TAX INFORMATION BULLETIN

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It has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

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THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

Inland Revenue produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents.

Because we are keen to produce items that accurately and fairly reflect taxation legislation, and are useful in practical situations, your input into the process—as perhaps a "user" of that legislation—is highly valued.

The following draft item is available for review/comment this month, having a deadline of 25 March 2004.

Ref.	Draft type	Description
ED0053	Operational statement	Income tax treatment of certain expenditures on conversion of land from one farming or agricultural purpose to another

Please see page 109 for details on how to obtain a copy.

The following draft item is available for review/comment this month, having a deadline of 31 March 2004.

Ref.	Draft type	Description
IS0062	Interpretation statement	Shortfall penalty—evasion

Please see page 109 for details on how to obtain a copy.

BINDING RULINGS

This section of the TIB contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates tax liability based on it.

For full details of how binding rulings work, see our information booklet *Adjudication & Rulings, a guide to Binding Rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin* Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

You can download these publications free from our website at **www.ird.govt.nz**

PRODUCT RULING – BR PRD 03/18

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Waratah Securities Australia Limited (WSAL).

Taxation Laws

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of sections BG 1, NG 1, and the section OB 1 definition of "non-resident withholding income".

The Arrangement to which this Ruling applies

The Arrangement is the raising of funds by WSAL, an Australian resident company, by way of issuing debt instruments in Australia to non-resident investors. Further details of the Arrangement are set out in the following paragraphs.

Background

1. This Ruling relates to a securitisation structure under which Waratah Receivables Corporation NZ Limited ("Waratah") acquires or invests in various categories of loan assets, trade receivables and other receivables ("loan assets") from banks, financial institutions, credit unions, building societies and New Zealand corporates, having received funding from WSAL and other financial institutions to make those acquisitions. The securitisation structure has been established since 1998 and to date Waratah has acquired or invested in loan assets from a number of sellers, amounting to approximately $2.74 billion.

2. WSAL has been established in Australia for some time and has carried on the business in Australia of raising international finance through Australian dollar commercial paper programmes. WSAL has a reputation in the Australian capital markets and has significant brand recognition in terms of its ability to raise funds through its commercial paper programmes.

3. Under the securitisation structure, WSAL carries on business from offices in both Australia and New Zealand (the New Zealand branch is referred to as "WSAL (NZ)"). The registered office of WSAL in Australia is Level 17, Chifley Tower, 2 Chifley Square, Sydney. These are the offices of Allens Arthur Robinson, an Australian law firm. WSAL has no direct employees and has four Australian-based directors.

4. WSAL and Waratah are wholly owned by Waratah Receivables Corporation Pty Limited ("WRC"). WRC is wholly owned by Allens Arthur Robinson Corporate Advisory Pty Limited. The ultimate parent entity of WRC is Allens Arthur Robinson Nominees Pty Limited. This entity was formerly called AA & H Nominees Pty Limited.

WSAL (NZ) activity

5. WSAL (NZ) carries on business in the PricewaterhouseCoopers Tower, 188 Quay Street, Auckland. The business activities of WSAL (NZ) are confined to the raising of funds by way of domestic New Zealand dollar commercial paper programmes (including medium-term notes and other market issues) and the provision of services to Waratah (which are described here). WSAL will raise funds by way of Australian dollar denominated commercial paper programmes. Some of the funds raised by WSAL and all of the funds raised through WSAL (NZ), are on-lent to Waratah to enable Waratah to acquire or invest in loan assets in New Zealand.

6. Approximately NZ$134 million of commercial paper has been issued by WSAL (NZ) in the New Zealand market as at July 2003. Westpac Banking

Corporation ("Westpac") has arranged WSAL (NZ)'s commercial paper programme (which has a maximum size of $NZ500 million), and as at the date of this Ruling the Reserve Bank of New Zealand acts as the registrar and paying agent.

7. As at the date of this ruling there are six tranches worth approximately $22 million each of commercial paper which need to be rolled over and this requires the secondees of WSAL (NZ) ("the Secondees") to carry out detailed tasks every two weeks. The amount on issue as at the date of this ruling is approximately $134 million, although WSAL (NZ) has had up to $150 million on issue previously. At the date of this ruling the commercial paper is issued for a 90-day term. WSAL (NZ) has a number of quite detailed procedures which outline the tasks undertaken by the Secondees in respect of this activity. The applicable procedures at the date of this ruling for commercial paper issued in New Zealand and WSAL (NZ)'s applicable procedures at the date of this ruling for New Zealand Series Australian dollar commercial paper funding were provided to Inland Revenue on 21 July 2003.

8. In brief, a workbook is used to record the dealers' bids for a commercial paper issue. As at the date of this ruling up to five dealers regularly bid for WSAL (NZ) commercial paper. The Secondees then select the most favourable bid(s) for the amount of commercial paper being rolled over in that tranche. The dealers are then notified of the success or otherwise of their bids and then the paying agent is notified of the successful bidder(s). A clearance system called Austraclear (operated by the Reserve Bank) is used to enter the details of the commercial paper issued by WSAL (NZ) and the paying agent consequently credits and debits the relevant accounts of the dealers and WSAL (NZ) as commercial paper is purchased and then later matures. Confirmations of the transactions are sent out by the paying agent to WSAL (NZ). WSAL (NZ) provides confirmation of the transactions to the successful dealers.

9. WSAL (NZ) NZ$ denominated commercial paper is rated by Standard and Poors and Moody's at A1+ and Prime 1 respectively. WSAL (NZ) must maintain liquidity facilities at 104% of outstanding receivables. As at the date of this Ruling the facilities to provide this liquidity are obtained from Westpac.

10. WSAL funds the New Zealand operations of Waratah under its existing foreign dollar denominated commercial paper programme, by advancing the proceeds of certain designated issues under that programme to Waratah. This commercial paper programme is undertaken by WSAL. There is no direct involvement by WSAL (NZ) in raising funds under the international commercial paper programme. The domestic NZ$ commercial paper programmes are undertaken by WSAL (NZ).

11. Where it is most advantageous for international finance to be raised in terms of the overall structure (depending on prevailing market conditions), Waratah contracts with WSAL to provide funding to Waratah. The reason for contracting WSAL is that Westpac's international debt securitisation personnel are located in Sydney. WSAL, through the directors of WSAL (who are Australian resident and who conduct their meetings in Australia), contracts with Westpac to have the services of those Australian personnel provided to it.

12. In respect of the raising of international funding, from time-to-time WSAL may consider it commercially desirable to raise funds in the United States commercial paper market to fund the acquisition of receivables in New Zealand (for example, there may be significant cost savings due to the low interest rates there or there could be a situation where there may be insufficient Australian or New Zealand-based investors to fund a particularly large transaction). The optimal way to raise such funding is by utilising the line of funding available to WRC through its United States commercial paper programme. In such an instance WRC would purchase commercial paper issued by WSAL under its Australian programme, and to obtain the necessary funding to do this, WRC would issue commercial paper under its US programme. This programme was established prior to the establishment of the Waratah securitisation structure and the only party entitled to borrow under it is WRC. The most cost-effective way for the Applicant to access these funds is to have WRC purchase the commercial paper issued by WSAL in Australia, and to fund itself in so doing by issuing commercial paper into the US market.

13. In respect of the raising of international funding, no contact is made by Waratah with WSAL (NZ). All contact has been and will be with WSAL, which provides the funding directly to Waratah. International funding will not be routed through WSAL (NZ) in any respect and has not been to date although, certain administrative matters are undertaken for Waratah by WSAL (NZ) (as noted here).

14. WSAL and WSAL (NZ) charge interest to Waratah at arm's length commercial rates, bearing in mind the size of the portfolio, the strength of the security, and the type of transaction.

Waratah's activity

15. In respect of the raising of domestic New Zealand funding, Waratah will contract with WSAL (NZ) which has the expertise necessary to raise such funding within the New Zealand domestic market.

No expertise or other resources are made available by Westpac to WSAL (NZ) (other than as stated in this ruling) to enable such funding to be raised. However, WSAL (NZ) does talk to dealers generally for advice regarding the commercial paper market and Westpac is one such dealer. On this basis there is a dealer/customer relationship between Westpac and WSAL (NZ).

16. In respect of all funding, Waratah will grant security over the mortgaged assets (ie the loan assets) in favour of a security trustee (Westpac) as trustee for WSAL and the providers of support facilities. WSAL in turn will grant a first charge over its assets in favour of a security trustee (Westpac) as trustee for investors.

17. Waratah has contracted WSAL (NZ) to provide administrative assistance and support facilities in respect of the portfolio of loan assets. The services which are provided by WSAL to Waratah are set out in the New Zealand Servicing Agreement (the “Agreement”), dated 2 March 1998, between Waratah, WSAL and Westpac which was provided to Inland Revenue on 11 June 2003. Under clause 2.1 of the Agreement, Waratah appoints WSAL (NZ) as an exclusive agent of Waratah to supervise and administer, on Waratah’s behalf, and subject to the direction of Waratah, all of the operations in connection with or relating to:

    (i) the acquisition and administration of receivable interests and other investments made by Waratah

    (ii) implementing and administering the loan agreement between Waratah, WSAL and Westpac

    (iii) the implementation and administration of the liquidity facility agreements

    (iv) monitoring compliance with the representations, warranties and undertakings given by Waratah, and

    (v) related operations and activities of Waratah as provided in the Agreement.

18. A list of duties to be performed by WSAL (NZ) is set out in clause 3.1 of the Agreement.

19. Clause 3.11 of the Agreement also requires WSAL (NZ) to provide services to Waratah.

20. Pursuant to the Agreement, WSAL is required to maintain the New Zealand branch until the Agreement is terminated.

21. Compliance work is required to be performed monthly by WSAL (NZ) for each seller of receivables that Waratah invests in. Such compliance work calculates and assesses the performance of each of Waratah’s clients. This compliance work is collated into an investor report that is sent to dealers and purchasers of WSAL (NZ) commercial paper. An example of the investor report was provided to Inland Revenue on 24 July 2003.

22. A diary report was provided to Inland Revenue on 24 July 2003 that shows the upcoming tasks that are required to be performed for Waratah including payment of due tax, writing of investor reports, payment of directors and agency fees, scheduling audits, and organising updates to directors.

WSAL (NZ) secondee activities

23. The provision of staff members by Westpac to WSAL (NZ) is governed by a Secondment Agreement dated 2 March 1998, between Westpac and WSAL, as amended by a Deed of Variation and Restatement executed on 24 July 2003 (the “Secondment Agreement”). Clause 2.1 of the Secondment Agreement states that Westpac agrees to second as many staff members as WSAL may reasonably require from time to time to assist it to perform the Services. However clause 2.1 makes it clear that at all times there will be at least one full-time secondee or, if more than one secondee is seconded, not less than the equivalent (in terms of hours worked) of one full-time secondee. As at the date of this Ruling an associate director, a senior associate, and a relationship officer are seconded to WSAL (NZ).

24. To reflect the practical realities of WSAL (NZ)’s business, which may require less than full-time commitment from an individual secondee in circumstances where more than one secondee is seconded to WSAL (NZ), subject to WSAL (NZ)’s agreement, Westpac may require WSAL (NZ) to release a secondee. WSAL (NZ) must agree before a release of a secondee will happen, and WSAL (NZ) will not do so where it considers that a secondee is necessary for WSAL (NZ)’s business.

25. The Services to be performed by the Secondees are as defined in the Secondment Agreement and will vary depending upon the circumstances at the time. For instance, where established transactions are being maintained and managed, the Secondees will be involved in general administration such as accounting and the preparation of Investor Reports, issuing and rolling over commercial paper, and where necessary drawing down on liquidity facilities provided under the structure. Where transactions are being pitched for, time will be spent on marketing activities, including researching clients, meeting with clients, preparing marketing documents such as proposals for clients. Where there is a new transaction, time will be spent by the Secondees on negotiation and finalisation of documentation, and on closing and funding that new transaction. As stated above, to perform these tasks

at all times WSAL (NZ) will have the services of at least either one full-time secondee, or more than one secondee working in aggregate the equivalent hours of one full-time secondee.

26. An important role undertaken by WSAL (NZ) is the marketing of Waratah's securitisation programme to potential sellers of receivables into the programme. In doing so, WSAL (NZ) effectively acts as a broker for Waratah. In return for these services, WSAL generates increasing servicing fees when new securitisation programmes are entered into by Waratah (which should arise as a consequence of broking services provided by WSAL (NZ)).

27. WSAL (NZ)'s marketing is focused and is developed through the updating and use of a paper known as the "pipeline" which identifies potential future clients. In developing the pipeline the secondees may work with the Westpac relationship manager who is in close contact with potential clients. From time to time WSAL (NZ) may work closely with WSAL in Australia when developing the pipeline because at times there are companies looking to securitise their receivable portfolios in both Australia and New Zealand. The fact that WSAL has a presence in both countries is considered by WSAL to be advantageous to the marketing effort. For example, companies that have both Australian and New Zealand operations may need a trans-Tasman tailored securitisation solution involving facilities in both Australia and New Zealand, with funds being raised in both the Australian and New Zealand markets to fund the potential client's portfolios. In this way the presence of WSAL in both New Zealand and Australia may provide cost-effective synergies for the potential client and therefore a competitive advantage.

28. Once a potential client expresses interest, WSAL (NZ) works to ensure that the client is in a position to comply with and provide sufficient security for the Applicant to invest in their pool of receivables. This requires due diligence and investigation by WSAL (NZ) (on behalf of the Applicant) so that the rating agencies are satisfied with the quality of the receivables and credit enhancement provided under the programme, and so the current WSAL (NZ) commercial paper rating is maintained.

29. The marketing for clients does not cause conflict between the Applicant and Westpac because Westpac does not perform securitisation on the scale of that performed by WSAL (NZ). The products offered by each company are different and marketed to different potential clients. Approaches by a secondee to a client are overtly and unambiguously on behalf of Waratah rather than Westpac once the decision to approach a client on behalf of Waratah has been made. When a secondee performs marketing activities it is clear from the outset whether a client is appropriate for the Waratah structure, in which case the secondee will be acting in his or her capacity as a secondee for WSAL (NZ), or a Westpac transaction, in which case (assuming WSAL (NZ) has consented to that secondee performing work for Westpac) the secondee will be acting in his or her capacity as a Westpac employee.

WSAL (NZ) premises

30. WSAL (NZ) is located in licensed space in Westpac's premises. The licence to use part of Westpac's existing premises as the offices for WSAL (NZ) is provided for in the Technical Services Agreement ("the TSA") between Westpac and WSAL dated 2 March 1998, as amended by deed of variation and restatement executed on 24 July 2003. Clause 2 of the TSA provides that Westpac grants and WSAL accepts, a licence to:

(i) Occupy the Office

(ii) Use the common areas

(iii) Use the Equipment, and

(iv) Display the name plate on the directory in the main entrance to the building and directories on the Premises where the Licensor and the Licensee mutually agree (refer to clause 8).

31. The office being occupied is a part of Westpac's premises (PricewaterhouseCoopers Building, 188 Quay Street, Auckland) containing approximately 10m^2 together with the right to use meeting rooms when available (clause 1.1). Clause 1.1 of the TSA further defines "the Office" as that area outlined in red on the attached plan marked "A", or any substitute area as agreed by the parties pursuant to the TSA. The space licensed is a cubicle and only WSAL (NZ) secondees will be situated in the designated 10m^2 area. The portion of the premises that is exclusively used for WSAL (NZ) work comprises an area of approximately 5m^2 and nobody else will be stationed in this area. The remaining 5m^2 will be used by WSAL (NZ) to the extent the secondee sitting in that area does WSAL (NZ) work. In addition some work for the benefit of WSAL (NZ) is performed directly adjacent to the WSAL (NZ) premises, being the area where one of the Secondees works. The TSA allows for changes to the area licensed. Meeting rooms are provided to be used for all the Secondees' confidential meetings and conversations with clients or WSAL's directors. All confidential papers are kept in a locked drawer or filing cabinets used exclusively by WSAL (NZ) when not under the supervision of the Secondees.

32. The WSAL (NZ) cubicle has a small card on the front of it saying Waratah Securities Australia Limited NZ Branch and includes two workspaces and filing cabinets. Inland Revenue holds

photographs of the WSAL (NZ) premises (taken on 24 July 2003). The 5m^2 exclusive area has a dedicated phone and phone list of dealers and clients. Inside the filing cabinet are records of all previous transactions and client information. Only the Secondees hold keys to access the filing cabinet and various drawers (these items are kept locked). The WSAL (NZ) computer records and programmes run through the overall Westpac system but only the Secondees have access to those files that relate to WSAL (NZ) business. Although only the Secondees can enter that part of the system, additional passwords are required to open up the spreadsheets used for WSAL (NZ) work. Once a secondee returns to full-time work at Westpac, access to these computer programmes and files is revoked. The WSAL (NZ) area may be relocated to another part of the Premises, or expanded, by agreement pursuant to the TSA.

33. Pursuant to clause 4 of the TSA, the licence is for an initial term of twelve months that will run on until determined by either WSAL, by the act of giving one month's written notice to Westpac, or by Westpac giving written notice to WSAL at any time after the expiration of the twelve-month term. It is intended by WSAL that the current business of WSAL (NZ) will be carried on indefinitely (there being no fixed timeframe within which WSAL will carry on business in New Zealand). It is not presently envisaged by either Westpac or WSAL that the licence will be terminated. The licence fee payable by WSAL to Westpac is $40,000 per annum.

34. WSAL also has the right under the TSA to use the secretarial services of one secretary from Westpac from time-to-time (clause 3.1) and certain office equipment as specified in the Schedule to the TSA. The cost of the office equipment and secretarial services is incorporated into the licence fee.

35. WSAL (NZ) has its nameplate in the foyer of the PricewaterhouseCoopers Building. WSAL (NZ) also has a direct phone line and has its own address (Level 15, 188 Quay Street, Auckland) printed on all its stationery (Level 15 is the reception area for WSAL (NZ)).

36. WSAL (NZ) has separate financial accounts from WSAL. A copy of the WSAL (NZ) accounts to 30 June 2002 was provided to Inland Revenue on 21 July 2003. WSAL (NZ) profits are derived from the provision of services and funding to Waratah.

Relationship between WSAL, Waratah, and Westpac

37. A number of agreements have been provided to Inland Revenue, and were either entered into to establish the structure, or are transaction documents that may be entered into on an individual transaction basis. These agreements, which are identified in BR Prv 03/68, form part of this Arrangement.

38. In relation to this securitisation structure, there is no association, relationship or understanding between WSAL, Waratah or any of their associates or trusts, and Westpac, and any of its associates or trusts, other than those listed in the preceding paragraph or mentioned in this Ruling. Also, it is accepted for the purposes of this Ruling that a Westpac officer may act as director of the Applicant. Westpac and WSAL deal with each other in transactions such as purchasing commercial paper, the supply of liquidity, and the securitisation of client assets (as described in the Arrangement above) on an arm's length basis.

39. The only fees Westpac or any of its associates or trusts receives in relation to this securitisation structure are:

    (i) a fee under the TSA

    (ii) a secondment fee for providing the services of the Secondees pursuant to the Secondment Agreement

    (iii) a fee for providing Australian administrative services to WSAL

    (iv) a commitment fee under the Enhancement Agreement

    (v) the fees payable under the Dealer Agreement, and

    (vi) arrangement fees, liquidity fees, liquidity margins, fees payable as a result of sellers of receivables entering or exiting the securitisation structure, and fees payable as a result of amendments to or variations of the securitisation structure.

40. No Westpac company has any interest, direct or indirect, beneficial or otherwise, in the share capital of Waratah or WSAL.

Structure of the Arrangement

41. WSAL was established in Australia and has carried on the business in Australia of raising international finance through Australian dollar commercial paper programmes. WSAL has a reputation and significant brand recognition as a funding entity for securitisation transactions. WSAL also has significant expertise in the market and access to funding arrangements in Australia that materially assist the Waratah structure in New Zealand. When the securitisation structure was established WSAL was considered the appropriate entity to attract funding from the New Zealand market. WSAL also had the advantage of having the proven ability to access existing offshore funding, and it was considered that the offshore market would raise significantly greater funding than the New Zealand market, because of the size of the New Zealand market. WSAL was an integral part of the establishment of the structure for those reasons.

42. At the time the Waratah structure was established, WSAL's brand recognition was such that it was considered useful for it to market the structure to potential sellers in the New Zealand market. As a consequence of that, and to access potential funding from the New Zealand market (including establishing strong relationships with dealers), WSAL established a New Zealand presence in the form of the Branch. In WSAL (NZ)'s opinion, the greater presence in New Zealand compared to competitor structures has provided a competitive advantage.

43. A branch rather than a subsidiary was chosen for WSAL (NZ) because of a desire for WSAL (NZ) to be directly managed by the established and experienced Australian office of WSAL rather than acting as an independent operation. This has allowed WSAL (NZ) to access the procedures, funding relationships and expertise of WSAL directly rather than indirectly. This structure is also recognised to provide favourable tax effects for WSAL as the funding entity.

44. Waratah was created as a subsidiary company rather than a branch to segregate its assets from the funding entity of WSAL particularly as WSAL had established business outside New Zealand. The segregation makes it easier for the rating agencies to evaluate the liabilities and risks associated with WSAL. Otherwise the rating of WSAL could be affected whenever a new client was taken on by Waratah. A company structure was chosen because of the beneficial features of a company such as limited liability and ease of commercial management. The nature of the structure established mirrors the proven Australian structure. The separation is traditional and copies that used in Australia as the structure was introduced to New Zealand in 1998 by an Australian employee of WSAL who was familiar with the structure used. At the time the New Zealand structure was established the proven expertise of WSAL was sought. At the time of setting up the WSAL branch, Waratah itself was a new company and did not have the expertise or brand recognition of WSAL. However, WSAL was a funding entity, not a securitisation entity, so Waratah was established to hold the assets. The consistency between the New Zealand and Australian structures is also beneficial for trans-Tasman companies who securitise assets on both sides of the Tasman. The fact that WSAL, is a branch structure can allow trans-Tasman companies to save costs as the information gained in one branch of the company can be used in its counterpart branch and this can save time and ultimately cost for the client.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) WSAL has an intention to make a profit from the activities of its New Zealand branch, WSAL (NZ).

b) WSAL reasonably considers that the presence of a New Zealand branch of WSAL is necessary in commercial terms and to ensure the success of its securitisation programme by having WSAL personnel present in New Zealand to actively market to potential sellers of receivables and to develop commercial relationships with potential clients.

c) In relation to the marketing of NZ$ commercial paper in New Zealand, WSAL reasonably considers that it is imperative for the success of the programme that strong networks are established between WSAL personnel and the treasury dealers in the various trading banks and the New Zealand investor base, and that these strong relationships can only be built through ongoing day-to-day contact through WSAL personnel located in New Zealand.

d) There will be no association, relationship or understanding between WSAL, Waratah or any of their associates or trusts, and Westpac and any of its associates or trusts, other than:

   (i) the arrangements listed in paragraph 37 which have been entered into on a stand-alone, arm's length basis

   (ii) such minor and ordinary arrangements or understandings as may be required for the day to day operation of the business activities contemplated by the securitisation structure as described in this Ruling

   (iii) swap agreements and other foreign currency hedge arrangements entered into between Westpac and WSAL, on stand-alone arm's length terms, and agreements with new sellers of loan assets into the securitisation structure, and

   (iv) contracts and understandings entered into on a stand-alone, arm's length basis which relate to the Australian securitisation structure undertaken by WSAL.

e) The only fees Westpac or any of its associates or trusts may potentially receive in relation to this securitisation structure, other than those listed in paragraph 39, are normal arrangement fees and fees payable as a result of new sellers of receivables entering the securitisation structure.

f) In respect of the issue of securities by WSAL to off-shore investors, no funds raised by WSAL will be applied towards the activities of WSAL (NZ).

g) Any arrangement entered into under this Ruling will not be materially different from the Arrangement as described in the binding private ruling in relation to the Waratah Securitisation Structure (BR Prv 03/68).

How the Taxation Laws apply to the Arrangement

Subject in all respects to any assumption or condition stated above, the Taxation Laws apply to the Arrangement as follows:

- Where an investor who lends funds to WSAL:

  (i) is a non-resident of New Zealand for tax purposes, and

  (ii) does not make loans in the course of any business carried on in New Zealand by that investor, and

  (iii) does not enter into contracts with WSAL or perform (wholly or partly) contracts in New Zealand

  then, pursuant to section NG 1(2), the interest paid by WSAL to that investor will not comprise "non-resident withholding income" (as defined in section OB 1) and accordingly that interest will not be subject to non-resident withholding tax.

- Section BG 1 does not apply to negate or vary the conclusion above.

The period or income year for which this Ruling applies

This Ruling will apply for the period 1 July 2003 to 30 June 2008.

This Ruling is signed by me on the 31st day of October 2003.

Martin Smith
General Manager (Adjudication & Rulings)

PRODUCT RULING – BR PRD 03/19

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by The New Zealand Mäori Arts and Crafts Institute (the "Institute")

Taxation Law

All legislative references are to the Income Tax Act unless otherwise stated.

This Ruling applies in respect of section CB 9(d)

The Arrangement to which this Ruling applies

The Arrangement is the payment of a scholarship by the Institute to students enrolled in the "Te Wananga Whakairo Rakau O Aotearoa" or a Diploma in Traditional Whakairo course. Further details of the Arrangement are set out in the paragraphs below.

1. The Institute was established by the New Zealand Māori Arts and Crafts Institute Act 1963. Under that Act, the purpose of the Institute is to operate as a showcase for Māoritanga with an emphasis on displaying aspects of Māori culture to tourists. It is also charged under the Act with furthering the development of carving in a traditional manner.

2. The Institute has awarded two types of certificate since 1967:

   - The New Zealand Māori Arts and Crafts Institute Diploma, and

   - The New Zealand Māori Arts and Crafts Institute Certificate.

3. In 1994 a "needs analysis" of the Institute was undertaken. It was decided to focus activities on training and educating Māori. Accordingly since 1996 the Institute has offered a three year Diploma course in Māori carving (called "Te Wananga Whakairo Rakau O Aotearoa" or a Diploma in Traditional Whakairo). The content of the Diploma has been modularised and Certificates are awarded for the successful completion of each of the 14 modules. The 14 modules are:

   Module 1 = Introduction to Māori art
   Module 2 = Tool technology
   Module 3 = Tool care and maintenance
   Module 4 = Manufacture Patuki

Module 5 = Manufacture Tekoteko

Module 6 = Introduction to Māori design

Module 7 = Tribal styles

Module 8 = Nga patu o te Riri (combat clubs)

Module 9 = Nga Rakau o te Riri (combat staffs)

Module 10 = Nga waka mauri

Module 11 = Taonga Whakatautau

Module 12 = Taonga Puoro (musical instruments)

Module 13 = Hanga Whare

Module 14 = Hanga waka

4. The Institute has trained student carvers since 1967. Initially, between four to eight carvers were taken on but since 1983 the intake has been limited to three students per year.

The Scholarship Agreement ("the Agreement") and Scholarship Policy ("the Policy")

5. The Institute offers a limited number of scholarships to assist students ("Tauira") while they are undertaking their studies. The Scholarship Agreement entered into between the Institute and its Tauira has the following features:

- Each scholarship has a three-year term and is for the amount of $17,500 per annum paid in weekly sums. The amount of the annual scholarship payments may be adjusted from time to time to reflect changes in the Consumer Price Index.
- The Agreement sets out the hours of class attendance required by the Tauira. Terms and study periods are also specified.
- The Agreement states that the Institute will provide a uniform and tools for the Tauira.
- Any carvings or other items produced by the Tauira in the course of their studies are the property of the Institute.

6. The scholarship payments aim to help cover the Tauira's living costs. Tauira have generally moved from their own tribal area, are young and have very few assets. All costs of training, protective clothing, tools, equipment and raw materials are covered by the Institute.

7. The Institute also has a scholarship policy which is set out below:

SCHOLARSHIP POLICIES

1. The Mäori Arts and Crafts Institute now offers Student scholarships to successful applicants to Te Wananga Whakairo.
2. Three Scholarships will be offered annually to successful applicants to Te Wananga Whakairo beginning the 2001 calendar year, and the number of students whakairo will be determined or negotiated between Institute and Te Wananga.
3. Scholarships will be awarded to a successful applicant for three one year terms of studies upon recommendation of the interview panel.
4. A review of the three one year terms will be undertaken encompassing the students achievements and compliance with Te Wananga and New Zealand Māori Arts & Crafts Institute Policies.
5. The Scholarship Awarded for all Students is ($17,500.00) for three years.
6. Award payments will be made weekly in an effort to assist students budget adequately for the year.
7. Award payments will be direct credited to Student bank accounts and record of payments identified through student bank statements.
8. Te Wananga reserves the right to terminate student's scholarship with one week's notice of such termination, for serious breaches of Wananga/ Institute policies and dismissal through misconduct.

   8a. Students will, for the first three months of their first year with Te Wananga, move through a probation period. During this time Te Wananga staff and Student will determine suitability/ability to cope with the course challenges.

   8b. Termination of a Student's Scholarship may also be the result of the Student's inability to fully complete Module assignments or practice tasks described within the Wananga's curriculum to prescribed standards and within given time-frames.

   8c. Students who wish to terminate their scholarships may do so either during the probation period or by giving one week's notice of such termination in writing.

8. Last year, the total received for all collectable carvings sold was $47,000. This included carvings produced by tutors and master carvers. As an estimate, approximately half of that figure can be attributed to carvings crafted by Tauira. A number of carvings are gifted, loaned or used as display pieces. The Tauira follow a set programme which means duplication of less popular items such as tekoteko—therefore they are very slow moving. The types of carvings produced are a direct result of the programme and do not take into account market demand. In addition, part of the programme is also dedicated to restoration work at marae around the country.

How the Taxation Law applies to the Arrangement

Subject in all respects to any assumption or condition stated above, the Taxation Law applies to the Arrangement as follows:

- Allowances paid by the Institute to a student pursuant to the Arrangement will be exempt income to the student under section CB 9(d).

The period or income year for which this Ruling applies

This Ruling will apply for the period from 6 November 2003 to 5 November 2008.

This Ruling is signed by me on the 6th day of November 2003.

Martin Smith
General Manager (Adjudication & Rulings)

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation, accrual and depreciation determinations, livestock values and changes in FBT and GST interest rates.

LIVESTOCK VALUES – 2004 NATIONAL STANDARD COSTS FOR SPECIFIED LIVESTOCK

The Commissioner of Inland Revenue has released a determination, reproduced below, setting the national standard costs for specified livestock for the 2003–2004 income year.

These costs are used by livestock owners as part of the calculation of the value of livestock on hand at the end of the income year, where they have adopted the national standard costs (NSC) scheme to value any class of livestock.

Farmers using the scheme apply the one-year NSC to stock bred on the farm each year, and add the rising two-year NSC to the value of the opening young stock available to come through into the mature inventory group at year-end. Livestock purchases are also factored into the valuation of the immature and mature groupings at year-end, so as to arrive at a valuation reflecting the enterprise's own balance of farm bred and externally purchased animals.

NSCs are developed from the national average costs of production for each type of livestock farming based on independent survey data. Only direct costs of breeding rearing rising one- and two-year livestock are taken into account. These exclude all costs of owning (leasing) and operating the farm business, overheads costs of operating non-livestock enterprises (such as cropping) and costs associated with producing and harvesting dual products (wool, fibre, milk and velvet).

For bobby calves, information from spring 2003 is used while other dairy NSCs are based on survey data for the year ended 30 June 2003. For sheep, beef cattle, deer and goats, NSCs are based on survey data for the year ended 30 June 2002 which is the most recent available for those livestock types at the time the NSCs are calculated.

The NSCs calculated for the year ended 31 March 2004 have increased for most livestock classes, with the main exception to this being the NSC for rising two-year dairy cattle which fell due to an increase in the number of livestock of this class which spread the cost over the greater number of animals, thereby reducing the cost per animal. The NSC for purchased bobby calves fell by 10.6% due to the reduction in the cost of milk-based feed in spring 2003. The NSC for pigs also fell slightly.

Total expenditure on most farm types increased in the survey year on which the NSCs are based. The increase in costs is mainly a result of improved incomes permitting additional expenditure on animal health, feed, fertiliser, and maintenance. While much of this expenditure increase is aimed at producing more of the dual products (particularly milk), and is consequently excluded from the NSCs calculated, some of the increase in costs flow to the higher average cost of producing livestock.

The new NSCs struck each year only apply to that year's immature and maturing livestock. Mature livestock valued under this scheme effectively retain their historic NSCs until they are sold or otherwise disposed of, albeit through a FIFO or inventory averaging system as opposed to individual livestock tracing. It should be noted that the NSCs reflect the average costs of breeding and raising immature livestock and will not necessarily bear any relationship to the market values (at balance date) of these livestock classes. In particular, some livestock types, such as dairy cattle, may not obtain a market value in excess of the NSC until they reach the mature age grouping.

One-off movements in expenditure items are effectively smoothed within the mature inventory grouping, by the averaging of that year's intake value with the carried forward values of the surviving livestock in that grouping. For the farm-bred component of the immature inventory group, the NSC values will appropriately reflect changes in the costs of those livestock in that particular year.

The NSC scheme is only one option under the current livestock valuation regime. The other options are market value, the herd scheme and the self assessed cost (SAC) option. SAC is calculated on the same basis as the NSC but uses a farmer's own costs rather than the national average costs. There are restrictions in changing from one scheme to another and before considering such a change livestock owners may wish to discuss the issue with their accountant or other adviser.

National Standard Costs for Specified Livestock Determination 2004

This determination may be cited as "The National Standard Costs for Specified Livestock Determination, 2004".

This determination is made in terms of section EL 3A of the Income Tax Act 1994. It shall apply to any specified livestock on hand at the end of the 2003–2004 income year where the taxpayer has elected to value that livestock under the national standard cost scheme for that income year.

For the purposes of section EL 3A of the Income Tax Act 1994 the national standard costs for specified livestock, for the 2003–2004 income year, are as set out in the following table.

Kind of livestock	**Category of livestock**	**National standard cost** $
Sheep	Rising 1 year	23.00
	Rising 2 year	14.90
Dairy cattle	Purchased bobby calves	128.00
	Rising 1 year	694.00
	Rising 2 year	86.00
Beef cattle	Rising 1 year	216.00
	Rising 2 year	125.00
	Rising 3 year male non-breeding cattle (all breeds)	125.00
Deer	Rising 1 year	75.40
	Rising 2 year	38.00
Goats (meat and fibre)	Rising 1 year	17.40
	Rising 2 year	11.90
Goats (dairy)	Rising 1 year	100.00
	Rising 2 year	16.40
Pigs	Weaners to 10 weeks of age	81.40
	Growing pigs 10 to 17 weeks of age	63.80

This determination is signed by me on the 22nd day of January 2004.

Martin Smith
General Manager (Adjudication & Rulings)

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, the Court of Appeal and the Privy Council.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision. Where possible, we have indicated if an appeal will be forthcoming.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

PROCEEDS OF CRIME AND ITS INCOME TAX AND GST IMPLICATIONS

Case:	Case W27, TRA decision 053/02
Decision date:	18 September 2003, 22 January 2004
Act:	Income Tax Act 1994, Goods and Services Tax Act 1985, Tax Administration Act 1994, New Zealand Bill of Rights Act 1990.
Keywords:	Asset accretion method of assessment, proceeds of crime, onus of proof, natural justice.

Summary

The taxpayer is involved in both legitimate and illegitimate businesses. He objected to the charging of income tax and GST on the profits of his illegitimate businesses as well as to various items added back to his asset accretion assessments for various years and claimed that the Commissioner had breached the New Zealand bill of Rights Act 1990. The TRA found for the Commissioner on all points but quashed various GST assessments as being time-barred. This was the subject of a recall application due to an error of fact that would result in a material injustice to the Commissioner in which the TRA held that the alleged error can readily be cured on appeal and that is the proper course to take.

Facts

The taxpayer has for some time mixed legal and illegal business activities and has been allowed since 1978 to file his income tax returns on an asset accretion basis on the condition that the taxpayer maintain full and accurate records in the areas of his legitimate business activities, living expenses and any capital expenses such as legacies. The taxpayer was advised that his GST returns should reflect all sources of income. On 20 July 1993 an investigator visited the taxpayer at his home. As a result of this and a further meeting on 23 July 1993 the Commissioner ("CIR") issued reassessments for the years 31 March 1983 to 31 March 1993 for income tax and amended GST returns for the periods ended November 1990 to May 1993 inclusive. These reassessments were contained in a letter dated 20 November 1996. The taxpayer objected to the reassessments by way of a brief letter merely stating that he objected but that he was in prison and could not do anything about it until he was released. The CIR did not consider this to be a valid objection.

On 24 December 1996 the taxpayer alleged that he sent another letter to the CIR, that the CIR had not received. The CIR asked for a copy of this letter but no copy had been kept. The CIR, therefore, considered the taxpayer to be out of time and on 6 June 1997 the CIR issued civil proceedings against the taxpayer claiming unpaid income tax and GST. The CIR eventually abandoned the claim and allowed the taxpayer to submit a late objection.

By letter dated 17 May 2001 the taxpayer objected to the CIR's reassessments for income tax for the years 1983 to 1993 and on 20 May 2001 he objected to the GST reassessments for the periods November 1990 to May 1993. The Commissioner accepted these late objections by way of letter dated 5 September 2001. Further income tax and GST reassessments were then issued. The CIR allowed the objection in part, accepting that the income years ending 31 March 1981 to 31 March 1990 are time barred and allowed a 25% deduction from assessable income to take account of the proceeds from the taxpayer's criminal activities.

Decision

The illegality point vis-a-vis the income tax assessment

The onus of proof was on the taxpayer to prove what if any of the money upon which the CIR had charged income tax had been derived from criminal activities. If the taxpayer wanted to take advantage of the window opened in *A Taxpayer* then he had to furnish the necessary proof of the origin of his income as the taxpayer did in that case. He failed to do so.

Income tax assessment

The onus was on the objector to satisfy the TRA that the relatively small difference between the taxable income returned and the reassessed income was wrong and by how much. He failed to do this and, therefore, the reassessments were confirmed and the 25% allowed for illegal income stands.

GST assessments

Period ending 31 May 1991 to 31 May 1992

The TRA made no order in respect of this period as the CIR accepted that the reassessments were time-barred and that the self-assessments must stand.

Period ending 30 November 1992 to 31 May 1993

The TRA affirmed these assessments as it was satisfied that the taxpayer had not discharged the onus of proving on the balance of probabilities that the amended reassessment was wrong and by how much.

Period ending 30 November 1993 to 31 May 1995

Although as the taxpayer failed to produce any tax invoices to support his claim for input tax credits and, therefore, did not discharge the onus of proving that the assessment was wrong, the TRA quashed the GST assessments for this period as being time-barred. The Authority did hold, however, that the assessments were arithmetically correct.

The objection point

The TRA came to the conclusion that there never was a timeous reassessment of the GST periods 30 November to 31 May 1995 to which the taxpayer was able to object as the first time the CIR notified the taxpayer that he had made a reassessment was on 25 February 2002. Therefore, the reassessment is time-barred.

The illegality point vis-a-vis the GST assessment

The taxpayer contended that he should not have to pay GST on proceeds he derived from his criminal activities. The TRA held that the taxpayer had failed to discharge the onus of proving either that the receipts that were sought by the CIR were derived from the proceeds of crime other than bookmaking or the existence of any tax invoices necessary to claim any input deductions for the relevant periods. The TRA, therefore, affirmed the CIR's GST reassessments that were validly before the Authority.

The TRA added in obiter dictum, however, that, on the face of it, the reasoning of Richardson P in the Court of Appeal case *A Taxpayer* in regard to the public policy surrounding income tax being charged on stolen money was equally applicable to GST. The proceeds of robbery do not belong to the criminal. He or she has no right, title or interest which could defeat the true owner, and as a matter of public policy there is no justification for reducing or defeating the victim's call on the funds available by an intermediate tax claim. There was also the question of the morality of the state participating in the proceeds of crime.

The New Zealand Bill of Rights point

The TRA held that even if the Act applied and provided for relief which was relevant to the proceeding, the taxpayer had not proved that the CIR had breached s27(1) of the Act.

Recall Application

Due to the confusion as to the quashing of the GST assessments for the period 30 November 1993 to 31 May 1995 as being time-barred the CIR applied for a recall of the TRA decision due to an error of fact that would result in a material injustice to the CIR. There is evidence that the reassessments for these GST periods were made on 2 October 1995 and are, therefore, not time barred. However, the TRA held that the alleged error can readily be cured on appeal and that that is the proper course to take.

WARRANTY REPAIR PAYMENTS BY A FOREIGN MANUFACTURER AND THE GST CONSEQUENCES

Case: Motorcorp Holdings Ltd and Ors v CIR

Decision date: 11 December 2003

Act: Goods and Services Tax Act

Keywords: Insurance, warranty payments

Summary

Warranty payments were made by a foreign manufacturer to a New Zealand distributor. The payments were made whenever the distributor, mostly through dealers, repaired motor vehicles under warranty that the distributor had previously sold to consumers. These repairs and payments were made in terms of warranties given by the manufacturer to the distributor and by the distributor, and sometimes by the dealers, to the consumers. The Court held that such payments were made pursuant to a contract of insurance as that term is understood and applied for the purposes of the Goods and Services Act, such that the payments were outside the Act.

Facts

The facts are similar to those contained in *Suzuki NZ Limited v CIR* (2001) 20 NZTC 17,096.

All nine Plaintiffs were importers and distributors of motor vehicles in New Zealand. In each case the relevant entities/persons were the manufacturer who was not resident in New Zealand, the New Zealand importer/distributor ("*the Plaintiffs*"), the dealers and the end purchasers.

Cars were sold by the Manufacturers to the respective Plaintiffs with Manufacturers' warranties. The Manufacturers either required the Plaintiffs to provide a further warranty to the ultimate purchaser or provided the warranty directly. In either case the Plaintiffs were required to meet the Manufacturers' obligations in New Zealand under the warranties. The Plaintiffs often also provided warranties to the customers that were more extensive than the warranties provided by the Manufacturers. For repairs made under a Manufacturer's warranty a Plaintiff would receive a payment from the Manufacturer.

If a car developed a fault that was within the warranty provided to the customer, a Dealer would make the necessary repairs at no charge to the customer. The Dealer then made a claim on the relevant Plaintiff for the labour, parts and any outwork used to effect the repairs. The Plaintiff would then reimburse the Dealer for the labour, parts and outwork. The Dealer would charge output tax and the Plaintiff would claim an input tax credit in respect of the transaction.

The Plaintiff would then claim under the warranty it had with the Manufacturer. If the Manufacturer accepted the claim it would reimburse or issue a credit to the Plaintiff. It is these payments and the supplies to which they relate that is the focus of the dispute.

It was common cause between the parties that the contractual arrangements in the current matter are similar to those contained in *Suzuki*. It was also common cause that the issue in respect of insurance (see below under 'issues') was not argued in *Suzuki*. The Plaintiffs therefore argued that the issue was never considered by the Court of Appeal while the Commissioner submitted that *Suzuki* was equally applicable to the contractual arrangements in this matter.

Decision – Issue 1

The parties had agreed prior to the trial that there were three issues to be resolved. The first issue was, where a manufacturer makes a payment to a distributor by way of reimbursement of a claim for the costs of parts and labour, is the payment made pursuant to a contract of insurance as that term is understood and applied for the purposes of the GST Act, such that the payment is outside the GST Act? It was common cause that if the payment was pursuant to a contract of insurance the supply would be deemed to be supplied outside New Zealand in terms of section 8(2) (and therefore not taxable). The proviso to section 5(13) would also prevent section 5(13) from applying.

"*Insurance*" is defined in section 2 of the GST Act. Venning J made the obiter statement that the definition is a broad concept which extends the concept of insurance. The definition extents the concept "*in terms of its creation (by contract or statute) by its nature (guarantee) and by the cover (loss, …risk of any kind whatever).*" Notwithstanding the wider definition within the Act, Venning J held that warranty payments were made pursuant to a contract of insurance (in terms of its common law elements).

Venning J relied on the elements of a contract of insurance identified in *Prudential Insurance Company v Inland Revenue Commissioner* [1904] 2 KB 652. These elements being:

1. There must be consideration, usually but not necessarily in the form of premiums.
2. The contract must secure some benefit upon the happening of some event.
3. The event should be one which involves some element of uncertainty either as to if it will happen (for example, an accident) or when it will happen (for example, death).
4. The uncertain event must be an event which is prima facie adverse to the interests of the insured.

Venning J held that there was consideration in return for the benefit on the happening of an event. While there was no "*premium*" this was not relevant as the consideration did not need to be in the form of a premium. Part of the price paid for the motor vehicle when it was imported was in respect of the warranty. This conclusion was reached notwithstanding that while the warranty payment was separately identified from the remaining purchase price of the car prior to late 1999, it was no longer separately identified thereafter. Venning J makes the point that under the various distributor agreements and arrangements the Plaintiff received not only the car, but also other rights and obligations. The rights included the right to be reimbursed (for which there was consideration in terms of the reciprocal obligations and the payment).

The Plaintiffs secured for themselves a benefit upon the happening of an event. The event was a fault developing in a car. The benefit to the Plaintiffs was the reimbursement payment made by the Manufacturer. (The Commissioner's construction was that the benefit—being the payment—was consideration for the repair and the event was therefore the repair and not the fault. This interpretation of the contract would then have a follow-on effect in terms of the remaining findings.)

Venning J stated that there was an uncertain event, namely a fault developing in the car. The fault was also prima facie "*adverse to the plaintiffs in that they have obligations to meet the manufacturer's warranty obligations in New Zealand during the warranty period.*"

Consequently it was held that the reimbursement payments were made pursuant to a contract of insurance. Furthermore, as the supplier of the contract of insurance is undertaken in each case by the overseas manufacturer, the supply does not fall within section 8(1) as the supply occurs outside New Zealand (read with the deeming provisions in section 8(2)).

Decision – Issue 2

The second issue was an alternative to the first issue. If the payments are not made pursuant to an insurance contract, do the reimbursement payments made by the manufacturers on warranty claims constitute a composite inbound supply of parts and labour which would be GST exempt?

Notwithstanding that the Court did not need to consider the second issue, it did so. The Taxpayers argument was that the supply of repairs was in fact a composite supply of parts in which the labour component was only ancillary. The reimbursement payment was merely a refund of the consideration initially paid on the purchase of the parts from the overseas manufacturer. As the sale of parts is outside the GST Act (deeming provisions of section 8(2)), the reimbursement payment is also outside the scope.

Venning J agreed that it was a composite supply but stated:

> "*In the event that the transaction is not able to be analysed as a claim under an insurance contract …I would accept the Commissioner's submissions based on the Suzuki case that the relevant supply is more in the nature of a reimbursement for repair services provided by the plaintiffs through their dealers for the overseas manufacturers to meet the manufacturer's obligations in New Zealand.*"

Decision – Issue 3

Issue 3 was an alternative to issues 1 and 2. The issue was whether the supply could be broken into component parts so that GST is payable only on that portion which relates to the supply of labour (as distinct from parts).

Issue 3 was based on the premise that the supply was not a composite supply but rather multiple supplies. As Venning J had held under issue 2 that it was a composite supply he did not consider the matter further.

FINAL DECISION – REASSESSMENT OF TIME-BARRED YEAR

Case: 049/02

Decision date: 28 November 2003

Act: Income Tax Act 1976

Keywords: Wilfully misleading, reassessment, reopening of time-barred years

Summary

Despite an interim finding that the taxpayer's return was wilfully misleading, the Authority held that there were no grounds available to it to reassess the taxpayer in the year under dispute. The interim decision was noted in Vol 15, No 10 (October 2003) of this bulletin.

Facts

In August 1987 the taxpayer entered into an agreement with a third party for the sale and purchase of certain horses. Clause 1.1 of the agreement provided for a purchase price of $3,435,000. This was to be paid as follows:

i. The sum of $601,000 in cash on or before 31 August 1987;

ii. The balance of $2,834,000 in cash on or before 31 August 1990;

$631,000 was paid on 31 August 1987 ($30,000 service fees were included in the payment). Possession of the horses was given and taken on the same day.

Clause 2.1 of the agreement provided

> "The purchase price payable in pursuance of Clause 1.1 hereof shall be adjusted in the manner set forth in the First Schedule hereto."

In terms of the First Schedule, the purchase price was to be reduced if the value of the foals produced by certain groups of mares were less than certain specified amounts—the purchase price payable was linked to the value of the foals which each group of mares produced. The purchase price could vary from $481,000 to $2,350,000.

There was some uncertainty as to how the adjustments were to work, as there was no mechanism to refund the difference between $481,000 and the $601,000 already paid (should low-value foals be produced), and discrepancies as to the total amount payable appeared between the taxpayer's evidence and the documentation, including the value at which the mares were brought into the taxpayer's books.

In its return for the 1987 income year, the taxpayer claimed a deduction of $3,105,000, being the $601,000 cash paid and the $2,474,000 unpaid portion of the purchase price (as entered into the taxpayer's accounts under "sundry creditors").

Unfortunately, within two months of entering into the agreement the New Zealand share market collapsed, which had adverse consequences for the bloodstock industry. In August 1988 some of the mares were transferred back to the vendor.

Around April 1989, the taxpayer and vendor entered into another agreement, under which the taxpayer transferred further horses back to the vendor. This was expressed to be in full and final settlement of all matters outstanding between the parties, ending all liability under the 1987 agreement. The value of the horses transferred back was given a nominal figure in the taxpayer's accounts, but the accounts continued to show the debt as still owing.

After some correspondence with the taxpayer, the CIR assessed the tax on the "cancellation of the debt" as payable in the 1990 year. After completing the disputes resolution process, notices of claim and defence were

filed. In the course of preparing his case, the CIR reconsidered the evidence and concluded that the correct year for which the taxpayer should have been assessed was the 1989 year. Judgment by admission was entered against the CIR for the 1990, and the disputes resolution procedures were recommenced for the 1989 year.

In an interim decision, the Authority held that the CIR was able to reopen the 1989 income year, however sought to hear counsel further on the possible consequences of this. The Authority held against the CIR on the questions of whether the money was caught by the accrual regime or was business income from any other source.

Decision

The taxpayer submitted that the Authority's previous findings simply required the original assessment to be confirmed, as there was no basis in law for any variation. The CIR submitted that the Authority has jurisdiction to revisit the specie of depreciation first claimed in the accounts for the 1987 year: if the 1989 is to be reopened, the automatic consequence is that the depreciation must be disallowed in the 1989 accounts.

After noting that litigation incidental to a tax dispute is not a general enquiry into the tax affairs of a disputant, the Authority sets out a passage from *CIR v VH Farnsworth* (1984) 6 NZTC 61,770, and concludes that it remains good law that the CIR cannot shift his ground once an assessment has been made.

The Authority went on to say:

> "In this case I have allowed the Commissioner to reopen the 1989 tax year and to reassess the claim for "depreciation" made in the accounts for that year. In the light of the above dicta he can only do this on some basis permitted by the Income Tax Act and within the procedural constraints discussed above."

In line with previous findings of fact, the Authority stated that as the mares were brought into the taxpayer's books, at the maximum purchase price, in the 1987 year, it was in that tax year that the taxpayer sought and obtained the income tax benefit of the purchase. That being so, the Authority held that:

> "where it transpires that because of subsequent events a "deduction" claimed in an earlier year should later be brought back to account as a specie of depreciation recovered, it can only be done by reopening the accounts for the year in which the deduction was, with the benefit of hindsight, wrongly claimed."

The Authority further rejected the CIR's submission in relation to section 138P TAA—that the Authority may make any assessment necessary which arises from the scope of the inquiry before it, and is a consequence of the factual issues and legal arguments raised by the parties during the hearing. The Authority held that it was bound by the issues raised in the parties' SOPs, and could not make an assessment on any other basis.

The Authority upheld the taxpayer's "self-assessment" for the 1989 year—the CIR had no basis to reassess in that year.

USE OF TRADING TRUSTS AND TAX AVOIDANCE

Case: TRA 004/2000 and 005/2000

Decision date: 22 December 2003

Act: Income Tax Act 1974, Income Tax Act 1994

Keywords: Trading Trusts, business restructuring; market salary, tax avoidance.

Summary

The taxpayer restructured his business from a partnership to a trading trust. The CIR disputed the legitimacy of the restructure and claimed it amounted to tax avoidance. In an interim decision the Court found there was a tax avoidance arrangement but the effect of it was merely incidental for the 1995 income tax year. In its final decision it found the purpose and effect was more than merely incidental for the 1996 income tax year as the taxpayers salary was set at an artificially low rate.

Facts

A dentist restructured his business in 1994 from a partnership to a trading trust. Under the trading trust structure the taxpayer's income was earned by the trading trust and the net income distributed among the beneficiaries (the taxpayer's wife and children). The money was then lent back to the taxpayer. The Commissioner of Inland Revenue ("the CIR") sought to apply the general anti-avoidance provisions to restructure the 1994–95 and 1995–96 income years.

An interim decision in April 2002 found there was tax avoidance in the 1995 year, but that its effect was "merely incidental". It was not clear what tax had been avoided in the 1996 year and Judge Barber requested further evidence on the advantages of using a trading trust compared to a corporate structure.

Decision

Judge Barber considered the tax avoidance for 1996 could not be merely incidental as it had been achieved by fixing an artificially low salary paid by the corporate trustee to the taxpayer. The taxpayer's dentistry practice was successful and the new structure paid him much less than he could actually command. Therefore it had the effect of allowing the taxpayer to avoid personal income tax.

Although it was possible for the taxpayer to reconstruct to a structure of his choice for reasons of general asset protection, such a restructure needed to be on a sensible and normal/ordinary business or family basis. Payment of a market salary was fundamental to that.

Judge Barber referred to the CIR's discretion to counteract a tax advantage of a transaction as set out in

the cases of Miller, Dandelion and Peterson. The CIR is to ensure no tax advantage is obtained from the arrangement and he agreed with CIR's counsel that it was not appropriate to reconstruct on the basis of "what might have happened". The comparison was to be between the new structure (trading trust) and the previous situation (partnership)

Judge Barber considered the arrangement was implemented in 1994 to avoid tax, although there were other purposes and effects such as asset protection. The distributions to the beneficiaries of the trust were merely accounting entries. Although they created a debt from the taxpayer there was an element of pretence to that.

While a taxpayer could order his affairs to minimise the incidence of income tax (Duke of Westminster principle) he needed to take care that any tax savings were "merely incidental". This could not be the case when paid an artificially low salary.

As the trading trust was void under section 99(2), the CIR could reconstruct under section 99(3) to counteract the tax advantage. However, Judge Barber considered the CIR's reconstruction went too far. Although $211,000 had been diverted to the trust the entire amount was not gained from the taxpayer's physical exertion but from employment of staff and return on capital investments. Where the CIR had reassessed the taxpayer on the entire amount, he considered reassessing the taxpayer at $120,000 was appropriate while the trust was to be assessed at $91,000. He also considered the trust should be given a chance to re exercise its discretion as to distribution

WITNESS SUMMONS SET ASIDE

Case: TRA decision 001/04

Decision date: 8 January 2004

Act: Taxation Review Authorities Act 1994

Keywords: Witness summons

Summary

Judge Barber set aside all witness summons that related to the substantive assessments and deferred ruling on witness summons in respect of the "vendetta" issue until he had been provided with an outline of the witnesses' likely or reasonably possible evidence.

Facts

This interlocutory decision related to certain participants of the JG Russell tax avoidance template. The template operated by grouping profitable companies with companies with tax losses so as to relieve the profitable companies of their income tax obligations. The scheme has been described by the Court of Appeal as a "blatant tax avoidance scheme" (*Miller v CIR; Managed Fashions Limited v CIR* (1998) 18 NZTC 13,961).

This decision follows on from the decision issued by Judge Barber on 13 August 2003 (now reported as *Case W24* (2003) 21 NZTC 11,246). In that decision Judge Barber ordered wide range discovery and that ten days of hearing would be put aside to focus on "vendetta" issues. This decision related to about 40 witness summons that the objectors had indicated that they would put before the Taxation Review Authority ("TRA").

The Commissioner argued that because of Judge Barber's findings in *Case U24* (1999) 19 NZTC 9,223 (known as the "justiciable issues decision"), the evidence that the objectors hoped to get from the witnesses would be irrelevant, because of earlier findings by appellate courts (eg that the template was tax avoidance, the effect of the Commissioner's policy statement on section 99).

Decision

Judge Barber noted that some of the prospective witnesses related to the substantive issue (tax avoidance), but others were thought to be for the "vendetta" argument.

In respect of the witnesses relating to the substantive issue, Judge Barber concluded that their evidence would not be relevant. A number of them authored documents that were issued after the assessment process, and therefore their evidence would not be relevant to the validity of the assessments. Judge Barber stated (in respect of various issues that the objectors wanted to call witnesses for):

> All these issues have been completely laid to rest by appellate courts in Russell template cases, and I cannot permit the same issues to be re-litigated again and again by Mr Russell and/or his advocates whether for Mr Russell or for his client objectors.

In respect of witnesses whom the objectors desired to call for the vendetta hearing, Judge Barber indicated that he would require a basic outline of their proposed evidence before deciding whether the summons should be discharged. The Judge indicated that he would need to be told what evidence was expected from the witnesses. The evidence would somehow have to show that assessments were invalid.

Judge Barber emphasised that he would not permit examination of witnesses to "fish" out matters to support the vendetta arguments. His Honour also stated that any vendetta evidence would have to be in relation to events prior to the issue of assessments, and also relate to matters which the TRA could not "cure" in the course of determining the correctness of the assessments.

The Judge noted the statements of the Court of Appeal in *Russell & Ors v Taxation Review Authority* (2003) 21 NZTC 18,255 and *Dandelion Investments Ltd v CIR*

(2003) 21 NZTC 18,010 where that Court emphasised the statutory primacy of the objection procedure. In those cases the Court of Appeal indicated that role of the TRA was to focus on the correctness of the assessments, and not on post-assessment events.

Judge Barber concluded that he was not satisfied that there was any relevant evidence which the proposed witnesses could provide on the substantive issues. In respect of the vendetta issues, the Judge said that he would defer his decision until he viewed a brief of evidence or an outline from counsel as to the witnesses' likely or possible evidence.

DISCOVERY ISSUES IN JG RUSSELL TEMPLATE CASES

Case: TRA Decisions 002/04 – 006/04

Decision date: 16 January 2004

Act: Tax Administration Act 1994

Keywords: Discovery

Summary

Judge Barber refused the objectors' discovery applications largely on the grounds that the documents that were requested were irrelevant.

Facts

These five interlocutory decisions relate to certain participants of the JG Russell tax avoidance template. The template operated by grouping profitable companies with companies with tax losses so as to relieve the profitable companies of their income tax obligations. The scheme has been described by the Court of Appeal as a "blatant tax avoidance scheme" (*Miller v CIR; Managed Fashions Limited v CIR* (1998) 18 NZTC 13,961).

These five decisions follow on from the decision issued by Judge Barber on 13 August 2003 (now reported as *Case W24* (2003) 21 NZTC 11,246) and a further one issued earlier this month (on 8 January 2004).

Decisions

Decision 1

This decision was a general ruling on discovery issues arising since *Case W24*. Judge Barber firstly noted the issues that arose out of *Case W24* and then summarised a number of recent Court of Appeal decisions which touched on the objection process in relation to Russell cases (*Dandelion Investments Ltd v CIR* (2003) 21 NZTC 18,010, *Russell v TRA & ABC* (2003) 21 NZTC 18,255). His Honour also emphasised the importance of his "justiciable issues" decision (*Case U24* (1999) 19 NZTC 9,223) and specifically noted that he had ruled that that judgment applied to these objectors.

Judge Barber held that the minutes of internal meetings of the Tax Avoidance Unit were not relevant to these objectors, and should not be discovered. His Honour also noted that a substantial part of those minutes were covered by legal professional privilege.

Judge Barber also rejected suggestions that the "fraud exception" applied in these disputes. That exception meant that privilege could be waived if the communication was brought into existence for the purpose of committing a fraud or wrongful act.

Decision 2

This decision dealt with an issue of waiver of confidentially of the minutes of a Russell team meeting, dated 1 September 1995. A copy of these minutes were apparently found in a car park in Auckland by an unidentified member of the public, and given to Mr Russell. The Commissioner argued that the minute was confidential and covered by legal professional privilege, which had not been waived. The Commissioner further applied that the minute and copies of it be returned to the Commissioner.

Judge Barber held that the minute was confidential and privileged and that it was inadmissible in the proceedings. His Honour also held that it was in any event irrelevant.

Decision 3

This decision related to the minutes of monthly meetings held between 31 March 1995 and 23 August 2002 of what was known as the Tax Avoidance or Russell team. The objectors argued that they were entitled to the minutes and that the fraud exception applied.

Judge Barber stated that he had been involved with Russell cases since 1989 and that "there has been nothing in these cases resembling fraud from the Commissioner of Inland Revenue, his officers and/or external legal advisors." His Honour held that the minutes were subject to legal professional privilege and in any case were irrelevant to the assessments in this group of cases.

Decision 4

This decision related to the minutes of the Tax Avoidance Unit Steering Group. All the objectors in this group were assessed before the time period covered by the minutes, and there is no mention in the minutes of any of them. Judge Barber held that the minutes were irrelevant, and were therefore inadmissible. Furthermore, most of the minutes were also covered by legal professional privilege and litigation privilege.

Decision 5

Documents prepared by one of the Commissioner's witnesses for counsel (and also provided to another employee of the Commissioner) were covered by litigation privilege.

QUESTIONS WE'VE BEEN ASKED

This section of the TIB sets out answers to some inquiries we've received. We publish these as they may be of general interest to readers. A general similarity to items published here will no necessarily lead to the same tax result. Each case should be considered on its own facts.

DISPUTING OR CHALLENGING A PAYE DETERMINATION MADE UNDER SECTION NC 1(2) OF THE INCOME TAX ACT 1994

SECTION 138M, TAX ADMINISTRATION ACT 1994 – WRONG PAYE DEDUCTION DETERMINATION A GROUND FOR CHALLENGE

Summary

Under section NC 1(2) of the Income Tax Act 1994, the Commissioner can determine whether and to what extent a payment is subject to PAYE. It is not possible to dispute or challenge such a determination under the tax statutes. But an employer or an employee who receives an assessment of tax deductions (or a notice of proposed adjustment proposing one) issued by the Commissioner can dispute the notice of proposed adjustment or challenge the assessment in the usual way on the ground that a section NC 1(2) determination on which it is founded is wrong in fact or in law. There is no other basis in the tax statutes for disputing or challenging a section NC 1(2) determination.

The question

Section NC 1(2) of the Income Tax Act 1994 provides that, if any question is raised as to whether or not a source deduction payment is wholly or partly subject to the PAYE rules, it shall be determined by the Commissioner. We have been asked whether and how a person might contest such a determination, and under what authority does the Commissioner issue an assessment of tax deductions.

The Commissioner's view on the right to contest a section NC 1(2) determination

Under sections 138B and 138C of the Tax Administration Act 1994 a person can challenge an assessment issued to them or any other disputable decision that affects them. But section 138E(1)(e)(i) of the Tax Administration Act 1994 bars any right of challenge on a matter that, by a provision in the PAYE rules is left to the determination of the Commissioner. Section NC 1(2) is part of the PAYE rules. Therefore it is not possible to challenge a section NC 1(2) determination.

The disputes procedures are set out in Part IVA of the Tax Administration Act 1994. They begin with the issue of a notice of proposed adjustment (a "NOPA"). Setting aside section 89D(4), which relates only to GST matters, you can only issue a NOPA in respect of an existing or proposed assessment or a disputable decision. Therefore, you can only begin an income tax dispute in respect of an existing or proposed assessment or a disputable decision.

A section NC 1(2) determination is the Commissioner's decision that a payment, or part of it, is subject to tax deductions. It does not quantify the amount of the tax deductions liability. Because quantification of the amount of the liability is a necessary element of a tax assessment, a section NC 1(2) determination is not an assessment. And paragraph (b)(iii) of the definition of "disputable decision" in section 3(1) of the Tax Administration Act 1994 excludes from the definition any decision of the Commissioner that you cannot challenge. Thus, because you cannot challenge a section NC 1(2) determination, it is not a disputable decision.

Therefore a section NC 1(2) determination is not one of the things in respect of which you can issue a NOPA, so that you cannot begin a dispute in respect of a section NC 1(2) determination.

The result is that you cannot directly dispute or challenge a section NC 1(2) determination under any tax statute. But section 138M of the Tax Administration Act 1994 provides a way of effectively challenging or disputing a section NC 1 determination. Section 138M provides:

> 138M. **Wrong PAYE deduction determination a ground for challenge** - A disputant may—
>
> (a) Dispute a notice of proposed adjustment; or
>
> (b) Challenge an assessment—
>
> that is issued by the Commissioner in respect of a tax deduction on the basis of a determination made under section NC 1 of the Income Tax Act 1994, on the ground that the determination is wrong, whether in fact or in law.

This does not authorise a direct dispute or challenge of a section NC 1(2) determination, but if the Commissioner issues you with a NOPA or an assessment in respect of tax deductions, you can dispute the NOPA or challenge

the assessment on the ground that a determination it is based on is wrong in fact or in law. That is, you cannot challenge a section NC 1(2) determination unless the Commissioner has issued a NOPA or an assessment in respect of tax deductions based on the determination.

The courts and the Taxation Review Authority have not considered this question under the Tax Administration Act 1994, but they have considered it under prior legislation.

In *Marmont v CIR* (27 February 1968) unreported, Supreme Court, Auckland Registry, M 122/62, Justice Speight found that there was an assessment of tax deductions and that under section 6(4) of the Income Tax Assessment Act 1957 (the original antecedent to section 138M) Mr Marmont could object to an assessment of tax deductions on the basis that a PAYE determination that it was based on was wrong in fact. *Marmont* supports the view that the Commissioner can assess tax deductions and that you can contest a PAYE determination by challenging an assessment based on it.

The decisions in *Geothermal Energy New Zealand Ltd v CIR* (1979) 4 NZTC 61,478 (Supreme Court, Beattie J), *Case N11* (1991) 13 NZTC 3,084 (Bathgate DJ) and *Case N58* (1991) 13 NZTC 3,447 (Bathgate DJ) confirm that you cannot directly contest a PAYE determination. In *Geothermal*, Justice Beattie found that there was no right under the Income Tax Act 1976 to object to the determinations, but made declarations on the substantive issue because, in the special circumstances of the case, it was desirable both in the public interest and the interest of the parties that he should do so. He made the declarations under the Declaratory Judgments Act 1908 and not under any tax law. In *Case N58*, Judge Bathgate also found that there was no right to object to the determination. Nonetheless, he dealt with the substantive question on the basis that, knowing there was no right of objection, the parties had indicated that they wanted to proceed with the dispute and would follow his determination (subject to appeal). In *Case N11*, Judge Bathgate said that employers are assessed for tax deductions, and that no assessment had been issued in that case. But in *Case N11* the matter ceased with Judge Bathgate's finding that there was no right of objection because there was no assessment.

The employee's assessment

The fact that a section NC 1(2) determination has been made does not bar the employee from exercising their separate dispute rights arising from the annual assessment of their income and the income tax on it. In the Commissioner's view, that would be a dispute with a different disputant, on a different assessment.

The Commissioner's view on the authority to assess tax deductions

There is no explicit authority in the Income Tax Act 1994 or the Tax Administration Act 1994 for the Commissioner to issue an assessment of tax deductions. But paragraph (a)(iii) of the definition of "tax" in section 3(1) includes "any other amount payable to the Commissioner under a tax law" and therefore includes tax deductions. Section 106(1) of the Tax Administration Act 1994 gives the Commissioner the power to issue an assessment of "tax" as so defined. Therefore it gives the Commissioner the power to issue assessments of tax deductions.

Section 106(1) applies if a person fails to furnish a return, or if the Commissioner is not satisfied with the return made by a person. These are the only circumstances in which an original assessment of tax deductions would be required – in other cases the employer or liable employee declares and quantifies the liability for tax deductions.

Section 113(1) of the Tax Administration Act 1994 provides that the Commissioner may amend an assessment at any time to ensure its correctness. Therefore it gives the Commissioner the power to issue amended assessments of tax deductions.

Section NC 13(1) of the Income Tax Act 1994 gives the Commissioner the power in limited circumstances to reduce the amount of the liability for tax deductions from past or future source deduction payments. A decision made by the Commissioner under section NC 13(1) of the Income Tax Act 1994 after the end of a pay period, specifying the amount of the tax deductions in respect of an employee for the pay period in a fixed amount and not subject to any terms or conditions will quantify the tax deductions liability. In such a case, the section NC 13(1) decision would be an assessment of tax deductions.

The assessment (whether under section 106(1) or section 113(1) of the Tax Administration Act 1994 or section NC 13(1) of the Income Tax Act 1994) is made when the Commissioner or a delegate, taking into account the relevant facts then in their possession and intending that it be final and not merely tentative, provisional, subject to adjustment or conditional, ascertains the amount of tax deductions that an employer or an employee is liable to make and account for to the Commissioner. But the right to challenge the assessment of tax deductions arises only if the assessment is issued. The assessment is issued when it is formally made known to the person to whom it is directed by notice of assessment. The Commissioner can remove any room for debate as to whether the assessment is issued by giving notice of the assessment according to section 14 of the Tax Administration Act 1994, though this is not mandatory and notice may be given in some other way: *Hieber & Ors v CIR* (2002) 20 NZTC 17,774 (High Court, Baragwanath J).

Previous published statements of the Commissioner's view on these questions

Page 13 of *Tax Information Bulletin* Vol 3, No 1 (July 1991) states that "as the law currently stands 'Notices of Deficient Tax Deduction' should be treated as though they are assessments for the purposes of the objection procedure". That statement is confirmed.

Page 26 of *Tax Information Bulletin* Volume 8, No 3 (August 1996) –

- Incorrectly states that a PAYE determination is a disputable decision, and the statement is withdrawn in that respect; and
- Correctly states that an employer or an employee may challenge an assessment or reject a NOPA that relates to a PAYE deduction determination, and the statement is confirmed in that respect. However it is emphasised that only the person to whom the NOPA or assessment of tax deductions is issued can contest it under the tax statutes.

NEW LEGISLATION

TAXATION (GST, TRANS-TASMAN IMPUTATION AND MISCELLANEOUS PROVISIONS) ACT 2003

TAXATION (ANNUAL RATES OF INCOME TAX 2003 – 04) ACT 2003

STUDENT LOAN SCHEME AMENDMENT ACT (NO 2) 2003

CHILD SUPPORT AMENDMENT ACT (NO 2) 2003

The Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Bill was introduced into Parliament on 23 June 2003. It received its first reading on 26 June 2003, its second reading on 13 November 2003 and its third reading on 19 November 2003. The four resulting Acts received Royal assent on 25 November 2003.

They amend the Income Tax Act 1994, Tax Administration Act 1994, Goods and Services Tax Act 1985, Student Loan Scheme Act 1992, Child Support Act 1991, Personal Property Securities Act 1999, Gaming Duties Act 1971, Gambling Act 2003, and Taxation (Māori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003.

MAJOR POLICY ISSUES

NEW GST RULES FOR FINANCIAL SERVICE PROVIDERS

Sections 3A(2)(c), 10(3A)-(3B), 11A(1)(q)-(r), 20(3)(h), 20C-20F, 21G(1B), 21H(2), 55(7)(d) and 55(7)(dab) of the Goods and Services Tax Act 1985

Introduction

The Goods and Services Tax Act 1985 has been amended to allow supplies of financial services by a registered person to another registered person to be zero-rated. The amendments give effect to reforms outlined in the government discussion document *GST and financial services*, which was released in October 2002. The amendments will take effect from a date to be determined by the Governor-General by Order in Council, which will not be earlier than 12 months after 25 November 2003.

The changes integrate the supply of financial services more fully into the GST system by taxing at the rate of 0% certain supplies of financial services to businesses and allowing financial service providers to claim input tax credits in respect of those supplies. This is in contrast to the "exempt" treatment of financial services, whereby GST is not charged and financial service providers cannot claim input tax credits.

Background

Since 1 October 1986, when GST first applied to goods and services supplied in New Zealand, supplies of financial services have been exempt from GST.[1] Exemption is used in a GST system as a substitute for taxing supplies of goods and services when the usual method for taxing those goods and services is impractical. Instead of directly taxing the supply of financial services, tax is collected when a financial service provider purchases goods and services to produce financial services.

Exemption departs from the usual operation of GST, which ensures that each time tax is paid in the supply chain businesses receive an input tax credit to offset the tax. Input tax credits allow GST to roll forward until the goods and services are purchased by a consumer that is unable to recover the GST. As it is the financial service provider that bears the GST cost instead of the private consumer, exemption creates the following problems:

- *Tax cascades:* When a financial service provider is unable to recover the GST paid on purchases goods and services, the irrecoverable GST forms part of the cost of production. The financial service provider faces a decision: raise the price of the services or absorb the GST cost. If it passes the cost on to businesses through higher prices, those businesses face a similar decision: either pass on or absorb the tax cost. The result of these decisions may be increased prices or reduced profits. This effect is known as tax cascading.

[1] Financial services that are supplied to non-residents that are outside New Zealand at the time of supply have been treated as exports and are eligible for zero-rating.

- *Self-supply bias:* Rather than make the decision to absorb or pass on the cost of GST, the financial service provider may attempt to minimise the impact of GST by "self-supplying" essential services rather than acquiring those same goods and services from third parties (which would be subject to GST).

The discussion document *GST and financial services* considered possible options to resolve these problems, with the objective of integrating the supply of financial services more fully into the GST system. While taxing all financial services at the usual rate of 12.5% would deal with these concerns, studies undertaken overseas have shown that such a treatment can be problematic. Part of the problem is in determining the value of the financial intermediation fee. Financial services can either be charged for directly (for example, through bank fees) or indirectly through the inclusion of the intermediation costs for the service in the supplier's margin (for example, in the interest rate margin). While a possible option would be to impose GST on discrete fee-based charges, the degree of substitutability that exists between direct and indirect charges would affect the ability to successfully apply GST to intermediation fees alone.

Given this constraint, the government outlined in the discussion document *GST and financial services* proposals to zero-rate financial services supplied between financial service providers and other businesses. Zero-rating business-to-business supplies has the advantage of removing the potential for tax cascades to arise while dealing with the valuation and identification problems that make the application of GST to financial transactions difficult. It also means that financial supplies to business will be treated in much the same way for GST purposes as non-financial transactions.

This outcome means that GST at the rate of 0% is charged on the supplies of goods and services rather than the usual rate of 12.5%. By charging GST, albeit at the rate of 0%, the supply of financial services will be treated as a taxable supply and the supplier will be able to claim back GST paid on purchases used in supplying the financial services.

The treatment of financial services made to final consumers remains unchanged in that such supplies will remain exempt from GST.

Key features

GST-registered persons will now have the option to elect to zero-rate supplies of financial services.

- New section 11A(1)(q) allows financial service providers that are registered for GST to zero-rate supplies of financial services to customers that are registered for GST if the level of taxable supplies[2] made by the customer, in a given 12-month period, is equal to or exceeds 75% of their total supplies for the period.
- New section 11A(1)(r) allows zero-rating of financial services that are supplied by financial service providers to customers that may not meet the 75% threshold but are part of a group that does meet the threshold in a given 12-month period—for example, the treasury or finance function of a group of companies that receive financial services.
- New section 20C allows for an additional deduction from output tax for supplies of financial services made by a financial service provider to another financial service provider, which in turn makes supplies to businesses that qualify to receive zero-rated financial services. The amount that the first financial service provider can deduct will be determined by the ratio of taxable to non-taxable supplies made by the recipient financial service provider.
- New sections 20D to 20F set out the administrative rules supporting new sections 11A(1)(q)-(r) and 20C.
- Remedial changes have also been made to the rules dealing with valuation of supplies between associated persons, the ability to claim a second-hand goods input tax credit, the rules concerning change-in-use adjustments and the rules affecting the GST treatment of groups of companies. These changes support new sections 11A(1)(q)-(r) and 20C.

Application date

The new rules will apply on the first day of a calendar quarter (January, April, July or October) that is at least 12 months after 25 November 2003. The date will be appointed by the Governor-General by Order in Council.

Detailed analysis

Election into the new rules

New section 20F requires that a registered person must give written notice to the Commissioner of Inland Revenue if they wish to zero-rate supplies of financial services under new sections 11A(1)(q)-(r) and/or be eligible to deduct input tax under new section 20C. This allows financial service providers to assess, in less straightforward situations, the trade-off between the benefits of zero-rating and the compliance costs associated with identifying the customer and determining the customer's mix of taxable and non-taxable supplies.

The election will take effect from the first day of the taxable period in which the Commissioner receives the written notice.

[2] Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

Election notices should be addressed to:

GST and financial services
C/- Manager
Banking and Insurance Sector
Corporates
Inland Revenue
Private Bag 39984
Wellington

An election by a registered person will cease from the end of the taxable period:

- in which the registered person ceases to carry on a taxable activity, or
- that is nominated by the registered person in a written notice, if the date nominated is after the taxable period in which the Commissioner receives the notice, or
- in which the Commissioner receives written notice if the registered person does not nominate a taxable period.

Zero-rating

General application

New section 11A(1)(q) provides that the supply of financial services, as defined in section 3 of the GST Act, by a financial service provider to its business customers may be zero-rated if the customers are GST-registered persons who have an activity of making taxable supplies[3] that equal or exceed 75% of their total supplies in a 12-month period.

Supplies of financial services will not be zero-rated if:

- the services are supplied to businesses that have more than an incidental activity of making exempt supplies of financial services and other non-financial exempt supplies – that is, if exempt supplies exceed 25% of total supplies, or
- the services are supplied to non-registered persons (or final consumers).

When determining whether a supply of financial services may be zero-rated the financial service provider will need to know whether the customer is GST-registered and the customer's ratio of taxable supplies to total supplies.

Figure 1 illustrates the questions that should be considered when determining whether a supply of financial services should be zero-rated.

Supplies of financial services to special purpose vehicles or group finance operations

The application of new section 11A(1)(q) could mean that some financial services supplied to businesses would not be zero-rated because they are received by:

- an entity that is not registered for GST but is part of a group of which some or all of the other members are GST-registered, or
- an entity that is primarily concerned with the financial activities of a group whose taxable supplies are 75% or more of its total supplies.

In either case, the entity itself may not be entitled to receive zero-rated supplies but might be if the total activities of the group were taken into account.

To address this, new section 11A(1)(r) allows a registered person to "look through" the entity that contractually receives the financial services to the wider group. Provided that the wider group is a group for the purposes of section IG 1 of the Income Tax Act 1994 and meets the 75% test, the supply of financial services to the recipient entity may be treated as zero-rated.

Estimations

New section 20E plays an important role in determining the operation of new sections 11A(1)(q) and (r). In the discussion document *GST and financial services* it was recognised that establishing whether a customer could qualify to receive zero-rated supplies on a transaction-by-transaction basis could be difficult.

New section 20E allows GST-registered financial service providers to use actual information supplied by the recipient or agree with the Commissioner of Inland Revenue a method that will determine which customers are eligible to receive zero-rated supplies (both in terms of whether the customer can be treated as registered for GST and whether the 75% test is met).

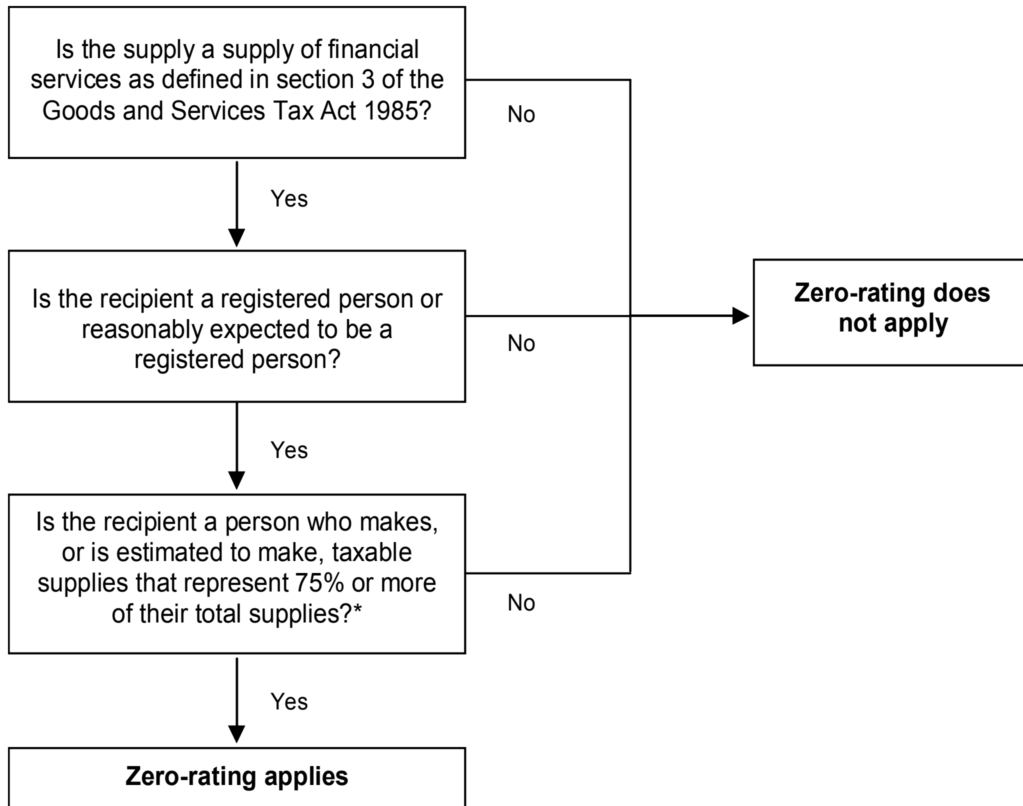
The reason for this is that the difference between zero-rating and exemption can generally be described as the respective ability or inability of financial service providers to claim input tax credits. The deduction of input tax credits is a matter for the financial service provider to determine—not the recipient. As far as the recipient of a financial service is concerned, GST has never applied to the receipt of financial services, a position that does not change with zero-rating.

Guidelines

Inland Revenue is preparing guidelines to assist taxpayers in determining when supplies of financial services may be zero-rated.

[3] Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

Figure 1: Applying the proposed zero-rating of domestic business-to-business supplies of financial services



* Administrative rules are being developed by Inland Revenue to assist in determining whether customers are appropriately categorised as businesses that are entitled to receive zero-rated financial supplies. The main determinant should be the nature of the customer's business. Thus:

– a customer that is a financial intermediary or a supplier of residential accommodation would not generally be categorised as entitled to receive zero-rated supplies as it is reasonable to expect that the volume of exempt supplies and zero-rated financial services would exceed 25% of its total turnover

– most manufacturers, primary producers and retailers, on the other hand, would be expected to be entitled to receive zero-rated supplies

– businesses that make a mixture of taxable and exempt supplies such as general and life insurers will need to be categorised on a case-by-case basis.

Deductions from output tax

Input tax

The key objective of the new amendments is to allow financial service providers greater access to input tax credits in respect of supplies of financial services to qualifying business customers. The level of input tax recovery will be representative of the GST cost incurred in making those supplies, based on current change-in-use methodologies.

Section 21A sets out the methods of allocating input tax credits to making taxable and other (including exempt) supplies.

Actual use: This method of allocation requires the taxpayer to directly attribute the use of the goods and services to the extent that those goods and services are used for a purpose of making taxable supplies.

Turnover method: This method is used in cases where the actual use method is too difficult to apply—for example, in the case of overhead expenses. The formula as shown in the legislation is:

$$\frac{\text{Total value of exempt supplies for taxable period}}{\text{Total value of all supplies for taxable period}}$$

An alternative (or special) method: This method is available, provided that the Commissioner approves it, if its use results in allocated amounts that are fair and reasonable in comparison with actual use.

In all cases, section 21A(3) requires that the method of allocation used must result in a fair and reasonable allocation of input tax credits between taxable and other supplies.

Supplies of financial services between financial service providers

Financial services supplied by a financial service provider to another financial service provider will not be zero-rated under new section 11A(1)(q) as it is expected that most financial service providers will not satisfy the requirement that 75% of their supplies are taxable supplies. However, it is recognised that denying the benefits of zero-rating in this situation will mean that the objective of removing the overtaxation of businesses is not met in the instance of the second financial service provider supplying financial services to a business customer. To address this, new sections 20(3)(h) and 20C provide an additional deduction to the first financial service provider to the extent that the second financial service provider makes supplies to businesses that would meet the 75% test.

This level of relief is calculated according to the formula:

$$a \quad X \quad \frac{b}{c} \quad X \quad \frac{d}{e}$$

where:

a is the total input tax that the registered person would be able to deduct, other than under new section 20(3)(h) (that is, as a result of the application this formula), in respect of the taxable period if all supplies of financial services by the registered person were taxable supplies

b is the total value of exempt supplies of financial services by the registered person to the recipient financial service provider in respect of the taxable period

c is the total value of supplies by the registered person in respect of the taxable period

d is the total value of taxable supplies by the recipient financial service provider in respect of the taxable period, and

e is the total value of supplies by the recipient financial service provider in respect of the taxable period.

The formula provides a deduction that is proportional to the total deduction that would be allowed if all supplies of financial services were taxable supplies. The proportion is found by multiplying two fractions. The first fraction is the proportion of the total value of supplies made by the registered person that consists of exempt supplies of financial services to a recipient financial service provider. The second fraction is the proportion of the total value of supplies made by the recipient financial service provider that consists of taxable supplies (including zero-rated supplies of financial services).

For practical reasons, the formula is limited to the activities of the second financial service provider, rather than extending to a third financial service provider and so on.

New section 20D requires that the method used to determine the deduction allowed under new section 20C is based on statistical information that is provided by the second financial service provider in relation to its taxable supplies (element d of the formula).

New valuation rules for supplies between associated persons

Section 10(3A) has been redrafted and new section 10(3B) has been inserted to prevent supplies of financial services between associated persons from being overvalued following the zero-rating of financial services and the deduction allowed under new section 20C.

The values required for the purposes of applying the new zero-rating rules and the deduction under section 20C when transacting with an associated person

Transaction	Agreed value of supply under contract	Must be valued at
Supply to associated financial institutions	Agreed value is less than market value	Agreed value 10(2)
Supply to associated financial institutions	Agreed value is more than market value	Market value 10(3B)
Supply to associated business customer	Agreed value is less than market value	Agreed value 10(2)
Supply to associated business customer	Agreed value is more than market value	Market value 10(3B)
Supply to associated final consumer	Agreed value is less than market value	Market value 10(3)
Supply to associated final consumer	Agreed value is more than market value	Agreed value 10(2)

- Section 10(3A) has been redrafted to make its meaning clearer.
- New section 10(3B) applies for the purposes of valuing supplies covered by new sections 11A(1)(q) to (r) and 20C. It requires supplies of financial services that are subject to those sections to be valued at market value if the consideration for a supply is greater than its open market value.

Adjustments to prior period GST returns

As originally drafted, the bill introduced a specific provision to address situations where a registered person made a return based on an amount relating to supplies made by another person and an inaccuracy in the figure for the amount had affected the accuracy of the return. The provision did not proceed at the recommendation of the Finance and Expenditure Committee, in response to concerns that it would impose high compliance costs arising from the fact that prior periods would need to be constantly reviewed as new information came to light.

This means that GST-registered financial service providers will have complied with the zero-rating provisions if they have applied a method of estimation that has been approved by the Commissioner. The Commissioner will, however, continue to have the ability to amend assessments relating to earlier taxable periods if the return is considered to be incorrect.

Secondhand goods input tax credits

Section 3A(2)(c) has been amended to limit the circumstances in which a financial service provider is able to claim an input tax credit for the purchase of secondhand goods. The section allows financial service providers to claim an input tax credit for secondhand goods that are purchased from an arm's length party. This is provided that the secondhand goods have not been previously owned or used by the GST-registered financial service provider or a person associated with the financial service provider.

The bill had proposed a wider prohibition on the availability of input tax credits for secondhand goods to mitigate possible revenue losses arising from the new zero-rating rules. The Finance and Expenditure Committee considered that this would prevent financial service providers from receiving input tax credits for the acquisition of secondhand goods when transacting with a genuine arm's length party and recommended that the amendment be changed to limit the scope of the prohibition.

One-off change in use adjustments

Amendments have been made to sections 21G and 21H to preclude one-off change-in-use deductions for assets held at the time that new sections 11A(1)(q) and 11A(1)(r) take effect. These changes in use must instead be made on a period-by-period basis, even if there has been a change in the principal purpose from one of making non-taxable supplies to one of making taxable supplies. This is intended to mitigate the revenue loss of the reforms.

Groups of companies

New section 55(7)(dab) has been inserted so that both taxable and exempt supplies to a member of a GST-registered group are treated as made to the representative member. This amendment is intended to provide consistency between the rules affecting groups of companies and new section 11A(1)(r). Section 55(7)(d) has been amended as a result of inserting new section 55(7)(dab).

GST ON IMPORTED SERVICES: REVERSE CHARGE INTRODUCED

Sections 2(1) "goods", 2(1) "non-resident", 2A(1)(bb), 3A(2)(b)(i), 5B, 8(2), 8(3), (4), 8(4B), 8(4C), 8(5), 8(6), 9(2)(a)(iv), 10(3), (3C), (3D), (3E) and (15C), 11A(1)(k), (l) and (ma)(ii), 11A(1B), 11A(2), 11A(4), 11AB(a), 20(2), (2)(c) and (2)(d), 20(3)(a), (a)(i), (a)(ia), (a)(ii) and (a)(iii), 20(3)(b), (b)(i), (b)(ii), (b)(iii) and (b)(iv), subparagraphs (iii) and (iv) of the proviso to section 20(3)(d), 20(4)(b)(i) and (ib), 20(4)(b)(ii), 24B, 25(2)(b), 25(5), 25AA, 51(1)(e), 55(7), (7)(db) and (7)(dc), 55(7B), 56B, 60(6)(a), (7)(a) and (7)(b), 78(6) and 84B of the Goods and Services Tax Act 1985.

Introduction

The amendments to the Goods and Services Tax Act 1985 introduce a "reverse charge" mechanism to tax certain imports of services.

The reverse charge requires GST-registered recipients of supplies of imported services to self-assess GST on the value of the services if:

- the services are not acquired by a person who makes taxable supplies that represent 95% or more of total supplies in a 12-month period, and
- the supply of those services, if made in New Zealand by a registered person, would be a taxable supply.

This means that if a registered person acquires, from a non-resident, services that would be subject to GST if supplied in New Zealand and they do not, in effect, make solely taxable supplies, the recipient is required to add GST to the price of the services and return the GST to Inland Revenue.

The recipient of a supply of imported services is also treated as the person who made the supply for the purpose of imposing and enforcing the reverse charge and for determining whether the GST registration threshold is exceeded. For all other purposes in the GST Act the recipient of a supply of imported services remains the recipient, rather than the supplier, of the services.

Amendments have also been made for the purpose of applying the reverse charge to related party internal charges, including cost allocations. Such charges exclude amounts relating to salaries and interest.

Application dates

The amendments to sections 2(1) "goods", 2A(1)(bb), 5B, 8(4B), (4C) and (5), 9(2)(a)(iv), 10(3), (3C), (3D), (3E) and (15C), 11A(1B), 20(2)(c) and (d), 24B, 25AA, 55(7) (excluding amendments to section 55(7)(d), (7)(db) and (7)(dc)), 55(7B) and 56B will come into force on the first day of a calendar quarter (January, April, July or October) that is at least 12 months after the enactment of the legislation. The date will be set by the Governor-General by Order in Council. This will allow sufficient time for implementation of the changes.

All other amendments apply from 25 November 2003.

Key features

The approach adopted in the legislation is based on treating certain imported services as being supplied in New Zealand and deeming the recipient of those services to be their supplier, rather than having a separate code for imported services.

The two key provisions are:

Section 8(4B): This section contains a new place of supply rule for imported services. It provides that there will be a supply of services in New Zealand if:

- services are supplied by a non-resident supplier to a recipient who is a New Zealand resident
- the services are acquired by a person who:
  - has not, in the 12-month period that ends with the month in which the supply is made, made supplies of which at least 95% in total are taxable supplies, and
  - does not, at the time of the supply, have reasonable grounds for believing that they will, in the 12-month period that begins with the month in which the supply is made, make supplies of which at least 95% in total are taxable supplies
- the supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

Section 5B: This section treats the supply of imported services to which section 8(4B) applies as having been made by the recipient of those services for the purposes of certain other sections. It also treats the services as having been supplied by the recipient in the course or furtherance of a taxable activity carried on by the recipient. Therefore the value of imported services supplied to a person will be included in the total value of supplies made by that person for the purposes of determining liability to register for GST under section 51.

Although businesses making exempt supplies in New Zealand will usually be registered for GST in any event, the reverse charge may require others to register—in particular, any person importing as a private consumer services exceeding $40,000 in value in a 12-month period.

In addition to these two key sections, other features of the legislation are:

- A definition of "non-resident" (a person who is not resident), which has been included for purposes of drafting style and makes no substantive change to the law. All references to "not resident in New Zealand" in the GST Act are replaced by a reference to "non-resident".
- The amended definition of "goods", which ensures that supplies of imported digitised products, such as software provided over the Internet, will be treated as supplies of services and thus potentially subject to the reverse charge.
- Section 2A(1)(bb), which treats branches or divisions treated as separate persons under section 56B as associated persons.
- Section 8(4C), which treats an allocation of costs from a non-resident to a resident as a taxable supply of services for the purposes of the reverse charge.
- Section 9(2)(a)(iv), which ensures that the time of supply for a supply of services between associated parties which is subject to section 8(4B) will be the earliest of:
  - when an invoice is issued
  - when payment is made in respect of the supply, or
  - the end of the taxable period that includes the date which is two months after the recipient's balance date for the year in which the service was performed.
- Section 10(3C), which provides that, for the purposes of a supply between associated parties to which section 8(4B) applies, the recipient is not required to value supplies at market value when the payment for those services is an allowable deduction to the recipient.
- Section 10(3D), which provides that, for the purposes of a supply between branches or divisions of the same company to which sections 2A(1)(bb), 8(4B) and 56B apply, the recipient is not required to value supplies at market value if the payment for those services would be an allowable deduction to the recipient.
- Section 10(3E), which provides that, for the purpose of a supply to which section 8(4B) applies, the value of the supply is equal to the consideration for the supply. This ensures that section 8(1) charges GST on the amount of the consideration for the supply, meaning the consideration for the supply is GST-exclusive in the same way as for imported goods.
- Section 10(15C), which provides that the value of related-party internal charges subject to the reverse charge under section 8(4B) is reduced by the value of any salary or interest component in the internal charge. The provision applies to supplies between branches and divisions subject to section 56B and to supplies between members of the same group of companies under section IG 1 of the Income Tax Act 1994.
- Section 11A(1B), which allows supplies of services that are consumed outside New Zealand to be zero-rated under the reverse charge. All of the zero-rating provisions will fully apply to zero-rate supplies of services subject to the reverse charge, except for the provision which zero-rates services physically performed outside New Zealand (section 11A(1)(j)). Section 11A(1)(j) will apply only to zero-rate supplies of services subject to the reverse charge if those services are physically performed outside New Zealand and the nature of the services is such that the services can be physically received only at the time and place at which the services are physically performed.
- Section 20(2)(d), which allows the recipient of a supply subject to the reverse charge to claim input tax credits (if the requirements of section 3A are met) for that supply if they have returned output tax for that supply.
- Section 24B, which requires any recipient of a supply of services subject to section 8(4B) to maintain sufficient records of the supply to enable the following to be ascertained:
  - the name and address of the supplier
  - the date on which, or the period during which, the supply was received
  - a description of the services supplied
  - the consideration for the supply
  - the time by which payment of the consideration for the supply is due, and
  - the amount of the consideration for a supply that the taxpayer is excluding from the value of the supply under section 10(15C)(a) and (b).
- Section 25AA, which is equivalent to section 25 (credit/debit notes and adjustments relating to them) for the purposes of supplies subject to section 8(4B).
- Amended section 55(7)(db) and (dc), which use terminology consistent with the adjustment provisions in sections 21(1) and 21E.

- Section 55(7B), which, for the purposes of supplies subject to section 8(4B), disregards the GST effects of grouping (overriding section 55(7)) for supplies made by a non-resident member of a group to a New Zealand resident member of a group.
- Section 56B, which, for the purposes of supplies subject to section 8(4B) and in relation to a person deems the following:
  - a branch or division outside New Zealand to be a separate person and a non-resident
  - activities carried on by that non-resident person to be carried on independently by that person
  - a branch or division inside New Zealand to be a separate person and resident in New Zealand
  - activities carried on by that person resident in New Zealand to be carried on independently by that person, and
  - a head office to be a branch or division.
- Section 78(6), which ensures that the natural supplier of imported services cannot increase the price charged for the services under section 78 to take into account GST.
- Section 84B, which provides transitional provisions to determine and apportion the time of supply for supplies which are provided on an ongoing basis and which span the introduction of the reverse charge.
- Minor remedial amendments:
  - to the following sections to reflect the use of the new term "non-resident" (no substantive change having been made to the law):
    - section 8(2), (3), (4) and (6)
    - section 11A(1)(k), (l) and (ma)(ii)
    - section 11A(2) and (4)
    - section 11AB(a)
    - subparagraphs (iii) and (iv) of the proviso to section 20(3)(d)
    - section 51(1)(e)
    - section 60(6)(a), (7)(a) and (7)(b)
  - to the following sections to clarify the terminology used in calculating tax payable under the GST Act in relation to the definition of "input tax":
    - section 20(2)
    - section 20(3)(a), (a)(i), (a)(ia), (a)(ii) and (a)(iii)
    - section 20(3)(b), (b)(i), (b)(ii), (b)(iii) and (b)(iv)
    - section 20(3)(i)
    - section 25(2)(b)
    - section 25(5)
  - to section 8(5) to reflect the insertion of section 8(4B)
  - to section 20(3)(a)(iii) and (b)(iv) to reflect the insertion of section 25AA
  - to section 20(4)(b)(i) and (ii), and section 20(4)(b)(ib) has been inserted, to reflect the introduction of the reverse charge.

Background

The GST treatment of imported services

Unlike imported goods, most services imported into New Zealand have not been subject to GST. When GST was introduced in 1986 it was decided that the tax would not apply to imports of services, even though both imports of goods and services are generally included in the GST base.

This treatment was adopted as most services were consumed in the jurisdictions in which they were produced. Legal and technological constraints either prevented international trade in services altogether or made it uneconomic. The volume of services imported into New Zealand at the time was low, and the exclusion of imported services from the GST base was therefore seen to be relatively non-distortionary. The compliance and administrative costs associated with imposing GST on imported services at the time outweighed the revenue gain and the benefits from removing the distortions that non-taxation would create.

The need for reform

The review of the GST treatment of imported services was included in the government's tax policy work programme for 2001– 2002, prompted by increased volumes of imported services. Deregulation of the telecommunications and financial services markets in New Zealand, coupled with the rapid advances in communication and computer technology driving electronic commerce, have increased the ability to consume in New Zealand at a reduced cost a wide range of services that have been produced offshore.

The government's electronic commerce strategy, as set out in the strategy paper *E-Commerce: Building the Strategy for New Zealand*, also identified addressing the GST treatment of imported services as a key part of ensuring that New Zealand's regulatory environment takes into account electronic commerce.[4]

The growth in the volume of imported services exacerbates the distortions caused by the non-taxation of imported services and undermines the competitiveness of New Zealand service industries. It also has the potential to undermine the GST base.

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[4] *E-Commerce: Building the Strategy for New Zealand*, November 2000, page 15.

The competitive distortions arise because New Zealand service providers making supplies in New Zealand are required to charge GST, while non-resident service providers in the same situation are not. New Zealand service providers are therefore at a disadvantage in relation to non-resident service providers. The price differential that the differing tax treatment causes may distort consumption decisions.

The majority of other countries with a GST or VAT system have a tax on imported services. There are benefits to be gained from having a tax treatment of cross-border supplies of goods and services similar to that of our trading partners. By not taxing imports of services the New Zealand GST system allows those services to avoid any impost of consumption tax, as such supplies would not have been taxed when exported from the jurisdiction in which they originated.

The increasing mobility of the supply of services and advances in electronic commerce mean that purchasing services supplied offshore will become more common. Although the tax base is not threatened at present by the fact that GST has not been applied to imported services, a significant revenue risk may arise in the future.[5]

Discussion document – GST and imported services: a challenge in an electronic commerce environment

On 27 June 2001 the Government released a tax policy discussion document addressing the GST treatment of imported services – *GST and imported services: a challenge in an electronic commerce environment*. This document proposed the introduction of a "reverse charge" mechanism to tax imports of services by businesses. The reverse charge would require businesses acquiring services from offshore to return GST on the value of supplies they have received. To minimise compliance and administrative costs for businesses, the reverse charge would apply only to those businesses which acquire services for other than taxable purposes (mainly financial institutions).

The reverse charge is intended to alleviate the distortion in favour of imported services created by the non-taxation of imported services compared to the taxation of domestically supplied services. It also aligns New Zealand's GST system with that of most other countries with a VAT or GST system and the treatment of services with that of goods.

Changes recommended by select committee

Provisions relating to cost allocations, valuing supplies between branches, the effect of the imposition of GST under the reverse charge and transitional provisions were added at the select committee stage of the process.

[5] *For example, globally, electronic commerce is precicted to reach approximately US$ 600 billion in trade by 2004-05, or roughly 8% of all global trade (OECD Presentaion: Electronic Commerce - Answering the Taxation Challenges, Tokyo OECD/Pacific Island Forum Conference, February 2001).*

Detailed analysis

The place of supply rule

General scheme

The imported services legislation has been integrated as far as possible with the general GST provisions. The approach is based on treating certain imported services as being supplied in New Zealand and deeming the recipient of those services also to be their supplier. This is in contrast to introducing a separate code, which would require far more detailed legislation as many existing provisions of the Act would need to be replicated.

The key provisions are section 8(4B), containing the place of supply rule for imported services, and section 5B, which treats the supply of imported services to which new section 8(4B) applies as having been made by the natural recipient of those services for the purposes of certain sections.

This article uses the terms "natural supplier", "natural recipient" and "deemed supplier": the first term refers to the non-resident supplier and the second and third terms refer to the New Zealand resident recipient of the imported services, who is required to apply the reverse charge.

Application of section 8(4B)

Section 8(4B) treats a supply as being made in New Zealand if:

- the services are supplied by a non-resident supplier to a recipient who is a resident
- the services are acquired by a person who:
  - has not, in the 12-month period that ends with the month in which the supply is made, made supplies of which at least 95% in total are taxable supplies, and
  - does not, at the time of the supply, have reasonable grounds for believing that they will, in the 12-month period that begins with the month in which the supply is made, make supplies of which at least 95% in total are taxable supplies, and
- the supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

Therefore supplies of services that would be exempt supplies if made in New Zealand, such as certain financial services, will not be subject to the reverse charge. Also, subject to section 11A(1B), which modifies the application of section 11A(1)(j), services that would otherwise be subject to GST at 12.5% under the reverse charge can be zero-rated under section 11A. This is because taxable supplies include zero-rated supplies for the purposes of the reverse charge as well as generally.

It is important to note that, as explained below, section 8(4B) refers to the natural supplier and recipient of services, not the deemed supplier. Section 8(1), which imposes the liability to GST does, however, refer to the deemed supplier so that the liability to return GST is imposed on the New Zealand resident natural recipient of the supply.

Application of section 5B

Section 5B deems the natural recipient of services to be the deemed supplier of those services in certain circumstances. For the purposes of certain listed sections in the GST Act, section 5B treats a supply of services to which section 8(4B) applies as having been made by the recipient of those services in the course or furtherance of a taxable activity carried on by the recipient. Therefore the value of imported services supplied to a person will be included in the total value of supplies made by that person for the purposes of determining liability to register for GST. A person, including a private consumer, who makes no other taxable supplies in New Zealand may be required to register as a result of importing in excess of $40,000 of services in a 12-month period.

When the total of a person's supplies that would be taxable if they were a registered person and supplies of imported services that would be subject to the reverse charge if they were a registered person exceed $40,000 per annum (the registration threshold), the person will be required to register for GST and charge GST on all of those supplies. For example, consider an unregistered business making $38,000 of supplies that would be taxable if the business were GST-registered. If the business imports $2,001 of services the total value of supplies will be in excess of $40,000 and the business will be required to register for and charge GST on all of the taxable supplies it makes, not just the supplies subject to the reverse charge.

For the purposes of sections not listed in section 5B, a supply of services to which section 8(4B) applies continues to be treated as having been made by the natural supplier of those services. It is therefore important to note that for the purposes of the sections not listed in new section 5B, references to "supplier" (and a supply being made by a person) and "recipient" will refer only to the natural supplier and natural recipient.

The most important provisions when the supplier (and recipient) references are to the natural supplier (and natural recipient) are sections 9 and 10. The time and value of supply provisions would not work if the supplier references did not refer to the natural supplier because, even though there may be a deemed supplier for the purposes of certain provisions, there is still only the one supply of imported services.

The sections for which section 5B applies to treat the natural recipient as the deemed supplier are:

Section	Topic
8(1)	Imposition of tax.
15	Taxable periods.
15A	Change in registered person's taxable period.
19A	Requirements for accounting on payments basis.
20(4)	Calculation of tax payable: output tax.
20B	Allocation of taxable supplies following investigation by Commissioner.
25AA	Adjustments if contract for supply of imported services changed.
51	Persons making supplies in course of taxable activity to be registered.
52	Cancellation of registration.
57	Unincorporated bodies.
75	Keeping of records.
76(6)	Avoidance: 12-month period.
78B	Adjustments to tax payable for persons furnishing returns on payments basis following change in rate of tax.
78BA	Adjustments to tax payable in relation to credit and debit notes following change in rate of tax.
78C	Change in accounting basis coinciding with or occurring after change in rate of tax.

Most provisions do not require any amendment to cater for the reverse charge. For example, Parts VI and VII of the GST Act, dealing with recovery of tax and refunds and relief from tax, are not based on the concept of a supply and therefore can be applied unchanged to the reverse charge.

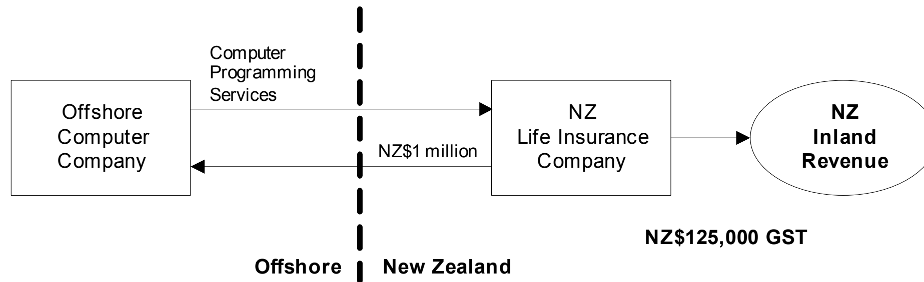
The operation of the reverse charge will not allow the life insurer in example 1 an input tax credit under section 3A, as it has imported services for a principal purpose other than that of making taxable supplies. Even though the imported services are a taxable supply with the life insurer as their deemed supplier, the services have still not been acquired by the life insurer as natural recipient for the principal purpose of making taxable supplies, as section 3A requires.

Mixed-use acquisitions

In some circumstances, a recipient of services subject to the reverse charge will be able to claim either an input tax credit under section 3A or a change-in-use adjustment under section 21F. Subject to section 3A, section 20(2)(d) allows the recipient of a supply subject to the reverse charge to claim input tax credits for that supply if they have self-assessed and returned output tax for that supply. This will occur when the services are not acquired by a solely non-taxable entity – that is, one that does not meet the 95% taxable supplies test.

For example, if a New Zealand company which principally (say, 70%), but not solely, makes exempt supplies, imports services, GST would be payable under the reverse charge but an input tax credit under section 3A would not be available because the company has not acquired the services for the principal purpose of making taxable supplies. However, the adjustment provisions in sections 21E and 21F would apply.

Figure 1: Example of the operation of the reverse charge



Example 1: The application of sections 8(4B) and 5B

An offshore computer company makes a supply of programming services to a New Zealand life insurance company (see figure 1). The life insurance company makes solely exempt supplies of services. It is charged $1 million for the programming services, which it pays on receipt of the services. An invoice is provided after payment is made. The two companies are not associated persons.

Applying sections 8(4B) and 5B to the simple example in figure 1:

- The services are supplied by a non-resident supplier to a resident recipient.
- The services are acquired by a person who:
  - has not, in the 12-month period that ends with the month in which the supply is made, made supplies of which at least 95% in total are taxable supplies, and
  - does not, at the time of the supply, have reasonable grounds for believing that they will, in the 12-month period that begins with the month in which the supply is made, make supplies of which at least 95% in total are taxable supplies.
- The supply of the services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

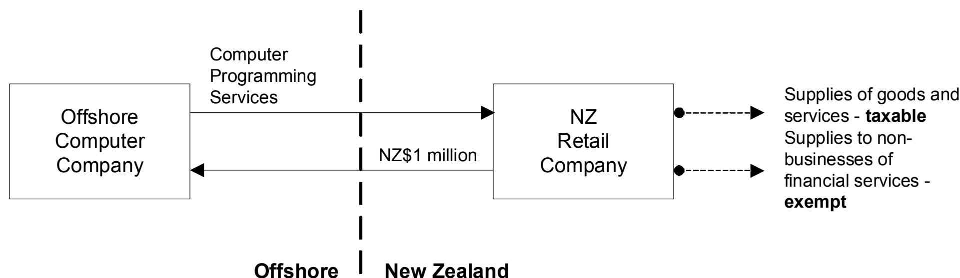
As section 5B treats the New Zealand insurer as the supplier of the $1 million of services for the purposes of section 51, the insurer will be required to register for GST, if it is not already registered. Therefore section 8(4B) treats the supply as having been made in New Zealand, and section 8(1), in conjunction with section 5B, treats the natural recipient as the deemed supplier of the services. This requires the New Zealand life insurer to add GST to the value of the supply and return the GST to Inland Revenue. The value of the supply is $1 million (the consideration for the supply), so GST of $125,000 must be returned to Inland Revenue.

The operation of the reverse charge will not allow the life insurer in example 1 an input tax credit under section 3A, as it has imported services for a principal purpose other than that of making taxable supplies. Even though the imported services are a taxable supply with the life insurer as their deemed supplier, the services have still not been acquired by the life insurer as natural recipient for the principal purpose of making taxable supplies, as section 3A requires.

Section 21E(1)(a) would be applicable because the New Zealand company acquires the imported services for the principal purpose other than that of making taxable supplies. Although the company is treated as the supplier under section 8(1), the company as the natural recipient has still acquired the services and section 5B does not apply for the purposes of the adjustment provisions. Accordingly, the company would not include the import as a supply it has made for the purposes of making an adjustment based on the turnover formula in section 21A.

The requirements of section 21E(2)(a) have also been met, and the section will apply, as tax has been charged under section 8(1) (as a result of the application of the reverse charge under sections 8(4B) and 5B) on the supply of services made to the company. Although the company is treated as the supplier under section 8(1), the supply has still been made to the company as the natural recipient. Therefore section 21F would allow a deduction under section 20(3), which would be made on a period-by-period basis under section 21G. A similar analysis would allow the company an input tax credit under section 3A(1)(a) if it has acquired imported services for the principal purpose of making taxable supplies.

Figure 2: Example of when the reverse charge will not apply



Example 2: When the reverse charge will not apply

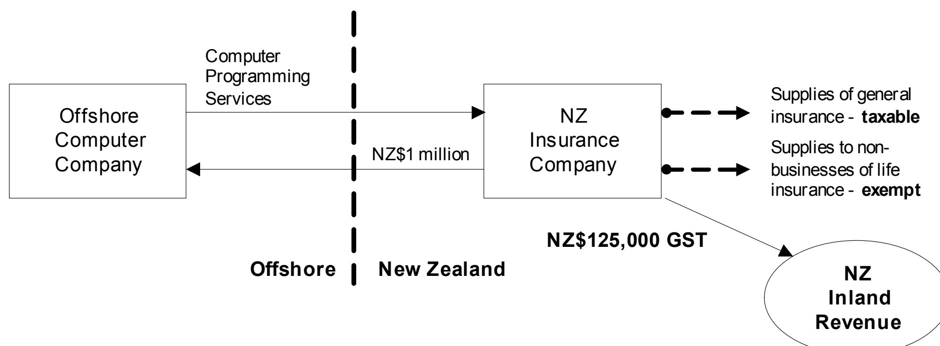
An offshore computer company makes a supply of programming services to a GST-registered New Zealand retail company (see figure 2). The retail company makes a mix of 98% taxable supplies of goods and services and 2% exempt supplies of financial services, such as hire purchase, to non-registered consumers. It is charged $1 million for the programming services, which it pays on receipt of the services. An invoice is provided after payment is made. The two companies are not associated persons.

Applying sections 8(4B) and 5B to the simple example in figure 2:

- The services are supplied by a non-resident supplier to a resident recipient.
- The services are acquired by a person who:
  - **has**, in the 12-month period that ends with the month in which the supply is made, made supplies of which at least 95% in total are taxable supplies, and
  - **does have**, at the time of the supply, reasonable grounds for believing that it will, in the 12-month period that begins with the month in which the supply is made, make supplies of which at least 95 % in total are taxable supplies.

Therefore section 8(4B) will not treat the supply as having been made in New Zealand, as the requirements of section 8(4B)(b) are not fulfilled. This is because the New Zealand retailer makes predominantly (98%) taxable supplies, which is in excess of the 95% threshold in section 8(4B)(b).

Figure 3: Application of the adjustment provisions



Example 3: Mixed-use acquisition – principally exempt

An offshore computer company provides software to a GST-registered New Zealand life insurance company for $1 million (see figure 3). Using a turnover approach, the software is used 70% for making exempt supplies of life insurance, and 30% for making taxable supplies of general insurance. Under the reverse charge, the life insurance company would, therefore, add GST to the $1 million, giving a figure of $1.125 million, and include the GST of $125,000 imposed under the reverse charge in its GST return.

The life insurance company is not entitled to an input tax credit under section 3A in relation to the supply of the computer programming services because it has not acquired the services for the principal purpose of making taxable supplies.

Because the life insurance company uses the software 30% for making taxable supplies, it is entitled to a change-in-use adjustment, and will be able to make a period-by-period deduction from its output tax liability.

The life insurance company would not, however, include the $1.125 million as a supply it has made for the purposes of making the adjustment based on turnover.

Example 4: Mixed-use acquisition – principally (but not 95%) taxable

An offshore computer company provides software to a GST-registered New Zealand life insurance company for $1 million (see figure 3). Using a turnover approach, the software is used 70% for making taxable supplies and 30% for making exempt supplies. The reverse charge will apply, as the software is not acquired by a company which makes taxable supplies amounting to 95% or more of total supplies.

Under the reverse charge, the life insurance company would, therefore, add GST to the $1 million, giving a figure of $1.125 million, and include the GST of $125,000 imposed under the reverse charge in its GST return.

The company will, however, be entitled to a full input tax credit of $125,000 on the importation of the services under section 3A, as they are acquired for the principal purpose of making taxable supplies. It would then be required to make an adjustment on a period-by-period basis for exempt supplies made using the software.

Zero-rating services consumed wholly outside New Zealand

The reverse charge will tax only services that cannot be regarded as being wholly consumed outside New Zealand. In the same way as with the place of supply rules in section 8(2) of the Act, the zero-rating provisions in section 11A, in conjunction with the reverse charge place of supply rule in section 8(4B), will operate to ensure that services that are wholly consumed outside New Zealand are not subject to New Zealand GST.

Thus all zero-rating provisions, except for section 11A(1)(j), apply fully to zero-rate services subject to the reverse charge. Section 11A(1)(j) zero-rates services "... that are physically performed outside New Zealand or are the arranging of services that are physically performed outside New Zealand ..." Some of these services, when supplied to a person in New Zealand, are exactly the services targeted by the reverse charge (for example, computer processing services provided from offshore). Zero-rating all such services would render the reverse charge ineffective, so section 11A(1B) excludes the zero-rating of certain services within the scope of section 11A(1)(j).

When the services are provided to a New Zealand resident who is outside New Zealand, and the services are consumed or received wholly outside New Zealand, zero-rating should apply. For example, if a registered sole trader took a holiday offshore, unconnected to his or her taxable activity, accommodation in a hotel outside New Zealand should be zero-rated. Offshore hotel accommodation provided to a company executive for business purposes should similarly be zero-rated. Section 11A(1)(j), therefore, for the purposes of the reverse charge, still allows such services to be zero-rated.

However, section 11A(1B) will not allow services which are intangible in nature, such as the provision of a legal opinion or feasibility study offshore, to be zero-rated under the modified application of section 11A(1)(j). They will be subject to GST, on the basis that such services cannot be regarded as being wholly consumed offshore.

Example 5: Zero-rating under the reverse charge

A GST-registered New Zealand life insurance company sends an employee to Sydney to collect a legal opinion from an Australian law firm with which it has contracted for advice on a proposed transaction and pays for the employee's accommodation in a Sydney hotel. The life insurance company makes predominantly exempt supplies of services.

The life insurance company is charged $1 million for the legal services, which it pays on receipt of the services. An invoice is provided after payment is made. The life insurance company is charged $500 for the accommodation services, which the employee pays for using a business credit card. The life insurance company is not an associated person of either the law firm or hotel.

Applying sections 8(4B) and 5B:

- The legal and the hotel services are supplied by a non-resident supplier to a resident recipient.
- The legal and hotel services are acquired by a person who:
  - has not, in the 12-month period that ends with the month in which the supply is made, made supplies of which at least 95% in total are taxable supplies, and
  - does not, at the time of the supply, have reasonable grounds for believing that they will, in the 12-month period that begins with the month in which the supply is made, make supplies of which at least 95 % in total are taxable supplies.
- The supply of the legal and hotel services would be a taxable supply if it were made in New Zealand by a registered person in the course or furtherance of their taxable activity.

Therefore section 8(4B) treats the supplies as having been made in New Zealand, and section 8(1), in conjunction with section 5B, treats the natural recipient as the deemed supplier of the services. This would require the New Zealand life insurer to add GST to the value of the supplies and return the GST to Inland Revenue.

However, it needs to be considered whether either of the services can be zero-rated under section 11A, in this instance under section 11A(1)(j), as modified by section 11A(1B). Section 11A(1)(j) zero-rates services subject to the reverse charge, if the services are physically performed outside New Zealand and the nature of those services is such that they can be physically received only at the time and place at which the services are physically performed.

Although it is arguable whether the supply of legal services is "physically received" when the employee collects the opinion, in any event the legal services can be physically received other than at the time and place at which they are physically performed. The Sydney law firm could have delivered the opinion to the New Zealand life insurer either electronically or through the post. The New Zealand life insurer can "use" the opinion at any time and place—indeed, it may be able to use the opinion for a limitless period. The supply of legal services cannot, therefore, be zero-rated and will be subject to GST at 12.5% under the reverse charge, requiring the New Zealand life insurer to return $125,000.

The hotel accommodation services, conversely, can only ever be physically received where they are performed. Therefore these services can be zero-rated under section 11A(1)(j), as modified by section 11A(1B), and the New Zealand life insurer will not have to return GST on the supply.

Therefore section 11A(1)(j) will apply only to zero-rated services under the reverse charge when the services are physically performed outside New Zealand and the nature of those services is such that the services can be physically received only at the time and place at which they are physically performed. While such services would include, for example, hotel accommodation outside New Zealand or a haircut received outside New Zealand, they would not include a legal opinion or accounting services provided for a New Zealand company by a non-resident company. In the latter case, zero-rating would be precluded even if the opinion or accounts were collected from the non-resident company's office outside New Zealand. While this could arguably be regarded as the physical receipt of the legal or accounting services, the physical performance of the legal or accounting services is able to be received anywhere, and not only at the time and place that the services are physically performed.

Example 6: Time of supply

A (offshore parent company) and B (New Zealand subsidiary) are parts of a multinational group. Throughout a year (monthly) A supplies B with administrative and accounting services. B is registered for GST, accounts for GST on a two-monthly taxable period basis and makes solely exempt supplies. B is not charged for these services until after the end of each year, when a lump sum is charged for administrative and accounting services provided by the parent company to all members of the multinational group.

The supply of services will be subject to the reverse charge as it is a supply that would be taxable in New Zealand and it is acquired by a business which makes taxable supplies amounting to less than 95% of total supplies. B's balance date is 30 June, and the end of the taxable period that includes the date that is two months after B's balance date is 31 August.

The time of supply for the services could either be:

Invoice: if A provides B with invoices/an invoice for the services provided before either payment is made or 31 August, the time of supply for the service/services will be when the invoice is issued.

Payment: if B makes payment for the services before either the issue of invoices/an invoice for the supply/supplies or 31 August, the time of supply will be when the payment/payments are made.

Taxable period following balance date: if neither an invoice is issued, nor payment made, before 31 August, then the time of supply will be 31 August. The supply will therefore be included in B's GST return due on 30 September.

Time of supply rules

The normal time of supply rules will generally apply for the purposes of the reverse charge. This means that the time of supply for the reverse charge would be the earlier of when an invoice is issued or payment is made in respect of the supply. If the supply is between associated persons, there may be supplies for which no invoice is issued, or payment is made only at, say, year-end (for example, head office charges). To cater for these circumstances the time of supply test for supplies between associated persons in section 9(2)(a) has been amended by including section 9(2)(a)(iv), which allows the test not to be applied until the end of the taxable period that includes the date which is two months after the recipient's balance date for the year in which the services were performed.

The time of supply for a supply of services between associated parties which is subject to section 8(4B) will, therefore, be the earliest of:

- when an invoice is issued;
- when payment is made in respect of the supply, or
- the end of the taxable period that includes the date which is two months after the recipient's balance date for the year in which the services were performed.

In the case of services supplied under an agreement which provides for periodic payments, section 9(3) treats the services as being successively supplied with each supply taking place when a payment becomes due or is received, whichever is the earlier.

Transitional provisions

Section 84B is a transitional provision to determine the time of supply for supplies which are provided on an ongoing basis and span the introduction of the reverse charge. It is intended to tax only those supplies made on or after the date the reverse charge is introduced. GST will not be charged on the part of a supply which was provided before the introduction of the reverse charge. That part of the supply provided after the introduction of the reverse charge will be subject to the reverse charge. When the time of performance spans the introduction date of the reverse charge an apportionment, on a factual or reasonable basis, is required to determine the proportion of the supply to be taxed.

Section 84B determines the extent of tax liability when the time of the supply of imported services spans the introduction of the reverse charge, and is a modified version of section 84, which applied on the introduction of GST. The section uses the definitions of "time of performance" in section 84(1), (1A) and (1B). Both section 84 and 84B address situations when tax would be either chargeable on supplies received before the introduction date of GST or the reverse charge, or would not be chargeable on supplies received after the introduction date of GST or the reverse charge. These situations arise under the time of supply rules in sections 9 and 21 to 21H (the adjustment provisions which act, in part, as time of supply rules). Section 84B, like section 84, introduces special time of supply rules based on the performance of services.

Time of performance is defined in relation to the supply of services as the time when the services are performed.

Example 7: Value of supply

As part of an international advertising campaign for a multinational group C (an offshore parent company) supplies D (a GST-registered New Zealand subsidiary that makes predominantly exempt supplies) with advertising services. As the advertising services are for a multinational group and most of the costs are absorbed and incurred in other countries in which the company operates, the New Zealand branch is not charged for the services, either explicitly or by way of a cost allocation from the head office.

The supply of services will be subject to the reverse charge as it is a supply that would be taxable in New Zealand and it is acquired other than for solely taxable purposes. Prima facie, as C and D are associated persons, D would have to calculate the market value of the services it has received. However, section 10(3C) would apply so that an uplift in the value of supply to market value is not required, as the cost of the advertising services would have been a deduction for company D under the Income Tax Act 1994. The value of the supply would therefore be zero, and GST at 12.5% on this would result in a zero amount.

Section 84(1A) provides that services are deemed to be performed continuously and uniformly during the whole of that period or those periods over which the services are performed.

Sections 84B(2), (3) and (4) ensure that:

- to the extent that services are deemed to be supplied before the reverse charge comes into effect (by the operation of section 84) the services will not have GST brought into account, and
- to the extent that services that are deemed to be supplied on or after the reverse charge comes into effect (by the operation of section 84) are invoiced or paid for before the reverse charge comes into effect, the services will have the GST brought into account as if the invoicing or payment occurred on the date the reverse charge comes into effect.

Value of supply

The normal rules for determining the value of a supply, other than certain rules for transactions between associated persons, will apply for the purposes of the reverse charge. Applying the normal rules would mean that the value of the supply would be either the actual consideration or the open market value of the supply if it is between associated persons and the actual consideration is less than the open market value of the supply.

The use of the open market value rule for supplies between associated persons, however, could lead to an increase in compliance costs and potentially to a revenue loss if tax deductions resulting from the deemed value of supply were taken into account. The valuation of services for which there is no charge could, in particular, involve substantial compliance costs.

To minimise any compliance costs and revenue loss, the cost basis for supplies between associated parties will be required to be used in the following circumstances:

- if the payment for those services is an allowable deduction to the recipient (section 10(3C)), or
- if the supply is between branches or divisions of the same company to which sections 2A(1)(bb), 8(4B) and 56B apply, and the payment for those services would be an allowable deduction to the recipient if it was a separate entity for income tax purposes (section 10(3D)).

Related party transactions

General position

In many instances, charges for services from an associated overseas business will be incorporated into a larger sum. This may be the case, for example, within a group of companies or single multi-national company, when the parent company or head office may allocate a proportion of its costs to the various parts of the enterprise or charge a management fee (referred to as “internal charges”).

The treatment of internal charges aims to achieve a balance between:

- the objective of imposing the tax on services that, if not taxed, would give rise to distortions
- the need to ensure that the revenue base is maintained, and
- the objective of minimising compliance and administrative costs, by limiting the extent to which the various components of the charge must be identified.

The amendments aim to achieve this balance in part by excluding the salary and interest components of an internal charge so that only the remainder of the charge is subject to the reverse charge.

A related issue is whether a New Zealand entity should be treated as distinct from its offshore parent or head office. This is problematic with branches, as a New Zealand branch, for example, is not a separate legal entity from its head office. The general approach proposed is to treat the New Zealand entity or presence as separate, but only in relation to supplies of services that would be taxable supplies if made in New Zealand by an unrelated registered person.

Example 8: Related party transaction

E is the offshore head office of a multinational company. F is the New Zealand branch of the multinational company. The multinational company supplies financial services. E provides administrative, accounting and management services to F and to other branches in other countries. E recovers the cost of providing these services by making a cost allocation to each branch every year.

F is debited with a cost allocation of $10 million. This covers administrative and management costs but, owing to the minor nature of the accounting costs for the New Zealand branch, F is not allocated any accounting costs, even though it is provided accounting services. Within the $10 million of administrative and management costs, there are the following cost components:

Staff salaries:	$5 million
Financing (interest) costs:	$1 million
Administration costs:	$1.5 million
Management costs:	$2.5 million
Total cost allocation	**$10 million**

Section 8(4C) treats a cost allocation to be a supply of services and deems it to fulfil the requirement in section 8(4B) of a supply by a non-resident to a resident that would be taxable in New Zealand. F has acquired the services other than for the sole purpose of making taxable supplies. Section 56B treats E and F as separate entities carrying on activities so, prima facie, the $10 million cost allocation is subject to the reverse charge. Under section 10(15D), however, components of a cost allocation that are attributable to salaries and interest incurred by E are excluded from the value of the cost allocation subject to the reverse charge. Therefore only $4 million of the cost allocation is subject to the reverse charge.

The accounting services provided to F at no cost are a taxable supply acquired for non-taxable purposes and should, prima facie, be required by section 10(3) to be given a market value so the reverse charge can be applied. However, section 10(3D) would apply so that there is no uplift in the value of supply to market value, as the cost of the accounting services would have been a deduction for F under the Income Tax Act 1994 if it was a separate legal entity for the purposes of that Act.

Therefore the amount subject to the reverse charge is:

Staff salaries:	0 excluded
Financing (interest) costs:	0 excluded
Administration costs:	$1.5 million
Management costs:	$2.5 million
Accounting:	0 no market value uplift required
Total subject to reverse charge:	**$4 million**
GST at 12.5%	
Total GST to be returned:	**$500,000**

The treatment of related party transactions can therefore be summarised as follows:

(i) Start from the principle that the reverse charge should apply to services which would be subject to GST if supplied in New Zealand by a GST-registered person.

(ii) Treat a New Zealand entity or presence as separate from its offshore presence in relation to the services described in (i). This requires:

- treating a New Zealand branch of a non-resident company as a separate entity, and
- not disregarding supplies within a group of companies.

(iii) Calculate the amount of an internal charge that is to be subject to the reverse charge by taking the internal charge and identifying component supplies or values that are excluded from the ambit of the reverse charge—these include salaries, interest and any other exempt supplies.

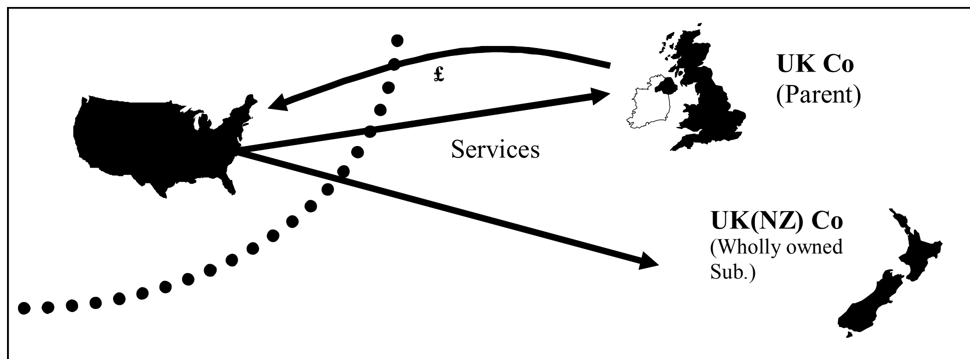
Separating entities

In respect of branches and head offices, section 56B deems the following for the purposes of supplies subject to section 8(4B) in relation to a person:

- a branch or division outside New Zealand to be a separate person and a non-resident
- activities carried on by that non-resident person as being carried on independently by that person

Example 9: Cost allocation

A financial services group with a United Kingdom-based parent (UK Co) and a wholly owned subsidiary in New Zealand (UK(NZ) Co) embarks on an international advertising campaign. UK Co contracts with a US-based public relations firm to arrange the production and screening of a series of generic advertisements in all of the countries in which the group operates, including New Zealand. UK Co allocates a proportion of the costs of the campaign to UK(NZ) Co, which makes only exempt supplies of life insurance services to private consumers.



Total cost of campaign: $10 million
Allocation to UK(NZ) Co: $2 million

Section 8(4C) treats an allocation of costs as a supply of services, deems it to fulfil the requirement in section 8(4B) of a supply by a non-resident to a resident that would be taxable in New Zealand, and treats the cost allocated as being the consideration for the deemed supply. UK(NZ) Co has acquired the services other than for the sole purpose of making taxable supplies. Accordingly, the $4 million cost allocation is subject to the reverse charge. Note that there are no services directly provided by UK Co to UK(NZ) Co (such as administrative services) associated with the advertising services, so there is no carve-out from this amount under section 10(15C).

Therefore the amount subject to the reverse charge is:

Total subject to reverse charge: $2 million
GST at 12.5%

- a branch or division inside New Zealand to be a separate person and resident in New Zealand;
- activities carried on by that person resident in New Zealand as being carried on independently by that person, and
- a head office to be a branch or division.

In respect of groups of companies, section 55(7A) disregards the GST effects of grouping (overriding section 55(7)(a) and (c) to (dc)) for supplies made by a non-resident member of a group to a New Zealand resident member of a group for the purposes of supplies subject to section 8(4B).

Related party charges

Section 10(15C) provides that the value of related party services that are to be subject to the reverse charge under section 8(4B) is reduced by the value of any salary or interest charges from any member of a non-resident company's wholly owned group under section IG 1 of the Income Tax Act 1994, or branches or divisions of the same company under section 56B, that form a part of an internal management services charge. Other exempt components will be excluded from the reverse charge more generally under section 8(4B)(c).

Cost allocations

In some circumstances individual services supplied to a business will not be charged for or identified separately. This may be the case within a group of companies or single multi-national company, when the parent company or head office may, for example, allocate a proportion of its costs to the various parts of the enterprise. The existence of a supply of services may not be easily ascertainable in this situation.

In principle, the nature of the charge, be it a global sum or a specific charge for specific services, should not

affect the GST treatment of any supplies made. An allocation of costs from a non-resident to a resident should be treated as a taxable supply of services. Section 8(4C) achieves this by treating a cost allocation as a supply of services, deeming it to fulfil the requirement in section 8(4B) of a supply by a non-resident to a resident that would be taxable in New Zealand, and treating the cost allocated as being the consideration for the supply. This ensures that a charge by an offshore-related entity is subject to the reverse charge except to the extent that certain excluded amounts can be identified.

The zero-rating provisions will ensure that services which can definitively be said to be consumed outside New Zealand are not taxed under the proposed cost allocation provision. This is because the cost allocation provision, as with the general reverse charge rule, will be subject to the zero-rating provisions of the Act, as modified by section 11A(1B). The exclusions in section 10(15C), which reduces the total amount subject to the reverse charge by the value of any salary or interest charges from any member of a non-resident company's wholly owned group under section IG 1 of the Income Tax Act 1994, or branches or divisions of the same company under section 56B, will also apply to cost allocations. Other exempt components will be excluded from the reverse charge more generally under section 8(4B)(c).

Documentation requirements

In the absence of invoices, alternative supporting documentation, such as a supply contract or record of payments made, will be allowed to substantiate the valuations adopted for the purposes of the reverse charge. It is necessary to be able to ascertain whether output tax has been charged on the correct value for a supply, particularly in relation to amounts excluded from the reverse charge under section 10(15C).

Section 24B requires any recipient of a supply of services subject to section 8(4B) to maintain sufficient records of the supply to enable the following to be ascertained:

- the name and address of the supplier;
- the date on which, or the period during which, the supply was received
- a description of the services supplied
- the consideration for the supply
- the time by which payment of the consideration for the supply is due, and
- the amount of the consideration for a supply that the taxpayer has treated as not affecting the value of the supply under section 10(15C)(a) and (b) (that is, salary and interest).

TRANS-TASMAN IMPUTATION

Sections ME 1B, ME 1C, ME 4, 5, 9, 11, 12, NF 2, NH 2, and OB 1 of the Income Tax Act 1994; sections 29, 43, 67, 69, 139 and 142 of the Tax Administration Act 1994

Introduction

The imputation rules have been amended to include Australian resident companies within its scope. This is part of a bilateral agreement with the Australian Government which has seen New Zealand-resident companies included within the Australian imputation rules.

Australian and New Zealand shareholders of trans-Tasman companies that choose to take up these reforms can now be allocated imputation credits representing New Zealand tax paid and franking credits representing Australian tax paid, in proportion to their ownership of the company. However, each country's credits can be claimed only by its residents.

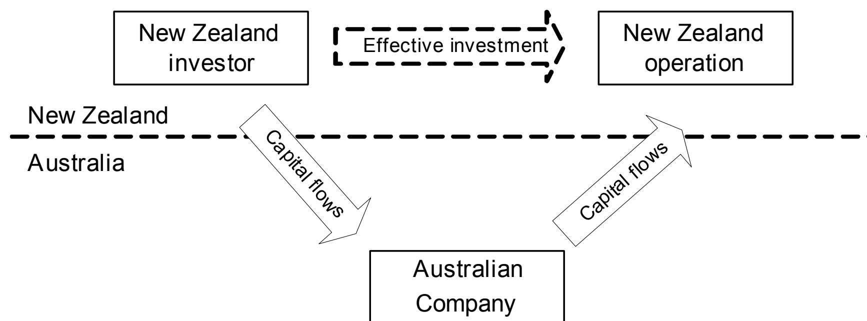
Background

The New Zealand and Australian reforms have been made to resolve the "triangular tax" problem between Australia and New Zealand. "Triangular tax" arose when investors made equity investment in their own country through a company resident in the other country. Figure 1 sets out an example of a New Zealand investor in an Australian company which in turn invests into New Zealand.

In the 1980s, when imputation rules were introduced in both Australia and New Zealand, these policies did not cause concern as Australians primarily invested into Australian companies and New Zealanders primarily invested into New Zealand companies. Since then, with the development of globalisation, generally, and Closer Economic Relations (CER), in particular, there has been a greater level of cross-investment between the two countries. This increased level of trans-Tasman cross-investment highlights the issue that Australia and New Zealand had been respectively imposing two layers of tax upon the same underlying income.

A pro rata allocation solution was chosen by both governments as it is the only method that apportions the tax benefits on the basis of the shareholders' ownership, consistent with both countries' current policy on imputation. Shareholders have the right to a proportion of the total income of a company rather than to a specific income source derived by the company. It seemed appropriate, therefore, that the credit allocation rules continued to require a company paying a dividend to attach the same proportion of each type of credit to each dividend that it pays.

Figure 1: New Zealand investor in an Australian company that invests into New Zealand



Relief from "triangular tax" based on a pro rata allocation of imputation credits sees dividends paid by an Australian or New Zealand company potentially having both an Australian and a New Zealand imputation credit attached. Subject to the respective countries' rules on the maximum allocation of credits (maximum ratio), the imputation credits would be allocated to shareholders in proportion to their shareholding in the company.

In New Zealand, the pro rata allocation method is being put into practice by allowing Australian companies to elect into the existing New Zealand imputation rules. This allows Australian companies that elect to maintain an imputation credit account and pay New Zealand tax to pass on that tax in the form of imputation credits on a pro rata basis to their shareholders.

Australia has passed similar legislation, to allow New Zealand companies to elect into the existing Australian imputation rules.

"Triangular tax" was a consequence of Australia's and New Zealand's policies of allowing only:[6]

- tax paid in their country to generate imputation credits, and
- resident companies to pass on imputation credits to their shareholders.

Key features

- New section ME 1B of the Income Tax Act 1994 allows Australian resident companies to elect to maintain an imputation credit account.
- New sections ME 4(1C), ME 4(2C), ME 5(1B), ME 5(2B), ME 11(1C), ME 11(2C), ME 12(1B) and ME 12(2B) allow payments and refunds of non-resident withholding taxes by Australian companies to be entries to the imputation credit account.
- New section 29(1B) of the Tax Administration Act requires Australian companies attaching imputation credits to dividends to describe them as "New Zealand imputation credits".

Application dates

With the exception of the rules which allow Australian companies to pay imputed dividends, all other amendments apply from 1 April 2003. The amendments allowing Australian companies to pay imputed dividends apply from 1 October 2003.

Detailed analysis

Election to maintain an imputation credit account – section ME 1B

This is the key section for Australian companies wishing to become an Australian imputation credit account company. The administrative requirements for making a valid election were set out in *Tax Information Bulletin* Vol 15, No 11 November 2003.

The legislative requirements are that an election by an Australian company to join the New Zealand imputation rules will be conditional upon:

- Its meeting the existing eligibility criteria to maintain an imputation credit account. That is, it is not otherwise excluded from eligibility under section ME 1(2)(c)-(i).
- Its Australian residence being determined by a new provision in section OB1 which tests whether the company is "resident in Australia". The new provision uses the New Zealand residence rules in section OE 2(1) but with application to Australia.
- Neither an Australian nor a New Zealand double tax agreement treating the company as not resident of either Australia or New Zealand.

[6] Australia's and New Zealand's current imputation models are not alone in this feature. It is common international practice.

If the Australian company is not already a New Zealand taxpayer, an IRD number will be issued for the maintenance of the imputation credit account.

New election forms

- *Election to form an imputation group (IR 473)*: to be used to provide written notice that a group of companies wishes to elect to form an imputation group.
- *Trans-Tasman imputation election form (IR 488)*: to be used for Australian companies wishing to elect to maintain a New Zealand imputation credit account.

30 days' notice of election required

The Australian company must give 30 days' notice to the New Zealand Commissioner of Inland Revenue that it elects to maintain an imputation credit account. An imputed dividend can be paid only after the notice period has passed, or 1 October 2003, whichever is later. For all other purposes, the start date is retrospective to the beginning of the imputation year in which the Commissioner receives the election.

Examples

On 30 March 2004 an Australian company notifies the Commissioner that it elects to maintain an imputation credit account. This is effective for the purposes of paying an imputed dividend from 29 April 2004, but the company may maintain an imputation credit account from 1 April 2003.

On 1 August 2003 an Australian company notifies the Commissioner that it elects to maintain an imputation credit account. This is effective for the purposes of paying an imputed dividend from 1 October 2003, but the company may maintain an imputation credit account from 1 April 2003.

Revocation of election or cessation of eligibility

Such an election may later be either revoked by the company at any time or lapse if the company ceases to be eligible to maintain an imputation credit account but is effective, for all purposes other than paying imputed dividends, until the end of that imputation year. Either a revocation or a cessation of eligibility will mean that the Australian company will cease to be an imputation credit account company.

The effect is that under section ME 5(1)(k), a debit will arise in the account to the extent there is a credit balance—meaning that on revocation or cessation of eligibility, the company will lose its existing imputation credits. Such credits cannot be reinstated if it re-elects to maintain an imputation credit account or its eligibility is restored and a re-election can be made.

Imputed dividends cannot be paid either from the date the Commissioner receives the revocation or from the date that eligibility ceases. Neither the revocation nor the lapse in eligibility will affect the obligations of the Australian company that arose while the company was maintaining an imputation credit account.

The Commissioner has the discretion to revoke a company's election in the event of an actual or potential breach in the imputation rules, including:

- non-payment of further income tax, penalties and interest without entering into an arrangement with Inland Revenue to remedy the default
- non-filing of imputation returns, or
- the Commissioner has reasonable grounds to believe the Australian company will incur and default on a liability to further income tax, penalties and interest.

The Commissioner also has a discretion not to accept the re-election of any company whose election has been revoked previously if the company cannot satisfy the Commissioner that the reasons for revocation will not occur again. A revocation by the Commissioner is also effective immediately for the purposes of paying imputed dividends, but for all other purposes it is effective from the end of that imputation year.

Such discretions are necessary given the difficulties the Commissioner would have in collecting tax arrears in a country other than New Zealand.

Joint and several liability

For the same reason, all companies that are in the same wholly owned group as the Australian company that has elected to maintain an imputation credit account will be jointly and severally liable for any further income tax, penalties and interest as the company that incurred the liability. Such joint and several liability will generally be invoked only in the event of a default by the Australian company.

The exception to the requirement for joint and several liability is when the companies within the wholly owned group are prohibited by an independent regulator from having such a joint and several liability with the company maintaining an imputation account.

Consequential amendments

Such companies that have a valid election will be defined as "Australian imputation credit account companies" in section OB 1. The definition of "imputation credit account" in section OB 1 has been expanded to include accounts maintained under section ME 1B. The definition of "imputation credit account company" has also been expanded to include companies that are required to maintain an imputation credit account under section ME 1B.

Continuing legislative requirements for imputation

Annual imputation return – section 69 of the Tax Administration Act 1994

An imputation return (IR 4J) must be filed annually regardless of the balance of the account at the end of the imputation year. Entries to the account are to be made in New Zealand dollars

Imputation year – section OB 1 of the Income Tax Act 1994

Regardless of a company's balance date, all companies in New Zealand's imputation system have a balance date of 1 April to 31 March for the purposes of imputation. This is known as the imputation year.

Shareholder dividend statement – section 29 of the Tax Administration Act 1994

Every time a company pays a dividend, it must provide to the shareholder receiving the dividend a shareholder dividend statement which includes the amount of the dividend, the amount of any imputation credits attached and the amount of any withholding taxes deducted.

Company dividend statement – section 67 of the Tax Administration Act 1994

Every time a dividend is declared a company dividend statement is required. It provides a summary of information that includes:

- the number of shares that received a dividend or bonus issue
- the date the dividend is declared and the date paid
- the total amount of imputation credits attached, and
- the imputation ratio.

These statements may be filed once a year with the annual imputation return (IR 4J)

Ratio change declaration – section GC 22 Income Tax Act 1994

The benchmark dividend is the first dividend paid. All subsequent dividends must attach imputation credits in the same ratio as the benchmark dividend. Companies can subsequently change the ratio attached to dividends only if an officer of the company declares that the change is not part of an arrangement to obtain a tax advantage. A *Ratio change declaration (IR 407)* form is available for this purpose and should be filed before payment of the subsequent dividend.

Additional credits and debits to an Australian company's imputation credit account

As well as the existing provisions in sections ME 4, 5, 11 and 12 new subsections ME 4(1C), ME 5(1B), ME 11(1C), and ME 12(1B) have been added to enable the following tax payments by the Australian company to create an imputation credit, and any refunds to create an imputation debit:

- non-resident withholding tax on interest, dividends or royalties
- non-resident contractors' withholding tax
- non-resident shippers' tax
- non-resident film renters' tax; and
- non-resident insurers' tax.

As these payments represent tax paid in New Zealand by an Australian company, it is appropriate that they also create imputation credits in the same way as payments of income tax or the receipt of imputation credits.

New subsections ME 4(2C), ME 5(2B), ME 11(2C), and ME 12(2B) have been added to clarify that the date the imputation credit or debit arises is the date the tax is paid or refunded respectively.

New subsections ME 4(1D) and ME 11(1D) have been added to ensure that these new provisions, when combined with the original provisions for creating imputation credits, do not create imputation credits that exceed the amount of tax originally paid.

Payment of dividend in Australian dollars

New section ME 1C has been added to allow Australian companies, when paying an Australian dollar dividend, to use the New Zealand dollar equivalent at the time of declaring the dividend for all purposes of the imputation rules. This concession is dependant on there being no more than three months between the declaration and the payment of the dividend.

In the event that an Australian imputation credit account company also has a requirement to deduct resident withholding tax from an Australian dollar dividend, section NF 2(3)(b) has been amended to allow the

Australian company to use the conversion rate specified in section ME 1C. While such an obligation may be rare, it could arise when the Australian imputation credit account company is also a New Zealand resident company – that is, a dual resident.

Even if the dividend is made in Australian dollars, the entries to the imputation credit account must be in New Zealand dollars.

Dividend withholding payment

Item c in the formula in section NH 2(1) has been amended to allow imputation credits attached to a dividend to reduce a dividend withholding payment liability on Australian dividends when no underlying foreign tax credits are available.

Further income tax

New subsection ME 9(5D) allows an Australian company that pays further income tax under section ME 9 but does not have a New Zealand income tax liability to gross up the tax paid into a loss, and transfer the loss to another group company.

The reason for grossing up the tax into a loss is that if the further income tax payment were simply transferred to another group company, the group company could have the tax payment refunded if it had sufficient imputation credits to comply with section MD 2.

Compliance requirements

New subsection 29(1B) has been added to the Tax Administration Act 1994 to require an Australian company paying a dividend with an imputation credit attached to specifically use the term "New Zealand imputation credit" on the shareholder dividend statement. This is because the term "imputation credit" is also used in Australia with respect to Australian credits of company tax attached to dividends.

New subsection 69(1B) requires an Australian company that maintains an imputation credit account but does not have to file a return of income to file its annual imputation return by 31 July following the end of an imputation year. The due date for further income tax will remain at 20 June for such companies.

Sections 139(A)(1) and 142(1)(d) have been amended to impose a late filing penalty of $250 on Australian companies that do not file their annual imputation account returns on time.

Subsections 43A(4) and (5), which can exclude companies from filing annual returns, has been amended to apply to New Zealand companies only.

New subsection 67(1)(eb) requires that Australian companies that pay dividends in Australian dollars show the applicable exchange rate on the company dividend statement when calculating the imputation ratio.

IMPUTATION GROUPING

Subpart FDB, sections ME 10-14, 18-20, 26, 28-29, NH 6 and OB 1 of the Income Tax Act 1994; section 74 of the Tax Administration Act 1994

Introduction

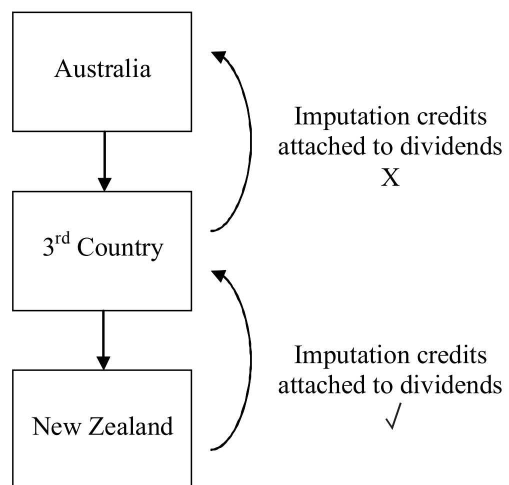
As part of the trans-Tasman imputation reform, a new form of grouping for imputation purposes has been created. This is an attempt to mitigate the problem that imputation credits cannot pass through companies that are not resident in either Australia or New Zealand. Imputation grouping is based on the previous consolidation provisions for imputation. As companies within the imputation rules, Australian companies may also elect to form an imputation group.

Imputation grouping will enable any Australian or New Zealand company within a wholly owned group to pay an imputed dividend if tax has been paid, or imputation credits received from companies outside the group, by any Australian or New Zealand company within the group. It will not, therefore, be necessary to pay a dividend up the chain of companies for the top company to access imputation credits created further down the chain.

Background

Imputation grouping has been introduced as part of the reform in an attempt to mitigate what has become known as the "third country issue", illustrated in figure 1. The issue is that imputation credits cannot flow through countries other than Australia or New Zealand.

Figure 1: The third country problem

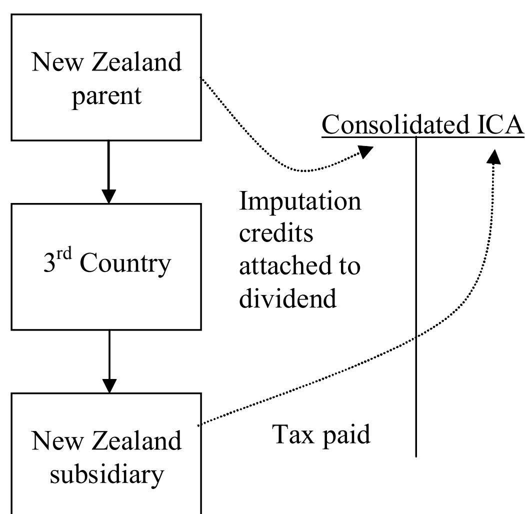


Previous consolidation provisions for imputation

To treat trans-Tasman and New Zealand structures alike, the option chosen by the New Zealand Government was one based on that which was available to New Zealand groups under the consolidation rules. Under those rules, there is no requirement that the chain of wholly owned companies be New Zealand-resident; the requirement is simply that the companies which consolidate are New Zealand resident.

This means that tax paid by any of the New Zealand consolidated companies can go to a single consolidated imputation account, which any consolidated company can use to impute a dividend.

Figure 2: Example of current imputation mechanism for consolidated groups



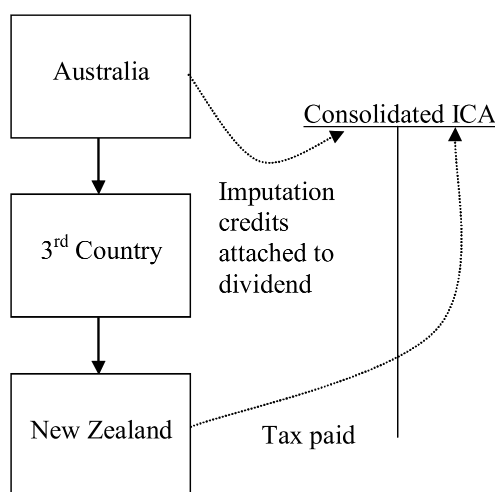
Even under consolidation, if a dividend is to be paid from the New Zealand subsidiary to the third country company, and the third country company is to receive a supplementary dividend, imputation credits must be attached.

The attachment of imputation credits causes a debit to the consolidated group's imputation credit account, but as the third country company is not a member of the consolidated group, the imputation credits it receives cannot form a credit to the consolidated account.

This is appropriate because the loss of imputation credits as the dividend leaves New Zealand ensures that New Zealand tax is always paid on the underlying income.[7]

This is similarly a feature in the rules relating to imputation groups. To pay a supplementary dividend to the third country company, imputation credits must be attached and an imputation debit made to the imputation credit account of the imputation group. There will be no credit to the group's imputation credit account when the dividend is received by the 3rd country company.

Figure 3: Example of proposed mechanism for imputation groups



Key features

- New subpart FDB incorporates the concept of imputation grouping within the Income Tax Act 1994. The effect is that any company in the imputation group can attach imputation credits if tax has been paid by another group member.
- A new concept of "consolidated imputation group" has been introduced. It is defined in section OB 1 as including imputation groups, resident imputation subgroups and consolidated groups no member of which is a member of an imputation group. The previous sections ME 10 to ME 14, which used to apply to consolidated groups, have been renamed to apply to "consolidated imputation groups".
- Under new section FDB 3(1) resident imputation subgroups are formed when the imputation group contains both New Zealand and Australian members—a trans-Tasman imputation group. It is a mechanism to ensure that tax is paid on all New Zealand dividends. New section ME 10(1D) ensures that all entries in the trans-Tasman imputation group that relate to a New Zealand member are also made in the resident imputation subgroup.

[7] More specifically, it is the subsequent further income tax liability, if the account is not brought to balance by 31 March, that ensures New Zealand tax is always paid on the underlying income.

Glossary of new terms

Imputation group – a group of wholly owned companies resident in Australia or New Zealand that have elected under subpart FDB to be one group for the purposes of imputation only

Trans-Tasman imputation group – an imputation group that contains Australian and New Zealand member companies. The New Zealand members must also form a resident imputation subgroup.

Resident imputation subgroup – the imputation group that consists of the New Zealand members of a trans-Tasman imputation group.

Consolidated imputation group – an umbrella term that includes all imputation groups, resident imputation subgroups and groups that have consolidated under subpart FD but whose members have not also elected to be part of an imputation group.

Nominated company – must be a member of the imputation group. If the imputation group is also a trans-Tasman imputation group, the nominated company must be a New Zealand resident. This New Zealand company will also be the nominated company for the associated resident imputation subgroup.

Detailed analysis

Main features of imputation grouping

Eligibility for imputation grouping is similar to eligibility for consolidation generally and is based on those rules.

The main differences between the previous consolidation provisions for imputation and the new imputation grouping provisions are:

- Australian companies that have elected to maintain an imputation credit account are also eligible to group (section FDB 1(a)).
- Members of a consolidated group may also be part of an imputation group so long as all members of the consolidated group join the imputation group (section FDB 1(e)).
- Members of more than one consolidated group may be part of an imputation group so long as the existing credits in the consolidated imputation accounts have the same shareholder continuity profile (section FDB 1(2)).
- An imputation group is formed and eligible companies join an existing imputation group for the beginning of the imputation year in which the Commissioner receives the notice of election (section FDB 2(5)).
- Imputation groups with Australian and New Zealand members, known as trans-Tasman imputation groups, must also form a resident imputation subgroup consisting of the New Zealand members of the trans-Tasman group section FDB 3(1) and section OB 1 definitions of "resident imputation subgroup" and "consolidated imputation group". An imputation group does not need to have Australian members—it is quite possible for it to consist only of New Zealand companies. Examples of the operation of trans-Tasman imputation groups are found later in this article.

New election form

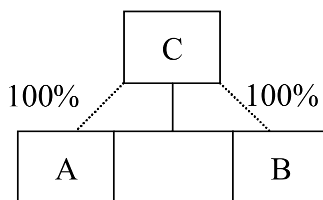
Election to form an imputation group (IR 473): to be used to provide written notice that a group of companies wishes to elect to form an imputation group.

The other key issues affecting imputation groups are:

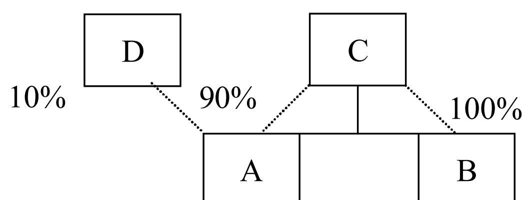
- Although two or more companies are eligible to form an imputation group (section FDB 2(1) and (2)), it may continue to exist if the group is reduced to one member (section FDB 3(2)) and that member is itself the nominated company (section FDB 5(3)).
- All members of the imputation group are jointly and severally liable for further income tax, penalties and interest incurred by any member of the imputation group (section FDB 4).
- The nominated company must be a member of the imputation group, and if the imputation group is also a trans-Tasman imputation group, the nominated company must be a New Zealand company. The same company must also be the nominated company of the associated resident imputation subgroup (section FDB 5(2)(b)).
- If a New Zealand member leaves an imputation group that is a trans-Tasman imputation group, it will also leave the resident imputation subgroup. This is because when the New Zealand member leaves the trans-Tasman imputation group, it will no longer be included within the definition of "resident imputation subgroup" in section OB 1.
- Section FDB 6 sets out the provisions for leaving an imputation group, which generally allow that a company leaving a group does so either on the date specified on the notice of election to cease to be an imputation group member or the beginning of the imputation year in which the notice is received by the Commissioner. Similarly, for a company ceasing to be eligible to be a member, the departure from the imputation group occurs either on the day eligibility ceases if an election is made under subsection 7 or from the beginning of the imputation year in which the cessation of eligibility arose.

Example of different shareholder continuity profiles

Consolidated group A and B now are both wholly owned by C.



Consolidated group A had previously been owned 90% by C and 10% by D, with C subsequently buying out D's 10% share.



Consolidated group B, however, has always been owned by C.

Consolidated group A is more likely to be subject to a future continuity breach with respect to future ownership changes on the credits that arose before the ownership change than consolidated group B is.

Thus there is a different shareholder continuity profile for the credits in A from B, so it would not be appropriate to allow those credits to be combined in one account. In this situation the members of consolidated groups A and B would not be entitled under section FDB 1(2) to form one imputation group.

However, if A had no residual credits from the previous ownership structure and all the credits in its account arose after C bought out D, A can be part of the same imputation group as members of consolidated group B.

Alternatively, once the imputation account of consolidated group A no longer contains credits from the time when C owned only 90%, the members of the two consolidated groups may be part of the same imputation group.

Otherwise, sections ME 11 to 14, which previously applied to consolidated groups, apply to consolidated imputation groups, except as amended for payments of:

- non-resident withholding tax on interest, dividends or royalties
- non-resident contractors' withholding tax
- non-resident shippers' tax
- non-resident film renters' tax, and
- non-resident insurers' tax.

Opening balances of the imputation groups' imputation credit accounts

Except when the imputation group is formed by one or more consolidated groups, the opening balance of the group's imputation credit account is nil (section ME 10(2)(a)).

To simplify the interface between consolidation and imputation grouping, the imputation credit account of a consolidated group that forms an imputation group without members of other consolidated groups becomes the imputation credit account of the new imputation group (section ME 10(1B)). This is to prevent groups having to continue to maintain an imputation credit account of the consolidated group as well.

Similarly, when more than one consolidated group forms or joins an imputation group, all the entries in the consolidated group become entries in the imputation credit account of the imputation group (section ME 10 (1C)). Such a combination is possible only because of the restriction on more than one consolidated group forming an imputation group except if their credits have the same shareholder continuity profile.

In either case, when the consolidated group forms or joins an imputation group that is a trans-Tasman imputation group, the equivalent provisions apply to the associated resident imputation subgroup (section ME 10(1D)(a)).

When there is only one consolidated group, its account becomes the account of the trans-Tasman imputation group as well as imputation credit account of the resident imputation subgroup. When more than one consolidated group form a trans-Tasman imputation group, all the debits and credits in the consolidated group's imputation credit accounts also become entries in the resident imputation subgroup's imputation credit account.

New section ME 10(1E) provides that if an imputation group consisting of New Zealand members only subsequently consolidates for income tax purposes and no longer wishes to be an imputation group, the imputation credit account used by the imputation group will continue and become the imputation credit account of the consolidated group.

This is further discussed in the later examples of the operation of the new imputation grouping provisions.

Interface with dividend withholding payment, policyholder credit account and existing consolidated group rules

Consequential amendments have been made to cater for the interface between individual policyholder credit account or dividend withholding payment account companies as well as consolidated groups containing a policy holder credit account or a dividend withholding payment account that may also be part of an imputation group. The concept of grouping for imputation without consolidation has not been extended beyond imputation. The only way to group for dividend withholding payment or policyholder credit account purposes is to consolidate for income tax purposes.

Therefore changes were made to sections ME 14, 18-20, 26, 28-29 and section NH 6(6), as well as subsections e, f, g, and k of section ME 11(1) and subsections b, f, m and n of section ME 12.

These amendments ensure that any transfers that were made to or from an imputation credit account of a policyholder credit account or dividend withholding payment account company are now made to the imputation credit account of the respective imputation group.

Refunds

The current effect of section MD 2, modified by section ME 14(5) for consolidated groups, is that a company or consolidated group cannot receive a refund if that refund would cause the imputation credit account to go into debit.

These provisions, however, envisage that for every company or consolidated group there will be an imputation return, but for imputation groups this is no longer the case. While the individual companies will still have an individual income tax liability, only one imputation return will be required for the group.

Section ME 14(6) has been added to allow the effect of section MD 2 to continue to apply but with the imputation group monitoring its compliance with section MD 2 rather than the Commissioner doing so. Thus the original concept will continue to apply to imputation groups but on a self-assessment basis.

Companies within an imputation group can now request a refund only if section MD 2 is complied with should references in that section to the company's imputation credit account be references to the imputation group's imputation credit account.

Should a company within an imputation group receive a refund without requesting it, the usual procedure applies: the company has the choice of either returning it to Inland Revenue or filing an updated imputation credit account that complies with section MD 2, under section 70(3) of the Tax Administration Act.

Filing of imputation credit accounts of consolidated imputation groups

Section 74 of the Tax Administration Act 1994 has been amended to apply to consolidated imputation groups generally rather than just consolidated groups, as it was before the introduction of imputation grouping.

There is an exception, however, for resident imputation subgroups. While they must still prepare an annual imputation return, they will be required to file it only if they have a further income tax liability under section ME 14(3).

Trans-Tasman imputation groups and resident imputation subgroups

As discussed earlier, imputation groups that have both Australian and New Zealand group members are to be known as trans-Tasman imputation groups (new definition in section OB 1).

To ensure that New Zealand tax is returned on all dividends paid offshore, imputation groups having both Australian and New Zealand members—trans-Tasman imputation groups—are also required to maintain a resident imputation subgroup, consisting of the New Zealand members only.

Without a resident imputation subgroup operating alongside a trans-Tasman imputation group, it would be possible for income to leave New Zealand without any tax being paid in New Zealand.

This would arise through a trans-Tasman imputation group paying a dividend to Australia, attaching imputation credits[8] and debiting the imputation credit account of the trans-Tasman imputation group accordingly.

When the dividend was received by the Australian company, it would then credit the imputation credit account of the trans-Tasman imputation group with the attached imputation credits,[9] bringing the account back

[8] To pay a supplementary dividend.

[9] And the non-resident withholding tax deducted.

into balance. Thus untaxed New Zealand income could leave New Zealand without any New Zealand tax being paid at all.

By having a resident imputation subgroup consisting of the New Zealand members of the trans-Tasman imputation group as well as the trans-Tasman imputation group itself, this problem is prevented.

If no New Zealand tax has been paid by the trans-Tasman imputation group, when a New Zealand resident member pays a fully imputed dividend to an Australian member both the trans-Tasman imputation group's imputation credit account and the resident imputation subgroup's imputation credit account are debited with the amount of imputation credits attached.

When the dividend is received by the Australian company, the attached imputation credits are credited only to the trans-Tasman imputation group's imputation credit account.

Should that debit balance remain in the resident imputation subgroup's imputation credit account at 31 March, further income tax will be payable. When the further income tax is paid, both the trans-Tasman imputation group's imputation credit account and the resident imputation subgroup's imputation credit account will be credited with this payment. This ensures that tax is ultimately returned on all dividends paid from New Zealand to Australia.

Legislative provisions

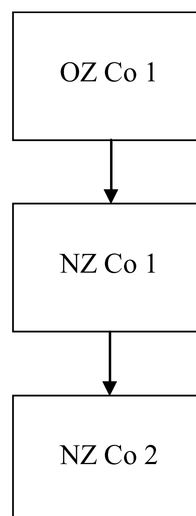
Section FDB 3(1) provides that the resident imputation subgroup consists of all the New Zealand resident members of the trans-Tasman imputation group. All entries that subsequently arise to the trans-Tasman imputation group that, had the imputation group not been formed, would have been entered in an imputation credit account of a New Zealand member must also be entered into the resident imputation subgroup's imputation credit account.

This arises because resident imputation subgroups are also consolidated imputation groups. Therefore sections ME 11 and 12 apply to ensure that any entries that arise from any of the New Zealand members of the trans-Tasman imputation group also occur in the imputation credit account of the resident imputation subgroup.

To ensure further clarity of this result, section ME 10 (1D) reinforces that all entries relating to a New Zealand member of a trans-Tasman imputation group are also entries to the imputation credit account of the resident imputation subgroup.[10]

Example of how a trans-Tasman imputation group and a resident imputation subgroup will work

OZ Co 1, NZ Co 1 and NZ Co 2 are all part of a wholly owned group of companies and wish to form a trans-Tasman imputation group.



As the group contains Australian and New Zealand members, it is a trans-Tasman imputation group, and the New Zealand members, NZ Co 1 and NZ Co 2, must also form a resident imputation subgroup.

[10] Section ME 4 (1D) ensures that ME 10 (1D) is for clarity only and doesn't allow two credits to arise from the one underlying entry.

Both groups start the imputation year with a zero balance in their respective imputation credit accounts. NZ Co 1 then pays to OZ Co 1 a:

- $67 dividend, and
- $11.82 supplementary dividend,

  with
- $11.82 of non-resident withholding tax deducted, and
- imputation credits of $21.18 attached.

On paying the supplementary dividend, NZ Co 1 receives a foreign investor tax credit of $11.82.

Looking first at the dividend coming from the New Zealand company, the imputation credits attached and the foreign investor tax credit create debits to both the trans-Tasman imputation group's imputation credit account and the resident imputation subgroup's imputation credit account.

Payment of dividend from NZ Co 1 – imputation entries

	Trans-Tasman imputation group ICA (debit)	Trans-Tasman imputation group ICA (credit)	Resident imputation subgroup ICA (debit)	Resident imputation subgroup ICA (credit)
Imputation credits attached	**21.18**		**21.18**	
Foreign investor tax credit	**11.82**		**11.82**	

Then looking at the receipt of the dividend by OZ Co 1 with $11.82 non-resident withholding tax deducted and $21.12 imputation credits attached.

Credits are made only to the trans-Tasman imputation group's imputation credit account as the receipt of the dividend relates only to the Australian company OZ Co 1.

Receipt of dividend by OZ Co 1 – imputation entries

	Trans-Tasman imputation group ICA (debit)	Trans-Tasman imputation group ICA (credit)	Resident imputation subgroup ICA (debit)	Resident imputation subgroup ICA (credit)
	21.12		21.12	
	11.82		11.82	
Imputation credits received		**21.12**		
NEWT deducted		**11.82**		

No other transactions take place throughout the imputation year. At the end of the year the resident imputation subgroup's imputation credit account has a debit balance of $33, so further income tax of $33 is payable.[11] When the further income tax is paid, a credit arises to both imputation credit accounts.

The trans-Tasman imputation group's imputation credit account now has a credit balance of $33, which can be distributed to the ultimate shareholders. This is the right result as $33 of New Zealand tax has been paid.

[11] Plus imputation penalty tax.

Payment of further income tax by the resident imputation subgroup – imputation entries
Trans-Tasman imputation group

Trans-Tasman imputation group ICA

	Debit	Credit
	21.18	
	11.82	
		21.18
		11.82
Further income tax paid		**33.00**

Resident imputation subgroup ICA

Debit	Credit
21.18	
11.82	
	33.00

Examples of the operation of the new imputation grouping provisions

An existing consolidated group does not wish to form an imputation group.

Other than the change in terminology in sections ME 10 onward, there are no changes to existing consolidated groups for imputation. They are now a consolidated imputation group as no members of the consolidated group are also in an imputation group.

They continue to apply the existing provisions in sections ME 10 onward that have been renamed as applying to consolidated imputation groups.

New Zealand members, that have not consolidated, of a wholly owned trans-Tasman group of companies now wish to group for imputation purposes only.

The New Zealand members of the trans-Tasman group can form an imputation group under subpart FDB and apply the provisions in sections ME 10 onward relating to consolidated imputation groups.

A resident imputation subgroup is not required as this imputation group does not include both New Zealand and Australian members, so it is not a trans-Tasman imputation group.

The opening balance of the imputation account of the imputation group will be nil as it is not formed from members of a consolidated group (section ME 10(2)(a)).

All the debits and credits of the members will go to the imputation group's imputation credit account once the imputation group has formed (subsections ME 11 and ME 12).

The pre-grouping balances of the members' individual imputation credit accounts are not transferred to the imputation group's imputation credit account, but remain separate until such time as the group's imputation credit account has a debit to its account which it cannot offset by an existing credit.

In such a case, and subject to shareholder continuity being maintained, a credit may be transferred from one of the members' individual imputation credit account to the imputation group's imputation account, to the extent of the debit balance (subsections ME 13(2) to (4)).

An existing consolidated group wishes some members of its consolidated group together with some Australian wholly owned group members to consolidate for imputation only.

This is not permitted as an imputation group must include either no members of an existing consolidated group or all the members of an existing consolidated group (section FDB1(e)). This is to prevent a wholly owned group of companies having access to two imputation credits for one payment of tax, once through an imputation group and again through a consolidated group's imputation account.

The members of several consolidated groups wish to form an imputation group. The imputation group will have no Australian members.

The nominated company or companies of the consolidated groups that wish to form an imputation group must give the Commissioner notice to this effect (section FDB 2(3)).

The members of the consolidated groups will be eligible to be members of the imputation group only if all members of the respective consolidated groups are also part of the imputation group (section FDB 1 (e)).

The consolidated groups themselves will be entitled to be in the same imputation group only if the existing imputation credits have the same shareholder continuity profile (section FDB 1(2)).

As there are no Australian members of this imputation group, it is not a trans-Tasman imputation group and so no resident imputation subgroup is required.

Section ME 10 (1C) then requires that the accounts of the consolidated groups whose members have joined an imputation group are merged to become the imputation credit account of the imputation group.

All the debits and credits of the members will go to the imputation group's imputation credit account once the imputation group has formed (subsections ME 11 and ME 12).

As with the original consolidation provisions, the existing pre-consolidation balances of the members' individual imputation credit accounts are not transferred to the imputation group's consolidated imputation credit account, but continue to remain separate until such time as the imputation credit account of the imputation group has a debit to its account which it cannot offset by an existing credit.

Australian members only of a wholly owned trans-Tasman group of companies wish to consolidate for imputation purposes.

Australian members of a trans-Tasman group that have a valid election under section ME 1B can form an imputation group under subpart FDB and apply the provisions in sections ME 10 onward relating to consolidated imputation groups.

There is no requirement to form a resident imputation subgroup as well, as this imputation group does not include both New Zealand and Australian members, so it is not a trans-Tasman imputation group.

The opening balance of the imputation account of the imputation group will be nil as it is not formed from members of a consolidated group (section ME 10(2)(a)).

All the debits and credits of the members will go to the imputation group's consolidated imputation credit account once the imputation group has formed (subsections ME 11 and ME 12).

To the extent there are any pre-grouping balances in the Australian members' individual imputation credit accounts, these are not transferred to the imputation group's consolidated imputation credit account, but remain separate until such time as the imputation credit account of the imputation group has a debit to its account which it cannot offset by an existing credit.

In such a case, and subject to shareholder continuity being maintained, a credit may be transferred from a member's individual imputation credit account to the consolidated imputation account, to the extent of the consolidated imputation credit account's debit balance (subsections ME 13(2) to (4)).

The Australian and New Zealand members of a wholly owned trans-Tasman imputation group wish to consolidate for imputation purposes. The New Zealand members are not part of an existing consolidated group.

The New Zealand and Australian members, who have elected to maintain an imputation credit account under section ME 1B, of the trans-Tasman group can form an imputation group under subpart FDB.

As this imputation group includes both New Zealand and Australian members, it is a trans-Tasman imputation group, and the New Zealand members must also form a resident imputation subgroup

Both the trans-Tasman imputation group and the resident imputation subgroup are consolidated imputation groups, so they both must comply with the provisions in sections ME 10 onward that apply to consolidated imputation groups.

The opening balance of the imputation accounts of the trans-Tasman imputation group and the resident imputation subgroup will be nil as they are not formed from members of a consolidated group (section ME 10(2)(a)).

All the debits and credits of the members will go to the trans-Tasman imputation group's consolidated imputation credit account once the imputation group has formed (subsections ME 11 and ME 12).

All the debits and credits of the New Zealand members will go to the imputation credit account of the resident imputation subgroup once the subgroup is formed (section ME 10 1D(b)(ii) and existing sections ME 11 and ME 12).

Consistent with the original consolidation provisions, the pre-grouping balances of the members' individual imputation credit accounts are not transferred to the trans-Tasman imputation group's consolidated imputation credit account, but remain separate until such time as the imputation credit account of the trans-Tasman imputation group has a debit to its account which it cannot offset by an existing credit.

In such a case, and subject to shareholder continuity being maintained, a credit may be transferred from a member's individual imputation credit account to the trans-Tasman imputation group's account, to the extent of the account's debit balance (subsections ME 13(2) to (4)).

Similarly, the pre-grouping balances of the New Zealand members are not transferred to the resident imputation subgroup's imputation credit account but remain separate until such time as the account has a debit which it cannot offset by an existing credit.

The members of an existing consolidated group along with wholly owned Australian companies and another New Zealand wholly owned company wish to group for imputation purposes only.

All the companies, including the ones that have already consolidated for income tax purposes, of the wholly owned group that wish to group for imputation purposes must form an imputation group under the provisions of subpart FDB.

As this group has Australian and New Zealand members, it is a trans-Tasman imputation group, and the New Zealand members must also form a resident imputation subgroup.

As an existing consolidated group is the basis of the new imputation group, new subsection ME 10(1B) applies. It requires that the imputation credit account used by the consolidated group continue to be maintained as the imputation group's imputation credit account.

New Australian and New Zealand non-consolidated members are treated the same as new companies joining an existing consolidated group. In this case:

- The existing consolidated group's imputation account will remain and become the trans-Tasman imputation group's imputation credit account (subsection ME 10 (1B)).
- All the debits and credits of the new Australian members, the new New Zealand members and the existing members of the consolidated group will go to the trans-Tasman imputation group's consolidated imputation credit account once the imputation group has formed (subsections ME 11 and ME 12).
- The pre-grouping balance of the imputation credit account of the new New Zealand member and, to the extent there are any, the Australian members' individual imputation credit accounts are not transferred to the trans-Tasman imputation group's imputation credit account, but remain separate until such time as the trans-Tasman imputation group's imputation credit account has a debit to its account which it cannot offset by an existing credit.
- In such a case, and subject to shareholder continuity being maintained, a credit may be transferred from one of the new members' individual imputation credit account to the trans-Tasman imputation group's imputation credit account, to the extent of the debit balance in the trans-Tasman imputation group's imputation credit account – subsections ME 13(2) to (4).

A similar process applies to the resident imputation subgroup:

- The existing consolidated imputation account remains and becomes the resident imputation subgroup's imputation credit account (interface of subsection ME 10 (1D)(b)(i) with ME 10 (1C)).
- All the debits and credits of the new New Zealand member and the existing members of the consolidated group go to the resident imputation subgroup's imputation credit account once the subgroup has formed (subsections ME 11 and ME 12).
- The pre-grouping balance of the new New Zealand member is not transferred to the resident imputation subgroup's imputation credit account but remains separate until such time as the subgroup's imputation credit account has a debit balance which it cannot offset by an existing credit.
- In such a case, and subject to shareholder continuity being maintained, a credit may be transferred from the new member's individual imputation credit account to the trans-Tasman imputation group's account, to the extent of the account's debit balance (subsections ME 13(2) to (4)).

DEFERRED DEDUCTION RULE

Sections DK 1, OB 1 and subpart ES of the Income Tax Act 1994

Introduction

The deferred deduction rule is aimed at aggressive tax arrangements, many of which are mass marketed, that result in investors receiving more tax deductions than the money they invest in the arrangement. Typically, the tax benefit of these deductions occurs regardless of the success of the arrangement.

The rule applies to situations where the investor is not at real risk of having to repay loans (called "limited-recourse loans") in respect of an arrangement. However, a number of criteria are used to target the rule to minimise its impact on everyday commercial activities. Where the rule applies, deductions are deferred to the extent the loans are outstanding and the investor continues not to be at real risk of having to repay them.

The valuation of assets used in the arrangements in question is the most problematic feature of these arrangements, so it should ideally have been the target of any legislative response. Targeting valuation, however, would be very difficult because the forecasts of income that underpin valuation of the assets involved are inherently difficult to determine and are very subjective. Instead, the rule focuses on situations where investors do not have to pay for the assets they acquire, as a proxy for dealing with valuation directly.

Section DK 1 (limitation of deduction for certain film expenditure to amount at risk) has been repealed because it is no longer necessary. The deferred deduction rule limits the expenditure, where appropriate, instead.

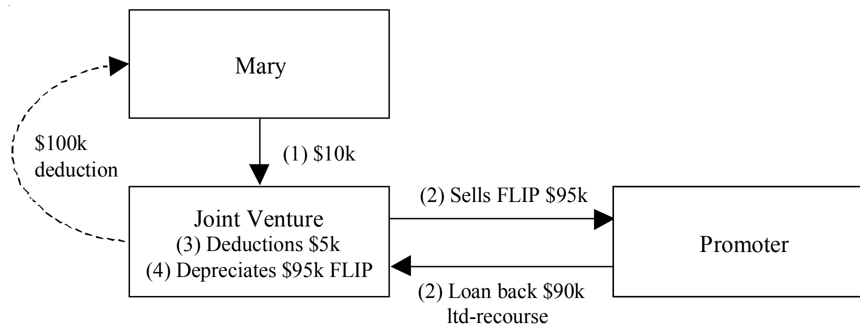
Example 1: Excessive tax savings

Mary puts $10,000 into a joint venture (JV) that forecasts losses of $100,000 per investor over the first three years. It forecasts income of $150,000 per investor in year four, which in fact does not arise.

The promoter of the arrangement sells fixed life intangible property (FLIP) to the JV for $95,000 per investor. This is depreciable over three years. The JV pays $5,000 cash (from Mary's investment) for the property, with the balance of $90,000 funded by a limited recourse loan from the promoter. The JV spends the remaining $5,000 in a way that causes it to be deductible.

Mary receives tax deductions of $100,000 over three years, saving her $39,000 if the 39% marginal tax rate applies to her income. This is $29,000 more than she has or will invest. She has made a substantial gain even though the JV has been unsuccessful.

The cashflows and loss transfers are as follows:



Background

The deferred deduction rule was designed to target aggressive tax arrangements that provide tax deductions from which tax savings in early years exceed the amount of an investors' own money put into the arrangement. In these arrangements the investor makes a cash return regardless of whether the arrangement is a commercial success or not.

The arrangements usually have most or all of the following features:

- They involve participation in a high-risk activity with apparently optimistic or unrealistic future sales projections.
- They include a transfer of property, including intangible and intellectual property that is difficult to value with precision. Transfer at an excessive price magnifies the available tax deductions, which are usually, but not always, by way of depreciation deduction.
- Their finance is arranged so that the investor is not at real risk of ever having to repay the loans. This can create inflated interest deductions and/or provide support for a higher transfer price.
- Their projected income is well into the future and may or may not materialise.

How the aggressive tax arrangements work

The arrangements in question are generally similar in structure and usually vary only in detail. Typically, investors put a relatively small amount of money into a joint venture or partnership. This can be by way of arrangement-specific, loss attributing qualifying companies or it can be direct.

The joint venture or partnership undertakes an activity. Most of the money provided by the investor goes into the activity, with the balance going to the promoter. The promoter arranges for investors to have access to loan money. The loan money is used to purchase purportedly high-value assets that diminish in value, at least for tax purposes, over time. The higher the purchase value, the greater the tax deductions.

The investors are not at risk of having to repay the loan even if the arrangement is commercially unsuccessful. A variety of mechanisms are used to ensure this. They range from the loan being provided on explicit limited or non-recourse terms, to it being lent to an arrangement-specific company often a loss attributing qualifying company (LAQC) and only secured over the assets and, perhaps, the shares of the company.

Future changes to the deferred deduction rule

At the time of print, the government had agreed to changes to be made to the deferred deduction rule in a future taxation bill, effective from the date of effect of the rule, the start of the 2004–2005 income year.

- The rule will be restricted so that it does not apply where at least 70% of the arrangement assets are shares held by companies on capital account in non-resident companies. Shares in non-resident companies do not produce taxable income to corporate shareholders because such dividends are explicitly tax-exempt. Comprehensive tax rules surround such investments, and the deferred deduction rule should not impose additional tax.
- The exclusions in section ES 1(1)(e) for specified tangible assets and limited recourse amounts as a proportion of net arrangement assets should be cumulative, not alternatives, as they are currently.
- The reference in section ES 1(1)(b)(i)(B) to section HG 16 losses (loss attributed from an LAQC) will be changed to match the LAQC mechanism in section ES 3. That is, the loss making LAQC will be ignored, but the section HG 16 loss attributed to the shareholder will be counted.
- The section ES 2(3)(d) criteria for a limited-recourse loan will be amended to reflect the original intent: loans are caught only if:
  - either they are from an associated person who in turn has borrowed on a limited recourse basis, or
  - they are not provided on an arm's length basis, and
  - they are not provided by a lender who regularly lends money and is resident or situated in New Zealand.

For the sake of increased clarity these changes have been incorporated in the text of this article.

Approach taken to target the arrangements

The valuation of assets used in the arrangements in question is the most problematic feature, so it should ideally have been the target of any legislative response. Targeting valuation, however, would be very difficult because the forecasts of income that underpin valuation of the assets involved are inherently difficult to determine and are very subjective.

Therefore the approach adopted to address these arrangements focuses on whether investors have used their own money or put their own assets at risk in the arrangement.

Key features

The rule defers tax deductions where the criteria set out in new subpart ES are met. In commercially unsuccessful arrangements this deferral can be permanent.

The criteria for the application of the rule, which were designed to minimise the possibility of genuine commercial investments being affected, are:

- The arrangement has a promoter—a person who sells or issues, or promotes the arrangement, whether or not for remuneration.
- The arrangement must produce losses in the early years.
- The limited-recourse loan (a defined term) must constitute 50% or more of the net arrangement assets of the investor and associated persons.
- The arrangement's net assets consist of less than 70% of:
  - tangible property that is comprised of land, buildings, plant or machinery
  - shares in listed companies that in total represent a direct voting interest of 10% or less in each company
  - shares held by companies on capital account in non-resident companies,or
  - shares or options relating to an employee share scheme.

This latter test is referred to as the "70% of net assets test" in this article.

The 50% and 70% calculations are expressed differently in the legislation, although this is the effect – as discussed later.

The definition of "limited recourse loan" and the 70% of net assets test are central to the targeting of the rule. "Limited recourse loans" are defined as:

- loans that are explicitly or economically limited or non-recourse
- loans where material payments are not required for ten years, or
- other loans which have the same effect.

A loan is explicitly a limited recourse when its terms so state (including a non-recourse loan). A loan is economically a limited recourse loan when repayment of

the money is, in substance, secured solely against assets that are employed in the arrangement.

Loans are excluded, however, from the definition of "limited-recourse loan" if the terms are on an arm's length basis, and the lender regularly lends money on arm's length terms and carries on business in New Zealand. Such loans can be part of commercial arrangements even though they also lend themselves to aggressive tax arrangements.

Intra-family and intra-group loans are also generally excluded.

The 70% of net assets test takes out assets which are easy to value and therefore do not need to fall within the rule. The rule has been carefully targeted so that it should not apply to financing arrangements for projects relating to tangible assets, vendor finance arrangements and other commercial activities.

Explicit consolidation rules have been provided to ensure that appropriate assets and liabilities, and income and expenditure are addressed by the deferred deduction rule.

Application date

The rule applies to deductions claimed for the 2004–2005 and subsequent income years for all schemes beginning in these years.

It also applies to existing arrangements, but only when 70% of the deductions claimed arise in respect of fixed life intangible property or software, or it can reasonably be expected that an investor knows that there are a total of ten or more investors. This limitation is intended to ensure that the rule does not affect existing arrangements that are not targeted.

Detailed analysis

The main provisions are new sections ES 1 to ES 3:

- Section ES 1 defines the circumstances in which the rule applies.
- Section ES 2 contains the definitions.
- Section ES 3 quantifies the amount of the deferred deduction, and provides that any amount deferred is allowed as a deduction in the subsequent income year.

Section ES 1 – the application

The deferred deduction rule applies to taxpayers (called the participant), if at any time after the arrangement begins, all of the conditions in section ES 1(1) are satisfied (and using the numbering of that subsection):

(a) The arrangement has a promoter. In this context a promoter is a person who sells or issues, or promotes the arrangement, whether or not for remuneration.

(b) The arrangement produces losses for the participant and any affected associates when considered together as a group. For the purposes of calculating this loss, deductions that were deferred in the previous income year and allowed in the current year under section ES 3(3) are ignored. Losses incurred by an LAQC are also ignored, to prevent double counting. (The section HG 16 loss attribution to the shareholder will be included.)

(c) The losses arise in the year in which an interest was acquired by participant or the affected associate, or cumulatively in the first and second years after the interest was acquired, or cumulatively in the first, second, and third years after the interest was acquired.

(d) The participant or an associated person borrows money under a limited recourse loan (as defined).

(e) At the end of any of the period(s) referred to in paragraph (c):

   (i) the limited recourse loan constitutes 50% or more of the total cost of the arrangement assets of the investor and associated persons,[12] and

   (ii) the arrangement's assets consist of less than 70%:[13]

      – of tangible property that consists of land, buildings, major plant and machinery

      – shares in listed companies that in total represent a direct voting interest of 10% or less in each company

      – shares held by companies on capital account in non-resident companies, and

      – shares or options relating to an employee share scheme.

For everyday transactions it is most unlikely that all these conditions will be met, so the subpart can be ignored.

Subsection (2) provides for the consolidation of interests for groups made up of a participant and affected associates. The gross income, allowable deductions and losses resulting from an arrangement, and the cost of the property held by each person are consolidated, where appropriate, for elimination of intra-group balances, in accordance with generally accepted accounting practice.

Under subsection (3), if a group consists of a partnership and its partners, a joint venture and its venturers, or an LAQC and its shareholders, consolidation is done using the proportionate method.

[12] Expressed in the legislation as being where the total cost of property is less than twice the mount of the limited loan.

[13] Expressed in the legislation as being where the total cost of property is more than 142.85% of the property detailed.

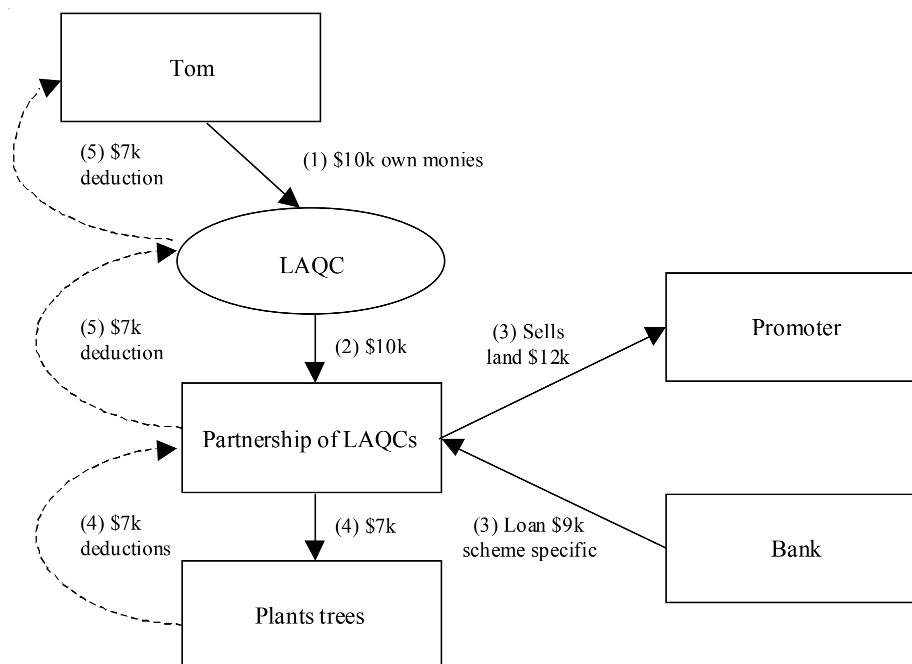
Example 2: Determining whether the rule applies

Tom puts $10,000 of his own money into a scheme-specific LAQC which in turn invests into a partnership of such companies. The partnership uses $7,000 of this to plant trees and obtains a deduction for it in year one. The balance is used as part payment for the land on which the trees are grown.

The arrangement provides that the promoter will sell to the partnership land on which to grow trees. This land will cost $12,000 per partner.

Because the partnership cannot afford to pay for the land in full, the promoter arranges a loan from offshore secured against the land of $9,000 per partner. This results in the investors actually not being at risk of having to repay this finance from their non-scheme assets. In economic terms, the loan is limited recourse against the scheme's assets and income—that is, against the assets and income of the LAQC.

The cashflows and tax deductions, ignoring interest, are summarised below:



Excess allowable deductions – section ES 1(1)(b) and (c)

Section ES 1(1)(b) requires the allowable deductions of the investor and affected associates to be considered together. In the example, the LAQC, and the partnership of LAQCs are affected associates of Tom. The partnership of LAQCs does not have allowable deductions because section HD 1(1)(b) provides that there is no joint assessment for partnerships. Partners each take into account their share of the allowable deductions incurred by the partnership. Allowable deductions claimed by Tom and his LAQC are:

Tom:	$7,000
LAQC:	$7,000
Total:	$14,000

However, section ES 1(1)(b)(i)(B) provides that the loss arising in the LAQC is ignored, but the loss attributed under section HG 16(1) is included to prevent double counting. Therefore, in the first year that Tom acquired an interest in the arrangement, Tom's consolidated share of the arrangement's allowable deductions is $7,000. Gross income from the arrangement is nil, so the arrangement satisfies section ES 1(1)(b) and (c).

Net asset test – section ES 1(1)(e)

The rule applies only if less than 70% of the property that is subject to the arrangement is:

- tangible property that is land, buildings or major plant and machinery
- shares listed in a company that in total represent a direct voting interest of 10% or less in a listed company
- shares held by companies on capital account in non-resident companies, and
- shares or options relating to an employee share scheme.

"Land" means the surface of the ground, and anything attached to it.

For the purposes of determining whether the property of the arrangement is tangible property:

- the property is measured at cost (refer to section ES 1(1)(e))
- the investor and any affected associated persons are considered together (refer to section ES 1(1)(b)), and
- the cost of the property is calculated on a consolidated basis for elimination of intra-group balances, similar to that used for companies under generally accepted accounting practice in New Zealand. (Refer to section ES 1(2) and (3).)

The investor and affected associated persons who are considered together are:

- Tom
- the loss attributing qualifying company, and
- the partnership of loss attributing qualifying companies.

Tom owns the shares in the loss attributing qualifying company, which is a partner in the partnership of like companies. The partnership owns land (including trees).

Under consolidation principles, the $10,000 capital Tom holds in the loss attributing qualifying company needs to be eliminated. Likewise, any capital or advances from the company to the partnership need to be eliminated.

After consolidation using the proportionate method insofar as the LAQC has an interest in the partnership, all of the assets of the arrangement consist of land (including trees), so the deferred deduction rule cannot apply.

Definitions – section ES 2

The main definitions include:

"Affected associate"

An affected associate is a person who is a party to an arrangement or is affected by an arrangement and who is:

- a loss attributing qualifying company where the participant is a shareholder in the loss attributing qualifying company (and vice versa), and
- an associated person of the participant under sections OD 7 or OD 8(3).

"Limited-recourse loan"

To qualify as a limited-recourse loan, a loan must satisfy all the paragraphs of section ES 2(3). That is, it must:

(a) **not** be an excepted financial arrangement

(b) involve the provision of money from a borrower to a lender

(c) have the purpose or effect of achieving an economic effect that is substantially similar to:

  (i) relieving the borrower from the obligation to repay all or some of the loan, whether the relief is contingent or not (explicitly limited recourse), or

  (ii) relieving the borrower from the obligation to make any material payments in respect of the loan for a period of ten or more years from the date the loan is made, or

  (iii) providing that the repayment of the money is, in substance, secured solely against assets that are employed in the arrangement (economically recourse), and

(d) involve money that:

  (i) if the lender is an associated person, the lender has not obtained the monies on a limited recourse basis.

  (ii) if the lender is not an associated person, it is **not** provided on arm's length terms by a lender who is:

    (A) a regular provider of money to persons on arm's length terms under arrangements that satisfy paragraphs (a) to (c), and

Example 3: Explicit limited-recourse loan

Bill puts $10,000 of his own money into a joint venture (JV). The JV uses this for a computer development activity that produces deductions of $10,000 in the first year.

The arrangement also provides that the promoter will sell to the JV fixed life intangible property that is depreciable over the first two years for taxation purposes. Each investor's share of this is $40,000. Because the JV cannot afford to pay for it, the promoter will arrange finance. To ensure that Bill is not actually at risk of having to repay this finance, the loan is explicitly a limited recourse loan.

In this example, the loan would satisfy the criteria of "limited recourse loan" because it satisfies all of the paragraphs of section ES 2(3).

Example 4: Economic limited-recourse loan

Kay puts $20,000 of her own money into an LAQC which in turn invests into a partnership of LAQCs. The partnership uses this money to make a film and obtains a deduction for it in year one.

The arrangement provides that the promoter will sell to the partnership fixed life intangible property (say, the right to use the film script) that is depreciable for taxation purposes. Each partner's share of this deduction is $70,000, also in year one.

The promoter will arrange finance. This finance is secured over the assets of and shares in the LAQCs, with the result that investors are not actually at risk of having to repay this finance from their non-arrangement assets. In economic terms, the loan is limited recourse against the arrangement's assets and income and accordingly satisfies all the paragraphs of the definition of "limited-recourse loan".

Example 5: Arm's length test satisfied

John puts $10,000 of his own money into an arrangement-specific LAQC which in turn invests into a partnership of LAQCs. The partnership uses $8,000 of this to plant a pine forest and obtains a deduction for it in year one. The balance is used as part payment for the land on which the trees are grown.

The arrangement provides that the promoter will sell to the partnership land on which to grow trees. This land will cost $42,000 per partner.

Because the partnership cannot afford to pay for the land in full, the promoter arranges a loan of $40,000 per partner from a New Zealand bank. The finance is secured by mortgage over the land. This results in the investors actually not being at risk of having to repay this finance from their non-arrangement assets. In economic terms, the loan is limited recourse against the arrangement's assets and income.

However, as the loan is from a New Zealand bank and is at arm's length on fully commercial terms and conditions, it does not satisfy all the paragraphs in section ES 2(3) (the definition of "limited recourse loan"). In particular, paragraph (d)(ii) is not satisfied.

Because there is no "limited recourse loan", the deferred deduction rule does not apply. John receives, through the loss attributing qualifying company, tax deductions of $8,000 plus interest. (Even if the loan was caught as a limited recourse loan the arrangement would not be caught because the arrangements only asset is land—refer example 2.)

(B) resident in New Zealand or carrying on a business in New Zealand through a fixed establishment:

If a lender is an associated person of the borrower, as long as the lender has not borrowed money under a "limited-recourse loan" the loan will be excluded from the definition of "limited-recourse loan" by paragraph (d)(iii). Thus, intra-family or intra-group loans are generally excluded.

If a lender regularly lends money on arm's length terms and carries on business in New Zealand the loan will be excluded from the definition of "limited-recourse loan" by paragraph (d)(ii). This exclusion was limited to New Zealand financiers because Inland Revenue is able to seek information from them.

Application of the definition of "limited-recourse loan"

Three examples are presented of how the deferred deduction rule will apply in practice. In the first two examples the rule applies to the arrangements involved.

The third example is of a structure to which the rule will not apply, even though it incorporates financing that is secured solely against the assets that are employed in the arrangement. The deferred deduction rule will not apply because paragraph (d)(ii) of the definition of "limited-recourse loan" is not satisfied.

The mechanics of the deferred deduction rule– section ES 3

To prevent double counting, deferred deductions are not calculated for LAQCs that are in a loss position. Therefore section ES 3(1) applies to other participants who are taxpayers, including shareholders of loss attributing qualifying companies, if:

- the conditions of section ES 1 are satisfied
- the participant incurred excess deductions over income from the arrangement
- excess deductions over income from the arrangement, calculated on a consolidated basis, are incurred in that year by the other participants and affected associates, and
- at the end of that year, the arrangement involves a "limited-recourse loan".

Section ES 3(2) quantifies the losses that are to be deferred by each participant each year and provides that they are treated as gross income in that year. Section ES 3(3) provides that amounts treated as gross income in one year are allowed as deductions in the following income year. Section ES 3(4) provides that certain transactions do not discharge an obligation to repay a limited-recourse loan.

Detailed provisions

Under section ES 3(1), the deferred deduction rule applies to a participant (by definition a taxpayer, so not a partnership or joint venture) if the following criteria are met:

- The participant, other than an LAQC, has allowable deductions from the arrangement, including any losses attributed from an LAQC and those allowed as a deduction under the deferred deduction carry forwards mechanism in this section, that exceed their income from the arrangement, other than income added back under the deferred deduction mechanism in this section.
- The participant and affected associates, other than an LAQC that has losses for the year, have, when considered together, allowable deductions from the arrangement, including any losses attributed from an LAQC and those allowed as a deduction under the deferred deduction carry forwards mechanism in this section, that exceed their income from the arrangement, other than income added back under the deferred deduction mechanism in this section.
- The arrangement involves a "limited-recourse loan" at the end of the income year. For the purpose of determining whether there is a "limited-recourse loan" at the end of the income year, subsection (4) provides that amounts repaid as a result of transactions involving the use of put and call options or a contract of insurance or guarantee are disregarded if:
  - the put or call option or the contract of insurance or guarantee is part of the arrangement, and
  - the transaction does not give rise to gross income.

Section ES 3(2) provides that the participant is treated as deriving gross income calculated under the formula:

$$a/b \times c$$

where

a is the amount of excess deductions over gross income for the participant from the arrangement for the income year:

- including any allowable deductions provided for by section ES 3(3) and any attributed LAQC losses, and
- ignoring any amount that is required to be added back as gross income under this subsection.

b is the amount of the excess deductions over gross income calculated including allowable deductions under section ES 3(3) and any attributed LAQC losses but ignoring amounts required to be added back under this subsection for the participant and affected associates other than affected associates:

- who are LAQCs, or
- which have excess gross income over allowable deductions for the year from the arrangement.

c is the lesser of:

(a) the amount of the excess deductions (calculated including allowable deductions under section ES 3(3) including any loss attributed from an LAQC but ignoring amounts required to be added back as gross income under this subsection) for the participant and affected associates other than affected associates who are loss attributing qualifying companies in a loss situation, and

(b) the amount of the limited-recourse loan owing at the end of the year for the participant and affected associates.

Example 6: Application of the deferred deduction rule

Jan puts $10,000 of her own money into a Joint Venture (JV). The promoter arranges a limited recourse loan of $40,000 for her to purchase fixed life intangible property (FLIP) from the promoter for $50,000 in total.

Jan is able to claim depreciation on the FLIP of $25,000 in each of the 2004–2005 and 2005–2006 income years. No income is derived from the arrangement in either of those years.

2004–2005 year

The deferred deduction rule will apply because:

- the criteria in section ES 1 have been satisfied
- deductions of $25,000 claimed by Jan exceed gross income (nil), and
- at the end of the year the arrangement involved a “limited-recourse loan” of $40,000.

Under the formula in section ES 3(2) Jan is required to treat as gross income the lesser of:

- excess allowable deductions ($25,000), or
- the amount of the “limited-recourse loan” ($40,000).

Therefore $25,000 is treated as gross income for 2004–2005.

2005–2006 year

Under section ES 3(3), Jan will be allowed a deduction of $25,000 in respect of the amount deemed to be gross income in 2004–05. She will also have current year depreciation deductions of $25,000. Thus she has total allowable deductions in the 2005–06 year of $50,000.

Again, the deferred deduction rule will apply because:

- the criteria in section ES 1 have been satisfied
- deductions claimed by Jan total $50,000 and exceed gross income (nil), and
- at the end of the year the arrangement involved a “limited-recourse loan” of $40,000.

Therefore $40,000 (the lesser of $50,000 or $40,000) is treated as gross income for 2005–2006. This provides an effective deduction for Jan’s $10,000 capital contribution in the second year.

2006–2007 year

In year three it is agreed that the arrangement will not succeed commercially (in fact, no income has been derived from sales) and the loan is expressly written off by the financier.

Under section ES 3(3), Jan will be allowed a deduction of $40,000 in respect of the amount deemed to be gross income in the previous year.

She also has $40,000 gross income from the accrual rules remittance of the $40,000 loan.

The income and expenditure offset each other in this year.

Over the life of the project, Jan has put in $10,000 capital and, in this case, enjoyed the tax benefits from a $10,000 deduction.

Section ES 3(4) provides that for the purpose of determining whether there is a “limited-recourse loan” at the end of the income year, amounts repaid as a result of transaction involving the use of put and call options or a contract of insurance or guarantee are disregarded if:

- the put or call option or the contract of insurance or guarantee is part of the arrangement, and
- the transaction does not give rise to gross income.

Repeal of section DK 1

Section DK 1 provides for deductions for film expenditure to be reduced when the expenditure is funded from a limited recourse loan. As the deferred deduction rule generally applies to such arrangements, section DK 1 is no longer required and is being repealed.

OTHER POLICY ISSUES

INCOME TAX EXEMPTION FOR COMMUNITY TRUSTS

CB 4(1) (m) and (n), HH 3(2), HH 3(5) and new section HH 3(5B) and section OB 1 of the Income Tax Act 1994

Introduction

The Income Tax 1994 has been amended to provide an exemption from income tax for community trusts that were established under the Trustee Banks Restructuring Act 1988. Distributions by these community trusts will now be taxed in the beneficiaries' hands. This ensures that tax-exempt entities continue to receive these distributions from community trusts without a tax cost to them.

Background

Twelve community trusts were originally established under the Trustee Banks Restructuring Act 1988, which was repealed in 1999, and are now subject to the Community Trusts Act 1999. When these community trusts were established, the Trustee Banks Restructuring Act provided that they were charitable for all purposes other than the Revenue Acts. However, they make most of their distributions to charitable or other tax-exempt organisations, so to ensure the income they distribute to mostly tax-exempt entities is not taxed, they have implemented complex structures. This has imposed considerable unnecessary compliance costs on community trusts.

Key features

Section CB 4(1) has been amended by introducing a new paragraph (m), which exempts community trusts from income tax.

Section HH 3 (2) has been amended by providing that a community trust does not have to satisfy any income tax liability of a beneficiary receiving taxable income from the trust. This is necessary given that distributions from community trusts will now be taxable in the beneficiaries' hands.

New section HH 3 (5B) provides that distributions to beneficiaries by community trusts are gross income of the beneficiary except when the distribution is from:

- trustee income derived by the trust in or before the 2003–2004 income year
- the corpus of the trust
- capital profits or gains of the trust, or
- a distribution, settlement or dividend made to a community trust on the winding up of a wholly owned charitable company or subtrust of the community trust in the 2004–2005 or 2005–2006 income year.

Those distributions by community trusts that are treated as beneficiary income are taxed at the beneficiary's own rate. If the beneficiary is exempt from income tax, it will have no tax liability. If the beneficiary is subject to income tax, it will be liable for any tax payable on a distribution that is treated as gross income. However, in practice, it is likely that distributions to taxable beneficiaries will be paid from those sources that will not be treated as gross income and therefore will not be taxable to the beneficiary

Application date

The amendment to provide an income tax exemption for the twelve community trusts applies from the 2004–2005 income year. Section CB 4(1)(n), which provides for a transitional period for winding up charitable entities wholly owned by the community trust, applies during the 2005 and 2006 income years.

REPEAL OF INCOME TAX EXEMPTION FOR SICK, ACCIDENT OR DEATH BENEFIT FUNDS

Sections CB 4, CB 5, CI 1, CI 3 and NF 9 of the Income Tax Act 1994

Introduction

The income tax exemption for the investment earnings of sick, accident or death benefit (SAD) funds has been repealed. A closely targeted exemption has been created for certain SAD funds that exhibit the mutuality characteristics of friendly societies, which are separately exempt from income tax. A closely targeted exemption has also been created for the investment earnings of funds established solely for the purpose of paying for the funeral expenses of employees and their spouses and dependants.

Background

Income derived by a trustee of a SAD fund (other than business income) was previously exempt from income tax under section CB 5(1)(i) of the Income Tax Act 1994. A SAD fund is defined in section CB 5(2) as "a fund established for the benefit of the employees of any employer, or the members of an incorporated society, and

the surviving spouses and dependants of any such employees and members." The fund is required to be approved by the Commissioner of Inland Revenue. The income tax exemption for these funds was first enacted in 1940.

The Committee of Experts on Tax Compliance (1998) considered that the income tax exemption for SAD funds was anomalous in terms of current tax policy and that there was no public policy justification for its continuance. Accordingly, the committee recommended the repeal of the tax exemption.

The income tax exemption for the investment earnings of these funds was inconsistent with the current policy for the taxation of savings. Because of the open-ended nature of the definition of SAD funds, such funds could be used as savings vehicles. The exemption effectively allowed earnings on personal savings to be exempt from income tax. The exemption therefore provided concessionary treatment that was not available to other forms of savings.

The income tax exemption was also inconsistent with the treatment of insurance policies entered into for protection against sickness, accident or death. The earnings on contributions or premiums paid on such policies are generally taxable.

The income tax exemption also raised tax base maintenance concerns. In particular, schemes with some very aggressive features which exploited this exemption have been marketed to high-income individuals to reduce the tax they pay.

Key features

The income tax exemption for the investment earnings of SAD funds in section CB 5(1)(i) of the Income Tax Act 1994 has been repealed. The corresponding resident withholding tax exemption in section NF 9(1)(i) of the Income Tax Act 1994 has also been repealed.

A closely targeted exemption has been created by section CB 4(1)(ab) for certain SAD funds that are similar to friendly societies which are separately exempt from income tax under section CB 4(1)(a). The new exemption has been enacted for reasons of compliance cost savings for those SAD funds that exhibit the requisite mutuality characteristics of friendly societies but would have to incur significant compliance costs if they had to restructure formally as such.

In particular, the following requirements need to be satisfied by an entity before the exemption can apply to it:

- The entity provides health insurance, accident insurance, life insurance or other health and welfare benefits to members.
- It has previously been approved by the Commissioner of Inland Revenue as a SAD fund.
- It is separately approved by the Commissioner for the purpose of this exemption as an organisation that, in the Commissioner's opinion, operates on the principles of mutuality. This approval must be given within six months of the date of enactment, which is 25 November 2003. The Commissioner has a discretion to extend the six-month approval period if satisfied that the reason for this deadline not being met is that the entity was not aware of the relevant law changes.

Only those SAD funds which have a widely spread membership will be able to qualify for this exemption. Therefore closely held SAD funds, which have been the subject of base maintenance concerns, will not qualify.

The new exemption has the same ambit as the exemption applying to friendly societies and, in particular, does not apply to an amount derived by an entity from a business carried on beyond the circle of its membership.

Section CB 5(1)(ib) enacts a closely targeted exemption for the investment earnings (interest and dividends) of funds established solely for the purpose of paying for the funeral expenses of the employees of an employer and the spouses and dependants of employees. The exemption will be limited to funds established by an employer for ten or more employees who have equal eligibility to benefits from the fund. All contributions to these funds will have to be made by either employers (and subject to fringe benefit tax under section CI 1(eb)) or employee beneficiaries of the fund. In addition, any such funeral expense fund would need to be approved by the Commissioner of Inland Revenue.

Application date

The amendments apply to amounts derived after 25 November 2003, the date of enactment.

HOME-BASED SERVICES

Sections CB 9, ID 1, and OB 1 of the Income Tax Act 1994

Sections 3, 33B, and 91AA of the Tax Administration Act 1994

Introduction

The Commissioner of Inland Revenue has been empowered to determine standard costs for specified home-based services. The Commissioner may also exempt from income tax specified taxpayers in recognition of the need for practicality and the minimisation of compliance costs, while providing a consistent framework for taxation in the industry.

Background

The amendment is aimed at helping taxpayers providing services based on the use of their home, such as the home-based childcare industry or those providing board, whose tax obligations are often disproportionate to the level of net tax paid. The amendment is intended to reduce or remove compliance costs, depending on the disparity involved, by allowing the Commissioner to exempt income in certain circumstances, and taxpayers to use standard costs in others.

Key features

A new section, 91AA, has been inserted into the Tax Administration Act 1994, and consequential amendments have been made to both that Act and the Income Tax Act 1994. The main changes are as follows:

- Section 91AA(1) and (2) of the Tax Administration Act 1994 allows the Commissioner to determine standard costs for specified home-based services.
- Section 91AA(3) of the Tax Administration Act 1994 allows individuals to use these standard costs in lieu of actual costs, thus significantly reducing industry compliance costs.
- Section 33B of the Tax Administration Act 1994 removes the requirement to file a return for those who have income below the standard costs, removing all compliance costs. However, the right to file an income tax return is retained, if desired, in which case either actual costs or the standard costs can be used. Under section ID 1(2) of the Income Tax Act 1994, no losses are allowed if standard costs are used.
- Section 91AA(2)(a) of the Tax Administration Act 1994 and section CB 9(h) of the Income Tax Act 1994 allow the Commissioner to determine that income earned by certain taxpayers providing home-based services is not taxable on the basis that the compliance costs of calculating and paying any tax owed exceed the benefits of the tax payment.

Application date

The amendment applies from 25 November 2003.

LARGE-BUDGET SCREEN PRODUCTION GRANTS

Sections CB 9, DC 1, EO 4, and OB 1 of the Income Tax Act 1994 and section 85F of the Tax Administration Act 1994

Introduction

Amendments ensure that the tax consequences of large-budget screen production grants are the same as if the grants had been made by way of a tax credit.

Background

A generic grant scheme has been established for large-budget screen productions, based on criteria of the Australian 12.5% tax rebate system. Criteria for the grant include:

- Access to the grant requires a minimum level of qualifying New Zealand expenditure of NZ$15 million on the production of the film or television project.
- If the film or television project's qualifying New Zealand production expenditure is between NZ$15 million and NZ$50 million, the producer is required to spend a minimum of 70% of the film or television project's total production expenditure on screen production activity in New Zealand to qualify for the grant.
- Eligible film and television productions that spend NZ$50 million or more in New Zealand qualify, regardless of the%age ratio of New Zealand expenditure to the film or television project's overall production expenditure;
- A film or television production company is eligible to apply for the grant if it is a New Zealand resident company or a foreign corporation operating with an establishment in New Zealand for the purposes of lodging an income tax return; and

The changes were added to the bill at the Committee of the Whole House stage of proceedings.

Key features

To ensure that the tax treatment of the grant is consistent with that of changes to the Income Tax Act 1994 are:

- Section CB 9(i) provides that a large-budget screen production grant is exempt income.
- Section DC 1 has been amended to ensure that a recipient of a large-budget screen production grant is not required to reduce claims for allowable deductions in respect of expenditure that is recouped by the grant.
- Section EO 4 has been amended to ensure that the current concessional tax treatment of New Zealand films does not apply to a screen production for which a grant is claimed.

Inland Revenue has a role in verifying information provided in support of applications for grants. New section 85F of the Tax Administration Act authorises the

Commissioner to communicate information relating to this process to the New Zealand Film Commission.

Application date

The new provisions apply from 25 November 2003.

ORGANISATIONS APPROVED FOR CHARITABLE DONEE STATUS

Section KC 5(1) of the Income Tax Act 1994

The following organisations have been granted charitable donee status from the 2003–2004 income year.

- Books for Africa
- Bright Hope International Trust
- Cheboche Area Trust Inc
- Greater Mekong Subregion Tertiary Education Consortium Trust
- Help a Child Foundation New Zealand
- Plan New Zealand
- Sampoerna Foundation Limited
- St Stanislas Charitable Trust of New Zealand
- Surf Aid International Incorporated
- The Sir Edmund Hillary Trust

Donations made to these organisations will entitle individual taxpayers to a rebate of $33^1/_3$% of the amount donated. The maximum rebate for all donations is $630 per year. A non-closely held company, or a closely held company which is listed on a recognised stock exchange, will be entitled to a deduction from its net income to a maximum of 5% of that income.

FAMILY ASSISTANCE – INCOME THRESHOLD INCREASES

Sections KD 2(6), KD 5B(5) and Schedule 12 of the Income Tax Act 1994

Introduction

Income thresholds for family support, the child tax credit and parental tax credit have been increased to provide an adjustment for inflation for the year ended September 2003. Income thresholds have been increased from $20,000 to $20,356 and from $27,000 to $27,481.

Background

Income thresholds are the points at which family assistance entitlement starts to be abated as family income rises.

At the new threshold levels, family assistance will abate by 18 cents for every extra dollar of family income above $20,356 a year and by 30 cents for every extra dollar of family income above $27,481. The increase in income thresholds has meant that low-income and middle-income families with income above $20,000 receive more family assistance.

Key features

Section KD 2(6) of the Income Tax Act 1994, which explains how the abatement of entitlement is calculated, has been amended to include the adjusted income thresholds.

Similar and consequential changes have also been made to the rules for calculating interim instalments, in section KD 5B(5) and Schedule 12 of the Income Tax Act 1994.

Application date

The amendments apply from 1 April 2004.

FAMILY ASSISTANCE – WRITING OFF OVERPAYMENTS ASSOCIATED WITH ADDITIONAL PAYDAYS

Sections KD (2)(1), KD 3(2) and new section KD 7B of the Income Tax Act 1994

Introduction

Changes have been made to allow Inland Revenue to write off overpayments of family assistance that arise when there is an extra payday in the year.

Background

Because a year is slightly longer than 52 weeks, claimants who receive interim payments throughout the year (rather than at the end in a lump sum) sometimes receive one more payment than usual.

In 2003-04, for example, there will be 27 fortnightly paydays for claimants paid by Inland Revenue, instead of the usual 26, and 53 rather than 52 paydays for Ministry of Social Development claimants paid weekly on Tuesdays and Wednesdays. In 2004-05 there will be 53 paydays for Ministry of Social Development claimants paid weekly on Thursdays.

As fortnightly or weekly entitlement is calculated on the basis of a standard year comprising of 26 or 52 payment periods, claimants who would otherwise have balanced at the end-of-year square-up will be overpaid in years with additional paydays. Claimants who would have been overpaid for some other reason will have their overpayment magnified by the extra payday.

When eligible recipients paid by Inland Revenue or the Ministry of Social Development receive an additional payment and incur an overpayment at the end-of-year square-up, an adjustment will be made so that the overpayment attributable to the extra payday is not collected from recipients.

Key features

Section KD 4 of the Income Tax Act 1994, which relates to the annual square-up of payments and entitlement, is subject to the application of new section KD 7B so as to reduce a claimant's overpayment subject to the satisfaction of certain criteria.

Claimants paid by Inland Revenue will have their overpayment reduced by an amount which is the lesser of 13/14th of the last instalment payment received and the amount of their overpayment if they:

- receive 27 fortnightly instalments of family assistance from Inland Revenue in 2003-04, and
- incur an overpayment at end-of-year square-up.

Claimants paid by the Ministry of Social Development will have a similar reduction in their overpayment if they:

- receive at least one instalment of family assistance from the Ministry of Social Development in 2003–04 or 2004–05
- do not receive a fortnightly instalment from Inland Revenue in the same income year, and
- incur and overpayment at end-of-year square-up.

These rules will also take effect in future, whenever the payment cycle results in extra paydays being made during the year.

Application date

The amendment applies from the 2003-04 year.

TAX POOLING

Sections MBB 4(3), MBB 6(8), MBB 9, ME 4(1), (1B), (2) and (2B), ME 5, ME 11, ME 13(1), NF 1(2) of the Income Tax Act 1994 and section 70 of the Tax Administration Act 1994

Introduction

Four technical amendments have been made to the recently enacted tax pooling provisions. The most significant amendment is a change to the imputation provisions to allow taxpayers who, through an intermediary, deposit an amount into a tax pooling account with Inland Revenue to receive an imputation credit for the amount deposited. Imputation debits arise for deposits refunded from the pool and for deposits transferred within the pooling account to another taxpayer. Consequential amendments have been designed to ensure that taxpayers participating in a pool and receiving imputation credits when deposits are made are in no worse or better a position than the standard imputation treatment affords.

More minor amendments provide that no resident withholding tax is to be deducted on use-of-money interest paid to a pooling intermediary by the Commissioner, and that amounts paid and received by pool participants in substitution for use-of-money interest is "interest" for the purpose of withholding tax and income provisions.

Finally, a change has been made to the requirement for an intermediary to notify a pool participant that payment to the intermediary does not satisfy a taxpayer's obligations to the Commissioner. It is sufficient for an intermediary to give a pool participant general written notice of this before or at the time of the first payment, rather than giving notice on receipt of every payment from the pool participant.

Background

The now-repealed section MBB 6(8) provided that companies that paid tax through a pooling account received a credit in their imputation credit account (ICA) for the amount of funds transferred to their income tax account. The credit arose at the time that the Commissioner received a request from the intermediary to transfer the funds (which would generally be after the end of the income year when the tax liability was known). This was a disincentive to taxpayers paying tax through a pooling account because it was penal relative to the imputation treatment of those who pay tax directly to the Commissioner.

Taxpayers who pay provisional tax directly to the Commissioner receive a credit in their ICA when tax is paid and they can attach these credits to dividends paid out in that imputation year. Taxpayers who instead pay provisional tax through a pooling account would receive a credit only after the end of the imputation year, when funds are allocated from the pool to their income tax account. Credits were therefore not available for distribution in the year the provisional tax was paid.

A new set of imputation provisions has therefore been enacted to apply to pool participants. The new rules are

not intended to confer an advantage on pool participants, but are intended to remove the disincentive discussed earlier and match, so far as possible, the imputation treatment afforded to companies that pay tax directly to the Commissioner.

Key features

Imputation

- Section MBB 6(8), which set out the time at which imputation credits arose for tax paid through a pooling account, has been repealed and a set of imputation provisions applicable to pool participants has been enacted. Broadly, companies will receive a credit in their imputation credit account when a payment they have forwarded to an intermediary is deposited in a tax pooling account with the Commissioner (sections ME 4(1)(ac) and ME 4(2)(ac)). Debits to the imputation credit account will arise in relation to refunds from the pooling account to the company and sales of the amount deposited to another taxpayer (sections ME 5(1)(eb) and (ec) and ME 5(2)(eb) and (ec)). Such debits are required so that a company still ultimately receives imputation credits only for tax paid by it, and deposits in a tax pooling account are not “tax paid” by the company for the purposes of the Act until deposits are transferred to the company’s income tax account. The new rules are intended to ensure that taxpayers are neither advantaged nor disadvantaged by paying tax through a pooling account.

Other remedial amendments

- Section MBB 4(3) has been amended so that an intermediary can give general notice to a pool participant that payment to the intermediary does not satisfy the participant’s obligations to the Commissioner. The notice is required to be in writing (see the definition of “notice” in section OB 1) and to be given before or at the time of the first payment
- Section MBB 9, which dealt solely with the deductibility of payments made between an intermediary and client that are substitutes for use-of-money interest, has been replaced with a provision that is broader in scope. New section MBB 9 clarifies that such payments are “interest”, which was assumed in the tax pooling provisions as enacted. Such payments are treated as interest income to the recipient, and expenditure incurred in deriving gross income to the payer. They are also treated as interest for the purposes of the resident and non-resident withholding tax provisions (though resident withholding tax is still not deductible on interest paid to an intermediary by a client under section NF 1(2)(a)(ix)).
- Under new section NF 1(2)(a)(x), the Commissioner will not deduct resident withholding tax from payments of use-of-money interest paid to a tax pooling intermediary.

Application date

The amendments generally apply from 1 April 2003, the date on which the tax pooling provisions came into effect. The amendment to section 70 of the Tax Administration Act 1994, which relates to filing of revised imputation returns in certain circumstances, applies from 25 November 2003.

Detailed analysis

Credits for deposits into pooling account

A company receives a credit in its ICA for amounts that it has paid to an intermediary and that are deposited in a tax pooling account with the Commissioner (section ME 4(1)(ac)). The credit arises on the date the funds are paid into the tax pooling account (section ME 4(2)(ac)). The intermediary will notify the taxpayer of that date.

No imputation credit arises if and when the funds deposited into the tax pooling account are transferred to the company’s income tax account (section ME 4(1)(a)(x)).

Refunds from pooling account

If all or part of those funds in the tax pooling account are refunded to the intermediary instead of being transferred to the company’s income tax account, a debit arises to the ICA equal to the amount of the refund (section ME 5(1)(eb)).

For companies that are not qualifying companies, the time at which the debit arises is set out in section ME 5(2)(ec). The amount of the refund is debited first against any credit balance in the company’s ICA at the previous 31 March. If this is insufficient to absorb the debit, the deficit is debited against the balance in the ICA at the date of the refund (which will have been adjusted to take into account the debit at the previous 31 March). Finally, if the balance in the ICA at the date of the refund is also insufficient to absorb the debit, the unallocated portion of the debit arises at the previous 31 March (and will result in the ICA going into debit, generating imputation penalty tax and further income tax liabilities). This is illustrated in example 3.

Section 70 of the Tax Administration Act 1994 requires a company to refile an imputation return if the refund has given rise to a debit in the ICA at the previous 31 March or if the taxpayer anticipates a refund of income tax to which section MD 2 will apply (that is, a refund that will be withheld by the Commissioner because there are insufficient credits in the ICA).

This timing rule is intended to achieve the same purpose as the restrictions on refunds of tax under section MD 2. That section prevents companies obtaining refunds of tax when they have already distributed imputation credits for that tax to their shareholders. In the case of refunds of amounts held in pooling accounts for which companies have received an imputation credit, it is not feasible for the Commissioner to withhold the refund as he does not know to whom the refund relates. (The funds could have

Example 1 – standard case

7/7/03 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. Credit arises to A Co's ICA (ME 4(1)(ac) and ME 4(2)(ac)).

7/11/03 Ditto

7/3/04 Ditto

30/6/04 After year end, A Co's residual income tax (RIT) is $120,000, so the intermediary requests IRD to transfer $40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co's ICA on this transfer (section ME 4(1)(a)(x)).

1/7/04 The intermediary purchases the $30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the $30k – it ceases to be held for A Co and is held for B Co. A debit of $30k arises to A Co's ICA (ME 5(1)(ec)). The debit is applied first against the credit balance at the previous 31 March (section ME 5(2)(ec)). This reduces the balance at that date to $120k.

A Co's ICA

	Cr	**Dr**	**Bal**
7/7/03	$50k		$50k
7/11/03	$50k		$100k
7/3/04	$50k		$150k
31/3/04			$150k
31/3/04		$30k	$120k

B Co uses the $30k to satisfy a $10k tax liability arising on each of 7/7/03, 7/11/03 and 7/3/04. An imputation credit arises to B Co's ICA for $10k on each of those dates (sections ME 4(1)(ad) and ME 4(2)(ad)(i))

been transferred from the original contributor to another taxpayer.) Instead, the timing rule is intended to act as a disincentive for taxpayers to pay funds into a pooling account, distribute the credits to shareholders and then seek a refund of that amount from the pooling account.

When a qualifying company obtains a refund from the pooling account, the date on which the debit arises is always the date of the refund (section ME 5(2)(eb)). This is because the restrictions in section MD 2 do not generally apply to qualifying companies (section MD 2(7)).

Transfers to other taxpayers

If a taxpayer does not require funds that are held for its benefit in the tax pooling account and sells the funds to the intermediary for on-sale to another taxpayer, a debit will arise in its ICA (section ME 5(1)(ec)). The timing rule for the transfer is the same as that applying to refunds from the pool described in the preceding section (section ME 5(2)(eb) or (ec)).

Purchase of entitlement to funds in pooling account

A credit arises to the ICA of a company that purchases an entitlement to an amount in the pooling account (section ME 4(1)(ad)). The timing of the credit depends on what happens to the purchased funds (section ME 4(2)(ad)). If the funds are transferred to the company's account with the Commissioner, the credit arises on the effective date of payment of the tax. In the unlikely event that the funds are refunded to the company, or transferred to the intermediary for on-sale to another taxpayer, the credit for their purchase arises on the date of the refund or transfer.

The time that the credit arises therefore differs for funds deposited in the pooling account and funds purchased from the intermediary. If the credit for purchased funds were to arise at the time of purchase, companies would easily be able to avoid the credit continuity provisions.

Breach of continuity

A new provision (section ME 4(1B)) has been introduced to ensure that a company that deposits funds into a pooling account is not over-penalised when the company suffers a breach of continuity and loses imputation credits arising from the deposit. The rule is based on that in section MD 2(4).

If a company that has deposited an amount in a pooling account has a breach of shareholder continuity and loses the credits arising from the deposit, and subsequently the company transfers those funds to its tax account at an effective date after the breach, a compensating credit will arise. This is because credits for tax paid after the breach should be preserved. The credit arises at the time of the transfer (section ME 4(2B)).

Example 2 – insufficient credits in A Co's ICA at end of previous imputation year

7/7/03 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. A credit arises to A Co's ICA (sections ME 4(1)(ac) and ME 4(2)(ac)).

7/11/03 Ditto

7/3/04 Ditto

20/3/04 A Co attaches $150k credits to dividends paid to shareholders.

7/7/04 A Co pays $40k to the intermediary, who deposits it into the tax pooling account. A credit arises to A Co's ICA (ME 4(1)(ac) and ME 4(2)(ac)).

31/8/04 After year end, A Co's RIT is $120,000, so the intermediary requests IRD to transfer $40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co's ICA for these transfers – section ME 4(1)(a)(x)).

1/9/04 The intermediary purchases the $30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the $30k – it ceases to be held for A Co and is held for B Co. A debit of $30k arises to A Co's ICA (ME 5(1)(ec)). The $30k debit would be applied first against thecredit balance at the previous 31 March. As the balance is $0 at that date, the $30k is debited against the credit balance at the date of transfer (section ME 5(2)(ec)).

A Co's ICA

	Cr	**Dr**	**Bal**
7/7/03	$50k		$50k
7/11/03	$50k		$100k
7/3/04	$50k		$150k
20/3/04		$150k	
31/3/04			$0k
7/7/04	$40k		$40k
1/9/04		$30k	$10k

If the funds deposited are instead refunded to the company from the pooling account, or are transferred to the intermediary for on-sale to another taxpayer, and the debit relating to the refund or transfer is after the breach, a credit arises at the time of the refund or transfer (section ME 4(2B)).

Consolidated groups

The imputation treatment described above applies in the same way to payments made by a consolidated group into a pooling account. Equivalent amendments to those discussed are made to sections ME 11– ME 13.

Examples

The examples 1 to 7 illustrate the application of the legislation. In each of the examples, A Co is not a qualifying company.

Example 3 – insufficient credits in A Co's ICA at end of previous imputation year and date of transfer to another taxpayer

7/7/03 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. A credit arises to A Co's ICA (sections ME 4(1)(ac) and ME 4(2)(ac)).

7/11/03 Ditto

7/3/04 Ditto

20/3/04 A Co attaches $150k credits to dividends paid to shareholders.

7/7/04 A Co pays $20k to the intermediary, who deposits it into the pooling account. A credit arises to A Co's ICA (sections ME 4(1)(ac) and ME 4(2)(ac)).

31/8/04 After year end, A Co's RIT is $120,000, so the intermediary requests IRD to transfer $40,000 from the pooling account to A Co's tax account as at each of 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co's ICA for these transfers (section ME 4(1)(a)(x)).

1/9/04 The intermediary purchases the $30k excess from A Co and sells it to B Co. There is a transfer on this date in the intermediary's books of the $30k – it ceases to be held for A Co and is held for B Co. A debit of $30k arises to A Co's ICA (section ME 5(1)(ec)). The $30k would be debited first against any credit balance as at 31/3/04. As the balance is $0 at that date, $20k of the $30k is debited next against the $20k credit balance at 1/9/04. This reduces that balance to $0.

Step 1

A Co's ICA

	Cr	Dr	Bal
7/7/03	$50k		$50k
7/11/03	$50k		$100k
7/3/04	$50k		$150k
20/3/04		$150k	
31/3/04			$0k
7/7/04	$20k		$20k
1/9/04		$20k	$0k

A debit arises for the remaining $10k at 31/3/04. This will trigger imputation penalties and a requirement to pay further income tax, and the ICA will need adjustment.

Step 2

A Co's adjusted ICA

	Cr	Dr	Bal
7/7/03	$50k		$50k
7/11/03	$50k		$100k
7/3/04	$50k		$150k
20/3/04		$150k	
31/3/04			$0k
31/3/04 [retro adjustment]		$10k	-$10k
7/7/04	$20k		$10k
1/9/04		$20k	-$10k

This is the correct outcome. A Co has distributed that $10k and would have had the $10k withheld by the Commissioner under section MD 2 if it had been tax paid directly to the Commissioner.

Example 4 – standard case with breach of continuity debit

7/7/03 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. A credit arises to A Co's ICA (sections ME 4(1)(ac) and ME 4(2)(ac)).

7/11/03 Ditto

15/12/03 Breach of shareholder continuity – debit to ICA of $100k (section ME 5(1)(i)).

7/3/04 A Co pays $50k to intermediary. Credit arises in ICA (sections ME 4(1)(ac) and ME 4(2)(ac)).

31/8/04 After year end, A Co's RIT is $120,000, so the intermediary requests IRD to transfer $40,000 from the pooling account to A Co's tax account as at 7/7/03, 7/11/03 and 7/3/04. No credit arises to A Co's ICA for the transfers. (The $40k transferred as at 7/3/04 comes from the $50 pool deposit made on that date).

1/9/04 The intermediary purchases the $30k excess from A Co and sells it to B Co.

There is a transfer on this date in the intermediary's books of the $30k – it ceases to be held for A Co and is held for B Co. A debit of $30k arises to the ICA as at 31/3/04, reducing the balance to $20k. Section ME 4(1B) also applies to $20k of the $30k transfer – A Co received a credit of $10k for a deposit on each of 7/7/03 and 7/11/03 which was offset by a continuity debit, and a further debit arose after the breach when the deposits were transferred to another taxpayer. Therefore a credit arises for $20k at the time of the transfer (section ME 4(2B)).

This is the right outcome. A Co paid tax of $120k, $80k of which was paid before the breach of continuity and lost. This leaves $40k for distribution to shareholders.

A Co's ICA

	Cr	**Dr**	**Bal**
7/7/03	$50k		$50k
7/11/03	$50k		$100k
15/12/03		$100k	$0
7/3/04	$50k		$50k
31/3/04		$30	$20k
1/9/04	$20		$40k

Example 5 – A Co buys tax from intermediary to satisfy underpayment

7/7/03 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. An imputation credit arises to A Co's ICA (ME 4(1)(ac) and ME 4(2)(ac)).

7/11/03 Ditto

14/12/03 Imputation credits of $70k are attached to dividends.

7/3/04 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. A credit arises in the ICA.

A Co's ICA

	Cr	Dr	Bal
7/7/03	$50k		$50k
7/11/03	$50k		$100k
14/12/03		$70k	$30k
7/3/04	$50k		$80k

31/8/04 After year end, A Co's RIT is $180,000. The intermediary requests IRD to transfer $50,000 from the pooling account to A Co's tax account as at each of 7/7/03, 7/11/03 and 7/3/04. No imputation credits arise as at those dates.

1/9/04 A Co purchases from the intermediary $10k that was deposited into the pool at each of 7/7/03, 7/11/03 and
7/3/04 and those amounts are transferred from the pool to the taxpayer's tax account as at those effective dates. No credit arises at the time of purchase, but a credit arises as at the effective dates (sections ME 4(1)(ad) and ME 4(2)(ad)(i)).

A Co's Adjusted ICA

	Cr	Dr	Bal
7/7/03	$50k + $10k		$60k
7/11/03	$50k + $10k		$120k
14/12/03		$70k	$50k
7/3/04	$50k + $10k		$110k

Example 6 – refund of pool deposit and breach of continuity

31/3/04 The balance in A Co's ICA is $10,000, representing an amount deposited into a pooling account.

2/7/04 There is a breach of continuity giving rise to a debit of $10,000

Step 1

A Co's ICA

	Cr	Dr	Bal
31/3/04			$10,000
2/7/04		$10,000	0
4/7/04			0

4/7/04 A Co receives a refund from the pooling account of $10,000. A debit arises at 31/3/04, which reduces the ICA balance to 0 at that date. Therefore there is no debit arising on breach of continuity

Step 2

A Co's Adjusted ICA

	Cr	Dr	Bal
31/3/04			$10,000k
31/3/04		$10,000	0

Example 7 – A Co buys tax from intermediary to satisfy underpayment and partially pays out credit balance in ICA before breach of continuity

7/7/03 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. An imputation credit arises to A Co's ICA.

7/11/03 Ditto

14/12/03 Imputation credits of $70k are attached to dividends.

15/12/03 Breach of continuity – $30k debit arises.

7/3/04 A Co pays $50k to the intermediary, who deposits it into the tax pooling account. A credit arises in A Co's ICA.

31/8/04 After year end, A Co's RIT is $180,000. The intermediary requests IRD to transfer $50,000 from the pooling account to A Co's tax account as at each of 7/7/03, 7/11/03 and 7/3/04. No credits arise in relation to these transfers. (Section ME 4(1B) does not apply because the amount deposited prior to the breach is transferred to A Co's tax account with an effective date prior to the breach).

A Co's ICA

	Cr	**Dr**	**Bal**
7/7/03	$50k		$50k
7/11/03	$50k		$100k
14/12/03		$70k	$30k
15/12/03		$30k	$0k
7/3/04	$50k		
31/3/04			$50k

1/9/04 A Co purchases from the intermediary $10k that was deposited into the pool at each of 7/7/03, 7/11/03 and 7/3/04. $10k is transferred from the pooling account to A Co's income tax account as at each of 7/7/03, 7/11/03 and 7/3/04. Credits for $10k arise as at these dates (section ME 4(2)(ad)). This gives rise to a further debit of $20k on breach of continuity.

A Co's Adjusted ICA

	Cr	**Dr**	**Bal**
7/7/03	$50k + $10k		$60k
7/11/03	$50k + $10k		$120k
14/12/03		$70k	$50k
15/12/03	$30k + $20k	$0k	
7/3/04	$50k + $10k		$60
31/3/04			
1/9/04			

This is the intended result. A Co has paid tax of $180k – $120k before the breach and $60k after the breach. It paid out $70k in credits before the breach. Therefore it loses $50k on the breach, and retains $60k to pay out after the breach.

FURTHER INCOME TAX

Sections MB 9 and ME 9 of the Income Tax Act 1994 and section 181C of the Tax Administration Act 1994

Introduction

In certain circumstances, companies can now apply for relief from what is effectively double taxation and extra penalties in relation to further income tax (FIT) liabilities which arise when imputation credit accounts (ICAs) are overdrawn.

Payments of FIT may be used to offset income tax liabilities, and income tax payments may be used to offset FIT liabilities. Relief from use-of-money interest and late payment penalties is available when FIT and income tax liabilities are outstanding at the same time.

Relief has also been provided where a FIT obligation is triggered more than once as a result of an ICA debit balance straddling more than one income year.

Background

FIT is charged when a company has a debit in its ICA at 31 March in any year. The amount charged is equal to the debit balance in the ICA and is due and payable on 20 June. Prior to the amendment, section ME 9(5) of the Income Tax Act 1994 provided that any payments of FIT could be credited to an income tax liability, as well as FIT, but only to an income tax liability that arose after the date of payment. This could produce inappropriate results, as shown in example 1.

Example 1

Company Z paid first and second instalments of provisional tax for the 2002 income year of $110,000 each (total amount paid: $220,000).

In December 2001 it declared a dividend and, in anticipation of a third instalment of provisional tax of $110,000 (making total provisional tax payments of $330,000), allocated imputation credits of $330,000.

However, the third instalment of provisional tax due on 7 March 2002 was overlooked and was not paid until 7 April 2002. As a result, Company Z's imputation credit account had a debit balance of $110,000 at 31 March 2002.

This triggered an FIT liability of $110,000 plus imputation penalty tax due on 20 June 2002, despite the fact that the ICA was balanced on 7 April 2002 by the late payment of $110,000. Alternatively, if that payment had been designated to FIT, the effect of section ME 9(5) would have been that it would not have been available to meet the outstanding provisional tax instalment. This effectively amounts to double taxation because Company Z's only default was in respect to the provisional tax payment.

A further instance where FIT can unfairly disadvantage a company is when the same debit balance that exists at the end of one year (year one) can be carried over and remain in existence at the end of the next year (year two). In these circumstances, FIT is correctly charged for the first year. However, prior to the amendment, the Income Tax Act also inappropriately required a separate FIT assessment to be issued for year two. This was unfair when the actions that caused the ICA debit balance occurred in year one and no further "offending" occurred in year two.

Key features

Subsection (5) of section ME 9 of the Income Tax Act 1994 has been replaced by two new subsections, ME 9(5B) and (5C). New subsection (5B) provides that payments of FIT may also be credited to an income liability (including provisional tax) that arises at any time when the company is an ICA company.

Likewise, new subsection (5C) provides that payments of income tax may also be credited against the FIT liability, as long as the payment was made after 31 March in the year in which the ICA debit balance caused the FIT liability.

In both cases a company will need to specify the amount to be credited.

New subsections (8) and (9) provide relief when the same debit balance is reflected in the ICA in successive years.

An amendment to section MB 9 ensures that set-offs of overpaid tax between companies in a wholly owned group are subject to section MD 2. That is, such setoffs are not allowed if they create a debit balance in a company's imputation credit account. This is consistent with the new transfer rules in Part XB of the Tax Administration Act because the rules apply only if excess tax is refundable. The amendment to section MB 9 is necessary to ensure that group company set-offs do not have inappropriate results under the relief provisions.

New section 181C of the Tax Administration Act 1994 provides for the remission of use-of-money interest and late payment penalties on FIT liabilities when income tax liabilities are outstanding at the same time. The remission applies to the extent that the amount of FIT charged is equal to or less than the amount of the unpaid income tax liability.

Application date

The amendments apply for imputation years that began on or after 1 April 1998.

Example 2

Company A pays first and second instalments of provisional tax for the 2003 income year of $10,000 each (total amount paid: $20,000).

In December 2002 it declares a dividend and, in anticipation of a third instalment of provisional tax of $10,000 (making total provisional tax payments of $30,000), allocates imputation credits of $30,000.

However, the third instalment of provisional tax due on 7 March 2003 is overlooked and is not paid until 7 July 2003. As a result, Company A's ICA has a debit balance of $10,000 at 31 March 2003.

This triggers a liability for FIT of $10,000 due on 20 June 2003.

Under section ME 9(5B), Company A can specify that the payment made on 7 July 2003 should be credited to the FIT liability (as well as the third instalment of 2003 provisional tax). This will extinguish the FIT liability, but not the use-of-money interest and late payment penalties relating to FIT for the period from 20 June 2003 to 7 July 2003, nor the imputation penalty tax.

As at 20 June 2003, Company A was liable to pay FIT under section ME 9(1) and was also subject to late payment penalties in relation to the third instalment of 2003 provisional tax that was paid late. The use-of-money interest and late payment penalties effectively apply to the same default, the late payment of the third instalment of provisional tax. Therefore section 181C of the Tax Administration Act provides relief. Company A can apply for relief from use-of-money interest and late payment penalties charged on the FIT. Imputation penalty tax will still need to be paid.

As far as late payment penalties are concerned, Company A incurred late payment penalties on outstanding income tax (the third provisional tax instalment) as follows:

8 March 2003 (1% initial penalty)	$100
14 March 2003 (4% initial penalty)	$404
8 April 2003 (1% incremental penalty)	$105

and so on until it was paid.

In relation to the FIT liability, Company A incurred late payment penalties of:

21 June 2003 (1% initial penalty)	$100
27 June 2003 (4% initial penalty)	$404

As the late payment penalty on the outstanding income tax liability is greater that that charged on the outstanding FIT liability, the late payment penalty on the FIT can be remitted in full.

Similar analysis applies to the interest running on both accounts.

Detailed analysis

Crediting FIT payments to income tax, and vice versa

Under the new rules, Company Z in example 1 is able to specify that the payment of $110,000 made on 7 April 2003 is also credited to the FIT liability due on 20 June 2003. This extinguishes the FIT liability, but not the imputation penalty tax, which will need to be paid separately. As no FIT is outstanding at 20 June 2003, there is no need to apply the new section 181C of the Tax Administration Act.

Example 2 shows how the relief provisions operate in relation to use-of-money interest and late payment penalties.Same debit balances reflected in ICA in successive years

New subsection (8) provides a company can apply for an adjustment where:

(a) the company had a debit balance in its ICA at the end of the immediately preceding imputation year, and

(b) that debit balance exceeds the credits arising to the ICA in the current imputation year.

When such an application is made, subsection (9) provides that the FIT liability for the current imputation year is reduced by the difference between:

(a) the ICA debit balance at the end of the immediately preceding income year, and

(b) the total of the credits arising to the ICA during the current imputation year.

Example 3

Company M pays tax of $1,000 in year one and allocates imputation credits of $2,000. At the end of year one, therefore, the ICA has a debit balance of $1,000. In year two a payment of $700 is made. At the end of year two, the ICA has a debit balance of $300.

ICA

Description	**Debit**	**Credit**	**Balance**
Tax paid during year		$1,000	$1,000
Credits allocated to dividend	$2,000		($1,000)
Debit balance at 31 March Y1 is $1,000			
Tax paid during Y2		$700	($300)
Debit balance at 31 March Y2 is $300			

Prior to the amendment, the company would have incurred a FIT liability of $1,000 for year one and another FIT liability of $300 in year two.

Under the amendment, relief applies in this case because the credits in year two ($700) are less than the ICA debit balance at the end of year one ($1,000). The FIT liability in year two is reduced to nil upon application by the taxpayer.

In example 3, the same result would have occurred if the maximum relief available had been the lesser of the year one and year two ICA debit balances. However, allowing relief on that basis in all instances is not appropriate because it could lead to a permanent deferral of the payment of income tax in some circumstances.

Subsections (8) and (9) are consistent with subsections (5B) and (5C). Under subsection (5B) and (5C), companies will be able to elect to have payments made during year two credited to a FIT liability for year one. Therefore it is not appropriate for those payments to be used to reduce the FIT liability for year two.

BRANCH EQUIVALENT TAX ACCOUNTS AND LOSSES

Sections MF 4-5, 8, 10 of the Income Tax Act 1994

Introduction

Amendments have been made to the branch equivalent tax account rules to ensure:

- only New Zealand-sourced losses can create branch equivalent tax account credits
- consistency between the treatment of current year domestic losses, as well as
- a simplification of the branch equivalent tax account credit rules generally.

Background

Foreign losses

The branch equivalent tax account rules aim to prevent double taxation of foreign income that is subject to income tax under controlled foreign company or foreign investment fund rules, as well as subject to dividend withholding payment on foreign dividends received. The intention is that regardless of which income stream occurs first, tax will be paid only once.

The branch equivalent tax account mechanism provides that if income tax has been paid first, a branch equivalent tax account credit arises which offsets the liability to dividend withholding payment. Alternatively, if a dividend had been paid in advance of the income being earned in the controlled foreign company, with dividend withholding payment being paid first, a branch equivalent tax account debit that offsets the liability to income tax arises.

A branch equivalent tax account credit could also be created when losses from New Zealand sources have been offset against attributed foreign income, so no liability to income tax arose—previous sections MF 4(1)(b) and MF 8(2)(b).

The intention was always that only losses from New Zealand sources could create branch equivalent tax account credits. However, the re-ordering of the Income Tax Act in 1994 and the subsequent changes made by the introduction of the Act's new core provisions in 1997, had made that unclear.

Upon reordering of the Act, all losses, both New Zealand and foreign, were grouped together under Part I. As a branch equivalent tax account credit could be created when "any loss" offset a company's attributed foreign income, this regrouping of losses made it less clear that branch equivalent tax account credits could be created only with New Zealand losses.[14]

The changes made as part of introducing the core provisions allowed "available net losses" to create branch equivalent tax account credits. "Available net losses" are defined under section OB 1 as losses offset under Part I, which include attributed foreign net losses and foreign investment fund net losses. As allowing attributed foreign net losses and foreign investment fund net losses to create branch equivalent tax account credits is contrary to the original policy intent, amendments have been made to exclude them with effect from the introduction of the core provisions.

Additionally, previous sections MF 4(1)(a) and MF 8(2)(a) allowed a branch equivalent tax account credit to be created if a company, or consolidated group, had attributed foreign income and had also paid income tax. While these sections had been in force since the start of the international tax rules, they also inadvertently allowed the creation of a branch equivalent tax credit from foreign losses. This is because they looked only at whether attributed foreign income and income tax paid had been paid. They did not consider the case where the foreign income had been offset by a foreign loss.

Domestic losses

Further amendments were added to the bill at the select committee stage of proceedings.

The amendments also sought to ensure consistency between the treatment of past year losses and allowable deductions and current year allowable deductions.

In the case of branch equivalent tax credits, the previous sections MF 4(1)(b) and MF 8(2)(b) created a branch equivalent tax account credit to the extent that losses had been offset against a company's, or consolidated group's, net income up to the amount of the attributed foreign income derived. This, except that foreign losses could also create credits, was the right result for past year losses or losses from group companies.

[14] The changes also apply to the Act as it was before the introduction of the new core provisions and clarify that "any loss" other than attributed foreign losses or foreign investment fund losses can create a branch equivalent tax account credit.

However, if the same level of deductions that were allowable in a past year to that company or a group company to create the resulting loss, were allowable in the company that earned the attributed foreign income, the deductions would be first offset against other income of the company. This would reduce the taxable income for the company.

Sections MF 4(1)(a) and MF 8(2)(a) created a branch equivalent tax account credit only to the extent tax was paid. Thus if little or no tax was paid, when the foreign dividend was paid from the underlying attributed foreign income, dividend withholding payment would still be due even though the attributed foreign income had come first.

Thus double taxation would ensue, once through the use of current year deductions and again through the subsequent liability to dividend withholding payment.

This was similarly the case when it came to using branch equivalent tax account debits to offset an income tax liability on attributed foreign income.

Sections MF 4(1)(a) and MF 8(2)(b) were used by sections MF 5(6) and MF 10(5) respectively to quantify the amount of the debit that could be used to offset an income tax liability. When there was little or no taxable income and or little or no income tax liability, the branch equivalent tax account debit would be small or non-existent and the income tax liability relating to the attributed foreign income would have been met by the current year deductions of the company or consolidated group.

Had the current year deductions been in another group company or the loss incurred in a past year, a branch equivalent tax account debit could be used to offset the tax liability on the attributed foreign income and the New Zealand losses used to offset domestic income.

Example 1

Year 1 company receives a foreign dividend of $100 and pays $33 dividend withholding payment. A debit of $33 is created in the branch equivalent tax account. Branch equivalent tax account balance = $33dr.

Year 2 company earns $100 attributed foreign income but also has current year deductions of $100. No income tax to pay and no offset from the branch equivalent tax account. Branch equivalent tax account balance = $33dr.

Year 3 company earns $100 New Zealand income. No more foreign income is earned. Tax to pay $33 and yet branch equivalent tax account balance = $33dr.

In total, over the three years, $100 in foreign income has been earned and nil ($100 gross income less $100 allowable deductions) New Zealand income has been earned. Only $33 dividend withholding payment should have been paid, and there should now be a zero balance in the branch equivalent tax account, while in fact $66 New Zealand tax has been paid and a $33dr balance remains in the branch equivalent tax account.

Amendments have been made to ensure the domestic loss is preserved and the branch equivalent tax account balance is reduced by the amount of the branch equivalent tax account debit that relates to the attributed foreign income.

Key features

- Sections MF 4(1)(a) and MF 8(2)(a) now consist of one formula which essentially allows a branch equivalent tax account credit of an amount being the attributed foreign income less any foreign losses multiplied by the appropriate tax rate. This ensures that regardless of how the tax liability of the company or consolidated group is met, other than with foreign losses, a branch equivalent tax credit will arise which can offset a future dividend withholding payment liability. It also reduces two provisions into one formula.
- Sections MF 4(1B) and MF 8(2B) have been repealed as more than one credit cannot now arise for the same underlying attributed foreign income.
- New sections MF 5(6B) and MF 10(5B) have been added to ensure that when current year deductions/losses offset a tax liability on attributed foreign income, the difference between an allowable branch equivalent tax account debit offset under sections MF 5(6) or MF 10(5) and the income tax payable, is grossed up and converted into a loss which can be used to offset future New Zealand income. This ensures in example 1 that in year two the branch equivalent tax account balance is zero, with a loss of $33 remaining which can offset income in future years.

Example 2 – after changes made to legislation

Year 1 company receives a foreign dividend of $100 and pays $33 dividend withholding payment. A debit of $33 is created in the branch equivalent tax account. Branch equivalent tax account balance = $33dr. ***No change***

Year 2 company earns $100 attributed foreign income but also has current year deductions of $100. No income tax to pay, so $33 dr is grossed up to $100 and carried forward as a loss. Branch equivalent tax account balance = ***$0dr.***

Year 3 company earns $100 New Zealand income, which is offset by year two loss. No more foreign income is earned. Tax to pay is $0 and now branch equivalent tax account balance = ***$ 0 dr. Right result***

Application dates

In the case of preventing foreign losses from creating branch equivalent tax account credits that resulted from the re-ordering of the Act and its interface with core provisions, the amendments apply from the 1995–96 income year. All other changes apply from the 1997–98 income year.

The exception in both cases is when a taxpayer has filed a return of income before 26 June 2003 and relied on the provisions as they were before the enactment of the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003, when it will apply from that date.

FURTHER DIVIDEND WITHHOLDING PAYMENT

Sections MG 9 of the Income Tax Act 1994

Introduction

Relief from double taxation and extra penalties has been provided in relation to further dividend withholding payment (FDWP) liabilities which arise when dividend withholding payment accounts (DWPAs) are overdrawn.

In certain circumstances, payments of FDWP may be used to offset dividend withholding payment (DWP) liabilities, and DWP payments may be used to offset FDWP liabilities.

Relief has also been provided where an FDWP obligation is triggered more than once as a result of a DWPA debit balance straddling more than one income year.

Background

A company that is resident in New Zealand and receives dividends from a non-resident company is required to deduct DWP from the dividend and pay it to Inland Revenue. DWP credits can be attached to dividends paid by New Zealand resident companies in the same way as imputation credits.

Companies may elect to maintain a DWPA separately from an imputation credit account (ICA). When a DWPA has a debit balance at 31 March in any year, the company incurs an FDWP liability. Prior to the amendment, a payment that satisfied an FDWP liability could also be credited in satisfaction of any DWP for which the company becomes liable after the date the FDWP was made. As with further income tax (see earlier article), this sometimes produced inappropriate results.

The issue of the same debit balances reflected in the ICA in successive years also occurs with DWPAs.

The changes were added to the bill at the select committee stage of proceedings.

Key features

Subsection (5) of section MG 9 of the Income Tax Act 1994 has been replaced by two new subsections, ME 9(5B) and (5C). New subsection (5B) provides that payments of FDWP may be credited to a DWP liability that arises at any time when the company is an DWPA company.

Likewise, new subsection (5C) provides that payments of DWP may be credited against the FDWP liability, as long as the payment was made after 31 March in the year when the DWPA debit balance caused the FDWP liability.

In both cases a company will need to specify the amount to be credited.

New subsections (7) and (8) provide relief when the same debit balance is reflected in the DWPA in successive years. Relief is provided, upon the application of the company, where a DWPA debit balance in the immediately succeeding imputation year exceeds the total of DWP credits for the current imputation year.

Application date

New subsections (5B) and (5C) apply to imputation years starting on or after 1 April 1998. New subsections (7) and (8) apply to imputation years starting on or after 1 April 2003.

APPLICATION DATE OF NEW TAX CODES

Section NC 8(4) of the Income Tax Act 1994

Introduction

An amendment clarifies that a new tax code applies from the start of the pay period in which it is received by an employer, instead of the succeeding one.

Background

The amount of tax deducted from salary and wages depends upon the tax code that the employee supplies to the employer. When employees' circumstances change—for example, if they become liable for student loan repayments or take on a second job—they can elect a new tax deduction code.

Previously, a new tax code applied from the start of the pay period after the one in which it was provided to the

employer. This caused confusion as many employers were applying new tax codes to the current period in which they were received, rather than the next period. Although this practice was not in keeping with the legislation, it actually increased the accuracy of the PAYE deduction system.

The amendment reduces compliance costs for employers in that they do not have to remember to apply the new code with effect from the following pay period. It also improves the accuracy of the PAYE deduction system and therefore requires fewer salary and wage earners to file returns or request income statements.

Key features

Section NC 8(4) of the Income Tax Act 1994 has been amended to provide that a new tax code applies for the current pay period if the code is delivered before the cut-off point for the preparation of the pay. If the new tax code is delivered after the cut-off point, it applies from the following pay period.

Application date

The amendment applies to pay periods ending on or after 1 April 2004.

PROGRESSIVE SPECIFIED SUPERANNUATION CONTRIBUTION WITHHOLDING TAX

New section NE 2AB and Schedule 1, Part A, clause 10(ab) of the Income Tax Act 1994

Introduction

Employers may apply progressive rates of specified superannuation contribution withholding tax (SSCWT) rather than the flat rate of 33%.

The amendments allow for the appropriate taxation of employer contributions to superannuation funds for employees earning $38,000 a year or less by enabling employers to determine a rate of SSCWT that reflects an employee's marginal tax rate based on his or her salary or wages.

Background

Employer contributions to superannuation funds for employees have been generally subject to a SSCWT rate of 33%. Therefore employers' contributions on behalf of low-income employees can be overtaxed because these employees are likely to have a lower marginal tax rate. In the 2002 Budget the government announced that it intended to introduce, by 1 April 2004, legislation to deal with the overtaxation of employer contributions for employees earning under $38,000.

The Finance and Expenditure Committee, during its consideration of the later bill, recommended the following changes to the proposal:

- applying a 15% rate to contributions on behalf of employees earning under $9,500 a year, rather than the 21% rate for all those earning under $38,000, as originally proposed in the bill, and
- removing the need to include the amount of the employer's superannuation contribution in determining the appropriate SSCWT rate.

Key features

Application of the new section NE 2AB is voluntary and at the discretion of the employer. If an employer decides not to offer progressive SSCWT rates, a flat rate of 33% will apply unless the employer makes an election under section NE 2A (1) or section NE 2AA (1) of the Act. The amendments apply to defined contribution schemes and to defined benefit schemes where an employer's contribution is expressed as a%age of the employee's salary.

If an employer chooses to offer progressive SSCWT rates the appropriate rate is determined by either the employer or fund manager (depending on the administrative features of the fund) at the beginning of the standard tax year, which is 1 April as follows:

- If the employee has been employed by that employer for a full year (including part-time, full year) the rate will be set by reference to the employee's annual salary or wages paid by that employer in the previous year.
- If an employee has not been in the employment of the employer for a full year, the employer is required to estimate the employee's salary or wages for the coming year.

The amendments to Schedule A, clause 10 provide for contributions to be taxed at 15% if an employee's salary or wages total less than $9,500, or at 21% if salary or wages total $38,000 or less.

There is no requirement to adjust the rate during an income year if an employee's salary or wages increase or decrease. If they do change during the year, affecting the applicable rate, a new rate will be set the following year based on this change.

Example

Employee A has been employed by a particular employer for two years. In the previous tax year (1 April to 31 March) the employer paid the employee a salary of $37,000. Because this total amount is less than $38,000 (but more than $9,500) the rate of SSCWT on the employer's contributions for the year ahead will be 21%.

Employee B has been employed by a particular employer for two months. The employer estimates that in the year ahead the employee will earn $9,000. Because this amount is less than $9,500, the rate of SSCWT on the employer's contributions for the year ahead will be 15%.

Application date

New section NE 2AB and the amendments to Schedule 1, Part A, clause 10(ab) apply from 1 April 2004.

QUALIFYING TRUST STATUS

Section OB 1 of the Income Tax Act 1994

Introduction

The definition of "qualifying trust" in the Income Tax Act 1994 has been amended to allow a non-qualifying trust to become a qualifying trust retrospectively if all of the trustee's income tax obligations are satisfied, including the payment of use-of-money interest and any penalties.

Background

Most trusts established by New Zealand resident settlors come within the Income Tax Act definition of a "qualifying trust". This definition includes the requirement that all of the trustee's income tax obligations have been satisfied since the beginning of the trust. The main benefit of a qualifying trust status is that, under section HH 3(5), all distributions from a qualifying trust of amounts other than beneficiary income (current year trust income distributed to beneficiaries) are not taxable to beneficiaries.

A draft Inland Revenue interpretation (ED 0047), issued in September 2003 for external consultation, addressed the issue of what is the tax treatment if the trustees of a qualifying trust have underpaid income tax in the past and subsequently make a distribution without rectifying the underpayment. The draft statement said that such a trust is not a qualifying trust for the period that the underpayment has not been rectified, and any distributions made in the period will be taxable distributions taxed at the rate of 45%.

A result of the draft Inland Revenue interpretation would have been that a small underpayment of income tax by a trustee of a trust could have had disproportionately penal consequences for the beneficiaries of the trust. For example, in the case where a home is owned by a family trust, an underpayment of tax of $100 several years ago by the trust could have resulted in the beneficiaries living in the home being taxed on the value of that accommodation, when they normally would not be.

When the trust taxation rules were developed, in 1988, the current comprehensive use-of-money interest and penalty provisions were not in place. The requirement in the definition of qualifying trust that all of the trustee's income tax obligations must be satisfied was intended as an incentive to comply with the trust taxation rules. This incentive can now be more appropriately provided by the current use-of-money interest and penalty provisions.

The policy underpinning the qualifying trust rules is that full New Zealand tax is paid on a current basis on the worldwide trustee income of trusts settled by New Zealand residents. This policy objective can be promoted by applying the use-of-money interest and penalty rules to any underpayment of tax by a trustee of a qualifying trust. It is not necessary for such a trust to lose its qualifying trust status so that beneficiaries are taxed at a 45% rate on taxable distributions.

Key features

The amendment to the definition of "qualifying trust" in the Income Tax Act 1994 allows a trust that is a non-qualifying trust (because all of the trustee's income tax obligations have not been satisfied) to become a qualifying trust retrospectively if all of the trustee's income tax obligations are satisfied, including the payment of use-of-money interest and any penalties.

The amendment will result in any taxable distributions, made during the period when there was an underpayment of tax that was subsequently rectified, being unwound.

The amendment supersedes the draft Inland Revenue interpretation discussed earlier which, accordingly, will not proceed.

Application date

The amended definition of "qualifying trust" applies for the 1997–98 and subsequent income years, the same application date as the income tax core provisions enacted in 1996. This application date was chosen because the draft Inland Revenue interpretation discussed earlier referred to the replacement of the definition of qualifying trust by the core provisions amendments as being the basis of that interpretation.

CONFIRMATION OF ANNUAL INCOME TAX RATES FOR 2003–2004

Schedule 1 of the Income Tax Act 1994

The income tax rates for the 2003–2004 income year have been confirmed as follows:

Policyholder income	33 cents for every $1 of schedular taxable income
Māori authorities	25 cents for every $1 of taxable income
Undistributed rents, royalties and interest of the Māori Trustee	25 cents for every $1 of taxable income
Companies, public authorities and local authorities	33 cents for every $1 of taxable income
Trustee income (including that of trustees of superannuation funds)	33 cents for every $1 of taxable income
Trustees of group investment funds in respect of category A	33 cents for every $1 of schedular taxable income
Taxable distributions from non-qualifying trusts	45 cents for every $1 of taxable distribution
Other taxpayers (including individuals)	
- Income not exceeding $38,000	19.5 cents for every $1 of taxable income
- Income exceeding $38,000 but not exceeding $60,000	33 cents for every $1 of taxable income
- Income exceeding $60,000	39 cents forevery $1 of taxable income
Specified superannuation contribution	39 cents for every $1 of contribution where the employee has made an election under section NE 2AA
	33 cents for every $1 of contribution where no such election is made.

The income tax rates confirmed are the same rates that applied for the 2001–02 and 2002–2003 income years. The rates apply for the 2003–2004 income year.

EMPLOYER OBLIGATIONS FOR STUDENT LOAN DEDUCTIONS

Sections OZ 1 (1) of the Income Tax Act 1994 and sections 25(1) and (2) of the Student Loan Scheme Act 1992

Introduction

Amendments to the Income Tax Act and to the Student Loan Scheme Act ensure that offences by employers relating to student loan deductions are penalised in the same way as offences relating to PAYE.

Background

The Student Loans Scheme Act 1992 originally contained its own offences and related penalties. In 1996 those relating to employer deductions were repealed. The intention was that student loan offences by employers in relation to repayment deductions would come within the provisions of the penalty rules introduced in Part IX of the Tax Administration Act.

However, the amendment made to the Student Loans Scheme Act at that time excludes section 143A(1)(d) and (e) and 143B(1)(d), and Part IX (except section 146). The original amendment should have applied sections 143A, 143B and 146 as far as they are applicable to repayment deductions.

Key features

Amendments have been made to the definition of "PAYE rules", in the Income Tax Act 1994, to omit unnecessary references to sections contained in Part IX of the Tax Administration Act, and to the Student Loan Scheme Act, to ensure Part IX applies as far as it is applicable to repayment deductions.

Application date

The amendment applies from the introduction of the compliance and penalties legislation, the 1997–98 income year.

REMOVING END-OF-YEAR RETURNS FOR IR 56 TAXPAYERS

Section 33A2(h) of the Tax Administration Act 1994 and section 80D(1) amended

Introduction

The requirement for most IR 56 taxpayers to file end-of-year income tax returns has been removed. They will instead be issued with an income statement for the year.

Background

Private domestic workers (such as home helpers, attendant caregivers, nannies and gardeners) and other IR 56 taxpayers (such as staff of foreign consulates and embassies, New Zealand-based representatives of foreign companies and Operation Deep Freeze personnel) are required to return tax on income from employment, under the PAYE rules, as if they were the employer. Previously, they were also required to file an end-of-year income tax return (an IR 3) to reconcile the PAYE deductions made throughout the year (as well as any other income and tax paid). This requirement was based largely on past ACC obligations, when levies payable were calculated on the return. Under the change, an income statement (or personal tax summary) will instead be issued to these taxpayers.

IR 56 taxpayers will still be required to file a return if, for example, they have income in a year other than from employment (and interest or dividends).

Key features

Section 33A(2)(h) of the Tax Administration Act 1994 has been repealed and section 80D(1) amended to remove the requirement for most IR 56 taxpayers to file IR 3 returns.

Application date

The amendment applies from the 2003–04 income year.

PROBLEM GAMBLING LEVY: INFORMATION TO BE DISCLOSED TO MINISTRY OF HEALTH

Section 81(4)(e) of the Tax Administration Act

Introduction

Section 81(4) has been amended to enable the Commissioner of Inland Revenue to disclose information to the Ministry of Health, as well as the Department of Internal Affairs for purposes of determining the problem gambling levy rate.

Background

The Gaming Act 2003 amended section 81(4) of the Tax Administration Act to enable Inland Revenue to disclose gaming information to the Department of Internal Affairs so it could determine the problem gambling levy rate. The problem gambling levy is imposed on gaming operators to provide funding for provision of problem gambling services.

However, for the amendment to operate as intended, gaming information also needed to be transferred to the Ministry of Health to enable it to participate in determining the problem gambling levy rate in conjunction with the Department of Internal Affairs.

The amendment was added to the bill at the select committee stage of proceedings.

Key features

A new paragraph (ea) has been inserted in section 81(4) to enable gaming information to be disclosed to the Ministry of Health as well as the Department of Internal Affairs. Information will be disclosed only in relation to the gaming industry and only for the purpose of determining the problem gambling levy rate.

Application date

The amendment applies from 25 November 2003.

SHORTFALL PENALTIES AND LOSS ATTRIBUTING QUALIFYING COMPANIES

Section 141FC of the Tax Administration Act 1994

Introduction

An amendment relieves the double imposition of shortfall penalties to a loss attributing qualifying company and its shareholders. The double penalty can occur as a consequence of the attribution of a net loss, and the subsequent disallowance of deductions to both the company and the shareholders, when shortfall penalties are charged to both parties.

The shareholders are now able to apply for a reduction in the penalty, once the shortfall penalty charged to the company has been paid in full.

Background

Net losses of loss attributing qualifying companies are attributed to shareholders. The High Court (*Chapman* v *CIR* (HC M402-SD02)) has recently held that when a loss has been overstated, causing a tax shortfall to both the company and the shareholders, shortfall penalties can be imposed on both the company and shareholders because they have taken separate tax positions.

Conceptually, only one penalty is appropriate in these circumstances.

The form of this amendment was chosen because it did not cut across the decision in the *Chapman* case. It was not clear at the time the legislation was introduced whether that case was to be appealed. It has subsequently been decided that the *Chapman* decision is not being appealed. That being the case, the legislation as enacted may not provide the best resolution of the double penalty issue. Further work is being done on this issue.

Key features

New section 141FC of the Tax Administration Act 1994 relieves the double penalty that occurs when, as a consequence of the attribution of a net loss by a loss attributing qualifying company and the subsequent disallowance of deductions to the company and, therefore, the shareholders as well, shortfall penalties are charged to both the company and the shareholders. In these circumstances the shareholder can now apply for a reduction in the penalty when the shortfall penalty charged to the company has been paid in full.

The reduction will be limited to the shareholder's pro rata proportion of the company's shortfall penalty.

Example

LAQC Ltd is charged a shortfall penalty of $20,000, which it pays in full.

A owns 20 of the 100 shares in LAQC Ltd (20%) and is charged a shortfall penalty of $800 in her own right.

A seeks an offset. The equivalent of A's share of LAQC Ltd's shortfall penalty is $4,000 ($20,000 x 20%). As the penalty charged to A is less than $4,000, A's shortfall penalty will be offset.

Application date

The amendment applies retrospectively to shortfall penalties imposed since 1 April 1998, to match the four-year time bar for reassessments.

GST TREATMENT OF CONTRIBUTIONS MADE TO LOCAL AUTHORITIES

Sections 5(7B)-(7C) and 11B(1B)-(1C) of the Goods and Services Tax Act 1985

Introduction

Changes have been made to clarify the GST treatment of contributions received by local authorities under the Resource Management Act 1991 and Local Government Act 2002.

The changes, which are directed at financial and development contributions, introduce new rules to clarify that contributions are consideration for taxable supplies and that certain contributions in the form of land are zero-rated.

Background

The amendments, which were added to the bill after its introduction into Parliament, are in response to arguments suggesting that financial or development contributions may not be subject to GST.

Under ordinary principles, GST is imposed according to whether there is a sufficient connection between a payment and any supply made in return for the payment. In the case of financial or development contributions imposed in accordance with a local authority's district or regional plan, however, the contributions sought by a local authority may or may not be used for the provision of specific goods and services. This absence of a link to any subsequent or identifiable supply could arguably mean that GST does not apply when a financial or development contribution is made by a resource applicant to a local authority.

This position was advanced as a tentative view, consistent with recent court decisions,[15] in draft Inland Revenue ruling PU 0095.[16] It noted that a local authority may seek a financial contribution from an applicant for a resource consent if, for example, the development work (such as a new subdivision) allowed under the resource consent would require the local authority under its district plan to provide additional new infrastructure assets such as sewerage or flood control or provide additional services such as a new library. A local authority may also require a financial contribution in accordance with its district plan with no specific provision of infrastructure in mind. For example, the contribution may be required to offset a potential environmental impact on the region and be used for education campaigns.

[15] *Commissioner of Inland Revenue v New Zealand Refining Company Limited* (1997) 18 NZTC 13,187 and *Chatham Islands Enterprise Trust v Commissioner of Inland Revenue* (1999) 19 NZTC 15,075.

[16] Inland Revenue is currently considering the merit in reissuing PU 0095, in whole or in part, in light of the enacted changes.

Inland Revenue's initial view, as presented in PU 0095, was that these contributions may not be subject to GST because the payment of the financial contribution is not necessarily a requirement of the resource consent being granted. This view departed from Inland Revenue's previous view set out in public ruling BR PUB 97/2.

The White Paper on GST noted that local authorities provide goods and services which are paid for by consumers by way of rates, fees, and other charges.[17] To ensure that local authorities are treated in a manner consistent with other suppliers of goods and services, the policy intent was that fees and charges by local authorities would be subject to GST. The amendments seek to achieve this outcome in relation to resource contributions in the same manner as it is achieved in relation to rates.

The amendments therefore confirm that when a local authority seeks a contribution in the form of land, money or both it is to be treated as a consideration for the supply of goods and services provided by the local authority to the person making the contribution.

Key features

- New section 5(7B) treats a local authority as supplying goods and services if it requires from a person:
  - a financial contribution as a condition of a resource consent under the Resource Management Act
  - a development contribution under the Local Government Act.
- New section 5(7C) treats a person as supplying goods and services to a local authority to the extent that land is provided as a financial or development contribution.
- New section 11B(1B) zero-rates the supply of goods and services made by a local authority under section 5(7B) to the extent that the consideration received for those goods and services is in the form of land.
- New section 11B(1C) zero-rates the supply of goods and services made by a registered person under new section 5(7C).

Application date

New sections 5(7B) and (7C) apply from 1 October 1991 in respect of financial contributions made under the Resource Management Act 1991. The retrospective application does not, however, apply to financial contributions which have not been treated as taxable supplies (other than zero-rated supplies). This is provided that the local authority has sought the financial contribution before 25 November 2003.

[17] *White Paper on Goods and Services Tax*, March 1985 pages 14 and 34.

New sections 5(7B) and (7C) apply to development contributions sought under the Local Government Act 2002 on and after 25 November 2003.

New sections 11B(1B)-(1C) apply on and after 25 November 2003.

Detailed analysis

Scope of the amendments

The Finance and Expenditure Committee recommended that for the purposes of the GST Act, the term financial or development contribution be limited to contributions that are in the form of land or money or both. This recommendation was in response to concerns raised by some submissions that the proposed legislation would extend the application of the GST Act beyond its scope. The effect of such an extension could result in double taxation if GST applied to conditions, not in the form of a contribution in land or money, imposed by a local authority in relation to applicants that are not registered for GST.

Therefore, for the purposes of the new sections:

- A "financial contribution" is as defined in section 108(9) of the Resource Management Act. This limits the term to a contribution in the form of money, land or both.
- A "development contribution" is as defined in section 197 of the Local Government Act. This means a contribution comprising of money, land (unless otherwise excluded) or both.

If a local authority seeks anything other than a financial or development contribution in relation to a consent the GST consequences will be determined under ordinary principles. That is, there will need to be an assessment of whether consideration is given by the resource application and whether the consideration is sufficiently connected to a supply of goods and services from the local authority.

GST on cash financial or development contributions

For the purpose of section 5(7B), unless otherwise agreed between the parties, the GST component of a cash contribution will be treated as one-ninth of the amount given to the local authority.

GST on non-cash financial or development contributions (land)

Conceptually, the provision of a non-cash financial or development contribution in return for a resource consent from a local authority can be regarded as a barter transaction. If the parties to a barter transaction are both registered for GST, the transaction is revenue-neutral because any GST charged will be met by a corresponding input tax credit (assuming that the supplies received as consideration were acquired for the principal purpose of making taxable supplies).

When a non-cash financial or development contribution is made in relation to a resource consent, new section 5(7C) ensures that the contribution is treated as a supply of goods and services in its own right. The revenue-neutral aspect of the reform is also supported by new sections 11B(1B) and (1C), which were inserted, at the recommendation of the Finance and Expenditure Committee, in recognition of concerns regarding the difficulties facing local authorities and resource consent applicants when valuing such contributions. The zero-rating is limited to transactions where the resource consent applicant and the local authority are registered persons.

Example – contribution in the form of land

As part of a development, a local authority requires a GST-registered property developer to provide a section that can be used as a playground. The value of the land once designated as a playground differs substantially from its value for development purposes. As the contribution is in the form of land and the transaction is between two registered persons, the contribution may be zero-rated.

If a non-cash contribution in the form of land is given by a recipient that is not registered for GST, the local authority which granted the resource consent will be required to return GST equal to one-ninth of the value of the non-cash contribution received.

Input tax credits

Whether a registered person can claim an input tax credit for GST paid on the purchase of goods and services depends on whether or not the purchase is for the principal purpose of making taxable supplies. The deduction of input tax credits is always therefore a question of fact and degree. Following the release of draft public ruling PU 0095, concerning the GST treatment of financial contributions, the ability of parties to claim input tax credits in respect of making a contribution was raised as an issue. One of the objectives of new sections 5(7B)-(7C) is to confirm that property developers and other GST-registered persons will be able to claim input tax credits in respect of cash contributions and for any GST paid in respect of any works and services that may be incorporated in a contribution in the form of land.

Deductions of input tax in respect of supplies of goods and services purchased outside the application of sections 5(7B)-(7C) will remain a question of fact, subject to ordinary GST principles.

Retrospective application date

New sections 5(7B)-(7C) apply from 1 October 1991. The retrospective application of sections 5(7B)-(7C), in relation to financial contributions made under the Resource Management Act, confirms general taxpayer expectations regarding the GST treatment of financial contributions before 25 November 2003. The purpose of this was to prevent backdated refunds being sought if taxpayers sought to apply draft ruling PU 0095 retrospectively.

As a period of time can pass between when a contribution is sought by a local authority and when the contribution is made by the resource applicant, section 144(2) of the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 includes a savings provision for certain contributions sought by local authorities before 25 November 2003. Section 144(2) ensures that sections 5(7B)-(7C) of the GST Act do not apply to contributions paid (or in the case of non-cash contributions when it vests to the local authority) at any time if the local authority:

- sought the contribution before 25 November 2003, and
- did not treat the contribution as being made in relation to a taxable supply that was charged with tax other than the rate of 0%.

Contributions that have been sought on and after 1 October 1991, but before 25 November 2003, and have been treated as subject to GST will not be covered by the savings provision.

GST TREATMENT OF LATE PAYMENT PENALTIES FOR OVERDUE RATES AND POSTPONEMENT FEES

Section 14(3)(a)-(c) of the Goods and Services Tax Act 1985

Introduction

Section 14(3) has been:

- redrafted to confirm that late payment penalties imposed under the Local Government (Rating) Act 2002 are treated as consideration for exempt supplies, and
- expanded to treat as consideration for an exempt supply finance costs imposed by local authorities that relate to the postponement of rates under the Local Government (Rating) Act 2002.

Under the redrafted section, penalty or default interest imposed under a contract for the supply of goods and services or an enactment will continue to be treated as consideration for an exempt supply.

Background

Both changes were added to the bill at the select committee stage of proceedings.

Late payment penalties

The Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002 amended the GST Act to allow penalty interest imposed under statute to be treated as an exempt supply. The amendment was made retrospective to 10 October 2000 to align the treatment of penalty interest imposed under statute with interest penalties imposed under contract. As a result of further consultation during the passage of that Act, local authorities were excluded from the retrospective application of the amendment owing to their concerns about compliance costs. It was expected that local authorities would be able to treat penalties imposed on unpaid rates as consideration for an exempt supply from 1 July 2003.

Inland Revenue interpreted the amendment as not applying to penalties on rates as the penalty was not regarded as in the nature of interest. This was because the late payment penalty is treated by the Rating Powers Act 1988 and Local Government (Rating) Act 2002 as being part of the rates on which GST is charged under section 5(7) of the GST Act. This interpretation was contrary to the policy intent at the time the amendment was enacted. The redraft of section 14(3), as amended by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003, clarifies that late payment penalties imposed by local authorities under the Local Government (Rating) Act are to be treated as consideration for exempt supplies.

Postponement fees

In response to submissions on the bill, the Finance and Expenditure Committee recommended that section 14(3) be further amended to clarify the treatment of fees charged by local authorities when rates are postponed.

Section 88 of the Local Government (Rating) Act allows local authorities to charge a fee when rates are postponed. This fee is meant to recover any administrative and financial costs associated with postponing rates. The current wording of section 88(3) of the Local Government (Rating) Act provides that for all purposes postponement fees, including finance costs, relating to the postponement of rates must be treated as part of the rates on the affected rating unit. This wording, in conjunction with section 5(7) of the GST Act, which treats local authority rates as consideration for the supply of public goods and services to the community, meant that GST would apply to postponement fees. While it is appropriate that GST continues to apply to postponement fees generally, finance costs should be exempt because postponement arrangements created by local authorities are similar to the creation of a debt security, as defined in section 3 of the GST Act.

Key features

Redrafted section 14(3) treats the following charges as consideration for exempt supplies:

- as previously, penalty or default interest, or a charge in the nature of interest, that is imposed either under a contract for the supply of goods and services or, under an enactment
- late payment penalties imposed by a local authority under the Local Government (Rating) Act for the late payment of rates, and
- finance costs charged by a local authority under the Local Government (Rating) Act when rates are postponed.

Application date

The amendments apply on and after 1 July 2003, the date of effect of the Local Government (Rating) Act.

GST TREATMENT OF DOMESTIC TRANSPORTATION SERVICES SUPPLIED TO NON-RESIDENTS

Section 11A(1)(cb) and (d) of the Goods and Services Tax Act 1985

Introduction

New section 11A(1)(cb) has been inserted to clarify that New Zealand-based transport services supplied under contract to a non-resident international removal company in relation to the movement of household goods in New Zealand (belonging to another person) are treated as zero-rated supplies.

Background

Under section 11A(1)(c), domestic transport services such as the movement of goods within New Zealand may be zero-rated if they are provided by the same supplier that transported the goods from a place outside New Zealand to a place in New Zealand. Generally, the supply within New Zealand is expected to be in conjunction with the original contract under which the goods were brought to New Zealand.

Concerns have been raised regarding the meaning and application of the "same supplier" test in section 11A(1)(c) in relation to the movement of household goods to New Zealand.

Example

An individual resident in Melbourne, Australia, is relocated to Wellington for work purposes. The individual decides to rent a property in Lower Hutt. To move the individual's household goods from Melbourne to Lower Hutt, the individual contracts with an Australian-based international removals company. The international removals company charges a single fee, including the New Zealand transport component from the port in Wellington to Lower Hutt. However, as the international removals company does not have a presence in New Zealand, it subcontracts a Wellington moving company to complete the New Zealand leg of the transport. The Wellington moving company charges the international removals company for the services it performs.

Under section 11A(1)(c), for zero-rating to apply to such arrangements, it would be necessary for the Wellington subcontractor to demonstrate that it is either the same entity as the international transport company or acting as agent on its behalf in order to satisfy the "same supplier" test.

This can be problematic given that:

- Most international removal companies do not have a presence in New Zealand.
- New Zealand based transport companies may not want to enter into the necessary contractual relationships associated with being an agent for a non-resident company.

The amendment was included in the bill at the select committee stage of proceedings.

Key features

Zero-rating under new section 11A(1)(cb) will apply to the supply of services being the transport of household goods from a place in New Zealand to another place in New Zealand, including ancillary transport activities such as loading, unloading and handling, provided that:

- The services are supplied to a non-resident who is outside New Zealand at the time the services are performed.
- The household goods are entered for home consumption under the Customs and Excise Act 1996.
- The arrangement for the supply of the services is made before the goods are entered into New Zealand.
- The services are reasonably expected to be completed within a period of 28 days that begins on the date of the entry of the goods.

Section 11A(1)(d) has been consequentially amended as a result of new section 11A(1)(cb).

Application date

The amendment applies on and after 25 November 2003.

GST DEREGISTRATION

Section 52 of the Goods and Services Tax Act 1985

Introduction

The Goods and Services Tax Act has been amended to allow notification of GST deregistration to be made by telephone.

Background

The amendment is intended to remove unnecessary compliance and administrative costs involved in deregistering for GST. Previously, when taxpayers deregistered for GST they were required to notify the Commissioner in writing. However, taxpayers were already corresponding via telephone with Inland Revenue requesting the form used for deregistering in writing. The entire deregistration process can now be completed in this one telephone call, without the need for a form to be sent, completed and returned.

This amendment was included after the bill was introduced into Parliament. The Finance and Expenditure Select Committee recommended it as a result of the significant reduction in compliance and administrative costs that will occur.

Key features

Section 52(2) has been amended to allow taxpayers to deregister for GST, either in writing or by telephone, when they fall below the registration threshold of $40,000.

Section 52(3) has been amended to allow taxpayers who must notify the Commissioner of the cessation of all their taxable activities to do so either in writing or by telephone.

Application date

The amendment applies from 25 November 2003.

STUDENT LOAN REPAYMENT DEDUCTIONS

Sections 2, 17, 17B, 18 and 25 of the Student Loan Scheme Act 1992
Section NC 8(1AA) of the Income Tax Act 1994

Introduction

Inland Revenue may now instruct an employer to make the correct student loan repayment deductions from a borrower's salary or wages.

Background

Borrowers whose income is from salary or wages, and whose primary income exceeds the repayment threshold, are required to advise their employer of their student loan liability. Repayment deductions, which are incorporated into the PAYE deductions, are then made by the employer. If the correct deductions are made, most salary or wage earners will have little, or no, end-of-year liability. However, despite being reminded of their obligations, some borrowers fail to fulfil this requirement.

Key features

For several years, Inland Revenue has had the power to instruct an employer to change an employee's income tax code to ensure that the correct amount of tax is deducted. Sections 2, 17, 17B and 25 of the Student Loan Scheme Act 1992 and section NC 8(1AA) of the Income Tax Act 1994 have been amended to create a similar power in relation to student loan repayment deductions.

Application date

This change applies from pay periods ending on or after 25 November 2003.

AMENDMENTS TO THE GAMING DUTIES ACT 1971 AND THE GAMBLING ACT 2003

Section 4 of the Gaming Duties Act 1971 and schedule 9 of the Gambling Act 2003

Introduction

Amendments to the Gaming Duties Act 1971 rectify errors made when that Act was amended by the Racing Act 2003. The first amendment correctly expresses the formula for calculating the betting profits from totalisator racing betting. The second amendment clarifies that the betting profits from sports betting and fixed-odds racing betting are to be calculated on a GST-exclusive basis.

The amendment to the Gambling Act 2003 amends the definition of "lottery" in the Gaming Duties Act.

Background

Two errors were identified in the amendments made to the Gaming Duties Act 1971 by the Racing Act 2003. The errors comprise a misplaced bracket in the formula for calculating the betting profits from totalisator racing betting and the inclusion of a reference to "GST-inclusive" in the new formula in relation to the refunds of bets in relation to sports betting and fixed-odds racing betting.

The initial amendment (by the Racing Act) to the totalisator formula was intended to reflect the changes to how the amount of winning dividends were to be calculated, while still ensuring the same duty was payable as was payable under the previous law. Under previous law, the amount of duty payable on totalisator racing betting was determined by aggregating the deductions required under the Racing Act 1971. This aggregation was the amount retained by the industry (the betting profits). Totalisator duty was 20% of betting profits. Under the new law, a subtraction method is used to calculate the betting profits. Betting profits are the amount bet minus the winnings paid. The new formula in the Gaming Duties Act 1971 states that the duty payable is at the rate of 20% of betting profits. Betting profits were defined as 8/9 (amounts received less refunds) less winning dividends and less fractions.

Industry practice before 1 August 2003 was for the TAB to exclude GST from the calculation of betting profits for the purposes of calculating gaming duty in relation to sports betting an fixed-odds racing betting. The Gaming Duties Act 1971 was silent on this issue. When the Racing Act 2003 amended the Gaming Duties Act 1971, a reference to "GST-inclusive" was included in the new formula in relation to the refunds of bets. The calculation of "betting profits" required such betting to be on a GST-inclusive basis.

An error in Schedule 9 of the Gambling Act 2003 resulted in an incorrect definition of "lottery" in the Gaming Duties Act 1971.

Key features

The amendments to the Gaming Duties Act 1971:

- express the formula for calculating betting profits with betting defined as 8/9 (amounts received less refunds less winning dividends less fractions), and

- make it clear that sports betting and fixed-odds racing betting be calculated on a GST-exclusive basis.

The amendment to the Gambling Act 2003 makes it clear that for the purposes of the Gaming Duties Act, "lottery" means a New Zealand lottery as defined in the Gambling Act 2003.

Application date

The amendment to the totalisator duty formula applies from 1 December 2003. The amendment to sports betting and fixed-odds racing betting applies retrospectively from 1 January 1996. This is to ensure that the practice of TAB in calculating such duty on a GST-exclusive basis is reflected in the law. The amendment to the definition of the term "lottery" will apply from the date of effect of the Gambling Act 2003, which will be by way of Order in Council.

REMEDIAL ISSUES

GROUP INVESTMENT FUNDS

Sections CF 3(1)(ga), DI 3A and OB 1 of the Income Tax Act 1994

Introduction

A deduction provision for management fees charged by trustee companies to investors of group investment funds has been repealed because it is no longer required.

Background

Section DI 3A was introduced to ensure that group investment funds could claim a deduction for management fees charged by trustee companies to investors in a group investment fund. Under the Trustee Companies Act 1967, trustee companies were prohibited from charging management fees to group investment funds. To get around this prohibition, trustee companies charged management fees to investors, and group investment funds deducted those fees and paid them to the trustee companies instead.

Section DI 3A, however, was an interim measure. The intention was that it would be repealed as soon as the Trustee Companies Act could be amended to provide for group investment funds to pay management fees to trustee companies.

The Trustee Companies Amendment Act 2002 removed the prohibition. Management fees paid by group investment funds to trustee companies are deductible under normal tax rules, so section DI 3A and section CF 3(1)(ga), which was a consequential amendment introduced at the same time as section DI 3A, are no longer required.

Key features

Section DI 3A of the Income Tax Act 1994, which allows group investment funds to claim a deduction for management fees charged by trustee companies to investors in a fund, has been repealed because it is no longer required. Section CF 3(1)(ga), which provides that any amount distributed to a trustee company on behalf of an investor is not a dividend, has also been repealed, along with a number of cross-references to section DI 3A.

Application date

The amendment applies from the start of the 2004-2005 income year so that group investment funds and trustee companies have time to make any required changes to their business practices and systems.

RELIEF FROM THE CONTROLLED FOREIGN COMPANY RULES FOR INTERESTS IN CERTAIN CONTROLLED FOREIGN COMPANIES LISTED IN “GREY LIST” COUNTRIES

Sections CG 6(1)(c), CG 7(5) and CG 7B of the Income Tax Act 1994

Introduction

An amendment provides relief from the controlled foreign company (CFC) rules for interests in certain CFCs listed in “grey list” countries.

The amendment was necessary to relieve a situation where taxpayers owning a controlling interest in a listed CFC were unable to comply with the attribution requirements of the CFC rules.

Background

The CFC rules tax New Zealand residents on their interests in foreign companies over which they are treated as having control. For countries outside the grey list (the grey list comprising Australia, Canada, Germany, Japan, United Kingdom, United States and Norway) the CFC rules attribute to the New Zealand owner their share of the foreign company’s income. To attribute income, the New Zealand resident must first recalculate this income using, broadly, New Zealand tax rules. This requires detailed information about the foreign company’s investments.

While no attribution is generally required from investments in grey list countries, when a CFC resident in a grey list country has interests in a non-grey list country the income from the non-grey list country must be attributed directly to the New Zealand resident.

It is possible, however, that the listing rules of the country in which the CFC is resident effectively prevent disclosure of such information. This situation can arise when the disclosure requirements of the stock exchange require that information made available to one shareholder must also be disclosed to the market. The disclosure of such information will often be commercially prejudicial to the company and therefore it will decline to make such information available. In this situation the New Zealand resident is unable to access the information required to comply with the CFC rules.

The amendment was added to the bill at the select committee stage of proceedings.

Key features

- The relief is provided for interests in CFCs which are resident in a grey list country and quoted on a recognised exchange throughout the accounting period in question. "Recognised exchange" is defined in section OB 1.
- The laws of the grey list country or the rules of the recognised exchange must also prevent the CFC from disclosing sufficient information to the New Zealand taxpayer or, when sufficient information may be disclosed, the disclosure of such information to other parties would be required and would cause the CFC commercial harm.
- The person must satisfy the Commissioner that because of the laws of the country or listing rules of the recognised exchange they are unable to obtain the information necessary to calculate their attributed foreign income under section CG 7.
- When all of these criteria are met, the person's attributed foreign income or loss (or FIF income or loss) is nil.

Application date

The new rules apply for the 2001–2002 to the 2005–2006 tax years. The exemption cannot be applied to a previous tax year if the taxpayer has, for that tax year, filed a return of income before 31 March 2003.

JUDGES' REMUNERATION

Sections OB 1 and OB 2 of the Income Tax Act 1994

Introduction

In 1998 the Income Tax Act 1994 was amended to ensure that remuneration and expenses paid to judges would receive the same tax treatment as similar payments made to employees. The amendments ensure the legislation reflects this policy.

Background

In 1998 the Income Tax Act 1994 was amended to ensure that judges would receive the same tax treatment as employees in respect of the income they derive from their office as a judge. However, it has since been found that those amendments may not have been sufficient to achieve that objective. This is because judges are not, in fact, in an employment relationship, and some provisions of the Act assume that such a relationship exists for employees. It was therefore necessary to add the remuneration of judges to the definition of "salary or wages", and include the activities for which that remuneration is paid in the definition of "employment".

Key features

The definition of "employment" in section OB 1 of the Income Tax Act 1994 has been extended to include the activities of the office of a judge which give rise to an entitlement to the receipt of a source deduction payment. The definition of "salary or wages" in the same section has been extended to include payment of salary or allowances paid to judges under a determination of the Remuneration Authority. A consequential amendment has repealed the definition of "specified office holder" in section OB 1, and the reference to the income of a specified office holder in the definition of "source deduction payment" in section OB 2(1).

The effect of these changes is to make the remuneration of judges fit more clearly within the tax treatment that applies to employees.

Application date

The amendments apply from 1 April 2003.

IMPUTATION AND DIVIDEND WITHHOLDING PAYMENT CREDITS

Sections MD 4 and MD 5 of the Income Tax Act 1994

Introduction

When overpaid tax is not refundable because it would create a debit balance in a company's imputation credit account or dividend withholding payment account, no debit or credit to those accounts results from crediting the overpaid amount to another income tax or dividend withholding payment liability. An amendment aligns the relevant legislation with the comprehensive transfer rules enacted in 2002.

Background

Comprehensive transfer rules (Part XB of the Tax Administration Act 1994) were enacted in the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002. Under Part XB, transfers of tax are treated as a refund and repayment of the relevant amount of tax. Section MD 4, which denied a credit to the imputation credit account in certain circumstances, was not consistent with this approach and has, therefore, been repealed.

Part XB applies to the extent that excess tax is refundable. It does not apply, for example, when the company's imputation credit account or dividend withholding payment account has insufficient credits and an overpaid tax or dividend withholding payments are credited under sections MD 2(5), NH 4(2)(b) or NH 5(5)(b).

Therefore, a special rule was required to deal with those situations. Amounts credited under those provisions should have no effect on the balance of the imputation credit account or the dividend withholding payment account, so they should not result in a debit or credit to those accounts.

Key features

Section MD 4, which denied a credit to an imputation credit account or dividend withholding payment account in some circumstances, has been repealed because it is no longer appropriate.

New section MD 5 provides that no debit or credit will arise to the imputation credit account when:

- overpaid tax that cannot be refunded under section MD 2 is credited to an income tax or provisional tax liability under section MD 2(5)
- overpaid dividend withholding payments that cannot be refunded under section NH 4(2)(a) is credited to a dividend withholding payment payable under section NH 4(2)(b), and
- overpaid dividend withholding payments that cannot be refunded under section NH 5(5) is credited to a dividend withholding payment payable under section NH 5(5)(b).

Application date

The amendment applies from 1 April 2003.

AMENDMENTS TO THE "PAYE BY INTERMEDIARIES" RULES

Sections NBB 1-NBB 8, NC 20(1), OB 1 definition of PAYE intermediaries, NE 2, NE 2AA, NE 2AB, NE 3-NE 6 of the Income Tax Act 1994 and sections 47, 167(2B), 167(2C) of the Tax Administration Act 1994

Introduction

A number of improvements to the "PAYE by intermediaries" rules, principally in section NBB of the Income Tax Act 1994, have been made. The changes include:

- extending the rules to give PAYE intermediaries the option to assume employers' obligations to deduct and pay specified superannuation contribution withholding tax (SSCWT)
- widening the scope for Inland Revenue to refund overpayments of PAYE to PAYE intermediaries, and
- providing an exemption from the use of a PAYE intermediary's trust account for net salary or wages paid by an employer to an employee in cash or cheque outside the normal payment date for salary and wages and for specified deductions retained by the employer.

Background

From 1 April 2004, the "PAYE by intermediaries" rules allows accredited intermediaries to largely assume an employer's obligations (calculating PAYE, paying it and filing returns) under the PAYE rules. Under the rules, employers' obligations are limited to paying their employees' gross salary and wages to the PAYE intermediary (to be held in trust before disbursement to Inland Revenue and employees) and providing basic payroll information.

The amendments, recommended for inclusion by the Finance and Expenditure Committee, are designed to enhance the operation of the "PAYE by intermediaries" rules. For example, a key aspect of the rules is shifting the tax compliance obligation from employers to payroll specialists, thereby reducing the costs to employers and improving the level of compliance. The extension of the rules to include SSCWT should reduce compliance costs for employers and increase the efficiency of the tax system. Previously, the "PAYE by intermediaries" rules would have limited the scope for refunding overpayments of PAYE by an intermediary to Inland Revenue if the overpayment was the result of an error. This had potential to create a significant and unnecessary fiscal risk for PAYE intermediaries.

Changes to the "PAYE by intermediaries" rules have also been made in recognition of the fact that there may be instances when an employer will need to pay employees outside the normal payment date for salary and wages, and in cash or by cheque (for example, in the case of a dismissal or if an employee is granted an advance on their pay). Previously, these payments would have been outside the "PAYE by intermediaries" rules because employees' net salary and wages would not have been transacted through an intermediary's trust account. Changes have also been made to allow greater flexibility in making certain third party deductions (such as amounts owing to employers). This change should reduce transactions costs for both employers and their PAYE intermediaries.

Key features

- Sections NBB 1 to NBB 6, NBB 8, NE 2, NE 2AA, NE 2AB, NE 3, NE 4, NE 5 and NE 6 of the Income Tax Act 1994 and section 47 of the Tax Administration Act 1994 have been amended to allow PAYE intermediaries to assume employers' responsibilities under the SSCWT rules, if so desired.
- Section NBB 7 of the Income Tax Act 1994 has been amended to allow Inland Revenue to refund overpayments of PAYE made by an intermediary if the overpayment is the result of an error.
- Sections NBB 4 and NBB 6 of the Income Tax Act 1994 have been amended to provide an exemption from the use of a PAYE intermediary's trust account for certain instances when net salary or wages are paid by an employer to an employee, in cash or cheque, outside the normal payment date for salary or wages, and also for specified deductions retained by the employer.
- Section 167(3) and 167(4) of the Tax Administration Act 1994, as introduced in the Taxation (Māori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, have been repealed and reinserted as sections 167(2B) and 167(2C), respectively, to correct numbering errors
- Section NC 20(1) and the definition of "PAYE intermediary" in section OB 1 of the Income Tax Act 1994 have been corrected for drafting errors.

Application date

The amendments are effective from the application date of the "PAYE by intermediaries" rules – pay periods beginning on and after 1 April 2004.

PROCEDURE FOR ISSUING NOTICES

Section 14(1) of the Tax Administration Act 1994

Introduction

Amendments clarify that the Commissioner of Inland Revenue may send notices to an address nominated by a taxpayer or by the taxpayer's agent, whether it is a physical address or a postbox. These amendments remove uncertainties about the procedure for issuing notices to taxpayers and ensure that notices posted in this manner by the Commissioner are valid.

Background

The Tax Administration Act 1994 did not explicitly allow for Inland Revenue notices to be posted to postboxes. However, the High Court decided in *Hieber* v *CIR*[18] that in some circumstances valid notice could be given via a postbox.

The decision caused some uncertainty for Inland Revenue as well as taxpayers and tax agents who were not covered by the decision but chose to receive correspondence through postbox addresses.

Taxpayers commonly use postboxes for security and ease of communication. Often the street address of a taxpayer (particularly business taxpayers and tax agents) is not equipped to receive mail. The amendments validate previous policy and practice, ensuring that all taxpayers can continue to receive notices from the Commissioner in a manner that provides certainty of delivery without causing disruption to their normal business practices.

The amendments have been backdated to provide certainty for taxpayers and Inland Revenue regarding notices that had already been issued to postboxes and other addresses nominated by taxpayers or their agents.

Key features

The amendments make two insertions in section 14(1) of the Tax Administration Act 1994, to clarify that the Commissioner may give valid notice by:

- posting the notice to an address nominated by the taxpayer, or
- posting the notice to an address nominated by the taxpayer's agent.

In this context, "address" includes a postbox.

Application date

The amendments apply from 1 April 1995, the date the Tax Administration Act 1994 came into force.

[18] (2002) 29 NZTC 17,774.

GST AND TELECOMMUNICATIONS SERVICES

Sections 8(8), 8(9) and 11AB(b) of the Goods and Services Tax Act 1985

Introduction

Amendments clarify the GST treatment of telecommunications services by:

- making the operation of the initiator test more certain;
- ensuring that supplies of telecommunications services initiated outside New Zealand are zero-rated, and
- ensuring that unless the supplier and the recipient agree otherwise, a supply of telecommunications services from a non-resident to a registered person in New Zealand for which the New Zealand recipient would be entitled to an input tax credit is not subject to GST.

Background

The original amendments

The Taxation (Māori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 contained provisions that clarified the GST treatment of cross-border supplies of telecommunications services by inserting a new place of supply rule, and including new zero-rating provisions and definitions. These changes were arrived at after extensive consultation with the telecommunications industry.

Fundamental to the operation of these place of supply and zero-rating rules is determining which party has initiated a supply. In general, when a person in New Zealand initiates a supply of services those services will be subject to GST in New Zealand, and when a person outside New Zealand initiates a supply of services those services will be zero-rated and, therefore, not be subject to GST in New Zealand. Section 8(9), as enacted in the Taxation (Māori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, set out the following factors to help determine which party to a supply of telecommunications services has initiated the supply:

- who pays for the services
- who commences the supply
- who terminates the supply, and
- who contracts for the supply.

Section 8(9) did not have a formal hierarchy of factors, or a "tie breaker" if two different persons fulfilled the factors, and clarification was therefore needed.

Section 11AB(b)

Concern was raised about the wording of one of the zero-rating provisions, section 11AB(b), specifically the phrase "…to a person outside New Zealand…", and the likely interpretation of this phrase as meaning to a person outside New Zealand in a contractual sense. This could have, in effect, negated the initiator test limb of section 11AB(b), which is intended to focus on who "uses" the telecommunications services.

In particular, when a New Zealand company has a cellular roaming agreement with a New Zealand telecommunications supplier and an employee of the New Zealand company uses a cellular telephone outside New Zealand (as shown in figure 1) the supply may have been subject to GST, because of the contract with the New Zealand company.

As the New Zealand employee who is outside New Zealand is making the telephone call, and therefore "using" the services, the employee should be considered the initiator of the supply of telecommunications services and the supply should therefore be zero-rated, as the initiator is outside New Zealand.

The initiator test is intended to be the pivotal test for the new place of supply rules for telecommunications service, and therefore the location of the initiator of the supply of services should be determinative of zero-rating under section 11AB(b). The phrase "…to a person outside New Zealand…" has therefore been removed from section 11AB(b).

Section 8(9)

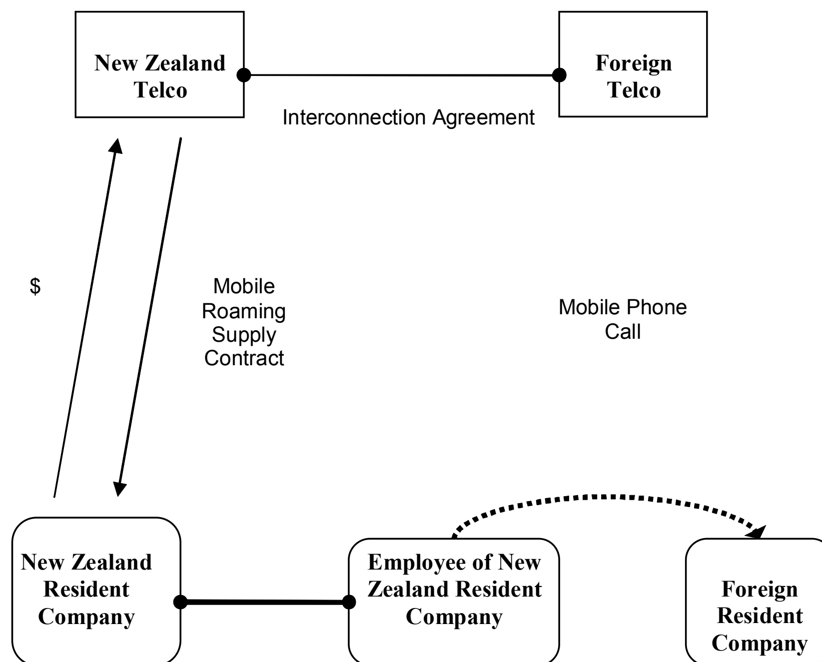
Concerns had been raised about the operation of the initiator test, specifically the relative weight of each of the factors and the ability to apply the test to achieve the most tax-efficient outcome.

The initiator test, while providing a pragmatic proxy for consumption in most situations, could be difficult to apply when there were two possible initiators of a supply–for example, when one party contracts and pays for a supply of telecommunications services but another party "uses" the services.

An amendment was therefore made to section 8(9) to clarify the operation of the initiator test in relation to the relative importance of the factors, particularly which party contracts for a supply of services.

In discussions with telecommunications suppliers, the necessity of the "termination" factor in the initiator test was raised, with concerns that it was confusing and unnecessary. The "termination" factor has therefore been removed from the initiator test in section 8(9).

Figure 1



Section 8(8)

Section 8(8) of the GST Act ensures that unless the supplier and the recipient agree otherwise, a supply of telecommunications services from a non-resident to a registered person in New Zealand for which the New Zealand recipient would be entitled to an input tax credit is not subject to GST. It referred to supplies by "telecommunications suppliers", which may have unduly limited the scope of the exclusion, as telecommunications services may be supplied by companies which do not fall within the definition of a "telecommunications supplier". The reference to "telecommunications supplier" has therefore been removed.

Provisions relating to zero-rating and the initiation of a supply of telecommunications services were added at the select committee stage of the process.

Key features

Section 8(8) has been amended to remove the reference to "telecommunications supplier". It will ensure that, unless the supplier and the recipient agree otherwise, a supply of telecommunications services from a non-resident to a registered person in New Zealand for which the New Zealand recipient would be entitled to an input tax credit is not subject to GST.

Section 8(9) has been amended to replace the definition of "initiator" with an ordering rule (similar to that of section CI 3(10) of the Income Tax Act 1994) ranking the factors for determining which party initiates a supply of telecommunications services. This means that if more than one person satisfied the factors in the initiator test, the initiator would be the person who satisfies the factor which appears highest on the list of factors in the test. The order of factors is:

- the person who controls the commencement of the supply
- the person who pays for the services, and
- the person who contracts for the supply.

Section 11AB(b) has been amended to remove the phrase "…to a person outside New Zealand…", so that a supply of telecommunications services is zero-rated if it is initiated by a person outside New Zealand.

Application date

The amendments apply from 1 July 2003, the date from which sections 11AB(b), 8(8) and 8(9) first applied.

CHARGES OVER PROPERTY

Section 169 of the Tax Administration Act 1994, section 169 of the Child Support Act 1991 and section 23 of the Personal Property Securities Act 1999

Introduction

The Tax Administration Act 1994 and the Child Support Act 1991 have been amended to ensure that they reflect the policy outcome intended when the Personal Property Securities Act 1999 was enacted: that Inland Revenue should be able to register charges over the property of persons who default in the payment of tax deductions, ACC earner premium and child support deductions.

Background

Inland Revenue has the power to create charges over the property of a person who defaults in payment of tax deductions and ACC earner premium and child support deductions. Until recently, such charges were registered under registers including those created by:

- the Chattels Transfer Act 1924, and
- Part VI of the Companies Act 1955.

Registers for charges over personal property created by these Acts were discontinued when the Personal Property Securities Register was established by the Personal Property Securities Act 1999 when it came into force, on 1 May 2002. The intention when that Act was introduced was that the status quo should be maintained in relation to the tax provisions that were affected by the Act. Therefore, charges over personal property that previously could be registered under the Chattels Transfer Act 1924 and the Companies Act 1955 should now be registered in the current register.

There is doubt about whether legislative changes made to the Tax Administration Act and the Child Support Act at the time the Personal Property Securities Act was enacted achieve this. The amendments ensure that the Personal Property Securities Act will operate in the same way, in relation to the Tax Administration Act and Child Support Act charges, as the registers that preceded it.

The amendment also replaces incorrect references to the "Land Transfer Act 1952" and the "Deeds Registration Act 1908" with a reference to the "Statutory Land Charges Registration Act 1928".

The changes to the Child Support Act 1991 were added to the bill at the select committee stage of proceedings.

Key features

Charges that are created under section 169 of the Tax Administration Act (Unpaid tax deductions etc to constitute charge on employer's property) and section 169 of the Child Support Act 1991 (Unpaid financial support to constitute charge on payer's property) may be registered on the Personal Property Securities Register.

Application date

The amendments apply from 25 November 2003.

MINOR TECHNICAL AMENDMENTS

A number of minor technical amendments have been made to the tax Acts. Unless otherwise stated, these amendments apply from 25 November 2003, the date of enactment.

Definition of "dual resident company"

Section IG 2 of the Income Tax Act 1994

The definition of "dual resident company" in section IG 2(11), which is part of the group loss offset provisions, previously referred incorrectly in two places to "an agreement". These references have been replaced with "double tax agreement".

Underlying foreign tax credits

Section LF 1 of the Income Tax Act 1994

Section LF 1(1), which deals with the purpose of the underlying foreign tax credit provisions, is intended to apply to New Zealand resident companies. Previously, the provision referred only to a "New Zealand company", which is defined in section OB 1 as a company incorporated in New Zealand, which is a narrower definition than that for New Zealand resident companies. Accordingly, the two references to "New Zealand company" have been replaced with references to a company resident in New Zealand. The amendment applies from the 1995–96 income year.

Offsetting provisions

Sections MB 8, MD 1, NF 7 and NG 16 of the Income Tax Act 1994 and section 46 of the Goods and Services Tax Act 1985

New rules relating to transfers of overpaid tax were enacted by the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002. These rules allow

Inland Revenue, at the request of a taxpayer, to transfer tax that is overpaid by the taxpayer to another period or type of tax or to another taxpayer.

Section 173T of the Tax Administration Act 1994 provides that when excess tax is used to offset an outstanding tax liability of a taxpayer, the taxpayer can request that the offsetting occurs at a date allowed by the new transfer rules. Consequential references to section 173T were inserted in the offsetting provisions in sections MB 8(1) and (2), MD 1(3), NF 7(5) and NG 16(4) of the Income Tax Act 1994 and section 46(6) of the Goods and Services Tax Act 1985. These provisions generally allow the Commissioner to offset tax refunds against outstanding tax liabilities.

A minor clarifying amendment has been made to the offset provisions to ensure that the Commissioner's offsetting powers are not reduced by the inclusion of references to "section 173T" in these provisions. However, a taxpayer may request that the Commissioner apply the offset from any date that is allowed by the transfer rules.

The offsetting provisions have also been redrafted so that they have a consistent structure and wording.

The amendments to the offsetting provisions have the same application dates as the related amendments enacted by the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002.

Electing the appropriate tax rate on extra emoluments

Section NC 8(1A) of the Income Tax Act 1994

Section NC 8(1A) of the Income Tax Act 1994 has been amended to allow employees to elect the 33% marginal tax rate on extra emoluments only if their total income in a year is $60,000 or less. Prior to the change, section NC 8(1A) allowed employees with taxable income in excess of $60,000 to elect to have any extra emoluments taxed at either the 33% or 39% tax rates. The amendment applies from 1 April 2004.

Resident withholding tax exemption certificates

Section NF 9 of the Income Tax Act 1994

Section NF 9(1)(c), which relates to resident withholding tax exemption certificates, referred to the Trustee Banks Restructuring Act 1988. This reference was redundant because that Act has been repealed. Accordingly, section NF 9(1)(c) has been repealed.

Redundant references to "additional tax"

Sections NF 9 and NH 4 of the Income Tax Act 1994
Section 94 of the Tax Administration Act 1994

Several redundant references in the Income Tax Act 1994 and the Tax Administration Act 1994 to "additional tax" have been replaced with references to "late payment penalty". The affected provisions are sections NF 9(11) and NH 3(7) of the Income Tax Act 1994 and section 94(2) of the Tax Administration Act 1994. These amendments apply to late payment penalties arising from the 1997–98 income year.

Definition of "commercial bill"

Section OB 1 of the Income Tax Act 1994

The list of provisions to which the definition of "commercial bill" in section OB 1 applies was incomplete. This list has been amended by adding references to section DJ 16 (expenditure incurred on acquiring commercial bills) and section GC 14A (an anti-avoidance provision relating to commercial bills).

Definition of "determination"

Section OB 1 of the Income Tax Act 1994

The definition of "determination" in section OB 1 has been repealed because it is redundant. The definition cross-referred to the definition in section LC 7(2), which had previously been repealed.

Definition of "emergency call"

Section OB 1 of the Income Tax Act 1994

The definition of "emergency call" in section OB 1 was amended by the self-assessment amendments enacted in 2001. As a result, paragraph (c) of the definition contained an incorrect cross-reference. Accordingly, the reference in that paragraph to "paragraph (a)(iii)" has been replaced with a reference to "paragraph (a)(iv)", with application from the 2003–03 income year.

Definition of "resident in New Zealand"

Section OB 1 of the Income Tax Act 1994

The definition of "New Zealand resident" in section OB 1 refers to a person resident in New Zealand under sections OE 1, OE 2 or OE 3. However, the corresponding

section OB 1 definition of "resident in New Zealand" did not previously contain a reference to section OE 3, which refers to a non-resident life insurer who elects to be treated as resident in New Zealand. Accordingly, a reference to section OE 3 has been included in the section OB 1 definition of "resident in New Zealand".

Measurement of voting and market value interests

Section OD 5 of the Income Tax Act 1994

Section OD 5(3), which relates to the measurement of voting and market value interests, refers to two types of trustee companies. A minor change to the terminology has been made to ensure that it is clear which type of trustee company is being referred to in the provision.

Requisition of information held by offshore entities

Sections 17, 143 and 143A of the Tax Administration Act 1994

Section 17(1B) and (1C) of the Tax Administration Act 1994 was recently enacted by the Taxation (Māori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 to ensure that Inland Revenue can requisition from New Zealand residents information or documents held by offshore entities controlled by the New Zealand residents. Clarifying amendments have been made to ensure that the effect of section 17(1B) and (1C) is carried through to the relevant offence provisions in sections 143 and 143A, which was always the legislative intention. Section 17(1B) has also been amended so that it refers to material in the knowledge, possession or control of a non-resident, consistent with the terminology used in the relevant offence provisions.

Non-filing of returns

Section 33A(2)(cb) of the Tax Administration Act 1994

Sections 33A(2)(d), (e) and (g) of the Tax Administration Act 1994 have been repealed and new section 33A(2)(cb) added to remove from end-of-year return filing requirements, taxpayers with income totalling $200 or less from withholding payments, foreign interest or dividends that have not had tax deducted at source, and beneficiary income. The amendment applies from the 2002–03 income year.

Redundant notice of assessment reference

Section 80H of the Tax Administration Act 1994

Section 80H(2) provided that if any income statement was treated as an assessment then the requirement in section 111 for the Commissioner to give notice to a taxpayer of an assessment did not apply. Following the self-assessment amendments enacted in 2001, section 80H treats an income statement as an assessment made by a taxpayer rather than the Commissioner. As the notice requirements in section 111 apply only to assessments made by the Commissioner, section 80H(2) was therefore redundant and has been repealed.

Accounting terminology

Sections 91E and 91F of the Tax Administration Act 1994

Two references in sections 91E(4)(j) and 91F(4)(h) to "generally accepted accounting principles" have been changed to "generally accepted accounting practice" to ensure that the use of accounting terminology is consistent between the Income Tax Act 1994 and the Tax Administration Act 1994. The Income Tax Act 1994 was previously inconsistent in its use of these two terms (which have the same meaning), and it was amended in 2002 to provide for consistent use of "generally accepted accounting practice", which is the terminology used in the Financial Reporting Act 1993. The amendments apply from 17 October 2002.

Redundant objection procedure reference

Section 100 of the Tax Administration Act 1994

In section 100, relating to the assessment of non-resident withholding tax, a redundant reference to the former objection procedures has been replaced with the reference to the new challenge procedures. The amendment applies from 1 October 1996.

Assessment made by Commissioner following incorrect income statement

Section 106 of the Tax Administration Act 1994

Section 106(1B) relates to the payment of tax under an assessment made by the Commissioner following an incorrect income statement. This provision has been amended to correct internal subsection cross-references, with application from the same income years the original cross-referenced provisions applied from.

Definition of "interest period"

Section 120C(1) of the Tax Administration Act 1994

The definition of "interest period" in section 120C(1) of the Tax Administration Act 1994 has been amended to reflect the effect of the Income Tax (Refund of Excess Tax) Order 2003. The Order raised from $50 to $200 the threshold under which a taxpayer who is issued with an income statement and is owed a refund does not have to confirm that the refund is correct to receive it. Under the change, the legislation will automatically update to reflect changes to the refund threshold by Order in Council. The amendment applies in respect of income statements issued on or after 15 May 2003 that relate to the 2002–03 or a subsequent income year.

Removal of redundant provision

Section 141FB of the Tax Administration Act 1994

Section 141FB was inserted by the Taxation (Māori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 and provides for the reduction of shortfall penalties when the taxpayer has a previous history of good behaviour. Section 141FB(2)(b)(i) referred to reducing the shortfall penalty for "evasion or similar act". However, reductions of the shortfall penalty for "evasion or similar act" are dealt with in section 141FB(1). Therefore section 141FB(2)(b)(i) was redundant and has been repealed.

Definition of "flat-owning" or "office-owning" company

Section 3 of the Goods and Services Tax Act 1985

The reference to "flat-owning or office-owning company" in section 3(3)(c) previously cross-referred to the definition in section 2(1) of the Companies Amendment Act 1964. This Act, however, was repealed in 1993, and the definition of "flat-owning or office-owning company" is now contained in section 121A of the Land Transfer Act 1952. Accordingly, the reference in section 3(3)(c) of the GST Act to "section 2(1) of the Companies Amendment Act 1964" has been replaced with a reference to "section 121A of the Land Transfer Act 1952". The amendment applies from 1 July 1994.

GST treatment of services supplied in connection with exported goods

Section 11A(1)(m) of the Goods and Services Tax Act 1985

Section 11A(1)(m) has been redrafted. The provision zero-rates services supplied directly in connection with exported goods if the services are supplied to a non-resident who is outside New Zealand at the time the services are performed. The redraft clarifies that the relevant services must be supplied to a non-resident. The drafting improvement does not result in a policy change.

GST returns

Section 18 of the Goods and Services Tax Act 1985

Section 18, which relates to other returns that are required to be made in addition to ordinary returns, contained a reference to section 19. Section 19 has been previously reorganised into several sections and the part of former section 19 that related to returns is now contained in section 19B. Accordingly, the reference in section 18 to section 19 has been updated by replacing it with a reference to section 19B.

Single change-in-use deductions

Section 21H of the Goods and Services Tax Act 1985

Section 21H(3)(d), which relates to the making of a single deduction for a change-in-use of a good or service, referred to the former section 21, which governed both output tax and input tax change-in-use adjustments. Given that section 21H(3)(d) is meant to refer to single output tax adjustments, the reference in it to "section 21" has been replaced with "section 21(1)", which is the corresponding part of the former section 21 that governed output tax adjustments. The amendment applies from 10 October 2000.

Student loan underestimation penalty

Section 44A of the Student Loan Scheme Act 1992

Minor drafting errors in the student loan underestimation penalty provisions have been corrected. The provisions previously referred to "repayment obligation", whereas the references should have been to "residual repayment obligation" or "interim repayment obligation", as appropriate.

OTHER LEGISLATION

NZAID GRANTS TRANSFERRED TO OVERSEAS DEVELOPMENT PROGRAMMES

An earlier description relating to the Goods and Services Tax (Grants and Subsidies) Amendment Order 2003/113 appeared in *Tax Information Bulletin* Vol 15, No 6 (June 2003). The present description of the amendment order emphasises the conditions that must exist for GST not to apply to any grants made by the New Zealand Agency for International Development.

From 1 July 2003, grants or parts of grants made by NZAID that, as a condition of payment, are transferred to overseas development programmes will not be subject to GST.

The change corrects an anomaly in the law whereby no GST is payable on a government grant that is paid directly to an overseas agency, but a grant made to a New Zealand agency that transfers the money to an overseas agency attracts GST.

The change means that any payment, or part of a payment, made by NZAID to a New Zealand organisation, on the condition that it is transferred to an overseas agency for overseas use, is not subject to GST provided that the payment is:

- transferred outside New Zealand
- transferred to an organisation that is operating overseas at the time the payment is received by that organisation, and
- used to acquire goods and services outside New Zealand.

GST must be returned to the extent that any portion of the grant is allocated or used for administration and capacity building in New Zealand.

The amendment order was approved by Order in Council on 26 May 2003.

Goods and Services Tax (Grants and Subsidies) Amendment Order 2003/113

REGULAR FEATURES

DUE DATES REMINDER

March 2004

5 Employer deductions and employer monthly schedule

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

8 Provisional tax instalments due for people and organisations with a March balance date

22 Employer deductions

Large employers ($100,000 or more PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due

Employer deductions and employer monthly schedule

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

31 GST return and payment due

April 2004

7 End-of-year income tax

- *2003 end-of-year income tax due for clients of agents with a March balance date*

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

30 GST return and payment due

These dates are taken from Inland Revenue's Smart business tax due date calendars 2003–2004 and 2004–2005

YOUR CHANCE TO COMMENT ON DRAFT TAXATION ITEMS BEFORE THEY ARE FINALISED

This page shows the draft binding rulings, interpretation statements, standard practice statements and other items that we now have available for your review. You can get a copy and give us your comments in these ways.

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	Draft operational statement	*Comment deadline*
☐	ED0053: Income tax treatment of certain expenditures on conversion of land from one farming or agricultural purpose to another	25 March 2004

	Draft interpretation statement	*Comment deadline*
☐	IS0062: Shortfall penalty—evasion	31 March 2004

Items are not generally available once the comment deadline has passed

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The Manager (Field Liaison)
Adjudication & Rulings
National Office
Inland Revenue Department
PO Box 2198
Wellington

INLAND REVENUE NATIONAL OFFICE PO BOX 2198 WELLINGTON TELEPHONE (04) 498 5800