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

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

September 2016

Prepared by Policy & Strategy, Inland Revenue, and the Treasury

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Closely held companies

The bill contains a package of amendments to the tax rules for closely held companies. These changes deal with concerns about the workability of certain aspects of the rules and aim to simplify the rules and reduce compliance costs. At the same time the amendments ensure the rules remain robust and in line with intended policy.

The amendments:

- tighten the eligibility criteria for look-through companies (LTCs);
- modify the entry tax calculation for LTCs so it is calculated at each shareholder's personal tax rate;
- restrict the coverage of the deduction limitation rule;
- address concerns about how the debt remission rules work in relation to LTCs and partnerships;
- remove qualifying status for qualifying companies (QCs) that have a change in control of the company;
- narrow the scope of the "tainted capital gains" rule;
- address current over-taxation of certain dividends under the resident withholding tax (RWT) rules; and
- enable shareholders receiving shareholder salaries to elect to split their income so their base salary is subject to PAYE and the variable amount is paid out before tax.

Fourteen submissions were received on the amendments. The majority focused on the proposed changes to the eligibility criteria for LTCs, and on technical issues.

Submitters generally supported the overall package of amendments. In particular, there was broad support for the changes to the rules on deduction limitations, debt remission, tainted capital gains, RWT on dividends, and shareholder salaries.

The key issue raised was in relation to the changes to the eligibility criteria for LTCs. Submitters were generally opposed to changes to the eligibility criteria for LTCs, mainly because of concerns that there would be additional compliance costs, and that LTCs that had entered into the rules in good faith would be negatively affected.

Officials consider that the tightening of the eligibility criteria is necessary to ensure that the LTC rules are targeted towards those originally intended to be covered, and to maintain their policy intent. The changes should only affect LTCs at the margin.

We are recommending some changes to address submitters' concerns about overreach. They include a transitional rule that will allow LTCs that lose their status as a result of the amendments to transition to ordinary companies without tax consequences, and the grandparenting of charities' LTC holdings as at the date of introduction of the bill. In addition, we are recommending some modifications to the proposed restrictions on a LTC earning foreign income, and to the rules for counting trustees and beneficiaries as LTC counted owners.

CLOSELY HELD COMPANIES REVIEW GENERALLY

Issue: General support for amendments to closely held company rules

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

Two submitters supported the amendments to closely held companies generally.

However, the two submitters had concerns about some of the specific features of the amendments. These specific concerns are addressed later in this report.

Recommendation

That the submission be noted.

Issue: Appreciation of officials' engagement

Submission
(Chartered Accountants Australia and New Zealand)

The submitter asks the Committee to note their appreciation of officials' engagement with them on the closely held company taxation review project.

Recommendation

That the submission be noted.

Issue: Need to address LTC transparency

Submission
(Chartered Accountants Australia and New Zealand)

Work on the extent to which a LTC is transparent should be progressed as a priority. Uncertainty regarding the extent of LTC transparency complicates the regime and increases compliance costs. The legislation should clearly state whether or not a LTC is fully transparent and if not, how transparent.

Comment

Transparency is the extent to which a LTC and its owners are treated as the same person for tax purposes. We agree that LTC transparency should be an area for further consideration.

However, we believe that it should be a low priority on the Tax Policy Work Programme given significant competing demands. The key issue in this area, namely the flow-through of debt remission income to owners is being addressed in the bill.

Recommendation

That the submission be declined.

LTC ELIGIBILITY GENERALLY

Clause 262

Issue: LTC eligibility criteria should be simpler and less restrictive

Submission

(Chartered Accountants Australia and New Zealand, New Zealand Law Society, The Whyte Group)

Three submitters opposed the proposed amendments to the LTC eligibility criteria generally. The reasons given were that the proposed amendments:

- are unnecessarily complex and restrictive;
- would increase compliance costs through the need to review whether existing LTCs who entered into the rules in good faith meet the revised criteria, as well as continued monitoring of on-going compliance with the LTC criteria;
- would create a risk that taxpayers would breach the eligibility rules inadvertently, which will cause significant hardship to closely held and family-owned businesses;
- the LTC eligibility criteria were originally drafted deliberately wider than the Qualifying Company (QC) regime and so were intended to be used more widely; and
- the changes would increase the tax costs for LTCs.

Comment

The LTC rules are intended to apply primarily to company situations when the investment could have genuinely been alternatively owned directly by the individual or family trust shareholders.

The proposed amendments to the LTC eligibility criteria are intended to ensure that the LTC rules achieve this goal and are appropriately targeted. The majority of current LTCs have only one or two owners and as a result we consider that the amendments will not affect the majority of current LTCs.

We are, however, recommending some changes to address submitters' concerns about overreach. They include a transitional rule that will allow LTCs that lose their status as a result of the amendments to transition to ordinary companies without tax consequences, and the grandparenting of charities' LTC holdings as at the date of introduction of the bill. In addition, we are recommending some modifications to the proposed restrictions on a LTC earning foreign income, and to the rules for counting trustees and beneficiaries as LTC counted owners.

Recommendation

That the submission be declined.

Issue: Need for wider grandparenting

Submission
(Chartered Accountants Australia and New Zealand, New Zealand Law Society, PwC)

The revised LTC eligibility criteria should generally apply only to companies that elect to be LTCs after the date the bill is enacted. This is fairer on LTCs that entered into the LTC rules in good faith and ensures that they are not penalised through the tax consequences of having to leave the LTC regime.

Comment

It is important that the LTC rules achieve their policy intent of being targeted towards situations where an investor could have genuinely made their investment directly.

We agree that appropriately targeted transitional rules are needed for some situations. In this regard, the bill includes:

- a transitional rule for trusts to move gradually to counting all distributions made to beneficiaries;
- a transitional rule for corporate beneficiaries through only counting distributions to corporate beneficiaries after the date of enactment; and
- grandparenting of Māori authorities with existing LTC interests.

In response to submissions we recommend a transitional rule to allow LTCs that will lose their LTC eligibility to be able to convert to ordinary companies without tax consequences and grandparenting of existing charities' LTC interests (see *Issue: Transitional provision for existing LTCs* and *Issue: Grandparenting charities that hold interests in LTCs*).

This means there is either grandparenting or a transitional rule for LTCs affected by these changes.

Recommendation

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

Issue: Transitional provision for existing LTCs

Submission
(New Zealand Law Society, PwC)

There should be a transitional provision to enable LTCs that will lose their LTC status as a result of the changes to restructure without a tax cost.

This is fairer on LTCs that entered into the LTC rules in good faith and ensures that they are not penalised through the tax consequences of leaving the LTC regime.

Comment

We agree with the submission. Although it may be necessary for some LTCs to lose their LTC status in order to ensure that the rules are appropriately targeted, this should not result in the parties having to pay tax earlier than they would have done. Ordinarily, on exiting the LTC regime the parties will pay tax on unrealised gains held on revenue account. A transitional rule will instead enable the tax book values to be rolled over to the ordinary company (subject to certain safeguards).

Recommendation

That the submission be accepted.

LTC ELIGIBILITY – CLASSES OF SHARES

Clause 262

Issue: Support for proposal to allow LTCs to have greater flexibility around classes of shares

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

Two submitters supported the proposal to allow greater flexibility around the class of shares LTCs can hold.

Recommendation

That the submission be noted.

Issue: Allowing LTCs to have shares with disproportionate voting rights

Submission
(EY)

The proposed changes to allow LTCs to have shares with different voting rights is too limited and will not provide the desired flexibility. For the proposal to be really effective it should be possible for shares to have no or disproportionate voting rights on any of the matters listed in paragraph (a) of the current definition so long as all shares retain equal rights to receive distributions.

Comment

The bill proposes to allow companies that have shares with disproportionate voting rights to become LTCs as long as all shareholders still have equal voting rights on decisions regarding the distributions to be made by the company and decisions to vary the capital of the company.

The key reason for the restrictions on classes of shares is to avoid the opportunity for the LTC to stream income or deductions to individual shareholders. However, this objective is achieved primarily through requiring equal rights to distributions rather than requiring equal decision making voting rights. As a result, we agree with the submitter that additional flexibility should be granted to enable shares to have disproportionate voting rights as long as all the shares retain equal rights to receive distributions.

Recommendation

That the submission be accepted.

LTC ELIGIBILITY – FOREIGN INCOME RESTRICTIONS

Clause 262

Issue: Opposition to restrictions on foreign LTC owners

Submission
(KPMG, New Zealand Law Society, OliverShaw)

Submitters raised the following concerns with the proposed restrictions on the amount of foreign income that a LTC can earn when controlled by foreign owners:

- The proposal is too broad and will exclude some family-owned businesses that have overseas owners.
- An owner moving overseas could inadvertently trigger the loss of LTC status. This could have retrospective impact if an owner moves overseas part-way through an income year.
- The proposal in the bill is wider than that proposed in the issues paper,[1] which provided assurances that the proposal would not capture a domestic family business through an owner emigrating.
- The proposed restrictions would apply to LTC owners that are resident in Australia. There is limited reputational risk through a LTC owner residing in Australia.
- The same tax outcome as a LTC could be achieved through the use of a limited partnership rather than a LTC, which is not subject to the restriction.
- The amendments will impose costs on taxpayers who formed LTCs in good faith, based on the settings that were in place when the LTC regime was enacted.
- There will be increased compliance costs in reviewing existing LTCs and monitoring LTCs ongoing compliance with the proposed amendments.

The proposal should not proceed. *(KPMG, New Zealand Law Society)*

The proposal should be amended to reflect the narrower proposal in the issues paper in relation to restricting the extent to which a company can derive foreign income and retain LTC status if it is controlled by non-resident shareholders. A resident trustee should be treated as a resident shareholder for the purpose of this test. *(OliverShaw)*

Comment

The proposed restrictions on foreign ownership of LTCs are intended to prevent the reputational risk to New Zealand from LTCs being used as conduit vehicles when a LTC that is owned by non-residents invests primarily or exclusively offshore. The proposed maximum foreign income threshold of the greater of $10,000 or 20 percent of the LTC's gross income is intended to provide some flexibility for LTCs to have combined non-resident shareholding and foreign income.

[1] *Closely held company taxation issues* – an officials' issues paper, September 2015.

We consider that these thresholds should reduce the chances of a domestic family business inadvertently falling outside the rules through an owner emigrating as it will only apply when 50 percent or more of the ownership interests are owned by non-residents. An owner who has less than 50 percent shareholding will not trigger the thresholds by emigrating. As a result, we believe the majority of family-owned businesses will not be affected by the proposed changes.

The *Government Inquiry into Foreign Trust Disclosure Rules* considered whether the existing foreign trust disclosure rules were adequate to ensure that New Zealand's reputation is maintained. The *Inquiry* made a number of recommendations to bolster the foreign trust disclosure rules, which have been introduced in the Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill.

In its report, the *Inquiry* commented that LTCs were commonly used with foreign trust structures, and noted the proposals in the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill to restrict foreign-sourced income above a certain amount. The *Inquiry* supported these measures and stated that it thinks they will reduce the scope for inappropriate use of foreign trusts. Overall, therefore, we consider the foreign income restrictions need to apply to all conduit LTC situations, including existing ones.

We are recommending some changes to provide a transitional rule so that LTCs affected by the changes to the eligibility criteria can convert to ordinary companies without tax consequences. We are also recommending an amendment to the rules for measuring a "non-resident settlor" to address the overreach raised by submitters in relation to the extent to which a resident trustee of a LTC is considered to actually be non-resident (see *Issue: Transitional provision for existing LTCs* and *Issue: Reference to "non-resident settlor" should be revised*).

Recommendation

That the submission be declined.

Issue: Raising foreign income threshold

Submission
(KPMG)

If the proposal proceeds, the foreign income threshold needs to be raised to a more commercial level with the foreign income component of a LTC raised to a maximum of 50 percent of the LTC's gross income and the proposed $10,000 income threshold should be removed altogether as it is arbitrary.

Comment

The LTC regime is targeted at businesses that are likely to be predominantly domestically focused. Therefore the expectation is that the source of income will be predominantly from New Zealand, but with some allowance for overseas income as businesses expand and export. To put the proposed rule in context, currently less than 1 percent of the 50,000 LTCs have foreign income.

The $10,000 threshold is intended to provide greater flexibility for very small LTCs. The interface of the LTC rules with New Zealand's international tax policy settings is far from straightforward and judgements need to be made about where to set the thresholds. Our judgement is that a non-resident who intends to use New Zealand purely as a conduit will not want to earn significant New Zealand income in order to meet the threshold. On the other hand, it will allow some foreign income when a LTC is an inbound investment by a non-resident.

It should be noted that if a LTC is controlled by residents then it can have significant amounts of foreign income as the threshold will not apply.

Recommendation

That the submission be declined.

Issue: Delaying restriction of foreign-controlled LTCs

Submission
(Chartered Accountants Australia and New Zealand, OliverShaw)

There is currently a narrow period of time between the likely date of enactment of this bill and the application date of 1 April 2017.

If the proposal to restrict foreign income proceeds, then the application date should be deferred to 1 April 2018. This will provide existing LTCs with a longer window to restructure.

Comment

We believe it is important to act quickly to address the reputational risk of LTCs being used as foreign conduits.

The proposed restrictions were signalled a year ago in the issues paper, *Closely held company taxation issues*, released in September 2015, and were confirmed in the bill introduced in May 2016.

Those losing their LTC status because they breach the foreign income threshold should be affected prospectively as LTC status will be lost after 1 April 2017. To ensure that those few who have early balance date LTCs are not in effect retrospectively excluded, we recommend that the application date be changed to income years commencing on or after 1 April 2017.

Recommendation

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

Issue: Reference to "non-resident settlor" should be revised

Submission
(Chartered Accountants Australia and New Zealand, EY)

New Zealand income tax law has a very broad concept of "settlor". This is too far-reaching for the purposes of the proposed restrictions on foreign LTC ownership.

Comment

Currently the bill considers the trust to be non-resident if any settlor is a non-resident irrespective of the relative value of their settlement.

We agree with the submission that this proposal may overreach and may result in a loss of LTC status through a trustee shareholder being "tainted" by a minority foreign settlor. As a result, we recommend that when determining whether a trust that is a LTC owner is resident or non-resident the trust will only be counted as non-resident to the extent that non-resident settlors have provided settlements to the trust. For example, if non-resident settlors have provided 25% of the total settlements, then the trust will be considered to be 25% non-resident when assessing whether the 50% threshold has been reached.

Recommendation

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

Issue: Use of term "foreign-sourced income"

Submission
(EY)

The bill uses a new term "foreign-sourced income". There are several similar terms in the Income Tax Act 2007 that should be used instead to provide greater clarity.

Comment

We agree with the submission and believe the existing term "foreign-sourced amount" should be used.

Recommendation

That the submission be accepted.

LTC ELIGIBILITY – TRUSTEES

Clause 262

Issue: Opposition to proposed amendments on how trustees and beneficiaries are counted

Submission

(Chartered Accountants Australia and New Zealand, KPMG, New Zealand Law Society, PwC)

Four submitters opposed the proposed changes on how beneficiaries and trustees are counted for the LTC rules, for the following reasons:

- The proposed amendments overreach and will negatively impact many family-owned businesses.
- The proposed amendments will increase the risk of an inadvertent breach of LTC status, create additional complexity and result in compliance costs through the need to restructure trusts and for LTCs to monitor ongoing compliance with the new rules.
- There is no ability to use trusts to pass on income to an excessively wide group through the distribution of trustee income and corpus, as trustee income has already been taxed and corpus is the original capital invested/settled.
- The risk of using trusts to increase the number of owners of a LTC is overstated.
- The proposed amendments require counting distributions to beneficiaries that have no relation to income the LTC earns.

Comment

Fungibility of money is the main reason for the proposed amendments on how trustees and beneficiaries are counted when determining the number of look-through counted owners.

The LTC rules are only intended to be available for entities with few owners. The current rules for counting beneficiaries and trustees can be used to enable LTCs to be more widely held and, therefore, to defeat this purpose.

A LTC can only have a maximum of five counted owners. Only natural persons, trustees and other LTCs can be owners. The current test for counting trustees and beneficiaries of trusts that have LTC interests only counts distributions that are sourced from the LTC in the current year and last three income years.

Given the fungibility of money and the three to four year measurement period, it is possible to replace distributions sourced from LTC income with other distributions, and to stream distributions from LTC-sourced income to artificially decrease the number of counted owners. Given it is not feasible to say from which source a distribution is funded it is more reasonable to assume that all beneficiaries are benefiting to some degree from the LTC holding.

We consider that for the majority of family trusts the proposed amendments will have little practical effect. This is because close family members are treated as a single counted owner. For those that are affected, the trust should have records of who it has made distributions to over the past three to four years.

Recommendation

That the submission be declined.

Issue: Support for proposed amendments for counting trustees

Submission
(Deloitte)

One submitter supported the proposed changes to the way that beneficiaries and trustees are counted.

Recommendation

That the submission be noted.

Issue: Simplifying transitional rule for counting trustees

Submission
(Chartered Accountants Australia and New Zealand)

The submitter supports a transitional rule to move gradually to counting all distributions to beneficiaries. However the submitter believed the rule proposed in the bill is too complex, will impose undue compliance costs and should be simplified.

Comment

The proposed transitional rule is intended to phase in the proposed new requirements given that they will for several years cast back to periods subject to the current test. The transitional rule is, therefore, intended to help mitigate concerns that a number of LTCs could lose their LTC status because they could not meet the new test in those prior years even though they met the current requirements.

We will provide further guidance on this rule in the *Tax Information Bulletin* that covers the bill changes.

Recommendation

That the submission be declined.

Issue: Counting trustees who have made no distributions

Submission
(Chartered Accountants Australia and New Zealand)

The bill should confirm that the trustees of a trust will be a single look-through counted owner if no distribution of income has been made.

Comment

We agree with the submission. This will ensure that a LTC has at least one counted owner, and when a LTC is owned by multiple trusts that make no distributions to beneficiaries that each trust is recognised as an owner.

Recommendation

That the submission be accepted.

Issue: Double counting for trusts

Submission
(PwC)

The proposal may result in double counting of trustees through counting both the trustee and the beneficiaries of a trust. The bill and *Commentary* should make it absolutely clear that this will not occur.

Comment

We agree that the current trustee counting rule in combination with the proposed rule for counting beneficiaries could result in double counting in some circumstances. We therefore propose to simplify the counting rule by removing proposed paragraph (c) from the definition of "look-through counted owner" and replacing it with a rule that states that a trustee is a look-through counted owner when no beneficiaries of the trust are look-through counted owners.

Recommendation

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

Issue: Disregarding distributions sourced from pre 2017–18 funds or assets

Submission
(EY)

There should be some revision of the wording of proposed new paragraph (bb) of the definition of "look-through counted owner" so that distributions sourced from pre-2017 assets or non-LTC income are also disregarded.

Comment

The LTC rules are intended to be simple given their intended audience of small closely held businesses. We consider that the proposed amendment would add significant additional complexity to the rules for marginal benefit. The non-LTC income has not been counted under the old rule and what is important going forward is who received a distribution, not its source.

Recommendation

That the submission be declined.

Issue: Should extend calculation period

Submission
(PwC)

If there are real concerns that the beneficiaries receiving LTC income are being rotated, then one solution would be to remove the four-year time limit so that a beneficiary is counted if they have received a distribution of LTC income as beneficiary income in any income year.

Comment

Having a longer measurement period was a proposal outlined in the issues paper but was dropped after strong concern from submitters that it would increase compliance costs, particularly given the proposed changes to how beneficiaries and trustees were to be counted. Officials consider it to be more important to address the fungibility issue which requires all distributions to be taken into account.

Recommendation

That the submission be declined.

LTC ELIGIBILITY – CORPORATE BENEFICIARIES

Clause 262

Issue: Widening LTC eligibility to include ordinary companies as owners

Submission
(Corporate Taxpayers Group)

There are good policy reasons to widen the LTC eligibility criteria to allow companies to become look-through counted owners under the LTC rules. Doing so would provide an alternative investment vehicle to achieve the same tax result as a limited partnership or joint venture but at a lower compliance cost.

The concern that this could encourage loss retailing is not in itself sufficient to preclude corporate ownership and could be addressed through applying the deduction limitation rule to corporate owners of LTCs.

Comment

The LTC rules are intended to apply only to closely held companies where individual and trustee shareholders could have genuinely made the investment directly. As a result, ordinary companies are currently not eligible to be shareholders of a LTC as this would enable LTCs to be more widely held than intended. Another LTC can, however, be a shareholder.

Recommendation

That the submission be declined.

Issue: Opposition to restricting distributions to corporate beneficiaries

Submission
(Chartered Accountants Australia and New Zealand, KPMG, New Zealand Law Society, The Whyte Group)

KPMG does not support the proposal to prevent LTC shareholding trusts with corporate beneficiaries making distributions. The potential revenue risk is minimal. A more appropriate rule would be to limit the counted distributions to a distribution of LTC income. *(KPMG)*

A distribution to a close company beneficiary should be allowed. It is not unusual for a family trust to include a close company beneficiary; it would be within the policy intent of the LTC regime for a trust with a look-through interest in a LTC to make a distribution to that close company beneficiary. *(Chartered Accountants Australia and New Zealand)*

The proposed changes should not proceed as they impose significant costs on taxpayers who formed LTCs in good faith based on the policy settings that were in place at the time the LTC regime was enacted. *(New Zealand Law Society)*

No change is required to the LTC rules for trustees. LTC owners should have the choice to pay tax at 28% on business profits that are reinvested in the business for investment or growth purposes, and pay tax at the trustee or personal marginal rate on profits applied for private purposes. The Government should be encouraging reinvestment of profits by business owners as opposed to collecting further tax and reducing the working capital available for growth.

If it is considered that some control is required, then trustees should only be able to distribute to ordinary companies which they wholly or substantially own. *(The Whyte Group)*

Comment

The LTC rules are intended to apply only to closely held companies when individual and trustee shareholders could have genuinely made the investment directly. As a result, ordinary companies are currently not eligible to be shareholders of a LTC as this would enable LTCs to be more widely held than intended.

The proposed amendment deals with a gap in the rules that enables an ordinary company to have an interest in a LTC indirectly through a trust. We consider that this gap should be closed to ensure that the LTC rules achieve their policy intent. Leaving this gap open would encourage structuring with trusts to avoid the company restriction. Such outcomes are not the simple business structures that the LTC regime envisages.

Ideally, indirect LTC interests should be precluded but in recognition that there are already trusts with corporate beneficiaries, the proposal in the bill only precludes the making of distributions to those corporate beneficiaries. This allows a business structure to be gradually simplified over time.

Moreover, the LTC regime is not intended to favour the retention of profits within businesses. Rather, it is about trying to create a more neutral tax transition between a sole trader who is taxed at personal rates on his or her business income and the outcome if these same businesses were to incorporate. Providing this transition lessens the likelihood that tax will distort decisions on whether to incorporate. To achieve this, it is necessary to have full flow through, so that income is taxed at the LTC owners' personal tax rates.

Allowing a LTC to have corporate beneficiaries does not create a neutral tax transition and instead enables tax advantages to be gained through structuring. For example, a LTC could be structured so that it has low marginal tax rate investors holding their shares directly while high marginal tax rate investors hold their shares through a corporate beneficiary of the trust.

Such a structure creates a tax advantage over both:

- the individuals holding the assets directly (as it provides deferral advantages for owners on marginal tax rates above 28%); and
- holding the assets in an ordinary company (because distributions do not need to be made to owners on low marginal tax rates for their share of the income to be taxed at the lower rate).

Also capital gains and losses from the LTC can flow through to the owners, which they cannot do for an ordinary company.

The proposed restriction will not apply to a LTC that has an interest in another LTC indirectly through a trust.

Recommendation

That the submission be declined.

Issue: Interposed trusts

Submission
(Chartered Accountants Australia and New Zealand, Deloitte)

The meaning of "a company that is indirectly a beneficiary of the trust" in the definition of "look-through company" should be clarified. Officials should clarify whether it is intended to catch interposed trust scenarios.

Comment

The definition of "look-through counted owner" is intended to include situations where there is a distribution to a corporate beneficiary through interposed trusts.

Take the following example:

- Trust A is a shareholder of Company X
- Trust B is a beneficiary of Trust A
- Company Y is a beneficiary of Trust B

Company X makes a distribution to Trust A. Trust A then passes on the distribution to Trust B who passes it to Company Y.

Under the proposed amendments, Company X will be ineligible to be a LTC. This is because a trustee shareholder of Company X has made a distribution of income to a company that is indirectly a beneficiary of the trust.

We will provide further clarity on this point in the *Tax Information Bulletin* on the enacted changes.

Recommendation

That the submission be accepted.

Issue: Distribution of income from trustee

Submission
(New Zealand Law Society)

The proposed changes to the definition of "look-through company" do not meet the stated policy objective.

Proposed paragraph (eb) of the definition of "look-through company" only prohibits a trustee shareholder of a LTC from making a distribution of income to a corporate beneficiary. The *Commentary* and the Regulatory Impact Statement state that this restriction should apply to all amounts, not just income, distributed by a trustee shareholder.

Comment

We agree with the submission and consider that this should be addressed throughout the definition of "look-through company".

Recommendation

That the submission be accepted.

Issue: Minor drafting issue

Submission
(Matter raised by officials)

Proposed paragraph (bb)(ii) in the definition of look-through counted owner currently refers to "after the 2017–18 income year". This provision should apply to income years after the 2016–17 income year.

Comment

This provision should refer to "after the 2016–17 income year" as the new rule for counting beneficiaries of LTC owners is intended to apply to and from the 2017–18 income years.

Recommendation

That the submission be accepted.

LTC ELIGIBILITY – MĀORI AUTHORITIES

Clause 262

Issue: Support for grandparenting Māori authorities

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

Two submitters supported the proposal to grandparent existing LTCs with interests in Māori authorities.

Recommendation

That the submission be noted.

Issue: Grandparented Māori authority

Submission
(Matter raised by officials)

The bill proposes to grandparent current Māori authorities that acquired interests in look-through companies before the introduction of the bill.

This grandparenting is intended to enable Māori authorities to continue to hold existing LTC interests that they acquired before the introduction of the bill and, therefore, avoid the compliance costs of converting their LTC interests to limited partnerships.

However, the current wording of the grandparenting provision provides wider concessions than was intended. Under the present proposed wording, a Māori authority that had a LTC interest prior to the introduction of the bill is able to both retain this previous interest as well as acquire new interests in other LTCs.

Comment

It was not intended that Māori authorities should be able to acquire new interests in LTCs after the introduction of the bill. As a result, we consider that the grandparenting provision should be tightened to apply only to interests in a LTC that a Māori authority held before the introduction of the bill.

Recommendation

That the submission be accepted.

LTC ELIGIBILITY – CHARITIES

Clause 262

Issue: Opposition to excluding charities from being counted owners of a LTC

Submission
(Hugh Green Foundation, New Zealand Law Society, PwC)

Three submitters opposed the proposal to exclude charities from being counted owners of a LTC.

A charity has no beneficiaries beyond its public purpose. As it has one purpose, it should be treated akin to an individual person and not considered to be widely held. There is no potential for mischief by allowing a charity to be a LTC owner as LTC income is required to be allocated pro rata, based on each owner's effective look-through interest.

The proposed amendment penalises charities that are already LTC owners and has negative consequences for any non-charitable owners of an existing LTC as there will be tax consequences for them if LTC status is lost, as well as restructuring costs.

Comment

We consider that charitable entities are in effect reflective of wide ownership even though the ultimate beneficiaries of the charity may have no control or influence over the LTC. This becomes more of an issue when the charity is able to control or influence the LTC distributions through a direct or indirect shareholding. As a result, we consider that companies with a charity shareholder should not be eligible to be a LTC as this would enable the LTC to be effectively widely held.

When, however, the charity is only a residual beneficiary or in effect receives a distribution akin to a donation, then the distributions should not result in a loss of LTC status.

Furthermore, we accept there is a case for grandparenting existing LTCs with charity shareholders. This is addressed in the submission below, *Issue: Grandparenting charities that hold interests in LTCs*.

Recommendation

That the submission be declined.

Issue: Grandparenting charities that hold interests in LTCs

Submission
(Chartered Accountants Australia and New Zealand, Hugh Green Foundation, PwC)

If the proposal to exclude charities from being LTC owners proceeds, then existing charities with LTC interests should be grandparented.

This would align the treatment with that proposed for Māori authorities. There is no policy justification to differentiate the treatment between Māori authorities and charities. *(Chartered Accountants Australia and New Zealand, PwC)*

There are good policy reasons for the preferential tax treatment of charities, and the ability to continue to be a LTC owner will mean that the charity will be able to maintain this treatment without having to undertake the unnecessary compliance costs of having to convert their LTC interest to a limited partnership. *(Hugh Green Foundation)*

There are some situations where the charity will be unable to convert its LTC interest into a limited partnership due to having insufficient ability to direct other owners of the LTC. *(Hugh Green Foundation)*

Existing LTCs owned by charities will have elected into the LTC regime in good faith before the introduction of the bill. The LTC that is part-owned by the Hugh Green Foundation elected into the LTC regime on a fully transparent basis and incurred significant costs in obtaining a private binding ruling from Inland Revenue confirming it is eligible to be a LTC. It is therefore overly harsh to effectively penalise the Hugh Green Foundation while Māori authorities are able to maintain their LTC owner status. *(Hugh Green Foundation)*

Comment

We agree with submitters that charities with LTC holdings face similar issues to Māori authorities. Grandparenting charities' LTC interests as at the date of introduction of the bill will reduce compliance costs for these charities. We anticipate that very few charities will have such LTC interests.

Recommendation

That the submission be accepted.

Issue: Distributions to a charitable beneficiary

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

Two submitters supported the proposal to allow charities, in some circumstances, to be beneficiaries of a trust that is a LTC shareholder.

Recommendation

That the submission be noted.

Issue: Reference to "tax charity"

Submission
(New Zealand Law Society)

The proposed changes to the definition of "look-through company" relate to tax charities. Not all charities will be a "tax charity", such as a charitable organisation that chooses not to register as a charitable entity under the Charities Act 2005. It is unclear why any proposed changes should apply only to tax charities.

Comment

The term "tax charity" provides a clear, easy to apply rule as all organisations that are "tax charities" are listed on the registry of charities. We believe that the term "tax charity" should continue to be used to help ensure the legislation is clear. We also consider it is unlikely that a tax charity would deregister solely to avoid the LTC eligibility rules.

Recommendation

That the submission be declined.

LOOK-THROUGH COMPANY ENTRY TAX

Clauses 14, 106, 178, 239 and 262

Issue: Opposition to proposed amendments to the look-through company entry tax

Submission
(The Whyte Group)

The proposal to calculate entry tax at the shareholder personal marginal rate will provide a disincentive for existing companies to join the LTC regime and access the lower compliance costs offered by the LTC regime.

Existing companies wanting to become a LTC will have to fund 5 percent of their retained earnings under the proposed approach. Only when profits are applied for private purposes should income be taxed at marginal personal rates or the trustee rate.

There is an incentive for a company that might be contemplating liquidation or downsizing to elect into the regime, have all of the earnings taxed finally at 28% and then distribute that amount to avoid the marginal rates. Rather than the amendments proposed in the bill, the focus should be on taxing these situations where entry and distribution of existing profits are connected.

Comment

The proposed entry tax calculation is intended to ensure that the retained earnings of companies becoming LTCs are appropriately attributed to shareholders at their personal tax rates as would be the case if the earnings were actually distributed prior to conversion. This deemed distribution needs to be done at the time of entry because distributions made subsequent to becoming a LTC are not taxable.

Currently, upon entry into the LTC regime, taxpayers can be undertaxed when their marginal rate is greater than 28% and overtaxed when their marginal tax rate is less than 28%. This arises because to the extent the company's retained earnings can be fully imputed, this income is regarded as being finally taxed.

Officials consider the proposed amendment is necessary to remove this over- and under-taxation and ensure fairness between taxpayers on different marginal rates.

It should be noted that the LTC owners have the tax liability or benefit, not the company converting to a LTC so there are no cashflow implications for the company from applying personal tax rates to the deemed dividend.

Recommendation

That the submission be declined.

Issue: Drafting of LTC rollover provision should be clarified and deal with the status of property transferred

Submission
(Chapman Tripp, Chartered Accountants Australia and New Zealand)

Proposed section HB 13 provides that a company who enters the LTC regime acquires the assets of the "superseded" company at their tax book value. The proposed section also refers to "steps into the shoes of the company".

This is problematic as:

- the terms "superseded company" and "steps into the shoes of the company" suggest that the previous company has been replaced when in fact it still exists; and
- the section does not clarify whether the LTC has the same acquisition date, status, intention or purpose in relation to the property.

The section should be redrafted to account for this.

Comment

We agree with the submission. The "steps into the shoes" concept should apply more widely than just to the tax book value.

Recommendation

That the submission be accepted.

Issue: Clarifying application date

Submission
(Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, Deloitte)

The *Commentary* to the bill states that the application date of proposed section CB 32C is the 2017–18 and subsequent income years but the bill says it applies from the date of Royal assent. *(Chartered Accountants Australia and New Zealand, Deloitte)*

The *Commentary* to the bill states that the application date of clause 239(2) is the 2017–18 and subsequent income years but the bill says it applies from the date of Royal assent. *(Corporate Taxpayers Group)*

This should be clarified.

Comment

Proposed section CB 32C contains the revised entry tax calculation and clause 239(2) of the bill contains a cross-reference to this section. The sections should apply to the 2017–18 and subsequent income years.

Recommendation

That the submission be accepted.

Issue: Extending transitional period for QCs that convert to LTCs

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

A number of QCs will have held off on becoming LTCs hoping for simplified dividend rules. Further work on dividend simplification is planned as part of Inland Revenue's Business Transformation. This work will not be concluded for some time.

In these circumstances, a two-year transitional window should be provided for QCs that convert to LTCs in the 2017–18 and 2018–19 income years. Under such a rule QCs should be able to convert to LTCs without tax consequences.

Comment

Under the proposed amendments in the bill, entry into the LTC regime will mimic more closely the outcome had the company liquidated. This will decrease the over-taxation of QCs with untaxed reserves that convert to LTCs and decrease the under-taxation of companies that have sufficient imputation credits to fully impute dividends when they convert.

A two-year tax-free transition was provided to QCs converting to LTCs when the LTC regime was first introduced. We do not consider there is a strong case for another transitional window. If such a window was provided we consider it likely that the only elections that would be made would be from QCs with shareholders predominantly on marginal tax rates greater than 28% who would wish to avoid the proposed removal of the under-taxation on conversion to a LTC. This would defeat the purpose of the proposed amendments.

Any further work on dividend simplification is unlikely to influence decisions on whether to become a LTC.

Recommendation

That the submission be declined.

Issue: Retrospective requirement to use tax book values on entry

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

The requirement for LTCs to use the tax book values of the company that elects into the LTC regime should be prospective. The grounds for retrospective amendment have not been made. The change does not correct something that is clearly contrary to the policy intent and there is no evidence that the current law poses an obvious risk to New Zealand's tax base. There has been no analysis of the actual problem and its extent in either the original issues paper or the *Commentary* to the bill to justify the change.

The uncertainty the proposed amendment proposes to remedy is a consequence of the haste in which the LTC legislation was enacted. Taxpayers should not be penalised for a deficiency in the rules when they have relied on the rules in good faith.

Comment

The proposed requirement that the LTC adopt the tax book values of the converting company is a clarification to ensure the rules work as intended. There would be a significant revenue risk if taxpayers could revalue their assets without any tax consequences at the time of conversion.

Take, for example, a taxpayer with a forest that has a tax book value of $0 and a market value of $1 million. On entry into the LTC rules, if the taxpayer could use the market value of the forest, the tax book value of the forest would become $1 million and there would be no requirement to pay tax on that $1 million (as these revenue gains are not realised upon entry into the LTC rules).

As a result, the amendment clarifies that this is not possible and prevents gains in asset values from leaving the tax base. We are not aware of any taxpayers that have used the market value of assets upon entry into the LTC rules. However, the proposed amendment is retrospective to ensure that this potential uncertainty is not abused through positions being reopened which could otherwise create significant revenue risk.

Recommendation

That the submission be declined.

Clauses 97 and 105

Issue: Support for removing deduction limitation rule

Submission
(Chartered Accountants Australia and New Zealand, KPMG, New Zealand Law Society, PwC)

Four submitters supported the proposal to remove the deduction limitation rule for LTCs.

Recommendation

That the submission be noted.

Issue: Technical issues should be addressed

Submission
(Chartered Accountants Australia and New Zealand)

Officials are aware there are a number of technical issues with the deduction limitation rule and have stated in the *Commentary* to the bill that they are continuing to work on them.

Officials should expedite this work and address the technical issues as a matter of urgency.

Comment

The bill will significantly limit the scope of the deduction limitation rule. Given this narrowing in scope, we consider these technical issues are not a high priority.

Recommendation

That the submission be declined.

Issue: Joint ventures

Submission
(Chartered Accountants Australia and New Zealand)

The term "joint venture" should be defined.

In some circumstances, there is uncertainty over whether or not a joint venture exists. It would be helpful if the term were defined in the legislation.

Alternatively, we suggest Inland Revenue provides detailed guidance and examples of the types of arrangements it considers would be "joint ventures" in this context.

Comment

The definition of "joint ventures" is not limited to just the deduction limitation rule or just to tax. As a result, any changes to the definition would need to consider the wider use of the term "joint venture" and the wider implications.

Given the significant competing demands on the Tax Policy Work Programme we do not consider legislatively defining the term to be a high priority.

Recommendation

That the submission be declined.

Issue: Revising sequence of wording in clause 97

Submission
(EY)

The sequence of wording in the proposed amendment in clause 97 should read "subparts HB and HG (which relate to look-through companies, and joint ventures, partners and partnerships)".

Comment

The sequence of wording in clause 97 follows the sequence of the sections it is referring to. We believe that this sequencing is appropriate.

Recommendation

That the submission be declined.

DEBT REMISSION

Clauses 13, 56, 104 and 119

Issue: Support for changes to debt remission for LTCs

Submission
(Chartered Accountants Australia and New Zealand, KPMG, New Zealand Law Society)

Three submitters supported the proposed changes to the debt remission rules for LTCs.

Recommendation

That the submission be noted.

Issue: Debt remission provision does not achieve the policy objective

Submission
(Chartered Accountants Australia and New Zealand, KPMG, New Zealand Law Society, EY)

Four submitters stated that the proposed debt remission provision for LTCs does not achieve the policy intent.

This is because the effect of the amendment is to provide the lender a deduction under section DB 6 by virtue of a negative base price adjustment. However, a deduction is available under section DB 6 only when the general permission is satisfied. This may not be satisfied in the circumstances of a debt remission for LTCs.

Submitters raised several different options for how the provision should be drafted to ensure it achieves the policy objectives.

Comment

We agree with the submission. We plan to rectify this by enabling the LTC owner to have an automatic right to a deduction for a base price adjustment as a result of a self-remission.

Recommendation

That the submission be accepted.

Issue: Extending debt remission provision to LTC liquidations and other LTC interest disposals

Submission

(Chartered Accountants Australia and New Zealand, Offen Advisors Limited)

The proposed debt remission amendment should be extended to cover other situations where the LTC owner effectively remits debt but through disposing of a LTC or otherwise.

Comment

We agree with the submission. The provision should be extended to cover the income that flows through to the lender-shareholder from the LTC as a result of a base price adjustment on the debt owed to the shareholder-lender that will not be repaid as a result of revocation of LTC status or permanent cessation.

Recommendation

That the submission be accepted.

Issue: Clarifying application date of credit impairment amendment

Submission

(Chartered Accountants Australia and New Zealand)

The *Commentary* to the bill states that the proposed credit impairment amendment will apply from 1 April 2011. However the bill provides that the amendment applies from 1 April 2017. This should be clarified.

Comment

Both are correct. The proposed amendment in effect applies from 1 April 2011 but to avoid reopening past returns, any additional income and associated penalties and interest from those earlier years is brought to account in 2017–18 income returns.

We will clarify this point in the *Tax Information Bulletin*.

Recommendation

That the submission be noted.

Issue: Credit impairment provision does not work as intended

Submission
(Chartered Accountants Australia and New Zealand, EY)

As currently drafted, section HB 4(7) provides that the market value of an owner's interest in a financial arrangement as a debtor must take into account the amount of any adjustment for credit impairment. It is uncertain what the phrase "must take into account" means; does it mean the debtor must take a deduction or add an amount back? It is unclear, as the credit impairment is an adjustment made by the creditor, not the debtor. *(Chartered Accountants Australia and New Zealand)*

It is unclear what the proposed credit impairment amendment is intended to achieve. If it is intended to ensure base price adjustment income arises for LTC owners on third-party debt which they are unable to pay all or in full, it would not necessarily be effective.

We would not expect a debtor LTC to have made any adjustment for credit impairment to a financial arrangement liability it (and its owners under the LTC rules) owes. On that basis proposed section HB 4(7) would not seem to effect the change apparently desired by officials. *(EY)*

The provision should be redrafted.

Comment

The proposed credit impairment clarification is intended to ensure that a debtor accounts for the debt at the market value of the debt, including, any impaired value of the debt when a base price adjustment is being calculated when a LTC owner is disposing of a LTC interest. For the purposes of the disposal price, the impaired value of the debt needs to be used in the base price adjustment rather than the face value. This ensures that what is in effect a debt remission is treated as income of the LTC owners.

This market value adjustment is similar for other situations where assets or liability may need valuation at a different level than their book value to account for risk or other intangible factors that could affect the value of the asset or liability.

Recommendation

That the submission be declined.

Issue: Guidance needed on how to determine amount of credit impairment

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

Guidance is required on how the amount of an adjustment for credit impairment is determined.

The credit impairment adjustment is made by the creditor, not the debtor. For commercial reasons this information is not likely to be made readily available to the debtor.

Comment

The adjustment needed for impairment of debt is, in principle, similar to other adjustments needed for assets to account for risk or other intangible factors that may affect their value.

Under the amendment, debtors will not need to rely on information from the creditor to determine the amount of credit impairment. Instead, the debtors will need to make a fair and reasonable estimate of the credit impairment based on the information they have available.

To determine the credit impairment, the key question to ask is "if the LTC was sold or liquidated, how much of the debt would be repaid to the creditor". In most cases, determining this would involve looking at the balance sheet of the LTC to determine the net assets of the LTC. Officials intend to include this explanation in the *Tax Information Bulletin*.

Recommendation

That the submission be noted.

Issue: Opposition to retrospective credit impairment amendment

Submission
(EY, Offen Advisors Limited)

Clause 104 stands to retrospectively impose income tax in a situation where no current or potential economic gain arises.

Moreover taxpayers could have restructured their affairs and avoided the tax consequences of this retrospective change if the other changes proposed in the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill had been in place from the beginning of the LTC regime (1 April 2011).

Retrospective legislation is not justified in this circumstance. It is up to the courts to determine how a provision is to be interpreted. The proposed amendment is not a mere clarification; otherwise retrospective legislation would be unnecessary. *(Offen Advisors Limited)*

Taxpayers will have made tax positions in previous years on an arguable legitimate basis of the tax law as then enacted. Retrospective taxation is unreasonable and unwarranted. *(EY)*

Comment

The policy intent of the LTC rules is to deem the assets and liabilities of the LTC to be disposed of at market value upon exit from the rules. This policy intent was clear at the time the rules were enacted and the legislation clearly intended to avoid the issues with the previous Loss Attribution Qualifying Company rules in this area where some were avoiding debt remission income being brought to account.

We accept that the legislation was not as clear as it could have been in the determination of credit impairment and the argument that debt should be deemed to be disposed of at face value is understandable.

However, we believe the case for retrospective legislation has been met in this case. The intent of the legislation was clear and deeming debt to be disposed of at face value would create absurdity. We also believe that retrospectivity is needed as this issue creates a significant revenue risk.

Recommendation

That the submission be declined.

QUALIFYING COMPANIES – CONTINUITY OF OWNERSHIP

Clauses 98 and 262

Issue: Opposition to proposed qualifying company continuity requirement

Submission
(KPMG)

Qualifying companies (QCs) should not lose their QC status if there is a shareholding change of over 50 percent in aggregate.

Qualifying companies do not provide a tax deferral advantage and instead provide tax deferrals no different to that of ordinary companies. More importantly, the population of QCs cannot increase, meaning the revenue risk (if any) can be managed.

Comment

One aspect of the 2010 tax package was that existing QCs were allowed to continue but no new QCs could be created. This grandparenting of existing QCs was, therefore, intended solely to enable existing owners to retain their QC interests. The sale of an existing QC interest would in effect allow new QC interests to be created, particularly if more than 50 percent of the shareholding was sold.

Any tax advantage that the QC might enjoy could be traded in this way, which was clearly not the intent of grandparenting.

Recommendation

That the submission be declined.

Issue: Repealing qualifying company regime and extending similar treatment to close companies

Submission
(New Zealand Law Society)

Consideration should be given to repealing the QC regime but at the same time enabling close companies to distribute amounts of tax to their shareholders to the extent the distribution is not a fully imputed cash distribution.

This would create a level playing field as all close companies would have this treatment rather than just QCs.

Comment

The issue raised by the submitter is complex and is intertwined with the treatment of entities generally.

We do not think that the issues can be considered in isolation to the whole approach to entity taxation. This would be a significant piece of work which we consider would best be handled through the standard Tax Policy Work Programme process at a future date.

Recommendation

That the submission be declined.

Issue: Sale of shares to close relative should be excluded

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

The sale of shares in a QC to a close relative should be excluded from the proposed continuity test. This is common in intergenerational planning and it would be unfair to lose QC status in these circumstances.

Comment

We agree with the submission. Such shareholder changes as part of intergenerational planning should not need to wait until a shareholder's death.

Recommendation

That the submission be accepted.

Issue: Shareholding changes within existing shareholder groups should be excluded

Submission
(Chartered Accountants Australia and New Zealand)

Shareholding changes within a group of existing QC shareholders should be excluded from the proposed continuity test. It would be unfair if a QC test applied to changes in shareholding between existing shareholders. This happens often in family situations and applying the continuity test in this situation would be unfair and unnecessarily restrictive.

Comment

Officials do not consider the situation of existing shareholders selling out to the remaining shareholders should be excluded from the proposed continuity requirement. Such exclusion would make the rule more complex and difficult to apply. It would also potentially enable a group of existing shareholders to realise upfront any future benefit through selling to one remaining shareholder. Many of the situations where shareholding changes occur within a QC are likely to involve family members in which case the recommendation to the previous issue (*Issue: Sale of shares to a close relative should be excluded*) will provide flexibility to change shareholding within existing QC shareholders.

Recommendation

That the submission be declined.

Issue: Rollover relief for livestock

Submission
(KPMG)

A LTC structure is generally not suitable for farm succession due to an omission in the rollover relief for trading stock on transfer of LTC interests not including livestock. This omission should be addressed.

Income arises due to livestock being held on the notional standard cost method which is used to a greater or lesser degree by almost all livestock farmers. Either livestock should be included in the rollover relief under section HB 6 or QC status should be maintained for transfers to associated persons.

Comment

Section HB 6 relates to disposals of a LTC owner's interests in trading stock other than livestock. The policy intent was to exclude livestock from section HB 6. Instead, livestock is transferred at market value rather than there being rollover relief.

This is because when there is a significant difference between market value and tax book value there is the opportunity to create tax planning advantages if the tax book value is rolled over. The difference between the tax book value and market value of livestock is generally large and so we do not wish to provide rollover relief for it.

Recommendation

That the submission be declined.

Issue: Dividends by ex-qualifying companies within wholly owned groups

Submission
(Alexandra Low & Associates, Chartered Accountants Australia and New Zealand, Deloitte)

Companies that have previously been a QC cannot utilise the exemption for dividends between wholly owned companies in section CW 10. This is an overreach and creates uncertainty and unintended consequences. It is common for a wholly owned group to have a company that at one point was a QC.

A limited exception should be introduced when the company can demonstrate to Inland Revenue that it has no overdrawn current accounts at conversion date. The change should be retrospective to the date the relevant section (CW 14) in its present form was introduced. *(Alexandra Low & Associates)*

The associated section in the QC rules (section HA 17) should be repealed and the mischief it is intended to target should be addressed through the general anti-avoidance rule. Alternatively, section HA 17 should be redrafted to more expressly and specifically address the scenario that it was enacted to prevent. *(Deloitte)*

Section HA 17 should be clarified to provide that the exclusion of the application of section CW 10 applies only if the recipient company is currently a QC. *(Chartered Accountants Australia and New Zealand)*

Comment

The current rule that prevents companies that were previously QCs from using the exemption for dividends between wholly owned companies (the intercorporate dividend exemption) is intended to address avoidance risks. These risks were identified when developing the QC regime in the early 1990s.[2]

The potential avoidance cited was when a QC creates capital gains through revaluing its shares it holds in a non-qualifying company. These capital gains can be passed to shareholders as exempt dividends and funded by a loan back to the QC. If the QC then converts to an ordinary company, the company can, if the intercorporate dividend exemption is available, receive an exempt dividend from other companies in a wholly owned group which could be used to repay the loan from the shareholder without a tax cost.

However, we agree that the current rule overreaches and would apply in situations where there is no significant avoidance risk.

We recommend that the prohibition should be narrowed and the rule should apply only when:

- the relevant QC has previously paid unimputed dividends; and
- it has been less than seven years since the company was a QC.

We recommend that this should be retrospective to the 2005–06 income year (the application date of the Income Tax Act 2004).

Recommendation

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

Issue: Aligning "minimum QC interest" definition with other definitions

Submission

(EY)

The proposed new section HA 6(4) definition of "minimum QC interest" should be revised so that it aligns with the "effective interest" concept defined in section HA 43 and measured under section HA 44. The proposed test would involve possibly having to compare different types of measurement for different shareholders and could result in additional complexity and possible confusion.

Alternatively, it could be expressed similarly to the criteria in sections IA 5(2) and (3) or OA 8(7).

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[2] *The Taxation of Distributions From Companies*, Valabh Committee, November 1990.

Comment

The test in proposed new section HA 6(4) is the test that is commonly used for all continuity provisions. A QC will have to apply a similar test for the purposes of the loss continuity rules. As a result, we consider that the proposed test in section HA 6(4) is preferred.

Recommendation

That the submission be declined.

Issue: Consistency between "qualifying company continuity period" and other defined terms

Submission
(EY)

Any references to "continuity period" in the "minimum QC interest" definition should be expressed as "QC continuity period" to ensure consistency with that defined term and remove any uncertainty.

Comment

We agree with the submission. The references in this section to "continuity period" are an error and should be expressed as "QC continuity period".

Recommendation

That the submission be accepted.

Issue: Including section HA 6 within definition of "continuity provisions"

Submission
(EY)

Section HA 6 should be included in the section YA 1 definition of "continuity provision" to ensure that section YC 8 can apply in relation to the death of a shareholder and section YC 9 in relation to trustee holders.

Comment

We agree with the submission. The provisions in sections YC 8 and YC 9 should apply to the QC continuity provisions.

Recommendation

That the submission be accepted.

TAINTED CAPITAL GAINS

Clause 23

Issue: Support for removing tainting from certain capital gains

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, KPMG, New Zealand Law Society, PwC)

Six submitters supported the proposal to remove "tainting" from certain capital gains.

Recommendation

That the submission be noted.

Issue: Wider review of taxation of capital gains and dividend regime

Submission
(Chartered Accountants Australia and New Zealand)

There is a need to review the rules for the taxation of capital gains and the dividend regime as a whole.

The current government policy is not to impose tax on capital gains. Companies can only distribute capital gains tax-free to shareholders on liquidation. It is not sound tax policy to restrict tax-free capital gains only to liquidation.

Comment

Look-through companies (and QCs) can distribute capital gains without needing to liquidate, because this means the tax outcome is the same as if the owner had invested directly. Other closely held companies can only distribute capital gains tax-free on liquidation.

While we acknowledge the concerns raised by the submitter, the issues are intertwined with the treatment of dividends and raise a number of complex considerations.

We do not think that the issues can be considered in isolation to the whole approach to entity taxation and the treatment of dividends. This would be a significant piece of work which we consider would best be handled through the standard Tax Policy Work Programme process at a future date.

Recommendation

That the submission be declined.

Issue: Support for proposal relating to assets sold outside the group

Submission
(Chartered Accountants Australia and New Zealand)

The submitter supports the removal of tainting of gains on assets sold between companies when the asset is subsequently sold outside of the group.

Recommendation

That the submission be noted.

Issue: Application to tainted capital gains from 1988–2010

Submission
(Chartered Accountants Australia and New Zealand)

Capital gains made between 1988 and 2010 are subject to the "related parties" test which preceded the "associated persons" test.

The "tainted" gains under the "related parties" test should be treated the same as the "tainted" gains under the "associated persons" test. Many taxpayers delayed winding up companies in expectation of this.

Comment

We agree with the submission. The policy intention is that both situations should be covered.

Recommendation

That the submission be accepted.

Issue: Assets that have ceased to exist

Submission
(Chartered Accountants Australia and New Zealand)

Clarification is needed in respect of how the proposed rule, which requires measuring ownership at the time of liquidation, operates when the property in question has ceased to exist or has been significantly impaired in value.

Comment

If, at the time of liquidation the asset ceases to exist, any capital gain amount or loss relating to the asset should be untainted. We will clarify this point in the *Tax Information Bulletin*.

Recommendation

That the submission be accepted.

Issue: Wider application to close companies

Submission
(New Zealand Law Society)

Consideration should be given to amending the proposed inter-company transfer provision, so that it will not apply to "close companies". Such a rule is not appropriate for "close companies", which should be taxed in a manner consistent with direct ownership of property.

If this proposal is adopted, consideration should also be given to the definition of "close company", which currently excludes companies in which 50 percent or more of the shares are held by one or more trusts.

Comment

The tainted capital gains rule is intended as an anti-avoidance measure to prevent closely associated companies selling assets between themselves to create additional capital reserves that can be distributed tax free.

The risk the rule is intended to address can occur in situations when any third party influence in the companies is minimal. This risk can therefore exist in close company situations and officials consider the rule should apply to them.

Recommendation

That the submission be declined.

Issue: Clarifying "time of liquidation"

Submission
(Corporate Taxpayers Group, Deloitte)

There is uncertainty about what amounts to the "time of liquidation". This might include:

- when the decision to liquidate is made;
- when resolution to liquidate is made;
- when the liquidator is appointed; or
- when amounts are distributed.

Comment

We consider that the time of liquidation should be the time when amounts are distributed. This should be clarified in the legislation.

Recommendation

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

Issue: Capital gains made before date of enactment

Submission
(Corporate Taxpayers Group, Deloitte, New Zealand Law Society)

Officials should clarify that the proposals will apply to situations when the capital gain has been made prior to the date of enactment and the liquidation (including distribution) has occurred after the date of enactment.

Comment

The provision is intended to apply to capital gains made either prior to or after the date of enactment and the relevant distribution as a result of the liquidation occurs after the date of enactment. We will clarify this in the *Tax Information Bulletin*.

Recommendation

That the submission be accepted.

Issue: Backdating tainted capital gains provision

Submission
(PwC)

Taxpayers who have wound up, made distributions and exposed themselves to a liability before enactment should be able to benefit from the proposed amendments.

The key issue for these taxpayers is inadvertent non-compliance as a result of the taxpayer and their advisors not being aware of the current rule which policymakers have acknowledged is too wide.

The proposed changes should be made retrospective from the commencement of the 2006–07 income year.

If it is deemed that retrospective application of these rules is not appropriate, Inland Revenue should issue operational guidance that confirms historic tainted capital gains will not be pursued except in circumstances where the new rules are breached. Taxpayers should have certainty over previous positions if their position is consistent with the proposed new rules.

Comment

We do not consider there to be a strong case for retrospective application in this situation or, alternatively preserving past positions taken.

The tainted capital gains rule clearly applied for the years prior to the proposed amendment. Retrospective legislation would provide a windfall gain for non-compliance with a clear rule. This would be unfair to those who were previously compliant and paid tax based on the rule or who incurred other costs as a result of the rule.

There will be situations when taxpayers have gained no advantage from the transfer but trying to distinguish this situation from others is not practically feasible.

Recommendation

That the submission be declined.

RWT ON DIVIDENDS

Clauses 20, 239, 240, 241 and 242

Issue: Support for relaxing RWT requirements

Submission
(Corporate Taxpayers Group, KPMG, New Zealand Law Society, EY)

Three submitters supported the proposed amendments to relax resident withholding tax (RWT) requirements.

Recommendation

That the submission be noted.

Issue: Removing RWT for all dividends between companies

Submission
(KPMG)

The RWT requirement to withhold should be removed altogether for dividends between companies. There is no policy reason for deducting RWT in this situation.

Comment

Removing RWT for all dividends for companies would create tax evasion and avoidance concerns. As part of the review of closely held company taxation issues, consideration was given to enabling a company to elect out of paying RWT when the company directors provide a guarantee of payment of the eventual tax (as the guarantee would address some of these evasion and avoidance concerns).

However, it was concluded that this issue was best dealt with as part of the work to simplify business tax processes as this work was considering similar issues, and because the change would, given existing processes, come at a significant fiscal cost.

Recommendation

That the submission be declined.

Issue: RWT rate on dividends between companies should be 28%

Submission
(Chapman Tripp)

The RWT treatment of dividends should be aligned with that for interest payments and the unimputed portion of dividends paid to companies should be 28% as it is for interest paid to companies.

Comment

In principle, we agree with this submission. In effect it would extend the proposal in the bill which enables RWT not to be deducted on dividends to corporates when the dividend is fully imputed. However, we are concerned about making this change without the opportunity for wider consultation. To ensure this matter is progressed expeditiously, officials recommend it be handled as part of other work currently being done on changes to business taxation proposed as part of Inland Revenue's Business Transformation.

Recommendation

That the submission be declined.

Issue: Wider issues on grossing up non-cash dividends

Submission
(KPMG)

The requirement to gross-up non-cash dividends can mean additional RWT must be withheld, even though this additional amount is ultimately refundable to the shareholder and comes at an additional cash cost to the payer. This highlights the cashflow issue many companies face with the current gross-up requirement for deducting RWT on non-cash dividends generally. This wider issue needs to be considered.

Comment

Issues with non-cash dividends are currently being considered by Inland Revenue in a separate project. We consider it is more appropriate to consider this issue in that project.

Recommendation

That the submission be declined.

Issue: New option should be available when non-cash dividends are paid

Submission
(EY)

Proposed new section RE 14B should also be available when a non-cash dividend subject to section RE 15 is provided. Doing so prevents gross-up and double taxation issues.

Comment

Section RE 15 relates to dividends that are bonus issues in lieu or shares issued under a profit distribution plan. Whether these types of non-cash dividends should also be included in the new formula that combines cash and non-cash dividends paid concurrently to determine the amount of RWT payable could be an item for further consideration as part of future work on RWT and dividends. However, at this time we do not believe it is a high priority item as we understand the key concern was in relation to other types of non-cash dividends, which is being addressed in the bill.

Recommendation

That the submission be declined.

Issue: Clarifying what gross amounts shareholders are taxable on for cash and non-cash dividends

Submission
(EY)

The wording of section RA 9 should be revised to ensure that the dividend amounts that may be taxable to shareholders include amounts of tax paid on a shareholder's behalf in relation to any distribution as well as to amounts withheld from monetary payment.

Comment

We consider that this issue would require more time for consideration and is more appropriately handled as part of any future work on dividends.

Recommendation

That the submission be declined.

Issue: Similar option for NRWT

Submission
(EY)

A similar amendment as that proposed for RWT should be made for NRWT as the same issue arises for NRWT as are being addressed for RWT.

Comment

We consider that the proposed amendment would require more time for officials to work through. This is an item that could be considered on any future review of dividends.

Recommendation

That the submission be declined.

Issue: Support for fix to backdated dividend provision

Submission
(BDO, KPMG)

Submitters supported the proposed fix to section CD 39(9) which allows a dividend to be backdated to clear a shareholder's overdrawn current account.

Recommendation

That the submission be noted.

Issue: Equivalent amendment to section RD 36(2)(b)

Submission
(BDO, Chartered Accountants Australia and New Zealand)

An equivalent amendment to that made in section CD 39(9)(c) needs to be made to section RD 36(2)(b), which relates to employment-related loans that can be cleared by backdating various income payments to the beginning of the income year. The policy rationale for both of these provisions is the same and both should be similarly amended to ensure that the provisions work as intended.

Comment

We agree with the submission. Both situations enable a payment to be backdated to clear a shareholder's current account. This backdating cannot be technically achieved because of the requirement that RWT has not been deducted from the payment. An amendment is required to rectify this.

Recommendation

That the submission be accepted.

Issue: Clarification on amount of cash dividend required to satisfy the RWT liability

Submission
(EY)

The proposed section RE 14B(2) formula should work appropriately but it assumes the "cash dividend" amount is known. The key question in practice will likely be "what amount of cash dividend is required simply to satisfy the RWT liability?". An appropriate formula in the legislation should be considered.

Alternatively, the Commissioner should provide appropriate examples to show how that amount is arrived at, as well as illustrating the relevant amounts to be included in dividend statements for shareholders.

Comment

We will provide further guidance on this in the *Tax Information Bulletin*.

Recommendation

That the submission be noted.

Issue: Clarifying application date

Submission
(Corporate Taxpayers Group)

The *Commentary* to the bill states that the application date of clauses 239(1) and (4) is from the date of enactment but the bill says it applies from 1 April 2017.

This should be clarified.

Comment

These clauses contain amendments to allow companies to opt out of deducting RWT from fully imputed dividends paid to corporate shareholders. The amendments should apply from 1 April 2017 as in the bill.

We will clarify this in the *Tax Information Bulletin*.

Recommendation

That the submission be accepted.

PAYE ON SHAREHOLDER-EMPLOYEE SALARIES

Clauses 234, 235, 236 and 262

Issue: Support for amendment

Submission
(Chartered Accountants Australia and New Zealand, New Zealand Law Society)

Two submitters supported the proposed amendment to PAYE on shareholder-employee salaries.

Recommendation

That the submission be noted.

Issue: Irrevocable nature of election unclear

Submission
(Chartered Accountants Australia and New Zealand)

It is unclear whether the legislation achieves the policy intent of making an election between provisional tax and PAYE irrevocable. This is because if the requirements of section RD 3C are not met it is unclear what the consequences are.

Comment

The consequence of non-compliance with section RD 3C should be that the person defaults to PAYE.

Recommendation

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

Issue: Elections should only be irrevocable for a limited period

Submission
(EY)

The proposed options for shareholder salary are too limited and should not be irrevocable or made on a "once only" basis. Instead, an election should be irrevocable for a limited period – say, three income years.

This would enable flexibility for changing circumstances such as changing profitability, solvency or ownership.

Comment

We agree with the submission and consider a three-income year irrevocable period appropriate for switches from PAYE.

We also consider that a taxpayer should be able to switch from paying full or partial provisional tax on shareholder salary to paying PAYE on the salary without time restrictions. This is because the consequence of non-compliance with the shareholder salary rule is that the taxpayer defaults to paying PAYE on the salary. If a taxpayer can switch to PAYE through non-compliance, a compliant taxpayer should be able to switch to PAYE without needing to be non-compliant.

Recommendation

That the submission be accepted.

Issue: Noting ability of LTC to pay non-PAYE deducted salary

Submission
(New Zealand Law Society)

Retrospective "minor technical amendments" have been proposed to section RD 3. The *Commentary* to the bill states that "these do not alter the scope of section RD 3". This does not appear to be the case and the changes will enable LTCs to pay non-PAYE deducted shareholder salaries.

This change should be noted in the *Tax Information Bulletin* for the bill.

Comment

The proposed technical amendment in clause 234 is a retrospective rewrite clarification and applies only up to the date which proposed clause 235 applies from. Clause 235 expressly excludes LTCs companies from the rule.

Recommendation

That the submission be declined.

Issue: Enabling LTCs to pay non-PAYE deducted salary

Submission
(New Zealand Law Society)

Given the ability of LTCs to pay non-PAYE deducted shareholder salaries, the proposed changes to enable a mix of PAYE and non-PAYE deducted salaries should apply to LTCs.

Comment

As outlined above, under the proposal in clause 235 of the bill, LTCs will expressly not be able to pay non-PAYE deducted shareholder salary. This is just a restatement of the current position.

Recommendation

That the submission be declined.

Issue: Application date of shareholder-employee amendments

Submission
(EY)

The proposed shareholder-employee amendments apply from the date of enactment.

However, it is unclear how elections under proposed new sections RD 3D and RD 3C would be made. Election under the provisions would apply to all amounts paid in the year even though the election may be during an income year.

The bill should clarify the first income year for which the election may be made and provide some savings provision as necessary for situations when amounts may already have been paid, but not treated exactly as required under either of the new provisions.

Comment

We agree with the submission and consider the amendment should apply for the 2017–18 and later income years.

We also consider that a taxpayer should be able to choose on election whether to use the new options for all payments over the income year or solely for payments from the date of election. This would help address transitional difficulties.

Recommendation

That the submission be accepted.

Issue: Drafting of section RD 3

Submission
(EY)

Section RD 3(1)(b)(ii) needs to refer to the circumstances set out in the proposed new subsection (3), at least to the extent amounts are treated as income other than from a PAYE income payment, as well as to subsection (2) (as proposed to be replaced).

Comment

We agree with the submission. Payments for which RD 3(3) applies should not be included in the definition of "PAYE income payments".

Recommendation

That the submission be accepted.

OTHER CLOSE COMPANY MATTERS

No clause

Issue: Clarifying definition of "close company" when there is a trustee shareholder

Submission
(Chartered Accountants Australia and New Zealand, KPMG, New Zealand Law Society)

The definition of a "close company" needs clarification. Many family companies are owned by trustees and it is appropriate that they get the compliance cost savings of being a close company.

There has been a view expressed that companies owned by trustee shareholders currently satisfy the definition of a close company. This should be clarified.

Comment

Inland Revenue is currently considering whether the current definition of "close company" can include companies with trustee shareholders. Once this is complete, officials plan to consider what legislative changes or further guidance is necessary.

Recommendation

That the submission be noted.

Issue: A revocation of LTC status should require a unanimous election

Submission
(PwC)

The current LTC election rules are unbalanced. All owners of a company must sign an election form to elect into being a LTC, but only one owner is required to revoke the election.

This can have significant impact on a company and should be addressed by requiring a unanimous election to revoke LTC status by all owners.

In practice, this risk can be mitigated by putting a shareholder agreement in place. However, this increases compliance costs and, in our experience is not routinely put in place by closely held companies.

Comment

We consider that as all look-through owners of a LTC are personally responsible for the tax on their share of the LTCs business profits, it would not be appropriate to change the rules to restrict an owner's ability to elect out. Furthermore, if the owners have had a falling out, obtaining unanimous agreement is likely to be difficult.

Instead we consider that shareholders' risks are best dealt with through the use of shareholder agreements.

Recommendation

That the submission be declined.

Issue: Clarifying scenarios where LTC owners are not bound by elections or methods adopted by a LTC

Submission
(PwC)

There are currently some situations when LTC owners are not bound by elections or methods adopted by a LTC.

There are a number of questions about how these various elections apply and they should be clarified either through legislative change or through further commentary by Inland Revenue.

Comment

We agree that, similar to LTC transparency issues, this could be an area for further consideration.

However, we believe that it should be a low priority on the Tax Policy Work Programme given the significant competing demands.

Recommendation

That the submission be declined.

NRWT: Related party and branch lending

"MONEY LENT" AND "INTEREST"

Clauses 246, 247 and 262

Issue: Money lent and branches

Submission
(Chartered Accountants Australia and New Zealand)

The proposed definitions of "money lent" and "interest" apply to "a resident in New Zealand". The amendment should equally apply to a non-resident where they carry on business through a fixed establishment in New Zealand.

Comment

Officials agree that these definitions, and the subsequent provisions that rely on them, should also apply to New Zealand branches of non-residents.

Recommendation

That the submission be accepted.

Issue: Excepted financial arrangements

Submission
(Chartered Accountants Australia and New Zealand)

The proposed new definitions both rely on the financial arrangement rules applying. However, not all "funding" is provided under the financial arrangement rules. For example, some "funding" relates to excepted financial arrangements.

An election to treat an excepted financial arrangement as a financial arrangement (under section EW 8) may have an impact on the NRWT regime applying under the current drafting. This is not appropriate (and such an election may only be made at year-end after interest is paid). There would also be an inappropriate difference between an election being made under section ED 4, which does not give rise to a financial arrangement and section EW 8, which does.

Comment

Where a taxpayer elects to treat an excepted financial arrangement as a financial arrangement and claims income tax deductions on that basis, officials see no reason why they should not also be covered by the proposed rules. Officials note that the submitter does not suggest any practical difficulties with doing so.

Recommendation

That the submission be declined.

Issue: Straightforward funding

Submission
(Chartered Accountants Australia and New Zealand)

The proposed definition of "interest" for the NRWT rules and a related party debt, broadly means amounts provided to the non-resident lender by the New Zealand resident borrower. In the case of complex derivative financial instruments, amounts may be provided by the non-resident lender to the related party borrower.

The definition of "interest" does not take into account amounts provided by the non-resident lender to the borrower and, as there is no mechanism to offset or reduce the borrower's non-resident financial arrangement income (NRFAI), this may result in over-taxation of the non-resident lender.

To minimise any over-taxation these rules should be limited to straightforward funding (relatively simple derivative financial instruments that are issued with standard features), or an offsetting mechanism should be introduced.

Comment

The intention of these proposals is to cover arrangements that are debt or economically equivalent to debt. It would be impossible to achieve the policy intention if the scope of the proposals was limited to arrangements that provided straightforward funding as there are an almost infinite number of options to achieve an equivalent outcome using more complex products.

These proposals have been limited to arrangements that provide funding and as such will not cover arrangements that are not entered into to provide funding such as interest rate or foreign exchange swaps or collateral held as security on a derivative. The proposed addition to the definition of interest only applies to amounts paid by a person in relation to money lent to a person. Officials also note that these arrangements are entered into between related parties who will continue to have choice over how they structure their arrangements and whether they will trigger the NRFAI rules at all.

Recommendation

That the submission be declined.

Issue: Scope of definitions

Submission
(Chapman Tripp, Chartered Accountants Australia and New Zealand)

We are concerned that the term "funding" is too broad and may capture commercial arrangements that should not give rise to NRWT. For example, it could be argued that swaps, or collateral provided in relation to swaps, provide "funding", with the result that payments under a swap become subject to NRWT. This is a significant departure from the current position and appears inappropriate. *(Chapman Tripp)*

The definitions are very wide. We recommend clear examples be published by Inland Revenue of balances that fall within the definition of "money lent" and the definition of "interest", and balances that do not. For example, some derivatives have a funding element and there is uncertainty about whether this could / would capture those. *(Chartered Accountants Australia and New Zealand)*

Comment

Due to the variety of financial products available it will not be possible for officials to provide a definitive list of examples of arrangements that will or will not be covered by these definitions. It is also for this reason that the legislation uses the term "provides funding" rather than providing a definitive list of what is or is not covered by these rules. However, officials agree that guidance will be useful to taxpayers who are affected by these rules, and will provide a number of examples in the *Tax Information Bulletin* after the rules are enacted.

As noted elsewhere, arrangements that are not economically equivalent to a loan, such as a forward foreign exchange agreement or interest rate swap, or collateral provided in relation to swaps are not intended to be covered by the term "provides funding"

Recommendation

That the submission be noted.

Issue: Cross-reference between money lent and NRFAI

Submission
(Russell McVeagh)

Given that proposed section RF 2(1)(e) would expressly include NRFAI in the definition of non-resident passive income, it is unnecessary (and confusing) to also define "interest" and "money lent" in section YA 1 to include NRFAI. Alternatively, if the amendments to the definitions of "interest" and "money lent" are retained, they should be amended to refer simply to NRFAI as defined in section RF 12D (as the definitions currently proposed are not consistent with the way NRFAI is defined).

Comment

The amendments to the definitions of "interest" and "money lent" are to ensure that amounts which give rise to financial arrangement deductions also give rise to NRWT rather than as an additional definition of NRFAI. Officials do not consider any changes are required in this area.

Recommendation

That the submission be declined.

Issue: Interest relates to money lent

Submission
(Matter raised by officials)

Proposed section RF 2(1)(d)(i) includes that the "interest relates to money lent". This wording is too wide as this exclusion from the definition of non-resident passive income should be narrowly targeted at only specific interest that should not be subject to NRWT.

Comment

Officials recommend that this wording is replaced by the wording "is derived from", which also links better with the opening wording in existing section RF 2(1).

Recommendation

That the submission be accepted.

Issue: Lending by non-resident banks

Submission
(Matter raised by officials)

Proposed section RF 2(1)(d)(ii) should be reordered to make it clear that the New Zealand branch relates to the non-resident rather than the borrower.

Comment

This change will not alter the meaning of the proposed section but will clarify its application.

Recommendation

That the submission be accepted.

NON-RESIDENT FINANCIAL ARRANGEMENT INCOME

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

Issue: The proposals should not go ahead

Submission
(Chapman Tripp, Chartered Accountants Australia and New Zealand, Deloitte, EY, KPMG)

We are broadly supportive of legislative amendment to prevent a mismatch in timing of payment of NRWT and interest deductions for related party lending. However, the proposals in the bill, particularly the calculations required to determine whether a substantial deferral of payment of interest has occurred, seem an overly complex method of preventing a mismatch. *(Chapman Tripp)*

We agree that New Zealand's tax policy settings need to be robust and that there is a need to strengthen the NRWT rules in respect of back-to-back arrangements. However, with the exception of back-to-back arrangements, there is not a strong case to change the current policy settings on NRWT and AIL, particularly in advance of the Government finalising its decisions on anti-BEPS measures. *(Chartered Accountants Australia and New Zealand)*

These proposals have been subject to extensive consultation over the last year. We expressed concerns that the proposals as originally consulted would increase the cost of capital in New Zealand and potentially defer inbound investment. Measures included in this bill are more targeted and so will have a lesser impact. We remain unconvinced that some of the measures are required. *(EY)*

We remain of the view that there has been no clear statement of the underlying policy of the NRWT rules and the proposed changes appear to be ad hoc solutions to a set of disparate problems. Our strong recommendation is that changes to the NRWT and AIL regimes be considered concurrently with any changes to the interest deductibility rules to ensure consistency and coherence. *(KPMG)*

Comment

One submitter noted the recent publication by officials of *New Zealand's Taxation Framework for Inbound Investment – A draft overview of current tax policy settings*. Officials consider this provides further detail on how NRWT fits into the policy framework and supports the introduction of the proposals in the bill.

Officials consider the proposals do not represent any significant shift in the framework behind how interest payments to non-residents are taxed. Rather, the proposed changes are to level the playing field, ensuring that economically similar transactions are taxed in the same way. The proposed changes will also only affect a small number of taxpayers. Firms who are currently paying NRWT on interest payments should be unaffected by the proposals – the majority of firms that will be affected are those that have planned around the existing rules, but will now have to join other firms and apply those rules.

For this reason officials do not consider it is necessary to delay this project so decisions are made at the same time as decisions on other BEPS-related measures. The changes in this bill are to ensure existing taxes apply appropriately. Furthermore, the proposals seem entirely consistent with the BEPS agenda. In particular, a component of the BEPS agenda is aimed at eliminating tax benefits arising from borrowers deducting on an accrual basis while lenders recognise the same income on a payments basis.

Recommendation

That the submission be declined.

Issue: Alternative approach – denying interest deductions

Submission
(Chapman Tripp, OliverShaw)

A simpler approach would be to defer the interest deduction for related party lending until NRWT has been paid. *(Chapman Tripp)*

To the extent to which accrued interest deductions on which NRWT/AIL are not paid is a base maintenance problem, in the interim a targeted response that is more clearly consistent with DTAs (such as a targeted denial of interest deductions) should be developed. *(OliverShaw)*

Comment

Several countries, including Australia and the United States, have rules which defer or deny deductions for interest paid to a non-resident where NRWT is not paid on the interest. These rules can be complex to understand and are not always targeted at the same issue that the bill attempts to address of aligning the timing of income tax deductions and NRWT payments for related party debts. For example, the rule in Australia does not attempt to align the timing of the tax on the income with the timing of the deduction. Where the deduction is available in advance of the income being taxed, the deduction is allowed, but then denied if the tax is not paid.

A rule which would achieve a similar outcome to the bill would defer a borrower's income tax deduction for interest on related party debt until the lender (or the borrower on its behalf) paid NRWT on the equivalent income.

The principal advantages of deferring deductions instead of imposing NRWT are that:

- there would not need to be any changes to the existing NRWT rules; and
- the cashflow issues arising from requiring a borrower to pay NRWT in the absence of an actual payment do not arise.

While officials agree that a deferral of deductions would simplify some aspects when compared with incurring NRWT on an accrual basis, it would also create concerns that do not arise under the bill proposal. The primary reasons the bill proposal is preferred are:

- It is more economically sound. The financial arrangement rules are designed to give an accurate measure of a person's income or expenditure from financial arrangements, for the purpose of then calculating the person's tax liability. Deferring deductions will reduce this accuracy. That in turn has the potential to create difficulties. For example, deferral allows a company in tax loss to artificially preserve the interest deduction (by not paying it), in a situation where it might otherwise be eliminated by an ownership change.
- The deferral calculation would be complex. For example, suppose deferral were applied to a related party loan in a foreign currency. It would not make sense to apply deferral to the recognition of foreign currency movements on the loan, since these are not subject to NRWT in any event. Furthermore, if the loan is hedged, deferral of recognition of foreign currency movements might well create a timing mismatch. Deferring part of the expenditure but not all would be complex.
- It would be difficult to integrate with the thin capitalisation regime. Deferral would, prima facie, mean that interest economically incurred in one year would give rise (or not) to an additional amount of income under the thin capitalisation rules, depending on the borrower's debt/equity ratio in the later year when the interest is paid, rather than in the year it economically accrues. That would not be desirable.

Recommendation

That the submission be declined.

Issue: Alternative approach – anti-avoidance/intention test

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, Russell McVeagh)

The proposed annual deferral calculation should be replaced with a purpose or intention-based test when the loan is entered into. A purpose or intention-based test will prevent a substantial increase in compliance costs as a result of the proposed complex rules. Alternatively, the proposed rules should not be enacted and section BG 1 should be applied if loans have an inappropriate deferral mechanism. Guidance on how section BG 1 applies to loans with an inappropriate deferral mechanism should be published by Inland Revenue. *(Chartered Accountants Australia and New Zealand)*

It would be preferable to adopt a targeted anti-avoidance rule. One possibility would be a rule reversing prior year deductions under the financial arrangements rules if NRWT is not paid on or before a base price adjustment (BPA) is performed. *(Corporate Taxpayers Group, Russell McVeagh)*

Arrangements with the purpose or effect of deferring NRWT (or similar) should already be caught under section BG 1 of the Income Tax Act 2007. This may suggest that no law change is required to target such arrangements; however, for clarification, officials may want to consider a targeted principle-based test as an alternative. On this basis, officials should consider a principle-based test targeting arrangements that have the purpose or effect of deferring NRWT (or similar). *(Deloitte)*

Comment

An anti-avoidance rule would not address all of the concerns motivating the NRFAI proposals. For example, if a non-resident invests in a newly planted forest, there may be good commercial reasons for any related party debt to be non-interest paying. However, this situation should not be allowed to give rise to a mismatch between NRWT and interest deductions.

Officials consider that the proposals in the bill are appropriately targeted so that many of the transactions that would need to be covered by an anti-avoidance rule will also be covered by the proposals in the bill. The advantage of the bill proposals when compared with an anti-avoidance rule is increased certainty to taxpayers and Inland Revenue over whether a transaction is covered by the rules. Furthermore, anti-avoidance rules can create uncertainty over the appropriate reconstruction even if the anti-avoidance rule applies.

While anti-avoidance rules are often desirable, officials consider the proposals in the issues paper are a more appropriate response, and do not recommend they be replaced by an anti-avoidance rule.

Recommendation

That the submission be declined.

Issue: Interaction with double tax agreements

Submission
(Chartered Accountants Australia and New Zealand, Deloitte, EY, OliverShaw)

New Zealand's current double tax agreements (DTAs) have been negotiated, understood and applied in the context of the existing NRWT rules, which focus on interest payments. Analysis is required on how the proposed changes will be affected by New Zealand's DTAs. For example, it is unclear whether the changes will be subject to challenge under the treaties. *(Chartered Accountants Australia and New Zealand)*

There needs to be further consideration of DTA implications relating to the NRFAI proposals and publication of detailed explanations on when and how any DTA relief or limitations will apply to any NRWT payable under the NRWT amendments for related party debt and the NRFAI rules. Particular DTA issues needing such treatment include:

- whether or not NRFAI income deemed derived under New Zealand's domestic law will be treated as payment of interest to which the Interest Articles of all New Zealand's DTAs may apply to limit the rate of any New Zealand NRWT;
- the need for clarification of the intended relationship of proposed section RF 12I(3) to the NRWT provisions; and
- whether or not any DTA relief may apply and, if so, how, if section RF 12I(3) is intended to apply to the effect that some or all interest paid to a direct non-resident lender (or NRFAI deemed to arise in such situations) has to be treated as received on behalf of some other non-resident party and subject to NRWT.

Confirmation is also required that non-resident entities, which are deemed to derive NRFAI income, will be able to claim appropriate foreign tax credits in their home jurisdictions. *(EY)*

The bill proposes that the interest is "deemed to be paid" but that cannot override a treaty already entered into – that is, change the treaty by deeming something to be what it is not. A reasonable conclusion is that the bill proposals are overridden by our treaties in the absence of a specific treaty override. As a result, if the bill proceeds, we give up the ability to tax under NRWT rules and we do not have the ability to tax under NRFAI rules because of the DTAs. It would seem that New Zealand would lose the right to tax interest income of foreigners in many DTA countries. *(OliverShaw)*

Comment

Officials can see no reason to believe that imposition of NRWT on an accrual basis would breach New Zealand's current tax treaties. Most of New Zealand's tax treaties define interest to include income treated as interest by the state imposing the tax (see, for example, article 11(5) of the New Zealand/Australia DTA). Only a few older treaties (for example, the United Kingdom DTA) use the OECD Model. Even the OECD Model is likely to be expansively interpreted, in this respect.

Officials also note that if a deferral approach were to be implemented instead, that might face an issue of treaty consistency under some of New Zealand's treaties, which contain an older form of anti-discrimination article, prohibiting discrimination in the tax treatment of a payment for the payer on the basis of the residence of the payee.

Officials do not agree there is a requirement that interest be "paid" before a source country can tax it under a treaty. For example:

- Many of New Zealand's DTAs (for example, those with Australia, the United Kingdom and the United States of America) do not use the word "paid" at all.
- Those DTAs that do use "paid" use it in paragraph (1), which allows the residence country to tax interest arising in the source country. The reference in paragraph (2) to "such interest" does not necessarily incorporate the "paid" requirement".
- If "paid" were interpreted literally (in the way suggested by submissions), in those DTAs where it is used, New Zealand would not be able to apply the financial arrangement rules to tax New Zealand-resident lenders deriving interest from borrowers resident in the other state. Paragraph (1) would only give New Zealand the right to tax interest sourced in (for example) China if the interest was "paid". In almost 30 years, no-one has made that argument.
- "Paid" is not defined in any of the DTAs so can be defined in accordance with New Zealand law.

Officials do not believe that the imposition of NRWT on an accrual basis would affect a foreign lender being able to claim a foreign tax credit (FTC) in its home jurisdiction. It would not do so in New Zealand or in Australia, nor has any basis been put to us on which that could sensibly be argued.

It is common for countries to have different rules for recognising income and expenditure. FTC systems need to deal with this issue all the time. Logically, if a source country withholds tax on an item of income before the residence country taxes it, there should be no difficulty for the residence country giving a credit for the source country tax at the time that the residence country taxes the income. Both New Zealand and Australia's FTC systems work in this way.

For non-resident lenders who for residence-country tax purposes have to declare income on an accrual basis (as Australian lenders are required to) the new rules will accelerate their ability to claim a foreign tax credit.

Recommendation

That the submission be noted.

Issue: Interaction with transfer pricing

Submission
(EY)

New Zealand's income tax transfer pricing rules include several provisions to deal with compensating arrangements and the effect of adjustments made when an arm's length amount of consideration is substituted under sections GC 7 or GC 8. Section GC 12 provides that withholding tax obligations are not generally affected by adjustments under any of sections GC 7 to GC 10, except to the extent to which GC 11(2) applies.

The bill does not currently include any specific provision about whether or how the NRFAI rules may apply if interest expenditure on cross-border associated party lending into New Zealand is adjusted under the transfer pricing rules. The position should be clarified and the statutory provisions amended appropriately.

Comment

The interaction between NRFAI and a transfer pricing adjustment will be the same as the interaction between interest and a transfer pricing adjustment. If a New Zealand borrower has paid NRWT on NRFAI and a transfer pricing adjustment subsequently reduces the income tax deduction that borrower is entitled to, this will have no effect on the NRWT liability, unless an application is made under section GC 11. Alternatively, if the parties agree to a reduction in the financing cost for the borrower in line with the application of subpart GC, this will have the same impact on the lender's liability for NRWT on NRFAI as it would if the NRWT were imposed on interest.

Recommendation

That the submission be declined.

Issue: Amounts subject to NRFAI

Submission
(Chartered Accountants Australia and New Zealand)

The definition of non-resident financial arrangement income "NRFAI" in proposed section RF 12D should be amended. Amounts (for example, certain fees) paid to parties other than the non-resident related party lender should not be included in the calculation of NRFAI.

Comment

Officials agree that amounts that will not be received by the non-resident lender should not be included in NRFAI (for example, fees paid by the borrower to a third party that are part of the same arrangement). Equivalent modifications should also be made to the deferral calculation and prepayment rule for the same reason.

Recommendation

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

Issue: Timing of foreign currency conversion – general

Submission
(EY)

The general section YF 1(2) rule would require conversion at the close of the trading spot exchange rate "on the date at which the amount is required to be measured or calculated". In the NRFAI context we assume that should mean conversion as at the "NRFAI due date" (that is, the last day of the second month after a terminating event, otherwise the last day of the second month following the New Zealand borrower's balance date (section RF 12E)), with no further conversion required (or allowed) as at the date the related NRWT must be paid to Inland Revenue. Confirmation would be desirable.

Comment

As noted by the submitter, the date that NRFAI is treated as paid is provided in proposed section RF 12E as the last day of the second month after a terminating event, otherwise the last day of the second month following the New Zealand borrower's balance date. The currency conversion should be calculated as at that day consistent with any other interest payment that had been paid on the same date. Officials note that this is not the NRFAI due date which is defined in proposed section RF 2(9) and will usually be the 20th of the month following the date the payment is treated as paid.

Recommendation

That the submission be noted.

Issue: Timing of foreign currency conversion – de minimis limit

Submission
(EY)

It is not necessarily clear when amounts should be converted in determining whether or not the NZ$40,000 de minimis limit in proposed section RF 2B(3) is met. Clarification of that aspect would be desirable.

Comment

The conversion of expenditure under loans denominated in a foreign currency will use different rates, depending on whether the taxpayer is converting foreign currency flows (valued at spot) or balances – for example, end of year balance might be valued at spot, or might be valued at a forward rate from when the loan was entered into, using the expected value approach. The taxpayer already has to work out its New Zealand dollar expenditure from a financial arrangement, including a foreign currency financial arrangement and this is the amount that would be included for the purpose of applying the de minimis.

Recommendation

That the submission be noted.

Issue: Timing of foreign currency conversion – mismatches

Submission

(EY)

There would be substantial mismatches between the New Zealand dollar amounts of NRFAI income brought in under section RF 12 first year adjustments, assuming the latter would convert the total accrual income for all pre-NRFAI periods at the single "NRFAI due date" when it had to be brought into account. In some cases, the New Zealand borrowers may have been parties to relevant FAs for a number of years and the New Zealand dollar value of any "interest" amounts, even when distinguished from other elements of their FA expenditure in those past years, may be quite different from any amount calculated and converted as a single amount of a future NRFAI due date.

Comment

As with the general point above, the conversion date of a first year adjustment will be the date in proposed section RF 12E(b). Officials acknowledge choosing a single currency conversion point for the first year adjustment is highly likely to result in a different conversion rate from when the arrangement matures or the interest would have otherwise been paid. Whether this results in a greater or lesser amount of New Zealand dollar NRWT being payable will depend on the relative strength of the New Zealand dollar at the point of conversion. This does not seem problematic. As the NRWT liability is initially calculated in the currency that the arrangement is denominated in, there would be no subsequent adjustment for any first year adjustment treated as paid to the extent foreign exchange rates subsequently move. Officials will include examples of the currency conversion in the *Tax Information Bulletin* after the bill is enacted.

Recommendation

That the submission be noted.

Issue: Numerator and denominator should be consistent

Submission

(Chartered Accountants Australia and New Zealand, Deloitte)

The numerator and denominator in proposed section RF 2B(4) are inconsistent. Accumulated payments (numerator) refers to interest paid to all non-residents. In some cases this will be narrower than the accumulated accruals test (denominator), which refers to total expenditure under the arrangement. Total expenditure is the amount allowed as a deduction under a financial arrangement which may not equate to the actual interest paid to a non-resident. For example, total expenditure will include integral transaction costs.

Amounts may also be paid to a resident and non-resident (if there are syndicated/multiple lenders) or interest may be paid to a resident and then the loan transferred to a non-resident. This does not appear to be addressed by the proposal.

Comment

Officials agree that the numerator and denominator should be the same – both should refer to all payments and accruals.

Recommendation

That the submission be accepted.

Issue: Interest accrued to balance date

Submission

(EY)

We are pleased to see that the proposals in the bill have taken some account of submissions made on the May 2015 issues paper. In particular, we welcome the provision which should prevent the NRFAI rules applying in many situations where interest accrued to balance date is typically paid shortly after that date each year.

Comment

Officials always intended that interest accrued over a period of up to 12 months and paid after a balance date would not trigger the NRFAI rules applying. However, the method for achieving this was not outlined in the issues paper. Officials welcome support of the method included in the bill.

Recommendation

That the submission be noted.

Issue: Financial arrangement income

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, Russell McVeagh)

The interest or consideration payable to the non-resident related party lender should not be spread using the same spreading method as the related party borrower as the borrower might use a method that does not correlate to the interest payments – for example, a fair value method. A mechanism is required to prevent over-taxation of the non-resident, when the borrower has income in one year and a deduction in a subsequent year. *(Chartered Accountants Australia and New Zealand)*

Where a borrower fair values the financial arrangement, the amount allowed under the financial arrangement rules will diverge from the interest payments over the life of the financial arrangement. The deferral calculation might inadvertently catch transactions outside the intended focus and be wider reaching than intended. An appropriate alternative in this situation could be to provide an option of testing on an "accruals" basis. *(Deloitte)*

Comment

The NRFAI rules are not intended to impose NRWT on either currency fluctuations or fair value fluctuations. Nor are they intended to change the existing law, which does not allow non-residents to reduce the amount of their non-resident passive income by reason of currency fluctuations, fair value fluctuations or non-payment either of accrued interest or principal.

By calculating the NRWT liability in the foreign currency, a significant source of financial arrangement income of a borrower is already omitted from the calculations. We agree with submitters that under the reform, where a borrower is accounting for the cost of a borrowing using the fair value method, and the borrower recognises expenditure due to an increase in the fair value of the borrowing, that should not give rise to income subject to NRWT for the lender. Nor should NRWT be reduced when there is a decrease in the fair value of the loan.

Accordingly we agree that the calculations in sections RF 2B, RF 12D and RF 12F should exclude fluctuations due to changes in the fair value of an arrangement, just as they exclude fluctuations due to changes in the exchange rate in the case of a foreign currency instrument.

Recommendation

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

Issue: Wash-up upon maturity

Submission
(Corporate Taxpayers Group)

The NRFAI rules should include an adjustment or a wash-up mechanism to reflect any financial arrangements income of the borrower so that over the life of the arrangement NRWT is only paid on interest that is in fact paid by the borrower.

There is no adjustment or wash-up mechanism to recognise financial arrangement income. As a result, the rules could (over the life of a financial arrangement) require NRWT to be paid on an amount exceeding (potentially very significantly) the total net interest deductions claimed by the borrower. This would be an anomalous outcome and presumably is not intended.

Comment

Due to the changes recommended above it is not expected that any financial arrangement income that should not be subject to NRWT will be included in the NRWT calculation. Therefore there should not be any sort of wash-up to reflect the amount of income ultimately economically derived by a non-resident.

Recommendation

That the submission be declined.

Issue: Income of non-resident

Submission
(EY)

NRFAI is proposed to be included in a taxpayer's income under section CC 4, which is headed "*Payments of interest*", but proposed new section CC 4(3) does not expressly state that NRFAI should be treated as "interest" or "interest paid" for the purposes of the Income Tax Act 2007. We consider it would be desirable to include explicit statements to that effect in the body of section CC 4.

Comment

The purpose of section CC 4 is to confirm that NRFAI is "income". Clearly, it is income from the lending of money, and this should be sufficient to ensure that it is treated as interest for the purpose of any DTA. It cannot be defined as "interest" for purposes of the Income Tax Act 2007, because interest is only subject to NRWT when paid.

Recommendation

That the submission be declined.

Issue: Proposed NRFAI rules should not apply to existing arrangements

Submission

(Corporate Taxpayers Group, Russell McVeagh)

For arrangements entered into after enactment of the bill, it may be possible for the parties to negotiate at the outset terms which either ensure the NRFAI rules do not apply, or provide a mechanism for the borrower to recover the cost of the NRWT on the NRFAI from the lender.

This is not the case for pre-existing arrangements however. The broad definition of "related-party debt" will capture a range of transactions where the borrower and lender are not commonly controlled – for example, where the lender is a member of a non-resident owning body, or where the parties are associated under the associated person rules. It cannot be assumed in such cases that the borrower will be in a position to renegotiate or prepay the loan such that the NRFAI rules will not apply.

Accordingly, the proposals may impose an additional tax cost in respect of a transaction that was negotiated at arm's length before the NRFAI proposals were introduced. Further, it may not be clear who will bear the burden of that tax cost.

The NRFAI proposals should not apply to arrangements entered into prior to enactment of the bill.

Comment

Officials consider the application of the new rules to existing arrangements is appropriate. These changes are intended to cover situations when the current tax treatment creates the incorrect outcome. It would be inefficient to continue this tax treatment for the term of existing arrangements, which in some cases may be perpetual or indefinitely extendable.

While it is proposed that existing arrangements will be covered by the new rules, these rules will only apply to interest expenditure arising from the start of the year after enactment of the proposed new rules. Even when NRFAI applies, this will frequently result in the same total tax paid as under the existing rules (the result when the arrangement involves only deferral of NRWT).

It is also important that most changes will only affect related party debt which can, in the majority of cases, be restructured at relatively low cost if the parties choose to do so. Due to the operation of the deferral calculation no NRWT on NRFAI will be required to be paid until the due date for the NRWT return two months after the end of the second year starting after enactment of the proposed rules. This will provide two to three years post-enactment of the rules for any existing arrangements to mature or be restructured before they incur any cashflow or tax consequences.

When there is genuine commercial funding involving third parties, a small number of targeted grandfathering provisions have been included.

Recommendation

That the submission be declined.

Issue: Reforms should not have retrospective effect

Submission

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, EY, Russell McVeagh)

In the first income year for which NRWT is required to be paid on NRFAI for an arrangement, proposed section RF 12F requires NRWT to be paid on the NRFAI for that income year, plus any NRFAI (less actual interest paid) that would have arisen from the date on which the borrower became party to the arrangement ("first year additional amount").

In respect of existing arrangements, the inclusion of this first year additional amount has the effect that NRWT could be required to be paid on NRFAI deemed to arise in the years before enactment of the bill.

The *Commentary* suggests that taxpayers can "avoid" paying NRWT under this first-year adjustment calculation by "making sufficient interest payments after the enactment of the proposals so that NRFAI does not arise". As, in many cases, the borrower and lender will not be commonly controlled, there will be commercial tension between them, and therefore it cannot be assumed that they will agree to vary their arrangement as a result of the proposed amendments in the bill.

The first year additional amount should not include financial arrangements rules expenditure incurred in income years of the borrower commencing before enactment of the bill.

Comment

The deferral calculation for existing arrangements only includes deductions and interest payments after the application of the new rules so that existing arrangements are treated consistently with new arrangements. It is only when an inappropriate level of income deferral post-enactment triggers NRFAI that the first year additional amount incorporates amounts accrued before the application of the new rules.

As demonstrated by example 4 on page 40 of the bill *Commentary*, including accrued interest in a first year additional amount calculation can still result in a deferral of NRWT compared with replacing an existing loan with a new loan that does not have an inappropriate level of income deferral. If not for this treatment borrowers would have an incentive to maintain existing arrangements indefinitely to permanently delay the payment of NRWT for interest accrued before enactment – an approach that is specifically targeted by the proposals.

The first year additional amount calculation also delays the payment of NRWT compared with applying section BG 1 to an arrangement, a proposal preferred by a number of submitters.

Officials acknowledge that there may be a limited number of cases where a borrower and lender of a related party debt will not be commonly controlled. Cases considered by Inland Revenue, however, suggest that in the vast majority of cases the lender will have sufficient control over the borrower that the benefit of their funding decisions will be aligned.

Recommendation

That the submission be declined.

Issue: First year adjustment

Submission
(Deloitte, EY)

In the first year that a non-resident derives NRFAI on a related party debt, the borrower will need to pay NRWT in relation to the debt for that income year. The proposals also require the non-resident to perform a "wash-up calculation" and pay NRWT to the extent any NRWT was deferred in previous income years (including income years the arrangement existed before enactment of these proposals). We are not supportive of this proposal. Proposals are inconsistent with the officials' issues paper, which proposed to perform the wash-up calculation in the income year that the financial arrangement matures. We are supportive of the approach in the issues paper. We submit that the wash-up calculation in relation to the payment of deferred NRWT should be made in the year the financial arrangement matures. *(Deloitte)*

The proposed NRFAI rules, particularly the proposed transitional "catch-up" adjustment, are punitive for taxpayers that made commercial decisions to invest in New Zealand forests years ago and entered into long-term funding arrangements to fund those investments on the basis that the payment of interest, with any resulting NRWT cash liability, would be met from revenues of harvesting completed at the end of a production cycle. *(EY)*

Comment

Officials note that the first year adjustment will only apply to existing arrangements when they continue to have interest payments that are less than interest deductions on related party debt after the enactment of the proposed new rules. When a borrower starts making interest payments (including crediting interest to the lender or funding interest payments by additional borrowing from the related party recipient of that interest) from the enactment of the proposed new rules the first year adjustment will not apply. This will result in an identical treatment to the maturity wash-up proposed in the issues paper, except that the NRWT obligation will be accelerated so that it matches deductions. This seems an entirely appropriate result.

Officials also note that these rules will only apply when an investment (such as forestry) is debt funded by a non-resident related party. In most instances these investments will generate sufficient cashflow to pay the NRWT impost. If not, it should be possible for the lender to fund the NRWT. In any case, NRWT will only be one cost of running the business.

The first year adjustment as contained in the bill was also recommended over the wash-up calculation proposed in the issues paper due to the significant complexity that would be required in the case of a wash up calculation.

Recommendation

That the submission be declined.

Issue: Deferral calculation where there is a novation

Submission
(Deloitte)

There is a risk that the deferral calculation does not work when there is a novation of a liability, as a borrower may be entitled to a deduction that is greater than the amount paid as interest. We consider that taxpayers would benefit from examples that show how the deferral calculation works in different transaction examples (for example, buying and selling the asset or liability for different values that can create a difference between the deduction and the NRWT/interest amount).

Comment

When a debt is novated the obligations of the borrower are taken over by a third party and the original borrower’s financial arrangement will mature which triggers a base price adjustment. If NRFAI had not yet been derived under that arrangement – as would be the case if the deferral calculation were still required – then the existing NRWT rules would continue to apply. Examples will be included in the *Tax Information Bulletin* once the bill is enacted.

Recommendation

That the submission be noted.

Issue: Examples of amounts other than interest

Submission
(Deloitte)

An example of how these rules are intended to work where amounts/consideration other than interest is included in the financial arrangement would be useful (for example, convertible notes, derivatives that have a funding element, financial reinsurance, credit/asset/index linked notes and the impact of “integral” transaction costs).

Comment

Examples will be included in the *Tax Information Bulletin* once the bill is enacted.

Recommendation

That the submission be noted.

Issue: Minor drafting points

Submission
(Chartered Accountants Australia and New Zealand, EY, Russell McVeagh)

The word “to” should be inserted between “person A” and “all non-residents” in section RF 12F(3)(b) before subparagraph (i).

In section RF 12H(1)(a)(iii), the cross-reference should be to “section RF 12I(4)”, rather than to “section RF 12I(3)”.

Comment

Officials agree with submitters. One submitter suggested that the reference in section RF 12H(1)(a)(iii) should be to section RF 12I(4) and (5) – officials do not consider a cross-reference to section RF 12I(5) is necessary.

Recommendation

That the submission be accepted.

Issue: Definitions of “person A” and “person B”

Submission
(New Zealand Law Society, Russell McVeagh)

The provisions in the bill dealing with NRFAI refer in a number of places to “person A” and “person B”. These references are confusing. It appears that these terms are defined in section RF 2B, and then used in other sections (for example, RF 12D) without reference back to the section RF 2B or to a standardised definition (for instance in section YA 1). *(New Zealand Law Society)*

To ensure that the NRFAI rules apply only where the borrower is subject to the financial arrangements rules and the lender is not, the definitions of “person A” and “person B” (in proposed section RF 2B(1) should be amended to align with the test for whether the financial arrangements rules apply (in section EW 9). As currently drafted, the NRFAI rules could apply in situations where both the borrower and the lender are subject to the financial arrangements rules in respect of the relevant arrangement. *(Russell McVeagh)*

Comment

The first submitter is correct that these terms are defined in section RF 2B then used in other sections without reference back. This is consistent with the drafting convention for related provisions. However, to assist application of these provisions, officials recommend references to “person A” and “person B” be replaced by the terms “borrower” and “lender”.

The NRFAI rules are not necessary where the lender is subject to the financial arrangement rules as they will already be subject to New Zealand income tax. Officials recommend changes to section RF 2B to ensure NRFAI does not include a lender that is a New Zealand branch of a non-resident.

Recommendation

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

Issue: Deferral calculation documentation

Submission
(PwC)

Although the outcome of the deferral calculation is not expected to require adjustments for a large proportion of taxpayers, in practice, we anticipate that all New Zealand borrowers with related party loans will need to consider the deferral calculation and document their compliance. In this respect, we note that the proposed calculation is still complex and will take taxpayers some time to consider and apply as intended. Inland Revenue should provide further guidance by way of a publication such as the *Tax Information Bulletin* to assist taxpayers and their advisors determine the potential application of the rules, with detailed examples and practical suggestions to minimise the complexity and compliance costs.

Comment

Officials do not intend for there to be a prescribed form for the deferral calculation. Taxpayers will, however, be expected to complete and retain sufficient records to support their tax position. As the deferral calculation is only important in determining whether NRFAI has been derived, rather than the specific value of that calculation, officials would expect that the record keeping would be broadly proportional to the significance of the calculation. For example, a related party debt that had regular interest payments equal to the interest accrued since the previous interest payment would not be expected to be near the 90% threshold so the records to support this would not need to be particularly detailed. Likewise a related party debt that did not have any interest payments would be treated as over 90% at the first NRFAI due date but would be less than 90% at the second NRFAI due date so again minimal records would be required. In contrast, a taxpayer that completed a deferral calculation showing that the result of the formula was 92% would need to maintain sufficient records to satisfy the Commissioner, if requested, that the 92% figure was accurate and should not instead be below 90%.

Recommendation

That the submission be noted.

Issue: Commencement date should be clarified

Submission

(Russell McVeagh)

Based on the *Commentary* to the bill (see in particular the examples at pages 37 to 40), officials' intention appears to be that, for an arrangement entered into before enactment, the first income year in respect of which the NRFAI rules could apply would be the second complete income year after enactment. For example, for a taxpayer with a 31 March balance date, assuming the bill is enacted before 31 March 2017, the earliest income year in which NRWT could be payable on NRFAI would be the income year ending 31 March 2019.

The mechanism by which the bill appears to achieve this is, however, highly complex. It relies on the fact that first, a financial arrangement would not become related party debt until section RF 12H applies (being the first income year after enactment) and secondly, the deferral calculation will not be breached in the first income year as a result of the rule in proposed section RF 2B(7)(b).

To reduce complexity and provide greater certainty, the intended date from which NRFAI could arise for existing arrangements should be more clearly and expressly stated in the bill.

Comment

Officials agree that the submitter has accurately applied the rules in their supplied example. The deferral calculation compares deductions up to the end of the previous year with interest payments up to the end of the current year, plus the period up to the NRFAI due date. This is necessary so that interest payments made after a balance date can be compared with interest accrued during the previous year. A consequence of this is in the first year an arrangement is related party debt, there is no previous year to compare the current year interest payments against. To resolve this, the proposed rules treat the deferral calculation as being over 90% for the first year of all arrangements that are related party debt.

For an arrangement that exists before the enactment of the proposed rules, the NRFAI rules will apply from the beginning of the first year but consistent with arrangements entered into after enactment, the deferral calculation only considers interest payments and interest accrued from when the proposed rules apply to the arrangement. A consequence of this is that NRFAI will not arise, at the earliest, until the second year.

As the NRFAI rules will apply to existing arrangements from the beginning of the taxpayer's first year after enactment of the bill it is not possible to define when the rules will apply as this will be dependent on the enactment date of the bill and the taxpayer's balance date.

Recommendation

That the submission be declined.

Issue: Symmetry between income and deductions

Submission
(EY)

If there is a policy focus on symmetry between New Zealand borrowers' deductions and income derived by non-resident lenders, then the provisions as currently drafted in the bill will be unlikely to achieve any symmetrical result where FAs are denominated and payable in overseas currency. Several of the proposed provisions refer to the total expenditure incurred by the New Zealand borrower under the FA rules. The proposed section RF 12D(2)(b) requires the borrower's spreading method under the FA rules to be used. But related provisions require that amounts be calculated in the currency of the FA which conflicts with the basic approach applied for the borrower under the FA rules.

There are difficulties in terms of mixed and inconsistent concepts in the NRFAI rules as currently drafted, which are likely to cause uncertainty and add to compliance, particularly in relation to foreign currency FAs. They include references to NRFAI amounts equalling the "expenditure incurred" by the borrower and requiring the borrower's spreading method to be used yet requiring calculations to use the currency of the FA.

Comment

The policy behind this change is to more closely align the deductions available to borrowers with income derived by related party lenders. The most egregious outcome under the existing rules is where a deduction is available to the borrower and the lender never has withholding tax withheld. Officials acknowledge it is not appropriate to exactly align these concepts, such as amounts calculated in a foreign currency as raised by the submitter. Calculating amounts in a foreign currency removes the effect of currency fluctuations from the scope of NRWT, which is consistent with New Zealand's current approach and international standards. Officials do not consider these differences detract from the desirability of achieving the overall goal.

Recommendation

That the submission be noted.

Issue: Special purpose vehicles

Submission
(Corporate Taxpayers Group, Russell McVeagh)

If NRWT is payable on NRFAI in circumstances when no interest (or less interest than the amount of NRFAI) has in fact been paid to the relevant lender, this will be problematic from a cashflow perspective for a securitisation special purpose vehicle (SPV). That is because securitisation SPVs do not tend to retain excess cash, but rather will typically pay out all cash receipts in accordance with a prescribed "cash waterfall". The practical result if NRWT is payable other than by reference to actual payments of interest (which it can then be deducted from) could be that the returns received by another (non-associated) lender to securitisation SPVs are reduced.

Further, the stated policy rationale for the NRFAI rules (to prevent related parties intentionally structuring lending arrangements so as to claim an immediate deduction for interest but defer payment of NRWT) does not apply to securitisation structures. That is because securitisation SPVs are intended to be tax-neutral and cashflow-neutral on an annual basis. Even if a securitisation SPV were to claim a deduction for accrued but unpaid interest or fair value adjustments on its liabilities, the SPV will likely be recognising corresponding income in respect of interest owing to it under, or fair value adjustments in respect of, the receivables it holds, such that there is no timing advantage for the SPV to bring forward the time at which it claims deductions.

We also note that although one of the lenders to the SPV may be associated with the SPV for tax purposes (for example, because it holds the nominal shares when the SPV is a company or it settled the SPV when the SPV is a trust), neither that lender nor any other lender would typically be associated with any of the underlying borrowers and the terms of the lending by the associated lender would typically be the same as for one or more other lenders. This reinforces the fact that securitisation SPVs are not within the intended scope of the NRFAI rules and should be excluded.

Comment

Officials understand that this issue largely arises due to fair value movements which, as noted elsewhere in this report, have been recommended to be removed from the deferral and NRFAI calculations.

Whether or not securitisation vehicles are intended to be cash-neutral is not relevant to the application of this reform to them. The fact that often none of the SPV funders are related to the underlying borrowers is also not relevant. It is the relationship between the SPV and its funders that is relevant. If an SPV is associated with a funder, and the SPV is entitled to a deduction for expenditure on a loan from the associated funder, it is not clear why NRWT should not be imposed at a similar time under this reform.

Recommendation

That the submission be declined.

Issue: Turning off NRWT on a payments basis

Submission
(Matter raised by officials)

Section RF 2(1)(d)(iii) should be amended to ensure NRWT on a payments basis is only disabled once NRWT on NRFAI is required to be paid.

Comment

Once NRWT is required to be paid on NRFAI, NRWT should not apply to any subsequent payments. The bill proposes to achieve this by excepting an interest payment from being non-resident passive income if it is paid after the first NRFAI due date for the financial arrangement. However, the NRFAI due date is the date the deferral calculation is required so will first occur at the end of the first year the arrangement is a related party debt. This is not appropriate, since related party debt will not necessarily give rise to NRFAI.

Recommendation

That the submission be accepted.

Issue: Onshore branch exemption

Submission
(Matter raised by officials)

NRFAI should not be derived when the lender is a non-resident acting through their New Zealand branch as this is a valid use of the onshore branch exemption.

Comment

If the New Zealand branch of a non-resident provides funds to an associated New Zealand borrower, the New Zealand branch will derive New Zealand-sourced income that will be subject to New Zealand income tax. Accordingly, any interest payments on this lending should not be subject to NRWT so should also not be covered by non-resident financial arrangement income. This can be achieved by removing such lending from the scope of section RF 2B(1).

Recommendation

That the submission be accepted.

BACK-TO-BACK LOANS

Clause 253

Issue: Support for proposals

Submission
(Chapman Tripp)

The bill proposes changes in relation to "back-to-back" lending and similar arrangements, which we understand are intended to prevent application of the approved issuer levy rules in circumstances when lending is, in substance, between related parties (but provided via an unrelated party in order to access AIL). We support legislative amendment to require NRWT in these circumstances.

Comment

Officials welcome the support.

Recommendation

That the submission be noted.

Issue: Alternative approach – intention test

Submission
(ANZ, Chartered Accountants Australia and New Zealand, Chapman Tripp)

The wording of proposed section RD 12I(2), which determines what is a "back-to-back" loan, creates significant uncertainty. Proposed section RF 12I(2) captures arrangements when a non-resident parent entity provides funds to a bank "in order for" the bank to provide funds to the non-resident parent entity's New Zealand subsidiary or the non-resident parent entity "compensates" the bank for providing funds to the non-resident parent's New Zealand subsidiary. As section RF 12I is, in essence, a specific anti-avoidance provision, it would be better that more typical anti-avoidance wording is used to determine when the "back-to-back" loan rules apply. This will create a more appropriate nexus between the provision of funds or compensation to the bank being provided to the New Zealand subsidiary for the purpose of defeating the intent of the NRWT rules. This is exactly what these proposed rules are designed to counter. A significant risk exists that, with such broad and uncertain wording, legitimate banking arrangements may be inadvertently captured.

Comment

Officials believe that the proposed wording, as amended in accordance with the submission considered immediately below, introduces an appropriate intention requirement. The section will not be engaged simply because a non-resident provides funding to a bank that also provides funding to a resident who is associated with the non-resident. The funding provided by the non-resident must be provided for the purpose of inducing the bank to provide funding to the resident, or to reimburse the bank for doing so. This will not be the case if the transactions are independent, and each could occur in the absence of the other.

Recommendation

That the submission be declined.

Issue: Working capital and similar commercial arrangements

Submission
(Chapman Tripp, PwC)

We are concerned that the legislation as drafted could have wider application and apply to genuine commercial arrangements that are not in substance related party lending. The mechanism for capturing back-to-back loans and similar arrangements as related party lending is the definition of "indirect associated funding" in proposed section RD 12I(2). The definition is in our view very broad, referring to the provision of compensation "in any way" in section RF 12I(2)(b). There is a risk that standard banking arrangements, such as working capital facilities provided to multi-national groups, could be captured. This is reinforced by the example provided in the *Commentary* on the bill that refers to cash pooling arrangements. We do not consider it appropriate for working capital facilities and similar commercial arrangements to be treated as indirect associated funding and submit that proposed section RF 12I(2) should be amended to ensure an appropriate outcome.

Comment

Officials do not intend that genuine commercial funding borrowed by a New Zealand resident from a third party, including funding from a bank which has entered into a cash pooling arrangement with the resident's worldwide group, would be covered by the wording of proposed section RF 12I(2), which requires that the indirect lender provides funds so they can be on-lent (or reimburse the direct lender for doing so) to the New Zealand borrower. This can best be demonstrated by the following examples:

- If a New Zealand borrower has a loan from the same worldwide banking group that an associated non-resident lender has lent to, this will not be covered unless there is a specific agreement that the bank would not have lent to the New Zealand borrower unless another party made the deposit or other similar agreement (for example, under a setoff or cross-guarantee arrangement).
- If a New Zealand taxpayer and an associated non-resident both use the same cash pool for their working capital facilities and the New Zealand borrower happens to have a negative balance for a short-term and the non-resident happens to have a positive balance this will not automatically trigger the back-to-back provisions as both transactions are independent of each other, other than the existence of the cash pool.
- If a New Zealand taxpayer has an on-going funding requirement and chooses to use a cash pool (instead of a more conventional bilateral lending arrangement) to meet this funding need and where there is an arrangement where one or more associated non-residents have a credit balance in account subject to the cash pool, then this may be a transaction that the back-to-back provisions would apply to.

Officials see there is a distinction between the second and third example. In the second example the New Zealand taxpayer and the non-resident are operating their cash pool accounts independently of each other and just using the facility offered by the bank to manage their working capital. Both parties will be free to deposit and withdraw money independently of the other party (subject to any borrowing limit that may be imposed by the bank) and the parties are likely to have fluctuating balances. In the third example, the New Zealand borrower requires funding on more than just a working capital basis and the degree of coordination between the New Zealand borrowing and the non-resident lending makes this transaction economically equivalent to a loan directly from the non-resident to the New Zealand taxpayer.

However, to address some concerns raised by submitters, officials recommend that an intention requirement is added to section RF12I(2). This should be in addition to the existing proposed requirements.

Officials note Inland Revenue has concerns that cash pools may give rise to inappropriate NRWT minimisation. The use of cash pools will be monitored by Inland Revenue and a further policy response may be considered in the future if this continues to be a concern.

Recommendation

That an intention requirement be added to the back-to-back provision.

Issue: Indirect associated funding should be narrowed

Submission
(Chartered Accountants Australia and New Zealand, Russell McVeagh)

Proposed section RF 12I(2) provides that indirect associated funding exists when the indirect lender either “provides funds” or “pays money” to a direct lender, in order for the funds to be provided to person A, or “to reimburse the direct lender, or compensate them in any way, for providing the funds to person A”.

This could have some overreach, because it could apply to situations when the “indirect lender”, for example, pays bank fees to the “direct lender” as opposed to arrangements when the “direct lender” has been interposed between lending that would otherwise have gone directly from the indirect lender to “person A”.

Section RF 12I(3) should be amended to clarify that it is only the provision of principal amounts by the indirect lender to the direct lender which can give rise to indirect associated funding.

Comment

Officials agree it would be possible for the back-to-back provisions to be triggered by an indirect lender paying bank fees to a direct lender when that payment was to reimburse the direct lender, or compensate them in any way, for providing the funds to the borrower. This would, however, depend on the specific facts of the arrangement. For this to apply there would have to be a link between that payment and the funds provided to the borrower, which would often not be present.

Given that back-to-back loans are already structured to achieve the desired tax outcome officials consider it would be difficult to design a rule that carved out specific payments by a non-resident associate without creating structuring opportunities to allow back-to-back loans of the type intended to be covered to be also carved out.

Officials also note that a payment of indirect associated funding is only treated as paid to the direct lender as agent for the indirect lender to the extent to which the amount is not more than the amount paid by the direct lender to the indirect lender. The consequence of this is if an arrangement was only indirect associated funding due to a payment of bank fees by the indirect lender, there would be no payment at all from the direct lender to the indirect lender. Therefore, none of the payment by the borrower to the direct lender would be affected by these provisions, and they would not give rise to any additional NRWT.

Recommendation

That the submission be declined.

Issue: "As agent" provisions should be removed

Submission
(ANZ, New Zealand Bankers' Association)

It appears, at least from the C*ommentary* to the bill, that if a New Zealand subsidiary does not pay the NRWT applicable where the back-to-back loan rules in proposed section RF 12I apply, the New Zealand bank will be obliged to pay the NRWT (through operation of the proposed "as agent" provision). For the following reasons, it is inappropriate to push this obligation to banks and the proposal will create rules that will be impossible to apply in practice:

- The bank may have no knowledge of whether the back-to-back loan rules are applicable to its customers. The back-to-back loan rules appear to be triggered where an intention or purpose to have a back-to-back loan exists in a non-resident parent entity. Such an entity will not be related to the bank. The non-resident parent entity's intention or purpose may not be known by, nor can be subsumed to, the bank.
- The bank will not know whether the New Zealand subsidiary has paid the NRWT. Pushing NRWT liability onto the bank, when it is not paid by the New Zealand subsidiary, is unfair. For example, if the New Zealand subsidiary was audited by Inland Revenue, which identified that NRWT should have been, but was not paid, by the New Zealand subsidiary, Inland Revenue may seek payment from the bank. In essence, the bank becomes liable for the poor tax compliance of the New Zealand subsidiary over which the bank has no control.
- Assuming the NRWT should be based on an accrual of interest per the NRFAI rule, the bank will have no knowledge of what the interest would be. The NRFAI rules are complex. They require an inherent knowledge of whether the proposed de-minimis rules would apply, determining the deferral calculation and the detailed workings of how the payer of the interest determines their accounting and income tax positions. The bank will not have this knowledge.

- The New Zealand subsidiary will be a New Zealand taxpayer within the New Zealand tax system. As such, if the New Zealand subsidiary did not pay NRWT but should have, it should be the only entity that is liable for the NRWT.

Comment

The submitters' concerns arise from proposed section RF 12I(3)(b), which treats the amount as paid to the direct lender as agent for the indirect lender. Officials agree that it would be inappropriate for Inland Revenue to pursue the direct lender for unpaid NRWT in certain circumstances. Officials consider, however, that treating the direct lender as agent for the indirect lender is still the correct starting point.

The items above should go some way to addressing submitters' concerns about the scope of the indirect associated funding provisions. The lack of commerciality in indirect associated funding mean that with the possible exception of certain cash pooling arrangements, there will be very few, if any, arrangements when the arrangement would be indirect associated funding without the direct lender being involved in negotiating the facilities that resulted in the provisions being applied. Even in a cash pooling arrangement the scale of borrowing relative to any previous limits that may have been negotiated by the borrower would be likely to put the bank on notice that they should make further enquiries with the borrower.

Officials also expect that if the law is enacted as proposed, financial intermediaries will minimise their risk by ensuring that they do not get involved in back-to-back transactions and, where necessary, requiring representations from their clients that they are not entering into transactions with the objective of avoiding NRWT. This will assist in achieving the objectives of the legislation.

However, officials agree that further clarification of the application of agency provisions to indirect associated funding is desirable. This is addressed in the item below.

Recommendation

That the submission be declined.

Issue: Application of "as agent" provisions

Submission
(Matter raised by officials)

Application of the "as agent" treatment of indirect associated funding should be clarified.

Comment

The proposed treatment, as explained below, is broadly in line with existing agency provisions that already apply to NRWT.

Officials consider the following principles should apply to an arrangement that meets the indirect associated funding definition:

- The borrower is required to withhold NRWT from interest payments that are deemed to be to the indirect lender (even if the direct lender is a New Zealand resident).
- If the borrower does not withhold NRWT (or withholds insufficient NRWT) the indirect lender should deduct the requisite amount of NRWT at the time they receive the payment.
- The direct lender will not have an obligation to deduct NRWT from the payment received if they have taken actions to confirm that this is not a back-to-back loan but have incorrect information. For example, if the borrower incorrectly represents that this is not a back-to-back loan.
- If the arrangement has insufficient interest payments that result in the NRFAI deferral calculation for the borrower being less than 90%, the borrower is required to pay NRWT on the NRFAI. The direct lender cannot be expected to know that this arrangement is NRFAI or the amount of NRFAI calculated so will continue to have the same obligations as above on any interest payments received. Any NRWT withheld by the direct lender on a payments basis will be available to the borrower and/or indirect lender to meet any NRWT liability arising on an NRFAI basis.
- In the event that the above NRWT was not withheld/paid by the relevant parties Inland Revenue would commence collection activity consistent with other debts. Inland Revenue would generally attempt to collect this tax from the borrower or the indirect lender in the first instance before attempting to collect from the direct lender and would not attempt to recover this tax from the direct lender when they did not originally have an obligation to withhold under the principles above.

Officials recommend drafting changes to ensure the above principles are achieved.

Recommendation

That the submission be accepted.

Issue: Double tax agreements and tracing

Submission
(EY, PwC)

Even assuming any relevant payments or income could be treated as interest paid for any DTA purposes, it is not clear that any DTA relief would necessarily then apply. The Interest Articles of New Zealand’s DTAs typically refer to interest payments as well as to the beneficial owners of the interest in some way in limiting the maximum rate of tax. Some DTAs expressly require the recipient of the interest to be its beneficial owner and be a resident of the relevant state but do not expressly require identity of recipient and beneficial owner.

We anticipate possible uncertainties and difficulties arising in some cases in determining which, if any, DTA may apply and whether any DTA relief may be available if section RF 12I(3) applies to treat an indirect funder:

- as the recipient of interest paid while the direct lender remains the legal and beneficial owner of that interest; and

- as deriving NRFAI, rather than interest payments, when the NRFAI rules supersede the general NRWT rules. *(EY)*

In a cash pooling scenario, when a company group may have multiple entities who deposit cash within the same cash pool, we foresee significant difficulty in the ability of the group to trace a loan out of the cash pool to the New Zealand borrower to specific cash deposits made by other companies in the cash pool group. The *Commentary* to the bill notes that when a portion of the borrowing is also supplied by the unassociated third party, an apportionment of the loan/interest payments is required to be undertaken to determine the portion of the loan that is supplied by a non-resident related party via the cash pool and how much is supplied by the unassociated third party. These calculations are likely to be complex and require significant oversight of the cash pool and lending arrangements for the group that the New Zealand group borrower in most situations will not have. In practice, when the New Zealand operations of a worldwide group only constitute a minor part of the group, the New Zealand borrower may experience difficulties in receiving the required documentation from its worldwide group and therefore the ability of the New Zealand entity to determine the financing decisions behind a loan received could be limited.

Further, in the case of the deemed loan from the non-resident related party, our understanding is that it is unlikely that the deemed lender will be in a position to claim a foreign tax credit for the NRWT withheld on the deemed loan. This will lead to double taxation on the payment from New Zealand.

Lastly, it should be noted that typical cash pooling arrangements include a gross up clause, whereby the New Zealand borrower will be required to "make good" any payment to the third party bank to ensure that its return on lending to the New Zealand borrower is not negatively impacted by the deemed related party loan and subsequent NRWT imposed. This additional cost of funds that will arise to the New Zealand borrower is counter to the policy drivers at the time of the introduction of the AIL regime. (*PwC)*

Comment

Officials have not considered whether a foreign tax credit would be available to the non-resident lender nor whether other DTA relief may apply. However, we note that these rules are essentially an anti-avoidance provision intended to result in a New Zealand tax treatment that is equivalent to recharacterising the loan in accordance with its economic substance. Any lender that found they were unable to claim a foreign tax credit on a back-to-back loan could restructure it as a loan directly from the non-resident to the New Zealand borrower.

Officials do not intend that commercial cash pooling account transactions of the type described by the submitter would be caught by the proposed back-to-back rules as they will not have a sufficient linkage between the New Zealand borrowing and the non-resident deposit. Examples of the types of cash pooling transactions that would be covered are when the New Zealand borrower uses a withdrawal from a cash pool to replace a previous related party loan at the same time that related party deposits a similar amount into the pool or when the New Zealand borrower has a new funding requirement and withdraws from the cash pool at the same time a related party deposits a similar amount having reached some agreement with the New Zealand borrower to do so. In these circumstances officials expect the New Zealand borrower would hold sufficient documentation to comply with their tax obligations without needing significant additional information from other members of the group.

The apportionment requirements are intended to make the tax outcome more consistent with the economic substance, which in this case, would be a loan from a related party and a separate loan from the direct lender. Officials consider it would be inappropriate to classify an entire loan as requiring NRWT when only a portion of it had been funded by a related party. Given the significant hurdle that needs to be met before an arrangement is classified as indirect associated funding (see for example the cash pooling examples above), officials expect the New Zealand borrower would have sufficient information that apportionment would not provide many practical difficulties.

Officials expect that most, if not all, lending in these circumstances would have a gross up clause so the third party borrower did not bear the incidence of the NRWT. This would be a commercial relationship between the respective parties that does not involve Inland Revenue. Officials do not agree that imposing additional costs on the New Zealand borrower is counter to the policy drivers of the AIL rules. The AIL rules have only ever applied to third party debt. These new rules will only be triggered when lending is in substance between associated parties but has been channelled through a third party for the purpose of inappropriately avoiding NRWT.

Recommendation

That the submission be declined.

Issue: Intended application of proposed section RF 12I(3)

Submission
(EY)

Proposed new section RF 12I(1) states that section RF 12I applies "for the purposes of section RF 12H to describe what is meant by arrangements involving indirect associated funding and funding through non-associated entities acting together". That wording suggests the section RF 12I provisions would be solely descriptive in function.

The proposed section RF 12I(3), however, states that payments will be treated in particular ways when indirect associated funding exists. That subsection does not appear to play any meaningful role in describing the sort of arrangements that are intended to fall within the section RF 12H definition of "related party debt".

If section RF 12I(3) is intended to play such an active role, it is not appropriate to include it in section RF 12I. Alternatively, the wording of section RF 12I(1) needs revising to provide a more appropriate description of the section's function and scope.

Comment

We agree that section RF 12I should be split into two so that descriptions and active provisions are appropriately separated.

Recommendation

That the submission be accepted.

Issue: Interposed trusts

Submission

(PwC)

The bill captures situations where a trust is interposed between the borrower and the lender and the non-resident has settled 50% or more of the trust. We expect that this proposal will have limited application, but note that the specific inclusion of an interposed trust was not outlined in the May 2015 issues paper. We request commentary as to the policy driver and application of this change.

Comment

Officials consider that the inclusion in the back-to-back loan rules of a loan which is made by a non-resident to an associated resident through an interposed trust is consistent with the issues paper. The purpose of the back-to-back proposals is to identify and recharacterise loans that interpose a non-associated party between two associated parties. Where one of these is a trust the same rules should also apply.

Recommendation

That the submission be noted.

Issue: New Zealand-resident direct lenders

Submission

(PwC)

It appears the bill will capture situations when a New Zealand-resident third party is interposed between the New Zealand borrower and the foreign lender. We request further commentary on the specific situation when a New Zealand-resident third party lender is interposed between the New Zealand-resident borrower and foreign lender.

It is unclear whether, in this situation, the loan between the New Zealand-resident third party and New Zealand borrower would still be deemed to be between the foreign lender and the New Zealand-resident borrower and therefore require NRWT to be withheld on interest payments made to the New Zealand-resident third party lender. This obviously would not be the answer without specific deeming provisions stating otherwise.

Other questions that arise are whether the third party lender is considered to derive the interest income, and could the New Zealand borrower have resident withholding tax (RWT) obligations as well to the New Zealand third party lender. The outcome of these issues needs to be considered. This scenario appears to produce an inconsistent tax outcome and we consider further guidance is needed.

Comment

In this circumstance the financial arrangement between the New Zealand borrower and the New Zealand third party is replaced in whole or in part by the financial arrangement between the New Zealand borrower and the non-resident, with the New Zealand third party acting as a kind of paying agent.

The consequence of this is that the New Zealand borrower's RWT obligation (if any, given most lenders will have an RWT exemption certificate) is replaced by an NRWT obligation. The New Zealand third party will also have not received any interest income for income tax purposes.

The consequence is the same as if the indirect lender, wishing to make a loan to person A, had provided the loan funds to the direct lender as agent, which the direct lender then provided to person A. Person A's payments to the direct lender that are in repayment of this loan are similarly received by the direct lender as agent, and passed on to the indirect lender. This is not an uncommon situation, and the tax consequences should be ascertainable.

Officials consider the current drafting of proposed section RF 12I(3) already achieves this outcome.

Recommendation

That the submission be noted.

Issue: Association with direct lender

Submission
(Matter raised by officials)

The current requirements for indirect associated funding do not prevent the application of the indirect associated funding when the borrower and the direct lender are associated.

Comment

These provisions are only intended to cover situations when an unassociated party is interposed between two associated persons in order to access the AIL rules. It is not intended to cover lending within a corporate group which is already subject to NRWT.

Recommendation

That the submission be accepted.

ACTING TOGETHER

Clause 253

Issue: Scope of proposals

Submission
(Chartered Accountants Australia and New Zealand)

We agree that limiting abuse of the AIL rules is important to protect the New Zealand tax base. We are pleased that the consultative process undertaken by officials resulted in some sensible changes to the scope of the proposals, including, for example, in the narrowing of the "acting together" rule.

Comment

Officials welcome the support.

Recommendation

That the submission be noted.

Issue: Scope of non-resident owning body definition

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Russell McVeagh)

The "non-resident owning body" definition (which is imported from the definition in section FE 4, and which currently applies for certain purposes under the thin capitalisation rules) includes not only shareholders who lend to a company in proportion to their ownership interests (paragraph (a) of the definition), but also shareholders that enter into an arrangement under which "member-linked funding" is provided to a company (paragraphs (b) and (c) of the definition), subject to an exception for companies that are not "widely held companies"

"Member-linked funding" may arise when one or more shareholders lend, or guarantee or provide security for lending, to the company as part of an "arrangement" between the shareholders or in a way recommended to or implemented for them as a group by a person. Such member-linked funding should not be included in related-party debt. That is because the broad member-linked funding concept can apply in situations where although there is an "arrangement" in respect of the debt, or debt has been provided in a way recommended by a person:

- none of the lenders has control over the borrower; and
- the debt (not being in proportion to equity) is not economically substitutable for equity.

The breadth of the member-linked funding concept may be manageable in the context of the thin capitalisation rules, as those rules include safe harbour debt-asset thresholds, such that being subject to the thin capitalisation rules does not necessarily result in any additional tax cost to the borrower or to investors. But it is not appropriate for the definition of "related-party debt".

Comment

In the NRWT rules, as in the thin capitalisation rules, it is necessary that the "non-resident owning body" definition is appropriately targeted. Officials disagree with the submitter that the safe harbour debt-asset thresholds compensate for an overreach in the application of the non-resident owning body definition as it applies to thin capitalisation.

The purpose of paragraphs (b) and (c) of the non-resident owning body definition is to cover arrangements which could be economically equivalent to debt that is proportional to ownership interests and officials consider this is equally applicable to NRWT as it is to thin capitalisation.

Officials consider the member-linked funding provisions are appropriately targeted and will cover arrangements where, despite no single lender having control over the borrower, there will be sufficient coordination between lenders and other owners (if any) that treating the lending as related-party debt is appropriate.

The non-resident owning body definition was inserted in 2014 in relation to thin capitalisation and officials are not aware with any problems arising in practice, nor have submitters on the current proposals raised specific changes which could improve coverage of the member-linked funding provisions.

Recommendation

That the submission be declined.

Issue: Section RF 12H(1)(a)(iii) is unnecessary

Submission
(New Zealand Law Society, Russell McVeagh)

The reference to "non-resident owning body" in section RF 12H(1)(a)(iii) appears superfluous as under proposed section RF 12I(5) a non-resident owning body is generally treated as being an associated person (meaning that section RF 12I(1)(a)(i) would apply. Proposed section RF 12H(1)(a)(iii) should be removed. *(New Zealand Law Society)*

Proposed section RF 12I(5) provides that person A, and a member of a non-resident owning body which holds 50 percent or more of the ownership interests in person A, are treated as associated person for the purposes of certain provisions. This deeming provision is unnecessary, however, because those provisions do not require that the lender be associated with person A; rather, the provisions will be triggered if the lender is providing "related-party debt". It is also confusing, given that section RF 12H(1)(a) provides that related-party debt includes funding provided by an associated person or by a member of a non-resident owning body. Accordingly, section RF 12I(5) should instead provide that the funding provided by the member to person A will be treated as related-party debt in accordance with section RF 12H(1)(a)(iii). (*Russell McVeagh*)

Comment

Officials note that the submitters have identified the same problem but have proposed different solutions. Officials consider that three limbs are necessary within section RF 12H(1)(a) and that proposed section RF 12I(5) should be removed and rewritten in section RF 12H(3) to include the section references within the rule.

Recommendation

That the submission be noted.

Issue: Location of "non-resident owning body" definition

Submission
(Independent advisor to the Select Committee)

The definition of "non-resident owning body" is contained in section FE 4 as it currently applies to the thin capitalisation rules. As this definition is proposed to be applied to the NRWT rules it should be moved to YA 1.

Comment

Officials agree that this definition should be relocated to section YA 1 so that a taxpayer does not have to refer to the thin capitalisation rules in order to apply the NRWT rules. Officials do not consider that any changes are necessary to this definition and that it should be carried over, consistent with the current definition in section FE 4.

Recommendation

That the submission be accepted.

ONSHORE AND OFFSHORE BRANCH CHANGES

Clauses 5, 247, 269, 270, 279 and 333

Issue: Lending by banks to unassociated residents

Submission
(ANZ)

We support excluding loans from an offshore head office company to unrelated third parties (which are sourced in New Zealand) from the proposed AIL changes. Taking such an approach mitigates what would otherwise be a significant compliance burden for a significant number of third parties.

Comment

The exclusion the submitter refers to is where a New Zealand resident borrows from a foreign bank with a New Zealand branch – usually to fund a foreign property. The most frequent use of this arrangement is where a New Zealand-resident buys a foreign investment property or holiday home or where a non-resident migrates to New Zealand while continuing to own a foreign property.

In these arrangements the tax treatment depends on whether the foreign bank has a New Zealand branch even though the branch may have no involvement in the transaction. Officials continue to consider the tax treatment should be aligned for all borrowers from foreign banks irrespective of the existence of a New Zealand branch that is not involved in the transaction. However, due to the compliance burden referred to by the submitter there is no change proposed at this time. Officials may revisit this issue at a later date.

Recommendation

That the submission be noted.

Issue: Grandparenting for non-banks

Submission
(Titan NZ Funding Trust)

In respect of the onshore branch exemption changes and the transitional treatment for registered banks, the five-year grandparenting concession should be extended to Titan New Zealand Funding Trust – NZ Branch, which operates as a third party intermediary finance provider with a purpose equivalent to that provided by registered banks.

Comment

Currently, the onshore branch exemption allows a New Zealand resident to borrow from a non-resident with a New Zealand branch without withholding NRWT or paying AIL on interest payments. The changes in the bill will require NRWT to be withheld or AIL to be paid on these interest payments. However, for certain existing transactions, these new rules will not apply until the end of the 5th year starting after enactment of the bill.

This five-year grandparenting arises from clause 5(4) of the bill and applies only when the borrower is not associated with the lender or when the borrower is a member of a banking group. This grandparenting will not apply to a New Zealand securitisation vehicle that is associated with the non-resident lender and borrows from that related non-resident even when the funding is ultimately borrowed from third parties.

Officials included registered banks in the grandparenting as it is recognised that these banks have non-resident parents that are also banks. These foreign banks are subject to regulatory oversight, and often tax laws, that are specific to banks. These provide officials with confidence that these entities will be borrowing money to fund their New Zealand operations and the funding cannot be considered equivalent to equity.

The same principles do not apply to non-banks including entities that are involved in securitisation structures or that provide non-bank funding to third parties.

For these reasons officials consider that the current grandparenting provisions for the onshore and offshore branch changes in the bill are appropriate.

Recommendation

That the submission be declined.

Issue: Increased cost of capital

Submission
(ANZ, Chapman Tripp, New Zealand Bankers' Association)

The onshore and offshore branch changes are not in New Zealand's interest and should not proceed for the following reasons:

- The terms of the relevant funding programmes will require the New Zealand banks to bear the cost of any NRWT or AIL. As a result, the cost of funding for New Zealand banks will increase. It can be expected that this increase in cost of funding will be passed on to New Zealand borrowers, with a resulting increase in cost of capital, negative impact on economic growth and/or reduction in tax payable by those borrowers. This outcome is inconsistent with the Government's Business Growth Agenda. If the increased cost of funding is not passed on by the banks, this will result in a reduction in taxable income for the New Zealand Banks and reduced tax payable by them.

- To the best of our knowledge, few (if any) other jurisdictions impose a withholding tax in similar circumstances – that is, banks in those jurisdictions can raise wholesale funding offshore without the bank's home jurisdiction imposing withholding tax. We cannot see a good rationale for New Zealand taking a contrary approach to other jurisdictions.

Comment

Many taxes, including the general company tax, (which applies to inbound as well as purely domestic investment) increase the cost of capital. This does not mean that they should be eliminated. Taxes are necessary to raise the revenue Government needs to finance its spending. What is important is to minimise economic efficiency costs. In order to do that it is important that taxes are applied as consistently and coherently as possible. That is the objective of the proposal.

At present AIL normally applies to third party lending to New Zealanders but not to lending by New Zealand's large foreign-owned banks. Some of the benefits of this may be passed through to New Zealanders in lower interest rates but the extent to which this happens is unknown. If fully passed on, it would mean that banks are offering lower interest rates that are lower by a factor of one fiftieth than would otherwise be the case (for example, an interest rate of, say 5.0% rather than 5.1%). But this is a maximum pass through assumption. In practice, loans by New Zealand's foreign-owned banks will be competing with other forms of lending that do not have access to the branch rules. These include other lending from offshore or lending by New Zealand-owned banks which cannot access the onshore or offshore branch exemptions on funds that they source from overseas. As a result New Zealand's foreign-owned banks may be passing on little of the tax saving they make from the branch rules. At the same time the rule provides them with a commercial advantage relative to the New Zealand-owned banks.

Thus, changing the branch rules so that they do not apply to the extent that the branch lends to New Zealand residents may increase interest rates offered by foreign-owned banks operating in New Zealand. But the effect is expected to be very slight. The burden that they will be subject to is only that which is applying to other third-party lending.

With respect to the submission that comparable jurisdictions do not impose withholding tax on wholesale offshore funding, in our view there is much less justification for these exemptions in New Zealand, as follows:

- Other jurisdictions do not have AIL, and are therefore faced with a choice of 10% or 0% rates. This is the position in Australia. Even though they do have 0% for particular situations in domestic law, the relevant exemption for interest paid to banks is only given in a few of their recent treaties – so it does not apply across the board (unlike AIL).
- Because AIL is only 2%, the deadweight costs it imposes are much less than those imposed by a 10% tax.
- Imposition of AIL ensures that New Zealand does not give up the opportunity to collect NRWT from lenders who are prepared to pay it without passing the cost on to the New Zealand borrower.
- Jurisdictions with wide-ranging financial sector-related NRWT exemptions (for example, the United States of America and the United Kingdom) generally have these because they have global financial sectors and need to provide exemptions to preserve them. New Zealand does not have a global financial sector, and therefore would reap less benefit from providing an exemption.

Furthermore, there does not seem to be a great deal of international consensus about what the best basis for an exemption might be. Accordingly, officials believe the current AIL/NRWT system serves New Zealand well.

Recommendation

That the submission be declined.

Issue: Zero-rated AIL should be extended

Submission
(Chapman Tripp, Russell McVeagh)

A better approach that does not harm New Zealand's interests and is consistent with international norms is to amend the 0% AIL regime contained in section 86IB of the Stamp and Cheque Duties Act 1971 to apply more broadly, so that current constraints preventing the application of AIL at 0% in practice to offshore funding programmes (of the New Zealand banks and other New Zealand corporates) are removed. This should be possible with relatively minor changes to section 86IB, such as permitting:

- the security to be denominated in a currency other than NZD; and
- an offer for the security to be made under relevant United Kingdom or European securities law. *(Chapman Tripp)*

It would have been better to investigate the possibility of an exemption from NRWT and AIL for banks' borrowing costs and widely held debt, since imposing NRWT or AIL on interest paid in such cases generally leads to increased costs of borrowing for New Zealanders. *(Russell McVeagh)*

Comment

The current zero-rated AIL provisions in section 86IB were introduced to remove a potential obstacle to the further development of the New Zealand bond market (bonds issued in New Zealand and denominated in New Zealand dollars) rather than reducing taxes on foreign debt funding more generally.

Extending the provisions as suggested by the submitters would not be consistent with that policy. There is no reason why borrowing on international bond markets should be tax favoured compared with other forms of borrowing from unrelated non-resident lenders.

Recommendation

That the submission be declined.

Issue: Money used to acquire or hold overseas assets

Submission

(Chartered Accountants Australia and New Zealand)

Interest is not subject to NRWT or AIL if the money is lent outside New Zealand to a New Zealand resident and is used by the New Zealand resident for the purposes of a business it carries on through a fixed establishment offshore (offshore branch). The proposed amendments will result in interest being subject to NRWT or AIL to the extent that the offshore branch lends to New Zealand residents.

The exclusion should be extended. NRWT or AIL should not apply when a New Zealand resident borrows offshore and uses the money to acquire or hold overseas assets. This includes, for example, when a New Zealand resident purchases a rental property in Australia that is financed by a loan from an Australian bank.

Comment

Inland Revenue has previously issued Questions We've Been Asked QB 11/01: *Residential investment property or properties in Australia owned by New Zealand resident – NRWT treatment of interest paid to Australian financial institution*, which details the tax treatment of interest paid to offshore lenders on overseas assets.

The submitter's proposal already applies when the New Zealand resident borrows through an offshore branch as this treatment allows the branch to be taxed equivalent to a foreign incorporated entity operating in the same jurisdiction. Extending this treatment to all foreign assets would not be consistent with New Zealand's tax framework and would also raise issues with apportioning debt between assets held or acquired in New Zealand compared with those held or acquired in a foreign country.

Recommendation

That the submission be declined.

Issue: Apportionment of interest paid to New Zealand

Submission

(New Zealand Law Society)

The proposed amendments in sections YD 4 and YD 5 of the Income Tax Act 2007 assume that it will be possible to trace foreign funds applied to New Zealand use. Tracing could be difficult if money is borrowed for various different purposes at various different times from various different lenders.

Difficulties in tracing how money is used may also mean that a borrower may not have the option of withholding NRWT in many cases.

The amendments to sections YD 4 and YD 5 should be considered further.

Comment

The proposed apportionment rules do not require a taxpayer to trace what money has been borrowed for or how it was used. Instead, apportionment is based on the value of the taxpayer's financial arrangements that produce income that has a source in New Zealand as a portion of their total assets. Officials expect taxpayers will not have particular difficult in confirming either of these amounts and that the proposed apportionment methodology should operate correctly.

Recommendation

That the submission be declined.

Issue: Apportionment of income having a New Zealand source

Submission
(Russell McVeagh)

Proposed section YD 4(11)(b)(i) should be amended to state "…and the interest or redemption payment is not apportioned…". As drafted, proposed section YD 4(11)(b)(i) could be read as referring to the money lent being apportioned to New Zealand rather than the applicable interest or redemption payment.

Comment

While the current drafting can arrive at the correct outcome officials agree that this change should be made to avoid any uncertainty.

Recommendation

That the submission be accepted.

Issue: Interest or redemption payments

Submission
(Russell McVeagh)

The source rule in section YD 4(11)(b) applies to "interest or a redemption payment". However, the proposed amendments to section YD 5, which relate to income having a New Zealand source under proposed section YD 4(11)(b)(i), only refers to "interest". For consistency between the primary source rule and the apportionment rule the amendments to section YD 5 should refer to both "interest" and "redemption payments".

Comment

Officials note that there are four references to "interest" in the proposed amendments to section YD 5 and that interest is already defined in section YA 1 as including a redemption payment for the purposes of the RWT rules and the NRWT rules. However, to avoid the inference that these terms may not also include redemption payment, officials agree with the submitter.

Recommendation

That the submission be accepted.

Issue: Interest derived in an income year

Submission
(Russell McVeagh)

Proposed section YD 5(5)(b) defines "amount" for the purposes of the apportionment formula in proposed section YD 5(4). As drafted, it states that "amount is the amount of interest described in subsection (1)(d) that is derived in an income year". To determine what amount of NRWT should be withheld or AIL paid in respect of an interest payment to which the proposed apportionment rule applies, it will be necessary to apply the apportionment formula on the day the relevant payment is made and in respect of the specific amount being paid. The definition of "amount" as drafted does not permit this as it requires reference to interest "that is derived in an income year". The words "that is derived in an income year" should be deleted.

Comment

It is intended that the apportionment formula is calculated based on the income and assets from the immediately preceding income year so that the borrower does not have to recalculate their apportionment each time they make an interest payment. The exception to this is if the borrower does not have an immediately preceding income year when the apportionment will be from the start of the current year to the day before the interest payment. This is already achieved in proposed section YD 5(9).

The submitter is correct that the definition of amount in proposed section YD 5(5)(b) cannot be applied correctly and the words "that is derived in an income year" should be removed so that it applies to the full value of an interest payment.

Recommendation

That the submission be accepted.

Issue: Reference to value

Submission
(ANZ, New Zealand Bankers' Association)

Proposed section YD 5(9) contains various definitions for the purposes of calculating the apportionment of income sourced from New Zealand for an offshore branch. These definitions refer to the "value" of certain assets. However, it is uncertain what value should be used for such purposes.

We recommend that the reference to value should be to the value as recorded in the relevant accounts. Such values should be non-controversial, are subject to accounting standard obligations and are generally applied for income tax purposes.

Comment

This reference to "value" in the bill will in most instances refer to the value in the accounts. However, there may be instances when the value is demonstrably different from that recorded in the accounts and this alternative value is more appropriate. Officials do not consider further clarification in the bill is necessary.

Recommendation

That the submission be declined.

Issue: Use of defined terms

Submission
(Russell McVeagh)

Proposed section YD 5(9)(a) refers to "financial arrangement assets", which is not defined. Proposed section YD 5(9)(a) should be amended to refer to "assets that are financial arrangements".

Proposed section YD 5(9)(b)(ii) refers to "the interest or redemption payment date", which is not defined. Proposed section YD 5(9)(b)(ii) should be amended to refer to "the date on which the interest or redemption payment is paid".

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

Issue: New Zealand banking group

Submission
(ANZ, New Zealand Bankers' Association)

Clause 5(4) of the bill determines the timing of application of the offshore branch rules. Clause 5(4) refers to a "*member of a banking group*", which is not a defined term. This should be amended to refer to a "*New Zealand banking group*" which is a term currently defined in the Income Tax Act.

Comment

Officials agree with the submitter and note the same issue in relation to the notional loan rules considered elsewhere in this report.

Recommendation

That the submission be accepted.

Issue: Further review of amendments

Submission
(ANZ)

We have discussed most of our recommendations with Inland Revenue officials and understand that they will undertake to amend the bill, where required, to provide the necessary clarification and certainty. We welcome the ability to have such discussions with officials.

We recommend having the opportunity to review any further amendments to the bill, in conjunction with officials, before enactment to assist in mitigating further unintended consequences and to provide certainty.

Comment

Officials have been empowered by the Select Committee to liaise with submitters as required but it is not possible to make further commitments, particularly given the limited time available.

Recommendation

That the submission be noted.

NOTIONAL LOANS TO NEW ZEALAND BRANCHES

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

Issue: Reference in section FG 2(1) to "for the purposes of the Act"

Submission
(ANZ, Corporate Taxpayers Group, Russell McVeagh)

Subpart FG is stated in section FG 1 to apply for the "purposes of the NRWT rules". However, section FG 2(1) states that a notional loan to a foreign bank's New Zealand branch is treated "for the purposes of the Act" as money lent to the branch. We are unsure why this inconsistency exists and the *Commentary* to the bill provides no explanation of what other parts of the Act would impact the notional loan or how they would do so.

Comment

Officials agree there should not be an inconsistency between these two provisions, and that section FG 2(1) does not need to apply for the purposes of the Income Tax Act 2007 more generally. However "the NRWT rules" is defined in section RF 1(1) and includes a number of specific provisions in the Income Tax Act 2007 and the Tax Administration Act 1994 but does not include the Stamp and Cheque Duties Act 1971. As subpart FG is used to calculate the AIL payable on notional interest payments it should also apply for the purposes of the Stamp and Cheque Duties Act 1971.

Recommendation

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

Issue: Meaning of "foreign bank"

Submission
(Russell McVeagh)

Proposed section FG 1(2) should be amended to clarify that it is the foreign bank and not its fixed establishment that is a registered bank. Registration as a bank under section 69 of the Reserve Bank of New Zealand Act 1989 applies to legal persons not branches.

Comment

Officials agree with the submitter.

Recommendation

That the submission be accepted.

Issue: Borrowing specifically for the purposes of a business carried on in New Zealand

Submission

(ANZ, Corporate Taxpayers Group, New Zealand Bankers' Association, Russell McVeagh)

If a head office of a foreign bank borrows money from a non-resident lender, and that money is used specifically for the purposes of a business carried on by the foreign bank through a fixed establishment in New Zealand, interest payments in respect of that money may have a source in New Zealand under section YD 4(11)(ii). Provided that the relevant lender does not have a fixed establishment in New Zealand, such interest would be subject to NRWT or AIL on notional interest payments from the New Zealand fixed establishment to the foreign bank's head office. This would result in double taxation as the interest payments from the head office of the foreign bank would also be subject to NRWT or AIL under subpart RF.

Comment

Officials agree that only a single amount of NRWT or AIL should apply to an interest payment by a New Zealand branch. Where a foreign bank borrows specifically to fund its New Zealand branch any interest payments on this borrowing will already be subject to NRWT or AIL and therefore should be excluded from the notional loan rules in subpart FG.

Recommendation

That the submission be accepted.

Issue: Interest on offshore notional loans is non-resident passive income

Submission

(ANZ, Corporate Taxpayers Group, New Zealand Bankers' Association, Russell McVeagh)

Notional interest payments deemed to arise under the notional loans proposals are intended to be subject to NRWT or AIL. The NRWT rules apply only to non-resident passive income. Proposed sections FG 2 and FG 3 do not, however, deem the notional interest payments to be non-resident passive income and it is unclear whether notional interest payments may fall within the exceptions to the definition of non-resident passive income in proposed section RF 2(1)(d)(i) and (ii).

The drafting of proposed subpart FG should deem such notional interest payments to be non-resident passive income. As such, deemed interest arises only in respect of the New Zealand branch of a bank, and in view of proposed section 86IC of the Stamp and Cheque Duties Act 1971, which makes AIL compulsory if NRWT is not paid, it is also appropriate to deem the notional interest to meet the criteria in section RF 12 for AIL to be paid.

Comment

Officials recommend changes to confirm that notional interest payments are non-resident passive income.

The bill already includes an extension to the definition of "registered security" in clause 329 and a replacement section RF 12(1)(a)(ii) in clause 252(1), which will allow AIL on a notional interest payment to reduce the rate of NRWT payable to 0%. Officials do not consider further changes are required to meet the criteria in section RF 12.

Recommendation

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

Issue: Payments vs amounts recorded in the financial accounts

Submission
(ANZ, New Zealand Bankers' Association)

We understand the intention is for subpart FG to apply to interest as recorded in the financial accounts of the onshore branch. Such interest recorded in financial accounts is on an accrual basis. We support this intention as a pragmatic and reasonable approach for ascertaining the interest subject to AIL. The drafting of subpart FG (particularly sections FG 2(2) and FG 3), however, includes references to both interest recorded in the financial accounts and interest payments. As these concepts are different, uncertainty arises from the current drafting of subpart FG.

Comment

The submitter is correct that the NRWT or AIL liability on notional interest amounts is intended to be on an accrual basis as this is expected to be easier for a bank to calculate as it is already required for financial reporting and income tax purposes.

Officials do not agree that a change is necessary to section FG 2(2). The current wording refers to "a notional repayment" and "the amount is treated as a repayment". These references already reflect amounts recorded in accounting records rather than a physical payment from the New Zealand branch to its head office.

Officials agree that the reference to a "payment made" in proposed section FG 3 should be replaced by an "expense" to ensure the section is consistent with the accrual approach.

Recommendation

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

Issue: Grandparenting will not apply

Submission
(ANZ, New Zealand Bankers' Association)

The current drafting of the transitional rules in clause 83(2) states that subpart FG applies:

(a) to a transaction that is recorded in the relevant accounting records on or after the date on which this Act receives the Royal assent; or

(b) from the first day of a person's income year that starts 2 income years after the last day of the income year in which this Act receives the Royal assent, for a transaction that is recorded in the relevant accounting records before the date on which this Act receives the Royal assent.

A transaction entered into before the date the Act receives Royal assent (which should be captured under paragraph (b) above) will also be recorded in the relevant accounting records after the date the Act receives Royal assent. As such, paragraph (a) above would also apply resulting in the proposed grandparenting not applying at all.

Further, this clause refers to the existence of a "transaction" between the foreign bank and its New Zealand branch. In a legal sense, no transaction exists as it is not possible to have a legal arrangement with oneself.

Comment

Officials agree that it was not intended that a transaction entered into before the application of the new rules would satisfy both (a) and (b) above. However, we recommend clause 83(2) be redrafted to use terminology more consistent with the application provisions for the other NRWT and AIL changes in clause 5. This redrafted section is intended to have the same effect as the submitters' suggestion but should be easier to follow.

Officials also agree that legally a branch cannot have a transaction with the foreign bank. Instead of referring to a transaction this should be replaced by a reference to an amount made available by the foreign bank to its New Zealand branch.

Recommendation

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

Issue: Sections FG 3(b) and FG 3(c)

Submission
(ANZ, New Zealand Bankers' Association)

Sections FG 3(b) and (c) appear to indicate that the interest on the notional loan is incurred by the New Zealand branch and derived by the foreign bank. However, we note that the interest on the notional loan is already treated as incurred and deductible through the combined application of the Income Tax Act 2007 and relevant Double Tax Agreements. Section FG 3(b) and (c) should therefore be removed.

Comment

Section FG 3 is closely modelled on the equivalent Australian provision in section 160ZZZA of their Income Tax Assessment Act 1936. However, officials agree that this interest is already deductible for income tax purposes. The real purpose of the provision is to ensure that there is interest for purposes of imposing NRWT or AIL.

Recommendation

That the submission be accepted with respect to proposed section FG 3(b).

Issue: Timing of AIL liability

Submission

(ANZ, Corporate Taxpayers Group, New Zealand Bankers' Association, Russell McVeagh)

Section FG 3 deems the interest on the notional loan to be paid on the last day of the income year, thereby triggering the timing for payment of AIL as the 20th day of the month following income year-end. The interest upon which AIL will be payable is to be based on the financial accounts of the onshore branch. However, the accounting records for the New Zealand branch are unlikely to be complete within 20 days of financial year end. More likely, they will be completed within three months following financial year end. As such, it will not be possible to determine the AIL payable with accuracy within the timeframe proposed by the bill. The timeframe for triggering the AIL liability should be extended to the 20th day following three months after financial year-end.

Comment

Officials agree that the timeframe for calculating the AIL liability should be extended to provide sufficient time for the relevant interest amount to be confirmed. Submitters were unanimous that the notional interest should be treated as paid at the end of the third month following balance date.

Officials note that equivalent provisions for NRFAI will continue to be at the end of the second month following balance date as originally proposed in the bill. No submissions were received on altering this timing.

Recommendation

That the submission be accepted.

Issue: Length of grandparenting

Submission

(ANZ, Corporate Taxpayers Group, New Zealand Bankers' Association, Russell McVeagh, Westpac)

The proposed grandparenting period for existing inter-branch loans is two years. In contrast, the proposed grandparenting period for other existing funding arrangement within banking groups is five years. A five-year grandparenting period for the onshore branch rules is more appropriate than a two-year grandparenting period. The inter-branch loans (or notional loans as so described in the bill) are often subject to detailed negotiations between the respective branches (or the foreign bank and the New Zealand branch), particularly as they relate to independent profit centres and are also subject to detailed and complex transfer pricing analysis. As the imposition of AIL in essence alters the pricing of such notional loans, a five-year grandparenting is more appropriate.

Comment

The five-year grandparenting applied to other branch changes reflects specific funding that, in almost all instances, has been raised from third parties or as part of a back-to-back arrangement with a third party that will usually have a term of up to five years. In contrast a notional loan from a foreign bank to its New Zealand branch cannot identify specific funding from a third party and the average maturity of the foreign banks funding pool will often bear no resemblance to the amount allocated to the New Zealand branch.

The purpose of all the grandparenting provisions is to minimise disruption to commercial transactions with third parties rather than purely to delay the application of the new rules for the purpose of minimising the amount of AIL payable. As such officials consider that two years is an appropriate period.

Recommendation

That the submission be declined.

Issue: Lending directly from offshore

Submission
(Chapman Tripp)

We are concerned that these proposals will encourage foreign banks to lend directly to New Zealand from offshore, rather than through their New Zealand branch. In that case, AIL would apply to interest income received by the foreign bank but otherwise New Zealand would not be entitled to tax the net interest margin made from the lending transaction. This would result in a reduction in New Zealand's tax revenue.

Comment

The proposed changes will, in general, neutralise the tax treatment of offshore borrowing from third parties. AIL will apply both when an offshore bank lends directly to a New Zealand company, and when a New Zealand bank borrows from offshore and then on-lends this money to a New Zealand company. This is in contrast to the present situation, where some borrowers (such as some of New Zealand's banks) are able to borrow from offshore without AIL whereas other borrowers (such as other New Zealand banks as well as other companies) are required to pay AIL on such borrowing.

This change may slightly increase the tax payable by some New Zealand-based banks compared with offshore banks lending directly into New Zealand. As the submitter points out, this may make it more likely that the New Zealand tax impost on an offshore bank lending directly to New Zealand may be lower than the tax impost on a New Zealand-based bank – making it more likely that direct lending from offshore will occur. Importantly, however, it is not the imposition of AIL that gives rise to this higher tax burden – the AIL impost for both banks is the same. Rather, it is the imposition of New Zealand's company tax on the New Zealand bank that may give rise to the higher tax impost. This is in line with our general framework – where we seek to tax the profits of companies, including banks, that operate in New Zealand, but do not tax profits made by non-residents from their non-New Zealand operations.

Officials note that, under present settings, offshore banks in many instances will have incentives to lend directly into New Zealand – for example, because of the franking system in Australia. Nevertheless, by and large, most individuals and companies borrow from New Zealand-based banks, not directly from offshore banks. Officials consider that any additional incentive that imposing AIL on the offshore funding of New Zealand-based banks will be marginal.

Recommendation

That the submission be declined.

Issue: Deductions for notional interest

Submission
(Chartered Accountants Australia and New Zealand)

Proposed subpart FG recharacterises the treatment of notional loans to New Zealand branches of foreign banks. As a general rule, a branch is not allowed a deduction for interest on a notional loan from its head office as that loan and the amount of interest do not exist. The wording of section FG 1(1) should be amended to reflect correctly that it does not apply solely for the purposes of NRWT but also applies for the interest deductibility provisions. For example, the provision could be worded "This subpart applies, for the purposes of the NRWT rules and section DB 6 (Interest: not capital expenditure) when …" This would mean that the deemed interest arising on the notional loan is deductible under section DB 6.

Comment

In general, branches are not entitled to a tax deduction for interest attributed from their head office and they also do not have to withhold NRWT on this notional treatment. However, this treatment does not apply to the New Zealand bank branches which are already entitled to a deduction as a means of determining the profit attributable to their New Zealand operations (see further explanation below). This current treatment for banks is what results in an asymmetric result of a deduction with no NRWT or AIL paid. The proposed changes in the bill will correct this asymmetry without requiring any changes to deductibility.

Recommendation

That the submission be declined.

Issue: Interaction with double tax agreements

Submission
(Chartered Accountants Australia and New Zealand, Russell McVeagh, Westpac)

New Zealand has many double tax agreements that restrict the amount of income tax that New Zealand can impose. Imposing tax on this notional loan is also clearly in breach of the OECD Commentary (see paragraph 28 of the commentary on Article 7) (Model Tax

Convention of Income and Capital). An analysis of how a notional loan will be treated under New Zealand double tax agreements should be carried out and published by Inland Revenue.

Comment

The reason NRWT is not withheld on the actual interest paid by the foreign bank is practical rather than conceptual. As an economic matter, and taking a fungibility of money approach, this interest does have a connection with New Zealand. Accordingly there is a conceptual basis for imposing a tax on it. Furthermore, because AIL is in any event imposed on borrowers (unlike NRWT which is imposed on lenders but collected by borrowers), its imposition on the bank in this case, rather than on the foreign lender to the head office, is not unusual.

New Zealand's treaties generally apply to income tax, and taxes which are identical or substantially similar and imposed after the date of signature of the convention. AIL is not identical or substantially similar to income tax. In particular:

- It is a tax imposed on a borrower, who clearly does not derive income under a loan.
- It is not subject to any reductions for expenses.
- Its imposition and collection are under different legislation and use different mechanisms from income tax or NRWT.

The OECD comment that notional interest deductions of this kind are not an appropriate subject for withholding is made in the *Commentary* on the new Article 7. It relates to OECD guidance on treaty policy on attribution of profits to branches. Specifically, it suggests that if countries are not willing to give up the withholding tax that they may impose under their treaties then they should not adopt the new Article 7 which implements the new approach to taxing branches (the "Authorised OECD Approach") and allows deductions for notional payments – including interest. It is not guidance regarding appropriate domestic law settings and is therefore not relevant.

New Zealand has reserved the right to use the previous version of Article 7 immediately before the 2010 update taking into account its observation and reservations on that version.

Recommendation

That the submission be declined.

Issue: Extension to non-bank financial institutions

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

Although this is a banking-specific rule there does not appear to be any strong policy rationale for restricting the concessionary treatment to registered banking groups over other financial institutions. For example, regulated non-bank deposit takers, insurers and asset managers, as well as dedicated finance or treasury companies within multinational groups. The proposed rules may create an unfair playing field to the advantage of other financial institutions.

Comment

The policy on the deductibility of interest expense by a branch is set out in paragraphs 44 to 52 of the 1984 Reports of the OECD Committee on Fiscal Affairs *Transfer Pricing and Multinational Enterprises three taxation issues.* This document sets out that deductibility applies to bank branches.

In general non-bank businesses are unable to claim an income tax deduction for interest expenses on a loan attributed from a head office to its New Zealand branch when a specific funding source cannot be identified. To ensure appropriate deductibility, these businesses will ensure that specific funding raised by the head office for the purpose of funding the New Zealand branch can be identified. Interest payments on these specifically identifiable loans will already be subject to NRWT or AIL so the provisions in the bill are not required to be applied more generally.

However, officials note there may be a limited number of examples of New Zealand branches that are claiming interest deductions for these notional funding amounts without being able to identify specific funding by the head office. This may arise, for example, where a foreign bank is not registered with the Reserve Bank of New Zealand as their New Zealand branch does not conduct banking operations.

Officials agree that there are good reasons why the notional loan provisions in the bill should be extended to such entities but that further work is necessary to identify the scope of such an extension. This work cannot be completed in time for inclusion in the current bill. To the extent that equivalent provisions were considered for a future bill this would also give the opportunity for businesses affected by these provisions to submit on the bill in the usual manner.

Recommendation

That the submission be declined.

Issue: Interaction with transfer pricing

Submission
(Westpac)

We are concerned that this change will impact the correct attribution of profit under permanent establishment/transfer pricing principles. This has the potential to give rise to cross-border disputes and it will be essential that Inland Revenue is able to defend the New Zealand branch position in such situations.

Furthermore, we seek assurance that should a transfer pricing adjustment rise from a reassessment of the allocation of interest, then Inland Revenue will permit previously levied AIL to be recovered since that AIL will have been overpaid based on a higher amount of interest allocation.

Comment

Under current legislation it is not possible to reduce NRWT to 0% by paying AIL on interest payments on debt with a related party. If such interest is reduced via a transfer pricing adjustment, existing section GC 12 confirms there is prima facie no effect on any NRWT that has previously been withheld. However, it is possible for the lender's NRWT obligation to be reduced by making an application under section GC 11. It is also possible for the obligation to be reduced if the lender agrees to accept a reduction in the interest payable to them so that the amount payable is no more than the amount deductible by the borrower.

Section GC 11 does not apply for purposes of AIL, so prima facie a reduction in the amount deductible does not allow an AIL reduction to be made. Amendments should be introduced so the Commissioner has the power to reduce AIL on interest that is held to be non-deductible to the borrower by reason of a transfer pricing adjustment, equivalent to the operation of section GC 11.

Recommendation

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

Issue: Costs will be passed on to borrowers

Submission
(Westpac)

Banks are margin lenders, so ultimately any significant funding cost incurred by banks will be passed on to the New Zealand borrowers. This extra cost will be borne by New Zealanders as opposed to the foreign investors as originally intended. This is therefore not good tax policy and law.

Officials have stated that the impact of such changes will be relatively small. This is possibly true in the current interest rate environment when rates are extraordinarily low. However, interest rates are expected to normalise at some point to historically higher levels and, at that time, the imposition of AIL will have a disproportionately larger impact on the economy than currently, since any extra borrowing cost will inevitably deter New Zealanders from taking on debt. This may harm the competitiveness of many New Zealand banks.

Westpac submits that the Finance and Expenditure Committee revisit the economic analysis underlying these changes and stress test that analysis for future higher interest rates before being satisfied that this policy be implemented through this legislation. We believe this is especially important given the significant requirements for funding investment in New Zealand business recently signalled by the government.

Comment

With respect to the cost of capital, the key point to note is that many taxes, including the general company tax, (which applies to inbound as well as purely domestic investment) increase the cost of capital. This does not mean that they should be eliminated. Taxes are necessary to raise the revenue Government needs to finance its spending. What is important is to minimise economic efficiency costs. To do that it is important that taxes are applied as consistently and coherently as possible. That is the objective of the proposal.

At present AIL normally applies to third party lending to New Zealanders but not to lending by New Zealand's large foreign-owned banks. Some of the benefits of this may be passed through to New Zealanders in lower interest rates but the extent to which this happens is unknown. If fully passed on, it would mean that banks are offering interest rates that are lower by one fiftieth than would otherwise be the case (for example, an interest rate of, say 5.0% rather than 5.1%). But this is a maximum pass-through assumption. In practice, loans by New Zealand's foreign-owned banks will be competing with other forms of lending that do not have access to the methods the bill proposals seek to counter. These include other lending from offshore or lending by New Zealand-owned banks, which are currently already paying AIL on funds that they source from overseas. As a result New Zealand's foreign-owned banks may be passing on only a portion, or possibly none, of the tax concession they currently enjoy. At the same time the methods provide them with a commercial advantage relative to the New Zealand-owned banks.

Thus, imposing the notional loan and other branch proposals may increase interest rates offered by foreign-owned banks operating in New Zealand. But the effect is expected to be very slight. The burden that they will be subject to is only that which is applying to other third party lending.

Further detail was provided in the Policy and Strategy, Inland Revenue and Treasury document *New Zealand's taxation framework for inbound investment: A draft overview of current tax policy settings*, which was released in June 2016.

Recommendation

That the submission be declined.

Issue: New Zealand banking group

Submission
(ANZ, New Zealand Bankers' Association)

Proposed section RF 2(3)(e) is designed to confirm that NRWT on interest paid by a New Zealand bank will be a final tax. Proposed section RF 2(3)(e) currently refers to a "member of a banking group", which is not a defined term. This should be amended to refer to a "New Zealand banking group", which is a term currently defined in the Income Tax Act.

Comment

Officials agree with the submitter and note the same issue in relation to the offshore branch rules considered elsewhere in this report.

Recommendation

That the submission be accepted.

Clause 252

Issue: Application date

Submission
(ANZ, Corporate Taxpayers Group, New Zealand Bankers' Association, Russell McVeagh)

The bill proposes that members of a New Zealand banking group have the ability to reduce the rate of NRWT to 0% by instead, paying AIL on interest paid to associated persons under existing arrangements. We support such a position. The *Commentary* states that 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. However, clause 5(2) of the bill provides that the ability to pay AIL applies from the first day of the person's income year that starts after the date on which this Act received the Royal assent. There is no reason to delay paying AIL on interest payments made by a member of a New Zealand banking group to an associated person.

Comment

Officials agree that the application date should be enactment of the bill.

Recommendation

That the submission be accepted.

Issue: Extension to other financial institutions

Submission
(Chartered Accountants Australia and New Zealand, Titan NZ Funding Trust)

Proposed section RF 12(1)(a)(ii) provides a concession for members of a New Zealand banking group. We welcome the concession for registered banks but we believe the concession should be extended to other financial institutions that play a role in importing "market" capital to New Zealand (and similarly act as a conduit). For example, a non-resident bank that provides funding to a non-bank subsidiary in New Zealand or a finance company that raises money in the market.

When a degree of control is required for non-banks, this could be managed by the issue of a determination at the request of the non-banks.

Comment

Officials included registered banks in the concession as it is recognised that these banks have non-resident parents that are also banks. These foreign banks are subject to regulatory oversight, and often tax laws, that are specific to banks. These provide officials with confidence that these entities will be borrowing money to fund their New Zealand operations and the funding cannot be considered equivalent to equity.

The same principles do not apply to non-banks including entities that are involved in securitisation structures or that provide non-bank funding to third parties. Officials note that it is still possible to operate a securitisation structure that will incur AIL, rather than NRWT, on interest payments to non-residents and that this treatment is consistent with the policy changes in this bill.

Officials limited this concession to New Zealand banking groups as they are easily defined. Officials are not aware of an equivalent definition that could be applied to financial institutions more generally that would distinguish between those that operate as a conduit and those that may be sourcing funding in the nature of equity. Officials note that there are already provisions in the tax system that apply a different tax treatment to banks compared to non-banks that are otherwise providing similar services. Examples include the branch notional loan proposals in this bill and the bank thin capitalisation rules.

As well as the concerns above, a determination approach would require empowering provisions and legislative guidance on whether these determinations should be issued to specific taxpayers. This would have to consider features of both the New Zealand borrower and non-resident lender. Officials are not aware of, and submitters have not provided, any suitable approach that could adequately distinguish between various non-bank financial institutions.

Recommendation

That the submission be declined.

PREPAYMENTS

Clauses 261 and 330

Issue: Clarification

Submission
(EY)

Proposed section RZ 12 has the aim of preventing parties to existing FAs prepaying interest where no NRWT is presently payable or using the present AIL rules when interest payments in due course would be subject to full NRWT and/or NRFAI treatment under the new rules. Section RZ 12 would treat any excess of interest paid over the borrower's total expenditure accrued as not being paid until the date the new rules first apply to the FA in question.

Proposed section RZ 12(2) refers to the "total interest paid under the arrangement" and the "total expenditure of person A accrued on the arrangement", which suggest the calculations should be based on those totals from commencement of the arrangement rather than some later date.

The example given in the bill, however, refers to a loan which commenced on 1 April 2010 but seems to be basing the section RZ 12(2) calculation solely on a portion of a September 2016 payment as relating to a period from 1 April 2016, rather than providing a comparison of the total interest payments made under the FA and X Ltd's total accrued expenditure.

It is not clear whether the borrower's accrued expenditure should be to the date of latest payment or to the date when the new NRFAI/NRWT rules start applying to the borrower, so clarification on that aspect is also needed.

Comment

As noted by the submitter, the prepayment rule should be calculated based on totals from commencement of the arrangement rather than some later date. It is necessary to complete this calculation from commencement of the arrangement as applying it only to the last or latter income years could result in a payment being classified as a prepayment when it was actually a payment of interest accrued in previous years. Officials consider the current drafting already achieves this result.

The example in the legislation assumes that the $60,000 interest payment each year by X is matched by a $60,000 interest deduction. The result of these matching payments and deductions is that a calculation from 1 April 2010 to the date the changes are enacted would result in an identical outcome to the same calculation from 1 April 2016 to the date the changes are enacted.

The date of accrued expenditure should match the date the proposed rules apply to the arrangement. Officials do not consider an interest payment should be covered by this rule just because it was paid to reflect interest accrued up to the date the proposed rules apply. Calculating accrued expenditure up to this date achieves this outcome. Officials consider the current drafting already achieves this result.

Recommendation

That the submission be noted.

Issue: Foreign exchange

Submission
(EY)

If FAs are denominated in foreign currency, the borrower's total expenditure under the FA rules to any given date would be affected by any foreign exchange variations to that point. We expect there could be situations where there has not been any deliberate pre-payment of interest to avoid or reduce the impact of the new NRFAI/NRWT rules but the impact of exchange gains over time could result in an apparent excess of the amount of interest payments over the amount of the borrower's FA expenditure.

We consider the application of section RZ 12 in such circumstances would be unreasonable and unjustified. We submit the section RZ 12(2) calculation should be revised to ensure that there is no deemed excess deemed payment on commencement of the new NRFAI/NRWT rules by reason of any foreign exchange gains included in the borrower's FA expenditure accrued to the relevant date.

Comment

Officials agree that foreign currency gains that result in a borrower claiming a smaller deduction that the foreign current amount of interest payments should not in themselves trigger the prepayment rule as this rule is only intended to cover interest payments in excess of what would otherwise be expected in a commercial transaction in order to defeat the intention of the proposed rules. Officials recommend that, where an arrangement is denominated in a foreign currency, the calculation of both interest payments and total expenditure in proposed section RZ 12(2) should be completed in that foreign currency and then any excess converted to New Zealand dollars using the existing rules in subpart YF of the Income Tax Act 2007.

Recommendation

That the submission be accepted.

Issue: Refunds of AIL

Submission
(EY)

Proposed section 86GB of the Stamp and Cheque Duties Act 1971 would allow refunds to be sought by those who have paid AIL in relation to amounts which would be treated as subject to NRWT by virtue of proposed section RZ 12(2). We submit such AIL should be transferred in the first instance on account of the NRWT which would become payable, unless a refund is expressly requested. Alternatively, taxpayers should have the option to have such AIL transferred in that way.

Comment

Officials always intended that a refund of AIL under section 86GB would be available to be transferred to partially meet an NRWT liability arising by virtue of section RZ 12(2). Officials recommend amendments to ensure this is achieved.

Recommendation

That the submission be accepted.

Issue: FA amounts other than interest

Submission
(Matter raised by officials)

Amounts that are not interest, such as fair value movements, should not be included in the calculation of the total expenditure of person A for the purpose of applying the prepayment rule.

Comment

When a borrower derives financial arrangement income this should not trigger the prepayment rule on an arrangement that otherwise pays interest in line with deductions. Likewise when a borrower incurs financial arrangement expenditure on amounts that are not equivalent to interest, such as fair value losses, this should not be available to shelter prepayments of interest before this rule applies.

These adjustments should be similar to those recommended above as being introduced for the calculation of NRFAI.

Recommendation

That the submission be accepted.

AIL REGISTRATION

Clauses 246, 294, and 330 to 332

Issue: The proposals should not proceed

Submission

(Chapman Tripp, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Russell McVeagh)

The proposals introduce additional compliance costs that are unwarranted. The additional criteria mean that some genuine arm's-length arrangements will no longer be entitled to use the approved issuer levy regime. Deliberate non-compliance with the AIL rules should be dealt with in the same manner as other taxes, with audit and enforcement action undertaken by Inland Revenue.

We question whether currently non-compliant taxpayers will comply with the proposed new law, and whether Inland Revenue will be any more willing or able to enforce the new law than the current law. If Inland Revenue does not consider it cost effective to scrutinise AIL registration applications and AIL returns made under current law, it is unclear how it would be more cost effective to do so under the proposals.

Comment

Submitters have identified a number of concerns with these proposals. These include that borrowing by and/or from certain borrowers will be unable to register for AIL and that even those that do comply will incur costs in continuing to ensure they still qualify. While many of these concerns could be rectified – for example, by expanding the categories or clarifying the application of the $500,000 threshold – it is acknowledged that these proposals have raised significant opposition and would impose compliance costs on many compliant borrowers that would be high as a proportion of the additional tax raised from non-compliant borrowers.

Officials consider that these proposals should be removed from the bill so that the current registration requirements for a registered security remain. Officials still consider that the inappropriate use of AIL by borrowers and lenders who are associated continues to be a concern. This is because it is time consuming and often impossible to determine the chain of funding in a family or friend context. There is common use of nominees and "hand-shake" agreements in masking the source of the funds. Even when Inland Revenue finds such arrangements it is time consuming to apply section BG 1.

Any decisions on the appropriate level of audit response will continue to be an operational decision for Inland Revenue. One problem with this approach is the current registration process does not allow Inland Revenue to refuse a registration even where the lender is associated with the borrower. This continues to raise integrity issues and officials may consider a further policy response in the future when this continues to be a concern.

There were a number of other submissions on technical aspects of the AIL registration rules. These have been superseded by the recommendation to withdraw the proposals.

Recommendation

That the submission be accepted.

GST

Clause 311(4)

Issue: Support for the amendment

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, KPMG, PwC)

Submitters support the proposed amendment to clarify an aspect of GST law that has been uncertain and on occasion an area of dispute with Inland Revenue. The proposed amendment will provide taxpayers with clarity and certainty.

Comment

Officials welcome the submitters' support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Application date

Submissions
(Corporate Taxpayers Group, Deloitte, PwC)

The application date should be brought forward to the date of application of the bill. Given there is consensus that the current legislation does not result in the desired policy outcome (that is, registered businesses are currently unable to recover GST costs when raising capital), businesses should be able to benefit from the new rules as soon as possible. *(PwC)*

The application date should be retrospective and apply from the date the GST issues paper announcing these reforms was released – 17 September 2015. There is a strong case for the amendment to apply with effect from the date of the issues paper, noting in particular that the amendment is taxpayer-favourable. It is arguable that taxpayers were already allowed an input tax deduction under our current law, however we acknowledge there was some uncertainty regarding this. In light of this, it would be detrimental to the integrity of the tax system for the uncertain state of the current law to be prolonged. If there is concern that taxpayers may seek to re-open prior tax positions, the application date could be set so that it applies to costs incurred after 17 September 2015 but with taxpayers only being able to claim input tax credits in future tax returns (that is, using the two-year rule in subsection 20(3) of the GST Act). *(Corporate Taxpayers Group)*

The date on which the GST and capital raising costs proposals were announced would be a fairer application date for taxpayers. Inland Revenue would have certainty that the proposals would not be misused because taxpayers cannot easily change capital-raising activities, as they are a time-consuming/drawn out process (sometimes taking years). On this basis, the application date of GST and capital raising cost proposals should be the date proposals were announced, 17 September 2015. *(Deloitte)*

Comment

Submitters have suggested a range of retrospective application dates.

Officials consider that the proposed amendment represents a policy change, rather than a clarification of the existing law.

Inland Revenue has maintained a well-documented position that the existing law does not allow GST to be recovered on capital raising costs. In 2004 the Court of Appeal confirmed this position in *CIR v Gulf Harbour Development Ltd* (2004) 21 NZTC 18,915.

Departing from the usual approach of applying policy changes prospectively could create inequity by advantaging a specific group of taxpayers if this treatment was not extended into other, comparable, policy changes. A retrospective policy change would also create uncertainty in the treatment that has been applied prior to the amendment, and could require or allow taxpayers to reopen and correct past returns.

Applying the law change on a retrospective basis would involve a fiscal cost of $10 million a year for each additional year covered. Back-dating the law change to September 2015, as proposed by some submitters, would cost an additional $17 million. The 1 April 2017 application date provides more certainty than the date of the bill's enactment, which is not fixed.

Recommendation

That the submissions be declined.

Issue: Grandparenting provision

Submission
(Chartered Accountants Australia and New Zealand)

A grandparenting provision that preserves the positions of GST registered persons who have already taken an input tax deduction for GST on capital raising costs would be appropriate and fair and would provide certainty for those persons on their historic GST positions.

Comment

As mentioned above, Inland Revenue has maintained a well-documented position that the existing law does not allow GST to be recovered on capital raising costs and has publicly communicated this position.

It would be unfair to grandparent the positions of businesses that incorrectly claimed GST deductions for their capital raising costs compared with those businesses that correctly complied with the existing law.

Recommendation

That the submission be declined.

Issue: Scope should be expanded to include failed attempts at capital raising

Submission
(KPMG)

The drafting of proposed section 11A(1)(rb) should be inclusive of unsuccessful capital raising attempts. Section 11A(1)(rb) should be amended as follows:

> the services are financial services supplied in the course of an activity of obtaining funds by a registered person who does not principally make supplies of financial services, to the extent to which the funds are used <u>or are intended to be used</u> by the registered person for expenditure in an activity of making taxable supplies… .

Comment

Expanding the scope of the amendment to include failed capital raisings is consistent with the policy intent of the amendment, as these are costs incurred as a part of a business's taxable activity, whether the capital raising is successful or not. Officials therefore agree with the submission.

Recommendation

That the submission be accepted.

Issue: Clarification as to the amounts of consideration for zero-rated supplies in GST returns

Submission
(EY)

Clarification may be needed or desirable as to the amounts of "consideration" that taxpayers should be showing for zero-rated supplies in their GST returns. At the practical GST compliance and return level, the current GST return form requires taxpayers to state the total value of their zero-rated supplies in any return period. The bill's proposals to zero-rate certain financial service supplies will mean that all GST-registered taxpayers (other than those who principally make supplies of financial services) will need to account for any zero-rated supplies arising from their debt or equity securities or related payments. Clear and detailed guidance should be provided so that taxpayers can comply with those obligations relatively simply and with certainty.

Comment

Officials acknowledge the point raised in the submission about the likely difficulty for businesses who do not principally make supplies of financial services in applying a zero-rating rule.

Rather than zero-rating the supplies, we propose that it would be simpler to use a special deduction rule (similar to section 20(3L) in the Goods and Services Tax Act 1985 which allows non-residents who are registered for GST under section 54B to claim back the GST on inputs purchased in New Zealand, despite the fact that they do not make taxable supplies in New Zealand). Such a rule would allow these businesses to claim back the GST on their capital raising costs, to the extent that the capital raising is undertaken to fund a taxable activity.

The special deduction rule would not affect the amount of input tax that is claimable for the costs incurred in capital raising in terms of the bill's proposal. Businesses will still need to account for the amounts of consideration paid for their inputs and determine which amounts relate to the capital raising activity. Further, businesses that make a combination of taxable and exempt supplies would still be required to apportion the input tax claimed where the capital raising is not undertaken to fund a 100% taxable activity.

Agreeing to the submitter's proposal would reduce compliance costs in relation to accounting for the value of their supplies of financial services (outputs) made to raise funds for a taxable activity. Stating the amounts of consideration for zero-rated supplies of certain financial services can be difficult due to the substitutability of fees and margins. Further, businesses that only make standard-rated supplies in the normal course of their business will not be accustomed to stating the amounts of consideration for zero-rated supplies in their GST returns.

Recommendation

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

AGREED METHODS OF APPORTIONMENT AND ADJUSTMENT

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

Issue: Support for the amendment

Submission
(Deloitte, EY, PwC)

The submitters are supportive of the proposals, which enable businesses to apply alternative methods of apportioning and making adjustments to input tax deductions. These proposals should reduce compliance costs for some businesses who apply the current apportionment and adjustment rules.

Comment

Officials welcome submitters' support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Proposed amendment should apply to all registered persons

Submissions
(Chartered Accountants Australia and New Zealand, Deloitte, EY)

The option to agree an alternative method of apportionment and adjustment with the Commissioner of Inland Revenue should not be restricted to persons who reasonably expect to make supplies of goods and services with a value of more than $24 million in a 12-month period – instead, it should be available to all registered persons. Submitters note that many businesses currently use an approximation of the apportionment and adjustment rules or pragmatic "shortcuts" (which are technically not legislated for) and would benefit from the proposal if the threshold was removed.

An alternative approach would be to expand the proposals to all taxpayers. This would encourage all taxpayers to have an open dialogue and relationship with Inland Revenue. This approach would be consistent with the Commissioner of Inland Revenue's duty to collect the highest net revenue over time, with specific regard to the importance of voluntary compliance. *(Deloitte)*

The proposal discriminates unfairly between large and other taxpayers by allowing taxpayers to agree an alternative method of making apportionments and adjustments only if the registered person is making, or reasonably expecting to make, supplies of goods and services in excess of $24 million in a current 12-month period. The details and expected administrative requirements for any application for approval of an alternative method should provide an effective and sufficient constraint in practice on the numbers of taxpayers likely to apply. Only those with the necessary resources and commitment to make appropriate applications would do so. If taxpayers are willing to commit their resources to making appropriate applications, there is no justification for refusing them on the basis their turnover or expected turnover in a current year does not exceed $24 million. *(EY)*

Comment

The proposed amendment allows large businesses that make a mix of both taxable and exempt supplies (such as residential accommodation and commercial accommodation) to agree an alternative method of apportionment with the Commissioner of Inland Revenue.

The proposed amendment is limited to larger taxpayers (including registered groups) with $24 million or more in turnover. This is because larger businesses are more likely to have difficulty applying the standard apportionment rules as they have a greater number of transactions and more complex transactions. This makes it more likely that there will be a net benefit for the business as there are costs associated with formulating and agreeing an alternative method of apportionment (such as advisor fees), and in some cases, these costs may exceed the costs of continuing to apply the standard apportionment rules.

It was envisaged that the majority of businesses who would apply to the Commissioner for an agreed method under the proposal would be retirement villages, as these are high-turnover businesses which supply a mix of both taxable supplies and exempt accommodation. Given their high turnover and this combination of taxable and exempt supplies, retirement villages have experienced particular difficulty in applying the apportionment and adjustment rules and, anecdotally, have used approximations which, technically, are not legislated for. We are not aware of any specific examples of other businesses or industries that would similarly benefit from the proposal if it were extended to all taxpayers.

Because New Zealand’s GST has few exemptions, the vast majority of smaller businesses only provide taxable supplies so should not need to apply the apportionment rules in respect of exempt supplies in the first place. For most smaller businesses who do make a combination of taxable and exempt supplies, it is desirable that as far as possible, these businesses apply the existing rules rather than use an approximation. However, in recognition of the fact that there are some smaller retirement village operators who belong to an industry association, industry bodies will be able to negotiate industry-wide apportionment ratios on behalf of their members. This provides a cost-effective, compliance-saving option for smaller suppliers, although they might not get the apportionment and adjustment method that would be most ideal from their perspective. In this case, these smaller taxpayers still have the option of applying the existing apportionment and adjustment rules. Members of an industry association with a turnover exceeding the $24 million threshold have the choice of using the industry ratio or applying to the Commissioner for their own ratio.

Recommendation

That the submissions be declined.

Issue: Lower threshold should apply

Submissions
(Chartered Accountants Australia and New Zealand, EY, PwC)

If the submission to remove the $24 million threshold is not acceptable, as an alternative, proposed sections 20(3EB)(b)(i) and 21(4B)(b)(i) should be amended to apply to those persons who reasonably expect to make supplies of goods and services with a value of more than $5 million in a 12-month period. *(Chartered Accountants Australia and New Zealand)*

If some threshold is desired, an annual turnover of $3 million (which would match the income tax definition of "low-turnover trader") would be more appropriate. Such a threshold would be less discriminatory than that presently proposed while excluding taxpayers whose level of trade is generally regarded as "small" by New Zealand's income tax system. *(EY)*

The eligibility threshold should be lowered, to at least $4 million, to ensure that more businesses are able to benefit from the proposal. *(PwC)*

Comment

Lowering the eligibility threshold to $3 million or $5 million could greatly increase the number of businesses that apply for an alternative apportionment method. Because agreeing on an apportionment method with the Commissioner is a resource-intensive activity, a high number of applications could create long delays and inconsistent practices. Extending the method could therefore result in significant additional administration costs for Inland Revenue, and needs to be balanced against the compliance cost savings to taxpayers.

The submissions do not provide any specific examples of affected businesses or industries that would benefit from a lower threshold. It would be possible to reduce the eligibility threshold as part of a future tax bill, if compelling cases emerge.

There is an expectation that taxpayers should apply the law. Officials note that, for the vast majority of taxpayers, the current apportionment and adjustment rules are already simpler than they were before the rules were significantly reformed in 2011.

Recommendation

That the submissions be declined.

Issue: Application of the threshold on a group basis, if taxpayers are registered as part of a group, should be clarified and confirmed

Submission
(EY)

The submitter assumes the $24 million threshold would be applied on a group basis if taxpayers are group-registered for GST purposes. Clarification and confirmation of that aspect would be desirable in any event.

Comment

Officials confirm that the $24 million threshold will be applied on a group basis if taxpayers are group-registered for GST purposes. This is consistent with the GST principle that a group is treated as an entity. The current drafting of the proposed amendment already provides for this result and will be communicated to taxpayers in the relevant *Tax Information Bulletin* after the bill is enacted.

Recommendation

That the submission be noted.

Issue: Publication of apportionment and adjustment methods agreed with the Commissioner

Submission
(Chapman Tripp)

There is a public interest in these agreed methods because they alter taxpayers' tax liabilities. The statute should require Inland Revenue to publish methods agreed under the new provision in anonymous form. Publishing these methods in anonymous form will help to preserve the integrity of the tax system as defined in section 6 of the Tax Administration Act 1994.

Comment

The agreed apportionment methods are specific to the facts and circumstances of each taxpayer. Officials therefore consider that it would be difficult to publish an agreed apportionment method in an anonymous form without disclosing information which could be commercially sensitive. In addition, publishing taxpayer-specific information would be contrary to the tax secrecy provisions of the Tax Administration Act 1994. An industry group may decide to publish the ratio agreed on behalf of its members.

That said, the submission made about preserving the integrity of the tax system (including the need for consistency and fairness) is noted by officials.

Recommendation

That the submission be declined.

SECONDHAND GOODS, AND GOLD, SILVER AND PLATINUM

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

Issue: Support for the amendment

Submission
(New Zealand Gold Merchants Limited)

The submitter supports the proposed changes to the GST treatment of secondhand goods provided for by these clauses. The changes will:

- clarify an aspect of GST legislation that has been unclear and has led to disputes with Inland Revenue;
- avoid an unworkable outcome that can result in jewellers and traders in gold and precious metal products being subject to the double impost of GST under Inland Revenue's current interpretation of the law;
- produce, in practice, a more uniform application of GST in the affected industry; and
- still protect the GST tax base from rorts.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Transitional provisions should be included in the legislation

Submission
(Chartered Accountants Australia and New Zealand)

Clause 304(5) and (6) is a transitional provision for registered persons who have previously applied the definition of "secondhand goods" as it reads before being amended. Clause 304(6) enables registered persons to claim a secondhand goods deduction for goods acquired in the four years preceding the date of enactment. For the sake of clarity the transitional provision should be inserted in Part 12 of the Goods and Services Tax Act 1985.

Comment

While inserting the transitional provision into Part 12 of the Goods and Services Tax Act 1985 would make the provision more accessible to taxpayers, officials note that the ambit of the amendment to which the transitional provision relates is quite narrow and will only apply to a small group of taxpayers who are already likely to be aware of both the proposed change and the transitional period. The transitional period covered by the provision is the four-year period preceding the date of enactment, so the transitional provision will be useful to the affected taxpayers for only a short period of time.

We note that the transitional provisions that are already in Part 12 of the Act are of a more fundamental or ongoing nature than the proposed transitional provision in clause 304(5) and (6) of this bill. We therefore see little benefit in inserting the provision into Part 12 of the Goods and Services Tax Act 1985. Instead, the transitional provision will be highlighted in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission be declined.

Issue: Monitoring the use of the amendment for tax avoidance

Submission
(Deloitte)

Inland Revenue should monitor the use of secondhand good amendments relating to gold, silver and platinum for tax avoidance.

Comment

Officials are aware of the fiscal risks associated with allowing input tax deductions for secondhand goods consisting of alloy gold, silver or platinum. Inland Revenue will keep a watching brief over claims for secondhand good deductions to mitigate this risk. We note that the amendment applies only to finished consumer goods that have undergone a manufacturing process. This lowers the associated fiscal risk, since fraud of the type referred to by the submitter would be more likely to occur if secondhand good deductions were allowed for alloy gold, silver or platinum that is in an unfinished state.

Recommendation

That the submission be noted.

SERVICES CONNECTED WITH LAND

Clause 311(1) and (3)

Issue: Support for the amendment

Submission
(KPMG)

The submitter supports the general expansion of the provisions relating to services connected to land both inside and outside New Zealand where the services are intended to enable or assist a change in the physical condition, ownership or other legal status of the land.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Not supportive of the amendment

Submission
(Deloitte)

Proposals relating to the GST treatment of services connected with land should not go ahead. While the submitter understands that the proposals seek to harmonise New Zealand's GST with other OECD members, they consider there is a good understanding amongst taxpayers of how the current rules operate. The removal of the ability for New Zealand suppliers to zero-rate certain services should only be introduced after careful consideration. Anecdotally, various New Zealand suppliers impacted by these changes expect that a significantly greater number and amount of transactions will be excluded from zero-rating by these changes, rather than will be included in the expanded zero-rating rules. This will impose additional GST costs, or cause an increase in the price required to be charged by these New Zealand suppliers.

Comment

The current legislative test is based on whether the services are "directly in connection" with land. The Court of Appeal, in *Malololailai Interval Holidays New Zealand Ltd v CIR* (1997) 18 NZTC 13,137, has interpreted this test more narrowly than the policy intention. Because of its focus on the physical relationship with land, this interpretation potentially results in a number of professional services with a very close connection to land such as architectural, real estate or legal services failing to satisfy the "directly in connection" test.

This interpretation of the current law results in outcomes contrary to the destination principle: the non-taxation of some services that ought to be regarded as consumed in New Zealand and the taxation of some services consumed outside New Zealand. In addition, the New Zealand rules are not aligned with the international approach, which could result in services being taxed in more than one jurisdiction or not taxed in any jurisdiction at all.

The proposed amendments are designed to ensure that New Zealand's rules reflect the policy intent and international practice, as well as better aligning the treatment of non-resident purchasers of New Zealand land with resident purchasers.

Recommendation

That the submission be declined.

Issue: More clarity required

Submission
(Chartered Accountants Australia and New Zealand, EY, PwC, Quotable Value, New Zealand Law Society)

Submitters acknowledge the rationale behind the proposed changes. However, they consider that the legislation needs to be drafted more clearly. The current position has developed through case law over many years, so shifting the boundary has the potential to create considerable uncertainty. The proposed legislation needs to be more explicit, and more detailed explanation and examples should be in the guidance issued by Inland Revenue. Examples of services that will likely have considerable uncertainty and difficulty regarding their GST treatment, include:

- advertising or marketing services;
- property valuation services relating to land in New Zealand;
- legal services relating to the disposal or acquisition, or proposed disposal or acquisition, of land and/or buildings or other improvements in New Zealand;
- legal services relating to leases, licences, mortgages and other such rights or interests in respect of land and/or buildings or other improvements in New Zealand;
- legal services relating to the procurement of physical works in respect of New Zealand land, including buildings, infrastructure and other improvements;
- architectural and design services;
- engineering services;
- real estate and property management services; and
- legal services relating to investing in New Zealand, including structuring advice and implementation of investment structures.

For example, it is not clear if the following supply of advertising services is standard-rated or zero-rated when a non-resident is selling land in New Zealand and the land is advertised for sale in a New Zealand newspaper. The *Commentary* includes only two examples of the type of services that can be zero-rated. Detailed guidance and examples are critical to the success of the change. *(Chartered Accountants Australia and New Zealand)*

Clarification, more detailed explanation and examples would be desirable on the use of the phrase "a parcel of land" and the types of services that are expected to be treated as being in connection with a parcel of land or an improvement "intended to enable or assist a change in the physical condition, or ownership or other legal status, of the land or improvement". *(EY)*

Specifically, the proposed reference to "ownership or other legal status" of the land or improvement may be too broad and could potentially apply to a wider range of transactions. Further clarity is also required in cases when the consideration includes a range of services, some of which may be subject to standard rating. In those cases, an apportionment exercise may be required. Guidance should be provided on how this can be done. *(PwC)*

Clarification should be given that the GST treatment of property valuation services provided by New Zealand residents to non-resident customers, in relation to New Zealand land are not considered to be services which are "intended to enable or assist a change in the physical condition, ownership or other legal status of the land or improvement". *(Quotable Value)*

Comment

Officials have taken note of submitters' concerns and agree that greater clarity is required in the proposed legislation. We have referred this matter to drafters.

The proposed test is intended to encompass services that have a very close relationship with land, such that they are effectively consumed where the land is located.

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, and those that only relate to land more generally (such as seeking general advice on land law or the housing market in New Zealand), are not.

In the case of general property valuation services which have not been undertaken for a specific property intended for sale, it is likely that these services relate to land more generally and, therefore, are not sufficiently connected with land to fall within the "intended to enable or assist a change in the physical condition, ownership or other legal status of the land or improvement" test. We note the point made in the submission that valuation services do not provide any authority to change the legal or physical status of land or improvements to land, nor do they necessarily assist with the process of such a change.

The proposed test is expected to apply to a variety of professional services such as real estate and legal 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.

Further guidance and clarification will be provided in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

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

Issue: Supplies of licences to occupy and associated facilitation services

Submission
(KPMG)

A licence to occupy is not generally legally considered to be an interest in land. Further, the extended definition of "land" in the GST Act only applies for the land zero-rating rules and does not explicitly cover licences to occupy.

The supply of accommodation that is closely, clearly and obviously connected with the underlying land should be zero-rated. A supply of land in this circumstance should be covered by both sections 11A(1)(e) and (k). This may be achieved by applying the extended definition of "land" in the GST Act to these two provisions.

Services that are in relation to land but which may not affect the physical condition, legal status and ownership of the land (such as facilitation services provided by a travel agent in relation to a booking for accommodation at an overseas hotel) should be zero-rated or not as relevant.

Comment

Officials understand that the submitter's primary concern in relation to supplies of licences to occupy (and associated facilitation services) is in the context of bookings for overseas accommodation made through a travel agent or online accommodation booker.

As the submitter has noted in their submission, the obiter comment in *Malololailai Interval Holidays New Zealand Ltd v CIR* (1997) 18 NZTC 13,137 suggests that the supply of a license to occupy in the context of overseas accommodation booked through a travel agent would be zero-rated (as the supply of an interval holiday in the *Malololailai* case was considered by the Court of Appeal to be "directly in connection with land"). On the basis that a supply of a licence to occupy is directly in connection with land, facilitation fees charged by travel agents and online accommodation bookers in relation to bookings for overseas accommodation would also be zero-rated under the proposed amendment.

However, officials acknowledge that there is some uncertainty about whether or not licences to occupy are indeed supplied "directly in connection with land" (as services that are "directly in connection" with land have been interpreted elsewhere as being those that directly affect a change to the physical or legal nature of land). Given this uncertainty, it is desirable that this issue be addressed as soon as possible to provide taxpayers with clarity.

This said, the proposed amendments in the current bill are intended to address particular issues that have arisen whereby the current treatment of some professional services that are closely connected with land does not reflect the broad policy intent. We have not consulted on the more fundamental amendments suggested by the submitter, so making such changes could create uncertainty and unintended outcomes.

Officials therefore suggest that a better way of ensuring the zero-rating of services provided by travel agents and online accommodation bookers in relation to supplies of overseas accommodation to New Zealand residents might be to amend section 11A(1)(j). Officials note another submission by KPMG on this bill, which suggests making such an amendment to section 11A(1)(j). As noted in our response to that submission, we will consider whether an amendment to section 11A(1)(j) should be put on the Tax Policy Work Programme. Any proposals will go through the usual Generic Tax Policy Process (GTPP).

Recommendation

That the submission be declined.

Issue: Drafting issue – section 11A(1)(k)(i) and (ii)

Submission
(Russell McVeagh)

There is a drafting issue in clause 311(3) that should be amended. The words "services which are" should be omitted from the proposed amendments to section 11A(1)(k)(i) and (ii), as those words already appear in the introductory sentence to section 11A(1)(k).

Comment

Officials agree that the words "services which are" in clause 311(3) are an unnecessary repetition of the phrase used in the introductory sentence to section 11A(1)(k), and that these words should be deleted from the clause.

Recommendation

That the submission be accepted.

Issue: Suggested drafting changes

Submission
(New Zealand Law Society)

Clause 311(1) and (3) should be amended as follows:

311 Section 11A amended (Zero-rating of services)

(1) Replace section 11A(1)(e) with:

(e) the services are:

(i) supplied directly in connection with ~~a parcel of~~ land situated outside New Zealand, or with an improvement to such land:~~, or~~

(ii) ~~are~~ supplied in connection with a particular parcel of land situated in New Zealand, or with an improvement to any such parcel of land,~~ such land or improvement~~ and ~~are~~ intended to enable or assist a change, or prospective change, ~~in~~to the physical condition, or the ownership or other legal status, of ~~the~~ that parcel of land or improvement; or

…

(3) Replace section 11A(1)(k)(i) and (ii) with:

(i) ~~services which are~~ supplied directly in connection with a particular parcel of land situated in New Zealand, or with an improvement to any such parcel of land;~~, or are~~

(ii) supplied in connection with a particular parcel of land situated in New Zealand, or with an improvement to any such land,~~ such land or improvement~~ and ~~are~~ intended to enable or assist a change, or prospective change, ~~in~~to the physical condition, or the ownership or other legal status, of ~~the~~ that parcel of land or improvement;~~; or~~

(iii) ~~services which are~~ supplied directly in connection with moveable personal property, other than choses in action or goods to which paragraph (h) or (i) applies, situated in New Zealand at the time the services are performed;~~; or~~

(i~~ii~~v) the acceptance of an obligation to refrain from carrying on a taxable activity, to the extent to which the activity would have occurred within New Zealand;"

Comment

As per our response to Russell McVeagh's submission, officials agree that the words "services which are" should be deleted from clause 311(3). However, we consider that some of the drafting changes suggested in the submission are not necessary, nor do they provide greater clarity.

This said, officials have taken note of the suggested changes and of the submission themes generally that greater clarity is required in this area. We have referred these suggested changes to drafters.

Recommendation

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

Issue: Post-implementation review

Submission
(New Zealand Law Society)

The submitter notes Inland Revenue's acknowledgement that the changes may have a negative impact on competitive neutrality between domestic and offshore suppliers of services to non-residents in connection with New Zealand land. The post-implementation impact of the changes in this regard should be scheduled for review.

Comment

Officials do not anticipate that the potential decrease in competitive neutrality should be a significant problem. In reality, a competitive advantage to non-resident businesses over their New Zealand-based competitors supplying services connected with New Zealand land to non-residents is not that likely, given resident businesses' existing advantage arising from being located in New Zealand (and therefore being closer to the land). Even if a distortion results, officials consider that this is relatively minor compared with the larger distortion created by the existing rules.

Inland Revenue will, however, monitor the operation of the proposed changes in the first 12 months of implementation, as part of the Generic Tax Policy Process (GTPP). The final step in the GTPP is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Any changes identified as necessary will be added to the Tax Policy Work Programme, and proposals will go through the usual GTPP.

Recommendation

That the submission be noted.

Issue: Consistency between zero-rating provisions relating to services connected with land and services connected with other goods

Submission
(New Zealand Law Society)

Inland Revenue should ensure that there is consistency between the zero-rating provisions relating to services supplied in connection with land and services supplied in connection with other goods.

Comment

The proposed amendments address particular issues that have arisen whereby the current treatment of some professional services that are closely connected with land does not reflect the policy intent. Officials note that the rules for services connected with other goods largely work as intended. We will, however, monitor the practical operation of the existing rules and review this issue at a later stage if necessary through the GTPP.

Recommendation

That the submission be noted.

SUPPLIES OF LAND LEASES

Clauses 310(3) to (6) and 314(7)

Issue: Support for the amendment

Submission
(Chartered Accountants Australia and New Zealand)

The submitter supports the proposed amendments, which will bring clarity and consistency to this area.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: "Savings" provisions should be included

Submission
(EY)

"Savings" provisions should be included the bill to protect tax positions taken by taxpayers in their transactions with relevant parties, in relation to the issuing of any GST "tax invoices" and GST returns filed up to the date the bill is enacted. A variety of approaches may have been taken by taxpayers in relation to lease surrenders, novations or other transactions relating to leases of commercial property. It is not appropriate for the proposed amendments potentially to render some taxpayers liable now to re-assessment of GST for previous periods at the standard rate or, conversely, to require re-assessment on a zero-rated basis if the parties had previously accounted GST at the standard rate.

Comment

Officials agree that savings provisions should be included to protect tax positions previously taken by taxpayers. We note that the relevant 2015 issues paper, *GST – current issues,* stated that these amendments would "provide for past tax positions to be preserved".

Recommendation

That the submission be accepted.

Issue: Clarification whether amendment applies only to novations

Submission
(Russell McVeagh)

If it is intended that proposed section 11(8D)(c) applies to any arrangement that consists of a lessee surrendering a lease and another lease being entered into by the lessor with a third party (as reflected in the current drafting), and not merely a novation (as indicated in the bill *Commentary*), then this should be acknowledged by officials in the *Tax Information Bulletin* released after the bill is enacted so that the apparent inconsistency between the drafting of the bill and the statements in the *Commentary* do not result in uncertainty in practice.

Comment

The *Commentary* to the bill states that proposed section 11(8D)(c) is intended to apply to arrangements when a lease is "novated". The *Commentary* implies that a novation occurs where a new lease is entered into on the same terms as an existing lease. However, this is not technically correct: a novation substitutes the lessor or lessee with a third party, so that the third party takes on either the lessee or lessor's obligations under the existing lease agreement.

We confirm that proposed section 11(8D)(c) also applies to arrangements that consist of a lessee surrendering a lease and the lessor supplying the interest in land under another lease with a third party, and not just novations We will clarify the intended scope of the provision in the relevant *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission be noted.

Issue: Drafting issue – section 11(8D)

Submission
(Chartered Accountants Australia and New Zealand)

The wording of the proposed legislation should be simpler. Unnecessary words should be eliminated. For example, the phrases "that is not a regular payment" and "are 25% or less of the consideration specified in the agreement" are unnecessarily repeated several times.

Comment

Officials have taken note of the feedback from submitters that the wording of the proposed legislation should be simpler. However, we do not agree that the phrases "that is not a regular payment" and "are 25% or less of the consideration specified in the agreement" have been unnecessarily repeated in clause 310(4). To avoid repeating these phrases, it would be necessary to define a new term for each phrase and refer instead to that term. We do not consider that this would be an improvement over the current drafting, especially since the use of the new terminology would be restricted to section 11(8D)(b) of the Goods and Services Tax Act 1985 only, and would not be referenced in other parts of the same Act (or even in other parts of section 11).

Recommendation

That the submission be declined.

Issue: Technical/drafting issues – section 11(8D)

Submission
(EY, New Zealand Law Society, Russell McVeagh)

Submitters have raised a number of issues with clause 310(3) to (6):

- Proposed section 11(8D)(b) should apply to determine the GST treatment separately of each successive supply under an agreement. The amendment as drafted places an inappropriate focus on *payments* made under the agreement. This is inconsistent with the way the GST Act works, which is that GST does not apply to a *payment*, but rather to a *supply* (which is triggered under section 9(3) by an amount paid or payable). *(Russell McVeagh)*
- Proposed section 11(8D)(b)(iv) as currently drafted appears to have some missing or incorrect words. We assume it is intended to say that the consideration specified in the agreement should be treated as the amount of consideration under the agreement calculated *in respect of* the longer of one year and the shortest possible fixed term of the agreement. If so, the provision should be amended accordingly. *(Russell McVeagh)*
- Proposed section 11(8D)(c) should be expanded to include a supply made under an arrangement that "includes", rather than "consists of" the surrender of a lease and entry into a new lease with a third party. *(EY, Russell McVeagh)*
- The current drafting of subclause (iii) of proposed new section 11(8D)(c) is problematic. The relevant supplies of the interest in land under the lease agreements are unlikely to meet the requirements of section 11(1)(mb), having regard to section 11(8D)(b). This is because, in the normal course, commercial leases do not involve significant premiums or similar upfront payments. Subclause (iii) of the proposed new section 11(8D)(c) should be worded as follows: "(iii) the supplies of the interest in land under the lease agreements meet the requirements set out in subsection (1)(mb), disregarding paragraph (b) of this subsection." *(New Zealand Law Society)*
- The two references to "land" in proposed section 11(8D)(d) should be replaced with "goods". The proposed provision relates back to section 11(1)(mb)(i) of the GST Act, which refers to "goods". *(New Zealand Law Society)*

Comment

Officials have taken note of the matters raised by submitters relating to the drafting of clause 310(3) to (6) and will make appropriate fixes for these issues.

Recommendation

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

Issue: Lease termination transactions

Submission
(PwC)

Under the proposals, some lease termination transactions which are subject to GST at 15% (early termination payment by tenant) or represent damages/compensation (no GST) are being made subject to compulsory zero-rating (CZR). The CZR rules should only apply if an interest in land is transferred.

Comment

Officials agree with the submitter that payments that represent compensation for damages will not be subject to GST as these do not represent consideration for a supply.

On a principled basis, if a lump sum payment exceeds the 25% threshold, the supply under the agreement to which the payment relates is treated as being equivalent to a transfer of land. Creating a series of exceptions for situations when that treatment is inappropriate would significantly increase the complexity of the rules.

Under the proposed amendment, for the CZR rules to apply, the payment (or amount payable) concerned needs to be more than 25% of the consideration specified under the agreement. The 25% threshold is a base protection measure aimed at preventing "phoenix" fraud. This recognises the fact that some commercial leases that include irregular large lump sum payments are essentially substitutable for a transfer of land (and hence the same risk of phoenix fraud associated with sales of commercial land also exists in this situation).

Recommendation

That the submission be declined.

Issue: Application date – section 11(8D)(c)

Submission
(Matter raised by officials)

There is an inconsistency between the stated application date of clause 310(5) in the bill *Commentary* and that stated in the bill.

Comment

The *Commentary* to the bill states that the application date for the supplies of land leases amendments is 1 April 2011, with the only exception being clause 314(7), which is the provision that deals with land acquired by non-profit bodies. However, the application date stated in the bill for clause 310(5) (proposed section 11(8D)(c)) is 30 June 2014.

Officials confirm that 30 June 2014 is the intended application date for proposed section 11(8D)(c), as this is the date on which the existing provision came into force.

Recommendation

That the submission be noted.

TIME OF SUPPLY WHEN CONSIDERATION IS UNKNOWN

Clause 308

Issue: Support for the amendment

Submission
(EY)

The submitter welcomes the proposal to provide taxpayers with a legitimate, practical way of accounting for GST on supplies when the total consideration is not known at the time of supply as determined under the time of supply rule, which would otherwise apply, and which would normally trigger an obligation to account for the total amount of GST.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Drafting issues – section 9(6)

Submission
(EY)

The wording of the proposed replacement section 9(6) of the GST Act should be revised to achieve its objective effectively.

Proposed replacement section 9(6) is expressed as applying "subject to the other subsections of this section". That wording suggests that the other time of supply rules in section 9, including the general time of supply rule in section 9(1), must continue applying, in which case section 9(6) would never apply.

In referring to the alternatives of invoice or payment, the wording is confusing (particularly the reference to "a payment, not relating to an invoice") and does not provide any priority as between invoice or payment.

Comment

The time of supply determines when a supplier must account for GST on a supply of goods or services. The general time of supply rule in section 9(1) requires the supplier to account for GST at the earlier of the time that a payment is made or when an invoice has been issued in relation to the supply.

An existing exception allows suppliers to instead treat a supply as multiple supplies (in relation to any payment or invoice issued) when goods are supplied under an agreement, and the consideration payable is not known at the time goods are appropriated under the agreement.

However, the current exception is relatively limited and does not apply to all supplies of goods or to any supply of services. Hence, an issue potentially arises when, at the time of supply, the total amount of consideration for the supply is unknown. The intention of proposed section 9(6) is therefore to allow suppliers to account for GST on a supply to the extent that a payment is made (or an invoice for a payment has been issued) when the total consideration payable is not known at the time of supply.

The submitter's comments will be taken into account in amending the bill.

Recommendation

That the submission be accepted.

GOODS AND SERVICES CONNECTED WITH EXPORTED BOATS AND AIRCRAFT – APPLICATION DATE

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

Submission
(Corporate Taxpayers Group, Deloitte)

There is an inconsistency between the stated application date in the bill *Commentary* and that stated in the bill. The bill's *Commentary* states that clauses 310(1), (2) and 311(2) apply from the date of the bill's introduction, however the legislation states that the provisions apply from the date of Royal assent.

Comment

Officials confirm that the intended application date of clauses 310(1), (2) and 311(2) is the date of Royal assent.

Recommendation

That the submission be noted.

SIX-MONTHLY FILING

Clauses 312 and 313

Issue: Support for the amendment

Submission
(PwC)

The submitter supports the proposed amendment to relax the eligibility for six-monthly filing. The proposed change would reduce the compliance costs faced by businesses that have fluctuating revenue throughout the year (businesses that operate on a seasonal basis).

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Amendment should be broadened

Submission
(Chartered Accountants Australia and New Zealand, EY)

To maintain greater fairness and equity for all taxpayers who make seasonal supplies, the proposed amendments should not be limited to registered persons who make most or all of their supplies within a period of six months or less that falls near the end of the 12-month period. The amendment should apply to all persons who make all or most of their supplies for a 12-month period during a period of six months or less. The words "that ends with or near the end of the 12-month period" should be excluded. *(Chartered Accountants Australia and New Zealand)*

Taxpayers with seasonal businesses may often have balance dates following the making of the bulk of their supplies so that they could be described as making their supplies mostly within the second six months of a 12-month period. But that may not always be the case. From a policy perspective, we see no reason why six-monthly filing should not be available to all taxpayers with seasonal businesses who make all or most of their annual supplies within a single part of their income year, up to six months. *(EY)*

Comment

The amendment grants a concession to seasonal businesses who make taxable supplies which exceed the $500,000 threshold for six-monthly filing. The proposal would allow such seasonal businesses that make almost all of their supplies each year in a period consisting of six months or less (and who prepare their accounts at the end of the season) to file GST on a six-monthly basis. The rationale for restricting the scope of the concession to businesses who prepare their accounts at (or shortly after) the end of the season is that the GST should be returned after the end of the seasonal period as soon as practicable. (The preparation and filing of the GST return relating to period in which almost all of the business's taxable supplies are made should be more timely when it is undertaken closely following the preparation of the business's accounts.)

It is our understanding that most taxpayers who have seasonal businesses (where most of their annual supplies are made in a period of six months or less each year) have balance dates which follow the making of the majority of their supplies for the year.

Recommendation

That the submission be declined.

NOTIFICATION A REFUND IS BEING WITHHELD

Clause 322

Issue: Not supportive of the amendment

Submissions
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte)

Submitters are concerned that, if implemented, the proposed change will lead to longer delays for taxpayers receiving notification that their GST return is being investigated. Anecdotally, it can take two weeks from the time that a notice is issued to when it is received by the taxpayer due to delays in the postal service. Submitters question the necessity of the proposed amendment, suggesting that the notice could be issued electronically under Inland Revenue's Business Transformation programme, rather than sending a physical letter out. The Commissioner would then have 15 days under the current law to issue the notice, as the date that it was issued would be the same day that it was received by the taxpayer.

If the Commissioner issued the notice by post two weeks after filing date, the taxpayer may not receive the notice until four weeks after the return has been filed. This will be a significant change from the current 15-day timeframe. *(Chartered Accountants Australia and New Zealand)*

There are no details provided of the scale of the problem to warrant the change. This proposal sends the wrong message to taxpayers that they are responsible for filing all information/payments on time, but Inland Revenue will not apply the same rule to itself. *(Corporate Taxpayers Group)*

Such notification could be legislated for on a "real time" basis (in accordance with Inland Revenue's Business Transformation programme). When notifications are computer generated and sent out electronically, the proposal's policy rationale appears moot. On this basis, proposals to give the Commissioner of Inland Revenue 15 working days to issue a notification that she was investigating the circumstances of a return or requesting further information should not go ahead and instead this area should be reconsidered once Inland Revenue's Business Transformation programme has advanced further. *(Deloitte)*

Comment

Electronic issue of these notices will be available for taxpayers who have registered for online services in Stage 1 of Business Transformation. However, the proposed amendment recognises that there are a number of taxpayers who are registered for GST who do not (and will not) use digital channels. In these cases, a physical letter will still need to be sent.

Where the notification is sent by post, 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 the vast majority of GST refunds are received. The amendment is intended to clarify the 15-day timeframe for the minority of taxpayers claiming refunds that are subject to further inspection and represents a minor change only.

Recommendation

That the submissions be declined.

Issue: Clarification needed on when a notice is "issued"

Submission
(Corporate Taxpayers Group)

Clarification is required on when a notice can be considered to be "issued", as it is not uncommon for there to be significant differences between the date on an Inland Revenue notice and the date it is received by a taxpayer and/or the date it is postmarked by New Zealand Post.

Comment

A notice can be considered to have been issued on the date shown on the notice. This will be clarified and confirmed in the relevant issue of the *Tax Information Bulletin*.

Recommendation

That the submission be noted.

ALIGNMENT OF THE TIME PERIOD TO REPAY OVERPAID GST

Clause 321

Issue: Support for the amendment

Submission
(PwC)

The submitter supports and endorses the proposed amendment. The amendment ensures the legislation reflects the original policy intent of the provision.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Transitional provision should be extended

Submission
(Chartered Accountants Australia and New Zealand)

The transitional provision should apply for all taxable periods beginning on or after 1 April 2005, which was the date from which the current provision applied. Furthermore, the transitional provision should apply to all claims, not just existing claims.

Comment

Officials note that the purpose of the amendment is to clarify an existing provision (which, as the submitter notes, applied from 1 April 2005) so that the law is aligned with the original policy intent. For this reason, we agree that the amendment in clause 321(1) should apply for all taxable periods beginning on or after 1 April 2005.

Instead of extending the transitional provision as the submitter suggests, we recommend instead deleting the transitional provision and making the application of clause 321(1) retrospective to 1 April 2005. This will have the effect of extending the amendment to all claims made in relation to taxable periods beginning on or after that date, instead of just existing claims.

Recommendation

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

AGENTS ACTING FOR PURCHASERS

Clauses 320 and 326

Issue: Support for the amendment

Submission
(Corporate Taxpayers Group, Deloitte, KPMG)

The Group supports this amendment, however we have some concerns with the application date. *(Corporate Taxpayers Group)*

We are supportive of the proposals. We also commend officials' willingness to listen to prior submissions regarding these proposals. *(Deloitte)*

We generally support the proposed amendment to allow agents acting on behalf of purchasers to opt out of the agency rules for a supply made to a principal. This 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. *(KPMG)*

Comment

Officials welcome the submitters' support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Application date

Submission
(Corporate Taxpayers Group)

We submit that the amendment should apply from 17 July 2013 as this would align with the application date of changes which became effective on the same date to allow agents and principals to opt out from the agency rules for agents making supplies on behalf of their principals (contained in section 60(1B) of the GST Act). As the underlying policy behind the current amendment and previous change is similar, it would be appropriate that the application of this amendment is back-dated to align with the application date of the previous change.

Comment

While the underlying policy behind the current amendment and the previous change is indeed similar, it is not the exact same situation. Because the proposed changes therefore represent a minor policy change rather than a clarification of the existing law, officials consider that a retrospective application date would not be appropriate. We recognise, however, that it is desirable that taxpayers are able to benefit from this amendment as soon as possible. This is why we recommend the date of enactment of the bill as the proposed application date for the amendment.

Recommendation

That the submission be declined.

Issue: Bad debt deductions

Submission
(KPMG)

The submitter disagrees with the inclusion of clause 320, which prevents a bad debt deduction being claimed for the supply by an agent to a principal where the principal has not repaid the agent. In the case of non-payment by the principal, the agent should be able to claim a bad debt deduction (subject to existing bad-debt deduction rules) as the agent has already returned output tax on the supply to Inland Revenue. If the agent is unable to claim a deduction for the supply, Inland Revenue will be unjustly enriched.

Comment

As a base maintenance measure, similar to the existing rules for suppliers and their agents, the agent should not be allowed to claim a bad debt deduction in the event of default by the purchaser. This is because it is possible that, if a bad debt deduction were allowed, an agent could claim a bad debt deduction without having returned the output tax.

The amendment is intended to ensure that agents and principals do not need to update their systems and incur compliance costs in doing so, without creating an inadvertent fiscal risk. Officials note that under the existing rules, the agent would not be treated as making a supply, and therefore would not receive a deduction for non-payment by the principal.

Recommendation

That the submission be declined.

CROSS-BORDER BUSINESS-TO-BUSINESS NEUTRALITY REMEDIAL AMENDMENTS

Clause 324

Issue: Support for the amendment

Submission
(KPMG)

The submitter agrees with the proposed amendments to make two changes to the non-resident registration rules to ensure: (1) that a non-resident cannot register under the rules when they make supplies that are consumed in New Zealand, and (2) a non-resident that only incurs GST paid to New Zealand Customs Service is able to register under section 54B.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Clarify "carrying on a taxable activity in New Zealand"

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

The meaning of the phrase "carrying on a taxable activity in New Zealand" should be clarified for this context so it is clear that the non-resident registration rules are not intended to be interpreted as narrowly as they are currently. Inland Revenue has been interpreting the new rules in a way that prevents a non-resident from registering under the non-resident registration rules if they have any kind of presence or commercial activity in New Zealand even though that presence or activity is less than a taxable activity which would entitle them to register in New Zealand. As a consequence, some non-residents have been unable to recover GST on any business costs incurred in New Zealand under either the non-resident registration rules or the standard registration rules. The narrow interpretation is inconsistent with the policy intent of the rules and creates a "black hole" for GST purposes. *(Chartered Accountants Australia and New Zealand)*

Section 54B(1)(d) should be amended to replace the phrase "carrying on a taxable activity in New Zealand" with "carrying on a taxable activity that involves making taxable supplies in New Zealand". *(KPMG)*

Comment

A non-resident cannot register under section 54B if they "are carrying on a taxable activity in New Zealand, or intending to carry on a taxable activity in New Zealand". There is some uncertainty over when a non-resident is carrying on a taxable activity in New Zealand for the purposes of section 54B(1)(d)(i). Specifically, it is arguable that when a non-resident receives goods or services in New Zealand (which are a part of their overall taxable activity), some part of that taxable activity is being undertaken in New Zealand (thereby preventing registration under section 54B).

For example, if a non-resident business sends its employees to be trained in New Zealand, then some part of its global activity is being carried on in New Zealand. The policy objective was only to prevent non-residents from registering under section 54B if they were making taxable supplies, and so were liable to (or able to) register under section 51.

Recommendation

That the submission be accepted.

Issue: Non-resident parent registration

Submission
(KPMG)

Inland Revenue's current view is that a Head Office and a New Zealand branch are the same legal entity for section 54B purposes. As such, the Head Office with a GST-registered New Zealand branch would not be able to separately register for GST under section 54B on the basis that it has a New Zealand branch that carries on a taxable activity in New Zealand. This outcome is inconsistent with the fundamental principle that GST should not be a cost for business (which is the rationale behind section 54B). The Head Office, which is carrying on a taxable activity overseas and is registered for an overseas equivalent of GST, should not bear the cost of New Zealand GST.

Section 54B of the GST Act be amended to explicitly provide that a branch registered for GST is treated as a separate person from its Head Office and any other branches. Such an amendment would allow an overseas company with a registered New Zealand branch to be able to be separately registered for GST under section 54B.

This amendment should have a retrospective effect from 1 April 2014, to be consistent with the original policy intent behind section 54B.

Comment

Officials agree with the submitter's analysis of the issue and acknowledge that the operation of section 54B in this context has been an area of uncertainty. As the submitter points out, the policy is that non-resident businesses should not have to bear the New Zealand GST cost. Section 54B should therefore be amended to align it with the policy intent by allowing a non-resident parent or branch to register separately under section 54B and claim input tax deductions on a payments basis.

Recommendation

That the submission be accepted.

Issue: Drafting issue – section 54B(1)(b)

Submission

(Matter raised by officials)

The current drafting of the proposed amendment to section 54B(1)(b) of the Goods and Services Tax Act 1985 may not achieve the desired policy outcome. Officials are therefore recommending the following clarification so that the amendment will operate as intended. The change suggested by officials is taxpayer-favourable, as it will allow more GST-registered businesses to claim back the New Zealand Customs GST costs charged on goods that have been imported by a non-resident.

Comment

When a non-resident who is an importer of goods is registered under section 54B, section 20(3LB) and (3LC) deem the Customs GST charged on goods submitted for import entry by the non-resident to have been paid by the recipient of the goods, and not by the non-resident importer. Where the imported goods are received by a GST-registered person for the purpose of making taxable supplies, that registered person should be able to claim the Customs GST back as an input tax credit, so that there is no GST impost on a business-to-business transaction. However, if the non-resident importer (who, under the place of supply rules is not treated as making a taxable supply in New Zealand) is ineligible to register under section 54B, a GST impost will result, as neither the non-resident importer nor the recipient will be able to claim the GST back.

Under the current law, it is likely that a non-resident who only has a connection with New Zealand as an importer of goods will be unable to register under section 54B. To address this problem, clause 324 in the bill proposes a new replacement section 54B(1)(b). As it is currently worded, the amendment allows a non-resident who only has a connection with New Zealand as an importer to register if that person's *input tax* is likely to consist only of Customs GST charged in relation to the importation of goods that are received by another person. However, the reference to *input tax* is likely to give rise to an interpretative issue which could prevent the operation of proposed section 54B(1)(b) as intended. This is because of the aforementioned interaction of section 20(3LB) and (3LC) with section 54B. The interaction of these sections means that it is arguable that the Customs GST is not the non-resident's *input tax* (because it is deemed to have been incurred by the recipient of the goods, not the non-resident). This could lead to problems with registering non-residents who operate only as importers (and who are not treated under the Act as making taxable supplies in New Zealand), contrary to the intent of the amendment.

Recommendation

That the submission be accepted.

GROUPING LIMITED PARTNERSHIPS

Clause 325(2)

Issue: Support for the amendment

Submission
(Deloitte)

The submitter is supportive of the clarification amendment that seeks to ensure that limited partnerships can apply the grouping rules and file a joint return with other registered persons who share common control.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Application date

Submission
(Deloitte)

This amendment is proposed to come into force on the date the bill is enacted. Given the clarifying nature of the amendment, it should be retrospective to cover non-time bar periods (this approach would be consistent with the proposed application date of bodies corporate amendments). This would provide certainty for taxpayers and be consistent with the Commissioner of Inland Revenue's duty to promote voluntary compliance.

Comment

Officials consider that the combined operational and fiscal impacts of back-dating grouping as suggested by the submitter would outweigh the benefits to the affected taxpayers. Going forward, the new rules will provide certainty for these taxpayers.

Recommendation

That the submission be declined.

HORSE RACING AND PRIZES

Clauses 306(3) and 309

Issue: Support for the amendment

Submission
(New Zealand Racing Board)

The submitter supports the purpose of clause 306(3), but believe the clause requires amendment to ensure that it applies equally to greyhound races and also to ensure it provides the clarity required.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Technical points – section 5(11CB)

Submission
(New Zealand Racing Board)

- The section should clarify the GST treatment of prizes paid by both Racing Clubs and Racing Codes. The proposed section refers to only a prize paid by a Racing Club. However a limited number of prizes are currently paid by a Racing Code directly, having regard to the performance of the animal at a Racing Club. It would be simpler for a GST-registered industry participant if the same GST treatment applies to all prizes, rather than creating a distinction (or leaving uncertainty of treatment) based on whether the prize is paid by the Racing Club or the Racing Code.
- The section should include dogs in a greyhound race so that it applies equally to each of the three Racing Codes. The New Zealand racing industry consists of three Racing Codes – New Zealand Thoroughbred Racing, Harness Racing New Zealand and Greyhound Racing New Zealand. There is no sound policy reason why this amendment should apply to a horse in a horse race and should not apply to a dog in a greyhound race.
- The section should focus on the receipt of a prize rather than who enters the animal in the race. It is common practice in the racing industry that a horse (or dog) may be entered into a horse (or greyhound) race by any of a number of people, including the owner, a lessee, a trainer or a racing manager, for example – all of whom could do so as a registered person in the course of a taxable activity. The treatment of the prize should not be dependent upon which of these individuals (or non-individuals) completes the act of entering the animal. The section refers to a prize paid by a Racing Club for the performance of a horse in a horse race. It is common practice for several persons to receive a prize paid by a Racing Club in this way.

Comment

Officials recognise taxpayers' need for certainty and clarity in this area. The legislation should be informed by and recognise common industry practice, so that it anticipates all eventualities and is consistent in the way that it applies to similar situations. We consider that the law should provide certainty in the GST treatment of horse racing and greyhound racing prizes alike. Extending the scope of the amendment to cover greyhound racing prizes and prizes paid by Racing Codes, as well as focusing on the receipt of a prize (instead of the act of entering an animal in a race) should achieve this result.

However, on the third bullet point above, officials note that the submitter has suggested some draft wording which would treat the likes of jockeys and trainers as making a supply of services to the Racing Club or Code. Inland Revenue's position is that, where a racehorse or greyhound is concerned, these persons do not provide any supply to the Racing Club or Code. The amendment should not disturb this position.

Recommendation

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

Issue: Guidance from Inland Revenue

Submission
(New Zealand Racing Board)

It is critical that future guidance from Inland Revenue provides clear commentary addressing these issues. In particular that guidance should clarify that this GST treatment is not limited to owners.

As recognised in the *Commentary* to the bill, these arrangements are GST-neutral, as any GST charged by the winner would be deducted by the Racing Club or Racing Code. In this respect, the guidance from the Australian Tax Office is particularly helpful and instructive.

Comment

An item on the changes will be published in the *Tax Information Bulletin* following enactment. Officials will consider, once the provision is enacted, whether further guidance is needed.

Recommendation

That the submission be noted.

Issue: Grandparenting provision

Submission
(New Zealand Racing Board)

The submitter agrees that these clarifications should be retrospective in nature and supports the proposed application date of 1 April 2012, to preserve and confirm the treatment of past transactions. However, if a prize has not previously been treated as consideration for a supply, that treatment should be "grandparented". That is, to the extent that a taxpayer previously did not treat a prize as being consideration for a supply and that supply was not included in a tax invoice or a buyer created tax invoice, then the amendment should not apply retrospectively to alter the GST treatment of that supply. This reflects the previous uncertainty, the desire that reassessments should not inadvertently be required for past periods, and that the GST treatment should remain neutral as between the parties in any event.

Comment

Given the retrospective application date, officials agree that it is both appropriate and fair to include a grandparenting provision to preserve the past tax positions of taxpayers, given the previous uncertainty about the GST treatment of racing prizes.

Recommendation

That the submission be accepted.

Issue: Application date – section 10(13)

Submission
(Matter raised by officials)

A correction should be made to the application date of clause 309(1).

Comment

Clause 309(1) makes a minor clarifying amendment to section 10(13), so that the section refers to subsection (12) (instead of section 12). The current application date of the amendment is the date of enactment of the bill. However, because this is a clarification, the amendment should apply with retrospective effect from the date on which the existing provision came into force, which was 1 August 2003.

Recommendation

That the submission be accepted.

SALES UNDER A SECURITY INTEREST WHERE AN INCORRECT STATEMENT IS PROVIDED

Clauses 306(1) and 323

Issue: Proposal should be "softened"

Submission
(Deloitte)

Proposals relating to sales under a security interest when an incorrect statement is provided should be "softened" to require the debtor to provide a statement in writing to the creditor confirming that the debtor is not aware of anything that may indicate that the supply would have been a taxable supply.

Comment

The amendment is intended to ensure that incorrect statements by debtors will mean that those debtors end up being liable for the GST on the mortgagee sale. The wording of proposed section 5(2)(a) makes it clear that the statement by the debtor has to be correct before the exception can apply.

We note that amending the proposal in the way suggested by the submitter would potentially send the wrong message, as it could give debtors the impression that they do not need to take much care in providing written statements to creditors, when in fact if the statement turns out to be incorrect the debtor will be liable for the GST. Given that this is the case, it is appropriate that debtors know that they need to take reasonable care in providing these statements to ensure that the statement is correct and fully states the reasons why the supply would not be taxable.

Officials note that there is a remedy available for a creditor who has incorrectly paid GST on a mortgagee sale under section 113A of the Tax Administration Act 1994. We also note that EY commented in their submission that the proposed amendments to section 5(2)(a) appear reasonable in tightening the criteria for debtors to notify creditors that the sale should be treated as "non-taxable".

Recommendation

That the submission be declined.

Issue: Drafting issues – section 51B(1)(b)

Submission
(EY, New Zealand Law Society)

The proposed replacement of section 51B(1)(b) should be revised to enable the proposed amendment to operate appropriately. It should treat those selling the goods (the creditors) as registered if they are required to furnish returns under section 17 or make default in that regard, with the debtors being treated as registered if they have provided inadequate or incorrect notices as to non-taxable status to the creditors.

Comment

Currently, a creditor who undertakes a mortgagee sale is treated (for the purposes of that sale) as a GST-registered person and is liable to make a special return of GST on the sale. Exceptions to this treatment are when the debtor has provided a written statement to the creditor that the sale would not be a taxable supply if the goods had been sold by the debtor, or, if the debtor has not provided such a written statement, the creditor can nevertheless reasonably determine that the sale would not be a taxable supply if it had been made by the debtor.

However, the current drafting of the proposed amendment mistakenly treats the creditor as being GST-registered when these exceptions apply.

This would render the creditor liable to file a special return in respect of the sale, even though there should be no actual liability to pay GST on the sale. Treating the creditor as a registered person in these circumstances is clearly not the intended policy outcome, as these circumstances are supposed to be the exceptions where a creditor exercising their power of sale is <u>not</u> required to return GST on the sale in a special return.

Another drafting issue with the proposed amendments is that, where the exceptions in section 5(2)(a) and (b) do not apply, proposed section 51B(1)(b)(ii) treats the debtor as a registered person in respect of a mortgagee sale even if the debtor did not make an incorrect statement. When the debtor has not provided the creditor with any statement as to the GST treatment of the supply (and the exception in section 5(2)(b) does not apply), the creditor should be treated as registered and be required to return the GST on the sale. Officials will therefore make appropriate changes.

Recommendation

That the submission be accepted.

Issue: Creditor should be able to rely upon statement by debtor

Submission
(New Zealand Law Society)

Proposed section 51B(1)(b)(i) does not clearly shift the deemed registration from the security holder to the debtor in circumstances when the debtor has provided a section 5(2)(a) statement that is, on the face of it, full and correct, but is deliberately false. The security holder should be able to rely on a statement that is ostensibly credible. If a false statement is given by the debtor, section 51B(1)(b) should apply to the debtor, not the security holder.

Comment

Proposed section 5(2)(a) states that a supply of goods by a creditor exercising its power of sale under a security interest are deemed to be supplied in the course or furtherance of a taxable activity by the debtor <u>unless</u> the supply of those goods would <u>not</u> be a taxable supply if sold by the debtor, and the debtor has provided a statement which correctly states this fact. Where an incorrect statement has been provided by the debtor, section 51B(1)(b) should treat the debtor as a registered person so that they are required to return GST on the sale.

However, the current interaction between proposed sections 5(2) and 51B(1)(b) does not necessarily make this entirely clear in the situation when a creditor has relied on a false statement that appeared at the outset to be full and credible. Officials agree that it should be clarified that section 51B(1)(b) applies to treat the debtor as registered (and not the creditor) when the debtor provides a false statement.

Recommendation

That the submission be accepted.

NO APPORTIONMENT FOR DE MINIMIS EXEMPT USE

Clause 314(2)

Submission

(EY)

Clarification is required as to the aim of the proposed amendment as it is not clear what it will really achieve. The *Commentary* (at pages 98-99) refers to the proposed amendment making it explicit again (to the same effect as the previous section 21(4)) that “the rule removes the need to make adjustments in respect of only exempt supplies (rather than, for example, private use)”. There may be ongoing confusion about what input tax adjustments may be required, when the section 20(3D) de minimis rule may apply and what is intended from a policy perspective.

Section 21(2) provides a number of exceptions to the general rule in section 21(1) that adjustments may be required to input tax claims made if there is a percentage difference to the end of an adjustment period in relation to the actual use of items acquired. One exception is when section 20(3D) applies. That section, both as currently enacted and as proposed to be amended, applies only if a person makes both GST-taxable and GST-exempt supplies.

On that basis, the section 20(3D) de minimis exception would never apply if a person makes a combination of GST-taxable supplies and private use, but does not make any GST-exempt supplies. If that is the intended position, it should be clarified as the *Commentary* seems to suggest otherwise.

Comment

The policy intention is that the section 20(3D) de minimis does not prevent adjustments in cases when the adjustment is due to a change in the ratio of taxable supplies and private use. The de minimis rule should only apply in cases when the person’s input tax adjustment is due to the actual ratio of exempt and taxable supplies being different from the initial estimate (rather than to an adjustment due to private use). This policy intention will be communicated in the *Tax Information Bulletin* following enactment of the bill.

This point may also be considered under a wider review of the apportionment and adjustment rules.

Recommendation

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

VALUE OF ENTERTAINMENT EXPENSES

Clause 318

Issue: Support for the amendment

Submission
(Corporate Taxpayers Group)

The submitter supports the proposed amendment, given it is a more pure outcome from a policy perspective.

Comment

Officials welcome the submitter's support for the proposed amendment.

Recommendation

That the submission be noted.

Issue: Not supportive of amendment

Submission
(Deloitte)

While the submitter agrees with this change from a pure policy perspective, in this specific case they are not supportive of this change for practical reasons. The proposal would introduce a change in the manner that taxpayers have been making the GST adjustment on entertainment expenses for over 20 years. While the amounts involved are likely to be relatively small for each taxpayer, this proposal would require every single GST registered taxpayer who spends money on entertainment expenses to change the manner in which they perform their annual GST calculation. There is a high chance that a significant number of smaller taxpayers would continue to make the GST adjustment in the manner in which they "did it last year", and therefore open themselves up to the risk of penalties or audit by Inland Revenue. This is likely to create tension between SME taxpayers and Inland Revenue on a matter that in the larger scheme of the GST Act is not that significant.

While this change would be "technically correct", due to the significant potential practical problems envisaged, and the small amount of GST involved, this proposal should not be enacted.

Comment

Officials have considered the concerns expressed by submitters and recognise the need for taxpayers to have certainty about how and when the change applies to them. We therefore recommend delaying the date of application to 1 April 2018. This will allow time for an education campaign to take place over a period of several months and thereby reduce the risk of taxpayers being caught unaware by the change.

Recommendation

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

Issue: Promote new rule

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte)

Submitters are concerned that there will be significant levels of non-compliance with the amended rule, given that it has applied for over 20 years and has been included in various Inland Revenue guides. There is a need for publicity and education around the new rule. Inland Revenue should also exercise leniency if taxpayers do not correctly apply the new rule.

Comment

An item will be included in the *Tax Information Bulletin* on the new rule following enactment of the bill. The changes will also be publicised through other channels, and guidance materials will be provided. Officials have suggested delaying the application date, in response to other submissions, to 1 April 2018, which should deal with the leniency issue as there will be period of several months for taxpayers to get up to speed with the change before it takes effect.

Recommendation

That the submission be noted.

Issue: Application date

Submission
(Corporate Taxpayers Group, EY)

An application date with reference to a specific date rather than the date of enactment would be more appropriate. Given taxpayers must return the GST in the earlier of the month their income tax return is filed or the month it is due to be filed, an application date of 1 April (either 2017 or 2018) would be most appropriate to take into account taxpayers with an extension of time for filing tax returns. *(Corporate Taxpayers Group)*

There may also be taxpayer confusion and uncertainty about when and whether the changed rule applies to them. It should be clear which returns of income will be subject to the changed GST calculations and some time should be allowed to ensure that taxpayers can be made properly aware of the enactment of any change before it applies. The amendments to section 24I(4) should be expressed as applying in relation to supplies deemed to arise in relation to returns of income for the 2016–17 tax year (or some later year if there are expected to be substantial delays in the enactment of the bill). *(EY)*

Comment

As the submitters point out, if enactment of the bill occurs before 31 March 2017, there could be many taxpayers who will be affected by the change who (quite legitimately) will not have already filed their income tax returns for the 2015–16 tax year. If the change simply applies to returns filed after the enactment date of the bill, there would therefore be a change in the GST liability relating to the 2015–16 tax year for taxpayers filing after that date compared with others who had already filed their returns. (This is because taxpayers must return the GST in the earlier of the month their income tax return is filed or the month it is due to be filed.) There should not be a difference in GST treatment between groups of taxpayers who are filing for the same period that is based solely on when taxpayers file their returns of income for a past tax year, as this is inequitable.

Officials therefore recommend delaying the date of application to 1 April 2018, so that the change applies to taxpayers' GST returns for taxable periods that fall within or after the 2017–18 year. This will also allow time for a publicity campaign to take place over a period of several months and thereby reduce the risk of taxpayers being caught unaware by the change.

Recommendation

That the submission be accepted.

Clause 319

Issue: Time for returning input tax

Submission
(EY)

The time for returning any excessive input tax in relation to supplies of secondhand goods acquired should depend on when the change becomes apparent or known to the registered taxpayer, rather than on when the change occurs.

Comment

The proposed amendment applies in circumstances when one of the following change events has occurred:

- the supply of secondhand goods has been cancelled;
- the nature of the supply has been fundamentally varied or altered;
- section 11(1)(mb) was incorrectly applied to the treatment of the supply (so that the supply was either zero-rated when it should not have been, or not zero-rated when it should have been);
- the previously agreed consideration for that supply of secondhand goods has been altered (for instance, through the offer of a discount); or
- the goods (or part of those goods) supplied have been returned to the supplier.

This being the case, the date on which the change event occurs should usually be the same date that the change event becomes known to the registered person who contracts with the supplier. Where this is not the case, determining the time for returning excess secondhand goods deductions that a registered person has claimed based on when the change becomes apparent to that person may set the wrong incentives for taxpayers to check the accuracy of the amount of input tax credits claimed.

Recommendation

That the submission be declined.

DEFINITION OF "NON-TAXABLE USE"

Clause 304(2)

Issue: Reference should be to "taxable supplies"

Submission
(Chartered Accountants Australia and New Zealand)

The word "taxable" has been omitted from the definition. The meaning of the phrase in this context should be: "non-taxable use, for goods or services, means use of the goods or services for making exempt supplies or other than for making taxable supplies".

Comment

Officials agree that the word "taxable" has been inadvertently omitted from the proposed definition of "non-taxable use".

Recommendation

That the submission be accepted.

Issue: Input tax deductions for deemed supplies

Submission
(Deloitte)

The submitter expresses some concerns with the proposed definition of "non-taxable use" in clause 304(2). The definition refers to the "use of goods or services for making exempt supplies *or other than for making supplies*". Their concern centres around whether this definition could be used to deny an input tax deduction where businesses acquire goods or services for promotional giveaways, prizes and societal impact projects. While these arguably are supplies, defining the term "non-taxable use" in this way places a large emphasis on what is a supply. While supply includes all forms of supplies, the majority of supplies that are provided for no consideration are "deemed" supplies in section 5. This definition may result in input tax for supplies that are not provided for consideration being denied.

We note that this definition is not consistent with the use of the term "non-taxable use" in the *Commentary* to clause 304(2), which refers to non-taxable use as consisting of exempt and private use of an asset. This definition is consistent with the general interpretation of "non-taxable use".

Comment

As the submitter points out, supplies provided for no consideration are still supplies (albeit deemed supplies) so taxpayers would still be able to claim input tax in relation to these supplies. It is therefore unnecessary to amend the proposed definition of non-taxable supplies any further beyond the change suggested by Chartered Accountants Australia and New Zealand, which will address the second issue raised by the submitter in relation to the inconsistency in the use of the term between the *Commentary* and the bill.

Recommendation

That the submission be declined.

No clause

Issue: GST treatment of supplies incorrectly zero-rated

Submission
(Deloitte)

Section 5(23) is not being applied in a manner which is consistent with the wording of the legislation, which currently reads:

> If section 11(1)(mb) is treated as applying to a supply of goods and, after the date on which the relevant transaction is settled, it is found that the provision does not apply, the recipient of the supply is treated as if they were a supplier making, on the date of settlement, a supply of those goods that is chargeable with tax under section 8(1).

Given the large number of property transactions that are undertaken and the substantial value of many of these transactions, having certainty over the GST treatment is causing concern in the market and needs to be resolved urgently.

Officials should include a clarification in the bill. Section 5(23) should be amended to read "… treated by the vendor as applying…", that is, insert the words "by the vendor" to ensure consistent application of the legislation.

Given this is a clarification of the law, rather than a change, we recommend that the amended wording apply from 1 April 2011 when the provision was first introduced.

Comment

The compulsory zero-rating of land (CZR) rules were introduced to help combat "phoenix" fraud whereby a supplier of commercial land absconds or is wound up without returning the GST, but the purchaser (often a related party) is still entitled to a deduction.

Under the CZR rules, certain supplies of land must be treated as zero-rated rather than standard rated. The rules do not allow the parties to a land transaction covered by the CZR rules to agree to the GST treatment of the supply, as this would render the zero-rating rules ineffective as a means to combat phoenix fraud. The CZR rules therefore operate by requiring the vendor to make a unilateral decision to zero-rate or standard rate the supply of land based on their interpretation of the law.

The matter raised by the submitter is complex and should be considered for a later bill. We note that the submission is out of scope of the bill under consideration, and that an attempt to deal with this complex issue now through an amendment could lead to unintended consequences.

Recommendation

That the submission be noted.

Issue: Travel insurance and facilitation of services performed offshore

Submission
(KPMG)

Section 11A(1)(j) previously stated that services can be zero-rated if they involve the arranging of services that are physically performed outside New Zealand. However, the recent change to section 11A(1)(j) as part of the GST on remote services amendments appears to have had the inadvertent consequence of changing this outcome for remote services which relate to something physically done offshore.

The arranging of a supply which is physically performed outside New Zealand and which is not itself a remote service should be able to be zero-rated. Section 11A(1)(j) should be amended accordingly to provide for this outcome.

Section 11A(1)(f) should be amended so that services in connection with moveable personal property outside of New Zealand are also able to be zero-rated.

Given the uncertainty raised by the remote services rule for insurance services, we submit, consistent with the policy intent, that such supplies be clearly zero-rated. A specific amendment to section 11A(1)(d) should be made to cover the insurance of persons and goods while outside New Zealand or in connection with international travel.

Comment

The policy change referred to in the submission is not an inadvertent one, but is a deliberate policy change to align New Zealand's GST treatment of remote services supplied by non-residents to New Zealand-resident consumers with the OECD's VAT/GST Guidelines. This change to the GST framework in the context of remote services does not amount to abandoning the destination principle, but instead is a modification to how the destination principle operates in this context, where the residency of the person who contracts with the supplier is used as a proxy for where the service is consumed.

However, officials recognise that there has been a possible overreach in the specific cases of travel insurance and remote services which involve the facilitation or arranging of services that are physically performed offshore (when the services that are being arranged require that the recipient is in the same location as the physical performance of those services – such as an overseas concert or overseas accommodation, for instance). In this particular case, it seems that the insurance or facilitation service should be zero-rated because the *underlying service* (which is not a remote service) is consumed outside of New Zealand.

While we acknowledge the desirability of a speedy response to the issues set out in the submission, we note that the submission is outside the scope of the bill under consideration, and that these are substantive policy issues that have not been consulted on. An attempt to fix these issues through an amendment to this bill could lead to unforeseen consequences. We therefore consider that it would be more appropriate to consider these issues outside of the process of this bill and undertake public consultation at a later date, if necessary.

Recommendation

That the submission be noted.

Issue: Drafting issues with remote services provisions

Submission
(Matter raised by officials)

Officials would like to raise a number of drafting issues with the new cross-border services rules in the Goods and Services Tax Act 1985.

Comment

Section 8B(1) and (5) outlines special rules that non-residents must use to determine whether recipients of remote services are New Zealand resident, GST-registered businesses or not. These sections apply to non-resident electronic marketplaces under section 60C. An amendment should be made so they also apply to non-resident non-electronic marketplaces under section 60D.

Sections 8B(5), 24(5B) and (5D) mistakenly refer to section 8(4), a provision that allows non-residents to agree with recipients to treat certain supplies as being made in New Zealand. These sections need to be updated to refer to the new section 8(4D) to reflect the fact that non-resident suppliers of remote services can independently choose to zero-rate the supply.

The title of the rules that allow non-residents to register and claim back New Zealand GST (sections 54B and 54C) were amended when the new remote services were introduced. The new title refers to *certain non-resident <u>suppliers</u>*. The new title mislabels the types of non-residents that can register under these rules. This is because in order to qualify under the rules, non-residents cannot make supplies in New Zealand and therefore are not *suppliers*. The new titles under section 54B and 54C should be amended to remove the reference to *suppliers*.

Recommendation

That the submission be accepted.

Issue: Resident suppliers and non-resident marketplaces

Submission
(Matter raised by officials)

Section 60(1C) of the Goods and Services Tax Act 1985, that treats supplies of remote services by resident suppliers through non-resident marketplaces as two separate supplies, does not operate as intended. An amendment is required to ensure the supply from the resident to the non-resident marketplace is zero-rated under section 11A(1)(k).

Comment

New section 60(1C) of the Goods and Services Tax Act 1985, that was introduced as part of the remote services rules, may not apply as intended. The section applies to New Zealand-resident suppliers of remote services that operate through a non-resident marketplace. The new marketplace rules require non-resident marketplaces, and not underlying suppliers to register and return GST on remote services supplied to New Zealand residents.

These resident underlying suppliers may already be registered for GST under the standard rules. If these suppliers were subject to the general marketplace rules under new section 60C or 60D, the services they supply through the marketplace would no longer be taxable, as the operator of the marketplace will have been treated as the supplier. This would mean that GST incurred by the underlying supplier in making these supplies would be irrecoverable.

To address this issue, section 60(1C) treats the supply of remote services as two separate supplies – a supply of services from the underlying supplier to the operator, and a supply of those services from the operator of the marketplace to the recipient. This will allow the resident underlying supplier to recover the GST costs incurred in making the supply.

It was intended that the supply to the marketplace would be zero-rated under section 11A(1)(k) (as the supply is made to a non-resident outside New Zealand). However, in some situations the supply may not be zero-rated as the service provided by the marketplace may be received by a person in New Zealand (see the exception to the zero-rating rules under section 11A(2)). This would mean the resident underlying supplier would be required to standard-rate the service to the marketplace and the marketplace would need to recover the GST in their GST return.

The supply between the two registered persons will remain GST-neutral. The marketplace, however, will be required to file a full GST return as opposed to the simplified "pay-only" GST return. This may impose some compliance costs on non-resident marketplaces, and consequently, an amendment is required to ensure the supply from the resident to the non-resident marketplace is zero-rated under section 11A(1)(k).

Recommendation

That the submission be accepted.

Issue: Exception to requirement to have a bank account in order to obtain an IRD number

Submission
(Matter raised by officials)

A new exception to the requirement to have a bank account in order to obtain an IRD number was introduced when the Residential Land Withholding Tax (RLWT) rules were introduced (see section 24BA(1B) of the Tax Administration Act 1994). The exception was intended to cover non-residents applying for an IRD number in order to register for GST. It is arguable that the wording of the exception may not cover all non-residents applying to register for GST, as the exception refers to a non-resident *supplier of goods and services*. This is problematic because non-residents applying to register under section 54B are prohibited from making supplies in New Zealand. The exception to the bank account requirement should therefore be amended to remove the reference to a *supplier of goods and services*.

Comment

Non-residents can register under section 51 of the GST Act if they carry on a taxable activity in New Zealand. However, registration under section 54B prohibits a non-resident from making taxable supplies in New Zealand. This means that a non-resident who is registered under section 54B is not a *supplier of goods and services* under the GST Act. Hence, the exception in section 24BA(1B) of the Tax Administration Act 1994 does not cover non-residents who are registered under section 54B as was intended.

The requirement to open a New Zealand bank account (in order to obtain an IRD number) therefore presents a barrier to registration under section 54B for a non-resident who does not make taxable supplies in New Zealand, but who carries on a taxable activity elsewhere in the world. For a non-resident in this category, being unable to register under section 54B means that they cannot claim back the GST incurred on goods and services used in making their worldwide supplies. This results in a GST impost on a business-to-business transaction, which conflicts with the purpose of GST as a tax on final consumption in New Zealand.

Recommendation

That the submission be accepted.

Other policy matters

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)

Issue: Support for the proposal

Submissions

(Chartered Accountants Australia and New Zealand, Chapman Tripp, Corporate Taxpayers Group, Deloitte, EY, KPMG, PwC, Russell McVeagh)

The tenor of the proposal is supported (and in a number of submissions, strongly supported).

Comment

Officials welcome support for the proposals.

Recommendation

That the submissions be noted.

Issue: The core debt remission rule should be rewritten

Submission

(Chartered Accountants Australia and New Zealand, Chapman Tripp, Corporate Taxpayers Group, Deloitte, KPMG, New Zealand Law Society, PwC, Russell McVeagh, Staples Rodway)

The core rule is complicated and may not achieve its stated purpose. It should be rewritten. Sister companies are given as an example. The submitters suggest that there should be an explicit wholly owned group company rule, and the pari passu and other situations be dealt with separately.

Comment

Officials agree that the core rule may be, upon reflection, trying to do too much too briefly and is therefore unnecessarily complicated. Further, it may not work as intended. It can be restructured so that it is clearer and its application is more certain. For example, the rewritten provision could deal separately with:

- if the debtor (borrower) and the creditor (lender) are in the same wholly owned group of companies, except when the remission results in a transfer of value from a New Zealand company or CFC to a foreign shareholder of the New Zealand company;
- where the creditor owner(s) (directly or indirectly) of the debtor (company, look-through company, partnership or limited partnership) all contemporaneously remit debt pari passu with ownership (in proportion to, or pro rata with ownership);

- where the creditor is associated with the owner the pari passu rule will continue to apply when the creditor:
  - is in the same wholly owned group of companies as the owner (with the same caveats about transfers of value to non-residents); or
  - is a person who, if they had advanced the loan to the owner, could forgive the debt tax free for natural love and affection under section EW 44.

Recommendation

That the submissions be accepted.

Issue: Partial or full debt remission

Submission
(Corporate Taxpayers Group, Deloitte)

It should be made clear that the proposed core rule deals with partial debt remission as well as full debt remission.

Comment

Given the deemed loan repayment concept inherent in the core rule, officials agree this is conceptually correct and will produce the intended outcome later when the debt ceases and the base price adjustment is performed.

Recommendation

That the submission be accepted.

Issue: Pari passu debt should be measured when remitted

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, Deloitte, New Zealand Law Society, Russell McVeagh, Staples Rodway)

The pari passu rule should measure debt that is remitted, not total owner debt held.

Comment

The intention was to require the debt to be pari passu at all times, but further consideration suggests this is a step too far, and as long as it is remitted pari passu, this satisfies the proportionality requirement. Officials agree with the submission.

Further, this should be extended so that when owners contemporaneously remit debt, to the extent that debt is pari passu, the debt remission rule should apply. This could be particularly relevant when look-through companies or partnerships are wound up.

Recommendation

That the submission be accepted.

Issue: Pari passu examples

Submission
(Chartered Accountants Australia and New Zealand, PwC)

Examples of the application of the proposed pari passu rule should, in the core rule, be included in guidance provided by Inland Revenue.

Comment

This point will be addressed in the *Tax Information Bulletin* that details the application of the changes in the bill following enactment. A number of examples are planned.

Recommendation

That the submission be accepted.

Issue: Clarification – "terms of art"

Submission
(Chartered Accountants Australia and New Zealand, Deloitte, EY, Russell McVeagh)

A number of the "terms of art" (such as "direct ownership interest and ownership interest" and "member debt") in the core rule should be clarified.

Comment

Officials agree. Rewriting the core rule as proposed in the analysis of the previous submission should address this.

Recommendation

That the submission be accepted.

Issue: Nominal shareholdings

Submission
(Chartered Accountants Australia and New Zealand, Deloitte)

Nominal shareholdings should be ignored when calculating ownership and debt percentages.

Comment

Nominal shareholdings, especially in the context of family companies, are common. When they are truly nominal they should be ignored – the model for this is the 3% criteria allowed by section IC 4(2) (employee shares in wholly owned group companies), but this would also need to pick up nominal holdings of shareholder-employee salary access shares, which should also be ignored.

Recommendation

That the submission be accepted.

Issue: Clarification of means of debt remission

Submission
(Chartered Accountants Australia and New Zealand, Chapman Tripp)

The term "the means by which debt is forgiven is immaterial" should be clarified.

Comment

The term is copied (with minor amendment) from long-standing section EW 44 of the Income Tax Act 2007 (which deals with debt forgiven for natural love and affection). Given that it has not caused problems in that context, officials believe it is sufficiently clear. However, this point will be addressed in the *Tax Information Bulletin* that details the application of the changes in the bill following enactment.

Recommendation

That the submission be noted.

Issue: The scope of the core rule should be wider

Submission
(KPMG)

The scope of the debt remission rule should be wider and should include:

- family trusts; and
- situations when the owner debt is not pari passu with ownership.

Comment

The proposals have always only concerned owner debt that is pari passu with ownership.

Given the scope, debt remission by family trusts is excluded (except where they are owners and creditors of the debtor).

Recommendation

That the submission be declined.

Issue: The scope of the debt to which the core rule applies

Submission
(Staples Rodway)

The core debt remission rule should apply more widely and to different types of debt, including trade creditors and current accounts.

Comment

Officials understand the point the submitter is making, but note that at this late stage it would add a significant degree of complexity, and may not be able to be adequately reflected in legislation anyway. Further, the consultation to date has been directed at financial arrangements only.

Recommendation

That the submission be declined.

Issue: Available subscribed capital

Submission
(PwC, EY, Matter raised by officials)

The proposal to allow a debtor who gains from a debt remission to have available subscribed capital (ASC) of the amount of debt that is remitted is too broad. *(PwC)*

When the debtor receives ASC as a result of the debt remission, the owner or the creditor should get cost base for that investment. *(EY)*

When the debt remission does not lead to ASC, the debtor's gain should not be regarded as a capital profit. *(Matter raised by officials)*

Comment

ASC is share capital of a company that, in appropriate circumstances, can be returned tax-free to shareholders. For example, when a person subscribes $100 cash for shares issued by a company, the company can attribute $100 ASC to those shares. This means their redemption, on liquidation, or in other appropriate circumstances, is not regarded as being a dividend and is therefore tax-free.

When a direct or indirect shareholder that is owed money by a company remits that debt, it is equivalent to that shareholder subscribing for more shares and the proposed amendment does this. However when the creditor that forgives the debt is not a direct or indirect shareholder in the debtor (for example, sister companies or inside a wholly owned group of companies) this is less appropriate. This is particularly the case when the debt remission is between sister companies that are owned by a non-resident or persons not in the same wholly owned group of companies as the sister companies.

We agree with the submission that when ASC is created, the owner should receive an uplift in their carrying cost of their shareholding in the debtor.

If a debt remission does not result in ASC, it should also not result in the debtor receiving a capital profit as this could lead to the artificial conversion of retained earnings (taxable on distribution) into capital gains (it can, in appropriate circumstances, be returned tax-free).

Recommendation

That the submissions be accepted.

Issue: Available subscribed capital

Submission
(EY, KPMG)

The proposal to allow a debtor who gains from a debt remission to have available subscribed capital (ASC), while conceptually correct, is not technically effective and should be refined.

Comment

Officials agree with the technical points made in the submission and recommend that the ASC be attributed to the class of shares that the shareholder owns (either directly or indirectly) that carries the most rights in the company.

Recommendation

That the submission be accepted.

Issue: Dividend if remission of debt owed by foreign debtor

Clause 16

Submission
(Chartered Accountants Australia and New Zealand, PwC)

The proposed wholly owned group dividend adjustments when debt owed by a shareholder is forgiven should be limited to prevent cross-border opportunities.

Comment

Officials agree that the remission of debt owed by a foreign shareholder in a New Zealand creditor company should continue to be taxed as a dividend. We recommend an amendment to the proposed exception to section CD 5(2) so that it applies when:

- the dividend is derived by a company that is resident in New Zealand or a subsidiary thereof wheresoever resident; and
- is derived from a company that is in the same wholly-owned group of companies as the recipient at the time the dividend is derived.

Recommendation

That the submission be accepted.

Issue: The dividend exclusion

Submission
(Russell McVeagh)

The dividend exclusion should be widened beyond the wholly owned group company exclusion proposed. There are unusual circumstances in which a qualifying debt remission could result in a dividend under section CD 27 and this is inappropriate.

Comment

In the time available officials have been unable fully analyse this complex and technical issue. However, we will continue to analyse this and if further amendments are appropriate we will recommend that they be done, retrospectively if necessary. Liaison with the submitter will continue.

Recommendation

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

Issue: Wholly owned group dividend exemption

Submission
(Chartered Accountants Australia and New Zealand)

Section CW 10(4) should be repealed as it is now redundant.

Comment

Officials agree that section CW 10(4) should be repealed.

Recommendation

That the submission be accepted.

Issue: Accrued and unpaid interest and bad debts

Submission
(Chartered Accountants Australia and New Zealand, Chapman Tripp, Corporate Taxpayers Group, Deloitte)

The proposed approach of deeming accrued and unpaid interest to be paid is inappropriate.

Alternatively, such an approach should be prospective only, as it is a fundamental change.

Comment

The primary submission results from the proposal to deem loans that are remitted to be repaid (and often the proceeds will be deemed to be reinvested in the debtor as equity). This is largely a cross-border issue. Appropriate cross-border rules (thin capitalisation, transfer pricing and non-resident withholding tax (NRWT)) apply to govern interest expense incurred by New Zealand subsidiaries of overseas companies. The approach of deeming the repayment reinforces the NRWT aspects of these rules.

However, officials agree that the alternative submission has merit and, as is reflected in the bad debt amendment, it was not intended to apply this aspect (the deemed interest income) retrospectively, and therefore it should apply from 1 April 2017.

Recommendation

That the alternative submission be accepted.

Issue: Limiting the application of the bad debt rule amendment

Submission
(Chartered Accountants Australia and New Zealand)

The amendment to the bad debt rule (to limit the deduction for a bad debt for interest accrued) should be limited to situations when the debtor has obtained a tax deduction in New Zealand – that is, the debtor is New Zealand-resident.

Comment

Officials agree with the submission as it addresses inappropriate tax deductions.

Recommendation

That the submission be accepted.

Issue: Refocusing the bad debt rule amendment

Submission
(New Zealand Law Society, Matter raised by officials)

The proposed bad debt amendment should be refocused given the proposed change to the core debt remission rule, which we propose will now focus on pro rata debt remitted, instead of pro rata debt held and remitted. *(Matter raised by officials)*

The rule, as drafted, technically does not work. *(New Zealand Law Society)*

Comment

Associated persons can only claim a bad debt deduction for interest accrued (not principal). Typically this claim will be made before any debt remission, and so cannot be guided by that remission.

The proposed bad debt amendment is primarily intended to address situations when the debt and creditor can, between them, claim two deductions and only have one amount of income. The debtor claims an interest deduction, and the creditor returns the interest income and as well takes a deduction for a bad debt. Examples of this include situations when the owner is the creditor and the entity (a company, look-through company, partnership or limited partnership) is the debtor.

This is especially inappropriate given the tenor of the proposed debt remission rule, which, if it applies, will deem the interest to be paid so that there is no bad debt.

The proposed bad debt amendment as introduced focuses on situations when the debt is held pro rata to ownership. As noted above, submitters recommended (and officials agree) that the core debt remission rule should focus on debt that is remitted pro rata to ownership, not debt held pro rata to ownership. The proposed bad debt amendment should be consequentially amended.

The simplest way to do this is to replace the bad debt pro rata requirement with an extension to the associated person denial of a deduction for a bad debt on principal to cover interest.

This will also address the technical matter raised by the New Zealand Law Society.

Recommendation

That the submission be accepted.

Issue: The denial of the bad debt deduction should not proceed

Submission
(Chapman Tripp)

The amendment to the bad debt rule to limit the deduction for a bad debt for interest accrued should not proceed.

Comment

This amendment is primarily intended to address situations when associated persons can claim two deductions and only have one amount of income as discussed above. The submitter seemingly has no objection to this intention.

A by-product of this will be that taxpayers will have to take care not to overload a company with debt where the company (or its group members) cannot use the interest deduction (that is, they are in a loss position). For direct inbound investment this is not relevant as the non-resident creditor is not subject to New Zealand's bad debt deduction rules. However, the transfer pricing, thin capitalisation and NRWT rules address this.

But, and this is the point the submitter is making, there will be some situations when a shareholder/creditor is an associated person and other shareholders/creditors may not be. If the associated person is New Zealand-resident this may appropriately constrain the debtor's interest deduction in some circumstances.

Recommendation

That the submission be declined.

Issue: Clarification of the proposed bad debt deduction amendment

Submission
(EY)

The amendment is incorrectly framed.

Comment

The refocusing of the bad debt amendment as above addresses this concern.

Recommendation

That the submission be noted.

Issue: The amalgamation rules should be consequentially amended

Submission
(Chapman Tripp)

The amalgamation rules, which contain specific debt valuation and remission rules, should be consequentially amended.

Comment

Officials agree as this follows the core amendment proposals.

Recommendation

That the submission be accepted.

Issue: Application of NRWT to deemed debt repayment

Submission
(PwC)

Existing legislation should be checked to ensure that appropriate NRWT is payable on any deemed repayment that includes interest.

Comment

We agree that a further amendment is necessary to ensure the correct outcome. This should apply from the commencement of the 2017–18 tax year.

Recommendation

That the submission be accepted.

Issue: Debt guarantees

Submission
(Corporate Taxpayers Group, Deloitte, EY)

The debt guarantee proposal should be reconsidered in situations when the guarantor explicitly has no recourse to the debtor. *(Corporate Taxpayers Group, Deloitte)*

The proposed debt guarantee amendments should be clarified as to both scope and the reference to "creditor's associate". *(EY)*

Comment

The key issue here is the guarantor obtaining an inappropriate deduction for a pay-out under the guarantee in inappropriate circumstances. Allied with this is that often the guarantor will not be solvent and therefore will not be able to pay any tax due on the debt remission caused by the guarantor meeting their obligations. This leaves a one-sided result of a net deduction. For example, when the guarantor is in the same wholly owned group of companies, the guarantee pay-out is just the group as a whole repaying the loan or, alternatively, the group buying the creditor's interest in the loan – either way the guarantor should not obtain a tax deduction.

The analysis is similar to the bad debt deduction. Under these bad debt rules a bad debt deduction for a bad loan is available to a person who is in the business of lending and who is not associated with the debtor.

When the guarantor is associated with the debtor there should be no deduction for a guarantee pay-out. Further, given the ability that exists to argue that anyone can obtain a guarantee pay-out deduction, such deductions are logically limited to guarantors who are in the business of offering such guarantees. This preserves the capital revenue boundary appropriately.

Under a traditional financial guarantee, if called, the guarantor ends up with a bundle or rights in the debtor. This bundle can logically be characterised as a loan "owned" by the guarantor. Financial reporting would consider that there is a loan from the guarantor to the original debtor.

However, if the guarantor has no recourse it is reasonable to conclude that the original loan has ended.

When the guarantor is an associated person of the debtor and has recourse we propose that the debt-parking treatment apply – that is, the loan is treated as having been repaid by the debtor at the amount the guarantor paid the original creditor and that a new loan for the same amount is deemed to exist.

When the guarantor is an associated person of the debtor but has no recourse we propose that the debtor's loan is deemed to come to an end with a payment equal to the amount the guarantor paid to the original creditor.

Both of these treatments could produce base price adjustment income to the debtor – conceptually this is correct.

Recommendation

That the submission be accepted.

Issue: Application date

Submission
(PwC)

The application date of the changes to the Income tax Act 2007 should be further backdated to the commencement of the 2006–07 tax year.

Comment

We have discussed this submission with the submitter and they have agreed that it should not be considered.

Recommendation

That the submission be declined.

LOSS GROUPING AND IMPUTATION CREDITS

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

Issue: Support for proposals

Submissions
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, KPMG, PwC)

Submitters expressed their support for the proposal, which will remove a tax inefficiency and ensure that, when there are good commercial reasons to retain minority shareholders in a company on a takeover, the group will not be disadvantaged from a tax perspective.

Comment

Officials welcome the general support for the proposed amendments.

Recommendation

That the submissions be noted.

Issue: 66 percent commonality for loss grouping

Submission
(Corporate Taxpayers Group)

Tax losses can only be offset between companies when there is at least 66 percent commonality of shareholders. When there is control by a group of shareholders they should be allowed to offset tax losses. That is, the 66 percent test should be reduced down to where the common shareholders have more than 50 percent of the two companies.

Comment

Changing this threshold would be a large project that would require significant resources and is not currently on the Tax Policy Work Programme. Officials note there are also arguments that this threshold should be raised rather than lowered and that a number of other countries, including Australia, allow loss grouping only within wholly owned groups.

Recommendation

That the submission be declined.

Issue: Drafting of section OB 83(5)

Submission
(EY)

Proposed section OB 83(5)(d) prescribes a continuity period to run "from the end of the income year in which the tax loss is made available…" while the proposed section OB 83(5)(e) requires the imputation credit transfer to occur in a period of four income years "beginning from the end of the income year in which the election is made".

Elections to transfer losses are not generally made within the income year to which they relate and are applicable, but are usually made within the following income year as part of the preceding year income tax return preparation and filing process. We assume the proposed continuity period requirements and the four-year period are intended to run from the end of the income year for which the losses are used, rather than from the end of the following (or later) income year when elections are actually made and notified to the Commissioner.

On that basis we suggest the word "for" be substituted for the word "in" so that section 83(5)(d) and (e) would respectively read "from the end of the income year for which the tax loss is made available…" and "beginning from the end of the income year for which the election is made".

Comment

As noted by the submitter the four-year period is intended to be from the end of the income year the loss offset and imputation transfer relate to rather than the following year in which the election is made. For example, a loss offset and imputation transfer relating to the year ended 31 March 2018 may be filed with the income tax return on 31 March 2019 and the four-year period to pay a dividend would expire on 31 March 2022.

Recommendation

That the submission be accepted.

Issue: Agreement between companies and irrevocability of elections

Submission
(EY)

The *Commentary* to the bill states that elections to make imputation credit transfers will be irrevocable (at page 110) and that the profit company, loss company and imputation source company (if applicable) must all agree to undertake an imputation credit transfer (at page 112). The provisions as currently drafted in the bill do not appear to specify such requirements.

Stipulating irrevocability would not seem to be consistent with the flexibility as to timing and amounts provided by the proposed section OB 83(5)(e) and OB 83(7), nor with the possibility of failing to meet the ongoing grouping and shareholder continuity criteria or to transfer all credits within the proposed four-year period. We assume any imputation credits that have not been transferred pursuant to a section OB 83 election within the four-year period would simply remain with their source company. Clarification and confirmation would be desirable as to intended requirements and as to the consequences of full or partial failure to transfer elected credits.

Comment

Officials consider it unnecessary to make the elections irrevocable as the election is the amount given by the formula in proposed section OB 83(3) where all variables are determined by the numbers in the income tax return. Once this election has been made the group continues to have control over the number of imputation credits transferred and attached to dividends up to the maximum amount given by the election. As noted by the submitter any credits not transferred by the end of the four-year period will remain with the source company.

Including a requirement that all parties must agree to the imputation credit transfer added a further unnecessary step. Officials expect that a commonly owned group would already take each party's individual circumstances into account and would only make an imputation credit transfer election when they decided it was worthwhile to do so.

This policy is already reflected in the proposed legislation and will be incorporated into guidance provided in the *Tax Information Bulletin* once the bill is enacted.

Recommendation

That the submission be noted.

Issue: Imputation shopping rules

Submission
(EY)

Clauses 180 to 182 propose amending sections OB 71, OB 72 and OB 72B of the Income Tax Act 2007. Proposed new sections OB 71(1)(c) and OB 72(2)(c) refer to a non-wholly owned group situation when "company A has transferred imputation credits under section OB 83 to a company in the former group". Proposed new section OB 72B(1)(ab) refers to a similar situation when "the ICA company has transferred imputation credits under section OB 83 to a company in the former group".

Under proposed section OB 83, the company which would transfer the imputation credits would not necessarily be the loss company and there may be a time lapse between the initial election and any or all transfers.

It should be clarified and confirmed that:

(a) The proposed section OB 71(1)(c) and OB 72(2)(c) references to "company A" and the proposed section OB 72B(1)(ab) reference to "the ICA company" are intended to refer to the company that actually transfers the imputation credits; and

(b) The relevant circumstance is the actual transfer of the credits by that company, rather than the making of any election by the loss company that credits be transferred.

Comment

The submitter is correct that references in sections OB 71(1)(c) and OB 72(2)(c) to "company A" and section OB 72B(1)(ab) to "the ICA company" are intended to refer to the company that actually transfers the imputation credits. The company that transfers the imputation credits will have recorded an imputation credit account debit when the credits are transferred so is the only company in the former group that could benefit by entering into an imputation credit shopping arrangement if not for these, and other, anti-avoidance provisions.

Proposed sections OB 71(1)(c), OB 72(2)(c) and OB 72B(1)(ab) only apply when imputation credits have been transferred. This transfer only occurs, under proposed section OB 83(6), when an imputed dividend is paid. Until the dividend is paid and the transfer occurs the imputation credit shopping rules will not apply solely due to an election under proposed section OB 83(1).

Officials consider the sections proposed in the bill already achieve this result.

Recommendation

That the submission be noted.

Issue: Māori authorities

Submission
(KPMG)

The proposal should be extended to Māori authorities, which have similar mechanisms to imputation, as they face similar issues.

A similar problem exists for Māori authorities, particularly in a sister company situation, when a Māori authority is the parent and owns more than 66 percent of a profit company and a loss company. There would be an imputation shortfall if the Māori authority is the recipient of a dividend and if it is unable to transfer credits to make up for the imputation credit shortfall.

Māori authorities should be able to make an imputation credit transfer (this would create the relevant debit and credit entries in its Māori authority credit account) to a profit company on behalf of a loss company. This would then allow the profit company to pay a fully imputed dividend to the Māori authority and any minority shareholders.

Comment

As a Māori authority cannot transfer losses to a non-Māori authority this submission relates to two non-Māori authority sister companies owned by a Māori authority. As a Māori authority does not maintain an imputation credit account, it would be necessary for them to transfer Māori authority credits and treat them as imputation credits. While existing provisions convert imputation credits to Māori authority credits, there is no equivalent provision to convert them in the other direction.

Further complications arise due to the profit company being taxed at 28%, whereas the Māori authority would only be taxed at 17.5%. Consequently, if credits were transferred at 17.5% the profit company would not have sufficient credits to fully impute the dividend, which would be particularly relevant to any minority shareholders that were not Māori authorities. If the credits were transferred at 28%, this would allow the Māori authority to shelter additional income above the dividend. While the payment of an imputed dividend to a Māori authority (or an individual taxed at less than 28%) will always have this result in this case, the credits would be more valuable when received by the Māori authority than when they originally transferred them.

Therefore, officials do not recommend the extension of these proposals to Māori authorities.

Recommendation

That the submission be declined.

Issue: Four-year time bar

Submission

(KPMG)

We understand the rationale for the four-year time limit is to align with the statute bar. This is not a valid comparison. Assuming the minimum 66 percent shareholding commonality is met between the time of loss grouping and the imputation credit transfer, there should be no time-based restriction – particularly if the loss company is required to provide information to Inland Revenue at the time the imputation credits are transferred.

Comment

Officials agree there is no direct link between the four-year statute bar and a four-year limit for completing an imputation credit transfer. The four-year statute bar was chosen as an acceptable period after which to draw a line and move on. The same arguments can be made for an imputation credit transfer. We also consider having a time limit will simplify monitoring of these transfers by both taxpayers and Inland Revenue.

Recommendation

That the submission be declined.

Issue: Consolidated imputation groups

Submission

(Corporate Taxpayers Group, Deloitte)

There are rules that apply to ICA companies, but there are no equivalent sections to apply the same rule to consolidated imputation groups. This can give rise to issues if the ICA company has a nil balance and all imputation credits are instead recognised in the consolidated imputation group.

In particular, section OB 72B (Limit on using entitlement to refund after joining wholly owned group) is part of the imputation credit shopping rules in sections OB 71 to OB 72. Section OB 72B applies to an "ICA company" and refers to the credit balance of the "ICA company's imputation credit account". There is no equivalent section to section OB 72B for ICA companies that are part of a consolidated imputation group.

Section OP 6 (Provisions applying to consolidated imputation groups) requires certain provisions to be applied as if the company referred to was the consolidated imputation group. It explicitly lists sections OB 71 and OB 72, but does not mention section OB 72B. There does not appear to be any policy rationale for section OP 72B not to have a consolidated group overlay. The imputation credit shopping rules in sections OB 71 and OB 72 were introduced with application from November 2004 and section OB 72B was only introduced with effect from March 2010. We therefore consider that it is likely that the extension of section OP 6 to section OB 72B was overlooked in the drafting and section OB 72B should equivalently apply to consolidated imputation groups. An equivalent of section OB 72B should be included in subpart OP to apply to consolidated imputation groups.

A similar issue also arises in section OB 62 (Retrospective attachment of imputation credits) when the provision only refers to the "company's imputation credit account" and does not refer to the consolidated group imputation credit account which the company has access to. Section OB 62(3) should apply based on the credit balance of the consolidated imputation group's imputation credit account if the company is a member of a consolidated imputation group.

There may be other provisions in subpart OB (company imputation credit accounts) that should be extended for companies in consolidated imputation groups in subpart OP. We recommend a review is undertaken in this regard.

Comment

Officials agree that, in most instances, there is no policy rationale for a consolidated imputation group to be treated differently to an ICA company. The submitters have identified a number of problems with consolidated imputation groups, both within the existing legislation and the loss grouping and imputation credit proposals in the bill, and suggested that a review should be undertaken. A review cannot be undertaken within the timeframe of the select committee process but officials note this could be considered for inclusion on the Tax Policy Work Programme.

Recommendation

That the submission be noted.

Clause 121

Issue: Pre-discharge tax losses

Submission
(EY)

Pre-discharge losses should remain available for use in relation to shortfall penalties that may relate to the period before the "loss cancellation date" or to any income which may be derived prior to that date.

Comment

Officials consider the circumstances on which the submission is based are unlikely to occur.

In relation to a bankrupt person, the Commissioner is obliged, under the Tax Administration Act 1994, to write off debts for tax that have been proved in bankruptcy. In this context tax includes shortfall penalties.

Officials agree that the proposals clarify that the bankrupt must attend to all income tax obligations during the period of bankruptcy. However, those actions remain subject to the oversight of the Official Assignee. This is because one of the roles of the Official Assignee is to ensure that a bankrupt does not incur additional debt that cannot be paid during bankruptcy.

Recommendation

That the submission be declined.

Issue: Clarification of commencement date

Submission
(EY)

Clarification is required of the commencement date for proposed section 42C of the Tax Administration Act 1994 as to which tax year it first applies.

Comment

Inland Revenue's practice is that a bankrupt is already required to file a return of income up to the date of bankruptcy and a separate return of income for all periods during bankruptcy. The proposed amendment only codifies existing practice.

Recommendation

That the submission be declined.

Issue: Tax treatment of property and unallocated deductions on adjudication of bankruptcy

Submission
(EY)

Clause 78 should be revised to:

(i) remove the reference to "words before paragraph (a)" as there is no paragraph (a) in current section FC 2(1);

(ii) amend section FC 2(3) to ensure that the provisions in the proposed new section FC 10 will override the general section FC 2(1) market value rule in bankruptcy situations;

(iii) clarify who derives any income, can claim any relevant deductions, and is required to file returns post-adjudication or Court approval of any relevant procedure under Part 5 of the Insolvency Act 2006.

Comment

Officials agree that submissions (i) and (ii) correctly identify cross-reference errors in the drafting.

Under the Insolvency Act 2006, income earned during bankruptcy is property that vests in the Official Assignee, subject to the common law reservation that income required for personal maintenance is retained by the bankrupt. The Official Assignee's practice recognises this common law principle and generally employment income is permitted to be retained by the bankrupt.

Officials consider that the Official Assignee's practice is based on the common law, and is intended to have the effect that the employment income is derived by the bankrupt. Therefore, officials consider no further legislative clarification is necessary.

Other non-bankruptcy procedures under the Insolvency Act 2006 do not result in income earned by an insolvent person who is not bankrupt being property of the Official Assignee. As a result, no clarification is required.

Recommendation

That submissions (i) and (ii) be accepted.

That submission (iii) be declined.

AIRCRAFT OVERHAUL EXPENSES: DEDUCTIBILITY AND TIMING

Clauses 28, 37, 42, 43, 47, 53, 72, 74 to 76, 262(2), (95) and (111)

Issue: The "as incurred" method should be retained

Submission
(Airwork Holdings Limited, Aviation New Zealand Limited)

The "as incurred" method:

- should be retained as it is consistent with the general deductibility and timing rules of the Income Tax Act 2007;
- is well-known and understood by taxpayers;
- is simple to apply and carries the lowest compliance cost compared with other methods; and
- presents no fiscal cost when compared with the status quo.

There is nothing special about aircraft and aircraft engines that warrants the current ability to deduct overhaul expenditure being taken away on the basis of economic purity.

Comment

Background to the proposals

The proposed spreading rules in the bill arose from the withdrawal of a long-standing technical ruling of the Commissioner that permitted aircraft operators to use provisions for future overhaul expenses to calculate and time deductions for aircraft overhaul expenses (a spreading method). This ruling was withdrawn because case law arising since that ruling was issued held that provisions of this nature do not satisfy the legal test of deductibility.

A review of the timing of deductions for aircraft overhaul expenses, including targeted consultation, was undertaken to determine an appropriate policy for the deductibility and timing of aircraft overhaul expenses. This review identified that:

- all aircraft operators are required by Civil Aviation Authority (CAA) regulations to keep records of maintenance and overhaul requirements and time in service for each aircraft's system modules, parts and components;
- about 61 percent of SME aircraft operators used this information to determine their deductions in each year using the provisioning method permitted under the now-withdrawn technical ruling;
- of the other 39 percent of operators in the SME sector, many used the information from their CAA record-keeping requirements in planning the timing of their overhauls and associated cash outflows;
- allowing deductions for provisions of future expenses is inconsistent with broad base, low rate (BBLR) tax settings, which generally do not permit provisions for future expenses to be deductible;

- provisions are generally used in accounting to recognise the decline in value of assets that are not recorded in the balance sheet (which is not the case for most aircraft operators in New Zealand); and
- a technical issue raised in submissions was whether the cost of restoring a major aircraft system to full operational life was capital in nature. The proposals address this by overriding the capital limitation on deductibility. This is acknowledged in discussion with Airwork Holding Limited as being a helpful clarification.

The initial consultation involved an officials' letter provided to some IFRS taxpayers, the Aviation Industry Association Inc. (now Aviation New Zealand), and Chartered Accountants Australia and New Zealand, and state agencies involved with the aviation sector. Submitters favoured introducing legislation to implement a timing regime outside the depreciation rules to better match aircraft overhaul expenses with revenue earned as the aircraft is flown. Main points made by submitters during the initial consultation phase included:

- An aircraft operator suffers loss and expense as an aircraft is flown, and agree that this is reflected in the economics of aircraft maintenance.
- Tax deductions for major aircraft overhaul expenses should be appropriately matched to revenues earned.
- The policy review of deductibility and timing of aircraft overhaul expenses should be restricted to overhaul of aircraft engines.
- It is intended that the aggregate amount of the cost of the maintenance value at acquisition and the cost of subsequent overhauls would be spread by a single appropriate use measure (time, hours on wing or flight cycles) determined by each operator according to their individual circumstances and each aircraft type's actual experience. Accordingly, these points were reflected in the proposals in the bill, as follows:

  – Use of examples in the *Commentary* on the bill.
  – The proposed approach allows taxpayers to adjust their rate of amortisation if the appropriate use measure changes due to high levels of use (for example, from time to hours, as noted by KPMG in its submission).
  – It allows taxpayers to choose the level of compliance for determining the amounts to be spread for each tax year from acquisition or after an overhaul.
  – It is consistent with BBLR settings for timing rules (including depreciation) in the Income Tax Act, and gives an accelerated deduction for the maintenance value at acquisition compared to current law.
  – It is not intended that a taxpayer should amortise the cost for each single component or part in a taxpayer's asset management register. It is unclear whether the submitter is referring to an overhaul of an engine or lift and propulsion system of a helicopter or the replacement of limited life parts. During consultation, it was clear that taxpayers were already identifying the total cost of the overhaul of an aircraft engine (fixed wing aircraft) and for each of the lift and propulsion systems of a helicopter. The proposals in the bill are to amortise those total costs and not to require identification of individual life-limited parts and the cost of their replacement. For taxpayers currently using the "as incurred" method, the main compliance impact is to spread that total overhaul cost on a use basis. Taxpayers and advisors engaging with officials during the consultation process indicated this does not carry a high compliance cost.

    - The timing of deductions for replacing life-limited parts is intended to be determined under the general deductibility and timing rules, which is the same as the current law.
    - Officials can explain this distinction in a future *Tax Information Bulletin* to ease any concerns about compliance impact.

- Accounting methodologies for spreading expenses are well understood, and are consistent with the record-keeping required by the CAA.

- Tax depreciation for aircraft and the "as incurred" method of timing deductions for overhaul expenses taken together do not appropriately reflect the real decline in value of some overhaul components as an aircraft is used.

- For small and medium-size aircraft operators, appropriate matching of major aircraft overhaul expenses in financial reporting enables more informed financial and business decision-making.

- Many aircraft operators use their accounting systems to forecast and predict when overhauls are required and the expected cash outflow for each overhaul and for the replacement of components that must be replaced at specific points in their use (time, hours on wing or flight cycles).

- Unexpired time left on overhaul/time-life components are taken into account in valuing an aircraft in the marketplace and it would be appropriate for taxation rules to recognise this effect.

- Aviation New Zealand and Chartered Accountants Australia and New Zealand submitted that a consistent timing frameworks for overhaul expenditure was desirable, but that a threshold should be set to allow some operators to elect for the "as incurred" method. This is provided for by permitting single-aircraft operators to elect out of the spreading method.

We note that Airwork Holdings Limited acknowledges the proposed spreading method is consistent with the economic effect of maintenance of engines.

The nature of overhaul costs for aircraft

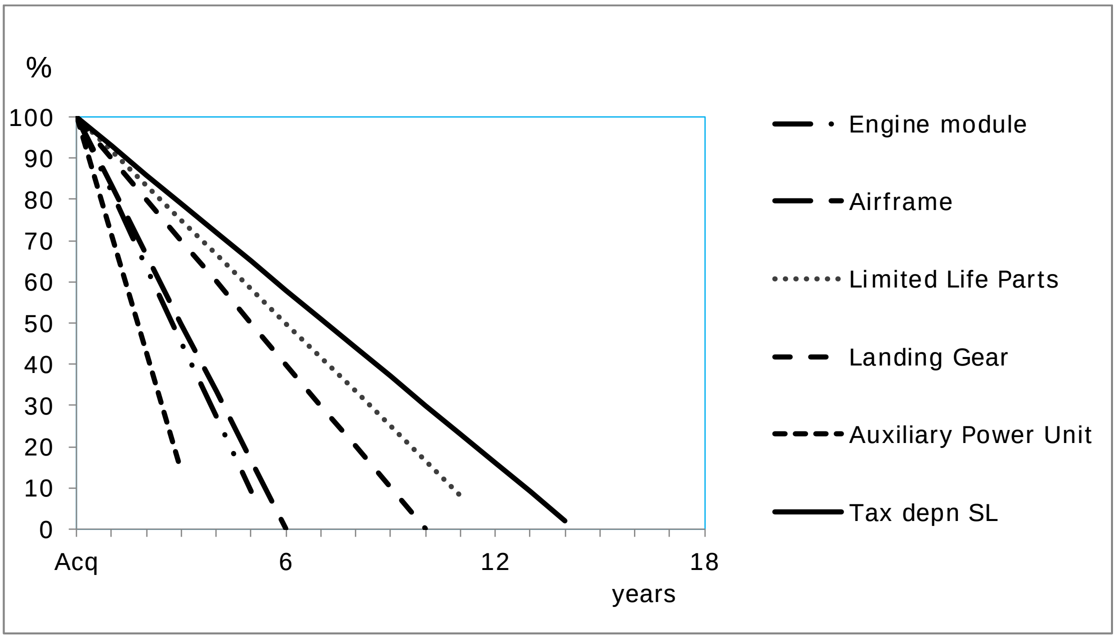
Airwork Holdings Limited considers there is nothing unique about aircraft and aircraft engines that warrants moving from the "as incurred" basis. As noted earlier, we estimate about 61 percent of aircraft operators already use a spreading basis for timing overhaul deductions, and that they favour a timing regime that appropriately recognises the varying rates of decline in value of major overhaul systems from acquisition of the aircraft.

The safety rules contained in CAA regulations are rigorous and differ significantly from other sectors in the economy, including the marine and rail sectors. The safety systems in those sectors were analysed during the policy review, and identified that a major distinction in the safety regulations is that aircraft operators are required to restore major systems to full operational capacity on a cyclical basis based on a use measure such as time, flying hours, flight cycles or the earlier of a combination of any two or more of those measures. Analysis of industry data identified that these systems are restored over time periods ranging from 5 to 12 years, depending on the system. This requirement to restore major systems to full operational capacity is not a feature of safety regulations in either of the marine or the rail sectors.

By way of example, we noted that KiwiRail's 2014 annual report stated that ships in its fleet are dry-docked at two-yearly intervals for regular maintenance, mainly involving scraping and painting of the hull, and a survey of the ships systems by a certified marine surveyor. The role of the surveyor is to ensure the ship is seaworthy, or if not, to identify from the survey which repairs to the ship are necessary. Analysis also identified that ship's engines are generally maintained on an on-condition basis rather than requiring a restoration to full operational performance. Deductions for on-condition maintenance are timed under the general timing rules and this is the same treatment that applies to aircraft on-condition maintenance.

Analysis of the economics of aircraft maintenance indicated that the value of overhaul systems included in an aircraft at acquisition decline at different rates from the tax depreciation rate (7% SL[3] in the graph). This is illustrated in Graph 1 (using maintenance data profile from an Airbus A320).

Graph 1: Decline in value of overhaul components for an Airbus A320 compared with tax depreciation (SL)



An overhaul is defined in CAA regulations as the process of dismantling, testing and reassembly in which the system is restored to full operational capacity. After an overhaul, the aircraft is returned to service with an airworthiness certificate.

Following our analysis of submissions on the initial consultation, we carried out further consultation on implementation and compliance issues. Those consulted agreed that:

- The "as incurred" method does not appropriately recognise the decline in value of overhaul components from acquisition.
- It is appropriate to adopt a spreading regime to match the cost of overhaul components at acquisition and subsequent overhauls with revenue earned as the aircraft is flown if the cost is significant and the period between overhauls is relatively long-dated.

[3] Straight line depreciation method.

- Each aircraft engine overhaul for a fixed-wing aircraft and the overhaul of each helicopter lift and propulsion systems were a significant cost relative to the value of the aircraft as a whole and that it was appropriate to amortise the total cost of each overhaul to match expenses with revenue earned.
- "Non-engine" overhaul costs and replacement of limited life components for all aircraft (apart from rotor blade replacement in helicopters) and on-condition maintenance were not a significant cost relative to the value of the aircraft as a whole and that it was appropriate to allow these to be deducted on the basis of "as incurred".
- Overhauls may occur on an unscheduled basis because of damage and unamortised deductions should be expensed at that time. This is consistent with the concept of loss on disposal used in the depreciation rules.
- For compliance cost reasons, we agreed with submitters to restrict any policy recommendations on the spreading of deductions for overhauls to the aircraft engine and helicopter lift and propulsion systems. This is on the basis that the actual costs are either:
  - relatively low compared with the value of the aircraft as a whole, and that the timing of these deductions are not significant to financial and business management decision making; or
  - are sufficiently long dated that the tax depreciation curve gives a reasonable rate of depreciation (for example, life-limited parts and landing gear).

Compliance and fiscal impact

Airwork Holdings Limited submits that the "as incurred" method has a neutral compliance and fiscal impact. Officials do not agree with this view. Analysis shows that approximately 61 percent of taxpayers would be required to change their tax accounting method from a spreading method to the "as incurred" method. On this point, Aviation New Zealand submitted during consultation that one-off compliance costs would occur to ensure relevant information was recorded for financial and business management decision-making reasons as follows:

> The operators would need to extend their fixed asset schedule to reflect a detailed breakdown of components and presumably they are depreciated over its finite life period. [A] difficulty arises with on-condition components and overhauled components verses replacement.

IFRS taxpayers submitted that IFRS results for engine overhaul components should be able to be used for tax purposes to reduce compliance costs rather than using the "as incurred" approach. They agreed this would mean tax depreciation would be based on a lower value for the aircraft as the engine components that received a faster rate of depreciation outside the depreciation regime should not be part of the depreciable asset.

We also consider that adopting the "as incurred" method would impact on tax imposts for taxpayers as follows (again this is consistent with submissions made during the consultation process):

- fluctuating taxable incomes would arise, resulting in under- and overpayments of tax in tax years between overhauls; and
- operators would be exposed to the estimation provisional tax regime and its associated underestimation penalties.

Recommendation

That the submission be declined.

Issue: Spreading method

Submission
(Airwork Holdings Limited, Aviation New Zealand Limited)

- The spreading method does not require legislative provisions specific only to aircraft engines, rather generic and flexible change can be implemented under the existing tax depreciation rules.
- The spreading method should be available for aircraft hulls, engines, landing gear and other major components, all of which are subject to the same civil aviation maintenance requirements and require significant overhaul expenditure.
- All taxpayers should have the choice of whether to use the spreading method or another method.

Comment

The tax depreciation rules require the use of a single rate of deprecation applied to either an individual asset or a pool of assets. This depreciation rate is set by reference to an estimated useful life, on an asset by asset basis, which is set by the Commissioner.

Addressing spreading for aircraft overhaul components (or for aircraft engines and helicopter lift and propulsion systems) would require the Commissioner to set estimated useful lives for a wide range of aviation systems, based on aircraft type and individual unit performance instead of by reference to changes in asset prices (as is currently the case). This suggested approach carries a very high administrative cost on an ongoing basis as the rates are not set by reference to market prices for the individual components but by performance measures and manufacturer-recommended thresholds for performing an overhaul.

In contrast, the spreading rules proposed in clause 53 provide for the flexibility suggested in this submission. This is recognised in the submission by KPMG on behalf of Helicopters New Zealand, seeking more certainty that the proposed spreading rule provides the envisaged flexibility. The submission by KPMG sets out an example that illustrates this intended flexibility under the spreading rule. This flexibility would not be possible if spreading were provided under the depreciation rules.

The proposed legislation treats non-engine overhaul costs and the replacement of life-limited parts outside an overhaul of an engine as deductible when incurred. This represents the consensus of views promoted by submitters during all phases of consultation.

Allowing a choice of timing methods could lead to arbitration opportunities, unless choice can be justified on the grounds of excessive compliance costs. For example, a taxpayer is incentivised to adopt the spreading method in transition or for a year in which an aircraft is acquired and then elects to use the "as incurred" method from the year of the first overhaul. This arbitrage would result in the taxpayer obtaining the faster rate of depreciation at acquisition (and in transition) while not being required to match overhaul costs with revenue earned from the aircraft time in service after the overhaul.

We have discussed with Airwork Holdings Limited whether there is a need to determine the spreading of overhaul costs by detailed reference to costs of individual items recorded in their asset management system. They have indicated that the main issues relate to the way helicopter lift and propulsion systems are required to be overhauled.

The proposed timing rule requires, at a minimum, the aggregate cost of an overhaul to be allocated under the most relevant measure of use. If the aggregate cost of an overhaul for an aircraft covers hull, engines and other major systems, the intention is that it would be acceptable to apportion that total cost between the overhaul of the engine system and other overhauls on a reasonable basis (for example, for an IFRS taxpayer, this is considered to be available from their IFRS accounting). It is not intended that a taxpayer need determine this allocation from an ongoing and detailed analysis of all parts and components included in the overhaul.

Airwork Holdings Limited asked if further compliance guidance would be forthcoming in the *Tax Information Bulletin*. We confirmed that detailed examples of the minimum compliance requirements for both fixed-wing aircraft and helicopters would be provided in the *Tax Information Bulletin*.

We note that IFRS taxpayers can elect to use their IFRS accounting for spreading aircraft overhaul costs. For a taxpayer using the "as incurred" method, we consider a minor increase in compliance costs will occur by determining the overhaul cost for the engine systems either on an reasonable apportionment basis or by actual identification.

Recommendation

That the submission be declined.

Issue: IFRS method

Submission
(Airwork Holdings Limited, Aviation New Zealand Limited)

IFRS taxpayers should have the option to use the IFRS method for tax purposes for the entire asset. This would require changes to the tax depreciation rules and this has the potential to significantly simplify compliance for IFRS taxpayers.

The IFRS method should apply to the IFRS treatment for the whole aircraft

Comment

The proposed legislation includes a provision in proposed section EJ 25 that would allow IFRS taxpayers to elect to apply IFRS for tax purposes. Several IFRS taxpayers have already indicated their intention to make use of this election.

The consultation process addressed implementation and compliance cost concerns for a range of taxpayers, from large IFRS taxpayers to a taxpayer with two aircraft. The general view in submissions was that the spreading regime should be constrained to engine overhauls. The main reason given was that, in general, the costs of overhauling non-engine systems (for example, landing gear) was not significant relative to the value of the asset and that consequently compliance costs arising could outweigh benefits from achieving consistency with BBLR settings. Officials agreed with these submissions during consultation.

It was also identified that the aviation sector has an active market for sale and lease of engines separately from an aircraft as a whole. This indicates that it is a normal practice in the aviation sector to consider engines can be viewed as a separate asset. For example, we have identified that an aircraft operator may swap an engine to a different aircraft in their fleet, hold spare engines to expedite the return to service after an unscheduled overhaul (for example, due to engine damage), and sold or leased as an independent asset.

Recommendation

That the submission be declined.

Issue: Compliance costs

Submission
(Airwork Holdings Limited, Aviation New Zealand Limited)

The provisions in the bill proposing changes to the timing of aircraft engine overhaul costs carry significant compliance costs.

Comment

Compliance costs arising from the proposals changing the timing of deductions for aircraft engine overhaul costs have been consulted on within the sector.

Officials consider there is no requirement in the proposals to separately identify and record costs on an item-by-item basis as suggested in this submission. Our analysis of compliance costs is based on information obtained during consultation with aircraft operators about existing practices under which they:

- already identify the total cost incurred for an overhaul of an aircraft engine overhaul to determine the timing of that deduction; and
- already know and use relevant use measures for determining when the next scheduled overhaul is likely to be required for asset and cashflow management purposes (or under the formerly approved spreading method).

We have also consulted with some aircraft operators on compliance and implementation costs arising from the proposals both before and after the bill was introduced. Compliance issues were resolved to the satisfaction of those operators.

The proposals are intended to require the total cost of an overhaul to be spread, and does not require any subdivision of that amount nor is intended that it would require any detailed record-keeping requirements in addition to those already required under CAA regulations. As noted earlier in this report, it is intended that apportionment on a reasonable basis of overhaul costs between engines and non-engine systems would be permitted. For example, IFRS taxpayers already apportion combined overhaul costs between engines and other non-engine systems for accounting purposes. It is intended that this approach would be acceptable for income tax purposes.

Examples in the *Commentary* on the bill illustrate that the timing proposals relate to the total cost (and not discrete parts and components) of an overhaul of an engine.

Officials consider that if a taxpayer chooses to adopt a more intensive compliance framework for their own commercial reasons, any compliance cost impacts for that more intensive framework would not arise from the proposals in the bill.

Recommendation

That the submission be noted.

Issue: Grandparenting of tax treatment for existing aircraft

Submission
(Airwork Holdings Limited, Aviation New Zealand Limited)

In the interest of minimising compliance costs, the existing rules in relation to tax depreciation of aircraft and deduction of overhaul costs under the "as incurred" method should be retained for aircraft currently owned or leased, and the proposals apply only to aircraft acquired from the 2017–18 income year.

Comment

We agree there is a one-off compliance cost in transition under the proposal to accelerate depreciation deductions in the bill. Taxpayers with whom we have consulted have welcomed these transitional proposals and the objectives they seek to obtain.

The transitional provisions under the bill have two objectives:

- Acceleration of depreciation deductions for existing aircraft to align tax values with the proposed spreading rules. This proposal requires appropriate apportionment of tax book value of the aircraft at transition to identify the deductible amount and the amount by which depreciation values are to be reduced. This proposal provides a significant benefit to the aviation sector through the acceleration of tax deductions. We have consulted with some taxpayers on this proposal and have agreed some principles that serve to minimise the compliance costs for this one-off calculation. We consider it would be useful to set out those principles in the *Tax Information Bulletin* to assist taxpayers more widely in transition.
- Spreading the reversal of past accrued provisions for future overhaul expenses against the actual cost of those overhauls (to prevent double deductions occurring) or, if the aircraft is disposed of prior to the next overhaul, the amount of the provisions are income on disposal. For both circumstances, this reflects existing practice and no compliance cost change occurs.

Recommendation

That the submission be declined.

Issue: Consultation

Submission
(Airwork Holdings Limited, Aviation New Zealand Limited)

Airwork Holdings Limited was not consulted on the proposed changes.

Comment

At the time of consultation, the Aviation Industry Association Inc. (now Aviation New Zealand Limited) indicated it would circulate officials' consultation letter to its membership for comment, collate those responses and submit on that basis. At the time of consultation, we identified that Airwork Holdings Limited was listed as a member of the agricultural division of Aviation New Zealand (and this continues to be the case). At that time, officials had an expectation that Aviation New Zealand would have provided its members with the targeted consultation letter for their comment.

We do not agree that the issues raised in consultation have generic application across other sectors of the economy due to the unique requirements of CAA regulations to restore full operational performance of major systems on a cyclical basis, as well as replace life-limited parts according to manufacturer recommendations. This level of regulation does not exist in other sectors of the economy and results in it being illegal to operate an aircraft without a current airworthiness certificate. Officials do not consider the proposals in the bill set a precedent for this reason.

We acknowledge that Airwork Holdings Limited was not directly consulted during the consultation process.

Officials provided Airwork Holdings Limited a briefing on the proposals to be introduced in the bill in December 2015 and have indicated that we are willing to engage to address compliance concerns (as we have done with other IFRS taxpayers).

Recommendation

That the submission be noted.

Issue: Measures of use

Submission
(KPMG on behalf of Helicopters New Zealand)

The legislation should clearly state that the measure of use on which spreading is based can be elected by the aircraft owner for each aircraft and may be changed from year to year as the relevant measure may vary from year to year.

Comment

We agree with the submission as the policy intention is that if the relevant use measure for a helicopter lift and propulsion system is based on the lesser of two measures, the allocation of the overhaul deduction should be determined at the end of each year on the basis of the most relevant use measure.

Recommendation

That the submission be accepted.

Issue: Pragmatic solution

Submission
(Chartered Accountants Australia and New Zealand)

The proposed amendment to the tax treatment of major aircraft engine overhauls is a pragmatic solution.

Comment

Officials acknowledge the submission.

Recommendation

That the submission be noted.

Issue: Grandparenting of accounting provision method

Submission
(Chartered Accountants Australia and New Zealand)

The existing accounting provision method should be grandparented for the option of aircraft operators who carry out scheduled overhauls on aircraft from time to time.

Comment

The existing accounting provision method that treats a provision for the cost of a future overhaul as a deductible expense does not give rise to an allowable deduction under current or proposed law.

Officials accept that in the absence of tax depreciation, the use of provisions can be argued to give a reasonable estimate of the decline in value of an overhauled engine. This is because provision accounting is used to reflect the decline in assets that are not recognised in the balance sheet of the taxpayer. If deductions for both engine overhaul provisions and tax depreciation on the engine overhaul component were allowed, taxpayers would have a significant timing advantage compared with other taxpayers using the spreading approach.

If the use of provisions for future overhaul expenses were consistent with BBLR settings (which they are not), it would be still be necessary for taxpayers electing this option to exclude the engine overhaul component from tax depreciation.

Smaller aircraft operators in the SME market may elect to apply the "as incurred" method. This measure is considered to address the risk of non-compliance.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(EY)

The proposed new timing rules apply from the first income year commencing after enactment of the bill.

Comment

The main points raised on this submission relate to applying the timing rule at the end of the 2017–18 income year and in calculating the transitional deduction. The submitter also points to other submissions in which it suggests technical drafting improvements to clarify inter-relationships between the proposed timing rules and other parts of the Income Tax Act 2007. We do not consider there are any aspects to the recommended technical amendments that would require any significant change to the proposed timing rules.

Officials consider that compliance with the proposed timing rules and calculation of the transitional deduction is generally first required when the taxpayer completes their return of income for the 2017–18 income year, which under extension of time arrangements, will not be finally due until 31 March 2019.

We have consulted with some taxpayers on a process for calculating the transitional deduction. We have identified that, as submitted in another EY submission, a minor technical adjustment to the proposed rule for calculating the transitional deduction is necessary to clarify that the adjustment is an apportionment of tax values in the deprecation rules on a reasonable basis (based on either the taxpayer's own data or on industry data) in order to minimise the compliance cost for this calculation. This can be addressed in the *Tax Information Bulletin* following enactment.

Consequently, officials do not consider there is any need to defer the implementation date.

Recommendation

That the submission be declined.

Issue: Spare parts, repairs and maintenance, and overhauls

Submission

(EY)

Clarification is required, particularly in relation to helicopter owners, to distinguish between the income tax treatment of aircraft engine components (as proposed to be defined) that are required to be held for repairs and maintenance outside regulatory overhauls, and those acquired as part of such overhauls.

Comment

The relevant definition for proposed new section DW 5 is “aircraft engine overhaul” and not “aircraft engine component”. The term “aircraft engine component” is not a defined term in the bill proposals.

An engine overhaul may occur on a scheduled basis or on an unscheduled basis (for example, because of bird strike). The proposed new section allows a deduction for the cost of an overhaul for an engine (fixed wing) and for the overhaul of listed major systems for a helicopter operator. An aircraft engine overhaul is defined as a process of disassembly, testing, restoring to specified operational conditions, and reassembly and testing. The cost of carrying out that process is the allowable deduction referred to in proposed section DW 5.

Officials consider this submission relates to a general timing rule that applies to spare parts held in inventory. Under this rule, the deduction for the cost of a part in inventory is timed to the year in which that part is used (for example, it is used to replace a part in the aircraft or helicopter) whether the part replacement is due to the use-by life expiring or due to on-condition maintenance (for example, replacement required as normal repairs and maintenance). It is intended that spare parts included in the overhaul process should form part of the cost of the overhaul and not be timed to the year of the overhaul but spread as part of the cost of the overhaul.

The intention is that the deduction for the cost parts held in inventory, and used for normal repairs and maintenance or replacement, is timed to the year the part is used in this way. This is no change from current law and practice.

Officials agree with the submission that it requires a minor technical amendment to clarify that the parts included in the overhaul process form part of the cost of the aircraft engine overhaul instead of being timed under the general timing rule that applies to normal repairs and maintenance.

Recommendation

That the submission be accepted.

Issue: Alternative methods, CIR agreement, and relationship with transitional adjustment provisions

Submission
(EY)

Clarification is needed or desirable in relation to:

- the process for making relevant elections and agreeing methods and adjustments under the IFRS alternative method;
- the CIR's expected approach to approving apportionments of consideration on disposal;
- whether or how the proposed transitional adjustment provisions apply if taxpayers elect to use the IFRS alternative method or the proposed single aircraft owner method.

Comment

Processes making relevant elections and agreeing methods and adjustments under the IFRS alternative method

Officials agree that the time by which relevant elections and agreement on methods should both be stated in the legislation. The processes are an operational matter rather than a matter for legislation. We have worked with our operational staff on these issues and anticipate outlining those processes in the *Tax Information Bulletin*.

The CIR's expected approach to approving apportionment of consideration on disposal

This is an operational matter. Again we are working with our operational staff to set out the expected approach in the *Tax Information Bulletin*. The main policy objective is to ensure that taxpayers are aware that apportionments are to be consistent with industry data.

The proposed transitional adjustment provisions apply for taxpayers electing to use either the IFRS alternative method or the single aircraft owner method

The transitional adjustment provisions are intended to apply to all taxpayers other than those who elect to use the single aircraft owner method.

Officials agree that the legislation should be clearer that the single aircraft owner method does not obtain the transitional deduction because they are electing out of the spreading method.

Recommendation

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

Issue: Transitional deduction

Submission
(EY)

Clarification is required of proposed sections DZ 22 and EZ 23BA, especially in relation to “unpriced aircraft engines”, and in relation to situations when taxpayers have previously capitalised all aircraft overhaul costs.

Comment

We agree with the submission that the provisions should clarify that the apportionment of the tax depreciation values should be on a reasonable basis. The intention is that a “reasonable basis” is one that either uses the taxpayer’s own historic information (for example, IFRS taxpayers already have appropriate ratios for their aircraft) or by reference to relevant industry data for that aircraft type. We were advised by taxpayers during consultation that:

- relevant cost data and aircraft values are readily obtained from commercial sources; and
- this data is already used by taxpayers using provisioning accounting and for asset and cashflow management.

Officials have seen no evidence that any taxpayers have previously capitalised past overhaul costs for income tax purposes. It is accepted that IFRS taxpayers have capitalised overhaul costs for IFRS purposes but not for income tax purposes.

Recommendation

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

Issue: Interface of definition of depreciable property with defined terms in the depreciation rules

Submission
(EY)

Amendments are required to clarify the relationship of the proposed amendment to depreciable property with sections EE 29(2), EE 37, EE 56 to EE 60, EE 61(3) and terms such as “aircraft” and “international aircraft”.

Comment

The amendments are technical in nature and are intended to provide greater clarity and certainty on how the tax depreciation rules operate after implementation. The submission is to make technical adjustments to improve the relationship between certain terms in the depreciation rules and:

- the amendment to the definition of depreciable property; and

- the transitional deduction.

Officials agree with this submission.

Recommendation

That the submission be accepted.

Issue: Leased aircraft

Submission
(EY)

Appropriate cross-referencing should be included to ensure that any disposal consideration for an aircraft (or aircraft engine) cannot be taxed twice.

Proposed section EJ 27 also applies to subsequent disposals of a leased asset by associates to ensure that it applies in the same manner as section FA 9.

Comment

Officials agree that:

- cross-referencing would clarify that no double taxation arises; and
- proposed section EJ 27 is intended to apply to a disposal of a lease asset by an associate in the same manner as existing section FA 9.

Recommendation

That the submission be accepted.

CLARIFICATION OF EMPOWERING PROVISION FOR NEW ZEALAND'S DOUBLE TAX AGREEMENTS

Clause 6

Issue: International obligations and overriding of treaties negotiated in good faith

Submission
(Corporate Taxpayers Group, KPMG, PwC)

It is not necessarily the case that other countries would interpret a double tax agreement (DTA) in the same way as New Zealand would, given our relatively broad interpretation of our general anti-avoidance rules (GAAR). This runs the risk that our domestic law would override the treaties negotiated in good faith with other countries. *(Corporate Taxpayers Group)*

A practical impact of this will be that application of section BG 1, pursuant to the proposed amendment to deny benefits otherwise arising under a DTA, may constitute a breach of New Zealand's obligations under international law (being those obligations owed to the other jurisdiction with which the DTA is entered into). *(PwC)*

It is also unclear whether parties to DTAs entered into by New Zealand before 2003 accept that section BG 1 overrides the relevant DTAs. *(KPMG)*

Comment

Inland Revenue's view of the existing law is that the provision that empowers New Zealand's DTAs does not prevent the anti-avoidance rules contained in income tax legislation from applying to counteract a tax advantage arising under a tax avoidance arrangement in respect of which a DTA applies. The proposal in the bill would make this explicit.

New Zealand's DTAs are based on the OECD's Model Tax Convention. The OECD's Commentary to the Model Tax Convention (the OECD Commentary) is an important part of the context in which these DTAs are internationally understood.

The OECD Commentary states that, as a general rule, there will be no conflict between GAARs and the provisions of tax conventions. It also confirms that States are not obliged to grant the benefits of a DTA if the DTA has been abused (noting that it should not be lightly assumed that the DTA has been abused).

The OECD's 2015 Action 6 ("Preventing the Granting of Treaty Benefits in Inappropriate Circumstances"), which will update the OECD Commentary in light of the OECD's Base Erosion and Profit Shifting (BEPS) project, has also confirmed this position.

Accordingly, in almost all cases, no conflict will arise between a DTA and the GAAR. While a conflict could theoretically result in a breach of international law, this issue is largely academic and arises for all countries that have the same law regarding their GAAR. These countries include Australia, the United Kingdom and Canada, who have also clarified in their domestic legislation that their GAAR overrides DTAs.

Inland Revenue has consulted on this proposal with the Ministry of Foreign Affairs and Trade, which has raised no concerns with the proposal.

Recommendation

That the submission be declined.

Issue: The amendment is a change not a mere clarification

Submission
(Corporate Taxpayers Group, PwC)

In our view, this proposal is not a "clarification" of existing law but represents a change in the law. It is misleading to describe these proposals as a mere clarification, and runs the risk that these proposals do not receive sufficient scrutiny during the Select Committee process.

Rather, it arguably alters the current position that in the event of inconsistency between a DTA and domestic law (the GAAR being part of the domestic law) the DTA prevails. *(Corporate Taxpayers Group)*

In our view it is very doubtful whether the proposed amendment is in fact a clarification of the relationship between section BG 1 and New Zealand's DTAs entered into before 2003. Rather, we consider that the proposed amendment will constitute a change in the position in respect of these earlier DTAs, and this amendment needs to be acknowledged as a change. *(PwC)*

Comment

On the face of the legislation there is a potential conflict between the GAAR and the provision that empowers New Zealand's DTAs. The provision in the Income Tax Act 2007 that governs the domestic implementation of DTAs states that DTAs override the other provisions of the Income Tax Act 2007. However, the Income Tax Act 2007 also states that the GAAR has overriding effect.

The legislation is not explicit about the ordering between the provisions that govern the domestic implementation of DTAs and the GAAR.

As noted above, Inland Revenue's view of the existing law is that the provision that empowers New Zealand's DTAs does not prevent the GAAR contained in income tax legislation from applying to counteract a tax advantage arising under a tax avoidance arrangement in respect of which a DTA applies. This is how Inland Revenue has applied the law in previous disputes.

Recommendation

That the submission be declined.

Issue: Creates uncertainty

Submission

(OliverShaw)

It creates the potential to considerably reduce the certainty for foreign investors that DTAs try to achieve. The problem it aims to fix has not been articulated.

Comment

The problem the amendment aims to fix is the uncertainty, on the part of some taxpayers, about whether the GAAR has overriding effect in respect of DTAs. The uncertainty arose because the relationship was not explicitly addressed in the legislation.

As noted above, Inland Revenue's current practice and interpretation of the law is that the GAAR does apply in the context of a treaty. Officials' view is that this amendment will reduce uncertainty by making it explicit that anti-avoidance rules can apply in the context of a DTA. Further, we note that the GAAR applies to all other situations and the growing body of case law on the GAAR generally provides considerable guidance to taxpayers. Additionally, there is comprehensive guidance in the Commissioner's Interpretation Statement IS 13/01 "Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007".

The lack of clarity in New Zealand's legislation contrasts with Canada and Australia, who amended their legislation to explicitly ensure that DTAs do not override the GAAR. As New Zealand's legislation is silent on whether DTAs override the GAAR, it has been suggested that there might be a possible inference that "the New Zealand Parliament is content to allow New Zealand taxpayers to use structures that employ the provisions of tax treaties to avoid New Zealand income tax".[4]

More recently (2014) the United Kingdom also amended its legislation to explicitly provide that DTAs do not override the GAAR.

Accordingly, if no similar amendment is made to New Zealand's tax legislation, a lack of action by the New Zealand Government may lead some taxpayers to infer that DTAs override New Zealand's GAAR. In other words, a lack of legislative action is likely to increase the uncertainty given the responses from Canada, Australia and the United Kingdom.

Recommendation

That the submission be declined.

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[4] See discussion in Elliffe, Craig and Prebble, John (2009) "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective," *Revenue Law Journal*: Vol. 19: Iss. 1, Article 4.

Issue: Not a current priority

Submission

(Corporate Taxpayers Group)

We submit that rather than introducing this change, given this is not a pressing issue, it would be more appropriate that when our treaties are re-negotiated over time, the particular DTA can be updated to deny DTA benefits in cases of tax avoidance (as has been done in more recently negotiated DTAs).

Comment

Officials consider that it is a priority issue, especially in light of the OECD work on the BEPS project and the Action 6 Final Report. While the amendment is consistent with how Inland Revenue currently interprets the law, there is a current uncertainty in the legislation.

Recommendation

That the submission be declined.

Issue: Lack of consultation

Submission

(Corporate Taxpayers Group, New Zealand Law Society, OliverShaw)

The proposed amendment to section BH 1 should be deferred until there has been more extensive consultation on the effect and potential implications of the change, including the effect of the proposed amendment on New Zealand's international law obligations, and that such consultation should expressly acknowledge and address:

- the lack of consensus as to the interaction between domestic anti-avoidance rules and DTAs in relation to DTAs entered into before 2003;
- the position in respect of DTAs entered into before 1992; and
- the potential for the proposed amendment, if applied in respect of pre-2003 DTAs, to contravene New Zealand's obligations under the Vienna Convention. *(New Zealand Law Society)*

This proposal has not been subject to consultation. These proposals should not proceed at least without full consultation and consideration of the need for it and the consequence of having such an override. *(OliverShaw)*

Officials approached the Group for pre-consultation on this issue however we never received any response to the concerns we raised. *(Corporate Taxpayers Group)*

Comment

Inland Revenue advised key stakeholders (New Zealand Law Society, Chartered Accountants Australia and New Zealand, and the Corporate Taxpayers Group) in July 2015 on the proposal, and received responses. Inland Revenue considered the issues that were raised in these responses, and had follow-up phone conferences with stakeholders. The Ministry of Foreign Affairs and Trade were also consulted in relation to New Zealand's international obligations.

No public issues paper was released. The process that was followed was to engage with key interested stakeholders on the proposal, bearing in mind that the amendment makes explicit the law as Inland Revenue currently interprets it. This change is consistent with international norms and with countries that have GAARs.

Accordingly, officials believe that the level of consultation in this context was appropriate.

Recommendation

That the submission be declined.

Issue: Application to treaties entered into before 2003

Submission
(New Zealand Law Society, KPMG, Chartered Accountants Australia and New Zealand)

In light of the 2003 amendments to the OECD Commentary, there seems little scope to argue that benefits under DTAs that were concluded after 2003 could not be justifiably denied in appropriate circumstances.

However, it remains an open question as to the position in respect of DTAs concluded prior to this date. Whether the OECD Commentary would permit the application of section BG 1 to deny benefits under a DTA concluded prior to 2003 would turn on the following issues:

- whether DTAs concluded prior to 2003 should be interpreted consistently with the 2003 amendments to the OECD Commentary with respect to DTA abuse; and if not
- whether the relevant OECD Commentary at the time the DTA was concluded would permit such application.

With respect to the first issue in particular it is noted that there is a general consensus among academics and other expert commentators that DTAs should be applied consistently with later Commentary where the later Commentary serves to clarify Commentary existing at the time the DTA was concluded, but not where the later Commentary contradicts this earlier Commentary. However, there is a lack of consensus as to which of these two categories the 2003 amendments fall into, and therefore whether the first principle cited in RIS9 can apply in respect of pre-2003 DTAs. It is also doubtful that either principle could apply in respect of DTAs entered into prior to 1992. *(New Zealand Law Society)*

There is some uncertainty regarding whether section BG 1 applies to DTAs concluded before 2003. The proposed unilateral amendment to section BH 1 does not alter the position in this respect. *(KPMG)*

Our concern is as follows. It seems clear that the OECD Commentary has changed from a view that for the GAAR to apply to a DTA it needed to be expressly incorporated into the DTA, to a view, more recently, whereby it is understood that a GAAR applies to a DTA. The proposed legislative amendments make it clear that the GAAR applies to DTAs. It is not, however, clear whether the proposed amendments are intended to be a deliberate override of older treaties entered into by New Zealand. If it is intended that the bill proposal amends these earlier DTAs unilaterally, we suggest this should be made very clear. *(Chartered Accountants Australia and New Zealand)*

Comment

The views expressed by submitters around whether section BG 1 applies to DTAs concluded before 2003 (or 1992) illustrate the current uncertainty in the legislation regarding the interaction between the provision which empowers treaties and section BG 1.

The proposed amendment is intended to apply in respect of all treaties regardless of the date they entered into force.

Inland Revenue's interpretation of the law is that the GAAR applies in the DTA context regardless of the date the treaty was concluded. In other words, Inland Revenue does not currently take a different approach to avoidance cases depending on the date the treaty was concluded. Accordingly, the change to the legislation is merely to clarify the domestic law and resolve any uncertainty on this point.

Recommendation

That the submission be declined.

Issue: Specific anti-avoidance rules

Submission
(Corporate Taxpayers Group)

Do officials intend for the other specific anti-avoidance provisions in subpart GB to override the effect of a DTA when there is a conflict?

Comment

The amendment applies only to the GAAR, not to the specific anti-avoidance rules (SAARs).

In relation to SAARs contained in, for example, subpart GB of the Income Tax Act 2007 there is not the same legislative issue that exists in respect of the GAAR – that is, DTAs and the GAAR are both expressed as having overriding effect, whereas subpart GB is not. Notwithstanding that this amendment does not deal explicitly with SAARs, it is intended that they can still apply when there is a DTA in accordance with the OECD Commentary.

The OECD Action 6 Final Report provides that conflicts between SAARs and DTAs will be avoided by a proper construction of both. New Zealand follows relevant OECD Commentary in determining whether there is a conflict between a SAAR and the DTA. In rare cases where a proper construction of the SAAR and the DTA nevertheless results in a conflict, the provisions of the DTA would prevail.

Recommendation

That the submission be noted.

Issue: No treaty relief is available if section BG 1 applies

Submission
(Chapman Tripp)

Under the proposed wording, DTAs arguably have no effect if section BG 1 applies – that is, no treaty relief is available if section BG 1 applies. The intended outcome is that a treaty should be applied to the reconstructed income under a tax avoidance arrangement, with the effect that the tax on the reconstructed income is subject to the limits in the treaty. A new provision is required to make it clear that, when section BG 1 applies, the treaty should be applied having regard to the reconstructed income and any treaty relief should be available with respect to that reconstructed income.

Comment

Under the general anti-avoidance rule in section BG 1, a tax avoidance arrangement is void as against the Commissioner of Inland Revenue. The Commissioner of Inland Revenue may then reconstruct the arrangement to counter tax advantages under section GA 1. The Interpretation Statement on the interpretation and application of the GAAR (IS 13/01 "Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007") contains a detailed analysis of the Commissioner of Inland Revenue's power of reconstruction, including a discussion of when the Commissioner will reinstate legitimate tax outcomes voided by the arrangement.

If the transaction has been reconstructed by the Commissioner as a result of applying the GAAR, a legitimate treaty benefit can be reinstated in the same way as in the case of a domestic tax law benefit. For example, if the proceeds of a share sale are recharacterised as a dividend under domestic law due to the application of the GAAR, then subject to the requirement that the provision of treaty benefits is a legitimate tax outcome, the dividend article of the relevant DTA would apply.

In other cases, no relief will be available. For example, a person who artificially inserts an entity into a country that has a DTA with New Zealand in order to get a lower withholding tax rate under a DTA ("treaty shopping") will not be entitled to treaty relief under that DTA.

It should be noted that the Commissioner is not obliged to reconstruct a transaction. For example, the Commissioner can simply treat the transaction as void (that is, assume the transaction did not take place). In that case, no treaty relief will be available in New Zealand as no transaction took place.

Officials consider that the current drafting provides for the outcome outlined above. We consider it would be difficult to make this clearer in the legislation.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(Corporate Taxpayers Group)

Would any law change be prospective only? It should apply only to arrangements entered into after the date of enactment or (in the alternative) to income years commencing after enactment.

Comment

The application date of the change will be prospective (that is, it will apply from the date of enactment).

Inland Revenue's view of the existing law is that the provision that empowers New Zealand's DTAs does not prevent the anti-avoidance rules contained in income tax legislation from applying to counteract a tax advantage arising under a tax avoidance arrangement in respect of which a DTA applies. This is how Inland Revenue has applied the law in previous disputes. Accordingly, there will be no change in how Inland Revenue has been applying the law.

Recommendation

That the submission be noted.

Issue: Further guidance and clarification

Submission
(KPMG, EY, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group)

Further guidance is needed on what the position is in a case when there is a conflict between the domestic law position and the treaty position.

Comment

As previously noted, Inland Revenue's view of the existing law is that the provision that empowers New Zealand's DTAs does not prevent the anti-avoidance rules contained in income tax legislation from applying and Inland Revenue has been applying this approach to date.

Further, the updated OECD Commentary states that in the vast majority of cases there is no conflict between the treaty provisions (under a proper interpretation of the treaty), and the domestic GAAR.

Appropriate policy guidance will be provided in a future *Tax Information Bulletin*. It should also be noted that the OECD's Action 6 Final Report considers the interaction of GAARs and DTAs in principle.

As noted above, in the Commissioner of Inland Revenue's view, the practical outcomes from an application of section BG 1 in this context are effectively determined in the same manner as where the avoidance is in respect of domestic provisions. The Commissioner of Inland Revenue has previously issued a substantial Interpretation Statement on the interpretation and application of the GAAR (IS 13/01 "Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007"). It is not considered that further general guidance on how the GAAR will apply in the DTA context would be helpful, and specific cases will depend on particular facts and circumstances.

Officials note that binding rulings, which are intended to provide certainty to taxpayers, are available to taxpayers who are concerned that a transaction may be subject to the GAAR.

Recommendation

That the submission be noted.

CHARITIES WITH OVERSEAS PURPOSES

Clause 272

Submission
(New Zealand Red Cross Incorporated)

Reference to “The Red Cross Society Incorporated” should be updated to reflect the charity’s correct legal name “New Zealand Red Cross Incorporated”.

Comment

Donors to organisations listed in schedule 32 of the Income Tax Act 2007 are entitled, as individual taxpayers, to a tax credit or 33⅓ percent of monetary amounts 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 before donors become eligible for these tax benefits. Charities on the list have purposes directed at providing overseas aid and relief.

The submitter has requested a revision to the list to reflect a legal name change made in 1993.

Recommendation

That the submission be accepted. Remove reference to “The Red Cross Society Incorporated” and replace with “New Zealand Red Cross Incorporated” in schedule 32 of the Income Tax Act 2007. The change should have effect from 14 December 1993.

LAND TAINTING AND COUNCIL CONTROLLED ORGANISATIONS

Clauses 9, 10, 11 and 12

Issue: Support for the proposals

Submission
(PwC, Auckland Council, Deloitte)

The submitters support the proposal to exempt entities controlled by local authorities from the land tainting rules.

Comment

Officials welcome support for the proposal.

Recommendation

That the submissions be noted.

Issue: Application date

Submission
(Deloitte)

The Dunedin City Council group had a council controlled organisation that commenced a property development business during the 2007 calendar year. Because the proposed amendment to exempt council entities from the land tainting rules in section CB 15C applies from 1 September 2015, land acquired by the Dunedin City Council group after the commencement of the group's property development activities and disposed of before 1 September 2015 would be subject to the land tainting rules, and would potentially be taxable.

To prevent an overreach of the rules for the Dunedin Council, and to ensure all local authorities are treated equally in relation to land held within their groups, proposed section CB 15C should apply from 1 April 2008 or at least 1 July 2010 to ensure that the proposed amendment applies to all periods not currently statute barred.

Comment

Officials accept that the land tainting rules are overreaching in the context of council groups by taxing capital account land in situations when there is no tax avoidance concern. However, officials do not agree that the amendment should be backdated, for the following reasons:

- The current amendment is prospective in a sense because Auckland Council's tax advisors sought an amendment from officials in April 2015, prior to any tainting implications occurring. Because of the legislative timetable an amendment was not able to be enacted prior to 1 September 2015. In order to provide a pragmatic solution for Auckland Council that would give them certainty of tax treatment, a retrospective amendment was included in the next available tax bill.

- Council groups knew the tax position at the time and entered into transactions (or refrained) on that basis.
- Backdating the amendment would provide no relief to council groups who refrained from entering into transactions because of tainting implications and would therefore be inequitable.
- Backdating the amendment would provide a windfall gain for those councils who paid tax on such land sales.
- The current amendment is equitable as it applies from the same date for all council groups.

Recommendation

That the submission be declined.

Issue: Consolidated groups

Submission
(Deloitte)

Sections CV 2 and/or FM 9 of the Income Tax Act 2007 should be amended to ensure that taxable income does not arise under the consolidated group rules for transactions that would otherwise be exempt under proposed section CB 15C. If not, the intent of the proposed amendments would be defeated as it is common for council-controlled organisations to be part of a consolidated tax group.

Comment

The consolidation regime was introduced in 1992 (with application from 1 April 1993) and allows wholly owned groups of companies to be treated as a single company for tax purposes. This simplifies the tax affairs of a group of companies by ensuring that intra-group asset transfers are tax deferred, by allowing imputation credits to be offset within the group, as well as ensuring losses are utilised by reference to the shareholder continuity of the group, not of individual members.

Section FM 9 applies when a company that is part of a consolidated group derives an amount that would not ordinarily be income of the company but would be income of the consolidated group if it were one company. The section provides that the amount is income of the company under section CV 2. This provision is intended to prevent intra-group arrangements where assets are transferred and re-characterised to avoid tax.

Officials agree with the submitter that the consolidated group rules would defeat the intent of the land tainting amendments, because any land disposed of that would be exempt under proposed section CB 15C would be taxable to the group because of the development activities of another group member.

Recommendation

That the submission be accepted.

Issue: Extension of the exemption to other entities should be considered

Submission
(Chartered Accountants Australia and New Zealand)

Consideration should be given to extending the exemption to other entities – for example, entities associated with social housing providers. Social housing providers may be considered property developers. The disposal of capital account land held by entities associated with a social housing provider may be subject to tax under the land tainting rules when there is no tax avoidance concern.

Comment

While officials support the submission in principle, competing priorities mean that this issue cannot be advanced at this time. A review will be considered for inclusion in a future tax policy work programme.

Recommendation

That the submission be noted.

Issue: The exclusions in part CB should be revised

Submission
(EY, New Zealand Law Society)

The meaning of the word "premises" in the business premises exclusion from the land tainting rules in section CB 19 of the Income Tax Act 2007 is uncertain - whether it should be regarded as restricted to buildings and their immediately surrounding land, or whether it might be regarded as applying to the property as a whole. The exclusion should be reviewed to ensure it can apply to land, as distinct from arguably being limited to buildings and their immediate surrounds, which is used within the normal scope of a taxpayer's business activities (*EY*).

The scope of the exclusions (the residential land exclusion in section CB 16 and the business premises exclusion in section CB 19) from the land tainting rules should be reviewed, to ensure that the land tainting rules do not unnecessarily catch disposals of land held on capital account in other contexts (*New Zealand Law Society*).

Comment

While officials support the proposals in principle, competing priorities mean that a review of the exclusions cannot be advanced at this time. A review will be considered for inclusion in a future tax policy work programme.

The meaning of the word "premises" in the business premises exclusion is a question of interpretation. The points the submitter has raised have been passed onto Public Rulings to consider for inclusion in their work programme.

Recommendation

That the submission be noted.

Issue: Expanding the local authority tax exemption to cover income derived from an unrelated CCO

Submission
(EY)

There should be an extension of the local authority income tax exemption in section CW 39 to cover income derived by local authorities from transactions with unrelated council-controlled organisations, port companies or energy companies. This should apply to land sales, other income from land use and other types of income more generally. Without an extension, if a local authority were to develop land, its sales to private buyers would be exempt from tax but any sale to an unrelated entity, which happened to be a council-controlled organisation, port company or energy company (as described in section 6(4) of the Local Government Act 2002) because of some other local authority's ownership or control, would be taxable.

Comment

Under section CW 39(4) of the Income Tax Act 2007, an amount of income a local authority derives from a council-controlled organisation (CCO) or a port or energy company (that would be a CCO in the absence of section 6(4) of the Local Government Act 2002) is taxable. This represents an exclusion from the general income tax exemption afforded to local authorities by section CW 39(2). This exclusion was introduced in 1989 to ensure that a CCO is treated as an ordinary company for tax purposes in relation to its commercial operations. The policy intent was to ensure competitive neutrality of CCOs with the private sector. Without this provision, this policy intent was able to be defeated as income from a CCO could effectively be extracted tax-free by the local authority charging the CCO rental or management fees, which would be deductible to the CCO but not taxable to the local authority due to its tax-exempt status.

Officials agree with the submitter that the exclusion should only apply to related entities – for example, entities within the council group, not to unrelated entities (such as a CCO within another council group).

Recommendation

That the submission be accepted.

Issue: Suggestions to improve drafting of proposed new section CB 15C

Submission
(New Zealand Law Society)

The drafting of section CB 15C should be amended to:

- make clear that the exclusion may apply to disposals not only by council controlled organisations (CCOs) and other local authority-controlled entities but also by local authorities (if the income tax exemption under section CW 39(2) would not apply to the disposal); and
- remove the additional references to a CCO or entity being "controlled" by a local authority (which imply greater than 50 percent control, whereas the CCO control tests and the *Commentary* on the bill indicate that joint (50/50) control should be sufficient).

Comment

In relation to the submitter's first point, officials consider that the current drafting is clear that the exclusion does apply to disposals by local authorities. However, there may be some room to improve drafting clarity.

Officials agree with the submitter that references to a CCO or entity being "controlled" by a local authority should be removed so as not to imply greater than 50 percent control.

Recommendation

That the submission be accepted.

Issue: Repeal of legislative information sharing provisions on commencement of an Approved Information Sharing Agreement

No clause

Submission
(Matter raised by officials)

Officials are progressing work to amalgamate the current legislative information sharing provisions into one Approved Information Sharing Agreement (AISA) under the Privacy Act 1993. This agreement will enable the two agencies to share the information they need to determine entitlements to benefits and subsidies, and for assessing tax obligations.

Officials propose that the current rules be repealed with effect from a future date to be determined by Order in Council, to enable the AISA to come into force as soon as possible.

Comment

The AISA will amalgamate seven information-sharing provisions under three Acts: the Tax Administration Act 1994, the Student Loan Scheme Act 2011 and the Child Support Act 1991, into one agreement. This agreement will be enacted by way of Order in Council, which is expected to occur in mid-2017.

When the AISA is enacted, there will be an overlap between the current legislative provisions and the AISA agreement. The current legislation will be the authorising legislation for information sharing, not the AISA, which would make the AISA inoperable. Officials therefore recommend that the current rules be repealed with effect from a future date to be determined by Order in Council. The date specified in the Order in Council will be the date the AISA comes into force, once that date is known.

This amendment will ensure that there is only one authorising provision in force at a point in time, and once the AISA comes into force, it will be the authority to enable information sharing between the two agencies to take place.

Recommendation

That the submission be accepted.

Issue: Section 81A amended (Disclosure of information under approved information sharing agreement)

Clause 292

Submission
(Office of the Privacy Commissioner)

The submitter supports the amendment proposed in clause 292 as it will ensure Inland Revenue can take full advantage of the intended flexibility of the approved information-sharing mechanism provided for under Part 9A of the Privacy Act 1993.

Comment

Currently, an exception to the tax secrecy rules allows Inland Revenue to share information in the context of AISAs approved under the Privacy Act. However, the exception refers only to personal information. This means Inland Revenue cannot share information that is not personal information (for example, information about companies or partnerships).

The amendment proposes an information-sharing agreement under the Privacy Act enabling the sharing of information, irrespective of whether the sharing also includes information that is not personal.

The submitter supports the proposed amendment as it will clarify that Inland Revenue may share both personal and non-personal information under an AISA without breaching its secrecy obligations to taxpayers. This will enable Inland Revenue to take full advantage of the intended flexibility of the approved information-sharing mechanism provided for under Part 9A of the Privacy Act 1993.

Recommendation

That the submission be noted.

Clause 295

Issue: Support for the proposal to extend the time bar to ancillary taxes and AIL

Submission
(EY, Deloitte, Corporate Taxpayers Group, New Zealand Law Society, Chartered Accountants Australia and New Zealand, KPMG, Chapman Tripp)

The submitters support the proposal to extend the time bar to ancillary taxes and the approved issuer levy.

Comment

Officials note the support for the proposal.

Recommendation

That the submission be noted.

Issue: Time bar should apply when no return has been filed

Submission
(EY)

Currently, the time bar can apply only if a return has been filed. That requirement may make sense in the context of returns of income, as most business taxpayers and entities are required to file these returns for each tax year. The requirement does not make as much sense in relation to ancillary taxes or the approved issuer levy (AIL). Taxpayers are not required to file returns for ancillary taxes or AIL if they do not consider any of these taxes or levies are payable, but they still take tax positions by not filing those returns for any given period, just as they take tax positions by filing returns (or other documents treated as returns) for those purposes.

There appears to be no policy reason why taxpayers taking a tax position in relation to ancillary taxes or AIL by not filing a return for any relevant period should not be able to apply the general time bar when taxpayers filing some sort of return, such as a nil return, would be able to do so (unless either of the section 108(2) exceptions applied).

The proposed amendment will encourage the filing of numerous nil returns for all sorts of ancillary taxes simply so taxpayers may obtain time bar protection in due course.

Given the above, as well as the context of self-assessment and the ongoing move to electronic filing, which tends to require simple numbers in boxes, rather than detailed information, explanations or calculations, it is suggested the wording of section 108 should be reviewed more generally, with a view to providing expressly for situations where tax positions have been taken in not filing returns for ancillary taxes or AIL.

Comment

The proposal is intended to be consistent with the current law on the time bar, which requires a return to be filed before the time bar applies. The purpose of the requirement to file a return is to ensure that the Commissioner has adequate information to decide whether the relevant assessment is correct.

The issue of whether the Commissioner could obtain the relevant information through a different channel is outside the scope of the current proposal. Inland Revenue is currently considering how the time bar will apply in the future under its Business Transformation programme. Officials consider that the issue of whether a return should be filed to trigger the time bar should be considered as part of that wider review of the time bar.

Recommendation

That the submission be declined, subject to the issue being referred to the broader review of the time bar.

Issue: Application of the exceptions to the time bar

Submissions

(EY, Deloitte, Corporate Taxpayers Group, New Zealand Law Society, Chapman Tripp)

The current time bar prevents the Commissioner from increasing an assessment after four years have passed from the end of the tax year in which the return is filed. However, exceptions in section 108(2) allow the Commissioner to increase the assessment in certain circumstances. Submitters raised some issues with the application of the exceptions to the time bar in relation to ancillary taxes and AIL.

The references in the "omission of income" exception to income of a particular nature or derived from a particular source are inapposite in relation to ancillary taxes or AIL, particularly in relation to FBT and fringe benefits, which are not anyone's "income". *(EY)*

There is insufficient guidance on the meaning of the "particular nature" of an amount in section 108(2) in a withholding tax context. It seems clear that section 108(2)(b) should be concerned with whether or not an amount is interest, a dividend or a royalty, and not with the character of the recipient for tax purposes (or, indeed, the circumstances surrounding the receipt or payment). In an AIL/NRWT context, section 108(2)(b) should not apply when a taxpayer who has paid interest discloses the payment as interest in its AIL return provided that the payment remains interest. In particular, it should be clarified that arguments about the status of the recipient as an associate, and therefore whether NRWT applies instead of AIL, should not prevent section 108(1) from applying. This issue is broader than AIL. It was submitted that section 108(2)(b) should be amended to clarify that "particular nature" does not include the characteristics of payees, or the circumstances surrounding an amount. *(Chapman Tripp, New Zealand Law Society)*

It is not entirely clear whether section 108(2) would apply in a situation where an AIL return has inadvertently been filed. There is a risk that Inland Revenue could take an interpretation that the time bar does not apply as interest paid to an associate is of a different nature to interest paid to a non-associated person, and therefore section 108(2) applies to enable a prior assessment to be amended despite the application of the time bar. To ensure that the time bar will apply in this situation, it is submitted that section 108(2) should be amended to provide that this subsection does not apply where AIL has been paid in respect interest income, where NRWT should have been paid instead. This will provide certainty to taxpayers that the time bar will apply in this instance (provided that four years have passed from the end of the income tax year in which a taxpayer has filed their return). *(Deloitte, Corporate Taxpayers Group)*

Comment

The proposal is intended to be consistent with the current law on the time bar, including the current definitions of the terms in the exceptions to the time bar.

Officials note that the current exception to the time bar is long-standing, and there is case law on the relevant terms in the provision. The current proposal is not intended to affect those interpretations of the relevant terms.

The current time bar and the exceptions to the time bar are currently being reviewed as part of Inland Revenue's Business Transformation programme. Officials consider it to be more appropriate to review the current exceptions to the time bar as part of that broader review, which will be able to consider the changing nature of the information required to be provided and the role of the exceptions to the time bar.

Recommendation

That the submissions be declined, subject to the issue being referred to the broader review of the time bar.

Issue: Starting date for the time bar

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, McIsaacs Ltd)

The time bar should apply four years from the date an income tax return has been filed rather than four years from the end of the tax year in which the taxpayer provides the tax return.

Alternatively, the ancillary tax return should not be treated as an income tax return so that the time bar is linked to a "tax year". Like GST, many ancillary taxes relate to periods that are shorter than a tax year. They should be treated in the same way as GST for time bar purposes, with the time bar commencing in the next period after the return is filed rather than from the beginning of the following tax year.

Submitters noted that under the current proposal the time bar could operate after five years has elapsed in some situations, rather than four years.

Comment

The broader issue of when the time bar should apply generally for income tax returns is outside the scope of the current amendment, and will be considered as part of the broader review of the time bar as part of Inland Revenue's Business Transformation programme.

Officials agree with the narrower submission that a different rule (to the general rule that applies to income tax returns) should apply for ancillary taxes and AIL.

Recommendation

That the submission be accepted that the time bar for ancillary tax and AIL should commence in the next period after the return is filed.

Issue: AIL returns should be treated as NRWT returns for other purposes

Submission
(New Zealand Law Society)

As AIL returns will be effectively treated as NRWT returns for the purposes of the time bar, further amendments should also be made to confirm that AIL returns are NRWT returns for the purposes of the types of decisions that are deemed correct (and can only be challenged in challenge proceedings). If this amendment is not made, it would be open for the Commissioner to challenge a tax position taken by a taxpayer in an AIL return outside of the current dispute mechanisms.

Comment

The proposed amendment treats the filing of an AIL return as having met the requirements for filing a NRWT return only for the purposes of the time bar. The broader issue of how AIL returns should be treated for the disputes process under the Tax Administration Act 1994 is outside the scope of the current proposal.

Recommendation

That the submission be declined.

Issue: Imputation credits should be included under the time bar

Submission
(Chartered Accountants Australia and New Zealand)

Imputation should be included as an ancillary tax for the purposes of the statute bar.

Comment

The proposal is only intended to apply the current time bar rules to ancillary taxes and AIL. This means that further income tax and imputation penalty tax, which relate to the imputation regime, would be subject to the time bar under the proposals.

However, the current proposal does not extend the time bar to tax credits, such as imputation credits. Officials consider that imputation credits are of a different nature to ancillary taxes and AIL, and so are outside the scope of the current proposal. Officials consider that it is more appropriate to review whether tax credits should be subject to the time bar as part of the broader review of the time bar being undertaken as part of Inland Revenue's Business Transformation programme.

Recommendation

That the submission be declined, subject to the issue being referred to the broader review of the time bar.

Issue: Consequences of amendments to losses or tax credits

Submission
(Chartered Accountants Australia and New Zealand)

When an amendment to a loss or other credit is outside the statute bar any consequential adjustment to an ancillary tax should be subject to the time bar. The current prohibition on decreasing a net loss prevents the Commissioner from amending an earlier year to reduce a loss and thereby effectively increase the amount of tax payable in a later year.

The proposed amendment does not alter this in relation to ancillary tax. For most ancillary taxes an earlier return does not affect a later return so this is of no consequence. However, this is not the case in relation to further income tax, imputation penalty tax, foreign dividend payment (FDP), further FDP, FDP penalty tax and research and development tax credits.

Alternatively, a section similar to section 108(1B) should be included so it is clear it applies to imputation penalty tax, further income tax, further FDP, FDP penalty tax, and research and development tax credits.

Comment

Officials note that the remaining FDP provisions in the Tax Administration Act 1994 are being repealed as part of the current bill, as the FDP regime is being repealed. This issue will, therefore, not arise for FDP, further FDP, or FDP penalty tax.

Officials consider this issue should be considered as part of the broader review of whether tax credits should be subject to the time bar. As noted above, officials consider that imputation credits are of a different nature to ancillary taxes and AIL, and so are outside the scope of the current proposal.

Recommendation

That the submission be declined, subject to the issue being referred to the broader review of the time bar.

Issue: Description of application date in the *Commentary*

Clause 295

Submission
(Corporate Taxpayers Group)

The language used when describing the application of the time bar reforms in the *Commentary* to the bill is unclear. It could be read as requiring four years to have passed from the date of introduction of the bill for the time bar to apply to an ancillary tax.

The submitter subsequently confirmed with officials that the intended effect of the proposal is that the Commissioner will not be able to increase an amount in an ancillary tax or AIL return after the date of introduction of the bill, provided the requirements of the time bar are met. This means that once the bill has been enacted the time bar will apply to ancillary or AIL returns filed four or more years prior (subject to the other time bar exceptions).

The submitter noted this interpretation is consistent with the wording of the current legislation.

Comment

The *Commentary* noted that:

> 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).

Officials acknowledge that while the first sentence detailed the application date for the proposed amendment, the second sentence explaining its application could have been clearer.

Recommendation

That the submission be noted.

Submission
(Chartered Accountants Australia and New Zealand)

Section MB 7B(3) of the Income Tax Act 2007 and Schedule 3, clause 12A(4) of the Student Loan Scheme Act 2011 should be amended to include a savings provision for past calculations of the FBT rate applied (other than the maximum rate) to employees' short term charge facilities used in the calculation of adjusted net income and family scheme income.

Comment

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 Working for Families tax credits, community services card and student allowance entitlements) and in their adjusted net income (used to determine student loan repayments). 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. The bill proposes to retrospectively give employees an option to apply the maximum FBT rate in situations when they are unable to obtain the FBT rate their employer used. This means if an employee applied the maximum FBT rate in order to finalise their social policy assessments (and determine their obligations and entitlements) quickly, they will not have breached the law. It does not require employees to apply the maximum FBT rate if they know the rate used by their employer. If an employee chooses the maximum rate, but at a later date they are able to obtain the rate their employer applied, their obligation or assessment can be amended (within the time bar rules). Providing an option to apply a default maximum FBT rate enables employees to quickly finalise assessments without undermining the fairness and integrity of the social policy schemes as short-term charge facilities are equivalent to cash wages.

Recommendation

That the submission be declined.

Remedial amendments

Clauses 163, 169, 204 and 209

Issue: Tax pooling should be available to taxpayers who have filed an AIL return and were then reassessed for NRWT

Summary of submissions

(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, New Zealand Law Society, Tax Pooling Intermediary Association)

The pooling rules should be made available to taxpayers who have filed an AIL return and were then reassessed for NRWT. This would be in line with other amendments in the bill which clarify that a taxpayer who has incorrectly paid AIL instead of NRWT will have assessments raised for the unpaid NRWT.

From a policy perspective, a taxpayer should be able to use tax pooling to meet a NRWT liability when they have mistakenly filed an AIL return. *(Corporate Taxpayers Group, New Zealand Law Society)*

The logic of applying the time bar protection by treating an AIL return as an NRWT return should also apply to the tax pooling rules. Not to extend the amendment would create an unprincipled inconsistency in the Act. *(Chartered Accountants Australia and New Zealand)*

Inland Revenue has not interpreted the existing legislation in the spirit in which it has been intended. *(Corporate Taxpayers Group)*

If taxpayers are not allowed to utilise tax pooling in these circumstances, they are encouraged not to inform Inland Revenue that they have taken an incorrect position and file a voluntary disclosure. *(Corporate Taxpayers Group)*

Comment

The policy behind the amendments relating to ancillary taxes and the time bar is different from the policy for allowing the use of tax pooling funds for reassessed returns.

Further consideration would be necessary to determine the full implications of submitters' proposals to allow tax pooling to be used to meet the NRWT liability when an AIL return has previously been filed. This cannot be achieved within the timeline for this bill. The matter could, however, be considered for future inclusion in the Tax Policy Work Programme.

Officials consider that the existing legislation has been interpreted consistently with current policy.

Failure to disclose the correct tax position is a breach of taxpayers' obligations under the Tax Administration Act 1994.

Recommendation

That the submissions be declined.

Issue: Timing of debits and credits

Summary of submissions
(Corporate Taxpayers Group, Deloitte, Tax Pooling Intermediary Association)

The drafting of the amendment to section OB 26 does not work as intended in all circumstances to create an offsetting credit for (and eliminate) the second debit on the same date that the debit arises. A timing issue could arise where there is a sale of tax and the date of the credit to eliminate the debit from the sale does not match the date of the debit for the sale of tax. There is a risk of a debit balance inappropriately arising at the end of the prior tax year. The credit date for the elimination of the double debit under section OB 26 should be the day the imputation debit arises under section OB 35(4). *(Corporate Taxpayers Group, Deloitte)*

We do not consider this to be the policy intent of the proposed amendments. *(Corporate Taxpayers Group, Deloitte)*

The wording of the provisions determining when the credit arises (for individuals, companies or consolidated groups) is unclear as it could be interpreted as either the effective date the purchaser acquires the tax or the date of the transaction. *(Corporate Taxpayers Group, Deloitte, Tax Pooling Intermediary Association)*

If it is the former, there is a risk that the credit is reinstated before a continuity breach and is ineffective. *(Tax Pooling Intermediary Association).*

The same matching rule should apply for refunds of pooling funds. *(Corporate Taxpayers Group, Deloitte)*

Section OB 26 should apply when section OB 41 cancels an imputation credit under section OB 6. *(Corporate Taxpayers Group, Deloitte)*

Subpart OP relating to consolidated imputation groups should be updated consistently with the above. *(Corporate Taxpayers Group, Deloitte)*

Section OP 23 should also apply when an imputation credit in the consolidated imputation group's imputation credit account under section OP 42 cancels an imputation credit under section OP 9. *(Corporate Taxpayers Group, Deloitte)*

When a company that has a shareholder continuity breach pays tax prior to joining a consolidated imputation group, and when there is a refund or sale of tax relating to tax paid in a pre-continuity breach period, the rules do not appear to work in a non-tax pooling context in section OP 30 nor in a tax pooling context in section OP 23. Sections OP 30 and OP 23 should recognise the credits and debits in sections OB 5 and 6 and OB 41 as relevant. *(Corporate Taxpayers Group, Deloitte)*

Comment

The tax pooling amendments that are part of this bill are of a remedial nature only, and are consistent with the current policy on imputation rules as they apply to tax pooling transactions.

Tax pooling imputation credit issues in relation to both individual companies and consolidated groups that have been raised by submitters could be considered for future inclusion in the Tax Policy Work Programme.

Making changes to the current tax pooling imputation framework to deal with isolated issues may have implications for the totality of the imputation rules applicable to tax pooling.

Recommendation

That the submissions be declined.

ZERO PERCENT AIL RATE FOR SECURITIES ISSUED VIA A LIMITED DISCLOSURE DOCUMENT

No clause

Submissions
(ANZ, New Zealand Bankers' Association, Chapman Tripp)

At present, for offers of securities under the Financial Markets Conduct Act 2013 to access the 0% rate of AIL under section 86IB(1)(b)(i) of the Stamp and Cheque Duties Act 1971 the issue of a security must be either:

- a regulated offer for the purposes of the Financial Markets Conduct Act 2013; or
- an offer referred to in clause 19 of Schedule 1 of the Financial Markets Conduct Act 2013.

Registered banks are exempt from the regulated offer regime as they are not required to issue a product disclosure statement.

Therefore a registered bank can only access the 0% rate of AIL if the issue of a security is an offer referred to in clause 19 of Schedule 1 of the Financial Markets Conduct Act 2013. Clause 19 of Schedule 1 of the Financial Markets Conduct Act 2013 requires the offer of a quoted financial product – in essence an offer of the "same class" as a previously issued security quoted on a licensed market. If a registered bank does not issue under an offer of a quoted financial product, it will be required to issue via a limited disclosure document process. This may occur when the registered bank amends the documentation of a security issue, such that the issue will not be of the "same class" as a previously issued security quoted on a licensed market. However, subsequent security issues of the same class as those offered via a limited disclosure document can be an offer of a quoted financial product. The only material difference between a limited disclosure document and a product disclosure statement is that a limited disclosure document is not required to disclose certain financial information about the issuer. A limited disclosure document contains greater disclosures than that required for a quoted financial product.

However, a limited disclosure document issue will not qualify for the 0% rate of AIL as it will not be a regulated offer or an offer referred to in clause 19 of Schedule 1 of the Financial Markets Conduct Act 2013. This appears to be an unintended gap in the Stamp and Cheque Duties Act. If the gap is not remedied, then whenever a registered bank issues a new class of listed securities, the first offer will not qualify for the 0% rate AIL, but all subsequent offers (being offers of quoted financial products), would qualify for the 0% rate AIL.

The Stamp and Cheque Duties Act should be amended to allow limited disclosure document offers to access the 0% rate of AIL. Given this clear and unintended gap in the Stamp and Cheque Duties Act, any amendment should be retrospective for any interest paid on limited disclosure document offers post 1 December 2014, or at least when the bill was introduced to Parliament.

Comment

Officials agree that there is no policy rationale to prevent a security issued under a limited disclosure document from qualifying for 0% AIL when an otherwise identical security issued under a quoted financial product would qualify. This was an unintended omission and should be rectified, with retrospective effect.

Recommendation

That the submission be accepted.

TAXABLE BONUS ISSUES AND AVAILABLE SUBSCRIBED CAPITAL

Clause 22

Submission
(Chapman Tripp)

There is no policy reason why the amendment that clarifies that imputation credits attached to a taxable bonus issue are not included in the available subscribed capital should not apply retrospectively.

Comment

Officials do not consider that a sufficient case has been made to depart from the standard approach of applying amendments prospectively.

Recommendation

That the submission be declined.

Issue: Interest deductibility when life insurer receives exempt income

Clause 38

Submission
(New Zealand Bankers' Association)

The submitters supports the proposed change and application date.

Comment

The bill proposes an amendment to section DB 7 of the Income Tax Act 2007 confirming 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.

Recommendation

That the submission be noted.

Issue: Treatment of fees for managing policyholder investments

Clauses 61 to 63, 65 and 66

Submission
(AMP, Chartered Accountants Australia and New Zealand, EY, Financial Services Council, KPMG)

A range of comments have been expressed on the proposed changes codifying the treatment of transfers of value (not related to life risk) from the policyholder base to the shareholder base by a life insurer when the transfer relates to the management of policyholder funds (investments) by the life insurer. Submitters' comments include:

- support for the proposed changes; *(AMP, KPMG)*
- the scope of the proposed charges:
  - should take into account explicit and implicit charges, and *(AMP)*
  - is too narrow and should be expanded to include "management, distribution and administration related services"; *(AMP, Chartered Accountants Australia and New Zealand, Financial Services Council)*
- additional consequential changes are needed to provide further certainty regarding the interaction of the proposed changes with the wider taxation rules for life insurance; *(AMP, Chartered Accountants Australia and New Zealand, EY)*

- the application date of sections EY 2 and EY 3 should be backdated to 1 July 2010. *(Chartered Accountants Australia and New Zealand, EY)* Historical tax positions from 1 July 2010 to 1 April 2005 not covered by the proposed amendments should be provided for. *(KPMG)*

Comment

Each of the submissions points are considered in turn.

Support for the proposed changes

Support for the change is noted.

Scope of the change: consideration and services covered by the proposed amendments

The scheme and purpose of the taxation rules for life insurance means that the life insurer is required to assess its tax liabilities using separate calculations to reflect two bases of taxable income:

- a shareholder base (representing income derived for the benefit of the life insurer's shareholders); and
- a policyholder base (representing income derived for the benefit of policyholders).

Income and deductions are recognised using the general income and deduction rules in parts C and D of the Income Tax Act 2007, with the addition of special rules in subpart EY to deal with unique timing and allocation issues inherent with life insurance products. All references in this section are to the Income Tax Act 2007 and the new life insurance rules that took effect from 1 July 2010.

The changes proposed in this bill codify the treatment of transfers between the shareholder base and policyholder base in response to the structure of the Income Tax Act. For income tax purposes, there are two bases of calculating taxable income within the one taxpayer (the life insurer). As such, the proposed changes set the tax treatment of certain intra-entity transactions and ensure symmetry.

The charges in question do not relate to life risk, the taxation of which is specifically integrated into the Income Tax Act, but instead concern the life insurer's management of funds set aside to meet in whole or in part future policyholder claims from life insurance policies. The "investment management services" referred to in the proposed amendments are those services provided by the life insurer to policyholders in respect of those pooled policyholder funds. The proposed amendments apply to life insurance policies that are savings product policies and not profit participation policies.

The proposed changes deal with charges that have two critical elements:

- The charge is based on a contractual relationship between the life insurer and the policyholder (and should be documented in the life insurance policy).
- The charge or "consideration" is related to managing policyholder investments. The charges are typically sourced from premiums.

Officials consider the term "consideration" is sufficiently comprehensive to deal with all situations where there is a contractual obligation on the policyholder to pay or otherwise compensate the life insurer for providing administrative and other financial intermediation services related to managing funds set aside to meet future policyholder claims ("policyholder funds").

Submissions recommend that the scope of the change be expanded to include "management, distribution and administration-related services". Submissions also note that deductions for these types of costs are allowed for comparable savings-vehicles such as unit trusts and superannuation schemes.

Officials note that external costs of the nature described in submissions allocated to the policyholder base under section EY 16 are generally deductible under Part D when there is a nexus to those costs to investment income (section EY 15). A more likely situation, however, is that these costs are allocated to the shareholder base under section EY 20 if they are deductible under Part D. The shareholder base would then seek reimbursement for these costs, including any fee for financial intermediation associated with managing the pool of policyholder investments, from the policyholder base via an internal charge, (to which new sections EY 16B and EY 19B now specify the tax outcome).

The composition of the charge is of itself not material. What is material is that the charge by the life insurer (the shareholder base) on the policyholder base is for investment management services for managing policyholder funds and supported by the life policy documentation. This can include the on-charge or cost-recovery of expenditure incurred by the life insurer and allocated to the shareholder base as well as a margin or fee for financial intermediation services provided by the life insurer. To assist users of the legislation, officials recommend the term "investment management services" be defined by reference to the financial intermediation services contractually provided by the life insurer in administering policyholder funds attributable to non-participation policies.

Need for consequential changes

Submitters have noted that the proposed changes introducing new sections EY 16B and EY 19B require integration into the wider life insurance rules, specifically:

- the link between sections EY 16 and proposed EY 16B; *(AMP, EY, Financial Services Council)*
- the link between sections EY 19 and proposed EY 19B; and *(Financial Services Council)*
- the link between proposed sections EY 19B and section EY 20. *(AMP)*

Given the scope and application of proposed sections EY 16B and EY 19B discussed above, officials consider a consequential change to section EY 16 could be made to ensure that deductions are not double counted. The effect of the change to section EY 16 would be to remove from its scope deductions claimed under section EY 16B. The new scheme and purpose would be created whereby the calculation of tax for the policyholder base would be based on:

> *income allocated to the policyholder base (section EY 15) less [deductions for allocated third party expenditure (section EY 16) plus deductions for internal charges by the shareholder base (section EY 16B)]*

This formula broadly replicates the proposed legislative structure that the bill creates for the purposes of recognising shareholder base income, whereby income to the shareholder base arising under proposed section 19B is excluded from the scope of section EY 19. The proposed amendment excluding such income from the scope of section EY 19 (clause 65) is supported by AMP. It is intended to respond to the concern identified by the Financial Services Council and prevent double counting of income for the shareholder base. Officials consider, however, for completeness, a rule preventing double counting of income could assist interpretation of the new rules.

Officials consider that section EY 20, in its current state, allows life insurers to allocate allowable deductions under Part D to the shareholder base. A direct reference to section EY 19B in section EY 20 is not necessary to facilitate deductions allocated to the shareholder base.

Application date and historical tax positions

The objective of the application date is to confirm, from the 2015 income year, the treatment of such charges. The objective is not to require life insurers to revisit earlier tax positions.

Submissions argue that the proposed application date for the changes to sections EY 2 and EY 3 (which describe for tax purposes what is shareholder base income and deductions and policyholder base income and deductions) should have the same application date proposed for sections EY 16B and EY 19B. Officials agree.

The issue raised by KPMG in its submission raises wider issues about when the Income Tax Act should describe an amount as not income. From a scheme and purpose analysis, this would be unusual and outside the scope of the amendments to the life insurance rules proposed in this bill. These wider matters mean that officials would like to defer consideration of this submission for a later bill, should a legislative solution be necessary.

Recommendation

That the submissions be accepted in part. The following changes are recommended to the proposed treatment of fees for managing policyholder investments:

- That the term “investment management services” be defined by reference to the financial intermediation services contractually provided by the life insurer in administering policyholder funds attributable to non-participation policies.
- That a general rule be provided that prevents double counting in connection with the interactions of sections EY 16 and EY 16B, and EY 19 and EY 19B.
- That the changes to sections EY 2 and EY 3 validate earlier tax positions if a life insurer has applied sections EY 16B and EY 19B in a tax position taken between 1 July 2010 (the start date of the life insurance rules) and before 1 April 2005.

Issue: Discount requirements for future amounts

Clauses 64, 67, 70 and 71

Submission
(AMP, Chartered Accountants Australia and New Zealand, Financial Services Council, EY)

The submitters support the proposed change.

Earlier tax positions that have used discounted future amounts as described in the proposed changes should be validated.

Comment

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 is enacted.

Submitters note that some life insurers have already taken tax positions using a discount method described in the bill as it produced more accurate and appropriate cashflow values.

Recommendation

That the submission be accepted. Tax positions taken in earlier income years as if the changes in clauses 64, 67, 70 and 71 had application should be validated.

Issue: Treatment of excess policyholder allowable deductions

Clause 61

Submission
(AMP, Financial Services Council)

A further change is needed to clarify the treatment of excess policyholder deductions on the transfer of life insurance business between life insurers.

Comment

Submitters have recommended that the Income Tax Act specify the tax treatment of excess policyholder allowable deductions ("excess deductions") that are the subject of a transfer of life insurance business. While this is a new matter, it is closely related to the proposed amendment to section EY 2(5) that establishes that excess deductions that cannot be subtracted from policyholder income for an income year are carried forward as policyholder base allowable deductions for the next year.

As excess deductions are not subject to any continuity requirement when life insurance business is sold to another life insurer, any excess deductions attaching to that business should, in principle, also follow.

The submitters recommend the insertion of a new rule into the Income Tax Act that codifies the treatment when excess deductions are transferred.

To ensure the excess deductions are correctly carried over, officials recommend that the Income Tax Act specify that the transfer does not affect the excess deduction carried forward in the policyholder base. It will be necessary, however, for the life insurers concerned to calculate the closing and opening balance for the excess deduction. It will also be necessary for life insurers to hold records on the composition of the excess deduction (that is, what deductions make up the quantum).

Officials are aware of only one transfer where the question of excess deductions has been identified as a concern. Given the record-keeping requirement and calculation of opening and closing values, officials recommend that the change should not apply retrospectively to 1 July 2010, but instead apply from the 2016–17 income year (starting 1 April 2016) as suggested by submissions.

Recommendation

That the submissions be accepted.

A new set of rules should be inserted in the Income Tax Act that provides that the carry-forward of policyholder base allowable deductions is unaffected by the transfer of life insurance business.

The change should apply from the start of the 2016–17 income year.

Issue: Miscellaneous technical matters

Clauses 61(2), 70(2), (3) and (6), 71(2) and (3)

Submissions
(Matters raised by officials)

A number of changes are recommended to improve readers' understanding of the proposed changes to the taxation rules for life insurance business. These are set out below:

Section EY 2(5): Policyholder excess allowable deductions – ordering rule

Clause 61(2) clarifies when excess policyholder allowable deductions (section EY 2(5)) should be used. To further assist readers, officials recommend an additional rule that specifies that the deductions that make up the quantum of excess deductions should be applied in the order in which they were incurred. The change should also support the operation of the recommendation to clarify the tax consequences when life insurance business is transferred. The change should apply for income years beginning on the day the bill is enacted.

Sections EY 28(5) and EY 29(6): Shareholder base other profit – valuation and attribution of amounts related to life reinsurance

Clauses 70(2) and (3), and 71(2) and (3) amend the measurement of amounts related to life reinsurance premiums and claims. A technical change is recommended that ensures that the amounts relate to the current income year. The change should apply for income years beginning on the day the bill is enacted, to align with the substantive changes.

Section EY 28(6): Shareholder base other profit – description of bonus declarations

Clause 70(6) amends the definition of "policy liability" in section EY 28(6). A change is recommended to rephrase the expression about future bonus declarations by removing the word "anticipated" to instead refer to "future vestings". The change should apply for income years beginning on the day the bill is enacted, to align with the substantive changes.

Section DB 23: Cost of revenue account property

Officials recommend a new clause to ensure that life insurance rules are fully integrated into the rest of the Income Tax Act.

The application of section DB 23 does not currently take into account that subpart EY apportions a life insurer's expenditure between a shareholder base and a policyholder base. As drafted, section DB 23(2) denies a deduction for expenditure incurred in deriving income that is tax-exempt under section CX 55 (proceeds from the sale of investments held by a portfolio investment entity). It is possible that expenditure to which section DB 23(2) applies could be allocated under section EY 20 to the shareholder base.

Officials consider that this expenditure should be deductible when it relates to a life insurer's shareholder base under section EY 19 or deemed income under section EY 19B.

Officials recommend that the application of section DB 23(2) be clarified so that it does not have effect on expenditure allocated to the shareholder base under the life insurance rules. The change should apply from 1 July 2010 or income years that include 1 July 2010, the date the life insurance taxation rules were substantively amended.

Comment

The purpose of the recommended changes is to help life insurers meet their obligations and deal with legislative housekeeping matters. The changes do not affect current policy settings.

Recommendation

That the submissions be accepted.

TAXABLE BONUS ISSUES – COST BASE

Clause 45

Submission

(Chapman Tripp, Chartered Accountants Australia and New Zealand)

All taxpayers that hold shares received from taxable bonus issues should be able to recognise a cost base for those shares.

Comment

The bill proposes to insert a rule that recognises, on disposal of shares received from a taxable bonus issue, a cost for those shares. The change applies to shares received from taxable bonus issues made on and after the date of enactment.

Submissions consider that this application date will continue to maintain double tax on existing taxable bonus issues. Officials acknowledge the concern but do not have a sense of the scale and likelihood of the problem for taxpayers. Officials are also aware that transactions involving the transfer of shares by a company to its shareholders can be structured under existing law in such a way that it eliminates the double tax problem described in submissions.

The application date proposed in the bill recognises that the proposed amendment comes with certain compliance costs associated with holding information about the cost of the shares. It was not considered reasonable to impose those costs on existing share stocks.

Recommendation

That the submission be declined.

Clause 124

Issue: "Savings" provision

Submission
(EY)

The proposed amendment to section IE 3 should not be retrospective but should apply for income years commencing after enactment of the bill. Alternatively, a "savings" provision should be included to protect the position of taxpayers who have taken tax positions, used losses and filed returns based on the legislation as it has stood since enactment of the Income Tax Act 2007.

Comment

The amendment proposed is to correct an unintended change occurring in the rewrite of income tax legislation. The amendment validates tax positions taken on the basis of the policy but officials agree that it is appropriate to include a savings provision to protect tax positions taken on the basis of the wording of the provision before enactment of this amendment.

Recommendation

That the submission be accepted.

LIMITS ON REFUNDS FOR ICA COMPANIES

Clause 257

Issue: Clarification of drafting

Submission
(EY)

Clarification is required to confirm that taxpayers may continue to obtain refunds based on the credit balances shown in:

- annual imputation credit account (ICA) returns to the latest 31 March filed before and separately from, their returns of income for the equivalent income year; and
- part-period returns up to a current date under section 70(3) of the Tax Administration Act 1994.

Comment

Under the general rule applying to ICA companies, if an ICA company is due a refund of income tax at 1 August 2016 and had not filed its annual ICA return for the tax year ending 31 March 2016, it would not be able to receive that refund of income tax.

However, the general rule is relaxed by section RM 13(3) of the Income Tax Act 2007 for companies having extension of time arrangements and who have not filed their annual ICA return by 31 March 2016 to permit the amount of the refund to be compared with the ICA balance at the preceding 31 March (in this example, 31 March 2015).

Officials consider that the first point of the submitters needs no additional clarification as the amendment only applies if the annual ICA return for the latest 31 March has not been filed, irrespective of whether the ICA return is filed with the annual return of income or separately.

Officials agree that is would be useful to clarify the relationship of the amendment with the general rule.

Recommendation

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

THIN CAPITALISATION AND THE POTENTIAL NEW OWNERSHIP STRUCTURE OF KIWIBANK

No clause

Submission
(Kiwibank, New Zealand Post)

Sections FE 2(5) and FE 36B of the Income Tax Act 2007 are intended to ensure the thin-capitalisation regime applies appropriately to the New Zealand Post group. They do this by splitting the group for the purposes of applying the thin capitalisation regime and ensuring that the non-banking part of the group is subject to the thin capitalisation rules for non-banks. In the absence of these sections the thin capitalisation rules for banking groups would have applied to the entire New Zealand Post group.

Section FE 36B(1)(a) requires that “Her Majesty the Queen in right of New Zealand has a voting interest of 100% in the registered bank”. On 6 April 2016 it was announced that New Zealand Post had commenced a sale process that could see New Zealand Post selling a 25 percent share of Kiwibank to the New Zealand Superannuation Fund and 20 percent to ACC.

Assets forming part of the New Zealand Superannuation Fund are owned directly by the Crown. However, ACC is treated as a separate public authority whose shares are held by a notional single person that does not hold anything else. Therefore, even though Kiwibank would remain wholly owned by the Crown or Crown entities, section FE 36B(1)(a) would no longer be satisfied. Accordingly, section FE 36B(1)(a) should be amended to include voting interests in the registered bank held by a public authority.

It is expected that the transaction involving the sale of shares to ACC and the New Zealand Superannuation Fund will be completed prior to enactment of the bill. The suggested amendment should apply from 1 July 2016, being the start of New Zealand Post’s current income year.

Comment

Officials agree with the submitters and support the proposed amendment.

Recommendation

That the submission be accepted.

FBT AND SPECIFIED INSURANCE PREMIUMS

Clauses 25, 31 and 32

Submission
(EY)

Clarification is required on the intended scope of the proposed definition of "specified insurance premium", especially the nature and extent of any employee benefits required to bring a policy within the definition.

Clarification would be desirable for any different treatment between policies taken out by employers and those taken out by trustees of employment-related superannuation schemes.

The scope of the definition should be limited to situations when employees have enforceable direct or contractual rights to benefit under a policy.

Comment

Intended scope

The intended scope of the proposed legislation relates to:

- premiums paid when the benefit of the policy passes to the employee (that is, the employee is entitled to receive claims under the policy); and
- premiums paid for life, accident, and medical insurance, and accident, disease or sickness insurance (whether or not fatal) if the insured person is either the employee or the employee's spouse, civil union partner, de facto partner or their child.

We consider the provision is sufficiently clear about its scope and that the above information would be set out in the *Tax Information Bulletin* following enactment.

Employment-related superannuation schemes

Further legislative clarification is not thought necessary at this stage. Premiums paid by an employer for a group life policy taken out by the trustees of a superannuation scheme for the benefit of employees who are members of that scheme is a fringe benefit. However, if the scheme is a superannuation fund (broadly, a superannuation scheme registered under the Financial Markets Conduct Act 2013) the payment is not subject to FBT but is subject to employer superannuation contribution withholding tax.

Limiting the scope of the definition to situations when enforceable rights exist

Officials consider that limiting the scope of the definition to situations when employees have enforceable direct or contractual rights to benefit under a policy would exclude policy benefits routed to employees through the employer. It is intended that benefits of this nature should be subject to FBT.

Recommendation

That the submissions be declined.

Clause 148

Submission
(EY)

Clause 148(3) proposes amending section MX 7(4) to clarify that all equity disposals and transfers from the year a credit was first taken should be included in calculating R&D repayment tax.

However, as currently drafted, new section MX 7(4) could capture disposals or transfers of shares in a company from the date the company was formed. There is nothing in the rest of section MX 7(4) that would limit the period or scope to the year a credit was first taken, which is the desired policy intent as stated in the *Commentary* to this bill.

The submission suggests various drafting changes to address this potential overreach.

Comment

The amendments in clause 148 concern the R&D repayment tax, which is payable if one of three reinstatement events occur. Two of the amendments add an ordering rule for which reinstatement events apply to a given situation if more than one event occurs to the same company. This is necessary because for one reinstatement event (breach of continuity from the effective sale of the company), the company may not have to repay the entire R&D loss tax credit, whereas for the other reinstatement events (if the company is liquidated or migrates) the entire amount of the R&D loss tax credit is required to be repaid.

The amendments also seek to clarify the meaning of "shares' market value" in section MX 7(4)(b), which is used to calculate the R&D repayment tax amount when a breach of continuity takes place. The amended definition clarifies that "shares' market value" includes all shares disposed of or transferred in the continuity period, not just the disposal or transfer which breached continuity.

Officials agree that the wording in clause 148(3) should be clarified so that the calculation under section MX 7(4)(b) applies to transfers or disposals of shares which occurred from the year a credit was first taken, up to and including the reinstatement year.

Recommendation

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

EXEMPT INCOME FROM PERSONAL SERVICES (92 DAY RULE)

Clause 30

Issue: Proposed amendment should be expanded

Submission
(Corporate Taxpayers Group)

That the proposed amendment may create a barrier for New Zealand businesses employing non-residents on a short-term basis, particularly in relation to Australian and New Zealand businesses engaging in business with each other.

That the 92 day exemption rule should be expanded to 183 days.

That the proposal should apply from the 2018–19 income year.

Comment

Under this provision, New Zealand provides an exemption for income derived from personal services provided in New Zealand by a non-resident if the person is not present in New Zealand for more than 92 days in a tax year.

It is possible that two visits across two consecutive tax years may total 184 days within a 12 month period. However, this is inconsistent with the count tests in our network of double taxation agreements and the domestic test of tax residence. The domestic tax residence test contains a personal presence rule, which focuses on whether a person is present in New Zealand for more than 183 days in a 12 month period.

The original policy intention and legislation for this exemption was crafted in a period when New Zealand did not have a count test (that is, presence in New Zealand for more than 183 days in any 12 month period) for determining residency. At that time, the only test of residence was by reference to whether the person had a permanent dwelling place in New Zealand.

The proposed amendment updates the law and improves the integrity of the tax system by bringing the count test into line with the domestic residency rule and the similar count test in double taxation agreements for individuals.

We do not agree with the submission that unilateral relief provided by the current rule should be expanded to 183 days, as the submission is inconsistent with DTA policy settings.

Officials agree it is appropriate that the rule change apply prospectively from a stated tax year. Officials consider the proposal should apply to visits commencing on or after 1 April 2017. This would allow non-residents to be aware of how the 92 day exemption applies to their circumstances. If the amendment applied from the date of assent, a non-resident individual may need to more fully consider the effect of the proposed change on visits commencing before the bill is enacted. We do not agree the proposal should be deferred until the 2018–19 income year.

Recommendations

That the submission that the period of relief be expanded to 183 days be declined.

That the submission on the application date be, subject to officials' comments, accepted,

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Issue: Proposed amendment should not proceed

Submission
(PwC)

That no change be made to the current drafting of section CW 19 and that the measurement of the 92 day exemption threshold continues to be on a 31 March tax year basis.

Comment

The submission considers that this amendment will give rise to increased compliance requirements for employers and individuals.

Officials consider that as the proposed amendment is prospective, it is unlikely to have significant impact on compliance costs.

Existing guidelines for non-resident employees and employers of non-resident persons are not affected by the proposals. Non-resident individuals coming to New Zealand to perform personal services prior to coming to New Zealand will continue:

- to be aware of the 92 day count test and its proposed amendment;
- to be able to apply for an exemption certificate if they do not wish to have their New Zealand income subject to PAYE; and
- to be aware of the circumstances in which they will be required to file an income tax return.

Recommendation

That the submission be declined.

DRAFTING ISSUE

Submission
(Matter raised by officials)

Section 81(4)(ec) of the Tax Administration Act 1994 should be amended to refer to section 191 of the Health and Safety at Work Act 2015 rather than section 28B of the Health and Safety in Employment Act 1992.

Comment

The Taxation (Transformation: First Phase Simplification and Other Measures) Act 2016 amended section 81 of the Tax Administration Act 1994 to allow Inland Revenue to share information with the Ministry of Business, Innovation and Employment, and with WorkSafe for the enforcement of employment standards.

The amendment referred to section 28B of the Health and Safety in Employment Act 1992. This Act has been repealed. The provision should be amended to refer to section 191 of the Health and Safety at Work Act 2015.

The amendment should apply from 2 June 2016, the date the amendment to section 81(4)(ec) came into force.

Recommendation

That the submission be accepted.

CLAUSE 82 (AMENDED SECTION FE 28) BE OMITTED

Submission
(Matter raised by officials)

Submission

Clause 82 (amended section FE 28) should be omitted as the amendment is no longer necessary as it overlaps with an earlier amendment made in the Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Act 2016.

Recommendation

That the submission be accepted.

AVAILABLE CAPITAL DISTRIBUTION AMOUNT AND CAPITAL LOSSES

Clauses 23(1) and 339

Submission
(EY, Russell McVeagh)

That the proposed changes need revising to deal with situations where the deficit between the cost of the property and its sale price is less than the depreciation deduction losses.

Comment

Officials agree with the submission that the calculation should not result in a capital loss being less than zero.

Recommendation

That the submission be accepted.

Submission
(Corporate Taxpayers Group, Deloitte)

Various submitters raised general observations relating to discrepancies between the proposed legislation and information provided in the *Commentary* to the bill. These principally relate to discrepancies in section references and application dates.

Comment

Although not mandatory to provide, commentaries have been made available when tax bills are introduced and are intended to provide useful background to the proposed legislation.

While every endeavour is made to ensure that commentaries are correct in every way at publication, variances between the *Commentary* and the proposed legislation can, regrettably, sometimes occur.

To help address matters raised by the submitters, additional steps have been added to the quality control processes in place around the compilation of bill commentaries.

Where appropriate, discrepancies between application dates referenced in the *Commentary* and the proposed legislation, as identified by submitters, have been clarified under the relevant items in this officials' report.

There was found to be no discrepancy between the *Commentary* and the proposed legislation in relation to clause 239(3).

Recommendation

That the submissions be noted, and addressed where appropriate.

MISCELLANEOUS DRAFTING AND MINOR TYPOGRAPHICAL MATTERS

Submission
(EY, Russell McVeagh)

The submitters made a number of minor drafting suggestions relating to various provisions.

Comment

The submissions have been noted and changes made where appropriate.

Recommendation

That the submissions be noted.