 11A(1)(ib) so that services that are provided directly in connection with the boats or aircraft will be zero-rated.

Clause 310(2) amends section 11(8). This section provides for the 60-day period in which export of a boat or aircraft must take place (if the supply of the boat or aircraft is to be zero-rated) to be extended. The period may be extended by the Commissioner if the inability to export the boat or aircraft within the prescribed period relates to the recipient acquiring goods incorporated into the boat or aircraft and services directly in connection with the boat or aircraft.

Alternatively, the Commissioner may extend the period if circumstances beyond the control of the supplier and purchaser have prevented or will prevent export within the 60-day period (consistent with the current rule).

## Background

In addition to zero-rating goods that are entered for export by the supplier, a boat or aircraft may be zero-rated if it is supplied to a person who exports it under its own power to a place outside New Zealand. Export must take place within 60 days of the recipient taking possession, although this time period may be extended when circumstances outside the control of the supplier and recipient prevent export within this timeframe.

Another example is supplies of goods that are incorporated into temporarily imported goods, or services provided directly in connection with such goods. These goods and services are zero-rated as they will be consumed outside New Zealand, when the good is re-exported.

This last exception means that goods and services provided in respect of temporarily imported boats and aircraft can be zero-rated. However, this exception does not strictly apply to boats and aircraft that are exported under their own power. This leads to potentially different treatments applying, based on whether a boat or aircraft has been purchased in New Zealand and is exported overseas, or whether it was brought in as a temporary import, before leaving New Zealand again.

# Six-monthly filing

### (Clauses 312 and 313)

## Summary of proposed amendment

The proposed amendment addresses technical issues with the eligibility to file 6-monthly, and introduces a self-assessed “one-off” exception that replaces the current discretion to allow a person to file 6-monthly, even if they do not satisfy the threshold.

## Application date

The proposed amendment will come into force on the date of enactment.

## Key features

The proposed amendment makes technical changes to the rules that govern eligibility to file six-monthly. In particular, the changes:

* ensure that a person is eligible to file 6-monthly when they make seasonal supplies, regardless of whether they exceed the turnover threshold;
* clarify that a person who exceeds the turnover threshold for 6-monthly filing must change their taxable period; and
* replace the current discretion for 6-monthly filing with a “one-off” exception, which enables a business to continue to file 6-monthly when the threshold is exceeded.

First, clause 312 amends section 15(2), which determines eligibility to file 6-monthly.

New section 15(2) expands eligibility under the section to a larger group. A person may now have a 6-month taxable period when they make or are likely to make no more than $500,000 of taxable supplies in a 12-month period (the current test). A person is also eligible if they make most or all of their supplies within a period of 6-months or less, that falls near the end of the 12-month period.

This last requirement is intended to allow businesses that make almost all their supplies in a single season, and prepare accounts at the end of the season, to file 6-monthly.

Secondly, clause 313(2) amends section 15C(2) and introduces new section 15C(2B). These sections address the requirements around changing a taxable period.

The amended section 15C(2) will require a person to change their taxable period from a 6-month period, when they exceed the threshold for 6-month filing and the exception for seasonal businesses does not apply. The person must change at the end of the next taxable period ending with or after the 12-month period when they do not meet the criteria. To do so, they will need to apply to file either 1-monthly or 2-monthly before the end of the current period, so that it takes effect at the end of the current period.

New section 15C(2B) overrides this requirement. It relieves a person of the requirement to change their taxable period where they are likely to not exceed the threshold in the following taxable period. For this exception to apply, the person must not have relied on the exception in the immediately preceding 12-month period.

## Background

A GST-registered person’s taxable period determines the frequency with which they must file GST returns. Taxable periods must be 1-month, 2-months or 6-months, and certain rules govern when a person may or must have a taxable period of a certain length.

A person whose taxable supplies exceed or are likely to exceed $24 million in a 12-month period, must have a 1-month taxable period. Alternatively, any registered person may choose to have a 1-month taxable period.

A person who is not required to have a 1-month taxable period may have a 2-month taxable period or, if their taxable supplies do not exceed and are not expected to exceed $500,000 in a 12-month period, they may choose to file 6-monthly.

A person may change their taxable period to a different period, if they meet the criteria, by giving notice to the Commissioner. The change takes effect from the end of the current period.

Currently, the Commissioner has discretion to allow registered persons, whose taxable supplies exceeded the $500,000 threshold, to file 6-monthly. When the rules were amended in 2006, this provision was not fully updated and there are a number of shortcomings with the current provisions.

First, there is a list of criteria the Commissioner must consider, when directing a change of a person’s taxable period. The reference to directing a change in taxable period relates to the legislative approach before 1 October 2007, when the Commissioner directed changes to a person’s taxable period. (These instead now take place “automatically”, as above.) The criteria are also unconnected to any other requirement – so it is unclear how they are to apply.

The criteria were intended to enable the Commissioner to allow a person who exceeded the threshold to file 6-monthly if they had a good compliance history, and other factors meant that they ought to be able to continue filing 6-monthly. For example, the person may unexpectedly exceed the threshold, or may make most or all of their supplies in a single season and prepare accounts at the end of the season.

Secondly, the criteria relate to directing a change in taxable period – they arguably do not allow a person to continue to file 6-monthly if they exceed the threshold. There is also no provision that explicitly sets out obligations to change to a different taxable period when the threshold for 6-monthly filing is breached.

# Notification a refund is being withheld

### (Clause 322)

## Summary of proposed amendment

Under the proposed amendment, the Commissioner of Inland Revenue will have 15 working days to issue a notification that she was investigating the circumstances of a return or requesting further information. This will replace the current requirement that the notice must be *received* within 15 working days.

## Application date

The amendment will come into force on the date of enactment.

## Key features

The amendment alters the requirement that the Commissioner give notice where she wishes to withhold a claimed GST-refund, pending further investigation of the return or requested information. The amendment will change the timing requirement so that the Commissioner must instead *issue* the notice or request to the person within the 15-working day period.

## Background

When a person provides a GST return that is in a refund position, the Commissioner of Inland Revenue must provide a refund either within 15 working days or on the day following the day on which she has investigated the circumstances of a return, or reviewed the information requested, and is satisfied that the claimant has complied with their obligations.

Section 46(5) applies when the Commissioner intends to investigate the circumstances of a return, or withhold a claimed refund pending the provision of an outstanding return. It provides that she must notify the registered person within 15 working days following the day on which the return is received.

Section 46(4) applies when the Commissioner requests information concerning a return. She must give the request within a period of 15 working days following the day on which the return is received.

The effect of giving notice or a request under either subsection is to enable the Commissioner to withhold the refund past the 15-working day time limit, pending her review or investigation, and her being satisfied that the claimant has complied with their obligations.

The Court of Appeal considered the timing requirements under these subsections in *Commissioner of Inland Revenue v* *Sea Hunter Fishing Ltd* (2002) 20 NZTC 17,468. They were considered to apply when the person received the notice, or would have received the notice in the ordinary course of the postal schedule (as provided for under the Tax Administration Act 1994).

Determining the timing based on when the notice is received creates uncertainty regarding whether a notice or request is issued in time. It also creates dependence on the postal schedule, and is affected by changes to delivery times.

The amendment is not expected to alter the times by which taxpayers receive refunds, the overwhelming majority of which are released without the legislative processes for undertaking further investigation or seeking information being taken. The amendment is intended to help ensure more time is available for the tiny minority that are subject to further inspection, and to conduct further checks without entering into the formal process.

# Alignment of the time period to repay overpaid GST

### (Clause 321)

## Summary of proposed amendment

The amendment allows the Commissioner of Inland Revenue to refund overpaid tax after the expiry of the four-year period, when the person overpaid GST in the relevant period and there has not been an amendment to the assessment. This matches the treatment when an assessment has been amended or was in a net refund position.

## Application date

The proposed amendment will come into force on the date of enactment.

A transitional rule will ensure the amendment applies to claims received before the date of enactment.

## Key features

The proposed amendment will allow the Commissioner to refund an amount of overpaid tax, within a four-year period following the expiry of the original four-year period in which overpaid tax must be refunded.

The amendment applies where the application is received in or before the second four-year period, and the overpayment is due to a clear mistake or simple oversight, and the return.

The proposed amendment also contains a transitional provision that ensures that the Commissioner may repay an amount in respect of existing claims, regardless of when the bill is introduced. This is intended to help ensure that the timing of a remedial amendment does not affect a person’s entitlement.

Under this provision, the Commissioner could provide a refund when an application was received before the date the bill receives royal assent, so long as it was received within four years of the expiry of the original four-year period. The overpayment must still be as a result of a clear mistake or simple oversight.

## Background

The Commissioner must refund an amount of overpaid GST, or pay an amount which a registered person could have deducted but did not, if she is satisfied that the person overpaid tax or did not receive their full refund entitlement. The payment must occur within a four-year period, applying from the end of the year in which a reassessment occurred or an amount was repaid, or within the general four-year time bar.

The Commissioner may also refund an amount after the expiry of this four-year period, within another four-year period. However, the overpayment (or failure to receive the full refund entitlement) must be due to a clear mistake or simple oversight. The additional four-year period is also limited to when a person has been reassessed and overpaid tax, or when they have not received their full refund entitlement. It does not apply when the original assessment resulted in a GST liability and was not amended.

# Agents acting for purchasers

### (Clauses 320 and 326)

## Summary of proposed amendment

The proposed amendment will allow agents acting on behalf of purchasers and principals to opt out of the agency rules for a supply made to the principal. Opting out will allow the parties to account for GST as though the supply was two supplies: between the supplier and agent, and between the agent and principal.

## Application date

The amendment will come into force on the date of enactment.

## Key features

Clause 326 will allow agents and principals to opt out of the agency rules for a supply made to the principal. Opting out will allow enable the parties to account for GST as though the supply was two supplies: between the supplier and agent, and between the agent and principal.

The agent and principal would need to agree in writing to treat a supply, or class of supplies, in this way.

Clause 320 prevents a bad debt deduction being claimed for the supply by an agent to a principal. This would prevent the agent from claiming a deduction when they have made a supply to the principal, and the principal has not repaid them.

This exception is intended to ensure that the amendment does not have an effect beyond helping to ensure that agents and principals do not need to update their systems and incur compliance costs in doing so. Under the existing rules, an agent would not be able to claim a deduction when they go unpaid by their principal.

## Background

For GST purposes, when a supply is made by or to an agent acting on behalf of a person, the supply is treated as being made by or to the principal, rather than the agent, subject to a number of exceptions.

In 2013 an “opt-out” to the agency rules was introduced for agents making supplies on behalf of their principal. The amendment enables an agent and their principal to agree to instead treat the supply as a supply between principal and agent, and then between agent and purchaser.

This addressed an issue when the agent’s and supplier’s accounting systems would automatically issue a tax invoice when they supplied the goods, potentially breaching a rule allowing only a single invoice to be issued for a supply.

A similar issue can arise for agents making purchases on behalf of their principals, when multiple invoices are also issued, contrary to the GST legislation. This could occur, for example, when the agent also makes supplies on their own behalf for which they would need to issue a tax invoice.

# Adjustments and exported goods

### (Clause 315(1))

## Summary of proposed amendment

The amendment provides that a non-resident who incurs GST when they import goods, and who subsequently re-exports the goods, does not need to make further adjustments to the claimed input tax deductions.

## Application date

The amendment will come into force on the date of enactment.

## Key features

New section 21(2)(ab) exempts a non-resident who incurs GST under section 12(1), when they import goods for home consumption, from the need to make adjustments to a claimed deduction.

The exception applies when the non-resident has exported the goods in or before the adjustment period, and has disposed of them overseas or holds them overseas.

This effectively allows the non-resident to retain the claimed GST.

## Background

Under the Goods and Services Tax Act 1985, registered persons may recover input tax incurred on goods and services to the extent that the goods and services are used to make taxable supplies. This use must be periodically reviewed, and when the use differs from the estimated use or a previous adjustment, the registered person may be able to claim a further deduction or must repay some or all of a claimed deduction.

Most supplies by New Zealand residents, other than exempt supplies, will be treated as taxable supplies (although GST may not in fact be charged on them if they are zero-rated). Consequently, most New Zealand resident businesses will be able to recover all the GST they incur, regardless of where the goods are used. However, not all non-exempt supplies by non-residents will be taxable supplies. Supplies of goods situated outside New Zealand at the time of supply fall outside the legislative framework.

This leads to a potential issue when a GST-registered non-resident imports goods for sale in New Zealand, and pays GST to New Zealand Customs Service. While the importer may be able to deduct this GST, if the good cannot be sold and is instead exported for sale overseas, they are arguably effectively taxed under the adjustment rules by the claw-back of the claimed deductions.

# Cross-border business-to-business neutrality remedial amendments

### (Clause 324)

## Summary of proposed amendments

The proposed amendments make two changes to the non-resident registration rules that allow businesses outside New Zealand to register and recover GST they incur. The amendments relate to the associated base protection rules.

The first amendment will ensure that a non-resident cannot register under these rules when they make supplies that are consumed in New Zealand. The second amendment will ensure the correct taxation of services consumed in New Zealand by allowing a non-resident who only incurs GST paid to New Zealand Customs Service to register under these rules.

## Application date

The amendments will come into force on the date of enactment.

## Key features

New section 54B(1)(c) replaces the current requirement with updated wording. Section 54B(1)(c) prevents a person who supplies services that will ultimately be consumed in New Zealand from registering under the non-resident registration rules.

Currently, section 54B(1)(c) prevents registration where it is reasonably foreseeable that the services will be received in New Zealand by a person who is not a registered person. The proposed new section will prevent registration when the person receives the services other than in the course of making taxable or exempt supplies.

This would ensure the correct treatment when services are reasonably foreseeably received by registered persons in a personal capacity. The proposed new wording is aligned with section 11A(2), which addresses a similar concern.

The second amendment relates to the requirement that for a person to register non-resident registration rules, their first input tax credit claim must be likely to exceed $500 (section 54B(1)(b)).

Under new section 54B(1)(b), the relevant criteria will also allow a person to register if the GST they incur is likely to only be levied in relation to the importation of goods that are received by another person or that the person delivers to another person (under section 12(1)).

This addresses a situation where unrecoverable GST could be incurred by a business that operates only as an importer. The effect of the 2014 amendment was to treat GST paid to New Zealand Customs Service on the import of goods, by a non-resident registered under these rules, as incurred by the recipient of the goods. This ensured that the rules could not be used to avoid the taxation of goods consumed in New Zealand.

A side effect of this requirement was that a non-resident who only incurred this GST would be unable to register, as they would not have GST to recover (since it would instead be attributed to the recipient of the goods). However, as they could not register, the attribution rule did not apply, and they incurred the GST themselves.

This led to a situation where the GST would be unrecoverable. The amendment allows the non-resident to instead register in this situation, so that the attribution rule can apply.

## Background

In 2013, special rules were introduced to enable non-resident businesses to voluntarily register for GST (despite not carrying on a taxable activity in New Zealand) and recover GST they incur.

As GST is a tax on the final consumption of goods and services, these rules were intended to help ensure that GST was not a cost for non-resident businesses and better ensure neutrality for cross-border business-to-business supplies.

These rules included a number of special rules to help ensure the integrity of the GST system. One special rule was to prohibit registration when the applicant made supplies that would ultimately be consumed in New Zealand.

Another special rule, introduced in 2014, treats GST paid to the New Zealand Customs Service by a non-resident registered under these rules, for imported goods to be delivered to a New Zealand resident purchaser, as being paid by the recipient of the goods.

# Grouping limited partnerships

### (Clause 325(2))

## Summary of proposed amendment

The amendment ensures that limited partnerships can apply the grouping rules and file a joint return with other registered persons who share common control.

## Application date

The amendment will come into force on the date of enactment.

## Key features

The amendment allows limited partnerships to apply the test for persons other than companies, to form a GST-registered group. This recognises that while limited partnerships are treated as companies for GST purposes, the grouping test that applies to companies does not apply well to limited partnerships. It is more appropriate to apply the alternative “control” test that applies to other persons.

## Background

Groups of registered persons can make an election to file a joint return for GST purposes. The effect of forming a group is that a representative member is treated as making or receiving all supplies that were made or received by the other members. The representative member files a return that includes all the members’ supplies. All members are liable for the joint return.

There are two alternative tests for determining eligibility to form a group. Companies may form a group if they are a group, or part of a group, of companies under section IC 3 of the Income Tax Act 2007 (subject to other requirements). Alternatively, a group of persons that does not consist only of companies may form a group if a common control test is satisfied.

Limited partnerships are treated as companies for the purpose of the Goods and Services Tax Act 1985, but are generally not companies for the purpose of the Income Tax Act 2007. This leads to a situation where a group of registered persons composed of limited partnerships and companies cannot form a group because:

* they would not be a group of companies, or part of a group of companies under the Income Tax Act 2007, as they include limited partnerships; and
* each member of the group is a company for GST purposes, so they cannot apply the alternative test.

The amendment allows a group of persons composed of a limited partnership and other limited partnerships and/or companies to apply the alternative test to form a GST-registered group.

# Horse racing and prizes

### (Clauses 306(3) and 309)

## Summary of proposed amendment

The proposed amendment codifies a practice of accounting for GST on race winnings used by the racing industry.

## Application date

The amendment will apply beginning on 1 April 2012.

## Key features

New section 5(11CB) treats a prize received by a horse owner as consideration for a supply of services provided to the racing club. The new section will apply when a registered person is carrying on the racing in the course of a taxable activity. As such, it is intended to codify the industry practice of treating winnings paid to registered horse owners, who enter the race in the course or furtherance of a taxable activity, as consideration for a taxable supply. It is not intended to alter the treatment of other persons, including causing an activity (which is not a taxable activity) carried on by a person to become a taxable activity.

It is also proposed that section 10(14) be amended, so that a supply under new section 5(11CB) does not change the calculation of the consideration payable under the formula. The formula in section 10(14) determines the consideration for a prize competition, based on the amounts received less the prizes paid in money.

Treating the prize as consideration for a supply means that the prize can be increased by the amount of the GST, without any economic change in the amount received by the winner or cost incurred by the racing club. The “prizes paid” amount is decreased by the input tax deductible by the organiser, so that the amendment does not unintentionally affect the calculation of consideration under the formula.

## Background

There has been some historic uncertainty about how GST applies within the horse racing industry. A practice has developed of treating a prize paid to a winner as consideration for a supply. When the winner is a registered person and enters the race in the course of their taxable activity, they would charge GST and issue the racing club a tax invoice. The racing club would then claim a deduction based on this invoice.

This arrangement is GST-neutral, as any GST charged by the winner would be deducted by the racing club. The prize can be increased by the GST payable, so that the same position is reached. However, as the prizes may not in fact be consideration for a supply, there is doubt whether this practice is technically correct.

The proposed amendment applies to a registered person who enters a horse in a race, in the course of a taxable activity. If the person wins a prize, they are treated as making a supply to the race organiser. The prize is treated as being consideration for the supply.

A consequential amendment ensures that a formula within the Act continues to operate correctly. The formula determines the GST payable for payments to enter the competition.

# Bodies corporate

### (Clause 317)

## Summary of proposed amendment

The amendment proposes to alter the application date of a “saving” provision that applies to past tax positions taken by members of unregistered bodies corporate, to claim deductions for supplies acquired by the body corporate.

## Application date

The amendment will apply on and after 1 October 2011, which is the date of application of the original savings provision.

## Key features

The amendment extends the application period of a saving provision that was introduced in the Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Act 2016. The provision preserved tax positions taken by GST-registered members of an unregistered body corporate to claim deductions for GST incurred by the body corporate.

The saving provision applies to supplies acquired by the body corporate on or before 26 February 2015, and in a taxable period ending on or after 1 November 2010.

A small number of businesses are now understood to have fallen outside the original provision, due to the technical requirements of the provision. The amendment extends the application period of the saving provision to include taxable periods ending before or including 3 November 2015 (the date the savings provision was introduced by SOP) and beginning after 1 November 2010. This will help ensure that their positions are also preserved by the provision so that all payments received by bodies corporate are treated in a consistent manner.

# Other GST amendments

### (Clauses 305, 306(1) and (2), 307, 309(1), 314(1), (2), (6), (8), 316, 318, 319, 323 and 325(1))

## Summary of proposed amendment

A number of minor amendments to the Goods and Services Tax Act 1985 are proposed, where the legislation does not technically give effect to policy, or where there are obvious errors.

## Application date

The proposed amendments will come into force on the date of enactment, with the exception of clause 306(2). Clause 306(2) will apply on and after 1 October 1986.

## Key features

### Clarifications and corrections

The following proposed amendments clarify the relevant legislation, or correct a clear error.

#### **Sales under a security interest where incorrect statement provided**

### (Clauses 306(1) and 323)

The proposed amendment will make it clearer that a person who has granted a security over a good, which is sold by the security holder in satisfaction of a debt, and provides an incorrect statement to the security holder, is liable to return GST on the supply themselves.

Under existing law, when a person exercises a power of sale over another person’s (the debtor’s) goods under a security, they are required to return GST on the supply unless they either:

* receive a statement from the debtor setting out, in full, the reasons why the supply would not be a taxable supply if the debtor supplied the goods themselves; or
* determine, relying on reasonable information they hold, that the supply would not have been a taxable supply.

The Court of Appeal’s judgment in *Commissioner of Inland Revenue v Edgewater Motel Ltd* [2003] 1 NZLR 425, at [14], confirmed that when an incorrect statement is provided, the position is reversed, and the debtor is liable to return GST on the supply. The amendment makes technical changes to the legislation consistent with this judgment, to make it clearer in the legislation that the debtor is liable where the security holder does not return GST on the supply (for example, due to an incorrect statement).

#### **Supply of financial products upon registration**

### (Clause 306(2))

The proposed amendment will better ensure that financial products are treated in the same way upon deregistration as if the person actually disposed of them, and were not inadvertently taxed.

A registered person who deregisters is treated as supplying all the goods and services forming part of the assets of their taxable activity in the course of that taxable activity, immediately before they cease to be registered. This ensures that a person cannot achieve a better result by deregistering before disposing of the assets, and that the consumption of the goods and services is taxed.

In certain circumstances, a financial asset could form part of the assets of a taxable activity. For example, when a supply has been made, but the purchaser has not yet made payment, the resulting debt security may be an asset of the taxable activity.

Normally the supply of a debt security would be an exempt financial service, on the transfer of ownership of the security. However, there is no transfer of ownership upon deregistration. The proposed amendment will ensure that, if a transfer of the ownership of the security would be a financial service, the deemed supply on deregistration is treated as a transfer of ownership to ensure the same outcome is reached.

#### **Financial services and options**

### (Clause 305)

In 2000 an amendment was made under section 3(1)(kaa) to treat the supply of a financial option as a financial service. However, there were two shortcomings:

* the section applied to the provision of an option, but not to the assignment; and
* the payment of an amount arising under a financial option was not included as a financial service under section 3(1)(ka), similar to payments arising under other financial products.

The proposed amendment will ensure that the transfer of ownership of a financial option or payment of an amount arising under a financial option are also treated as financial services.

#### **No apportionment for de minimis exempt use**

### (Clause 314(2))

A registered person may claim deductions for all input tax they incur, subject to the need to apportion the deduction to reflect non-taxable (exempt and private) use. Section 20(3D) provides an exception to this, when a person makes incidental exempt supplies in carrying on their taxable activity. This has been a longstanding approach, and was previously embedded in section 21(4) before the new apportionment rules applied from 1 April 2011.

Under the previous section 21(4), it was clear that the rule removes the need to make adjustments in respect of only exempt supplies (rather than, for example, private use). The amendment to section 20(3D) makes this effect explicit again.

#### **Output tax by purchaser who acquires zero-rated land**

### (Clause 314(6))

When a person acquires a supply that is zero-rated under section 11(1)(mb) they are required under section 20(3J)(a)(iii) to account for output tax on use that is not in making taxable supplies. This ensures the same result as if they instead incurred GST and claimed a deduction.

As defined, output tax is normally GST charged on supplies made by a person. While this only applies unless the context requires otherwise, an amendment to section 20(3J)(a)(iii) clarifies that this amount is treated as output tax under section 20(4).

#### **Value of entertainment expenses**

### (Clause 318)

Certain entertainment expenses may not be fully deductible under the Income Tax Act 2007. This recognises that the entertainment may also confer a private benefit on the recipient. GST is imposed on this private consumptive element by section 21I(4) of the Goods and Services Tax Act 1985. The section treats an amount equal to the denied income tax deduction as consideration for a taxable supply.

However, the denied income tax deduction is a GST-exclusive amount, while consideration is a GST-inclusive term. The proposed amendment to section 21I(4) instead treats the amount as the value of the supply (a GST-exclusive amount) so that the section applies as intended.

#### **Secondhand goods and variation of price**

### (Clause 319)

The proposed amendment will ensure that the rules dealing with changes in consideration apply correctly to input tax deductions claimed for secondhand goods supplied other than as a taxable supply.

When the terms of a taxable supply are varied (for example, by a discount being subsequently offered), the supplier may be required to issue a debit or credit note to the recipient. This triggers obligations on both the supplier and recipient to correct their tax position.

This requirement does not apply well to supplies of secondhand goods, which are sold other than as a taxable supply. Although an input tax deduction will still be available, the debit and credit note rules do not apply well to correct a supply where the consideration changes. (As the recipient claims a deduction to the extent payment is made, it would seem to primarily be to the extent that they receive a refund of a payment).

New section 25AB will help ensure that these rules apply correctly to supplies of secondhand goods.

#### **GST group filing – liability of departing member for unpaid tax**

### (Clause 325(1))

Section 55(7)(g) provides that when a person is a member of a GST-registered group, they are jointly and severally liable for tax payable by the representative member of the group. Section 57(3) performs a similar function for members of an unincorporated body.

While in both cases a person will remain liable for an amount owed by the representative member while they were a member of the group or unincorporated body, section 57(3) is clearer. The amendment to section 55(7)(g) aligns the wording more consistently with the latter section, so this outcome is more apparent.

### Cross-references

Finally, the bill proposes a number of incorrect or redundant cross-references, which can be updated or removed.

* Section 6(5) provides a deeming rule, for the purposes of “subsections (3)(b), (c)(iii), and (4)”. However, the reference to section 6(4) is unnecessary, and can be removed (clause 307);
* Section 10(13) refers to section 12. This should instead refer to subsection (12) (clause 309(1));
* Sections 20(3)(e) and 20(4)(c) link to sections that calculate amounts of deduction or output tax. When section 21FB was introduced, the sections were not updated to refer to this section. The amendment inserts this cross-reference (clauses 314(1) and (8)); and
* Section 21D(3)(b) refers to accounting for output tax under section 21A. Output tax is instead attributed to a taxable period under section 20(4), and section 21D(3)(b) should instead refer to this latter section (clause 316).

Other policy matters

# Related parties debt remission

### (Clauses 16, 22(1) and (9), 39, 41(1) and (6), 57, 58, 59, 262(17) to (19) and (75), 337, 338, 342 and 343(2) to (5))

## Summary of proposed amendments

Amendments to the debt remission rules are proposed to address the current asymmetric tax outcome that can arise when debt is remitted between related or associated parties. These parties are referred to as an “economic group” for the purposes of the bill. When a loan to an associated person is forgiven the asymmetric tax outcome arises because the creditor is denied a bad debt deduction for the principal of the loan, but the debtor is treated as having income of the amount remitted or forgiven.

The proposed amendment will ensure that the debt remission rules do not produce debt remission income in circumstances where the debt remission causes no change in the net wealth of the economic group or dilution of ownership. Instead, the debt will be regarded as being fully repaid. This negates the impact of QB 15/01,[[4]](#footnote-4) which deals with capitalising debt within an “economic group”.

The economic group can refer to:

* members of the same wholly owned group of companies; or
* situations where the debtor is a company or partnership (including look-through companies and limited partnerships); and
* all of the debt remitted is owed to shareholders or partners of the debtor; and
* the debt remitted is held and remitted pro-rata to ownership.

The proposed amendments do not generally alter the treatment of debt remission by a company to its shareholders, which except within a wholly owned group of companies, continues to be taxed as a dividend.

When the creditor of the company or partnership is someone who could have forgiven the debt owned by the owner (shareholder or partner) for reasons of “natural love and affection” it is proposed that the actual debt to the company or partnership is treated as being advanced to the company or partnership by the owner.

Some more technical amendments are proposed as a consequence of this core amendment, and to ensure that the bad debt and debt guarantee rules work as intended within the economic group context.

## Application dates

The core amendment and its associated changes are backdated to the commencement of the 2006–07 income year to provide certainty to taxpayers. However, positions taken before the commencement of the 2014–15 income year are final and it is proposed that reassessments would not be allowed.

The bad debt and debt guarantee proposals will apply from the commencement of the 2017–18 income year.

## Key features

### The core rule

Clause 57 proposes new section EW 46C, which provides the core machinery for dealing with debt remission within an economic group. The proposed new rule will mean that when there is a debt remission within an economic group, the debt will instead be treated as having been repaid in full. A consequence of this is that any unpaid interest will be deemed to have been paid. This is modelled on the section EW 44 debt forgiveness for natural love and affection mechanism.

Proposed subsection EW 46C(1) applies when:

* The debtor is a company or a partnership (including look-through companies and limited partnerships).
* The creditor is a member of the “creditor group” of the debtor.
* The debt forgiven is “pari passu” debt.

If it applies, the debtor is treated as having paid the debt and the creditor to have received the payment on the date the debt is forgiven (proposed subsection EW 46C(2)).

As in section EW 44 unpaid interest is also treated as being paid. Also, it is treated as being received. The new section confirms that the means of debt remission does not matter (proposed subsection EW 46C(3).

Proposed subsection EW 46C(4) contains a number of necessary definitions to support the proposed amendment, including:

* “creditor group” which is the group of creditors who are also owners of the debtor, and includes the “creditor’s associates”;
* “creditor’s associates” which are either:
* companies in the same wholly owned group of companies as the creditor; or
* associated natural persons who have “natural love and affection” for the creditor.
* “pari passu debt”, being debt that is held and forgiven in proportion to ownership;
* “creditor’s interests” is used within the “pari passu” definition to determine ownership interests.

When calculating the “pari passu debt” held by the “creditor’s associates”, the debt held by “creditor’s associates” is regarded as being held by the owner for this test.

### Supporting detail

Supporting detail includes:

* When the debt remission is inside a wholly owned group the remission will not cause a dividend to have been paid with the removal of associated imputation considerations (see the proposed replacement of subsection CD 5(2) in clause 16). Given that within a wholly owned group a debt remission cannot change the economic wealth of the group, this removes the long-standing overreach of the original rules.
* When proposed section EW 46C applies and a company is the debtor, proposed new paragraph CD 43(6)(bb) (clause 22(1)) causes an increase in the debtor’s available subscribed capital. The debt remission is akin to a capital injection (as recognised by International Financial Reporting Standards).

### Bad debts

Bad debt deductions for interest receivable in respect of debt advanced that could, under proposed new section EW 46C, be remitted tax free, will now not be deductible under the proposed insertion of paragraph (bb) into section DB 31(2) (clause 41(1) refers). This restores a symmetric outcome (deduction to the creditor and income to the debtor).

### Debt guarantees

Proposed new section EW 49B (clause 59) provides the core rule for debt guarantees within the economic group. Essentially, regardless of whether the guarantor actually acquires any rights of recovery against the debtor, the guarantor will be deemed to have acquired the loan being guaranteed to the extent of the guarantee payments.

If this results in the original financial arrangement being extinguished, the original loan is deemed to be repaid as between the original debtor and guarantor for the amount of the guarantee payments and a notional new loan is established for the same amount.

If, eventually, the debtor repays more of the new loan than its carrying value, it is proposed to treat the excess as income of the guarantor and a deduction is available to the debtor (section DB 13 as amended by clause 39).

This is modelled on the “debt parking” rules in section EW 49.

### Income Tax Act 2004

Similar amendments to the Income Tax Act 2004 are proposed, to ensure taxpayer certainty. The proposed amendments are backdated to the commencement of the 2006–07 income year.

## Background

The financial arrangement rules have always treated debtors’ gains from debt remission as economic income and therefore taxable.

However, a deduction as a bad debt for the principal of a loan is only available for a creditor who is in the business of holding or dealing in such debt. Further, this deduction is denied when the debtor and the creditor are associated persons. This is on the basis that, at least domestically, debt and equity are substitutable, and allowing a bad debt deduction would cause a bias for debt as losses on shares would be much less likely to be deductible. In contrast, all increases in values would accrue to the shares, and none to the debt.

The combination of these factors results in an asymmetric taxation outcome – income to the debtor and no deduction to the creditor. In the context of an economic group, this result is not appropriate from a tax policy perspective. However, for many years it was considered relatively easy to circumvent this asymmetric outcome by capitalising the debt, so the policy analysis was not an issue.

Given a new interpretation of law concerning the capitalisation of debt (see QB 15/01) it became necessary to further consider from a policy perspective the law concerning the remission of debt within an economic group and the asymmetric outcome.

This policy analysis was further complicated by both inbound and outbound investment. However, in the end, it was agreed that one solution should apply across both domestic and cross-borders.

# Loss grouping and imputation credits

### (Clauses 167, 175, 180 to 182, 186, 187(4) and 188(4))

## Summary of proposed amendments

Proposed amendments will allow companies that are commonly owned (having at least 66 percent common voting interests) but not wholly owned (100 percent) to transfer imputation credits as part of loss grouping. Imputation credits will be transferred to the company that receives the benefit of the loss grouping (the profit company) and be sourced from either the company that provides the benefit of the loss grouping (the loss company) or another company in the group that will receive the benefit of a dividend paid by the profit company (the imputation source company).

Without this imputation credit transfer the profit company, due to the reduction in income tax it pays because of loss grouping, may not have sufficient imputation credits to pay an imputed dividend to its shareholders. If a company pays an unimputed dividend its shareholders will have to pay income tax on the dividend which effectively claws back the benefit of the loss grouping.

## Key features

Companies will be able to transfer imputation credits to another company in a commonly owned group as part of loss grouping.  These credits will come from the company transferring the benefit of the loss or another company with an ownership interest in the company accessing the benefit of the loss.  Groups will elect to transfer credits equal to the tax effect of the total of loss grouping to a company within the commonly owned group that is in a profit position and the transfer will occur when, within four years, the profit company pays an imputed dividend to its shareholders.

* Proposed section OB 19B sets out the amount and timing of the imputation credit received by the profit company.
* Proposed section OB 46B sets out the amount and timing of the imputation credit transferred by the loss company or another company in the commonly owned group.
* Proposed amendments to sections OB 71, OB 72 and OB 72B extend the imputation credit shopping rules to a commonly owned group that sells a company that has undertaken an imputation credit transfer and a wholly owned group that purchases a company that has undertaken an imputation credit transfer.
* Proposed section OB 83 sets out who can make an imputation credit transfer election and the consequences of that election including that the imputation credits transferred must match with imputation credits attached to an imputed dividend paid.
* Proposed section OB 84 sets out the timing and process for making an imputation credit transfer election.

## Application date

The amendment will apply for the 2017–18 and later income years.

## Background

The Income Tax Act 2007 allows a loss company to elect to make the benefit of the loss available to a profit company in a commonly owned group. The loss company does this by offsetting some or all of the loss against the net income of the profit company. Alternatively, a profit company can make a deductible subvention payment to the loss company. These are collectively referred to as “loss grouping.”

A profit company that has benefited from loss grouping will pay less income tax and therefore generate fewer imputation credits. If the profit company is wholly owned by its parent company, any dividends will not be taxable due to the inter-corporate dividend exemption. However, if the profit company is not wholly owned as part of a group that includes the loss company, the reduced level of imputation credits may mean the dividend cannot be fully imputed.

When a shareholder of the profit company receives a partially imputed dividend they will have to pay income tax to the extent the dividend is not fully imputed.[[5]](#footnote-5) This income tax effectively claws back the benefit of the loss grouping and may leave the owners of the profit company worse off than if the loss grouping had not occurred. Example 1 illustrates the problem.

## Detailed analysis

The proposals will allow imputation credits equal to the tax effect of loss grouping to be transferred to the profit company by another member of the group, provided the eligibility criteria are met.

**Example 1**

LossCo has a 90 percent shareholding in ProfitCo (which makes it eligible to group losses).

* LossCo’s $10,000 loss is transferred to ProfitCo via a combination of a $2,800 subvention payment and a loss offset election for the remaining $7,200 tax loss.
* ProfitCo has $10,000 of profit after the loss grouping so pays $2,800 tax. It therefore has $14,400 of cash[[6]](#footnote-6) and $2,800 of imputation credits.
* ProfitCo pays 10 percent of its profits as a dividend to Minority shareholder. This is $1,440 cash and $280 of imputation credits. This dividend is not fully imputed so Minority shareholder has to pay extra tax of $202.
* ProfitCo pays 90 percent of its profits as a dividend to LossCo. This is $12,960 cash and $2,520 of imputation credits. This dividend is not fully imputed so LossCo has to pay extra tax of $1,814.
* LossCo pays its $10,000 interest bill and distributes its remaining $3,946[[7]](#footnote-7) as a cash dividend with $1,534 of imputation credits attached.
* This can be shown in a diagram as:



As this issue does not arise within a wholly owned group, due to the inter-corporate dividend exemption, the current tax settings provide an incentive for groups to be wholly owned rather than take on minority shareholders. The proposals are intended to remove this tax disadvantage against non-wholly owned groups.

**Example 2**

* As part of the $2,800 subvention payment and $7,200 loss offset, LossCo also transfers $2,800 of imputation credits.
* ProfitCo still has $10,000 of profit after the loss grouping so pays $2,800 tax. It therefore has $14,400 of cash and $5,600[[8]](#footnote-8) of imputation credits which is the same as if no loss grouping had occurred.
* ProfitCo pays 10 percent of its profits as a dividend to Minority shareholder. This is $1,440 cash and $560 of imputation credits. As this dividend is fully imputed Minority shareholder has no extra tax to pay.
* ProfitCo pays 90 percent of its profits as a dividend to LossCo. This is $12,960 cash and $5,040 of imputation credits. At this dividend is fully imputed LossCo has no extra tax to pay.
* LossCo pays its $10,000 interest bill and distributes its remaining $5,760[[9]](#footnote-9) as a cash dividend with $2,240 of imputation credits attached.
* This can be shown as:



### Amount of credits

The maximum amount of imputation credits that could be transferred as part of a loss grouping transaction would be:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| *(* | *amount of* *subvention payment* | *+* | *amount of loss offset election* | *) x the company tax rate[[10]](#footnote-10)* |

There will be no restriction on a group of companies wanting to transfer less than the maximum amount. However, consistent with the underlying loss grouping, the imputation credit transfer election once made will be irrevocable.

### Destination of credits

The company receiving the imputation credits would always be the same company that received the benefit of the loss grouping (the “profit company”).

### Source of credits

The company transferring the imputation credits could be one of the following companies, at the option of the group:

* a company within the same commonly owned group that has transferred its loss to the profit company (the loss company); or
* a company within the same commonly owned group that has an ownership interest of at least 66 percent in the profit company (the imputation source company).

### Imputation credit transfer election

In order to transfer imputation credits it is proposed that the loss company must make an election to the Commissioner of Inland Revenue to transfer imputation credits. This election would be emailed to [ICA.transfers@ird.govt.nz](mailto:ICA.transfers@ird.govt.nz) at the same time that the income tax return (including the loss grouping) is due.

It is proposed that the election must include the following information:

* the name and IRD number of the profit company;
* the name and IRD number of the loss company;
* the name and IRD number of the imputation source company (if applicable); and
* the amount of the loss offset and/or subvention payment.

### Timing of imputation credit transfer

Rather than when a loss grouping occurs, it is proposed that the imputation credit transfer will be recorded by an entry in the imputation credit account of each company at the time the loss company pays a dividend to its shareholders. This is the time at which the issue of insufficient imputation credits would arise and partially mitigates the risk that this mechanism could be used as a way of imputation “credit shopping” (see section below).

The legislation achieves this by requiring that the imputation credits transferred are attached to a dividend paid by the profit company.

If the amount of the imputation credits attached to the dividend is less than those elected to be transferred, the transfer is limited to the amount of the imputation credits attached to the dividend. Any remaining balance from the election would continue to be available to be transferred if and when a subsequent dividend was paid.

### Limit on imputation credit transfers

Irrespective of the amount of an imputation credit transfer election, credits cannot be transferred if any of the following events occur:

* the loss company, profit company and imputation source company (if applicable) cease to be part of a commonly owned group or become part of a wholly owned group;
* the loss company and/or the profit company and/or the imputation source company (if applicable) breach the shareholder continuity requirements for memorandum accounts for the period beginning on the first day after the year that contains the loss grouping; or
* four years have passed since the end of the income year of the profit company that benefited from the loss grouping.

### Eligibility for transfers

Companies would only be eligible to transfer imputation credits if all of the following criteria are met:

* The profit company, the loss company and the imputation source company (if applicable) are all part of the same commonly owned group.
* The profit company is not part of the same wholly owned group with either the loss company or the imputation source company (if applicable).
* The profit company, the loss company and the imputation source company (if applicable) must be eligible to maintain an imputation credit account.
* The profit company, the loss company and the imputation source company (if applicable) have all agreed to undertake an imputation credit transfer.
* The loss company has elected to undertake an imputation credit transfer.

### Imputation credit shopping rules

The imputation credit shopping rules are intended to prevent separate groups structuring so that one group can benefit from the tax payments or imputation credits of the other group. These rules, which currently apply only to certain transactions involving wholly owned groups, are proposed to be extended to cover transactions involving companies that have transferred imputation credits.

Currently, section OB 72B calculates a restricted refund amount that can only be refunded if the company satisfies the Commissioner that the imputation credit that allows that refund arises from tax paid, or an imputed dividend received, by the company or another company that was part of the same wholly owned group before the company joined the new group. For the purpose of applying this rule to imputation credit transfers, the restricted refund amount will also be refundable if the imputation credit arises from an imputation credit transfer from a company that was part of the same group before the company joined the new group.

# Remission income, tax losses and insolvent individuals

### (Clauses 26, 27, 77 to 79, 123, 141 and 335(2))

## Summary of proposed amendments

The proposed amendments cancel tax losses of an insolvent individual who is discharged from bankruptcy or is fully released from provable debts under Part 5 (not including subpart 1) of the Insolvency Act 2006 (for example, on discharge from the No Asset Procedure). The amendments seek to improve the alignment of the income tax system with:

* the “fresh-start” principle of insolvency law;
* current administrative practice; and
* the neutrality of the tax system in relation to investment decisions.

Proposed retrospective amendments remove potential adverse impacts to entitlements and obligations arising for social policy recipients of Working for Families and the Student Loan Scheme from the recent enactment of section CG 2B (relating to a discharge from bankruptcy).

## Application date

The proposed amendments relating to the cancellation of tax losses apply to a person who, on or after Royal assent, is either discharged from bankruptcy or is released under Part 5 (other than subpart 1) of the Insolvency Act 2006 from each liability that is a provable debt under the Insolvency Act.

The remedial amendments relating to Working for Families and the Student Loan Scheme recipients are proposed to apply retrospectively to persons discharged from bankruptcy after 1 April 2014.

## Key features

An insolvent person is unable to carry forward tax losses after the date a person is either:

* discharged from bankruptcy; or
* released from fully satisfying provable debts under Part 5, other than subpart 1, of the Insolvency Act 2006.

The main effect of the proposed amendment is that the person may not use carried-forward tax losses:

* in calculating taxable income for any period after the loss cancellation date; or
* to satisfy a shortfall penalty incurred after the loss cancellation date.

The proposed amendments also ensure that:

* the tax value of assets vested in the Official Assignee are correctly taken into account in calculating taxable income of a person declared bankrupt for the part-year falling before the bankruptcy judgment; and
* the law is clearer that an undischarged bankrupt is required to satisfy income tax obligations for income earned during the period of bankruptcy.

Consequential amendments are proposed to ensure recent legislative amendments relating to the treatment of tax losses of a person discharged from bankruptcy are consistent with the objectives of Working for Families and the Student Loan Scheme.

## Background

A person is able to carry forward unused tax losses to offset against net income in a future tax year on the assumption that a person will continue in business and make sufficient profits to absorb those earlier losses. This assumption is consistent with a principle that allowing losses to be carried forward encourages entrepreneurial risk-taking and that Governments share in the rewards of that business through taxes.

However, the ability to carry-forward tax losses has always been contingent on the debtor fully satisfying his or her liabilities for expenses incurred that have been included in past tax losses.

Current tax law potentially gives a non-neutral tax treatment for tax losses of a discharged bankrupt. This is because remission income arises for some types of business debt finance (for example, trade debts) but not for other forms of business finance (for example, capital, financial arrangement debt or a bank overdraft). These different tax effects may lead to taxpayers preferring one form of business finance over another.

Income earned by an undischarged bankrupt is, under insolvency law, property of the Official Assignee. This rule is subject to the right of a bankrupt to retain sufficient funds from that income for personal maintenance. The Official Assignee’s website indicates that undischarged bankrupts are responsible for attending to personal income tax obligations for all income earned during the period of bankruptcy.

The proposed amendments do not apply to debts that the Insolvency Act 2006 provides are to remain enforceable against a person either:

* discharged from bankruptcy; or
* released from provable debts under any provision of Part 5 of the Insolvency Act 2006, other than under subpart 1 of that Act.

Recent amendments to the remission income rules in the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 may result in adverse outcomes for entitlements and obligations under Working for Families and the Student Loan Scheme. These potential adverse outcomes are addressed in the proposed retrospective remedial amendments.

## Detailed analysis

### Proposed amendment to section CG 2

Proposed amendments to section CG 2(4) ensure that section CG 2 will cease to apply to a person for liabilities cancelled:

* on discharge from bankruptcy; and
* on release from repayment of all provable debts under any provision of Part 5 of the Insolvency Act 2006, other than under subpart 1 of that Act. An example of this would be debts cancelled when a person is discharged from the No Asset Procedure under section 377A of the Insolvency Act 2006.

### Proposed repeal of section CG 2B

The proposed amendment ensures section CG 2B will not apply after Royal assent and consequently, remission income does not arise when debts are cancelled on discharge from bankruptcy. This is because, following the proposed amendments in subpart IA to prevent tax losses being carried forward by a person on discharge from bankruptcy, it will no longer be necessary to apply a remission income rule.

### Proposed amendment to sections FC 1, FC 2 and FC 10

The proposed amendments provide that the vesting of revenue account property and depreciable property in the Official Assignee will:

* ensure that the value of trading stock, livestock and excepted financial arrangements are taken into account in calculating a person’s taxable income for the part-year before the person is bankrupt. Revenue account property subject to section EA 1 is proposed to be treated as a disposal and acquisition at market value on the date the person is declared bankrupt;
* ensure that any unallocated deduction for other types of revenue account property as at the date of vesting is not deductible to the person declared bankrupt. Revenue account property subject to section EA 2 is proposed to be treated as a disposal and acquisition for a value equal to the original cost of the property to the bankrupt. As a result, there is no deduction allowed to the bankrupt for the property; and
* provide that the Official Assignee has acquired revenue account property and depreciable assets at their tax values. For depreciable property, the Official Assignee is also treated as having also acquired the property with the same acquisition date and acquisition cost as the bankrupt. This enables the Official Assignee to have the relevant deduction or depreciation recovery income if the bankrupt estate is liable for income tax (for example, if the Official Assignee carries on the business formerly conducted by the bankrupt).

### Proposed amendments to subpart IA

The loss cancellation date is the date debts of an insolvent individual are released either due to:

* discharge from bankruptcy; or
* being released from all provable debts under Part 5 (other than subpart 1) of the Insolvency Act 2006 (for example, on discharge from the No Asset Procedure of the Insolvency Act).

The amendments proposed in subpart IA will result in a person being unable to:

* use the tax loss to pay a shortfall penalty incurred after the loss cancellation date; or
* carry forward the tax loss as part of a loss balance to a period ending after the loss cancellation date.

### Proposed amendments to section MB 14 and the Student Loan Scheme Act 2011

The proposed amendment ensures neither family scheme income nor the adjusted net income under the Student Loan Scheme Act include remission income derived under section CG 2B.

For income tax purposes, the remission income under section CG 2B is intended to absorb tax losses for certain periods. That income was not intended to result in any change to benefits or obligations under Working for Families or the Student Loan Scheme. However, both of those schemes do not count tax losses in calculating the income related entitlements or obligations. Therefore, any remission income under section CG 2B should similarly not be counted.

The proposed amendment applies retrospectively to the beginning of the 2014–15 income year, the time from which section CG 2B applies. When section CG 2B is repealed, no remission income will arise after that time for the cancellation of debts:

* on discharge from bankruptcy; or
* on being released from all provable debts under Part 5 (other than subpart 1) of the Insolvency Act 2006 (for example, on discharge from the No Asset Procedure of the Insolvency Act).

# Aircraft overhaul expenses: deductibility and timing

### (Clauses 28, 37, 42, 43, 47, 53, 72, 74 to76, 262(2), (95) and (111))

## Summary of proposed amendments

The proposed amendments set out new rules for the deductibility and timing of:

* the cost of an aircraft engine, including for helicopters, all systems relating to lift and propulsion. In both cases, these are termed “the engine overhaul component” in this *Commentary* item; and
* the cost of an aircraft engine overhaul component.

The proposed amendments result in:

* the costs relating to the engine overhaul component being treated separately from the depreciation rules; and
* the aircraft engine overhaul component no longer being included as part of the aircraft itself for depreciation purposes.

Other aircraft maintenance and overhaul costs will continue to be deductible and allocated under the general deductibility and timing rules of the Income Tax Act 2007.

Transitional rules apply to:

* allow a catch-up deduction for the engine overhaul component of existing aircraft; and
* recover accounting provisions for future overhaul expenses that were used to value tax deductions for aircraft maintenance expenses prior to the 2017–18 income year.

## Application date

The amendments will apply from the beginning of the 2017–18 income year.

## Key features

The proposed amendments apply to aircraft operators who are required, under Civil Aviation Rules published by the Civil Aviation Authority, to carry out scheduled overhauls on an aircraft from time to time.

Under these rules, it is illegal to operate an aircraft without it having a current airworthiness certificate. To retain an airworthiness certificate for an aircraft, the operator must comply with a maintenance programme, which includes scheduled and unscheduled overhauls of different systems of an aircraft.

The main aspects of the proposed amendments are:

* the engine overhaul component is no longer treated as part of the aircraft as a whole for depreciation purposes;
* the cost of the aircraft engine overhaul component and subsequent overhaul of that component is an allowable deduction. This deduction is allocated to an income year on a time-in-service basis;
* a deduction is allowed in transition equal to the undepreciated amount of the cost of an existing aircraft that relates to the engine overhaul component;
* accrued provisions for future overhaul expenses, as at the beginning of the 2017–18 income year, are to be offset against those future overhaul expenses, when incurred;
* the general deductibility and timing rules will continue to apply to all maintenance and overhauls other than expenditure incurred for the engine overhaul component; and
* when an aircraft (or engine) is disposed of, engine overhaul deductions are proposed to be recovered in a manner consistent with the application of the depreciation recovery rules.

As a consequence, the administrative practice of accepting the accounting practice of valuing overhaul deductions under a provisioning methodology will cease.

***Proposed allowable deductions***

The proposed amendments will change the income tax treatment of the acquisition cost of aircraft by:

* estimating the value for an aircraft’s engine overhaul component at acquisition and excluding that value from the aircraft’s base value under the depreciation rules;
* treating the acquisition value of the engine overhaul component as an allowable deduction, subject to a timing rule;
* providing that the capital limitation is overridden in determining this deduction; and
* clarifying that the cost of overhauling an engine overhaul component is an allowable deduction, and that the capital limitation is overridden, unless the overhaul includes a significant upgrade in engine performance.

***Proposed timing rule***

The amendments propose a timing rule to allocate, on a time-in-service basis, allowable deductions for both the engine overhaul component at acquisition and for subsequent overhauls.

Relevant use measures for the time-in-service basis for allocating the deductions are proposed to be determined from current regulated practice (that is, either from the manufacturer’s recommended time-in-service measures or under modifications to the manufacturer’s recommendations as set out in airworthiness directives issued by the Civil Aviation Authority).

***Recovery of overhaul deductions on disposal of aircraft***

On disposal of an aircraft, proposed new sections EJ 27 and CG 9 will apply in a manner consistent with the depreciation recovery rules that apply to the aircraft (not including the engine overall component).

***Key definitions***

An “aircraft engine” is proposed to be defined in relation to its function of propulsion, and in the case of a helicopter each relevant system that relates to the function of lift and propulsion.

The proposed definition of “aircraft engine overhaul” is similar to the definition of “overhaul” in the Civil Aviation Rules issued by the Civil Aviation Authority. Due to the modular nature of the helicopter propulsion systems, the proposed definition of “aircraft engine overhaul” will be extended to apply to each system that relates to lift and propulsion of a helicopter. This ensures that the timing of deductions is applied to each of the systems, irrespective of whether any or all of those systems are overhauled at the same time.

The proposed definition of “scheduled overhaul period” is defined by reference to the period or time between overhauls that an aircraft operator is required to perform. This definition is consistent with terms in the Civil Aviation Rules relating to the overhaul period.

The proposed definition of “unpriced aircraft engine” refers to an aircraft engine acquired with an aircraft but for which no price for the engine is separately identified.

***Transitional deduction***

A transitional deduction is proposed in relation to an aircraft owned at the end of the 2016–17 income year and which continues to be used in the aircraft operator’s business in the 2017–18 income year.

The proposed amendment allows a deduction for the proportion of the adjusted tax value (the tax book value) that relates to the engine overhaul component instead of continuing to depreciate that amount as part of the aircraft.

The timing of this deduction is related to when the first overhaul of the aircraft engine has or will be incurred. The adjusted tax value of the aircraft as a whole will be reduced by an amount equal to the transitional deduction allowed.

***Transitional adjustment relating to accounting provisions***

Prior to the 2017–18 income year, some taxpayers valued their overhaul deductions using a provisioning methodology, under which a provision for estimated future overhaul costs was calculated. This practice was based on a now withdrawn technical ruling, and the practice will not be accepted for calculating tax deductions for aircraft overhaul expenses, from the 2017–18 income year.

A matching rule is proposed to offset accrued provisions as at the end of the 2016–17 income year with the related future overhaul expenditure, when incurred. However, if the aircraft (or engine) is disposed of before the relevant overhaul occurs, the provision is treated as income on disposal of the asset. Both treatments are consistent with the practice under the provisioning accounting methodology.

## Background

The proposed amendments arise from a tax policy review of the deductibility and timing of aircraft overhaul expenses undertaken under the Generic Tax Policy Process. This review was undertaken in the context of:

* the Commissioner publishing a draft statement concluding that the amount of an accrued provision for future overhaul expenditure is not expenditure incurred and did not meet the requirements of the general permission, which determines when an amount is an allowable deduction;
* the regulatory environment in which aircraft are operated; and
* the economics of the maintenance process.

The main conclusions drawn from the tax policy review were as follows:

* A regulatory obligation to carry out an overhaul arises when the relevant time-in-service threshold is reached or out-of-cycle maintenance is required if the aircraft operator wishes to retain an airworthiness certificate for the aircraft.
* The legal test of when overhaul expenditure is incurred must be satisfied before a deduction is allowed for overhaul expenditure.
* The costs of acquiring an aircraft engine component and subsequent overhauls should be matched with the income generated from subsequent use of the aircraft. This is consistent with the economics of the maintenance process and results in an appropriate measure of taxable income from year to year.
* For leased assets, end-of-lease contractual conditions may require the lessee to incur expenditure. No change is proposed to the tax treatment of these obligations, as the current tax treatment of finance leases and the general deductibility and timing rules give the appropriate outcome.

## Detailed analysis

***Proposed section DW 5***

#### Application

Proposed section DW 5 applies to aircraft operators who are required to comply with Civil Aviation Rules for performing engine overhauls on an aircraft (proposed section DW 5(1)).

#### Deduction for overhaul expenditure

Proposed section DW 5(2) allows a deduction for the cost of an overhaul. An engine overhaul is generally considered to be of a maintenance nature on the basis that the overhaul would restore the asset to its former condition. The cost of an overhaul is not defined but is expected to include the cost of labour, parts and other relevant direct and indirect costs.

Non-engine overhauls are not included in these proposed amendments. Therefore deductions for overhaul expenditure relating to aircraft components such as the airframe check and landing gear will usually be timed to the years in which those expenditures are incurred.

However, the tax treatment of aircraft engines (including relevant lift and propulsion systems for helicopters) under proposed sections DW 5(3) and (4) results in the separation of a substantial part of the cost of an engine from the aircraft as a whole.

A submission during the policy review asked whether the nature and scale of an overhaul of an aircraft engine might result in the overhaul expenditure being viewed as having a capital nature. The submitter noted that the scale of overhaul expenditure relative to the engine (the identified asset) might be considered capital expenditure under ordinary principles, as discussed in the Commissioner’s Interpretation Statement *IS12/03 Income tax:* *Deductibility of repairs and maintenance expenditure – general principles.*[[11]](#footnote-11)

To address this issue, proposed section DW 5(6) overrides the capital limitation in applying section DW 5(2) to ensure that overhaul expenditure is generally treated as being on revenue account. An exception to this treatment arises if there is a significant performance upgrade to the engine during an overhaul.

Proposed section DW 5(2) also ensures that if an overhaul results in a significant performance upgrade, the deduction allowed is limited to the amount that would have been incurred if no upgrade in performance had occurred. The non-deductible portion is proposed to be treated as an addition to the aircraft’s depreciation base value (and depreciated).

#### Deduction for part of the cost of an aircraft engine

Proposed section DW 5(3) applies when an engine is acquired on a stand-alone basis, whether as a spare engine or the engine’s cost is identified as a separate item when acquiring an aircraft, including an engine or engines.

Proposed section DW 5(4) applies when an aircraft is acquired, including an engine or engines, and no separate cost is identified for the engine or engines.

Section DW 5(3) and (4) require the aircraft operator to estimate, at the time of acquisition, the cost of an overhaul for an aircraft engine, including all relevant direct and indirect costs. The estimated cost is to be determined from market prices. Proposed section DW 5(6) ensures that the capital limitation does not apply to the amounts allowed as a deduction under section DW 5(3) and (4) depending on whether the aircraft engine is at the beginning of a scheduled overhaul period or part-way through that period.

If the engine cost is identified separately from the cost of the aircraft as a whole, the deduction may not exceed the cost of the engine. For example, the estimated cost of an overhaul would likely exceed the cost of an engine that is acquired shortly before an overhaul of that engine is due.

If the engine cost is not identified separately from the aircraft as a whole, the amount of the deduction is normally to be determined from market prices but may be determined using a ratio agreed with the Commissioner.

Proposed sections DW 5(3)(a) and DW 5(4)(a) value the deduction as the estimated cost of an overhaul of the engine, determined as at the time of acquisition. The amount of the deduction cannot exceed the cost of the aircraft engine. These proposed provisions apply only if the engine is new or has just been overhauled prior to acquisition. This value would be similar to the estimated value used by taxpayers that have used provisioning methodology in the past to value tax deductions.

**Example 1: Application of proposed section DW 5(3)(a) (engine cost identified)**

Aircraft acquisition cost of $1.4 million, engine cost separately identified as $460,00

Estimated cost of an overhaul at acquisition is $450,000.

The estimated cost of an overhaul is less than the engine cost separately identified at acquisition. The allowable deduction is $450,000.

The base value of the aircraft for depreciation purposes is –

**Example 2: Application of proposed section DW 5(4)(a) (engine cost identified)**

Aircraft acquisition cost of $1.4 million.

Estimated cost of an overhaul at acquisition is $450,000.

The allowable deduction is $450,000.

The base value of the aircraft is –

Proposed sections DW 5(3)(b) and DW 5(4)(b) require the taxpayer to estimate the cost of an engine overhaul at acquisition and then apportion that amount between the expired and the unexpired portion of that estimate (based on relevant use measures). The expired portion is included in the cost base of the aircraft under the depreciation rules (as part of the base value) and the unexpired portion is the allowable deduction under proposed sections DW 5(3)(b) and DW 5(4)(b).

**Example 3: Application of proposed section DW 5(3)(b) (engine cost identified)**

Aircraft acquisition cost of $1.4 million, engine cost separately identified as $460,000.

Estimated cost of an overhaul at acquisition is $450,000.

The time between engine overhauls is 3,000 hours and the unexpired time in the overhaul period at acquisition is 2,800 hours.

The calculation under section DW 5(3)(b) is as follows –

The result of the calculation ($420,000) is less than the engine cost identified at acquisition.

The allowable deduction is $420,000.

The base value of the aircraft for depreciation purposes is –

**Example 4: Application of proposed section DW 5(4)(b) (engine cost identified)**

Aircraft acquisition cost of $1.4 million.

Estimated cost of an overhaul at acquisition is $450,000.

The time between engine overhauls is 3,000 hours and the unexpired time in the overhaul period at acquisition is 2,800 hours.

The calculation under section DW 5(4)(b) is –

The allowable deduction is $420,000.

The base value of the aircraft for depreciation purposes is –

Proposed section DW 5(3)(c) applies if the acquisition cost identified for an engine is lower than the value of the deduction under either of proposed sections DW 5(3)(a) or (b). This proposed rule ensures that neither of sections DW 5(3)(a) or (b) can result in a value for the deduction for the engine overhaul component that exceeds the identified cost – for example, when the engine is part-way through the scheduled overhaul period.

Proposed section DW 5(4)(c) applies if proposed section DW 5(4)(a) or (b) cannot be applied – for example, if the relevant market price information is not readily available. In this circumstance, the deduction allowed is based on an apportionment basis agreed with the Commissioner.

**Example 5: Application of proposed section DW 5(3)(c)**

Aircraft acquisition cost of $1 million, engine cost separately identified as $19,000, as it is due for an overhaul.

Estimated cost of an overhaul at acquisition is $450,000.

The time between engine overhauls is 3,000 hours and the unexpired time in the overhaul period at acquisition is 200 hours.

Under section DW 5(3)(b), the result of the calculation is

The allowable deduction is $19,000 (the engine cost identified).

The base value of the aircraft for depreciation purposes is

**Example 6: Application of proposed section DW 5(4)(c) (engine cost not identified)**

Aircraft acquisition cost of $1.0 million.

Estimated cost of an overhaul at acquisition is $450,000 but non-market prices are used.

The time between engine overhauls is 3,000 hours and the unexpired time in the overhaul period at acquisition is 200 hours.

Under section DW 5(4)(b), the result of the calculation is

Under section DW 5(4)(c), the fraction agreed by the Commissioner for the proportion of a new aircraft’s acquisition cost that would be allowed as a deduction under section DW 5(4)(a) is 2.5%. This fraction would be adjusted by the ratio of unexpired hours to the total hours in the scheduled overhaul period as 25% x 200 ÷ 3,000 = 1.67%).

The allowable deduction is 1.67% of the unpriced aircraft’s acquisition cost = $16,700.

The base value of the aircraft is

#### No deduction under proposed section DW 5(3) or (4) for single aircraft owners

Proposed section EJ 264 allows a single aircraft owner to elect out of the spreading rule set out in section EJ 24. If this election is made:

* no deduction us allowed for the estimated cost of an engine overhaul under proposed sections DW 5(3) and DW 5(4);
* the aircraft operator allocates the deduction for an aircraft overhaul to the year in which the expenditure is incurred; and
* the full acquisition cost of the aircraft is the base value of depreciation purposes.

***Proposed section DW 6***

#### Application

Proposed section DW 6 applies to an aircraft operator that:

* acquires an aircraft with an engine or an aircraft engine under a finance lease; and
* is required to make payments to the lesser in relation to return conditions set out in the lease agreement.

#### Maintenance reserve payments

A lease contract may contain an obligation for the lessee to make regular maintenance reserve payments during the term of the lease. These payments relate to redelivery conditions in the lease that require the lessee to return the aircraft or aircraft engine in a stipulated part- or full-life condition. The purpose of the maintenance reserve obligation is:

* to protect the lessor’s investment in the leased asset, by providing a fund which can be drawn on by the lessee to pay for overhaul costs during the term of the lease; and
* to protect the lessor from the credit risk that the lessee may not be able to meet redelivery conditions in the lease that require the lessee to return the aircraft or aircraft engine in a stipulated part- or full-life condition.

Proposed section DW 6:

* denies a deduction for these payments as they represent the accumulation of an amount (in effect a sinking fund) that will be used in the future to fund aircraft overhaul expenses;
* provides that an amount drawn down by the lessee from the maintenance reserve fund is not income;
* allows a deduction at the end of the lease for an amount equal to maintenance reserve payments that are retained by the lessor; and
* ensures that the allowable deduction for an aircraft engine overhaul in section DW 5(2) is spread as intended.

**Example 7: Application of proposed section DW 6**

The lessee (an aircraft operator) is required to pay $10,000 per month to the lessee to be held in a maintenance reserve account for future engine overhaul expenses. This payment is in addition to the monthly payments for the right to use the aircraft.

After six years, an overhaul of the engines is due, and the aircraft operator incurs $750,000 of overhaul expenditure. The maintenance reserve fund at this time has $720,000. The lessor pays the lessee this amount, and the lessee is required to fund the additional $30,000 from its own working capital.

No deduction is allowed for any of the monthly payments. Nor is the draw-down in the year of overhaul treated as income.

Instead, the aircraft operator is allowed a deduction for the $750,000 of overhaul expenditure and this deduction is allocated on a time-in-service basis under proposed section EJ 24.

After 10 years, the lease is terminated and the aircraft is returned to the lessor, and an engine overhaul is due within one year. The lessor carries out that overhaul. The maintenance reserve fund at this time is $480,000, and this amount is retained by the lessor to fund the next engine overhaul.

The $480,000 is allowed as a deduction to the lessee in the year the lease is terminated.

#### End-of-lease adjustment payments

Instead of providing for a maintenance reserve payment obligation, some leases provide for end-of-lease adjustment payments. The amount of an end-of-lease adjustment payment is also determined by redelivery conditions in the lease that require the lessee to return the aircraft or aircraft engine in a stipulated part- or full-life condition. These end-of-lease payments are also to protect the lessor’s investment in the leased asset.

If the leased asset’s condition at redelivery is:

* lower than stipulated, the lessee would make an end-of-lease adjustment payment to the lessee; or
* higher than stipulated, the lessor would make an end-of-lease adjustment to the lessee.
* proposed section DW 6(3) provides that an end-of-lease adjustment payment:
* made by the lessee is an allowable deduction; or
* received by the lessee is income of the lessee under section CG 4(2); and in both cases.

The deduction or income for end-of-lease adjustment payments is allocated to the income year in which the expenditure is incurred or income is derived under the general timing rules in the core provisions or under proposed section EJ 25 (for IFRS taxpayers electing to apply section EJ 25).

***Proposed section DZ 22 and EZ 23BA***

#### Transitional deductions for aircraft engine overhaul components

Proposed sections DZ 22 and EZ 23BA apply to an aircraft operator in relation to each aircraft owned at the end of the 2016–17 income year.

Proposed section EZ 23BA is an apportionment rule. It proposes:

* to align the tax treatment of aircraft engine overhaul components for aircraft owned at the end of the 2016–17 income year with the proposal to remove the aircraft engine overhaul component from the depreciation rules; and
* to reduce the depreciable cost of each aircraft (base value) and depreciated tax value of each aircraft (adjusted tax value) as at the beginning of the 2017–18 income year. The reduced values are proposed to be carried forward and used for calculating depreciation on the aircraft and for calculating any gain or loss.

The proposed amendment in sections DZ 22(2) and (3):

* allows a deduction for an amount equal to the reduction in the adjusted tax value for each of those aircraft (as reduced under proposed section EZ 23BA). This deduction represents the undepreciated amount relating to the engine overhaul component); and
* that deduction to either the 2017–18 income year or to the 2017–18 and later income years. The timing of the deduction is proposed to depend on the year in which the first overhaul of the aircraft engine has occurred or will occur.

Proposed section DZ 22(2) applies if an overhaul of the aircraft’s engine has occurred prior to the 2017–18 income year. In this case, the allowable deduction for the undepreciated amount of the engine overhaul component is proposed to be allocated to the 2017–18 income year.

Proposed section DZ 22(3) applies if the first overhaul of the aircraft’s engine occurs after the start of the 2017–18 income year. In this case the deduction is allocated to the 2017–18 income year and later income years based on the unexpired amount of the relevant use measure (for example, flying hours, landing cycles) for the scheduled overhaul cycle.

Example 8 illustrates the effect of proposed sections EZ 23BA and DZ 22 in aligning the timing of deductions for the aircraft overhaul engine component for aircraft already owned at the beginning of the 2017–18 income year.

**Example 8: Transitional deductions**

*Proposed sections DZ 22 and EZ 23BA: Apportionment of adjusted tax value (depreciated tax value) and base value (acquisition cost)*

Adjusted Base value

Tax value

Aircraft 1: $250,000 $1,000,000

(first overhaul of engine(s) during 2013–14 income year)

Aircraft 2: $800,000 $1,000,000

(first overhaul of engines for 2019–20 income year):

Both aircraft are assumed to be of the same type, and the fraction of the aircraft’s acquisition cost relating to the aircraft engine overhaul components referred to in proposed section EZ 23BA(1)(b) is 20%.

Aircraft 1

Reduction in adjusted tax value =

Reduction in base value =

Aircraft 2

Reduction in adjusted tax value =

Reduction in base value =

*Allowable deduction under proposed section DZ 22*

Aircraft 1

The allowable deduction under proposed section DZ 22(2) is an amount equal to the reduction in the adjusted tax value = $50,000. This deduction is proposed to be allocated to the 2017–18 income year.

Aircraft 2

The allowable deduction under proposed section DZ 22(3) is an amount equal to the reduction in the adjusted tax value = $160,000.

The deduction for $160,000 is proposed to be spread between the 2017–18, 2018–19 and 2019–20 income years, based on actual time-in-service during each of those income years, and time-in-service remaining in the current scheduled overhaul period, taking into account the depreciation deductions already allocated to income years prior to 2017–18.

Assume 1,000 hours time-in-service remain in the current scheduled overhaul period (3,000 hours) as at the beginning of the 2017–18 income year. Assume the following time-in-service hours from

2017–18 income year.

2017–18 income year: 400 hours

2018–19 income year: 350 hours

2019–20 income year: 250 hours

The allocation of the deduction of $160,000 under section DZ 22(3) using the following assumed time-in-service from 2017–18 is proposed to be calculated as follows:

2017–18 income year:

2018–19 income year:

2019–20 income year:

Total deduction allocated:

***Proposed section DZ 23***

Proposed section DZ 23 applies to a person who, prior to the 2017–18 income year, has used a provisioning accounting methodology to:

* value a deduction (based on an estimate of future aircraft overhaul expenditure) in the calculation of taxable income for a tax year before the 2017–18 income year; and
* the related overhaul expenditure is not incurred until after the beginning of the 2017–18 income year.

The accrued provisions are proposed to be reversed against the cost of the next succeeding overhaul. If the provisions are accrued on an item-by-item basis (for example, by serial number or part number), the reversal against the actual overhaul cost should be made against the relevant overhauled or retired part.

In the event the aircraft is disposed of before the next overhaul, the value of all provisions would be treated as income under existing law (section CG 2), as the provision represents a liability that is cancelled. This approach is consistent with the accounting provisioning methodology presently used.

A non-engine overhaul (for example, airframe check or landing gear) against the incurred cost for that non-engine overhaul. For example, if an aircraft operator has accrued a provision of $50,000 for an overhaul of landing-gear accrued provision up to the end of the 2016–17 income year, the full amount of the provision is offset against the cost of the landing gear overhaul. If the amount of the provision exceeds the cost of the non-engine overhaul, that excess is treated as income in the year of the overhaul under section CZ 33.

Proposed section DZ 23(3) offsets the value of an accrued provision for an aircraft engine overhaul against the related overhaul expenditure (for helicopters this would be matched to the relevant overhaul on a system by system basis). It may be possible that the accrued provision may exceed the actual overhaul cost when incurred. In this case, the excess amount is carried forward and applied against the cost of the next relevant overhaul. This has the effect, in transition, of:

* reducing the amount of the allowable deduction for an aircraft engine overhaul after the beginning of the 2017–18 income year;
* ensuring that the aircraft operator does not receive a deduction for both the provision for future overhaul expenses prior to the 2017–18 income year and again when the actual expenditure was incurred; and
* spreads the tax effect of reversing a provision for aircraft engine overhauls over a number of years.

**Example 9: Application of proposed section DZ 23(3)**

Company A has an accrued provision of $20,000 at the beginning of the 2017–18 income year for the replacement of the main rotor blades on a Bell Jetranger helicopter.

The next overhaul is scheduled to occur after another 3,900 hours of flying time. Deductions allowed for that accrued provision for tax years before the 2017–18 income year are not adjusted. However, no further deductions are allowed for a provision for future overhaul expenditure as the amount of a provision will not meet the requirements to be an allowable deduction.

The next scheduled replacement of the rotor blades is expected to cost approximately $100,000. The accrued provision of $20,000 is proposed to be offset against the cost of that next scheduled overhaul, resulting in the allowable deduction being $80,000. That deduction is then spread across the following scheduled overhaul period under proposed section EJ 24 (or section EJ 25 for IFRS taxpayers).

***Proposed section EE 7***

The proposed amendment to section EE 7 is to ensure that an aircraft remains depreciable property even though part of the cost of the aircraft is to be an allowable deduction under proposed section DW 5.

***Proposed section EJ 24***

Proposed section EJ 24 sets out the timing rule for deductions allowed under section DW 5 for the estimated cost of an aircraft engine overhaul. An IFRs taxpayer may elect (under section EJ 25) to use their IFRS reports as the basis for allocating deductions under sect DW 5 and DW 6.

Under proposed section EJ 24(2), a deduction allowed under section DW 5 is proposed to be allocated to income years on a time-in-service basis. The relevant basis for determining time-in-service is the relevant measure set out in that aircraft’s maintenance schedule, which may be the earlier of a use measure or a period of time.

**Example 10: Application of proposed section EJ 24(2)**

Company A owns a Bell Jetranger helicopter. Its master transmission has been overhauled for a cost of $135,000 in the first month of the 2017–18 income year and is returned to service in the second month of the same year. Its next scheduled overhaul is due after 4,500 flying hours. The helicopter on average is in use for 500 hours each year. The helicopter has 460 flying hours in the 2017–18 income year following the overhaul. The allowable deduction is $135,000 and is proposed to be allocated as follows:

2017–18 income year:

2018–19 income year: (assuming 500 flying hours)

In the year of an engine overhaul, proposed section EJ 24(2) allocates the remaining portion of the deduction that has not been allocated in prior years.

**Example 11: Application of proposed section EJ 24(3)**

Assume the same facts as in Example 10. The next scheduled overhaul would likely occur in the 2026–27 income year. Assume the helicopter has 40 flying hours in that income year prior to the overhaul. The amount of the deduction is proposed to be allocated to the 2026–27 income year as follows:

Under proposed section EJ 24(3), (4), and (5), the amount of any unallocated deduction for an overhaul component (by serial or part number) at the beginning of an income year is allocated to that income year if:

* an out-of-cycle overhaul occurs, for example, because of bird strike; or
* the aircraft (with an engine), or engine is leased and the asset is returned to the lessor.

***Proposed section EJ 25***

Proposed section EJ 25 provides that aircraft operators who are required to adopt IFRS[[12]](#footnote-12) for financial accounting purposes may agree a method with the Commissioner to value and allocate deductions allowed under proposed section DW 5, and based on their IFRS accounting treatment. This election is restricted to taxpayers that:

* are a New Zealand resident; or
* hold a valid certificate of registration for the aircraft from the Director of Civil Aviation.

***Proposed section EJ 26***

Proposed section EJ 26 permits an aircraft operator having just one aircraft in the business to elect:

* to not have the proposed deduction at acquisition for the estimated cost of an aircraft engine overhaul; and
* to apply the general timing rules in the Income Tax Act 2007, which allocate deductions for aircraft engine overhaul expenses on an “as incurred” basis.

This election is not available to an aircraft operator who, along with aircraft owned by associated persons, has more than one aircraft.

***Proposed section EJ 27***

Proposed section EJ 27 applies, on disposal of an aircraft, to recover deductions for aircraft engine overhauls (including the deduction allowed under proposed section DW5(3) and (4)). The proposed effect is similar to the effect given by the rules applying on disposal of depreciable property.

Proposed section EJ 27(2) provides that the unexpired portion of a deduction allowed under section DW 5 (determined as at the date of disposal) is to be allocated to the year of disposal.

Proposed section EJ 27(3) requires the consideration derived on disposal to be apportioned between the depreciable asset (the aircraft) and the engine overhaul component.

* The portion of the consideration attributable to the depreciable asset is proposed to be taken into account in the depreciation rules applying to disposals.
* The portion of the consideration relating to the engine overhaul component is proposed to be taken into account as income under section CG 9, subject to that amount being limited to the lesser of total deduction allowed under proposed section DW 5 for the current scheduled overhaul period and the portion of the consideration attributable to the engine overhaul component,. Any amount in excess of this limit is proposed to not be income of the taxpayer.

***Proposed section FA 9***

The proposed amendment to FA 9 ensures that if the lessee acquires the lease asset at the end of a lease, the amount of a deduction allowed to a lessee under section DW 5 or DW 6 is not treated as part of the original cost of the aircraft as a whole. This ensures that income derived under section CC 1 from a subsequent sale of the aircraft by the lessee or associated person is measured against the correct cost base.

***Proposed section FA 10***

The proposed amendment to section FA 10 ensures that an end-of-lease payment made on redelivery of the leased aircraft or engine (for example, life-condition payments) are not included in the amount of consideration under section FA 10 if that payment is an allowable deductions under proposed sections DW 5 or DW 6.

***Proposed section FA 11***

The proposed amendment to section FA 11 ensures that the amount of a deduction allowed under section DW 5 or DW 6 is not included in the adjustment calculation for an operating lease that becomes a finance lease.

# Clarification of empowering provision for New Zealand’s double tax agreements

### (Clause 5)

## Summary of proposed amendments

It is proposed that the Income Tax Act 2007 be amended to clarify that the empowering provision for New Zealand’s double tax agreements (DTAs) does not prevent the anti-avoidance rules contained in income tax legislation from applying to a tax advantage arising under a DTA.

A remedial change to the current provision is also proposed, to ensure that it operates as intended in relation to the process for bringing DTAs into force.

## Application date

The amendments will come into force on the date of enactment.

## Key features

An amendment to section BH 1 of the Income Tax Act 2007 will clarify that this section does not prevent the anti-avoidance rules contained in the Income Tax Act 2007 from applying in situations where a DTA applies. The amendment will make it clear that the general anti-avoidance rule (GAAR) can apply to deny any tax advantage obtained from a tax avoidance arrangement, whether the tax advantage arises under domestic law or the provision of a DTA.

In addition, a remedial amendment to section BH 1 will ensure that the provision operates as intended in relation to the process for bringing DTAs into force.

## Background

### Interaction between section BH 1 and the anti-avoidance rules

New Zealand, like many other countries, has a GAAR in its income tax legislation. The GAAR overrides other provisions of income tax legislation (under section BB 3) to deny the tax benefits of an arrangement if a more than incidental purpose of that arrangement is to obtain a tax benefit and the tax benefit is outside Parliament’s contemplation for the relevant provisions. The GAAR applies to all income tax transactions, including those with an international dimension (that is, New Zealand residents investing offshore or non-New Zealand residents investing in or through New Zealand).

New Zealand also has anti-avoidance rules that target specific avoidance behaviour. These rules also apply to transactions with an international dimension.

DTAs are international treaties that are entered into primarily to prevent double taxation on income earned cross-border. The tax incidence for taxpayers entering into international transactions can be reduced when there is a DTA between the taxpayer’s country of residence and the country from which the income is sourced. Section BH 1 authorises the making of Orders in Council to give effect to New Zealand’s DTAs. Section BH 1 generally provides that DTAs have overriding effect despite anything in the Income Tax Act 2007.

It has been suggested that, because the current legislation does not explicitly address the relationship between New Zealand’s DTAs and its anti-avoidance rules, taxpayers are able to argue that section BH 1 prevents the anti-avoidance rules from applying to a DTA. It has also been argued that the GAAR may be prevented from applying when the DTA provisions prescribe a specific outcome (such as a defined term in the DTA that mandates the treatment that is sought to be counteracted under the GAAR).

Inland Revenue considers that the better view of the existing law is that the provision which empowers New Zealand’s double tax agreements does not prevent the anti‑avoidance rules contained in income tax legislation from applying to counteract a tax advantage arising under a DTA. The proposed amendment will clarify the position.

### Process for DTAs coming into force

A further remedial amendment to section BH 1 is proposed to ensure that the provision operates as intended in relation to the process for bringing DTAs into force. The amendment will ensure that the legislation better reflects the process by which a DTA enters into force. That is, section BH 1 currently refers to a DTA entering into force as a result of a declaration by Order in Council, and on a date specified in the Order in Council. The updated references will refer to the current specific steps for entry into force.

# Charities with overseas purposes

### (Clauses 2(19), (25), (26) and 272)

## Summary of proposed amendments

The bill proposes to amend the Income Tax Act 2007 by adding 14 charities to the list of donee organisations in schedule 32 and renaming an existing charity on the list. The bill further proposes to remove Bicycles for Humanity, Auckland, from the list as this charity has ceased activities and has wound up.

## Application date

The amendments will apply from 1 April 2016, unless otherwise specified.

## Key features

It is proposed to add 14 charitable organisations to schedule 32 of the Income Tax Act 2007. Donors to the following charities will be eligible for tax benefits on their donations.

* Astha Childrens Home (Nepal/New Zealand)
* Cambodia Trust (Aotearoa-New Zealand)
* Destiny Rescue Charitable Aid Trust
* First Steps Himalaya
* Fountain of Peace Children’s Foundation New Zealand
* GC Aid
* Hornsby Pacific Education Trust
* Mercy Mission of New Zealand Trust Board
* Microdreams Foundation New Zealand Humanitarian Trust
* NPH New Zealand Charitable Trust
* Orphans Refugees and Aid (ORA International) of New Zealand Charitable Trust
* Siphala Foundation
* Solomon Outreach Society
* Toraja Rural Development Charitable Trust.

It is also proposed that The Destitute Children’s Home, Pokhara Charitable Trust, which has donee status, be renamed Youth Education and Training Initiatives (YETI) Nepal Trust, with effect from 1 April 2013.

The bill also removes Bicycles for Humanity, Auckland, with effect from 3 December 2015 as the charity has ceased activities and wound up.

## Background

Donors to organisations listed in schedule 32 are entitled, as individual taxpayers, to a tax credit of 331/3% of the monetary amount donated, up to the value of their taxable income. Companies and Māori Authorities may claim a deduction for donations up to the level of their net income. Charities that apply funds towards purposes that are mostly outside New Zealand must be listed in schedule 32 of the Income Tax Act 2007 before donors become eligible for these tax benefits.

The 14 charitable organisations being added to schedule 32 are engaged in the following activities:

### Astha Childrens Home (Nepal/New Zealand)

Established in 2014, this trust formalises a funding arrangement that started in New Zealand in 2005 to support a girls’ home in Kathmandu, Nepal. The girls’ home is managed and operated by a Nepalese charity Astha Childrens Home for Girls. The New Zealand charity, Astha Childrens Home (Nepal/New Zealand) Trust raises funds to support the capital development of the home and provides financial support for schooling and vocational training.

### Cambodia Trust (Aotearoa-New Zealand)

Established in 1994, the trust assists the victims of landmines and other people with physical disabilities in Cambodia. Working in conjunction with Cambodia Trust (Cambodia), the New Zealand trust’s core work is in the development and provision of prosthetic and orthotic services (artificial limbs and orthopaedic braces). The New Zealand trust is also involved in building the capacity of the Cambodia Trust to train local prosthetic and orthotic specialists.

### Destiny Rescue Charitable Aid Trust

Destiny Rescue’s activities are directed at providing care and rehabilitation for victims of sexual abuse and exploitation, and rescuing children from sexually abusive situations. Created in 2013, the New Zealand charity’s efforts are aimed at relieving the wider effects of poverty by ensuring at-risk children have access to education and are generally supported by their local communities. Destiny Rescue acts in partnership with sister charities in the United States and Australia.

### First Steps Himalaya

Established in 2008, the objective of the trust is to render assistance to disadvantaged communities in Nepal by providing early childhood development, community health and awareness programmes. The Trust’s work focuses primarily on education, working closely with state schools to upgrade existing classrooms, train teachers and provide support through regular supervision and management.

### Fountain of Peace Children’s Foundation New Zealand

Established in 2012, Fountain of Peace Children’s Foundation New Zealand was set up to support a community project in Uganda initiated by Ms Peace Ruharuza (Fountain of Peace Children’s Foundation Uganda). Her work is motivated to assist orphaned and abandoned children and babies. The New Zealand trust’s activities at this time are directed at supporting Peace’s project in Kyenjojo, Uganda, providing educational opportunities for disadvantaged children, and developing the infrastructure of local communities. The New Zealand trust has been instrumental in the construction of a seven-classroom school and creating a facility to receive unwanted babies.

### GC Aid

GC Aid was set up in 2008 to be the humanitarian aid arm of Global Connections in Mission (a charity that has been in existence under various guises for over 115 years). GC Aid’s objectives are to develop and transform communities by funding projects that relieve poverty, respond to the effects of natural disasters, improve health and education outcomes in developing countries, and encourage entrepreneurship in developing countries in the form of direct microfinance lending.

### Hornsby Pacific Education Trust

Established in 2014, the trust formalises an earlier four-year funding relationship directed at supporting St Andrew’s High School in Tonga. The purposes of the trust are to continue to support St Andrew’s High School and raise the educational standards of students at that school and other schools in Tonga, and other developing island nation states throughout the Pacific.

### Mercy Mission of New Zealand Trust Board

Mercy Mission of New Zealand Trust Board was established in 2010 to formalise a longstanding financial support arrangement between a number of New Zealand individuals and the Mercy Mission Welfare Society in Vizianagaram, India. Mercy Mission of New Zealand Trust Board supports projects that are directed at relieving the effects of extreme poverty in Vizianagaram.

### Microdreams Foundation New Zealand Humanitarian Trust

Microdreams Foundation New Zealand Humanitarian Trust (Microdreams New Zealand) is involved in microfinance. Its objectives are directed at relieving poverty in the Pacific Islands. Microdreams New Zealand was set up in 2014[[13]](#footnote-13) to work in partnership with Microdreams Foundation (a United States charity) to raise funds to support for-profit private sector microfinance lenders in Pacific and Micronesian developing countries.

### NPH New Zealand Charitable Trust

NPH New Zealand Charitable Trust was established in 2012 to assist the work of NPH International. The objective of the New Zealand trust is to provide financial and other support for orphaned, abandoned and at-risk children who live in conditions of extreme poverty. This support is implemented by providing homes, programmes and facilities to care for affected children. The main focus of the charity’s efforts is in Central America, Haiti and the Dominican Republic.

### Orphans Refugees and Aid (ORA International) of New Zealand Charitable Trust

Orphans Refugees and Aid (ORA International) of New Zealand Charitable Trust has had a presence in New Zealand since 1999 and a charitable trust was created in 2003. The charity’s purposes are:

* child development and relief, with particular emphasis towards education;
* community development and capacity-building projects, including business development, in developing countries;
* preventing children and women from becoming victims of human and sex trafficking; and
* rehabilitating and educating former child soldiers who have been conscripted or levied in civil or ethnic conflicts.

### Siphala Foundation

Siphala Foundation was created in 2007 to assist underprivileged and economically disadvantaged children to enhance their educational activities in New Zealand and Sri Lanka. Siphala Foundation provides scholarships to further studies in chemistry at Auckland University. In Sri Lanka, the Foundation’s activities are directed at sponsoring students to further their secondary school and tertiary education, and developing capacity in neglected schools in remote parts of Sri Lanka.

### Solomon Outreach Society

Registered as a charitable entity in 2012, the trust’s objective is to provide educational resources and medical goods directed at the alleviation of poverty in the Solomon Islands.

### Toraja Rural Development Charitable Trust

Formed in 2005, the Toraja Rural Development Charitable Trust funds and manages projects in Indonesia to relieve poverty amongst farming communities in the Toraja region. The principal focus is to improve the financial viability of farm families involved in growing coffee, and improve the quality and quantity of production.

### Revisions to the list of recipients of charitable and other public benefits gifts

The following revisions are to be made to the list of organisations on schedule 32:

* Reference to The Destitute Children’s Home (Pokhara) Charitable Trust is replaced with Youth Education and Training Initiatives (YETI) Nepal Trust with effect from 1 April 2013.
* Bicycles for Humanity, Auckland, is removed with effect from 3 December 2015 as the charity has ceased operations and wound up.

# Land tainting and council controlled organisations

### (Clauses 9, 10, 11 and 12)

## Summary of proposed amendment

An amendment is being made to the Income Tax Act 2007 to exempt entities controlled by local authorities from the land tainting rules. This exemption does not apply when an entity controlled by the local authority is associated with a property development entity that is outside the council group.

## Application date

This amendment will apply from 1 September 2015, the date on which Auckland Council established a land development entity. The amendment will prevent land held by council-controlled organisations of Auckland Council from being tainted by the land development entity.

## Key features

Proposed new section CB 15C of the Income Tax Act 2007 provides an exemption from the land tainting rules contained in sections CB 9(2), CB 10(2) and CB 11(2), and applies to entities controlled by or associated with a local authority.

The exemption does not apply to:

* entities associated with a local authority under the tripartite relationship test in section YB 14; and
* entities associated to a property developer when that developer is outside the council group, unless that association occurs under section YB 14.

## Background

The land tainting rules were introduced to prevent tax avoidance, but are overreaching in the context of council groups by taxing capital account land in situations when there is no tax avoidance concern. There is not considered to be any tax avoidance concern in this context for the following reasons:

* Council-controlled organisations are holding land necessary for their operations to ensure they are individually accountable for the use of the land and able to more easily make commercial decisions in relation to the land, not to avoid tax for a developer in the group.
* Many of the affected council-controlled organisations have held land prior to any entity in the group being considered a property developer.
* If a council group were intending to avoid tax, it would not develop land in a taxable entity, nor would it hold land in its taxable council-controlled organisations. Instead, the council would undertake the development itself and lease all necessary land to its council-controlled organisations. This would have no tax effect, as councils are exempt from tax whereas their council-controlled organisations may not be.
* Council-controlled organisations operate independently of each other, with distinct business objectives. They are so independent that each organisation has its own separate board and makes decisions without reference to the council or the other council-controlled organisations. Therefore, any land held by a council-controlled organisation is likely to be unrelated to the development activities of another entity within the group.

The policy intent behind the proposed amendment is to exempt entities within the council group from the land tainting rules to prevent the overreach described above.

**Examples**

Example 1 illustrates the situation when entities associated with a local authority under section YB 14 are excluded from the exemption as this has the potential to exempt entities outside the council group.

**Example 1**



Entities associated to an external property developer are not exempt as it is considered that there is some tax avoidance concern when an external entity has some form of control over an entity within the council group. For example, the development entity may seek to avoid tax by holding properties in the name of the entity it jointly controls with the council.

Examples 2 and 3 illustrate situations when the exemption is not intended to apply.

**Example 2**



**Example 3**



Both the C Co in example 2 and the company in example 3 with the “tainted” labels beneath them are not exempt under proposed section CB 15C because of their association to development entities that operate outside the council group.

Example 4 shows what happens when the property development occurs within the council group but an external entity still exerts control over a council entity. The council entity will still be exempt as it is considered that there is no tax avoidance concern when the development occurs within the group.

**Example 4**



Example 5 illustrates what happens when an entity associated to the local authority is also associated to the property developer under section YB 14. The entity will still be exempt as the developer does not exert control over that entity in that situation and so there is no tax avoidance concern.

**Example 5**

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# Loss offsets to mineral miners

### (Clause 125)

## Summary of proposed amendment

A proposed amendment to the Income Tax Act 2007 will allow a company to make its tax loss available to a mineral miner that is part of the same group. This will achieve a similar outcome to that available to mining holding companies before the repeal of those provisions in 2014.

## Application date

The proposed amendment will apply for the 2014–15 and later income years. This date aligns with the application date of the 2014 mineral mining amendments.

## Background

Section IS 1(1) of the Income Tax Act 2007 restricts a mineral miner from being included in a group of companies that can use a tax loss from, or provide a tax loss to, another member of the group. This restriction was introduced to reflect the unique income tax treatment of mineral miners.

Before its repeal in the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014, section IS 3 of the Income Tax Act 2007 overrode section IS 1(1) and allowed a mineral miner to use the tax loss of a mining holding company. Mining holding companies also previously had other purposes but were removed as part of the review of mineral mining tax rules completed in 2014.

Under the current rules, a mineral miner that is carrying forward tax losses and that breaches loss continuity due to an ownership change can continue to carry those tax losses forward to offset against future income from the same permit area. The trade-off for this concession is that a mineral miner cannot make their tax losses available to other members within their group.

The current rules also restrict a mineral miner from accessing the tax losses from other members within their group. There is no policy reason why this restriction is necessary.

The proposed amendment removes the restriction on a mineral miner using the tax loss of another member from the same group. The restriction on another member of the group using the tax loss of a mineral miner will be retained.

# Attribution of mineral mining losses to shareholders of loss attributing qualifying companies

### (Clauses 102, 122(1), (2), (5) and (6))

## Summary of proposed amendment

A proposed amendment to the Income Tax Act 2007 will clarify that a mineral miner that was a loss attributing qualifying company (LAQC) could attribute a net mining loss to its shareholders.

## Application date

The proposed amendment will apply for the 2008–09 and later income years beginning before 1 April 2011. This period aligns with the start of the Income Tax Act 2007 and ends with the repeal of the LAQC rules.

## Key features

Following the removal of the lower tax rate applying to mining income, there remains little policy justification for preventing the attribution of mining losses to shareholders in a LAQC. The proposed retrospective amendment validates past tax positions taken that attributed mining losses of a LAQC to its shareholders.

A “savings” provision will ensure an LAQC that did not attribute a mining loss to its shareholders and does not request to amend their tax position will not be required to do so.

## Background

For some time there has been considerable uncertainty over the relationship between the mineral mining rules, the loss rules and the LAQC rules. The LAQC rules were repealed for income years beginning on or after 1 April 2011.

Due to the ring-fencing of mineral mining losses, it was not clear whether an LAQC could attribute a mining loss to its shareholders, consistent with the broad policy objective of attributing losses to shareholders of a LAQC.

Amendments to the mining rules from 1996 onward did not clearly deal with how taxpayers should treat a mining loss. This has led to different views on how to apply mining loss provisions to a LAQC.

The Income Tax Act 2007 clarified the law to reflect the original policy intention that all ring-fenced losses (including mineral mining losses) could only be used as set out in the specific loss rules.

# Sharing non-personal information under an approved information sharing agreement

### (Clause 292)

## Summary of proposed amendment

The amendment proposes to enable Inland Revenue to share both personal and non-personal information under an Approved Information Sharing Agreement (AISA).

The current tax secrecy rules under the Tax Administration Act allow Inland Revenue to disclose personal information about an identifiable individual under an AISA but not non-personal information. The change will allow for the more efficient use of information, in approved circumstances, across government agencies.

## Application date

The amendment will apply from the date of enactment.

## Key features

The tax secrecy provision, section 81A of the Tax Administration Act 1994, enables Inland Revenue to share personal information when the sharing is authorised under an AISA under Part 9A of the Privacy Act. However, personal information is often mixed in with non-personal information. In these instances the current wording of the tax secrecy provision does not allow Inland Revenue to fully realise the potential to share taxpayer information under an AISA (which can accommodate the sharing of both personal and non-personal information).

The proposed change will allow non-personal information to be shared under an AISA. This amendment would fulfil the intention of the AISA framework to enable all information (personal and non-personal) to be shared for an approved purpose.

## Background

Inland Revenue has extensive information-collection powers to make sure all taxpayers are compliant with their tax obligations. As a counterbalance, these powers come with requirements on Inland Revenue to maintain tax secrecy. Tax secrecy has traditionally been considered necessary for promoting taxpayer compliance. Inland Revenue’s tax secrecy laws are broad, covering all matters relating to legislation administered by Inland Revenue.[[14]](#footnote-14) Communication of these matters is not normally permitted other than for the purpose of carrying into effect that legislation.

Over time a number of exceptions to this strict rule have developed, the majority of which involve cross-government information sharing. These exceptions reflect the weighing of principles of tax secrecy against the need to support economic efficiency and growth, and wider government outcomes such as public safety.

One of these specific exceptions relates to the sharing of information under an AISA under Part 9A of the Privacy Act.

# Time bar and ancillary taxes

### (Clause 295)

## Summary of proposed amendment

The proposed amendment clarifies the time bar applies to ancillary taxes and the approved issuer levy (AIL).

## Application date

The proposed amendment will apply from the date of introduction of the bill. This will mean that the Commissioner cannot increase an amount in an ancillary tax or AIL return if four years have passed from the end of the tax year in which the taxpayer provides the relevant return and the introduction of the bill (unless one of the existing exemptions applies).

## Key features

The amendment treats the filing of the relevant return for each of the different ancillary taxes as an income tax return for the purposes of the time bar provision. The amendment also treats an AIL return as an income tax return for the purposes of the time bar.

The filing of the relevant return for the ancillary tax is treated as a self-assessment for the purposes of the time-bar section only. The returns will only be self-assessments for the time-bar provision to avoid the wider consequences of being assessments under the Tax Administration Act 1994. In addition, the filing of an AIL return will trigger the time bar for NRWT and AIL purposes, to give taxpayers certainty for amounts paid to non-residents.

The effect of the proposed amendment will be to ensure the time bar applies to ancillary taxes and AIL (including the exceptions to the time bar). This means that the Commissioner will only be able to increase a self-assessment of an ancillary tax or AIL:

* within four years from the end of the tax year in which the taxpayer provides the relevant return; or
* at any time, if the return is fraudulent or wilfully misleading, or fails to mention income of a particular nature or from a particular source (consistent with the existing exceptions in the income tax time bar).

## Background

The time bar prevents the Commissioner from increasing an income tax assessment four years from the end of the tax year in which a return has been filed and an assessment has been made (subject to certain exceptions).

There is some uncertainty about whether the time bar ordinarily applies to ancillary taxes or the AIL. Ancillary taxes include some important elements of the New Zealand tax system, including PAYE, fringe benefit tax, resident withholding tax (RWT), non-resident withholding tax (NRWT) and several other ancillary taxes. The approved issuer levy, while not within the definition of an ancillary tax, is similar in many respects to the other ancillary taxes. The application of the time bar is uncertain because, for it to apply, three requirements must be satisfied:

* the taxpayer must have furnished an income tax return;
* an assessment must have been made; and
* four years must have passed from the end of the tax year in which the taxpayer provides the tax return.

In some cases, it is unclear whether an income tax return has been filed in the circumstances. For example, an AIL return is filed under the Stamp and Cheque Duties Act 1971 and is not treated as an income tax return. More significantly, in most cases no assessments are made for ancillary taxes. It is only if the Commissioner decides to issue an assessment under one of the discretionary assessment provisions in the Tax Administration Act 1994 that an assessment is made. This means that, although the Tax Administration Act 1994 provides that the time bar should apply to ancillary taxes, in practice the time bar does not apply in the majority of cases.

# Annual setting of income tax rates

### (Clause 3)

## Summary of proposed amendment

The bill sets the annual income tax rates that will apply for the 2016–17 tax year. The annual rates to be confirmed are the same that applied for the 2015–16 tax year.

## Application date

The provision will apply for the 2016–17 tax year.

## Key features

The annual income tax rates for the 2016–17 tax year will be the rates specified in schedule 1 of the Income Tax Act 2007.

Working for Families tax credits

# Overview

A number of Working for Families tax credits (WFFTC) remedial amendments are proposed. A review of the parental tax credit legislation has indicated areas where the legislation could be clarified to ensure the policy intent for entitlement to and abatement of payments of parental tax credit (PTC) is clear. In particular, problems were identified when the parental entitlement period spans multiple entitlement periods and crosses tax years. Several proposals apply on 1 April 2008, when a rule for PTC recipients who have a parental entitlement period that crosses two tax years and receive their PTC as a lump sum was introduced. Other proposed amendments clarify the legislation that relates to the policy change to the parental tax credit abatement formula as part of Budget 2014. The remaining amendments enable employees, when determining their income for social policy purposes, to apply the maximum fringe benefit tax (FBT) rate (currently 49.25%) on their short-term charge facilities (such as vouchers) provided by their employer. Alternatively, they can apply their correct FBT rate if this has been provided by their employer.

All section references relate to the Income Tax Act 2007 unless otherwise stated.

# Parental tax credit abatement formula

### (Clause 142)

## Summary of proposed amendments

The proposed amendments to section MD 2(3) and (4) will ensure parental tax credit (PTC) recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year have the correct amount of abatement applied to their credit. The change also applies to PTC recipients whose WFFTC entitlement changes during their parental entitlement period.

## Application date

The proposed amendments to section MD 2(3) and (4) apply for dependent children born on or after 1 April 2015; this ensures the amendments apply to all children affected by the Budget 2014 PTC abatement changes.

## Key features

The proposed amendment to the PTC abatement formula in section MD 2(3) changes “entitlement days” to “70”. This change to the formula ensures that PTC recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year, or whose WFFTC entitlement changes during their parental entitlement period, do not have a greater amount of abatement applied to their credit than the Government intended.

The number of days a recipient is entitled to the PTC within the full 70-day parental entitlement period does not need to be explicitly included in the PTC abatement formula. The adjustment for these days is already accounted for in the calculation of “period abatement amount” (proposed to be renamed “entitlement period abatement amount”) and “amount used”.

The proposed related amendment to section MD 2(4) deletes the definition of “entitlement days” as this term is longer used in the parental tax credit abatement formula.

## Background

As part of Budget 2014, the Taxation (Parental Tax Credit) Act 2014 introduced a new PTC abatement formula in section MD 2(3) of the Income Tax Act 2007. As enacted, the resulting PTC abatement formula was intended to ensure the PTC is abated against each dollar of family scheme income earned above the annual WFFTC income threshold (currently $36,350) for the entire tax year. Previously, the PTC was only abated against the income earned by a family during their parental entitlement period. This shorter period resulted in an effective abatement rate of around 4% over the year. In contrast, the other Working for Families tax credits are subject to an abatement rate of 22% on family scheme income earned above the income threshold for the tax year. The lower effective abatement rate on PTC meant most parents continued to receive PTC on family incomes over $100,000 a year while the new formula better targeted assistance to families on lower incomes.

The PTC abatement formula applies to families who receive the PTC either as instalment amounts during a tax year or as a lump sum amount at the end of a tax year (sections MD 11, MD 13 and MD 16).

## Detailed analysis

Officials are concerned that the drafting of the PTC abatement formula in section MD 2 and its related provisions in the Income Tax Act 2007 could inadvertently result in a person’s PTC entitlement being subject to a greater amount of abatement than intended in specific circumstances. Hence, the amount of PTC some people receive could be reduced below what the Government intended when the PTC Budget 2014 changes were made. The PTC abatement formula is as follows:

*(period abatement amount − amount used) × 365 ÷ entitlement days*

The concern surrounds the use of “entitlement days” in the formula. “Entitlement days” is defined as being “the number of days in a parental entitlement period that are in the abatement period”. If a person is entitled to the full 10 weeks of PTC, this would equate to 70-entitlement days. In this situation the formula works. It grosses the PTC abatement amount for the 70-day period up to a full year equivalent.

However, if a person is entitled to the PTC for less than 10 weeks, the formula could subject PTC recipients’ credit to a larger amount of abatement than the Government intended. A person may only be entitled to the PTC for say five weeks if they receive a welfare benefit for the other five weeks, and their “entitlement days” would be 35. The number of “entitlement days” would also be lower for parental tax credit recipients who have a parental entitlement period that spans two tax years (their child was born near the end of the tax year). They could, for instance, have 35 entitlement days in the first tax year and 35 entitlement days in the second tax year. In this situation the formula in section MD 2 could gross up both 35-day abatement periods to a full year equivalent. Conversely, the PTC calculation formula in section MD 12 reduces a recipient’s entitlement to take into account of the number of days they were eligible to receive the payment out of the maximum number of days (70). Therefore, the recipient would only be eligible to receive half the PTC for each tax year but abated against a full year’s income. The net result being that PTC recipient’s credit is subject to a larger amount of abatement than the Government intended.

## PTC abatement formula examples[[15]](#footnote-15)

Nikki and Danny have one child aged 4, and a new baby. Danny works as an electrician earning $95,000.

Their family tax credit entitlement is $8,173, their in-work tax credit entitlement is $3,120. They also claim the PTC as a lump sum and are eligible for a parental tax credit of $2,200, before abatement, for the year to 31 March 2016.

Family scheme income $95,000

Less abatement threshold ($36,350)

Abatement rate \*21.25%

Full year abatement $12,463.13

**Example 1:Parental entitlement period and entitlement period= 1 April 2015 to 9 June 2015**

(70 days/10 weeks)

Family credit abatement for entitlement period = $12,463.13 x 70/365

= $2,390.19

Family tax credit ($8,173 x 70/365) $1,567.42

*Less* abatement ($2,390.19)

-$822.77

In-work tax credit ($3,120 x 10/52)$600.00

*Less* remaining abatement ($822.77)

-$222.77

Before the PTC amount is abated, the remaining credit abatement is scaled up, using the new formula in section MD 2(3):

Scaled up credit abatement = (period abatement amount – amount used) x 365

for PTC entitlement days

= ($2,390.19 – $1,567.42 – $600.00) x 365

70

= **$1,161.59**

Abated PTC = $2,200 - $1,161.59

= **$1,038** (correct abatement applied)

**Example 2: First entitlement period = 26 Feb 2016 to 31 March 2016** (35 days/5 weeks)

Family credit abatement for entitlement period = $12,463.13 x 35/365

= $1,195.09

Family tax credit ($8,173 x 35/365) $783.71

*Less* abatement ($1,195.09)

-$411.38

In-work tax credit ($3,120 x 5/52) $300.00

*Less* remaining abatement ($411.38)

-$111.38

Before the PTC amount is abated, the remaining credit abatement is scaled up, using the PTC abatement formula in section MD 2(3):

Scaled up credit abatement = (period abatement amount – amount used) x 365

for PTC entitlement days

= ($1,195.09 – $783.71 – $300.00) x 365

35

= **$1,161.53**

There is a similar calculation for the period 1 April 2016 to 5 May 2016 (35 days) under section MD 16, resulting in a scaled up abatement of $1,161.53.

Abated PTC = $1,100 – $1,161.53 (1st entitlement period) + $1,100 – $1,161.53 (2nd entitlement period)

= **$0** (incorrect abatement applied)

The proposals will change “entitlement days” in the formula to “70” which will result in the correct level of abatement.

Abated PTC = $1,100 – $580.77 (1st entitlement period) + $1,100 – $580.77 (2nd entitlement period)

= **$1,038** (correct abatement applied)

# Entitlement periods

### (Clauses 142 and 144)

## Summary of proposed amendments

The proposed amendments to sections MD 2(3), MD 2(4), MD 12(1) and MD 12(3)(b) make it clear that a separate amount of PTC and a corresponding amount of abatement apply to each entitlement period within a parental entitlement period.

## Application dates

The proposed amendments to section MD 2(3) and (4) apply for dependent children born on or after 1 April 2015. This ensures the amendments apply to all children affected by the Budget 2014 PTC abatement changes.

The proposed amendments to sections MD 12(1) and MD 12(3)(b) apply on and after 1 April 2008, the date the PTC rule for recipients who have a parental entitlement period that spans two tax years and receive their credit as a lump sum was introduced, as they merely clarify the rule’s original policy intent.

## Key features

Proposed amendments to the definition of items in the PTC formula in section MD 2(4) and the insertion of these terms into the formula in section MD 2(3) ensures separate PTC amounts are calculated for each entitlement period within the parental entitlement period.

A proposed amendment to the PTC entitlement provision in section MD 12(1) makes it clear that a separate PTC entitlement is calculated for each entitlement period.

Proposed amendment to section MD 12(3)(b) changes the definition of “days” in the PTC entitlement formula to make it clear that it refers to the number of days in an entitlement period within a parental entitlement period.

The amendments make it clear that a separate amount of PTC and a corresponding amount of abatement apply to each entitlement period within a parental entitlement period.

## Background

Determination of a PTC entitlement involves calculating a separate amount of PTC and a corresponding amount of abatement to apply to each entitlement period within a parental entitlement period. The separate abated PTC amounts for a tax year are added together to create the total parental tax credit for a tax year. All the separate Working for Families tax credits abated amounts for each entitlement period are added together in this way to ensure a WFFTC recipient’s end-of-year entitlement reflects changes to their family’s circumstances during the year.

However, in some of the PTC abatement and entitlement provisions it was not clear that a separate amount of PTC and a corresponding amount of abatement apply to each entitlement period within a parental entitlement period.

In particular, there is concern that the wording in the current PTC abatement formula in section MD 2 could produce unintended results. “Period abatement amount” in the PTC abatement formula in section MD 2(3) could be interpreted as being the abatement amount for the whole tax year. But the way the general WFFTC provisions are worded indicates that a new PTC abatement amount is calculated each time a person’s WFFTC entitlement changes. Therefore, it could be argued that section MD 2 calculates a full year PTC abatement amount to apply against the PTC each time a person’s WFFTC entitlement changes. This would result in a PTC recipient’s credit being subject to a larger amount of abatement than the Government intended.

A similar problem with ambiguity in the PTC legislation regarding the relationship of the parental entitlement period and the entitlement period has been identified in the definition of “days” in section MD 12(3)(b).

# Parental tax credit “cross-year” situations

### (Clauses 141, 144, 145 and 146)

## Summary of proposed amendments

The proposed amendment to section MD 1(3)(c) will clarify that PTC recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year may receive their credit as a lump sum in an end-of-year assessment for the first tax year (cross-year situation).

The proposed changes to section MD 1(3)(d), and addition of subsection (5) to section MD 12, and (4B) to section MD 13 make it clear when a PTC recipient has a “cross-year situation”, an extra amount of PTC abatement is added to the first tax year that relates to one or more entitlement periods in the second tax year that are within the parental entitlement period.

Proposed new section MD 12B matches new sections MD 12(5) and MD 13(4B). Section MD 12B makes it clear that a corresponding extra amount of PTC is added to the first tax year that relates to the entitlement period that starts in the second tax year.

## Application dates

The amendment to section MD 1(3)(c) applies on and from 1 April 2008, the date the “cross-year situation” rule for recipients that have a parental entitlement period that spans two years and receive their credit as a lump sum was introduced.

The proposed amendment to section MD 1(3)(d) applies for dependent children born on or after 1 April 2015, to ensure that the amendments apply to all children affected by the Budget 2014 PTC abatement changes.

New subsection (5) in section MD 12, and new section MD 12B apply on and after 1 April 2008, the date the PTC rule for people in “cross-year situations” was introduced, as they merely clarify the rule’s original policy intent. The parts of the provisions that refer to “56 days” are changed to “70 days”; this applies for dependent children born on or after 1 April 2015. The subsequent change reflects the Budget 2014 extension of the maximum parental entitlement period.

The amendment to new section MD 13(4B) applies on and after 1 April 2014 as this provision refers to the formula used in section MD 16. This formula was changed on this date to clarify that an extra amount of PTC abatement calculated which relates to the recipient’s entitlement days in the second tax year is added on to the PTC abatement calculated for the first tax year in “cross-year situations”. Due to the Budget 2014 changes, the part of the provision that says “56 days” is changed to “70 days”; this applies for dependent children born on or after 1 April 2015.

## Key features

The proposed amendment to section MD 1(3)(c) amends the definition of PTC to make it explicitly clear that if a PTC recipient receives their credit as a lump sum in the first tax year, an extra amount of credit will be added to the last entitlement period in the first tax year to account for the days in the second tax year.

The proposed amendment to section MD 1(3)(d) amends the definition of credit abatement to make it clear when a PTC recipient has a “cross-year situation”, an extra amount of abatement is added to the last entitlement period in the first tax year that relates to one or more entitlement periods that starts in the second tax year.

Proposed new sections MD 12(5) and MD 13(4B) clarify that the extra amount of credit or abatement, as applicable, to apply to the first tax year when a PTC recipient has a “cross-year situation” relates to the number of days in their parental entitlement period are in the second tax year. It also outlines that this is calculated under section MD 12B or MD 16, not section MD 12 or MD 13. As a result, sections MD 12(5) and MD 13(4B) ensure that there is no “double counting” of credit or abatement amounts that relate to parental entitlement days in the second tax year in cross-year situations.

Proposed new section MD 12B operates the same way as section MD 16, but it calculates an additional amount of PTC, rather than an additional amount of PTC abatement.

## Background

A PTC “cross-year situation” rule was introduced on 1 April 2008 that was intended to ensure recipients who have a parental entitlement period that starts at the end of one tax year and extends into the beginning of the next tax year can receive their PTC entitlement as a lump sum in the end-of-year assessment for the first tax year. However, this extra amount has not been explicitly provided for in the WFFTC entitlement provisions. A “cross-year situation” rule is required because when a PTC recipient’s parental entitlement period spans two tax years, the family credit abatement provision in section MD 13 could produce unintended results (for example, because the parent will generally take unpaid leave once the child is born and have reduced income in the second tax year).

It could also be of more use to the recipient to receive the PTC closer to the time of the birth of the child. The PTC abatement formula in section MD 16 was introduced as an alternative way to calculate total abatement for these “cross-year situations”. This formula was amended on 1 April 2014 to clarify that the PTC abatement is calculated using the general formula for the first tax year, then this section calculates an extra amount of abatement relating to the recipient’s entitlement periods in their parental entitlement period in the second tax year.

The Budget 2014 legislative changes to the PTC abatement provisions did not update the provision in section MD, 16 which calculates the additional amount of PTC abatement that is applied in the first tax year if recipients receive the PTC as a lump sum in the end-of-year assessment for the first tax year. It is not clear whether the PTC abatement formula in section MD 2 applies the full-year abatement to each tax year for people in this “cross-year situation”. If this were the case, these recipients’ PTC could be subject to a greater amount of abatement than the Government intended.

The proposed amendment should make it clear from the relationship between section MD 16 and the other abatement provisions (in sections MD 1(3)(d) and MD 13) that an extra amount of abatement will apply to the first tax year when a PTC recipient has a “cross-year situation”. The extra amount relates to the number of days in their parental entitlement period that are in one or more entitlement periods in the second tax year. It should also be clear that as section MD 16 calculates the additional amount of PTC abatement in the second tax year, the other provisions (that is, section MD 13) should not also calculate an amount of PTC abatement for the second tax year.

# Minor PTC clarifications

### (Clauses 142, 143 146 and 147)

## Proposed amendments

A proposed amendment to section MD 2(3) to replace “sections MD 1 and MD 16” with “sections MD 1(3)(d)(i) and MD 16(3)(a)” makes it explicitly clear when the PTC abatement formula should be used.

A proposed amendment to section MD 11(6)(a) and (b) makes it clear when the PTC is paid out as a lump sum in an end-of-year assessment, and when the PTC is paid out as instalment payments during the year.

A proposed amendment to section MD 13(4) changes the section heading so that it more clearly states that it outlines what happens when the parental entitlement period crosses two tax years. A proposed amendment to section MD 16 changes the section heading so that it more clearly states that the additional PTC abatement is to apply in the tax year of birth if the parental entitlement period crosses two tax years and the credit is paid as a lump sum.

## Application dates

The proposed amendment to section MD 2(3) applies for dependent children born on or after 1 April 2015. This ensures the amendment applies to all children affected by Budget 2014 changes to the PTC abatement formula in section MD 2.

The proposed amendments to section MD 11(6)(a) and (b) come into force on the date of enactment, as they are minor clarifications.

The amendments to sections MD 13(4), and MD 16 apply on and after 1 April 2014, as this is the date that relevant changes were made to the formula in section MD 16, which is referred to in section MD 13. The parts of the provisions that say “56 days” are changed to “70 days” applies for dependent children born on or after 1 April 2015. The subsequent change reflects the Budget 2014 extension of the maximum parental entitlement period.

# FBT vouchers and social policy income

### (Clauses 138 and 334)

## Summary of proposed amendments

Proposed amendments to section MB 7B of the Income Tax Act 2007 and schedule 3, 12A of the Student Loan Scheme Act 2011 will enable employees, for social policy purposes, to apply the maximum fringe benefit tax (FBT) rate on their short-term charge facilities provided by their employer, if the employer does not provide the correct rate.

## Application date

The amendments will apply on and after 1 April 2014, the date from which employees have been required to include short-term charge facilities in their income for social policy purposes.

## Key features

A proposed amendment to section MB 7B (the rules for including fringe benefits in family scheme income) inserts new subsection (3) which enables employees to use either the rate of FBT used by their employer or the maximum rate of FBT to calculate the FBT payable on their short-term charge facilities. This will enable employees, when calculating their income for WFFTC, community services card and student allowance purposes, to apply the maximum FBT rate (currently 49.25%) on their short-term charge facilities (such as vouchers) provided by their employer, if the employer does not provide the correct rate.

A proposed amendment to schedule 3 (adjustments to net income), 12A (income from employment benefits) in the Student Loan Scheme Act 2011 inserts new subsection (4), which enables a person to use the FBT rate used by their employer or the maximum FBT rate to calculate the amount of FBT on a short-term charge facility. This enables employees, when calculating their income for student loan repayment purposes, to apply the maximum FBT rate on their short-term charge facilities provided by their employer, if the employer does not provide the correct rate.

## Background

Under the current rules, from 1 April 2014, employees have been required to include short-term charge facilities (such as vouchers) from their employer in their family scheme income (used to determine WFFTC, community services card and student allowance entitlements) and in their adjusted net income (used to determine student loan repayments). This requirement was intended to improve the fairness and integrity of the schemes as short-term charge facilities are equivalent to cash wages. Included in the calculation of the value of an employee’s short-term charge facility is the amount (if any) of FBT paid by their employer. However, social policy recipients and student loan borrowers are unable to include the correct amount of FBT in their family scheme income or net adjusted income if the employer refuses or is unable to provide them with this information. This makes completing the application forms difficult.

Other remedial amendments

# Tax pooling provisions

### (Clauses 163, 169, 204 and 209)

## Summary of proposed amendments

The proposed amendments aim to ensure that the tax pooling rules work as intended. It is proposed to allow an imputation credit date when purchased tax pooling funds are used to meet an increased amount of tax that is not income tax. The proposed amendments also prevent the double counting of an imputation debit when new shareholders of the company or group sell the company’s or group’s own deposited tax pooling funds to another pool user.

## Application date

It is proposed that the application date for the amendments relating to an imputation credit date where purchased tax pooling funds are used, is 6 October 2009. For amendments that provide for the elimination of an imputation debit when new shareholders of the company or group sell the company’s or group’s own deposited tax pooling funds to another pool user the proposed application date is 1 April 2008.

## Key features

The amendments propose to provide for a credit date where purchased tax pooling funds are used to meet an increased amount of tax that is not income tax, with the credit date being the date of the transfer, by amending sections OB 6(3) and OP 9(3) of the Income Tax Act 2007. Due to a drafting error, there is no current legislative provision which gives a credit date in this situation.

The amendments also propose to provide for the elimination of the second debit when new shareholders of the company or group sell the tax pooling funds to another pool user by amending sections OB 26(2), (4) and OP 23(4)(a) of the Income Tax Act 2007. This debit in turn follows the previous debit in the imputation credit account (ICA) when there was a breach of the shareholder continuity and subsequent cancellation of imputation credits from pooling funds. Currently, if the shareholders of the company or group sell the tax pooling funds to another pool user, it results in a second ICA debit in relation to the same deposit amount.

The proposed amendments are relevant for standard ICA companies and for consolidated groups.

## Background

ICAs record the amounts of tax paid by the company on its income and the allocation of this tax to shareholders. Tax payments and their allocation to shareholders by the companies must have credit and debit dates.

ICA companies commonly purchase funds from tax pools. With effect from 6 October 2009, changes to tax pooling rules were made to allow tax pooling to be used for some payments of tax other than income tax. Two drafting errors have been identified following these changes:

* the omission of a credit date when an ICA company uses purchased pooling funds to meet a non-income tax obligation that resulted from an increased amount of tax; and
* double counting of debits in the ICA relating to the sale of tax pooling funds after a breach of shareholder continuity.

## Detailed analysis

***No credit date when pooling funds purchased to meet a non-income tax obligation***

Because the imputation rules require all funds that go through a tax pooling account to flow a corresponding credit (and where necessary a debit) through the company’s ICA (subpart OA), this means all use of tax pooling funds for non-income tax obligations also flow through the ICA by way of reciprocal credits and debits with appropriate dates.

However, when the 2009 changes to tax pooling were made, a drafting omission resulted in no credit date being able to be determined in relation to the funds that go through a tax pooling account in the situation where an ICA company uses purchased pooling funds to meet a non-income tax obligation that resulted from an increased amount of tax (section OB 6(3) and section OP 9(3) for consolidated groups of companies). There are no issues with debit dates.

When the money has been purchased from a tax pool in accordance with section OB 6(3) or section OP 9(3), as applicable, the purchaser of the funds may then want to:

1. use the purchased funds to satisfy an income tax liability;
2. request for the purchased funds to be refunded;
3. on-sell the purchased funds to another person;
4. use the purchased funds to satisfy a non-income tax liability.

Although section OB 6(3) and section OP 9(3), as applicable, provide credit dates for situations “a” to “c”, no legislative provision gives a credit date for situation “d”. This is illustrated by the example below.

**Example**

Company A (Co A) deposits its own funds ($100) into the tax pool, on 28 August 2014. Co A automatically receives an ICA credit which equals the amount of the deposit (section OB 5 or OP 8, as applicable), with the credit date being 28 August 2014. So when Co A deposited $100 in the tax pool, its ICA account is credited with $100, with a credit date of 28 August 2014.

Company B (Co B) bought funds on 30 November 2014 from the same tax pool to meet a tax liability that it believes will arise on 15 January 2015. Co B bought $80 of Co A’s $100 deposit (the $80 retains an effective date of 28 August 2014). Co A immediately gets an ICA debit of $80 (section OB 35 or OP 33, as applicable), with the debit date(s) being determined by an ordering rule set out in section OB 35(4) or OP 33(4). Co B, however, gets no ICA credit date for the $80 at the time of purchase, though it has an imputation credit entitlement of $80 upon acquiring this amount; this credit is not allocated a credit date until one of the three events set out in section OB 6(3) or OP 9(3) occurs. This is because until the credit date is established it is not possible to determine when to credit the ICA.

Co A then uses its remaining deposit of $20 to pay income tax. It produces no ICA impact as Co A’s ICA has already been credited with $20 ($100 credit on deposit into the tax pool less $80 debited for the funds sold to Co B).

Co B can use its $80 of purchased tax pooling funds in any one of the following ways:

1. Co B can pay its second instalment of 2015 provisional tax on 15 January 2015 (say, $80) – Co B’s ICA account is then able to be credited by $80, with the date of the credit for both income tax and ICA purposes being 28 August 2014 (or any later date chosen) (section OB 6(3)(a) or OP 9(3)(a) as applicable).
2. Co B can request a refund from the tax pool of the purchased funds (say on 28 January 2015 Co B wants the $80 refunded). This then causes Co B’s ICA to be credited with $80, with the credit date being 28 January 2015 (section OB 6(3)(b) or OP 9(3)(b) as applicable), and its ICA being debited by $80, with the debit date(s) being determined by an ordering rule set out in section OB 34(4) or OP 32(4) as applicable.
3. Co B can on-sell some of the $80 of purchased funds (say $20) to Co C on 28 January 2015 – Co B’s ICA is credited by $20, with the credit date being 28 January 2015 (section OB 6(3)(c) or OP 9(3)(c), as applicable, and debited by $20 with the debit date(s) being determined by an ordering rule set out in section OB 35(4) or OP 33(4), as applicable). Co C has an entitlement to a $20 ICA credit but a credit date cannot be determined under section OB 6(3) or OP 9(3), as applicable, until Co C has decided how the funds will be used.
4. Co B wants to pay an increased amount of GST of $5. Co B’s ICA is debited by $5 (section OB 33 or OP 31, as applicable), but there is no credit date able to be determined due to the absence of a legislative provision giving such a date.

The effect of this is that while an imputation credit arises in scenario “d”, this credit is not able to be allocated on any credit date in the ICA to eliminate the corresponding imputation debit that has arisen.

The proposed solution is to amend section OB 6(3) and for consolidated groups section OP 9(3) of the Income Tax Act 2007 to provide for a credit date where purchased tax pooling funds are used to meet an increased amount of tax that is not income tax with the credit date being the date of the transfer.

***Double counting of debits in the ICA***

If there is a breach of shareholder continuity, pre-breach imputation credits from the taxpayer’s own deposited pooling funds in the company’s ICA get cancelled. This results in a debit arising in the ICA (section OB 41 and for consolidated groups section OP 42).

If the new shareholders of the company or group, as applicable, sell the tax pooling funds to another pool user it results in the second ICA debit in relation to the same deposit amount (section OB 35 or section OP 33, as applicable).

Previously, in the Income Tax Act 2004, this was relieved by the provision of an imputation credit arising, which eliminated the second debit. However, following the rewrite this relief was inadvertently omitted.

The proposed solution is to amend several sections of the Income Tax Act 2007 – OB 26(2)(a) and (4)(a) and OP 23(2)(a) and (4)(a) – to ensure that such relief is provided.

# Cross-reference errors in provisions relating to depreciation recovery income

### (Clauses 49, 50, 51, 262(11) and 341)

## Summary of proposed amendments

The amendments propose to correct a number of cross-reference errors in the depreciation rules of the Income Tax Act 2007, along with relevant corresponding provisions in the Income Tax Act 2004.

## Application dates

The proposed amendment to section EE 49(8) of the Income Tax Act 2007 will apply from the start of the 2007–08 tax year, and the proposed correction of the cross-reference error in section EE 42(8) of the Income Tax Act 2004 will apply from the start of the 2005–06 tax year. It is proposed that there is a “savings” provision for both amendments for taxpayers who have taken a tax position on the law as it existed before introduction of the bill.

It is proposed that the correction of the cross-reference errors in sections EE 44, EE 47 and in the paragraph (a) of the definition of “consideration” in section YA 1 of the Income Tax Act 2007 apply from the date of enactment.

## Key features

There are two different types of proposed remedial amendments, which correct cross-reference errors in the following rules:

* The rules relating to partial business use of an asset.

It is proposed to change the cross-reference in section EE 49(8) of the Income Tax Act 2007 from section EE 48(1) to section EE 48(1)(a), and the cross-reference in section EE 42(8) of Income Tax Act 2004 from section EE 41(1) to section EE 41(1)(a).

* The rules relating to calculation of depreciation recovery income and in the definition of “consideration”.

It is proposed to correct cross-reference errors in sections EE 44, EE 47 and in the paragraph (a) of the definition of “consideration” in section YA 1 of the Income Tax Act 2007, from sections EE 48 to EE 52 to sections EE 48 to EE 51.

## Background

### Cross-reference error in sections EE 49(8) (Income Tax Act 2007) and EE 42(8) (Income Tax Act 2004): Partial business use of an asset

There is a cross-reference error in the apportionment rule in section EE 49(8) of the Income Tax Act 2007 (and section EE 42(8) of the Income Tax Act 2004), which results in an incorrect apportionment of depreciation recovery income between the business and private elements. Section EE 49(8) of the Income Tax Act 2007 should refer to section EE 48(1)(a). Section EE 42(8) of Income Tax Act 2004 should refer to section EE 41(1)(a).

The policy intent is that if a person derives consideration on disposal of a depreciable asset (other than a building) in excess of the tax depreciated value (adjusted tax value), the person derives depreciation recovery income calculated as the lesser of:

* the person’s total allowable deductions for depreciation loss for that asset; or
* the difference between the consideration and the adjusted tax value.

The cross-reference error results in an outcome that is inconsistent with the policy intention, as illustrated in the following example:

**Example**

A self-employed person purchases a motor vehicle for $40,000 and has business use of it for 65 percent of the time. In the first month of the third year of ownership the vehicle is sold for $40,000. For the first two years of ownership the deductions for depreciation loss (not including private usage) total $13,693 under a 31.2% diminishing value (DV) rate of depreciation (including 20% loading). The adjusted tax value (ATV) at disposal is determined by taking into account the deprecation on the asset, irrespective of private use as follows:

Year 1: Depreciation = $12,480; deductible proportion = $8,112; ATV = $27,520

Year 2: Depreciation = $ 8,586; deductible proportion = $5,581; ATV= $18,934

Total tax deductions allowed for depreciation in years 1 and 2 = $13,693

Consideration less ATV at disposal = $21,066

The depreciation recovery income that the person has to account for in the year of sale is calculated using the formula in section EE 49:

The *amount of depreciation recovery income* is currently calculated in accordance with section EE 48(1), which says that it is the lesser of the amounts determined under section EE 48(1)(a) ($21,066) and section EE48(1)(b) ($13,963).

The depreciation recovery income is therefore $8,900:

This outcome is not consistent with the policy intent: as consideration ($40,000) exceeds the ATV ($18,934) by $21,066, all depreciation deductions ($13,693) for the asset should be recovered, whereas in fact only $8,900 is recovered under current law.

The amendment corrects the cross-reference from section EE 49(8) to EE 48(1)(a) and results in the law working as intended, as shown below:

### Cross-reference errors in sections EE 44, EE 47 and in the definition of “consideration” in section YA 1: Calculation of depreciation recovery income

There are identical errors in the rules which provide for the calculation of gain or loss on disposal of a depreciable asset, in sections EE 44 and EE 47, and in the definition of “consideration” in section YA 1: these sections and the definition refer to sections EE 48 to EE 52 when they should refer to sections EE 48 to EE 51.

It is proposed that the references to sections EE 48 to EE 52 be changed in the following sections:

#### Section EE 44

The references to “sections EE 48 to EE 52” in section EE 44 will be changed to “sections EE 48 to EE 51”. This is because section EE 52 will usually apply only when there has *not* been a disposal of the relevant item or an “event” (as defined in section EE 47) affecting it. Accordingly, section EE 44(1) should not require there to be a disposal or other “event” before section EE 52 applies.

#### Section EE 47

The reference to “sections EE 48 to EE 52” in section EE 47 will be changed to “sections EE 48 to EE 51”. This is because section EE 52 should not apply if there is an “event” in relation to depreciable property, as the tax consequences arising from an “event” are set out in section EE 48. If section EE 52 applied as well as section EE 48, double taxation would arise. In addition, section EE 52 already specifies the situations to which it applies in section EE 52(1), and these do not include the kind of “events” (as defined in section EE 47) against which property would usually be insured (loss, theft or irreparable damage). Accordingly, section EE 52 would be deprived of its practical effect if it only applied when there was an “event”.

#### Definition of “consideration” in section YA 1

The reference to “sections EE 48 to EE 52” in the definition of “consideration” arises because paragraph (a) of the definition quotes the heading of section EE 44, and the phrase “sections EE 48 to EE 52” is included in that heading. Following on from the proposed amendments in section EE 44, the reference in paragraph (a) in the definition of “consideration” will be changed to “sections EE 48 to EE 51” to ensure it correctly reflects the new heading of section EE 44.

# Taxable bonus issues and available subscribed capital

### (Clause 22)

## Summary of proposed amendment

The proposed amendment clarifies that imputation credits attached to a taxable bonus issue are not included in the available subscribed capital (ASC).

## Application date

The amendment will come into force on the date of the enactment.

## Key features

An amendment is proposed to section CD 43(7) of the Income Tax Act 2007 to clarify that imputation credits attached to a taxable bonus issue are not included in a company’s ASC. This will also allow for equal treatment between taxable bonus issues and ordinary cash dividends, which are reinvested.

## Background

A company can allocate additional shares to its shareholders as bonus issues. These may be taxed as if they were dividends and imputation credits can be attached. Imputation credits are a tax credit against the shareholder’s tax liability for the dividend and are not equivalent to capital invested into the company.

When a company makes a taxable bonus issue, the amount of the issue is included in the company’s ASC amount, which may be returned tax-free to shareholders upon liquidation of the company.

In the ASC rules, section CD 43(6)(b) states that the subscriptions amount includes, in the case of a taxable bonus issue that is not a bonus issue in lieu or a share issued under a profit distribution plan, the amount of the dividend arising from a taxable bonus issue. Section CD 15(1)(a) states that the amount of a dividend is increased by an imputation credit attached to the dividend. The result is that the word “dividend” in the ASC rules can be read to include imputation credits.

This is not intended. Imputation credits are a tax credit against the shareholder’s tax liability for the dividend and are not equivalent to capital invested into the company. The result is that the ASC can be overstated. This also results in an unequal treatment between taxable bonus issues and ordinary cash dividends, which are reinvested, although in economic terms there is no difference between the two methods of increasing the share investment.

The proposed amendment to section CD 43(7) clarifies that imputation credits attached to a taxable bonus issue are not included in a company’s ASC.

# Exceptions to the requirement to use the same calculation method for the same FIF

### (Clause 60)

## Summary of proposed amendment

The amendment proposes to remove the potential for conflict over which calculation method should be applied when a person holds more than one interest in the same foreign investment fund (FIF), due to the requirement to use the same method for multiple interests, and the separate requirement to use a specific method for one of the interests.

## Application date

The amendment will come into force on the date of the enactment.

## Key features

The proposed amendment will clarify the intended policy on exceptions to the requirement to use the same calculation method for multiple interests in the same FIF. The proposed amendment to section EX 46 will clarify that a different calculation method is allowed for interests in the same FIF when a particular provision requires a specific method to be used.

## Background

Currently the Income Tax Act 2007 provides several methods for calculating a person’s FIF income. There is currently some uncertainty about which method should be applied when a person holds more than one interest in the same FIF. The uncertainty is a result of a conflict between section EX 46 and sections EX 47, EX 48 and EX 62. Section EX 46 requires the use of the same calculation method for multiple interests in the same FIF (when the interests are of the same class), while sections EX 47, EX 48 and EX 62 require the use of a specific method for one of the interests.

Under section EX 44, a taxpayer has a choice between various methods when calculating FIF income or losses from their FIF interests, subject to certain limitations.

If a taxpayer has two or more attributing interests in the same FIF for the same period, they are required to use the same calculation method for each interest (section EX 46(1)). A taxpayer can also use a different calculation method for each interest if the interests are of different classes (for example, fixed-rate shares and ordinary shares), and if section EX 46 prevents the same method being used.

However, there are other sections that limit the choice of calculation methods, which are not contained within section EX 46 (namely, requirements imposed by sections EX 47, EX 48 and EX 62). This results in a potential conflict between the requirement to use the same method for multiple interests in section EX 46(1) and a requirement to use a specific method for one of the interests (due to any of the sections EX 47, EX 48 and EX 62).

For example, when a taxpayer has two interests in one FIF that are of different classes – one being ordinary shares and the other fixed rate shares – the taxpayer is *prima facie* required to use the same calculation method for each interest. Section EX 47 limits the calculation methods available for fixed-rate shares and generally requires the comparative value method to be used. Therefore in this case it is arguable that the taxpayer must apply the same method to the ordinary shares as well. The taxpayer should, however, be allowed to choose a different method for the ordinary shares.

# Rationalisation of foreign tax credit provisions

### (Clauses 132, 133 and 262(44))

## Summary of proposed amendment

The proposed remedial changes amend or repeal a number of provisions in subpart LJ, and amend section YA 1 of the Income Tax Act 2007, to rationalise the foreign tax credit provisions.

## Application date

The amendment will apply from the date of enactment.

## Key features

The proposed changes amend or repeal a number of provisions in subpart LJ relating to foreign tax credits, including:

* repealing the now obsolete section LJ 1(5);
* removing the reference to “foreign tax” in section LJ 1(4) and the corresponding definition in section YA 1;
* amending the scope of section LJ 1(4) so that it applies to dividends paid by companies resident in countries with which New Zealand has a double tax agreement (DTA) and countries with which New Zealand has no DTA;
* amending section LJ 3 to clarify that the definition of “foreign income tax” applies to both foreign tax credits arising under New Zealand’s domestic provisions and foreign tax credits arising under DTAs.

## Background

Foreign tax credits prevent the double taxation of foreign-sourced income derived by a New Zealand-resident taxpayer by providing a credit for foreign tax paid on that income. Foreign tax credits can be credited against the relevant New Zealand income tax.

Foreign tax credits can be bilateral (arising under a double tax agreement), or unilateral (arising under New Zealand’s domestic provisions). The rules for bilateral foreign tax credits were enacted in 1960, and the rules for unilateral foreign tax credits were enacted in 1962. In legislation preceding the Income Tax Act 2007, the provisions governing foreign tax credits primarily referred to credits allowed under DTAs. As part of the re-write of the foreign tax credit provisions and other amendments, the references to DTAs have been largely removed. The proposed changes seek to further rationalise the foreign tax credit provisions in light of the general removal of DTA references. The proposed changes will not affect current entitlements to foreign tax credits.

The following provisions are proposed to be repealed or amended:

***Section LJ 1(5)***

Section LJ 1(5) is proposed to be repealed. This provision provides that subpart LJ, for the purposes of section LJ 2 – the provision under which foreign tax credits are allowed – applies as if section LJ 1(5) were a DTA.

Section LJ 1(5) and its forerunners were a mechanism for making the original unilateral foreign tax credit provision subject to the rules in the foreign tax credit provisions that referred to DTAs. Because provisions regulating tax credits no longer refer to DTAs only, the original purpose of section LJ 1(5) no longer exists and it now serves no practical purpose and is potentially confusing. It should therefore be repealed.

***The definition of “foreign tax” in section YA 1***

The definition of “foreign tax” in section YA 1 is proposed to be repealed. The definition applies for subpart LJ purposes but it is only used in section LJ 1(4). The rest of subpart LJ refers to the definition of “foreign income tax” in section LJ 3. The definition of “foreign tax” used to be widely used in earlier versions of the foreign tax credits provisions. As part of the rewriting of the foreign tax credit provisions, all references to “foreign tax” in subpart LJ have been removed (except in section LJ 1(4)). Removing the “foreign tax” definition would rationalise the definitions applying for foreign tax credit purposes.

As part of rationalising the foreign tax credit rules, the reference to “foreign tax” is also proposed to be removed in section LJ 1(4).

***Section LJ 1(4)***

The scope of section LJ 1(4) is proposed to be amended to apply to dividends paid by all non-resident companies. Section LJ 1(4) attributes a foreign source to dividends paid by non-resident companies for foreign tax credit purposes. Section LJ 1(4) is currently restricted to dividends paid by a company resident in a country with which New Zealand has a DTA. This provision ensures that a credit for foreign withholding tax paid on a dividend derived by a New Zealand resident from a non-resident company that is listed on the New Zealand Stock Exchange is still available. Without this specific provision there is a risk that the dividend could be regarded as being sourced in New Zealand. A New Zealand resident is only allowed a credit under section LJ 1(2)(a) for foreign tax paid on income sourced from outside New Zealand. It is proposed that section LJ 1(4) is amended to remove its DTA references so that it applies to dividends paid by all non-resident companies.

***Section LJ 3***

The definition of “foreign income tax” in section LJ 3 is being clarified. “Foreign income tax” is defined in section LJ 3 as meaning “an amount of income tax of a foreign country or territory”. There is no clear link between the definition of “foreign income tax” and either a tax that gives rise to a foreign tax credit under a DTA or the definition in section YA 2(5) of income tax imposed by other countries. The definition of “foreign income tax” in section LJ 3 is proposed to be amended so that it refers to both foreign taxes under a DTA as well as the definition of “income tax” in section YA 2(5). This means that the definition of “foreign income tax” in section LJ 3 will clearly apply to both unilateral and bilateral foreign tax credits.

# Repeal of redundant foreign dividend payment provisions

### (Clauses 14, 17 to 19, 21, 22, 24, 36, 84 to 88, 90, 94 to 96, 99, 100, 101, 103, 107, 115, 117, 118, 120, 126 to 131, 134, 137, 149 to 155, 158, 159, 161, 162, 165, 166, 168, 170 to 174, 176, 177, 183 to 185, 187 to 190, 192, 194, 197 to 203, 206 to 208, 210 to,219, 221, 222, 224 to 229, 232, 239 to 241, 243 to 245, 249 to 251, 254, 256, 262 (3), (4), (10), (12 to 15), (22), (24), (25), (27 to 29), (31 to 41), (47), (50), (61), (62), (87), (88), (92), (99), (101), (103), 263, 266 to 268, 271, 274 to 278, 282, 283, 285 to 290, 293, 296 to 299, 301, 302)

## Summary of proposed amendments

It is proposed to remove a large number of redundant provisions from the the Income Tax Act 2007 and Tax Administration Act 1994 that still refer, or relate, to foreign dividend payments (FDP).

## Application date

It is proposed that the amendments will apply to the tax year beginning 1 April 2017 and later years.

## Key features

The proposals amend or repeal a large number of the redundant FDP payment provisions in the Income Tax Act 2007 and the Tax Administration Act 1994.

## Background

There are a large number of provisions in the Income Tax Act 2007 and Tax Administration Act 1994 that still refer, or relate, to foreign dividend payments (FDP), which are no longer charged for income years beginning on or after 1 July 2009. The FDP charging provision was abolished as part of the overall changes to the international tax rules in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009.

On 1 July 2009, the Government announced that companies’ existing FDP credit balances could be carried forward and used for five years. As this period ended on 1 July 2014, the remaining FDP references are proposed to be removed.

# Changes to the taxation of life insurance business

### (Clauses 2(12) and (23), 38, 61 to 71, 89, 149(2), 150(5), 151(3), 152(3), 154(2) and (5), 156, 157, 158(2), (3) and (5), 160, 168(2), (4) and (6), 191, 217, 221, 262(6), (82) and (113))

## Summary of proposed amendments

A number of remedial changes are proposed, to clarify the taxation rules for life insurance business conducted in New Zealand.

## Application date

Various dates apply to the proposed amendments and are described under “Detailed analysis”.

## Key features

The main proposed changes involve:

* codifying the tax treatment of fees charged by the life insurer for managing policyholder investments; and
* clarifying the deductibility of interest expenses connected with certain life insurance treaties with a non-resident life reinsurer.

Other technical changes are proposed to the treatment of policyholder excess deductions, the definition of “profit participation policy”, the rules relating to amounts under the premium smoothing reserve and the description of amounts that are discounted.

The purpose of these changes is to remove ambiguities with the current law and ensure that the rules continue to work as intended.

The remaining amendments are technical or consequential in nature.

## Background

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 made significant changes to the way the Income Tax Act 2007 applied to life insurance business in New Zealand.

The changes proposed in this bill are part of a continuing programme of work to ensure that the changes to the taxation of life insurance and general insurance work as intended. The changes therefore largely confirm or clarify existing policy settings.

## Detailed analysis

### Shareholder base and policyholder base treatment of fees for managing policyholder investments – sections EY 2, 3, 16B, 19 and 19B

The bill proposes to codify the treatment of transfers of value from the policyholder base to the shareholder base by the life insurer when the transfer relates to the management of policyholder funds (investments) by the life insurer.

New section EY 16B will provide a deduction in an income year for the policyholder base equal to the amount transferred by the life insurer to the shareholder base. The amount transferred must be connected to services (not including life risk) provided by the life insurer in respect of managing policyholder funds (investments) under a non-participation savings life insurance policy.

New section EY 19B will create income for the shareholder base equal to the amount transferred by the life insurer from the policyholder base under section EY 16B as consideration for investment management services. A consequential change is also proposed, to section EY 19.

The changes inserting new section EY 16B and EY 19B will apply to income years beginning on or after 1 April 2015. Tax positions taken by life insurers in earlier income years that are consistent with new sections EY 16B and EY 19B will be validated.

Consequential changes to sections EY 2 and EY 3 cement the relationship the new sections have with the scheme of the life insurance tax rules, with specific reference to policyholder base deductions and shareholder base income. The changes to sections EY 2 and EY 3 will apply for income years beginning on or after 1 April 2015.

### Interest deductibility when life insurer receives exempt income – section DB 7

A change is proposed to section DB 7 to confirm that groups of companies that include a life insurer, including the life insurer itself, are able to deduct interest expenses notwithstanding that the life insurer may have received tax-exempt income from a life reinsurance treaty with a non-resident under section CW 59C. The change will apply for the income year that includes 1 July 2010 and later income years.

### Policyholder base excess deductions – section EY 2

A change is proposed to section EY 2(5) to ensure that excess deductions that cannot be subtracted from policyholder income for an income year are carried forward as policyholder base deductions for the next year. The change creates a timing rule regarding when excess deductions should be used, and will apply from the start of the income year following the enactment of the bill.

### Definitions of “asset base” and “profit participation policy” – section YA 1

A change is proposed to the definition of “profit participation policy” to make it clear that the rules relating to such life insurance policies apply only when both policyholders and shareholders participate in the life insurer’s profits from such business. The aim of the amendment is to clarify that life insurance policies that allow policyholders to earn an investment return (as opposed to participating in the life insurer’s profit) are not subject to sections EY 17 and EY 18, and EY 28 and EY 29. A consequential change will be made to the definition of “asset base” to ensure consistency with the revision to the term “profit participation policy”. The proposed changes will apply for the income year that includes 1 July 2010 and later income years.

### Premium smoothing reserve – sections EY 23 and EY 25

A number of clarifications are proposed to the drafting of section EY 25, which allows life insurers to smooth the recognition of premium income against life risk when a life insurance policy is sold on the basis of a single or level-term premium. The proposed changes will clarify the following:

* The meaning of “PSR period” in section EY 23(6), to make it clear that the reserve has application when there is a material mismatch in the timing of life risk and the timing of life risk components of premiums.
* The principles used to calculate the reserving amount for the premium smoothing reserve in section EY 25(3) to make it clear that the reserve does not include amounts for policies for which the life insurer’s obligations to the policyholder have ceased. The drafting of the section is also revised to be consistent with the definition of “PSR period”.
* A retrospective grammatical change is proposed to section EY 25(3) by replacing the “:” [colon] with an “and” to clarify that the principles used to calculate a reserving amount for the PSR are conjunctive. The change has effect for periods starting from the income year that includes 1 July 2010 and later income years to the first income year beginning after the day this bill receives Royal assent.
* The definition of “expected life risk proportion” in section EY 25(6) will be consequentially amended as a result of the redrafted definition of “PSR period” in section EY 23(6).
* Further changes will be made to section EY 23(1) to (4) to ensure that the reserving rules generally apply to a class of policies that are not profit participation policies.

Apart from the retrospective grammatical change in section EY 25(3), the proposed changes to the rules for the premium smoothing reserve apply from the first income year beginning after the day the bill receives Royal assent.

### Description of future amounts – sections EY 17, EY 21, EY 28 and EY 29

The life insurance rules require future amounts to be discounted and, when appropriate, net of tax. The bill proposes to update these references in sections EY 17(2), EY 21(2), EY 28(6) and EY 29(8) so that “future value” is consistent with values the life insurer used in its financial reports. The change means that future values will not be calculated by reference to a risk-free rate. References to discounting in connection with reinsurance premiums and claims are also removed by the bill in sections EY 28(5) and EY 29(6). The changes apply from the first income year beginning after the day the bill receives Royal assent.

### Shareholder base income “Other profit” drafting revisions to the definition of “closing liabilities” – sections EY 28 and EY 29

The bill redrafts the definitions of “closing policy liabilities” and “estimated closing policy liabilities” to improve readability and remove incorrect concepts. The proposed changes apply from the first income year beginning after the day the bill receives Royal assent.

### Removal of redundant terms “Policyholder Credit Account” and “PCA” – sections FM 30, OA 5 to OA 7, OA 10, OA 13 to OA 15, OA 17, OB 24 and OP 75

The new taxation rules for life insurance do not use the terms “Policyholder Credit Account” and “PCA”. The bill proposes to remove these terms from the Income Tax Act from the date it receives Royal assent.

# Recharacterisation of shareholder’s base: repurchasing shares

### (Clauses 2(6) and 73)

## Summary of proposed amendments

The bill replaces the reference to “amount” in section FA 4(2)(b) with “the cost to the shareholder of the cancelled share”. The effect of the change means that taxpayers add the initial cost of the repurchased shares to the remaining shares of the same class. Currently, the amount the taxpayer receives as consideration for the cancellation is added to the remaining shares.

## Application date

The proposed change applies from the 2008–09 and later income years. Earlier tax positions that relied on the current law for income years and transactions in a return of income filed before the date the bill is introduced are preserved.

## Background

A share repurchase is when a company purchases (repurchase) its own shares from current shareholders. Monies paid to a shareholder under a share repurchase may be taxed as a dividend.

The rewrite of the Income Tax Act changed the amount of the adjustment to the cost price of remaining shares for revenue account taxpayers. Before the rewrite, revenue account taxpayers added the initial cost of the repurchased shares to the remaining shares of the same class. The rewrite changed this rule with the effect that consideration received for the repurchase is added to the value of the remaining shares. The amendment is intended to restore the original law as it was before the rewrite.

# Taxable bonus issues – cost base

### (Clause 45)

## Summary of proposed amendments

The bill proposes amendments that will allow taxpayers to recognise, under certain conditions, a cost base for shares in a company received from taxable bonus issues.

## Application date

The amendments will apply for shares received under taxable bonus issues made on or after the date of enactment.

## Key features

Section ED 1 of the Income Tax Act 2007 will be amended by inserting a new rule (section ED 1(4B)) that recognises on disposal of shares received from taxable bonus issues, a cost for those shares. The recognised cost is equal to the amount of the dividend (taxable bonus issue), not including the amount of any imputation credits or withholding tax that applies to the taxable bonus issue.

## Background

The proposed amendments address an interpretation risk that taxpayers could be subject to a double layer of income tax if the shares received from taxable bonus issues are disposed of as revenue account property.

# Further income tax and carried forward debit balance in imputation credit account

### (Clause 179)

## Summary of proposed amendment

The proposed amendment corrects a drafting error to ensure that a debit balance of an imputation credit company’s account which is carried forward from one year to the next is not subject to a double imposition of income tax.

## Application date

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

## Key features

The amendment proposes a wording change in section OB 67(2) to make clear that further income tax is not imposed on the net increase in a debit balance in a company’s imputation credit account for an income year. The proposed amendment ensures that double counting of a prior tax year’s debit balance is not subject to double imposition of income tax.

## Background

The imposition of further income tax applies if a company’s imputation credit account has fallen into deficit (a debit balance) during a tax year, and that deficit is not corrected by 31 March of that tax year. Further income tax is imposed to clear that debit balance.

It is possible that in the next tax year, the amount of credits attached to dividends result in the company having a debit balance in its imputation credit account at the end of that following tax year. In this circumstance further income tax is intended to be imposed on the net increase in the debit balance of the imputation credit account.

# Basic tax rate when changing balance date

### (Clause 280)

## Summary of proposed amendment

The proposed amendment corrects a drafting error to ensure that a taxpayer is taxed at the correct basic rate for the tax year that corresponds to the income year in which the taxpayer changes their balance date for income tax purposes.

## Application date

The amendment comes into force on the date of enactment.

## Key features

The proposed amendments are to:

* clarify which income the formula is to be applied to;
* clarify how the formula applies in a leap year;
* align the law with existing practice;
* correct and clarify terminology; and
* correct an error in the formula.

## Background

In an income year in which a person has approval to change their balance date, the person is required to calculate an average tax rate, based on an annualised amount of business taxable income plus other income, such as wages. That average tax rate is then used, as the basic tax rate, to calculate the income tax liability for the taxpayer's actual income earned in the transitional year.

This annualisation is necessary because the marginal tax rates in schedule 1 of the Income Tax Act 2007 are set on the basis that the income bands apply to a 12-month period and the person could be over- or under-taxed in the year in which the balance date is changed. These rates are set or confirmed by Parliament each year.

The existing law does not clearly identify which income should be included in the determination of annualised income on which the basic rate of tax is calculated.

## Detailed analysis

***Proposed amendments to section 39(5), (6)***

When a person changes their balance date for income tax purposes, the period between balance dates (the transition year) will be either shorter or longer than a standard 12-month income year.

If tax were imposed in the transition year on the basis of the basic tax rates in schedule 1 of the Income Tax Act 2007, the person would potentially be:

* undertaxed if the transition year is shorter than 12 months; or
* overtaxed if the transition year is longer than 12 months.

The proposed amendments in section 39(5), (6), and (7) clarify the type of income to which the formula in proposed section 39(6) applies and ensure that a person is taxed appropriately in a transition year. In particular, these proposed amendments require a person to determine:

* the amount of income from activities (net of allowable deductions, if any) that are unrelated to the changed balance date (for example, wages and salaries);
* the annualised amount of income (net of allowable deductions) from those activities for which the Commissioner has agreed the new balance date; and
* the basic tax rate on the aggregate of those two amounts.

**Example 1: Transition year greater than 12 months**

Change in balance date for partnership from 31 March to 31 May.

Approval was given on 14 Dec 2011 for the 2012 tax year.

Return of income filed for period 1 April 2011 to 31 May 2012 (426 days).

Partnership income share for 14 months to 31 May 2012– $100K (2012 tax year).

Interest & dividends for 12 months to 31 March 2012 – $200K (2012 tax year).

In the absence of section 39, the income tax liability for 2012 on $300,000 would be $89,920 (overtaxed).

Annualised taxable income under section 39(5)(a) and (b) =

$

Income tax that would be payable on this annualised amount of taxable income for the 2012 tax year is $85,271.95.

The basic tax rate under section 39(5) is calculated as follows:

The income tax liability for the 2011–12 tax year is therefore:

**Example 2: Transition year shorter than 12 months**

Change in balance date for partnership activity from 30 June to 31 May.

Approval was given on 14 Dec 2011 for the 2012 tax year.

Return of income filed for period 1 July 2011 to 31 May 2012 (336 days).

Partnership income for 11 months to 31 May 2012– $100K (2012 tax year).

Interest & dividends for 12 months to 31 March 2012 - $200K (2012 tax year).

In the absence of section 39, the income tax liability for 2012 on $300,000 would be $89,920.

Annualised taxable income under section 39(5)(a) and (b) =

$

Income tax that would be payable on this annualised amount of taxable income for the 2012 tax year is $92,866.24

The basic tax rate under section 39(5) is calculated as follows:

The income tax liability for the 2011–12 tax year is therefore:

***Proposed amendments to section 39(1), (2)***

The proposed amendments to section 39(1) and (2) of the Tax Administration Act 1994 ensure that the term “year” is read as a calendar year and not as a 12-month period.

# Transport in vehicle other than a motor vehicle

### (Clauses 33 and 340)

## Summary of proposed amendment

The proposed amendment corrects an unintended legislative change arising in the rewrite of income tax legislation to ensure that transport of an employee in a heavy goods vehicle is not a fringe benefit.

## Application date

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

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

## Key features

Section CX 19B restores to the Income Tax Act the effect of section CI 1(o)(vi) of the Income Tax Act 1994 by providing the exemption from fringe benefits on transport provided to an employee in a heavy goods vehicle.

These vehicles are not designed for the carriage of passengers and typically the transport provided to the passenger employee is in relation to the business of the employer. Some business activities require a person, in addition to the driver, to carry out those activities (for example, the business of furniture removal).

## Background

Under the Income Tax Act 1994, the fringe benefit tax rules (FBT rules) exempted the provision of transport in a heavy goods vehicle from fringe benefit tax (for example, an employee of a removal company is picked up from home on the way to the first removal task of the day). The reason for the exclusion from FBT is that heavy goods vehicles were generally outside the FBT net because they were designed for carrying goods rather than passengers, and the type of transport provided was likely to be work-related.

An unintended legislative change has been identified in rewriting the 1994 Act’s FBT exemption into the Income Tax Act 2004.

The proposed amendment corrects this oversight.

# Available capital distribution amount

### (Clauses 23(1) and 338)

## Summary of proposed amendment

An amendment corrects a drafting error to clarify that a depreciation loss arising on disposal of a depreciable asset is not taken into account in determining the available capital distribution amount.

## Application date

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

The proposed amendment to the Income Tax Act 2004 applies from the beginning of the 2005–06 income year

## Background

The available capital distribution amount is the amount that is able to be distributed tax-free (as a capital distribution) on the liquidation of a company. It represents capital gains less capital losses made by the company prior to the liquidation. The calculation of the available capital distribution amount is made under section CD 44(9). The calculation of capital losses is not intended to include a depreciation loss that is allowed as a deduction.

# Livestock and the definition of “trading stock”

### (Clauses 262(107), (108), (116), 343(7) and (9))

## Summary of proposed amendment

The proposed amendment:

* corrects an unintended legislative change arising in the rewrite of income tax legislation;
* results in consideration derived on disposing of livestock being taxable in the same manner as would have occurred for the same circumstances under corresponding provisions of the Income Tax Act 1994; and
* a savings provision is proposed to protect a tax position taken on the basis of the existing law prior to 5 December 2014.

## Application date

The amendments to the Income Tax Act 2007 apply generally from the beginning of the 2008–09 income year. However, the amendment repealing the cross-reference to section CD 48 applies for income years beginning on or after 1 July 2009 (due to the repeal of section CD 48 from that date).

The amendments to the Income Tax Act 2004 apply from the beginning of the 2005–06 income year.

## Background

The definition of “trading stock” in the Income Tax Act 2004 differs from the corresponding definition in the Income Tax Act 1994. That difference has also been re-enacted into the Income Tax Act 2007.

Due to the unintended legislative change in the defined term “trading stock”, there are some circumstances in which livestock would not necessarily be treated as trading stock in the same way as it was under the provisions of the 1994 Act.

An example of the effect of this unintended legislative change occurs in section CB 2 of the 2007 Act. This rule is intended to ensure that, if a business is sold, and trading stock is included in the business assets being sold, part of the sale price (normally a capital transaction) is treated as a sale of trading stock (on revenue account). Under the 1994 Act, livestock would have been included in the meaning of trading stock when applying this rule.

# Pre-amalgamation losses

### (Clause 124)

## Summary of proposed amendment

The proposed amendment in section IE 3 corrects a drafting error to ensure that an amalgamated company may only carry forward its tax losses from an earlier income year if both of the following requirements are satisfied:

* the loss is able to be carried forward to the year under the continuity rules; and
* the loss could have been grouped against the net income of each of the other amalgamated companies.

## Application date

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

## Key features

Proposed section IE 3(1) sets out that the section applies to an amalgamated company in relation to:

* the part of a net loss for the income year in which the amalgamation occurs the company has for the part-year before the date of amalgamation; and
* tax losses carried forward by the company satisfy the continuity requirements.

Proposed section IE 3(2) is an ordering rule that ensures a carried forward tax loss of an amalgamated company must first be used to subtract from the company’s part-year net income (if any) up to the date of amalgamation (in the year of amalgamation). Any balance remaining may then be made available to the amalgamating companies under the grouping rules.

To the extent an amalgamated company’s tax loss for the year of amalgamation comprises pre-amalgamation losses, proposed section IE 3(3) provides that the pre-amalgamation loss may only be used under section IA 3 or section IA 4 after the date of amalgamation if:

* the amalgamated company satisfies the continuity requirements for the income year of amalgamation;
* the amalgamated company satisfies the commonality requirements with each of the amalgamating companies up to the date of amalgamation; and
* to the extent the tax loss is an attributed CFC net loss or a FIF net loss, the amalgamated company and the amalgamating companies must be a wholly owned group in order to satisfy the commonality requirements for these two types of losses.

Proposed section IE 3(4) clarifies that the part-years in the amalgamation are treated as separate tax years for applying section IE 3, for example in determining the amount of net income or net loss for a part-year period in the year of amalgamation.

Proposed section IE 3(5) clarifies that the general tax rules do not apply in determining whether a loss of an amalgamated company carried forward into the year of amalgamation will be able to continue to be carried forward from the amalgamation.

## Background

The amendment corrects an unintended legislative change in rewriting the amalgamation provisions to ensure the legislation works as intended.

# Late election to make tax loss available under loss grouping rules

### (Clause 123)

## Summary of proposed amendment

The proposed amendment:

* corrects an unintended change in legislation arising from the rewriting the Income Tax Act; and
* ensures that, after the due date for filing a loss company’s return of income, the Commissioner may allow the company to elect to make its tax loss available to another company in the same group of companies.

## Application date

The proposed amendment applies from the beginning of the 2008–09 income year.

## Background

The policy intention is that a company may elect to make its tax loss available to another company in the same group of companies either by:

* the last day for filing a return of income; or
* a later date allowed by the Commissioner.

The rewritten loss rules in the Income Tax Act 2007 do not clearly provide for a company to elect to use the loss grouping rules after the last day for filing the company’s return of income.

# Limit on tax refund for an imputation credit company

### (Clause 257)

## Summary of proposed amendment

The proposed amendment clarifies the provisions of section RM 13 of the Income Tax Act 2007 for an imputation credit account company that files its income tax and imputation account returns under an extension-of-time arrangement.

The proposed amendment ensures that if the current tax year’s return is not yet due, the refund of tax to the imputation credit company is limited to the credit balance of the imputation credit account as at the end of the preceding tax year.

## Application date

The proposed amendment comes into force on the date of enactment.

## Background

In general, imputation credit account companies may receive a refund of tax only if the refund does not result in the company's ICA going into deficit. This policy also extends to transfers of overpaid and non-refundable tax to another company in the same wholly owned group of companies. This general rule empowers the Commissioner to require part-year ICA tax returns to be filed, to determine the balance of the company’s ICA before releasing the refund.

However, the general rule is modified for companies that file their tax and ICA returns under an extension-of-time arrangement. The purpose of this modification is for consistency with self-assessment, so that refunds can be processed quickly, with reduced compliance and administration costs.

# Carrying back foreign investor tax credits

### (Clause 136)

## Summary of proposed amendment

The proposed amendment:

* corrects an unintended legislative change arising in rewriting the Income Tax Act; and
* clarifies that a company may carry back unused foreign investor tax credits (FITC) from one year to any one or more of four immediately preceding years, to satisfy the company's income tax liability in the earlier year.

## Application date

The proposed amendment applies from the beginning of the 2008–09 income year.

## Background

The FITC rules in the Income Tax Act 2007 are designed to ensure that the total New Zealand tax on income derived by a non-resident investor through a corporate structure does not exceed the company tax rate (currently 28%).

As part of that design, the FITC rules are also intended to permit a New Zealand company to either:

* carry forward unused FITC; or
* carry back unused FITC from one year to any one or more of four immediately preceding years, to satisfy the company’s income tax liability in the earlier year.

The rewritten provisions of the Income Tax Act 2007 allowing the carry back of FITC have been interpreted as permitting the carry back of these tax credits to be made to only one of those four immediately preceding years, instead of to any one or more of the four preceding years. That outcome is inconsistent with the policy intent.

# Duplication of land provisions

### (Clause 7)

## Summary of proposed amendment

The proposed amendment removes a duplication of a provision relating to the land provisions by repealing section CB 6(3) of the Income Tax Act 2007. The effect of the law remains unchanged.

## Application date

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

## Background

Sections CB 6(3) and CB 23B both provide that if part of the land is disposed of together with other land, the disposal will be taxable under the land sale rules. The Rewrite Advisory Panel determined that only one of the provisions is necessary.

# Non-resident withholding tax and a non-filing taxpayer

### (Clauses 233, 247(3) and 262(66))

## Summary of proposed amendment

The proposed amendment improves the clarity of the relationship between sections RB 2, RF 2 and the definition of “non-filing taxpayer” in the Income Tax Act 2007. The proposed amendment ensures the provisions work as intended. The amendment proposes:

* correcting the cross-reference in the definition of “non-filing taxpayer” to refer to section RF 2(3) instead of section RB 2;
* consequentially repealing section RB 2 as it overlaps with section RF 2; and
* eliminating overlap between section RF 2(4) and section RF 2(3).

## Application date

The proposed amendment will come into force on the date of enactment.

## Background

The policy intent is that that:

* if a non-resident’s only income derived from New Zealand is non-resident passive income subject to final withholding, the non-resident is a non-filing taxpayer; and
* if a non-resident derives other types of income in addition to non-resident passive income subject to final withholding, the non-resident must file a return of income.

# Fringe benefit tax and specified insurance premiums

### (Clauses 25, 31 and 32)

## Summary of proposed amendment

The proposed amendment rationalises the fringe benefit tax (FBT) treatment of life insurance premiums to ensure that all life insurance premiums for life insurance policies taken out by an employer on employees’ lives (or a spouse, civil union partner or de facto partner or a joint policy, or on the life of their child) are treated as specified insurance premiums. This simplifies compliance with these rules.

## Application date

The proposed amendment comes into force on the date of enactment.

## Key features

The proposed amendments in section CE 5 and CX 5 are consistent with the proposed treatment for life insurance premiums as specified insurance premiums under the FBT rules.

The proposed amendments to section CX 16 clarify that all life insurance premiums for life insurance policies, including group life insurance premiums, taken out by an employer on employees’ lives (or a spouse, civil union partner or de facto partner or a joint policy, or on the life of their child) are treated as specified insurance premiums.

## Background

All life, accident and sickness insurance policies, including group life insurance, taken out by an employer on employees’ lives (or certain family members) in connection with their employment (and tax deductible to the employer) are subject to FBT.

Under current law, the FBT rules require these insurance premiums to be categorised as either a “specified insurance premium” or as an “unclassified benefit”. For compliance cost reasons, many taxpayers and their advisors have generally been treating as these premiums as specified insurance premiums.

This approach to compliance has been adopted because the legislation for these premiums has proved to be confusing due to:

* tautologies or redundancies in the wording; and
* overlapping rules, which have different thresholds.

# Financial arrangements – bad debt rules

### (Clauses 2(20), 41(2) and (3))

## Summary of proposed amendment

The proposed amendment to section DB 31(4C)(b) of the Income Tax Act 2007 corrects a timing mismatch in the bad debt deduction rules by allowing a bad debt deduction in an income year to match income on limited recourse arrangements in the same income year when using section EW 15D (IFRS financial reporting method).

## Application date

The amendment will apply beginning on 20 May 2013, the date the changes made in 2014 came into force.

## Background

As part of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014, changes were made to the bad debt deduction rules to prevent deductions when no economic loss has been suffered. One of the changes deferred bad debt deductions for debts funded by and matched to limited recourse arrangements, to the maturity, disposal or remittance of the limited recourse arrangements.

However the deferral of the bad debt deduction in the above circumstances can, depending on how the debt and the associated limited recourse arrangements are accounted for under the financial arrangement rules, create an unintended effect when income arises on the related limited recourse arrangements in a year prior to the base price adjustment on the limited recourse arrangements. This creates a mismatch in that income year, as the income on the limited recourse arrangements is taxable while the related bad debt deduction is deferred. The situation should reverse when the base price adjustments are made on both arrangements but a timing mismatch can arise in the meantime, which has the potential to become permanent in some circumstances.

# R&D loss tax credit remedials

### (Clause 148)

## Summary of proposed amendments

The proposed changes create ordering rules for when multiple loss reinstatement events occur in a single income year. The intention is to simplify the payment of R&D repayment tax and protect the tax base. The proposed changes also clarify that, when a loss of continuity has resulted from equity disposals and transfers, all equity disposals and transfers from the year a credit was first taken to the current year should be included in calculating R&D repayment tax.

## Application date

The amendments will apply from the 2016–17 income year.

## Key features

An ordering rule is proposed to modify the application of section MX 7(4) by prescribing that if there is a loss of continuity in the business and a liquidator is appointed and/or the company suffers a loss of eligibility, the loss of continuity does not give rise to R&D repayment tax. This is because the latter events require the balance of the R&D loss tax credit to be repaid in full as R&D repayment tax.

Proposed section MX 7(2) ensures that the company will be liable for R&D repayment tax if the sale of intellectual property and a loss of business continuity occur in the same income year, as neither of these events may create a liability to repay the balance of the R&D loss tax credit in full.

Section MX 7(4)(b) will be modified to clarify that, in the event of a loss of business continuity, all equity disposals and transfers from the year a credit was first taken to the current year should be included in calculating R&D repayment tax.

## Background

It is possible that a loss of business continuity and the appointment of a liquidator and/or a loss of eligibility can take place in a single income year, creating multiple R&D repayment tax liabilities. The current legislation does not adequately address how R&D repayment tax should be paid in this situation.

The current legislation does not require R&D repayment tax arising from the sale, transfer or disposal of intellectual property when a loss of continuity (an effective sale of the company) also occurs. This is a risk to the tax base, as the value of the shares in the company are likely to be very low if the company’s intellectual property has been sold.

Currently, section MX 7(4) does not make it sufficiently clear that equity disposals and transfers that occurred in an earlier year than the year the loss of business continuity took place are included in the calculation of R&D repayment tax.

# Exempt income from personal services – 92-day rule

### (Clause 30)

## Summary of proposed amendment

The proposed amendment:

* aligns the count test in section CW 17 with other count tests in requiring the days of personal presence to be determined within any 12-month period; and
* ensures that a non-resident derive exempt income from providing personal services in New Zealand if the presence in New Zealand exceeds 92 days in any 12-month period.

## Application date

The proposed amendment will come into force on the date of enactment.

## Background

A non-resident person may derive exempt income from providing personal services in New Zealand if they meet the requirements of section CW 19. One of those requirements is that the person’s visit must not exceed 92 days in a tax year.

As this is a tax year-based rule, taxpayers can arrange for their visit to straddle the 31 March and remain in NZ for up to 182 days. Basing the count test on a period of time in a tax year is inconsistent with the count test used in the definition of “New Zealand resident”. The count test in that definition is based on personal presence in New Zealand of 183 days during any 12-month period.

The proposed amendment is to ensure that a visit to New Zealand cannot straddle the 31st March to permit the non-resident to provide personal services in New Zealand for more than 92 days.

# Tax status of Employment Relations Authority members

### (Clause 237)

## Summary of proposed amendments

Amendments are being made to the Income Tax Act 2007 to ensure that the salaries and allowances of Employment Relations Authority (ERA) members are subject to PAYE. Currently, section RD 5(5) provides for the salaries of “judicial officers” to be subject to PAYE, but there is uncertainty around the scope of that term due to the lack of a legislative definition.

## Application date

The amendments will come into force on the date of enactment.

## Key features

Amendments are being made to section RD 5(5) of the Income Tax Act to ensure that:

* Employment Relations Authority members will have their salary and allowances subject to PAYE.
* The term “judicial officer” will be defined to mean those officers listed in section 12B of the Remuneration Authority Act, namely judges of courts, and coroners.

## Background

PAYE generally applies to individuals who meet the common law definition of “employee” and receive salary and wages. Section RD 5(5) of the Income Tax Act 2007 expands the meaning of “salary and wages” to include “salary and principal allowances made to a judicial officer” that are “made under a determination of the Remuneration Authority”. Section RD 5(5) was originally enacted to codify existing practice at the time, which was that judges’ salaries were subject to PAYE.

The Income Tax Act does not provide a legislative definition for “judicial officer”, which has resulted in some uncertainty about whether ERA members come under the definition and are subject to PAYE.

The Commissioner’s view is that “judicial officer” does not include ERA members. As a result, the law does not allow ERA members to have tax on their salaries deducted through PAYE. An amendment is therefore necessary to ensure that ERA member salaries are subject to PAYE.

Withholding tax at source is desirable for the efficient administration of tax, and PAYE is the appropriate method for taxing the salaries of ERA members. The members are paid regular salaries and work full-time. Applying the M code under the PAYE rules deducts the correct amount of tax under New Zealand’s progressive tax rate scale.

# Miscellaneous technical amendments

## Summary of proposed amendments

The following amendments are intended to clarify or correct minor errors in the legislation, to ensure the rules work as intended.

## Income statements for IR 56 taxpayers

### (Clause 291)

The Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 removed the requirement for most IR 56 taxpayers to file end-of-year income tax returns. Instead, the Commissioner was required to issue an income statement to IR 56 taxpayers. The drafting of section 80D(1)(c)(iii) of the Tax Administration Act 1994 did not, however, make it clear that it was only intended to apply to IR 56 taxpayers, leaving open the possibility that income statements could be required to be issued to many other taxpayers, including those who would not otherwise have to file an income tax return.

An amendment in the Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Act 2016 clarified the application of the relevant provision. However, an amendment in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012, which applied from 1 April 2016, replaced section 80D(1)(c)(iii) with a revised provision that did not include the clarification. The proposed amendment in this bill reintroduces the clarification, and comes into force on 1 April 2016.

## New start grants

### (Clause 122(3) and (4))

The Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Act 2016 repealed five references to “new start grants” as they are no longer part of the suite of responses the Government uses for primary sector adverse events. The proposed amendment repeals the one remaining reference, and comes into force on the date of enactment.

Rewrite remedials

# Summary of proposed amendments

The following amendments reflect minor technical maintenance items arising from both the rewrite of Income Tax legislation and subsequent changes. Unless otherwise stated in the following table, all the amendments are to the Income Tax Act 2007 (2007 Act).

## Application dates

Unless otherwise stated in the following table, all amendments come into force on the date of enactment.

## Minor maintenance items

The following amendments relate to minor maintenance items to correct any of the following:

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

| Clause | Section | Act | Amendment | Commencement date |
| --- | --- | --- | --- | --- |
| 44, 108-113, 262(30) | EC 26B(2), HG 5-HG 9, HG 11, YA 1 | Income Tax Act 2007 | Inserts a definition for an existing term “exiting partner” |  |
| 23(2) | CD 44(10B) |  | Correction to cross-reference | 1 April 2010 |
| 34 | CX 47(4) |  | Correction of terminology |  |
| 40 | DB 19 |  | Correction of defined terms list |  |
| 48 | EE 41(2)(b) |  | Correction to cross-reference |  |
| 52 | EJ 2(1) |  | Correction to cross-reference | 1 April 2014 |
| 54 | EW 5(3D) |  | Correction of terminology |  |
| 80 | FE 2 |  | Correction of defined terms list |  |
| 81 | FE 9(3) |  | Correction of terminology and cross-referencing. | 1 April 2008 |
| 82 | FE 28(2)(b) |  | Correction of grammar | 1 April 2008 |
| 92 | FO 20(1) |  | Correction to cross-reference |  |
| 93 | FZ 6(1) |  | Correction of terminology |  |
| 114 | HM 3(2) |  | Correction to cross-reference | 2 November 2012 |
| 135 | LP 2 |  | Correction of terminology | 1 April 2008 |
| 231 | RA 15(3) |  | Correction to cross-reference |  |
| 234 | RD 3 |  | Correction of terminology | 1 April 2008 |
| 238 | RD 21(3) |  | Correction of terminology | 1 April 2008 |
| 262(9) | YA 1 “close relative” |  | Correction of terminology |  |
| 262(21) | YA 1 “distant workplace” |  | Correction of drafting error | 4 September 2010 |
| 262(65) | YA 1 “non-attributing active FIF” |  | Correction of drafting error |  |
| 262(71)-(73) | YA 1 “out of town secondment” |  | Correction of drafting error | 4 September 2010 |
| 262(76)-(78) | YA 1 “PCA” “PCA company” “PCA person” |  | Repeal redundant terms |  |
| 262(79)-(81) | YA 1 “period of continuous work” |  | Correction of drafting error | 4 September 2010 |
| 262(83)-(85) | YA 1 “project of limited duration” |  | Correction of drafting error | 4 September 2010 |
| 262(194) | YA 1 “tax-base property” |  | Correction of terminology |  |
| 265 | YC 10(1)(a) |  | Correction of grammar | 1 April 2008 |
| 272(1)-(3) | Schedule 32 |  | Remove from the list a charity that has been wound up | 3 December 2015 |
| 262(32)-(40) | Consequential amendments after repeal of subpart LH |  | Repeal of redundant cross-references and defined terms | 1 April 2009 |
| 284 | 69(2)(g) | TAA 1994 | Repeal redundant paragraph |  |
| 300 | 174AA | TAA 1994 | Correction of terminology |  |
| 344 | Schedule to Goods and Services (Grants and Subsidies) Order 1992 | Grants and Subsidies Order 1993 | Repeal redundant item |  |

1. A LTC is a company that, like a partnership of individuals, is “looked through” for tax purposes, with its income and expenditure being attributed back to owners and taxed at their personal tax rates rather than at the company tax rate. A QC is only partially “look-through”, being taxed like an ordinary company except that un-imputed dividends are tax-free. Both LTCs and QCs allow capital gains to flow through tax-free to owners during the course of business, as would be the case under direct ownership, but not for a standard company. [↑](#footnote-ref-1)
2. This was as a result of two tax cuts – from 33% to 30% from the 2008–09 income year and to 28% from the 2011–12 income year. [↑](#footnote-ref-2)
3. The exception is if the two companies are part of the same wholly owned group, in which case the dividend is exempt from tax, or the recipient company holds a certificate of exemption from RWT. [↑](#footnote-ref-3)
4. QB 15/01 concerns debt a company owes to its only shareholder being capitalised. It concludes that *prima facie* this is avoidance of the debt remission rules. The analysis in QB 15/01 can be extrapolated to cover a number of debt capitalisation scenarios that result in no change of ownership proportions of the debtor (i.e. companies with more than one shareholder, partnerships and look-through companies). [↑](#footnote-ref-4)
5. This will depend on the shareholder’s marginal tax rate. Examples in this *Commentary* are simplified by assuming all shareholders have a 28% tax rate. [↑](#footnote-ref-5)
6. $20,000 less $2,800 subvention payment and $2,800 tax payment. [↑](#footnote-ref-6)
7. $2,800 subvention payment plus $12,960 cash dividend less $10,000 interest payment less $1,814 tax payment. [↑](#footnote-ref-7)
8. $2,800 from the tax payment and $2,800 from the IC transfer. [↑](#footnote-ref-8)
9. $2,800 subvention payment plus $12,960 cash dividend less $10,000 interest payment. [↑](#footnote-ref-9)
10. The company tax rate for the return period that included the loss grouping. [↑](#footnote-ref-10)
11. At paragraphs 8 and 178 of the Interpretation Statement *IS12/03.* [↑](#footnote-ref-11)
12. International Financial Reporting Standards [↑](#footnote-ref-12)
13. The New Zealand charity has existed since 2007 in other forms. [↑](#footnote-ref-13)
14. Section 81 of the Tax Administration Act 1994. [↑](#footnote-ref-14)
15. These examples are based on the example outlined in the *TIB* 2014 No 28: <http://www.ird.govt.nz/technical-tax/legislation/2014/2014-28/2014-28-index.html> and use the former abatement rate of 21.25% and in-work tax credit rate of $3,120. The abatement rate increased to 22.5% and payment to $3,770 from 1 April 2016. [↑](#footnote-ref-15)