TAX INFORMATION BULLETIN

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This *Tax Information Bulletin* is also available on the internet in PDF. Our website is at **www.ird.govt.nz**

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

If you prefer to get the *TIB* from our website and no longer need a paper copy, please let us know so we can take you off our mailing list. You can do this by completing the form at the back of this TIB, or by emailing us at **IRDTIB@datamail.co.nz** with your name and details.

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 26 September 2005.

Ref.	Draft type	Description
ED0076	Question we've been asked	Tax treatment of RWT credits on interest

Please see page 66 for details on how to obtain a copy.

The following draft item is available for review/comment this month, having a deadline of 28 September 2005.

Ref.	Draft type	Description
ED0079	Standard practice statement	Remission of penalties and interest

Please see page 66 for details on how to obtain a copy.

The following draft items are available for review/comment this month, having a deadline of 30 September 2005.

Ref.	Draft type	Description
QB0045	Question we've been asked	The impact of company amalgamations on financial arrangement determinations
IS0061	Interpretation statement	Shortfall penalty for taking an abusive tax position

Please see page 66 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 05/02

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 BNZ Investment Management Limited as Trustee ("the Trustee") of the superannuation fund known as the BNZ 25 NZ Equity Index Fund.

Taxation Laws

All legislative references are to the Income Tax Act 2004 unless otherwise stated.

This Ruling applies in respect of section HH 3(5) and the definitions of "superannuation fund" and "qualifying trust" in section OB 1.

The Arrangement to which this Ruling applies

The Arrangement is the operation by the Bank of New Zealand of a superannuation fund known as the BNZ 25 NZ Equity Index Fund ("the Fund"). The operation of the Fund is governed by the Trust Deed dated 24 February 1997 ("the Trust Deed") as amended on 23 March 2001, 31 July 2002 and the Deed of Amendment which will be the same as, or not materially different from, the draft deed provided to the Commissioner on 21 June 2005 ("the Amending Trust Deed").

Further details of the Arrangement are set out in the paragraphs below:

1. The Fund is registered under the Superannuation Schemes Act 1989, as are the "retail" superannuation funds which invest in it.
2. The Sponsor of the Fund is the Bank of New Zealand. The Trustee is also the Manager of the Fund.
3. The Fund acts as a "wholesale" superannuation fund into which other "wholesale" and "retail" superannuation funds invest. The Fund also operates for the purpose of providing retirement benefits to the limited number of natural persons who invest directly in it.
4. Members of the Fund are only treated differently in relation to the application fees, issue price and exit price (to the extent that such prices change over time to reflect the change in value of the Fund) and costs associated with entry into, and maintenance of, the Fund.
5. The "retail" funds investing in the Fund are superannuation funds (both employee and personal) which have previously been (or may in future be) established completely independently from the establishment of the Fund. For example, an existing BNZ "retail" fund—the Bank of New Zealand Future Lifestyle Plan—currently invests in the Fund. Superannuation funds other than superannuation funds established by or managed by the Bank of New Zealand have also invested in the Fund.
6. The Fund was established for the purposes of being a "wholesale" investment vehicle for other "wholesale" funds and "retail" superannuation funds and for the purposes of providing retirement benefits to the limited number of individual natural persons who invest directly in it. All the "wholesale" and "retail" superannuation funds which invest in the Fund have been or will be established for the purposes of ultimately providing retirement benefits for individual natural persons.
7. The Fund is a passive investment vehicle, investing only in a portfolio of equity securities each of which is listed on the New Zealand Stock Market ("NZSX") operated by New Zealand Exchange Limited ("NZX"), together with a small cash pool. The Fund will be managed so as to track the composition of a set of listed equity securities which together form the constituent part of an Index known as the BNZ 25 Equity Index ("the Index").

The Index

8. The Index comprises up to 25 of the largest New Zealand equity securities listed on the NZSX, based on average weekly market capitalisation. The Fund will not be subject to any active management as such. Rather, it will be managed to track the composition of a set of listed equity securities that together form the constituent parts of the Index. The weighting of each security in the Index will reflect its respective market capitalisation at the relevant date.

9. The "home" exchange of each stock can be any of the "grey list" countries as they are defined in New Zealand tax law. If the equity security is listed on the NZSX and meets the other criteria, it will be included in the Index. There is no discretion as to whether a grey list country security listed on the NZSX is included in the Index. The equity securities will normally be shares but there may also be convertible notes.

10. The market capitalisation for securities is calculated as follows:

    (a) securities that have the NZX as their "home" exchange will be calculated in accordance with the formula:

    number of shares (or convertible notes) on issue x closing price of the share (or convertible note) –

    where "number of shares (or convertible notes) on issue" does not include treasury stock;

    (b) securities that have their "home" exchange outside New Zealand will be calculated in accordance with the formula:

    number of shares (or convertible notes) listed in New Zealand x closing price of the share (or convertible note)

Cash investments of the Fund

11. Approximately 99% of the net asset value of the Fund will be invested in such investments as the Trustee considers necessary to track the Index. While the majority of available funds will be invested to track the Index, a "cash pool" of up to 1% of the net assets of the Fund will be maintained subject to the exceptions listed in condition (a) of the existing binding private ruling for the Fund (BR Prv 05/16). The pool is only invested in bank accounts or money market deposits.

12. Although it is not an objective of the Fund to invest in cash securities, the Fund may hold cash to facilitate easier administration of the Fund. In any event the cash pool will not exceed what is strictly necessary in order to fulfil the following purposes:

    (a) Allow for cash outflows due to expenses and net withdrawals.

    (b) Allow for net cash inflows from investments and dividends to accumulate to a level sufficient to minimise the transaction and administrative costs associated with analysing which stocks are to be purchased and making the necessary purchase orders.

Index changes

13. Changes will only be made to the Index composition in the following circumstances:

    (a) At the end of each quarter (being a three month period ending on, respectively, 15 April, 15 July, 15 October and 15 January, a "quarter"), securities will be ranked according to their average weekly market capitalisation for the previous 6 month period (ie the 6 month period ending on the end of the month preceding the quarter end). If a security not previously included in the Index has risen at the end of the 6 month period above 21st position, that security will be included as a constituent security in the Index at the quarter end and the lowest ranked Index security held at the quarter end will be removed. If a security that is currently included in the Index at the quarter end has dropped below a ranking of 30th by the end of the 6 month period, that security will be removed as a constituent security from the Index and the highest ranked security at the quarter end not already included in the Index will be included.

    (b) At the end of each quarter, securities are reviewed with regard to compliance with the necessary minimum liquidity requirements. In order to be included and to maintain inclusion in the Index, a constituent security must meet a minimum liquidity requirement. Liquidity is defined as the average daily trading volume (over a 6 month period leading up to the end of the month preceding the end of the relevant quarter after eliminating the highest and lowest months), expressed as a percentage of the total issued and quoted securities of the same class. The minimum liquidity measure for inclusion in the Index is 0.75% per month. In the event that there are not 25 securities that meet the liquidity requirement, the number of securities in the Index would be less than 25.

    This liquidity test does not apply to a new listing, which falls within the concessionary rule in paragraph (c) below, until the end of the second complete quarter following the quarter in which listing occurs.

    (c) If a security is listed on the NZSX for the first time, it will be included in the Index immediately if:

(i) it ranks, in terms of market capitalisation, above 21st position (compared with other Index securities ranked according to their average weekly market capitalisation for the 6 month period ending with the month end preceding the previous quarter end); and

(ii) at least 25 percent of the security is freely tradeable at the time of listing.

For the purposes of calculating the market capitalisation of a security listed on the NZSX for the first time, the "closing price" of the security will be the undiscounted issue price, as advised to NZX, to be paid by investors who subscribe to the security's public offering.

The security previously ranked 25th within the Index at that time will be removed.

If a security listed on the NZSX for the first time does not meet the 25% free float test at the time of listing but meets that 25% test at the end of the quarter in which listing occurs or the following quarter, it will be included in the Index at the relevant quarter end (subject to ranking above 21st at that time). Again, the security previously ranked 25th will be removed at that time.

(d) If the Trustee recommends, and the independent monitor referred to in paragraph 19 agrees, then the Index must be altered to reflect a material change to NZX's market capitalisation calculation rules.

(e) If there is a merger, takeover offer, scheme of arrangement sanctioned by the High Court or other offer under the Takeovers Code for all of the issued securities of a company:

(i) If the merger, takeover, scheme of arrangement or other offer proceeds and as a result (regardless of whether it has 100% acceptance) less than 25% of the company's securities are freely tradeable, the company's securities will be removed from the Index; and

(ii) The company's securities will be immediately removed from the Index when the acquirer becomes entitled to, and an announcement is made that it will, proceed with compulsory acquisition.

The highest ranked security not already in the Index at that time will be added.

(f) If there is one or more partial offers under the Takeovers Code for control (50% or more) of a company included in the Index and at any time after such offer or offers less than 25% of the company's securities are freely tradeable, the company's securities will be removed from the Index.

The highest ranked security not already in the Index at that time will be added.

(g) If there is one or more partial offers under the Takeovers Code for less than 50% of a company included in the Index and at any time after such offer or offers less than 25% of the company's securities are freely tradeable, the company's securities will be removed from the Index.

The highest ranked security not already in the Index at that time will be added.

(h) If, under the Takeovers Code, a company's shareholders approve an allotment of securities and, at any time after that approval is given, less than 25% of the company's securities are freely tradeable, the company's securities will be removed from the Index.

The highest ranked security not already in the Index at that time will be added.

(i) If a company's securities are acquired under rule 7(e) of the Takeovers Code and, at any time after the securities are acquired, less than 25% of the company's securities are freely tradeable, the company's securities will be removed from the Index.

The highest ranked security not already in the Index at that time will be added.

(j) If there is a rights issue or bonus issue (other than a bonus issue election scheme for reinvestment of dividends) to existing security holders, the Index will be changed to reflect the issue of shares on the issue's "ex" trading date. (If the rights issue is not fully underwritten, the adjustment is calculated as if all rights were exercised.)

(k) If any other capital adjustment event such as a share issue (including under a dividend reinvestment scheme) or share buy back occurs which increases or decreases the number on issue of any constituent security and that increase or decrease, measured by market capitalisation on a cumulative basis since the last adjustment, is less than 0.03% of the Index, then any adjustments to the Index will be made at the end of the quarter in which the number of listed securities are increased or decreased. In the event that an increase or decrease represents more than 0.03% of the Index, then an adjustment to the Index will be made as at the close of the NZSX on the 15th day of the month in which the number of listed securities is increased or decreased.

(l) If there is any other form of capital reconstruction in relation to a constituent security which impacts on the security's Index weighting, the Index will be adjusted on the same date to reflect the capital reconstruction.

(m) Any changes to the Index composition that are described in paragraphs (a) – (l) (other than where the timing of the change is specified in the relevant paragraph) will be made at the close of business on the 15th of the month, subject to five (5) business days notice of the event occurring.

(n) The Fund currently owns shares in Westpac (NZ) Investments Limited (WPT). Westpac Banking Corporation Limited (WBC) has decided to exercise its rights to convert these WPT shares to WBC shares. WPT is to be delisted from NZX on 1 July. The WPT shares will be removed from the Index. The WBC shares will be capitalised on the NZSX on 11 July and, as a result of this, are likely to rank above 21st position in the Index. Therefore, the Fund will continue to hold the WPT shares until after delisting and will hold the converted shares (the WBC shares), when issued, until the new capitalisation on 11 July. On 11 July the Index will be altered in accordance with paragraph 13(c) as if the capitalisation of the WBC shares were a new listing and the Fund will be rebalanced. Any residual rebalancing required due to the WBC shares being outside the tolerance levels will be completed at the end of the quarter (15 July). The WBC shares will be held from 1 July to 11 July as part of the Index notwithstanding that these shares will have no value on the NZSX until 11 July.

Rights issues

14. In the event of any rights issue by an Index company, the Manager will retain the entitlement and take up the securities if the securities the subject of the entitlement will be immediately included in the Index.

15. Notwithstanding paragraph 14, if the securities the subject of the entitlement are over-represented, the Manager will sell the entitlement and reinvest the proceeds in securities to track the Index.

16. If the Manager does not know whether the securities the subject of the entitlement will be included in the Index, the Manager will sell the entitlement at the earliest possible time and reinvest the proceeds in securities to track the Index.

Rebalancing

17. The Fund is rebalanced in the following circumstances:

    (a) When the quarterly adjustments are made to the Index;

    (b) When the Index changes other than quarterly due to market driven changes or corporate actions such as merger, takeover, bonus issue, rights issues and capital reconstructions;

    (c) If the Fund's holding of a security will be (or is) outside the tolerance levels provided for in paragraph 18 of this Ruling.

18. The Manager will use best endeavours to track the Index as closely as possible. Rebalancing will only occur in accordance with condition (b) of the existing private ruling for the Fund (BR Prv 05/16) and any deviation from the Index remaining after rebalancing will not exceed 1% of the Index.

19. The Trustee has appointed an independent party (the Fund's auditors) to provide an annual confirmation that the operations of the Fund have conformed to these criteria.

20. The Trustee is authorised to accept from an investor a subscription in kind, ie a subscription in the form of a basket of securities that achieves a result of the Fund tracking the then Index composition.

21. Disposition of securities by the Trustee on behalf of the Fund (other than those in the cash pool) will only occur in the following circumstances:

    (a) If the Fund is ever wound up.

    (b) If, at any time, the Index composition changes and as a result the composition of the securities in the Fund no longer tracks the weightings in the Index.

    (c) If, on any day, there is a net withdrawal of funds from the Fund by investing superannuation funds or natural persons which cannot be met out of the cash pool.

    (d) If there is a claim on the Trustee in respect of the Fund that cannot be met other than as a result of liquidating some securities. This is not anticipated, but the Trustee needs some ultimate protection against extraordinary circumstances such as, say, a change in taxation law or an unanticipated liability or expense.

    (e) If the Fund is rebalanced in accordance with paragraph 17 of the Arrangement.

In respect of the events under these subparagraphs, sales of securities will only be made to the extent required in each case.

22. A fee will be payable to the Trustee by each member of up to 0.3% per annum of the value of the units held by that member (plus GST, if any).

23. Each investing superannuation fund must make a minimum initial contribution to the Fund of $200,000 or such lesser amount as the Trustee with the written consent of the Sponsor may approve.

24. Under the Trust Deed for the Fund, members of the Fund have an individual Member Account, into which is credited any contributions by the member together with any growth in value of the funds invested. It is anticipated that the Member Accounts will be calculated and recorded on a unitised basis, ie the total value of the Fund will be divided into units and each member will be allocated the number of units which reflects their respective contributions and earnings.

25. The Fund is required to buy and sell shares as required to ensure that it continues to correspond to the Index. Such buying and selling will not be motivated by any intention to derive a profit or gain from such sales. In this regard, the Trust Deed states:

    The Fund and the Trustee do not have an intention to profit from holding, acquiring or selling Index Company securities.

26. The powers contained in clause 10.1(h) of the Trust Deed will only be exercised to facilitate the purposes of the Fund and in any event will only be used in accordance with paragraph 25 of this Ruling.

27. Members may from time to time elect to withdraw funds from the Fund. A substantial withdrawal from the Fund could be in the millions of dollars. In that circumstance, the Fund may not be able to fund the withdrawal in one portfolio trade as, depending on the market circumstances (including liquidity), brokers are likely to be limited as to the size of the trade they will accept at all. Even if a broker (or brokers) did accept a trade of significant size, they would not be able to guarantee that the trade would be completed or settled within 3 business days. In these circumstances the Fund will accumulate funds to the full withdrawal amount.

28. The Manager does not have the power to purchase units from Members.

29. The Applicant has confirmed that all aspects of the previous private ruling (BR Prv 02/33) and the private ruling prior to that (BR Prv 01/17), relating to the Fund, have been complied with, except that:

    - in regard to the previous ruling, on the takeover of Powerco Limited by Prime Infrastructure Networks (New Zealand) Limited, the Manager did not rebalance the Fund to include a replacement security until the following quarterly rebalancing. As a result, there was a period where the number of securities held by the Fund was 24. For the avoidance of doubt, this has been disclosed as a circumstance of non-compliance even though the previous ruling was silent on the date of reintroduction of a replacement security; and
    - in regard to BR Prv 01/17, the Fund received a compulsory share acquisition by court order which required the Fund to hold non-Index shares. This occurred during the Fletcher Energy acquisition when the Fund was issued shares in a company that did not track the Index. (The shares were in a United States company called Capstone. Each Fletcher Energy shareholder was issued with a small number of Capstone shares as well as other consideration.) As it was a court approved compulsory acquisition, the Manager had no choice but to receive those shares. The terms of the issue of the Capstone shares meant that all the recipients had to hold the shares for a period of time before they could sell them and use the proceeds to invest in the Index.

30. There has been no change to the Trust Deed of the Fund (except for the noted amendments dated 23 March 2001, 31 July 2002 and the Amending Trust Deed), nor any change to the management or operation of the Fund since its establishment.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) The Fund is a registered superannuation scheme under the Superannuation Schemes Act 1989.

b) The existing binding private ruling for the Fund (BR Prv 05/16) (or any such replacement ruling) remains in force and continues to apply in all respects to the Arrangement.

c) The Amending Trust Deed provided to the Commissioner on 21 June 2005 will be executed by 31 August 2005 so that it is the same as, or not materially different from, the draft deed provided to the Commissioner.

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:

- The Fund is a "superannuation fund" as defined in section OB 1.
- The Fund is a "qualifying trust" under paragraph (b) of the definition of "qualifying trust" in section OB 1.

- Amounts derived by investors as a result of withdrawals from the Fund are excluded from income by virtue of section HH 3(5).

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 July 2005 and ending on 30 June 2008.

This Ruling is signed by me on the 30th day of June 2005.

David Kelly
Manager (Financial Sector)

DIRECTORS' FEES AND GST PUBLIC RULING – BR PUB 05/13

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 00/11 which was published in T*ax Information Bulletin* Vol 12, No 11 (November 2000). BR Pub 00/11 applied until 31 March 2005. BR Pub 05/13 applies on 1 April 2005 for an indefinite period.

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Ruling applies in respect of sections 6(3)(b), 8, and 57(2)(b).

The Arrangement to which this Ruling applies

The Arrangement is the engagement, occupation, or employment of a person as a director of a company. The engagement may either be by direct contract between the director and the company for whom the person acts as a director, or by a third party appointing, or agreeing to provide, a director to a company.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- If a natural person is engaged as a director and the services are not undertaken as part of carrying on the person's own taxable activity, the engagement will be excluded from the term "taxable activity" due to the application of section 6(3)(b). The proviso does not apply as the services are not supplied as part of carrying on the person's taxable activity.
- If a natural person is engaged as a director as part of carrying on his or her taxable activity, the proviso to section 6(3)(b) will apply and the services will be deemed to be supplied in the course or furtherance of that taxable activity. If the person is registered for GST or is liable to be registered for GST, the person will be required to account for GST on the fees received for the supply of the directorship services.
- If a natural person is contracted by a third party to take up an engagement as a director of a company and the person has not accepted the directorship as part of carrying on a taxable activity:
  - the engagement of the natural person as a director will be excluded from the term "taxable activity" due to the application of section 6(3)(b). The proviso does not apply as the services are not supplied as part of carrying on the person's taxable activity;
  - the provision by the third party of the services of the natural person director does not fall within the provisions of section 6(3)(b), as the third party has not been engaged as a director of a company. If the third party is registered for GST or is liable to be registered for GST, that third party will be required to account for GST on the fees received for the supply of the person's services as a director of the company under section 8.
- If a natural person is contracted by a third party to take up an engagement as a director of a company and the engagement is part of carrying on the person's taxable activity:
  - the engagement of the natural person director will fall within the proviso to section 6(3)(b) and the services will be deemed to be supplied in the course or furtherance of the taxable activity;
  - the provision by the third party of the services of the director does not fall within the provisions of section 6(3)(b), as the third party is not engaged as a director of a company. If the third party is registered for GST or is liable to be registered for GST, that third party will be required to account for GST on the fees received for the supply of the person's services as a director of the company under section 8.
- If an employee, as part of his or her employment, is engaged as a director of a third party company by way of a contract between his or her employer and the third party company:

- the engagement of the employee will fall within the provisions of section 6(3)(b) and is therefore excluded from the term "taxable activity". The proviso to the section does not apply as the services are not supplied as part of carrying on a taxable activity of the employee;
- the provision by the employer of the services of a director does not fall within the provisions of section 6(3)(b), as the employer is not engaged as a director of a company. If the employer is registered for GST or is liable to be registered for GST, that employer will be required to account for GST on the fees received for the supply of the employee's services as a director of the company under section 8.

- If an employee is engaged by a third party company to be a director of that company, where: the employee is required to account to the employer for the director's fees received; there is no contract between the employer company and the third party company; and where the employee does not undertake the services as part of carrying on his or her own taxable activity:
  - the engagement as director will be excluded from the term "taxable activity" due to the application of section 6(3)(b). The proviso does not apply as the services are not supplied as part of carrying on the person's taxable activity;
  - if the employer is registered for GST or is liable to be registered for GST, the employer is required to account for GST on the consideration received for the supply of services to the employee under section 8, ie permitting the employee to be a director.
- If a partner in a partnership accepts an engagement as a director of a company as part of the partnership's business:
  - the activity of the partner, in accepting the engagement as a director, falls within the provisions of section 6(3)(b) and is therefore excluded from the term "taxable activity". The proviso to the section does not apply as, although the partner may be carrying on the taxable activity of the partnership, the services are deemed to be supplied by the partnership in terms of section 57(2)(b);
  - the provision by the partnership of the services of the director does not fall within the provisions of section 6(3)(b), as the partnership is not engaged as a director of a company. The partnership will be required to account for GST on the fees received for the supply of the partner's services as a director of the company as it is considered to be part of the normal taxable activity of the partnership.

The period for which this Ruling applies

This Ruling will apply on 1 April 2005 for an indefinite period.

This Ruling is signed by me on the 2nd day of August 2005.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 05/13

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 05/13 ("the Ruling").

Background

Section 6 defines the term "taxable activity" for the purposes of the Act. Under section 6(1), a person conducts a taxable activity when all the following characteristics are present:

- There is some form of activity.
- The activity is carried on continuously or regularly.
- The activity involves, or is intended to involve, the supply of goods and services to another person for a consideration.

Section 6(3) provides certain exclusions from the term "taxable activity". Under section 6(3)(b), the activities of a salary and wage earner or of a person in receipt of directors' fees are excluded from the term.

Under the proviso to section 6(3)(b), if a person in carrying on a taxable activity accepts any office, any services supplied by that person in holding that office are deemed to be supplied in the course or furtherance of that taxable activity. Therefore, if a GST-registered sole trader who, in carrying on his or her taxable activity, takes on a company directorship, the proviso applies and GST is chargeable on the directors' fees paid.

Public Information Bulletin (*PIB*) 164 issued in August 1987 contained an item titled "GST on Directors' Fees". The item concerned the circumstances in which directors' fees did and did not attract GST. The item listed indicators that could be used in identifying the correct GST treatment to be applied to directors' fees. These indicators were:

1. Directors' fees paid to directors personally, and retained by them.

   Not subject to GST—excluded from the meaning of taxable activity by section 6(3)(b).

2. Directors' fees paid to directors personally, but applied by them to their partnership or business income, where the partnership or business is a registered person.

   Subject to GST—subject to the proviso to section 6(3)(b).

3. Directors' fees paid directly to director's partnership or company, where that partnership or company is a registered person.

   Subject to GST—a normal taxable supply.

In July 1988 the Department issued *PIB* 175 containing, at page 26, a further item "GST on Directors' Fees", restricting the policy set down in *PIB* 164. The item advised that the proviso to section 6(3)(b) applies only to a sole trader, eg an accountant (being a registered person) who, in carrying on his or her taxable activity, is appointed a director of a company. The statement said that directors' fees paid to a partner in a partnership or to a shareholder, director, or employee of another company are not therefore subject to GST. The reason given for this interpretation was that, in terms of the Companies Act 1955, a director could only be a natural person. Therefore, directors' fees either paid to directors on behalf of their companies or partnerships, or paid direct to the company or partnership for directorship services carried out by their employees or partners, do not attract GST under this policy.

In September 1996 Inland Revenue published an interpretation statement in *Tax Information Bulletin* (*TIB*) Vol 8, No 4 on "Tax deductions from directors' fees paid to GST-registered persons". This interpretation statement is also relevant to the subject matter of this Ruling, even though it deals with tax deductions under the Income Tax Act 1994. The statement says, at page 3, that if an employee is acting as a director of a company on behalf of another company, the directors' fees paid are for services rendered by the employer company. Regulation 4(2) of the Income Tax (Withholding Payments) Regulations 1979 ("the Regulations") states that payments for work done or services rendered by a company are not withholding payments. Therefore, tax deductions are not required to be made from the payments. Similarly, if a company pays directors' fees to a partnership account in return for the partner performing partnership services, the fees are business income of the partners and the Commissioner will not require tax deductions to be made under section NC 13 of the Income Tax Act 1994. Therefore, if it is the company or partnership that is providing the services of its employee or partner as a director, the question arises as to whether GST should be charged on these services as they would normally be supplied in the course or furtherance of a taxable activity of the company or partnership.

In September 2000 Inland Revenue published public binding ruling BR Pub 00/09 in *TIB* Vol 12, No 9 to replace the policy items on "GST on Directors' Fees" contained in *PIBs* 164 and 175. Inadvertently, BR Pub 00/09 contained an application period that could be seen to be retrospective, as the period of the ruling issued was effective from 1 April 2000 to 31 March 2005. As the ruling was intended to apply prospectively, BR Pub 00/09 was withdrawn in November 2000 in *TIB* Vol 12, No 11 and BR Pub 00/11 was issued in its place for the period 26 October 2000 to 31 March 2005.

This ruling, with similar content, replaces BR Pub 00/11, which expired 31 March 2005, and is effective on 1 April 2005 for an indefinite period.

Legislation

Section 2(1) defines the words "person", "registered person" and "unincorporated body" as follows:

> "Person" includes a company, an unincorporated body of persons, a public authority, and a local authority:
>
> "Registered person" means a person who is registered or is liable to be registered under this Act:
>
> "Unincorporated body" means an unincorporated body of persons, including a partnership, a joint venture, and the trustees of a trust:

Section 6 states:

(1) For the purposes of this Act, the term "taxable activity" means—

   (a) Any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:

   (b) Without limiting the generality of paragraph (a) of this subsection, the activities of any public authority or any local authority.

(2) Anything done in connection with the beginning or ending, including a premature ending, of a taxable activity is treated as being carried out in the course or furtherance of the taxable activity.

(3) Notwithstanding anything in subsections (1) and (2) of this section, for the purposes of this Act the term "taxable activity" shall not include, in relation to any person,—

   (a) Being a natural person, any activity carried on essentially as a private recreational pursuit or hobby; or

   (aa) Not being a natural person, any activity which, if it were carried on by a natural person, would be carried on essentially as a private recreational pursuit or hobby; or

   (b) Any engagement, occupation, or employment under any contract of service or as a director of a company:

   Provided that where any person, in carrying on any taxable activity, accepts any office, any services supplied by that person as the holder of

> **that office shall be deemed to be supplied in the course or furtherance of that taxable activity; or…**
> (Emphasis added)

Section 8(1), dealing with the imposition of goods and services tax, states:

> Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 12.5 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

Section 57(2), dealing with unincorporated bodies, states:

(2) Where an unincorporated body that carries on any taxable activity is registered pursuant to this Act,—

(a) The members of that body shall not themselves be registered or liable to be registered under this Act in relation to the carrying on of that taxable activity; and

(b) Any supply of goods and services made in the course of carrying on that taxable activity shall be deemed for the purposes of this Act to be supplied by that body, and shall be deemed not to be made by any member of that body; and

…

(Emphasis added)

Section 151(3) of the Companies Act 1993 states:

> A person that is not a natural person cannot be a director of a company.

Application of the Legislation

Section 8(1) provides that GST is charged on the supply (but not an exempt supply) in New Zealand of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person.

Therefore, one of the determining features in ascertaining whether there is a liability to account for GST, is the existence of a "taxable activity". Another determining feature is whether the person is a "registered person".

Section 6(1) defines a "taxable activity" as an activity that is carried on continuously or regularly, and involves or is intended to involve, the supply of goods and services to another person for a consideration. The section also includes within the term "taxable activity" the activities of any public or local authority.

Under section 6(2), anything done in connection with the commencement or termination of a taxable activity is deemed to be carried out in the course or furtherance of that taxable activity.

Paragraphs (a), (aa), (b), (c), and (d) of section 6(3) exclude from the term "taxable activity" such activities as hobbies, employment under a contract of service and engagement as a director of a company, certain government-type and local authority appointments, and the making of exempt supplies.

The proviso to paragraph (b) states that if a person, in carrying on a taxable activity, accepts any office, services supplied by that person in holding that office are deemed to be supplied in the course or furtherance of that taxable activity. Therefore, if a person is carrying on a taxable activity, and accepts an engagement as a company director in carrying on that taxable activity, the proviso will apply.

If it is established that a taxable activity is in existence after applying section 6, the question of whether the person is liable to account for GST will depend on the application of the remaining criteria set down in section 8. One of these criteria is whether the person is a "registered person", ie whether the person is registered for GST or is liable to be registered for GST, which includes whether the taxable activity threshold amount in section 51 has been satisfied.

Section 57(2)(b) provides that where an "unincorporated body", which by definition under section 2(1) includes a partnership, carries on a taxable activity, any supply of goods and services made as part of carrying on that taxable activity are deemed to be supplied by the partnership and not by any of the partners.

Section 151(3) of the Companies Act 1993 provides that only a natural person can be a director of a company.

The following scenarios illustrate how section 6(3)(b) is applied in respect of a person engaged as a director of a company, ie whether a taxable activity is in existence. It is important to note that the Ruling itself deals specifically with section 6(3)(b). If it is established that an activity does not fall within the exclusion from a "taxable activity" set down in that section, the remaining criteria under section 8 must be applied in order to determine the existence of a liability to account for GST.

Finally, it should be mentioned that it is the contractual relationship between the parties, founded on a genuine basis, that determines the GST treatment of the relevant transactions (Wilson & Horton v CIR (1995) 17 NZTC 12,325).

A. Personal capacity

A natural person is engaged as a director of a company in that person's personal capacity and not as part of carrying on any taxable activity.

The activity of this person falls within the provisions of section 6(3)(b) in that it involves a person who is engaged as a director of a company. The activity is therefore excluded from the term "taxable activity". The proviso does not apply, as the person has not accepted the engagement as part of carrying on a taxable activity.

B. Carrying on a taxable activity

A natural person is engaged as a director of a company as part of carrying on that person's taxable activity.

The activity of this person falls within the provisions of section 6(3)(b) in that it involves a person who is engaged as a director of a company. The activity is therefore prima facie excluded from the term “taxable activity”. However, as the person has accepted the engagement as part of carrying on a taxable activity, the proviso deems the services to be supplied in the course or furtherance of that taxable activity. If the person is registered for GST or is liable to be registered for GST, the person will be required to account for GST on the fees received for the supply of the directorship services.

C. Person contracted as a company director

A natural person is contracted by a third party to take up an engagement as a director of a company. The person is not undertaking the directorship as part of carrying on any taxable activity. The third party invoices the company for its services in providing it with a director.

The engagement of the person as a director of a company is excluded from the term “taxable activity” under section 6(3)(b). The proviso to the section does not apply as the services are not supplied as part of carrying on the person’s taxable activity. The provision by the third party of the services of the director does not fall within the provisions of section 6(3)(b) as the third party is not engaged as a director of a company. Provided the third party is registered for GST, or is liable to be registered for GST, that party will be required to account for GST on the fees received for the supply of the services of the person as a director of the company.

D. Person contracted as a company director in carrying on a taxable activity

A natural person, as part of carrying on a taxable activity, is contracted by a third party to take up an engagement as a director of a company. The third party invoices the company for providing the services of the director, who in turn invoices the third party for his or her services.

The engagement of the person as a director of a company is prima facie excluded from the term “taxable activity” under section 6(3)(b). However, as the person has accepted the engagement as part of carrying on his or her taxable activity, the proviso to the section deems the directorship services to be supplied in the course or furtherance of his or her taxable activity. The natural person’s liability for GST will therefore depend on satisfying the remaining requirements of section 8. The provision by the third party of the services of the director does not fall within the provisions of section 6(3)(b) as the third party is not engaged as a director of a company. Provided the third party is registered for GST, or is liable to be registered for GST, that party will be required to account for GST on the fees received for the supply of the person’s directorship services.

E. Employee engaged as director

An employee of an employer is engaged as a director of a third party company as part of the person’s employment duties.

The engagement of this person as a director of a company is excluded from the term “taxable activity” under section 6(3)(b). The proviso to the section does not apply as the person has not accepted the directorship as part of carrying on a taxable activity—the person is merely carrying out his or her employment duties. The provisions of section 6(3)(b) do not apply to the employer who is supplying the services of its employee as the employer is not engaged as a director of a company. Provided the employer is registered for GST or is liable to be registered for GST, that party will be required to account for GST on the fees received for the supply of the services of the person as a director of the company.

F. Employee required to pay over directors’ fees to employer

Sometimes an employee is permitted to accept directorships of third party companies provided that the employee accounts to the employer for the fees received. This might occur with family companies. In this type of scenario there would not be a contract between the employer and the third party company.

In this situation, the engagement of the person as a director of a company is excluded from the term “taxable activity” under section 6(3)(b). The proviso to the section does not apply as the person has not accepted the directorship as part of carrying on a taxable activity. The employer company, provided it is registered for GST or liable to be registered for GST, will be required to account for GST on the supply of services by the employee. These services could best be described as allowing the employee to undertake directorship duties in work time or permitting the employee to be a director.

G. Partner in a partnership engaged as a director

A partner in a partnership accepts an engagement as a director of a company as part of the partnership’s business.

The engagement of this person as a director of a company is excluded from the term “taxable activity” under section 6(3)(b). The proviso to the section does not apply as, although the partner may be carrying on the taxable activity of the partnership, the services are deemed to be supplied by the partnership in terms of section 57(2)(b). Therefore, the partner is not required to account for GST on the supply of the directorship services. Section 6(3)(b) does not apply in the case of the partnership as the partnership is not engaged as a director of a company. The partnership supplies the services of one of its partners to the company as part of its taxable activity.

The partnership will therefore be required to account for GST on the fees received for the supply of the partner's directorship services.

Examples

Example 1

Taxpayer A, who is not registered for GST, is a partner in a firm of chartered accountants. Company B engages taxpayer A as a director, and pays him fees for his services. Taxpayer A's appointment as a director is not connected with his involvement in the partnership nor has he accepted the directorship as part of carrying on a taxable activity. He retains the fees, having received them in his personal capacity.

Taxpayer A is engaged as a director of a company, an activity that is excluded from the term "taxable activity" by section 6(3)(b). The proviso to the section does not apply, as taxpayer A is not providing directorship services as part of carrying on a taxable activity. Taxpayer A is not required to account for GST on the fees received for directorship services.

Example 2

Taxpayer B is a human resources consultant in business on her own. She is registered for GST. She accepts a company directorship as part of carrying on her taxable activity, and receives fees for her services.

Taxpayer B's engagement as a director is *prima facie* excluded from the term "taxable activity" in terms of section 6(3)(b). However, as she has accepted the engagement as part of carrying on her taxable activity, the proviso to the section deems the directorship services to be supplied in the course or furtherance of her taxable activity. She should therefore account for GST on the fees she is paid.

Example 3

A GST-registered financial management company supplies the services of one of its specialist employees as a director of another company. Directors' fees are paid to the company for the services provided.

The engagement of the employee as a director is excluded from the term "taxable activity" under section 6(3)(b). The proviso does not apply as the employee has not accepted the office as part of carrying on a taxable activity. Therefore, the employee is not required to account for GST on the supply of the directorship services. Section 6(3)(b) does not apply to the activity of the management company as that company is not engaged as a company director. The fees are paid in consideration of the management company providing the services of one of its employees to the other company. This is a supply in the course or furtherance of a taxable activity of the management company and that company will be required to account for GST on the fees received for this supply.

Example 4

A partner of a GST-registered legal partnership is elected on to the board of directors of a client company as a representative of the partnership. The partnership is providing legal advice to the company, which in turn pays fees into the partnership's account.

The engagement of the partner as a director of a company falls within the provisions of section 6(3)(b) and is therefore excluded from the term "taxable activity". The proviso to the section does not apply as, although the partner may be carrying on the taxable activity of the partnership, the services are deemed to be supplied by the partnership in terms of section 57(2)(b). Therefore, the partner is not required to account for GST on the supply of the directorship services. The provisions of section 6(3)(b) do not apply to the partnership as it is not engaged as a director of a company.

The partnership will therefore be required to account for GST on the fees it receives from the company.

Example 5

A GST-registered accountant in business on his own is contracted by a consulting firm to take up an engagement as a director of a company with the object of monitoring the company's financial systems.

The engagement of the accountant as a director of a company is excluded from the term "taxable activity" under section 6(3)(b). However, as the person has accepted the engagement as part of carrying on his taxable activity, the proviso to the section deems the directorship services to be supplied in the course or furtherance of his taxable activity. The accountant will therefore be required to account for GST on the fees he receives in respect of these services. The provision by the consulting firm of the services of the accountant does not fall within the provisions of section 6(3)(b) as the firm is not engaged as a director of a company. Provided the consulting firm is registered for GST or is liable to be registered for GST, it will be required to account for GST on the fees received for the supply of the directorship services of the accountant.

Example 6

Company A agrees to one of its employees taking up a directorship position with Company X on the proviso that the employee hands over the directors' fees payable to the employee by Company X. There is no contract between Company A and Company X.

The engagement of the employee as a director is excluded from the term "taxable activity" under section 6(3)(b). The proviso does not apply as the employee has not accepted the office as part of carrying on a taxable activity. Therefore, the employee is not required to account for GST on the supply of the directorship services. If Company A is registered for GST or is liable to be registered for GST, it is required to account for GST on the supply of services, ie permitting the employee to be a director of Company X.

NEW LEGISLATION

TAXATION (BASE MAINTENANCE AND MISCELLANEOUS PROVISIONS) ACT 2005

The Taxation (Base Maintenance and Miscellaneous Provisions) Bill was introduced into Parliament on 16 November 2004. It received its first reading on 14 December 2004, and its second and third readings on 14 June 2005. Two Acts resulted: the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 and the Privacy Amendment Act 2005, which merely inserts a new cross-reference into the Tax Administration Act 1994. They received Royal assent on 21 June 2005.

They amend the Income Tax Act 1994, Income Tax Act 2004, Tax Administration Act 1994, Goods and Services Tax Act 1985, Taxation Review Authorities Act 1994 and Privacy Act 1993.

POLICY ISSUES

THIN CAPITALISATION RULES FOR BANKS

Sections FG 2, FG 3, FG 4, FG 8, FG 8B to FG 8J, FH 1 and OB 1 of the Income Tax Acts 1994 and 2004

New thin capitalisation rules apply to foreign-owned registered banks operating in New Zealand. The rules determine the extent to which interest is deductible to the New Zealand business of the foreign-owned bank as part of calculating its New Zealand income for tax purposes. Banks are denied interest deductions if they do not have sufficient equity for tax purposes to support their New Zealand business.

The rules compare the equity of the New Zealand banking business with a legislatively prescribed level of equity based on 4% of the bank's New Zealand risk-weighted exposures. If there is a deficiency in the New Zealand equity compared with the required equity, interest is denied on the shortfall.

Application date

The thin capitalisation rules for banks apply from 1 July 2005.

Background

The rules were introduced in response to government concerns that tax paid in New Zealand by foreign-owned banking groups appeared insufficient relative to their accounting profits. Of particular concern was the level of debt held by these banking groups in New Zealand compared with their New Zealand-based assets. Two key issues were identified: the first related to the debt funding of a bank's outbound investment given that the income from this investment is generally not subject to full New Zealand taxation; and the second related to the extent of debt funding of some banks' New Zealand business.

Under the previous tax rules, foreign-owned banks were subject to the same thin capitalisation provisions as other foreign-owned companies controlled by a single non-resident. However, in practice these rules did not limit their interest deductions for tax purposes. This was primarily because of the on-lending concession in the general thin capitalisation rules.

The banking sector was consulted on the development of the thin capitalisation rules for banks.

Key features

The amendments introducing the bank thin capitalisation rules are to both the 1994 and 2004 Income Tax Acts, and section references are identical.

- The new thin capitalisation rules apply to *registered banks* that are controlled by a single non-resident (sections FG 2(1), FG 3, OB 1).
- Where the rules apply to a registered bank, that bank must determine its *NZ banking group* (section FG 8C).
- The NZ banking group is required to calculate its *NZ net equity* at least quarterly (sections FG 8E, FG 8G).
- The NZ banking group must also calculate its *net equity threshold* at least quarterly (sections FG 8E, FG 8H).
- Where the NZ net equity of the NZ banking group is less than its net equity threshold, interest will be denied (section FG 8B).
- The interest denial will be calculated using an interest rate based on average cost of funds (sections FG 3(2)(b), FG 8B).
- The registered bank will be the *reporting bank*. The reporting bank must make an adjustment for any interest denial in its tax return (sections FG 3, FG 8D).

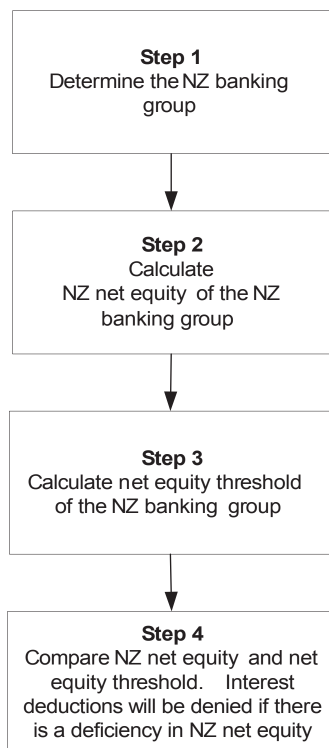
- The calculations draw on the accounts prepared by banks for financial and regulatory reporting purposes (sections FG 8F, FG 8I).
- Temporary changes to the amounts included in NZ net equity or net equity threshold as a result of an arrangement to defeat the intent and application of the new rules will not be taken into account for the purposes of the thin capitalisation calculations (section FG 8J).

Detailed analysis

The rules apply to foreign-owned registered banks operating in New Zealand. A registered bank is defined in section OB 1 as having the same meaning as in the Reserve Bank of New Zealand Act 1989.

A registered bank is subject to thin capitalisation rules if it has sufficient non-resident control as set out in section FG 2(1). Under the bank-specific thin capitalisation rules, a registered bank must determine its NZ banking group, calculate the NZ net equity of this group and compare that to the net equity threshold. If NZ net equity of the group is less than the net equity threshold, interest deductions will be denied.

Steps to apply the bank thin capitalisation rules



Step 1: NZ banking group

A foreign-owned registered bank which is subject to thin capitalisation rules is required to determine its NZ banking group under section FG 8C. This group includes all resident entities operating in New Zealand that would be required to consolidate with the ultimate foreign parent of the registered bank for financial reporting purposes. Fixed establishments (generally branches) operating in New Zealand are included in the consolidated accounts.

If the ultimate foreign parent does not include a New Zealand-resident entity or fixed establishment in its accounting consolidation because that entity or fixed establishment is not material in the context of its worldwide consolidation, that entity or fixed establishment will still be included in the NZ banking group.

Section FG 8C gives the bank the option to exclude its life insurance entities from its NZ banking group. Entities that are part of a life insurance entity's group can also be excluded from the NZ banking group, provided they do not have a main activity of banking, financing or leasing, and they are not holding companies of banking, financing or leasing companies. The excluded entities may include a non-resident person or company (with a fixed establishment in New Zealand) whose main activity is the provision of life insurance.

The election to exclude an entity from the NZ banking group is made at the time of filing the annual tax return. There is no specific form of election, nor a requirement to separately notify Inland Revenue. The act of excluding the entities from the banking calculation is the election. This election may be changed annually.

A taxpayer included in a NZ banking group will not be subject to the general interest apportionment rule in section FG 8 or the interest allocation rules in section FH 1. This is to ensure that there is no doubling up of adjustments resulting from insufficient levels of equity for tax purposes.

Companies that elect to be excluded from the banking group will continue to be subject to the general thin capitalisation rules in section FG 8 and interest allocation rules in section FH 1.

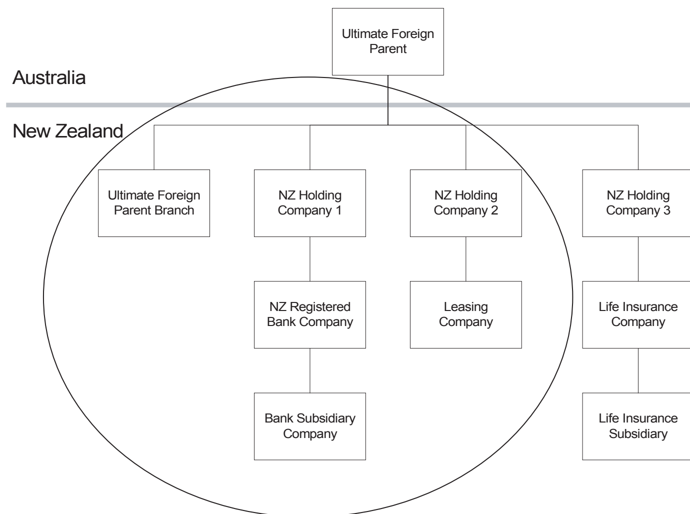
The reporting bank, defined in section FG 8D, is responsible for performing the NZ banking group's thin capitalisation calculation. This will be the registered bank in the group. If there are two or more registered banks in the NZ banking group, the banks must elect a reporting bank by notifying the Commissioner within six months after the end of the tax year. Where no notification is given the Commissioner will choose.

Example: Entities included in the NZ banking group

In the diagram below the New Zealand entities are all potential members of the NZ banking group. While the ultimate foreign parent is not part of the NZ banking group, it is shown in this diagram because the NZ banking group is determined with reference to the ultimate foreign parent of the registered bank. In this example, the NZ banking group must include the:

- Ultimate foreign parent branch;
- New Zealand holding company 1;
- New Zealand holding company 2;
- New Zealand registered bank company;
- Bank subsidiary company; and
- Leasing company.

New Zealand holding company 3, Life insurance company and Life insurance subsidiary can elect to be excluded. If so, they would not be part of the NZ banking group. The circled area represents the NZ banking group where an election to exclude the life entities has been made. The reporting bank will be the New Zealand-registered bank company.



Step 2: NZ net equity

The NZ banking group must determine its NZ net equity at least quarterly. NZ net equity is defined in section FG 8G. This calculation begins with aggregating the NZ banking group's shareholder and branch equity based on their financial accounts. The aggregation of this equity is done in accordance with accounting rules that apply to consolidations.

Certain subtractions are then made from this aggregated accounting equity. Some of these subtractions follow the prudential deductions required by the Reserve Bank's Capital Adequacy Framework. An example of a prudential deduction is goodwill. Another subtraction for the purposes of the NZ net equity calculation is certain offshore assets of the NZ banking group.

For the tax calculation of the NZ net equity of the NZ banking group there is an exception to the rule that requires the subtraction of goodwill. This concerns certain goodwill relating to non-banking business.

Aggregated accounting equity (EQV)

The starting point for NZ net equity of the NZ banking group is the aggregation of the accounting values of shareholders' equity and branch equity included in the financial statements of NZ banking group members. This aggregation is done based on accounting consolidation principles.

The consolidation of the NZ banking group may or may not actually be required for accounting purposes. If there is no requirement to consolidate the NZ banking

group for financial reporting purposes, a "notional" accounting consolidation of the NZ banking group for the purposes of the tax rules is needed. This may, for instance, be based on an aggregation of consolidations of sibling groups. This means that where two or more sibling consolidated groups are aggregated, inter-group transactions must be eliminated.

Any amounts considered equity for tax purposes but not for accounting purposes are added to the aggregated accounting amount of shareholders' and branch equity. Equity for accounting purposes that is considered debt for tax purposes is subtracted, as referred to below. Interest-free loans to the NZ banking group from non-resident associates will generally also be included in NZ net equity.

Section FG 8F(1) sets out the criteria to determine accounting values of the relevant items. Generally there is a focus on external financial reports that are prepared in accordance with generally accepted accounting principles.

The aggregated accounting equity is referred to in the legislation as EQV.

Subtractions from EQV

Following the determination of the group's EQV certain subtractions are made from this amount. Sub-sections FG 8G(2) and (3) ensure that items cannot be subtracted from equity more than once.

The following is a summary of the required subtractions. Included in brackets after each item is the reference used in the legislation. The amounts subtracted are, in general, based on the amounts from accounts prepared for financial or regulatory reporting purposes.

- **Intangible assets (INTG)**: All intangible assets except for:
  - goodwill that relates to a business that is not banking, financing, leasing, or life insurance. The goodwill must have arisen from an acquisition by the NZ banking group member from a person who is not associated with any NZ banking group member;
  - films or film rights;
  - property that is depreciable property for income tax purposes or is expected to become depreciable property.
- **Capital gain amounts (CGA)**: Capital gain amounts, as defined for income tax purposes, where those gains are made in the 2004-05 and subsequent years as a result of transfers of intangible assets to associated persons outside of the NZ banking group.
- **Asset revaluation reserves (REV)**
- **Future tax benefits (TXB)**: Net future tax benefits if they arise from tax losses or from timing or temporary differences that would result in tax losses, if the item that gave rise to the timing or temporary difference would have been deductible in the current year.
- **Certain prudential deductions (CEFA and NAFA)**: These prudential deductions are defined in the Reserve Bank of New Zealand's Capital Adequacy Framework and relate to certain credit enhancements provided by a NZ banking group member, and certain loans made by a NZ banking group member to a connected person who is not a part of the NZ banking group.
- **Fixed rate shares (FRS)**: Fixed-rate shares, as defined in section LF 2(3), where they are issued by members of the NZ banking group to New Zealand residents. The reason for this subtraction is because fixed rate shares are economically similar to debt in several respects, and they may be used flexibly as a substitute for it. The subtraction from NZ net equity applies to fixed rate shares that have been offered to the public on or after 1 January 2005. Fixed rate shares that have been offered to the public before 1 January 2005 are not required to be subtracted from NZ net equity until after 1 January 2010.
- **Debt for tax purposes (EID)**: This refers to amounts included in EQV which are considered equity for accounting purposes but which give rise to a deduction for tax purposes.
- **Policyholder liabilities (UPB)**: This applies only to life insurers that are included in the NZ banking group. Where unvested policyholder liabilities have been included as equity for financial reporting purposes, they are not included in EQV under the thin capitalisation rules.
- **Cross holdings (AEQ and AEQI)**: Cross holdings between members of the NZ banking group and any life insurance entities that have elected to be excluded from the group.
- **Offshore assets (EOI)**:
  - Shares in non-resident companies that are held by members of the NZ banking group, or are held by life insurance entities that have elected to be excluded from the group.
  - Shares in a resident company in circumstances where:
    (i) the NZ banking group member or potential member holds a direct voting interest of 10% or more in that resident company; and
    (ii) the NZ banking group member or potential member receives a dividend from the resident company that has conduit relief attached to it in the current income year.

This ensures that the thin capitalisation rules cannot be avoided by placing shares in offshore companies in a NZ-resident company which is outside the NZ banking group. This will apply only when a NZ banking group member receives the flowed through conduit relief with the dividend from the NZ resident company.

The following offshore assets are not subtracted from EQV:

- interests in foreign investment funds where the comparative value or deemed rate of return methods are used;
- shares in companies in grey list countries which are listed on a recognised exchange, and are held on revenue account, and would not be "sufficient interest" if the class of shares were the only class of share issued by the offshore company. Sufficient interest is defined in section LF 1(2) and is, in general, an interest of 10% or greater.

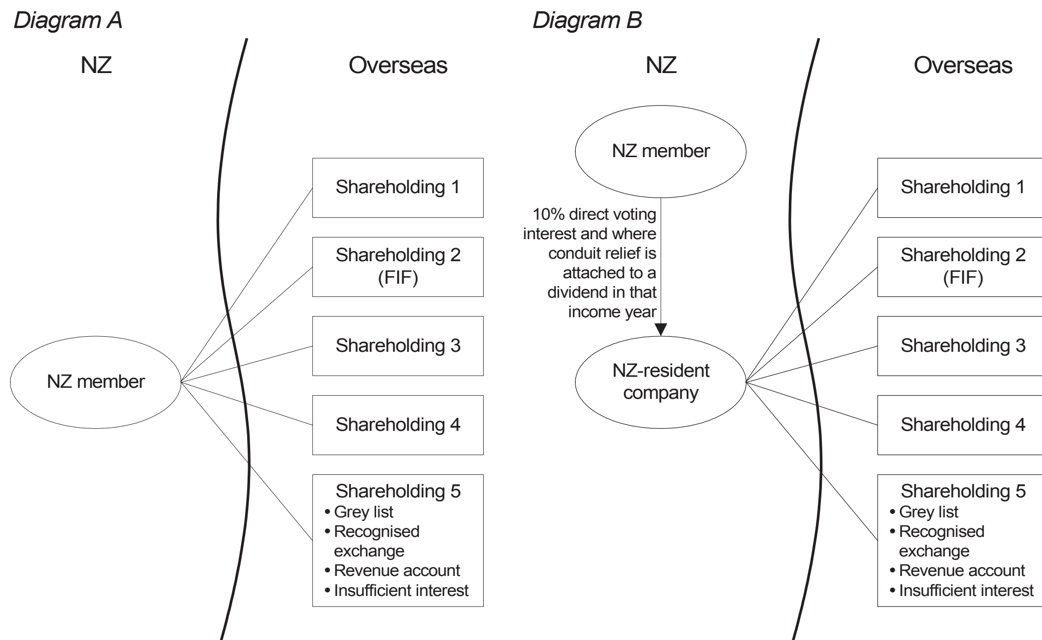
- **Notional offshore investment amount (NOIA)**: A notional offshore investment amount is subtracted from EQV. Foreign tax credits claimed by the NZ banking group against their income tax liability are used as a basis to calculate this amount. The notional amount effectively represents the offshore investment that the group would have made to generate the foreign tax credits it received.

  The NZ banking group can claim up to $5 million of foreign tax credits before it is required to calculate a notional offshore investment amount. This minimum threshold allows for a reasonable level of debt funded offshore investment that would not be subject to the thin capitalisation banking rules, while capturing significant offshore lending that does not result in tax payable in New Zealand.

  The notional offshore investment amount is calculated according to a formula which essentially "grosses up" foreign tax credits in excess of the minimum threshold.

Example: Offshore assets subtracted from EQV

In Diagram A, a member of a NZ banking group holds five shareholdings in overseas companies. In Diagram B, the five shareholdings are held by a resident company in which a member holds a direct voting interest of 10% or more and where conduit tax relief is attached to a dividend paid to the member in that year.



In both diagrams, shareholdings 1 to 5 fall under EOI because they are offshore shareholdings. At first glance, they would be subtracted from the NZ net equity of the NZ banking group. However, Shareholding 2 represents an interest in a foreign investment fund where the comparative value or deemed rate of return method is used. Shareholding 5 represents an interest in a company which operates in a grey list country, is listed on a recognised exchange, is held on revenue account, and would not be a "sufficient interest" if the class of shares were the only class of share issued by the offshore company. This means that Shareholdings 2 and 5 fall under the exceptions to EOI and are included in the NZ net equity of the NZ banking group.

Example: Notional offshore investment amount calculation

This calculation of a notional offshore investment amount is based on foreign tax credits of $5,033,000.

Foreign tax credits	$5,033,000
Less minimum allowance	$5,000,000
Excess foreign tax credits	$33,000
Gross up 33%	$100,000
Gross up at interest rate (deemed return rate) to calculate offshore investment	7%
Notional offshore investment amount	$1,428,571

Transitional rules cover foreign tax credits on income after 1 July 2005 to take account of a part year situation. Correspondingly, the minimum threshold applying to foreign tax credits is pro rated for the first year the rules apply.

Regulation-making power

In situations where it is unclear whether an instrument is debt or equity for the purposes of the NZ net equity calculation, a regulation can be made by Order in Council that clarifies its treatment for the purposes of the thin capitalisation rules. This uncertainty may arise where a new instrument has some debt characteristics and some equity characteristics, such as where the legal form of an instrument is equity but has some economic characteristics normally associated with debt.

Clarification of the status of the instrument should take into account:

- the underlying policy reflected in the legislation; and
- accounting and regulatory concepts of equity.

In a situation where there is uncertainty about whether an instrument is debt or equity for the purposes of NZ net equity, the Policy Advice Division of Inland Revenue should be contacted. Correspondence should be addressed to:

The Deputy Commissioner
Policy Advice Division
Inland Revenue
PO Box 2198
Wellington
New Zealand

Where possible, there will be consultation following the generic tax policy process prior to the introduction of any Order in Council.

Step 3: Net equity threshold

Section FG 8H measures the net equity threshold of the NZ banking group in order to compare it to the groups NZ net equity calculated in step 2. The net equity threshold is based on 4% of the NZ banking group's aggregate risk-weighted exposures (RWE).

RWE is a regulatory concept and includes the regulatory values of on and off-balance sheet assets of the NZ banking group adjusted for risk. Under section FG 8F(2), regulatory values are determined by applying the Reserve Bank of New Zealand's Capital Adequacy Framework, which sets out the methodology and rates for risk-weighting assets.

The calculation of the total of RWE is reduced by the value of assets (in aggregate referred to as DEQ in the legislation) that are subtracted from shareholder and branch equity for the purposes of determining NZ net equity. The subtraction from RWE uses regulatory values of the relevant assets. The notional offshore investment amount is not deducted from RWE. Because the amount is notional there is no corresponding separately identifiable asset to include in DEQ.

Resident entities and fixed establishments that are members of the NZ banking group that do not currently risk-weight their assets for banking regulation purposes will need to carry out this risk-weighting exercise for the new thin capitalisation calculation.

Step 4: Compare NZ net equity and net equity threshold

Section FG 3 requires a reporting bank to calculate its annual total deductions based on the calculation in section FG 8B. Reporting bank is defined in section FG 8D. Under section FG 8B if, for any quarter (or more frequent measurement date that the bank chooses), NZ net equity is less than the net equity threshold based on 4% of RWE, there will need to be an adjustment to the reporting bank's annual total deductions for that measurement period. These adjustments for any measurement period must be included in the reporting bank's tax return for the income year in which the adjustments arise.

Interest denial calculation

The adjustment required under section FG 8B, uses an interest rate generally based on average cost of funds. The average cost of funds interest rate is based on the total interest expense of the NZ banking group divided by average quarterly interest-bearing debt for the group over the income year.

The interest expense and total debt amounts are based on financial reporting amounts after aggregation using consolidation principles and, therefore, elimination of intra-group and inter-group transactions. Adjustments are made to exclude equity funding where the amounts count as interest for financial reporting purposes but not

for tax purposes, and debt funding where the amounts do not count as interest for financial reporting purposes but is interest for tax purposes. The accounting policies of the group must be consistent with those of the reporting bank.

Measurement periods for NZ net equity and net equity threshold

The reporting bank is required to measure the NZ banking group's NZ net equity and net equity threshold at least four times a year. These four measurement dates align with the reporting bank's quarterly reports to the Reserve Bank of New Zealand. The NZ banking group is determined at each measurement date.

If a bank is purchased by another bank, separate calculations must be made for any measurement periods before the acquisition, and then a joint calculation will be made for measurement periods after acquisition. Each bank will return its respective calculation pre-takeover. The joint calculation is made and returned by the bank designated to be the reporting bank for that latter period.

The reporting bank has the option, under section FG 8E, to measure the NZ net equity of the NZ banking group and net equity threshold on a daily or monthly basis, rather than on the standard quarterly basis.

Section FG 8J is an anti-avoidance rule targeting temporary changes in equity, assets or RWE where these results have the effect of defeating the intent and application of these rules (see example over the page).

Consequential amendments

A number of consequential amendments have been made. Subsection FG 2(7) has been omitted because its contents were incorporated in amendments to subsection FG 2(1). A series of amendments have been made to sections FG 3, FG 4 and FG 8 to ensure that the bank thin capitalisation rules do not overlap with the general thin capitalisation rules.

Section FH 1 excludes members of the NZ banking group from the subpart FH interest allocation rule as the bank thin capitalisation rules incorporate appropriate interest allocation concepts.

Section FG 8I provides that various values are determined in New Zealand currency and using the appropriate close of trading spot exchange rate.

A number of definitions have been added to section OB 1

Transitional arrangements

Transitional rules are available for the first income year, to take account of part-year application of the new rules for some banks. Transitional rules also apply when a foreign-owned company registers as a bank in New Zealand and when a company ceases to operate as a registered bank in New Zealand.

The bank thin capitalisation rules apply from 1 July 2005. For banks with a September financial year this means that the rules have application for part of their 2004-05 income year, specifically in the last quarter of this year. This has implications, in particular, for the notional offshore investment amount calculation.

In the case of part-year application for the 2004-05 income year, the rules allow for the notional offshore investment amount to be based on foreign tax credits that have been claimed against income tax for the part year. The transitional rule in section FG 8G(3) allows for a calculation based only on the credits attributable to the part of the income year in which the new rules apply. The minimum threshold of $5 million has also been adjusted accordingly.

Where there is a change in the bank treated as the reporting bank, a transitional rule also requires calculations to be made for all measurement periods since the last measurement period included by the former reporting bank in its previous income tax return. This is required when the two banks have different balance dates, which would otherwise cause a gap or an overlap.

Example: Calculations of NZ net equity, net equity threshold and resulting interest denial

Notwithstanding banks are likely to perform this calculation quarterly, and are required to do so at least quarterly, the following calculation for simplicity reasons shows the calculation inclusive of adjustments such as NOIA that are performed, in general, on an annual basis. Likewise any interest denial is determined using an annual interest rate which is then applied to any quarterly shortfalls. The references to steps in the example are to the steps described above.

A NZ banking group has an accounting shareholder equity of $3,000m, debt of $37,000m and assets of $40,000m based on a consolidated balance sheet for the group.

Step 2. Calculate NZ net equity of NZ banking group

	$m
EQV	
Shareholder equity	3,000
Interest-free loan from parent	600
Items subtracted from EQV:	
– Goodwill	- 1,000
– Shares in non-resident companies	- 2,000
– Notional offshore investment amount	- 500
	100

Step 3. Calculate net equity threshold of NZ banking group

	Risk weighting	Accounting values	Risk-weighted exposures (RWE)
Cash	0%	500	-
Due from other banks	10%	1,000	100
Investment securities	20%	3,000	600
Residential mortgages	50%	20,000	10,000
Commercial loans	100%	12,000	12,000
Shares in non-resident companies	100%	2,000	2,000
Goodwill	N/A	1,000	-
		40,000	24,700
Plus RWE of off-balance sheet items			2,000
			26,700
Less RWE of shares in non-resident companies			– 2,000
			24,700
Net equity threshold (4% x $24,700m)			= 988

Step 4. Compare NZ net equity and net equity threshold

Net equity threshold	988
Less NZ net equity	100
Capital shortfall (NZ net equity < net equity threshold)	– 888
Interest deductions disallowed at 5% based on average cost of funds	– 44
Tax effect of disallowed deduction	$ 15

NEW RULES FOR BUSINESS ENVIRONMENTAL EXPENDITURE

Sections CB 6B, CB 24B, CX 43B, DB 16, DB 37, DP 10, DQ 4, EK 1 – EK 23, Schedule 6B and a number of definitions in section OB 1 of the Income Tax Act 2004, section DJ 10 of the Income Tax Act 1994 and sections 36BC and 91AAN of the Tax Administration Act 1994

The rules covering tax deductions for business environmental expenditure to avoid, remedy or mitigate the discharge of contaminants have been clarified and expanded by:

- specifying categories of qualifying environmental expenditure and default deduction rates;
- giving the Commissioner the power to issue rates for other categories of environmental expenditure;
- removing the current distinction between industrial and non-industrial waste; and
- introducing a mechanism so that site restoration and monitoring costs can be matched against prior business income.

Background

These changes have been made to ensure that all business operating costs, including those for dealing with environmental concerns, are taken into consideration in calculating taxable income, and that the timing of such deductions is appropriate. The changes counter uncertainty regarding the scope of tax deductions available for environmental expenditure.

Previously, business taxpayers could claim a tax deduction for environmental expenditure in three ways:[1]

- a deduction for normal operating (revenue) expenditure;
- a deduction under the tax depreciation rules for certain types of capital expenditure, such as tanks, reservoirs, pipes, pumping machinery and screens; and
- a deduction under section DB 37 (DJ 10) for other capital environmental expenditure.

Under the previous rules, section DJ 10 permitted business taxpayers a deduction for expenditure incurred for the purpose of treating industrial waste when no other allowance was available. It allowed business taxpayers to claim a deduction for the cost of constructing on land in New Zealand any earthworks, ponds, settling tanks, or other similar improvements primarily for the purpose of treating industrial waste to prevent or combat pollution of the environment. When a deduction was available, it was spread evenly over five years, beginning with the year in which the expenditure was incurred.

Despite the existence of a specific section to provide for environmental costs, there were certain expenses which were arguably not deductible. Section DJ 10 pre-dated the Resource Management Act 1991, so did not clearly provide a deduction for costs incurred in complying with new health and environmental standards. It was also unclear what was covered by the term "industrial waste". The uncertainty around the meaning of "industrial waste" and ability to claim tax deductions for site restoration resulted in the incorrect calculation and taxation of income from business activities.

There were also problems in matching business income and tax deductions for environmental costs incurred on or after the cessation of business. Even if a tax deduction was permitted it was likely to give rise to a tax loss of limited value. In determining the tax liability of a business, future restoration liabilities were not taken into account.

Key features

A number of changes have been made to the tax rules to counter the problems identified with the tax treatment of business environmental expenditure.

Default expenditure categories and deduction rates

Section DB 37 along with Schedule 6B set out categories of deductible environmental expenditure and the rate at which a deduction is available to business taxpayers. The schedule of deductible environmental expenditure is based around the following four categories of costs:

General description of expenditure	Rate
Testing and feasibility expenditure	100%
Construction/improvement expenditure	Default rate based on the lesser of 35 years (1/35) or the length of the applicable resource consent granted 1/life of resource consent).
Restoration expenditure	100%
Monitoring expenditure	100%

Category-specific deduction rates

Where the default deduction rates do not result in the correct calculation and taxation of income from business activities, a business can apply to Inland Revenue for a category-specific rate.

[1] Excluding industry-specific provisions.

Environmental restoration account (ERA)

A mechanism has been introduced so that site restoration and monitoring costs can be matched against prior business income. Operators of a business can make cash deposits into an ERA equivalent to the tax effect of their accounting restoration provision. This deposit will give rise to a tax deduction so that the business's cash position is unchanged. Interest will be paid on deposits at 3% per annum.

Business taxpayers can obtain a refund from the account if they incur restoration and monitoring expenditure or if the anticipated liability for restoration (as shown by their audited financial statements) decreases. This refund will give rise to taxable income which will be offset by tax deductions for restoration and monitoring expenditure. This is consistent with the objective of matching restoration and monitoring costs against prior business income.

If a business transfers their liability for site restoration or environmental monitoring (for example, on the sale of a site, death, liquidation or bankruptcy) the balance of the restoration account will be transferred to the new taxpayer, if they can be identified, or otherwise to the Ministry for the Environment.

Clarifying the meaning of "industrial waste"

Sections DB 37 (2004 Act) and DJ 10 (1994 Act) have been amended retrospectively to remove the word "industrial". This eliminates the previous distinction between industrial and non-industrial waste.

Application dates

The majority of amendments apply for income years beginning on and environmental expenditure incurred after 10 June 2005. However, the removal of the distinction between industrial and non-industrial waste is retrospective to the 1995-96 income year. This protects businesses who have taken a wide interpretation of the term "industrial waste", either in filing their tax returns or in raising a dispute with Inland Revenue. Businesses who have not taken a wide interpretation of the legislation will not be able to take advantage of the retrospective change.

Detailed analysis

Default expenditure categories and amortisation rates

Section DB 37 along with Schedule 6B set out categories of deductible environmental expenditure and the rate at which a deduction is available to business taxpayers.

Taxpayers are now able to claim a tax deduction for environmental expenditure under section DB 37 if:

- they carry on business in New Zealand;
- they incur, as part of that business, or in ending the operations of the business, expenditure listed in Schedule 6B;
- the expenditure is not listed in Part C of Schedule 6B (land reclamation expenditure, non-environmental dredging expenditure or expenditure related to the acquisition of land);
- the expenditure is not incurred in relation to revenue account property (other than land that is subject to a section CB 6B election); and
- no other provision allows a tax deduction for the expenditure.

Farming businesses are included in these provisions so that when the specific agricultural provisions do not provide for an environmental tax deduction, farmers can now rely on section DB 37.

Example 1: No deduction available under other provisions

Parkways Limited builds and operates inner-city parking buildings. It has purchased a site in the central city for a new parking building and obtained the necessary resource consents. However, before construction can begin, Parkways Limited needs to deal with a contamination issue left by the previous owner. It will be necessary to remove contaminated soil, fill the area with clean soil and then construct an impermeable surface cap to prevent further contamination. Parkways Limited will then construct the normal car park surface on top of the cap.

The process of removing the contaminated soil and the installation of an impermeable surface cap should constitute expenditure on remedying, or mitigating detrimental effects on the environment. An immediate tax deduction should therefore be available under section DB 37. However, if a tax deduction were available under another provision, for example it if were not possible to separate the restoration activities from the construction of the car park, then a tax deduction would have to be claimed as tax depreciation rather than under section DB 37.

The default categories of expenditure in Schedule 6B are:

Expenditure in avoiding, remedying, or mitigating detrimental effects of discharge of contaminant

Part A – Expenditure relating to activity or improvement to land

	General description of expenditure	*Rate*
1	Expenditure on investigating and testing locations and methods before a decision is made to use a location or method for an activity or improvement that is intended to avoid, remedy, or mitigate future detrimental effects on the environment from the discharge of a contaminant.	100%
2	Expenditure, in the construction of an improvement on land in New Zealand, incurred in order to avoid or mitigate future detrimental effects on the environment from the discharge of a contaminant.	Lesser of 1/35 or 1/consent period
3	Expenditure on screen planting on land in New Zealand incurred in association with the construction of an improvement to the land that is intended to avoid, or mitigate future detrimental effects on the environment from the discharge of a contaminant.	Lesser of 1/35 or 1/consent period
4	Expenditure on riparian planting on land in New Zealand incurred in order to avoid or mitigate future detrimental effects on the environment from the discharge of a contaminant.	Lesser of 1/35 or 1/consent period
5	Expenditure on an activity that is intended to avoid or mitigate the future discharge of a contaminant.	Lesser of 1/35 or 1/consent period

Part B – Expenditure relating to monitoring, remedies, and mitigation

1	Expenditure related to monitoring the discharge of a contaminant.	100%
2	Expenditure related to monitoring detrimental effects on the environment from the discharge of a contaminant.	100%
3	Expenditure incurred after the discharge of a contaminant, on avoiding, remedying, or mitigating detrimental effects on the environment from the discharged contaminant.	100%
4	Expenditure, incurred after the discharge of a contaminant, on removing an improvement to land in New Zealand for the purpose of avoiding, remedying, or mitigating detrimental effects on the environment from the discharged contaminant.	100%
5	Expenditure, incurred after the discharge of a contaminant, on the installation of impermeable surfaces on land in New Zealand with the purpose of avoiding, remedying, or mitigating detrimental effects on the environment from the discharged contaminant.	100%
6	Expenditure, incurred after the discharge of a contaminant, on replanting land in New Zealand in association with expenditure to avoid, remedy, or mitigate detrimental effects on the environment from the discharged contaminant.	100%
7	Expenditure, incurred in the cessation of a business, on disposing of a stored substance that is a potential contaminant in a way that avoids detrimental effects on the environment.	100%

Part C – Excluded expenditure

1. Expenditure related to land reclamation.
2. Expenditure relating to dredging, other than dredging for the principal purpose of remedying or mitigating detrimental effects on the environment from a discharged contaminant.
3. Expenditure related to the acquisition of land.

To avoid the uncertainty surrounding the definition of industrial waste, section OB 1 now contains a definition of “contaminant”. The definition is linked to section 2(1) of the Resource Management Act 1991 and an item can still be a contaminant even if it is never discharged into the environment.

Businesses planning to take advantage of these changes to secure tax deductions for the investigation, remediation and aftercare of contaminated land should refer to the best practices for management of contaminated land set out in the Ministry for the Environment’s *Contaminated Land Guidelines* series and, in particular, the minimum reporting standards in *Guideline Number 1* of that series.

Example 2: Types of environmental expenditure

Green Limited is a plastics manufacturer. A number of by-products are produced as a result of its manufacturing processes. Green Limited is therefore looking at potential options for dealing with the by-products. These include changing its manufacturing process, immediate treatment of the by-products, and storing the substances for a period and processing at a later date.

Green Limited pays for a report from an environmental consultant evaluating the different options. Alteration of the manufacturing process proves to be impractical and, due to its location and economies of scale, immediate treatment of the substances is not cost efficient. Green Limited therefore makes an application for a resource consent to store the by-products.

The expenditure incurred on the environmental report is expenditure on investigating and testing an activity intended to avoid, remedy or mitigate detrimental effects on the environment. Expenditure incurred prior to the date a decision is made to use one particular option, (likely to be the date that a resource consent application is made) is environmental feasibility expenditure and immediately deductible under section DB 37. Expenditure incurred from this date would constitute construction expenditure. If no other tax deduction is available (for example for tax depreciation) this expenditure would be deductible over the lesser of 35 years or the period for which the resource consent is granted. If Green Limited felt that this did not accurately reflect the life of the expenditure then they could apply to Inland Revenue for a category specific deduction rate.

Example 3: Types of environmental expenditure

Pinot NZ Limited runs a winery. A portion of a neighbouring property has been contaminated as a result of past business activities. Pinot NZ Limited is worried about the impact this may have on its own property, business reputation and income. The owner of the site and person responsible for the contamination cannot be identified. Pinot NZ Limited therefore works with the local council to rectify the contamination (removing and replacing the soil and replanting the area in native bush). While Pinot NZ Limited is not responsible for the contamination and does not own the neighbouring site, this expenditure should qualify under section DB 37 for an immediate tax deduction. It is expenditure incurred by a business in remedying the detrimental effects on the environment from a discharged contaminant and expenditure on replanting land in New Zealand in association with expenditure to avoid, remedy, or mitigate detrimental effects on the environment.

Amount and timing of deduction

Section DB 37 sets out the amount of the tax deduction and when this can be claimed. The amount of the deduction for an income year is calculated by multiplying the value of the expenditure by the applicable rate.

The default rates are 100% for testing and feasibility, restoration and monitoring expenditure (listed in Schedule 6B, Part A, item 1 and Part B) and based on the lesser of 35 years or the length of the applicable resource consent for construction and improvement expenditure.

The formula for calculating the rate for construction and improvement expenditure is set out in section DB 37(7). Businesses can opt for either a straight-line or diminishing value deduction by adjusting the rate accordingly. The rate is 100% divided by the assumed life of the environmental expenditure and rounded to the nearest rate listed in Schedule 11. For expenditure that does not require a resource consent the assumed life is 35 years. For expenditure that requires a resource consent, the assumed life is the lesser of 35 years and the number of years remaining in the resource consent period at the time the expenditure is incurred.

Businesses can also obtain a rate for specific categories of environmental expenditure by applying for a determination from the Commissioner (section DB 37(4)(c)).

Example 4: Calculating the correct deduction rate

Olivia Limited is a large multinational corporation. It applies for a resource consent regarding emissions from a new factory. While the factory will undertake all necessary steps to reduce emissions there will still be a small discharge made. To counter this, and as part of its resource consent process, Olivia Limited agrees to spend $50,000 planting and maintaining an area of native bush. A resource consent is granted for 25 years.

As the planting expenditure is incurred by Olivia Limited for the purposes of obtaining a resource consent for its new factory it is viewed as business expenditure. The planting expenditure is an activity that is intended to avoid or mitigate the discharge of a contaminant. As such, a tax deduction should be available under section DB 37.

The annual deduction for the expenditure is calculated by multiplying the cost ($50,000) by the deduction rate. The deduction rate is calculated by dividing 100% by the assumed life. As the planting expenditure is associated with a business activity that requires a resource consent, the assumed life is 25 years (being the lesser of 35 years and the resource consent period). The closest straight-line rate in Schedule 11 is 4%. Alternatively, a diminishing value rate of 6% can be used.

Section DB 37 also provides for the destruction of an environmental improvement or closure of a business. In these situations, a business can claim the remaining unamortised balance of the expenditure.

The definition of diminished value has been amended to take into account the new environmental expenditure rules. For environmental improvements, diminished value is calculated by taking the amount of environmental expenditure as described in section DB 37, adding any claw-back income under section CB 24B(8) and deducting any environmental tax deductions previously claimed.

Example 5: Closure of a business

After 10 years, Olivia Limited closes its operations in New Zealand. Up until the year of closure, Olivia Limited has claimed $20,000 of tax deductions under section DB 37 for its native planting expenditure.

On the closure of its New Zealand factories, the operations for which the expenditure was incurred have come to an end. Olivia Limited is therefore able to claim the remaining $30,000 of expenditure in the year of closure.

Claw-back

While the default deduction rate for environmental construction and improvement expenditure is based on the life of the applicable resource consent, there is a claw-back mechanism in section CB 24B. This is intended to prevent businesses from manipulating the period of their resource consent for the purpose of obtaining a faster tax deduction.

Where a business has claimed a tax deduction based on the period of a resource consent and then substantially altered the period of that consent (consent period is extended or renewed by more than 50%) the taxpayer will be required to calculate tax deductions based on the default rate of 35 years. Any difference between the deductions claimed to date will be clawed back as taxable income in the year that the consent is altered.

Example 6: Claw-back

Forest Fields Limited runs a timber treatment plant. It spent $200,000 constructing a settling pond for dealing with the by-products of the treatment process. It has a five-year resource consent for operating the pond. As such it has claimed tax deductions of $180,000 under section DB 37 based on an assumed life of five years. At the end of five years, Forest Fields Limited applies for a 30-year extension to its resource consent.

continued

If Forest Fields Limited had claimed tax deductions based on an assumed life of 35 years, the tax deductions claimed to date would have only been $30,000. Forest Fields Limited is therefore deemed to derive income of $150,000 in the income year in which the consent is extended (because the consent period was extended by more than 50%).

Other changes

A tax deduction for restoration expenditure will not always equate to the loss in land value from contamination but in the majority of circumstances it provides a practical solution. However, landfill operators are likely to suffer a complete loss in land value no matter how much is spent on site restoration. The new environmental tax rules therefore allow taxpayers who acquire and use land for the purpose of constructing and operating a landfill to file a revenue account property election under section CB 6B. This ensures a tax deduction is available for the cost of land used for a landfill.

The section CB 6B election must be made before 24 June 2006 or 12 months after the date of acquisition (whichever is the latest). To ensure a consistent treatment, all of a business's landfill sites and those of any associated parties also need to be subject to the same election. Any consideration received on the disposal of the landfill property will also be taxable income of the business under section CB 6B.

Sections DB 16 (amounts paid for non-compliance and change in use) and DP 10 (cost of timber) have been amended to ensure that section DB 37 remains the section of last resort for deducting environmental expenditure.

Category-specific deduction rates

Where the default deduction rates will not result in the correct calculation and taxation of income, a business is able to apply to Inland Revenue under section 91AAN of the Tax Administration Act 1994 for a category-specific deduction rate.

The Commissioner may determine that a person, group or class of persons is to use a particular diminishing value or straight-line rate listed in Schedule 11 for certain types of environmental expenditure.

In making the determination, the Commissioner may consider a number of factors including:

- the length of time that the expenditure is expected to be effective for its intended purpose;
- the length of time that the expenditure is expected to earn income;

- the accounting treatment (including depreciation method);
- the period of any associated resource consent; and
- a valuer's estimate.

The Commissioner may decline to issue a determination if the information supplied in support of the determination request is insufficient or if the proposed rate does not differ sufficiently from the existing rate.

Within 30 days of issuing a determination the Commissioner must give notice of the determination to the applicants and publish a notice in the *New Zealand Gazette* stating where copies of the determination can be obtained. A business affected by a determination may dispute or challenge the determination under Parts 4A and 8A.

Environmental Restoration Account

The new environmental tax rules introduce a matching mechanism so that site restoration and monitoring costs can be matched against prior business income.

Section EK 1 establishes a Crown Bank Account called the Environmental Restoration Funds Account (referred to as an ERA in subpart EK) into which businesses can make payments towards their restoration and environmental monitoring liabilities.

Section EK 4 requires the Commissioner to keep an ERA in the name of every business who makes a qualifying payment. Every payment made under section EK 2 must be entered in that person's ERA.

Amounts entered into a business's ERA may not be removed except by way of refund under sections EK 9 or EK 12 or by way of transfer. However, the Commissioner is allowed to close an ERA if the balance of the account is zero.

Payments to an ERA

Under section EK 2, to be eligible to make payments to an ERA, a taxpayer must carry on business in New Zealand and expect to incur future expenditure that:

- is listed in Part B of Schedule 6B (monitoring and restoration expenditure);
- is not listed in Part C of Schedule 6B (land reclamation, non-environmental dredging and land acquisition costs); and
- is not on revenue account property (other than where section CB 6B applies).

The business must also make a provision for such expenditure in its audited financial statements.

Example 7: Calculating the ERA payment

M.A.E. Limited has an accounting restoration provision in its audited financial statements for $2 million. This consists of $1 million for dealing with contaminated soil, $0.5 million for the removal of plant and equipment (necessary to clean up the contaminated soil) and $0.5 million for publicity costs to promote its "green image".

Both the soil clean-up costs and removal of plant and equipment necessary to do this will constitute restoration expenditure under Part B of Schedule 6B. However, the plant and equipment removal costs will be deducted under the tax depreciation rules rather than section DB 37. This does not prevent M.A.E. Limited from making an ERA payment for these costs. Under section EK 2, a person can make a payment to an ERA for expenditure that is of a type listed Part B of Schedule 6B. It is not necessary for a deduction to be claimed under section DB 37 for a deposit to be made to an ERA.

No ERA payment is able to be made in respect of the publicity costs as these do not constitute expenditure that is of a type listed in art B of Schedule 6B.

Section EK 3 deals with the size of payments to an ERA.

The minimum payment level is $1,000. A business's maximum payment is defined in section EK 22 as the lesser of:

- the amount by which the maximum account balance exceeds the ERA balance at the end of the income year; and
- the amount permitted as a deposit under the initial five-year spreading mechanism.

A business's maximum account balance (defined in section EK 23) is:

- zero, if the person does not satisfy section EK 2; or
- an amount calculated by multiplying the level of their accounting restoration provision by the applicable tax rate.

The spreading mechanism is a transitional measure intended to reduce the cost of allowing payments for historic restoration liabilities. After the initial five-year period taxpayers will be able to make payments up to the (tax effected) level of their accounting restoration provision.

Under the spreading mechanism, the maximum payment for the 2005-06 to the 2010-11 income years is calculated as follows:

Level increase + (year x 0.2 x initial level) – contents

- "Level increase" is the greater of zero or the amount by which the maximum account balance exceeds that for the 2005-06 income year.

- "Year" is 1 for the 2005-06 income year and increases by 1 for each successive income year. This allows a "catch-up" if no deposit is made for the 2005-06 income year.
- "Initial level" is the maximum account balance for the 2005-06 income year.
- "Contents" is the amount of the ERA at the end of the income year.

Example 8: Maximum account balance and maximum payment

DF Limited has a future site restoration liability as a result of its New Zealand manufacturing operations. To recognise this it has created an accounting restoration provision in its 2005-06 audited financial statements of $1 million.

DF Limited's maximum account balance is $330,000, being $1 million multiplied by 33% (the highest tax rate in Schedule 1 applying to a corporate taxpayer). DF Limited's maximum payment for the 2005-06 income year is $66,000 (being 0 + (1 x 0.2 x 330,000) – 0). Its maximum payment for the 2006–07 income year is $66,000 (being 0 + (2 x 0.2 x 330,000 – 66,000).

In the 2007-08 income year, DF Limited recalculates its restoration liability and increases its accounting provision to $1.5 million. DF Limited's maximum account balance is now $495,000. DF Limited's maximum payment for the 2007-08 income year is $231,000 (being (495,000 – 330,000) + (3 x 0.2 x 330,000) – 132,000).

DF Limited's restoration balance remains unchanged for the 2008-09 and 2009-10 income years and it makes maximum payments to its ERA of $66,000 for each of these years.

In 2010-11, it revises its accounting provision upwards again to $1.8 million. Its maximum account balance is now $594,000. It no longer needs to apply the five-year spreading calculation and therefore its maximum payment for the year is the difference between its ERA balance and maximum account balance ($594,000 – 495,000 = $99,000).

A business is allowed a tax deduction under section DQ 4 for a payment to an ERA. The amount of the deduction is calculated by dividing the amount of the payment by the applicable tax rate (section EK 7). The applicable tax rate is the highest rate of income tax that is stated in Schedule 1 which could apply to the business. The deduction is allowed for the income year for which the payment is made. Section EK 3 deals with the amount and time for making payments to an ERA. Any payment made up to six months after the end of an income year will be treated as a payment for that income year.

Discretion has also been given for the Commissioner to accept payments made after this period.

To ensure that the Commissioner has sufficient information to deal with an ERA payment, section EK 5 requires a business making a payment to provide (within two working days) some basic information. This includes:

- the name of the person;
- the income year for which the payment is made;
- a calculation of the business's maximum payment; and
- any additional information required by the Commissioner.

When this information is not supplied, section EK 9 requires the Commissioner to refund the payment to the payee as soon as it is practical. The payment will not qualify for a deduction under DQ 4 or for interest under section EK 6. Similarly, the refund will not be taxable under section CX 43B (section EK 10). Any payment which is in excess of a business's maximum payment receives the same treatment.

Section EK 21 gives the Commissioner the power to require ERA information in an electronic format and section 36BC of the Tax Administration Act 1994 allows the Commissioner to prescribe the electronic format in which details may be provided. This provides flexibility should the system be administered via the internet in the future.

ERA transfers

A business may also apply for a transfer from an ERA. An amount may be transferred from an ERA:

- to the ERA of another business in accordance with sections EK 15 or EK 16(3)(b);
- to the department responsible for the administration of the Environment Act 1986 under section EK 16(3)(a); or
- to an ERA of an amalgamated company under section EK 19.

The transfer application must be in writing, state the grounds on which the application is made and the amount of the transfer required (section EK 14). A business who makes a transfer from their ERA under sections EK 15, EK 16 or EK 19 derives income equivalent to the grossed-up amount of the transfer (section CB 24B).

The transfer is treated by the recipient as a payment (meaning a tax deduction is available under section DQ 4) as long as the associated environmental obligations have also been transferred, and the business would be entitled to make an equivalent ERA payment. If any part of the transfer does not satisfy these requirements the

Commissioner may return the non-qualifying amount back to the transferor. This will be effective as at the date of the original transfer.

As well as a voluntary transfer by a business, the ERA rules also provide for a transfer on the death, bankruptcy or liquidation of a taxpayer. Under section EK 16, if the administrator of a person's estate, the Official Assignee or a person's liquidator notifies the Commissioner that the obligation associated with an ERA deposit has been transferred to another person, the Commissioner must transfer the ERA balance to that person. Where the obligation has "in effect" been transferred to the New Zealand Government (for example, where it is an orphan site) then the Commissioner is required to transfer the associated ERA balance to the Ministry for the Environment (or the department that is at the time responsible for the administration of the Environment Act 1986).

The amount of the transfer will be the amount in the business's ERA on the day they die, become bankrupt or are put into liquidation. The transfer will result in income for the transferor derived on the day before the taxpayer's death, bankruptcy or liquidation. For administrative purposes, section EK 17 places a $1,000 minimum threshold on the value of transfers. This applies apart from where the ERA balance is less than $1,000 at the date of refund or transfer.

Finally, sections EK 19 and EK 20 sets out what happens upon an amalgamation or tax consolidation. If an amalgamating company ceases to exist on an amalgamation then there is a transfer to the ERA of the amalgamated company. The amalgamated company is treated as having made all the payments, transfers and refunds made by the amalgamating company. Under section EK 20, on consolidation, the nominated company makes payments and receives refunds on behalf of the consolidated group.

Refunds from an ERA

Under section EK 11, a business is able to apply for an ERA refund when they have incurred Schedule 6B Part B (monitoring and restoration) expenditure that is not listed in Part C of the schedule. The expenditure must be incurred after the date that the business first establishes their ERA (by payment or transfer) and must be equal to or greater than the amount calculated by dividing the refund requested by the applicable tax rate (section EK 12). The application for the refund must be in writing, state the amount of the refund required, grounds on which the refund is made and provide evidence to support those grounds. The amount of the refund is limited to the lesser of the refund requested, the balance of the ERA, and the amount of qualifying expenditure.

The Commissioner must also make a refund where a business's ERA balance exceeds their maximum account balance.

Example 9: ERA

Horace Co Limited has an accounting restoration provision in its audited financial statements of $600,000. Over the 2005-06 to 2009-10 income years it makes payments to its ERA of $198,000. This gives rise to total tax deductions over the period of $600,000 and a reduction in Horace Co Limited's tax liability of $198,000 (meaning there is no impact on Horace Co Limited's cash position).

In 2010-11, Horace Co Limited starts to wind down its operations and contracts with an environmental consultant to restore its site (obtaining the necessary resource consents and following Ministry for the Environment guidelines). The total cost of the site restoration is $500,000. Horace Co Limited writes to Inland Revenue to request a refund and supplies accounting records to verify that it has incurred the site restoration expenditure.

Inland Revenue issues a refund of $165,000 (being $500,000 multiplied by 33%). This gives rise to taxable income of $500,000 in the year of receipt. Horace Co Limited is able to offset the tax deductions for the restoration costs against the ERA refund income meaning that there is no further tax to pay.

When the remaining accounting provision is reversed (once Horace Co Limited has met the conditions of its resource consent), Horace Co Limited's maximum account balance will be zero and the remainder of the ERA balance of $33,000 will be refunded. This will give rise to taxable income of $100,000.

A refund is income under section CB 24B. The amount of income is calculated by dividing the value of the refund by the applicable tax rate. ERA refunds are sourced from payments on a first-in-first-out basis (section EK 18).

Interest on ERA balances

To encourage businesses to participate in the ERA scheme, the rules provide for a small amount of interest (3% p.a.) to be paid on deposits. This is equivalent to the interest rate paid on the income equalisation scheme.

Interest is calculated from the day after a payment is made until the date it is included in a refund under section EK 12 or transfer under sections EK 15, EK 16 or EK 19.

Interest is paid annually rather than being credited to the ERA. Interest is paid out on the earlier of 31 March each year or the date that the payment is included in a refund or transfer under sections EK 15, EK 16 or EK 19.

Clarifying the meaning of "industrial waste"

The previous environmental tax rules (section DB 37 of the Income Tax Act 2004 and section DJ 10 of the Income Tax Act 1994) applied solely to dealing with "industrial"

waste. There was no definition of this term which led to ongoing uncertainty as to when tax deductions were available for environmental expenditure.

The word "industrial" has been removed from sections DB 37 and DJ 10 to protect taxpayers who have taken a wide interpretation of the term "industrial waste". This clarifies that a tax deduction is available for dealing with all forms of waste.

This change to section DB 37 applies for income years (and expenditure incurred) beginning before 10 June 2005. The change to DJ 10 is retrospective (back to the 1995-96 income year) and applies where a taxpayer has filed a tax return, notice of proposed adjustment or response notice, or has requested a reassessment, before 16 November 2004, and the correctness of the tax position, notice or request depends on the interpretation of the meaning of "industrial waste".

TAX EXEMPTION FOR PETROLEUM EXPLORATION AND DEVELOPMENT

Sections CB 16 and OB 1 of the Income Tax Act 1994 and CW 45B and OB 1 of the Income Tax Act 2004

Income earned from drilling exploratory or development wells and from undertaking seismic survey work relating to petroleum exploration in New Zealand has been exempted from tax for a period of six years. The activities must be carried out by non-resident companies and confined to offshore petroleum fields.

The measure is intended to remove a tax obstacle to gas exploration in New Zealand, caused by the "183-day rule", as part of a package of measures to boost gas exploration over the next five years.

Background

Domestic rules previously taxed non-resident drilling rig operators and seismic ship operators from the first day of their presence in New Zealand. Under some of its double tax agreements, however, New Zealand could, if it chose to do so, tax a non-resident rig or seismic ship operator only if the period of presence in New Zealand was longer than 183 days. If the ship or rig did stay for longer than 183 days, the non-resident was generally taxed from the first day of its presence in New Zealand.

This rule created an incentive for seismic ship operators and drilling rig operators to leave New Zealand before 183 days elapsed to avoid any New Zealand tax liability. Moving drilling rigs and seismic ships to and from New Zealand is very expensive and contributes to other costs caused by delays in drilling operations resulting from rigs or ships leaving New Zealand and other rigs or ships taking their place.

The government announced in August 2004 that it would introduce legislation to remove a tax obstacle to gas exploration by temporarily lifting the "183-day rule" for offshore rig operators. In September 2004 the government announced it would extend the measure to cover drilling rigs engaged in gas field development work and to seismic survey ships involved in gas exploration. The period of application of the exemption is set to coincide with other measures in the government's gas exploration package announced on 14 June 2004.

Key features

The exemption is contained in a new section CW 45B of the Income Tax Act 2004 (CB 16 of the 1994 Act), and further definitions have been included in section OB 1 of both Acts.

The exemption applies to certain income of non-resident rig operators – specifically, income from the drilling of wells to explore or develop offshore petroleum fields in New Zealand. It also applies to income of non-residents from ships providing seismic survey readings in order to identify petroleum in New Zealand.

The exemption will apply for six years.

Application date

The amendment applies to income from drilling activities and seismic survey activities in New Zealand from 1 January 2004 to 31 December 2009.

CHANGES TO IMPUTATION CREDIT RULES

Sections CD 7, GC 22, MB 6, ME 4, 5, 9B, 9C, 14, OB 1 of the Income Tax Act 2004; sections GC 22, MB 6, ME 4, 5, 9B, 9C, 14, OB 1 of the Income Tax Act 2004; sections 101B, 140(B) of the Tax Administration Act 1994

The dividend and imputation rules have been amended to ensure that, in certain circumstances, when a company is sold the benefits of any prepaid tax will stay with the original group that paid the tax and cannot be refunded. The changes were designed as a revenue protection measure.

The amendments ensure that imputation credits earned by one group of companies cannot effectively be paid to a different group's shareholders.

Companies that leave wholly owned groups that have available net losses in excess of $1 million may elect that a debit balance in their imputation credit account or an amount of prepaid tax in excess of their imputation credit account's credit balance be transferred to another New Zealand group company immediately before leaving the group.

If such an election is not made and the company then joins another wholly owned group with different ultimate shareholders, a final tax – additional income tax – that

cannot be credited against other tax liabilities of the company or group will be payable.

Other amendments:

- modify the imputation credit anti-streaming rule;
- ensure that within wholly owned groups, a taxable bonus issue election can only arise when there is an issue of shares fully paid from reserves; and
- as a remedial measure, clarify that all payments of income tax can create imputation credits.

Background

Under the classical dividend system that applied in New Zealand until 1988, two amounts of tax were levied on company profits: first, as they were earned, by way of company tax, and again when they were distributed as dividends to shareholders. The imputation rules have the effect of relieving this double taxation. A New Zealand company can attach imputation credits to dividends paid to shareholders representing the tax paid by it. Shareholders can use these imputation credits to alleviate the taxation obligations in respect of the dividend.

Detailed provisions within the imputation rules ensure that, among other things, the shareholders at the time the tax was paid are the same shareholders who receive the imputation credits. Obviously, this is in general terms only, since it is not always practicable to track individual shareholders, particularly of widely held companies. Companies are required to maintain a record of the payments of tax and the tax passed on to shareholders through an imputation credit account.

There are also specific provisions within the imputation rules that govern tax refunds. Essentially, a refund may not be claimed unless the company concerned has an equivalent level of imputation credits. This is to ensure the tax paid by a company is not refunded when the imputation credits created by the original payment have already been attached to dividends paid to shareholders and used by them as tax credits.

The imputation rules do not prevent a company prepaying its income tax in order to create imputation credits that it can attach to its dividends. Typically, this happens when the company is in a loss situation.

Several companies have done this in the past, presumably in order to enhance the value of their shares, as dividends with imputation credits are worth more than dividends with no credits. They have also done it, presumably, in circumstances where they anticipate paying income tax in the reasonable future.

When tax has been prepaid in this fashion, use-of-money interest is not payable, on the basis that the shareholders have actually used the imputation credits to reduce their tax liability. There is no policy objection to these prepayments.

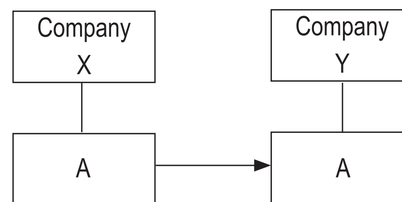
Transactions that are contrary to the policy intent

It was always the intention that a tax overpayment not matched by an equivalent credit balance in the imputation credit account would not be refunded but used to offset a tax liability of the company owned by the shareholders who had received the imputation credits.

The changes were aimed at two types of transactions that were contrary to the underlying policy intent of the imputation rules.

The first type involves a special-purpose subsidiary with a prepaid tax amount and imputation credit account with no imputation credits. It is sold to a consolidated group with surplus imputation credits.[2] The special-purpose subsidiary then joins the consolidated group and, as the group has imputation credits in excess of the prepaid tax amount, a refund of the tax is made.

For example, Company A, owned by Company X, has prepaid tax of $300 and no imputation credits in its imputation credit account. Company A is sold to Company Y, which is part of a consolidated group with a credit balance of $500. Company A joins Company Y's consolidated group.



A comparison is made between the amount of prepaid tax in Company A, $300, with the credit balance of the imputation credit account of the consolidated group – $500. As the credit balance exceeds the prepaid tax, a refund is released and the consolidated group's imputation credit account debited by the amount of the refund.

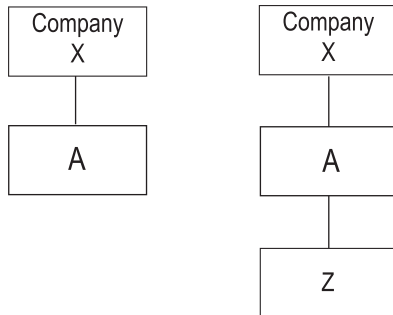
A's Tax Account		Consolidated group's ICA	
	333		500
Refund 333		Refund 333	

The second type of transaction is more complicated. Here a special purpose subsidiary of the company with a prepaid tax amount and an empty imputation credit account is created. The special purpose subsidiary pays a fully imputed taxable bonus issue, in a form other than by way of a fully paid issue of shares from reserves, to its parent company. The parent company's imputation credit account now has sufficient imputation credits so that its

[2] As there is prepaid tax and no imputation credits in the imputation credit account, this would indicate that tax prepayment was made to square up an imputation credit account. The square-up would have been necessary because imputation credits had been attached to dividends and yet no underlying tax had previously been paid.

prepayment of tax can be refunded. While the special purpose subsidiary has an equivalent debit balance in its imputation credit account, the final step is that the company is sold to and amalgamated with a company with surplus imputation credits.

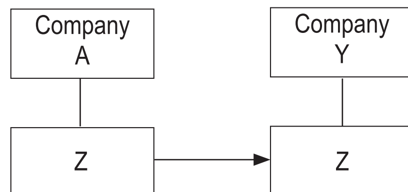
For example, Company A, with prepaid tax of $300, no imputation credits and owned by Company X, now incorporates a special purpose subsidiary Z.



Special purpose subsidiary Z makes a subdivision of shares, electing that the subdivision be a taxable bonus issue, with a value of $609 and so attaching imputation credits of $300. This causes a debit to Z's imputation credit account of $300 with a corresponding credit to A's imputation credit account.

Now that A has a credit balance of $300 in its imputation credit account, it can receive a refund of its prepaid tax.

Z, with a debit balance in its imputation credit account of $300, is sold to Company Y, which, as before, has a credit balance of $500 in its imputation credit account.



Company Y and Company Z then amalgamate, and Company Y, as the amalgamated company, puts its debit balance into its imputation credit account.

Key features

New section ME 9B of the Income Tax Act 2004 and the Income Tax Act 1994 applies to companies leaving wholly owned groups that have available net losses in excess of $1 million at the end of the previous tax year. Immediately before leaving the group, a company may elect that a debit balance in its imputation credit account or an amount of prepaid tax, for the amount exceeding the credit balance in its imputation credit account, may be transferred to another company in its original group. Alternatively, the company that leaves may elect to pay additional income tax of an amount equal to the debit balance or excess amount of prepaid tax. This additional income tax will be a final tax and cannot be credited against other tax liabilities. This is because the additional income tax is to offset the tax benefit that has already been received by the leaving group's shareholders in the form of imputation credits.

New section ME 9C generally applies to the companies that did not elect to transfer the debit balance or excess prepaid tax and did not make a payment of additional income tax. It can also, in some limited circumstances, apply to other companies whose ownership changes.

If such a company then joins a new wholly owned group with different ultimate shareholders it will be required to make a payment of additional income tax equal to the debit balance in its imputation credit account, or the amount of prepaid tax to the extent it exceeds its credit balance in its imputation credit account. Again, as in section ME 9B, additional income tax cannot be credited against other tax liabilities because this additional income tax is to offset the tax benefit received by the leaving group's shareholders in the form of imputation credits.

Section ME 14(3B) has been added to ensure that new sections ME 9B and ME 9C also apply to consolidated groups.

Section CD 7 of the Income Tax Act 2004 and section OB 1 – taxable bonus issues of the Income Tax Act 1994 – have been amended to ensure that, within a wholly owned group, only issues of shares that are fully paid up from reserves can become a taxable bonus issue. Outside a wholly owned group the existing law remains.

Section GC 22(4)(b) of the Income Tax Act 2004 and the Income Tax Act 1994 have been amended to ensure that the anti-imputation credit streaming rules apply when there is an account advantage that may not also be accompanied by a tax credit advantage.

As a remedial measure, section MB 6 has been amended to include tax in excess of the taxpayer's income tax liability within the scope of voluntary payments of provisional tax. This means that a voluntary payment of tax includes situations when a taxpayer has no income tax or provisional tax liability. The effect of this inclusion is that, as such payments are now treated as a payment of provisional tax, an imputation credit will arise when such a payment is made.

Application date

The revenue base protection amendments apply from the date of introduction of the original bill – 16 November 2004. The remedial measure applies from 1 April 1995.

Detailed analysis

The amendments are aimed primarily at companies that have no immediate expectation of being liable to income tax but who prepay tax to impute dividends to shareholders and then engage in transactions to have the prepaid tax refunded to them in some way.

The mechanisms, to date, have involved the sale of a company, that has either a debit balance in its imputation credit account or an amount of prepaid tax that exceeds the credit balance in its imputation credit account, to another company that has imputation credits surplus to its immediate needs.

The end result is that, in effect, imputation credits are transferred from the shareholders of the imputation-rich company to the shareholders of the imputation-poor company. This is contrary to the intent of the imputation rules that imputation credits should be of benefit only to the shareholders of the company who paid the tax in the first place. It is for this reason that, under present law, breaches in excess of 66% in shareholder continuity trigger losses in imputation credits.

Because of the need for an explicit buttress for the shareholder continuity rules, but balanced by the concern that non-tax driven transactions should not be disturbed, the amendments are targeted at wholly owned groups that have group losses in excess of $1 million.

Loss-making groups are the most likely to be at risk of entering into such transactions because they are more likely to impute dividends without an expectation of having taxable income.

Therefore section ME 9B has been added to give companies that leave wholly owned groups with accumulated losses in excess of $1 million in the last tax year the ability to transfer immediately, before sale, any debit balance in their imputation credit account or an amount of prepaid tax in excess of their imputation credit account's credit balance to another company within the original wholly owned group.

This is to allow the original group's shareholders to retain the benefit of the amount of prepaid tax that enabled their dividends to be imputed. Similarly, with any debit balance, they retain the obligation to pay tax by 31 March, since this obligation arose because the group utilised the imputation credits.

The election procedure is set out in section ME 9B(8B). This must be:

- in a form acceptable to the Commissioner;
- made by the leaving company and accompanied by a notice of agreement from the company that either receives the imputation debit or the prepayment of tax; and
- made before the company leaves the group or such further period as the Commissioner may allow.

A "leaving company" may instead choose to pay additional income tax equal to the amount of the debit balance or the excess prepaid tax. It is not expected this will be the preferred option as additional income tax is a final tax and cannot be credited against other tax liabilities.

Section ME 4(1)(cb), (cc) and (cd) has been added to allow the transfer of the debit balance, or the payment of additional income tax to create an imputation credit. Section ME 4(2)(bb) has also been added to make the creation of the imputation credit effective from the date the leaving company ceases to be a member of a wholly owned group in the case of a transfer or the date the payment of additional income tax is made, as applicable.

To buttress section ME 9B, section ME 9C provides that imputation credit companies that leave wholly owned groups, and certain other companies, that have available net losses in excess of $1 million and join another wholly owned group with different ultimate shareholders will be required to make a payment of additional income tax equal to any debit balance in the joining company's imputation credit account or any amount of prepaid tax that exceeds the credit balance in its imputation credit account. The additional income tax cannot be credited to other tax liabilities.

It is expected that a liability to additional income tax will arise only in unusual cases.

Sections 101B have been added and 140B has been amended to include additional income tax that arises under section ME 9C within the scope of the Tax Administration Act 1994. Additional income tax under section ME 9B is not included as that is effectively a voluntary tax.

Tax pooling accounts

Entitlements to funds in a tax pooling account are included in the quantification of an "excess entitlement" in ME 9B (3) and ME 9C (4). This is because deposits to a tax pooling account create imputation credits in the same way as voluntary or prepayments of tax.

To prevent the imposition of additional income tax, if any amounts of excess entitlement are held by a company that leaves a wholly owned group with $1 million available net losses in a previous tax year and then joins a wholly owned group with different ultimate owners, a transfer in the tax pool by the leaving company will be necessary.

As the operation of tax pooling accounts are outside the direct control of Inland Revenue, this transfer will need to be initiated by the leaving company to ensure there is no liability to additional income tax when joining a wholly owned group with different ultimate owners.

Subdivisions of shares

In the transactions discussed in the background section, a common feature is the use of a subdivision or share split, for which it was argued that it was a bonus issue, and so when an election is made for it to be a taxable bonus issue, can have imputation credits attached. This is because taxable bonus issues are treated as dividends for income tax purposes.

The change as originally proposed in the bill clarifies that subdivisions or share splits could not be taxable bonus issues. However, the Finance and Expenditure Committee recommended that the restriction apply only to wholly owned groups, with the existing law remaining for non-wholly owned groups. The committee's reasoning was that within these transactions the shareholding company was not subject to tax because of the intercompany dividend exemption on the taxable bonus issue. Therefore the usual constraint on excessive taxable bonus issues that the shareholder is subject to tax on the dividend did not apply.

Because a share split or subdivision was possible under sections other than 48(b) and (c) of the Companies Act 1993, the committee further recommended that, for wholly owned groups, it was preferable to specify the type of issue of shares for no consideration that was acceptable from a policy perspective – that is, an issue of shares fully paid up from reserves.

Strengthening the anti-imputation credit streaming rule

Earlier anti-imputation credit streaming rules appeared not to envisage a situation where an arrangement could create an advantage to an imputation credit account – an "account advantage" – without also creating a credit for use against an income tax liability – a "tax credit advantage".

In the transactions discussed in the background section, the taxable bonus issue to which imputation credits were attached was paid to a wholly owned group member and was therefore exempt from income tax. As there was no tax credit advantage, the anti-streaming rules appeared not to apply, even though there was an account advantage.

To buttress the other amendments, section GC 22(4)(b) has been amended to apply when there is an account advantage, regardless of whether there is also a tax credit advantage.

Clarification that all payments of income tax create imputation credits

A subsidiary issue that arose when these transactions were reviewed by Inland Revenue is that the previous legislation may not have allowed all payments of income tax to create imputation credits. In particular, according to the previous provisional tax rules, tax payments made by companies that were not provisional taxpayers were not considered payments of provisional tax. Therefore no equivalent imputation credit could arise.

The companies most likely affected would be those that have no tax liability because of accumulated losses, but impute dividends to shareholders. The voluntary prepayments of tax were made with the expectation that this would square up the imputation credit account after attaching imputation credits to dividends. In other words, the prepaid tax amount was intended to pay for the tax benefit the shareholders received.

It appeared, however, that this was not the case and that voluntary payments of tax did not create imputation credits, which was contrary to the original policy intent.

Section MB 6, relating to voluntary payments of provisional tax, has been amended to include voluntary payments of tax that exceed a taxpayer's income tax liability for the year. This has the effect of ensuring that all voluntary payments of income tax can create imputation credits. The amendment is retrospective in application to 1 April 1995, to ensure that no imputation credits can be disallowed which would have been contrary to the original policy intent.

CHANGES TO THE TAX DEPRECIATION RULES

The tax depreciation rules have been changed to improve their operation. They include changes to the tax depreciation treatment of patents, additions to the list of depreciable intangible property, extending deductibility for losses on buildings and the special tax depreciation rate rules.

PATENTS

Sections CB 26, DB 31, EE 27, EE 27B, EE 27C, EE 27D, EE 52(4), FF 8, OB 1 and Schedule 17 of the Income Tax Act 2004

Tax depreciation of patent costs will be allowed to begin from the date a patent application is lodged with a complete specification, for applications lodged on or after 1 April 2005.

For patent applications lodged before 1 April 2005 that are granted in the 2005-06 or a subsequent income year depreciation will be allowed from the date of grant. Depreciation for the period the patent is pending will be allowed as a "catch-up" deduction in the year of grant.

Background

Depreciation of patents was previously allowed only from the date a patent was granted. However, the legal life of a patent – 20 years (or 240 months) – applies from the date the application for a patent was lodged with a complete specification, once a patent is granted. The change originally proposed was to recognise depreciation for the period a patent application was pending as a "catch-up" deduction in the year a patent application was granted.

Submissions put forward the view, however, that the economic life of a patent effectively begins when an application is lodged as this is when the underlying

invention is typically commercialised. Also, the date of filing an application is important as it has implications for the legal priority given to competing patents.

The application first filed has legal priority and enables its owner to both generate revenue from commercialisation of the invention and prevents others from operating in the same field.

Therefore, on the recommendation of the Finance and Expenditure Committee, tax depreciation for patent costs will begin from the date a patent application with a complete specification is lodged. This change will apply to patent applications with a complete specification lodged on or after 1 April 2005. As a patent application is now being treated as a depreciable item, on the recommendation of the committee, any gain on the sale of a patent application will be taxable (as is currently the case with the sale of a patent).

As a transitional measure, the committee recommended that patent applications lodged before 1 April 2005 that are granted in the 2005-06 or a subsequent income year be allowed a depreciation "catch-up" (for the period the patent application was pending) in the year of grant. The changes that were originally proposed have therefore been retained for patent applications lodged before 1 April 2005.

Key features

Section EE 27B applies to patent applications lodged before 1 April 2005, that are granted in the 2005-06 or a subsequent income year. This section allows depreciation for the period a patent is pending to be allowed as a "catch-up" when the patent is granted (for the first income year of use). The formula for the first income year of use comprises the catch-up deduction plus the annual rate for the year. In each subsequent year, the annual rate applies. An adjustment to the formula is required where a patent is granted to a person other than the person who originally filed the patent application.

Section EE 27C applies to patent applications lodged on or after 1 April 2005 and allows depreciation from the income year of application with a complete specification. Section EE 27C applies for the period between when a patent application is lodged and when it is granted (or refused or withdrawn). The section provides an annual rate to be applied in each income year in the relevant period. To allow for these items to be depreciable intangible property, patent applications with complete specifications that are lodged on or after 1 April 2005 have been included as depreciable intangible property in Schedule 17 of the Income Tax Act 2004.

Section EE 27D applies to patent applications lodged on or after 1 April 2005, once those applications have been granted (when a patent exists). This section provides an annual rate to be applied in the income year a patent is granted, and in every subsequent year until the patent expires.

In both sections EE 27C and EE 27D, an adjustment to the respective formulas is required where the person holding the patent application (in the case of section EE 27C) and the person to whom the patent is granted (in the case of section EE 27D) are not the same as the person who originally filed the patent application.

Section CB 26 has been amended to deem any gain on the sale of a patent application (with a complete specification) to be taxable. On the recommendation of the Finance and Expenditure Committee, this change will apply only to the sale of a patent application with a complete specification where the patent application was lodged for the first time (with a provisional specification) on or after the date of enactment.

A number of consequential amendments have also been made to sections DB 31, EE 27, EE 52(4), and FF 8. In addition, a definition of "patent application date" has been included in section OB 1.

Application date

The changes to allow depreciation of patent costs, from the date a patent application is lodged with a complete specification, applies to patent applications with complete specifications lodged on or after 1 April 2005. The changes to allow a depreciation "catch-up" when a patent is granted will apply to patent applications with complete specifications lodged prior to 1 April 2005 that are granted in the 2005-06, or subsequent income years. The changes to tax gains on the sale of patent applications will apply to patent applications that were lodged for the first time on or after the date of enactment, 21 June 2005.

The above changes will apply to patent applications lodged with the Intellectual Property Office of New Zealand or a similar office in another jurisdiction.

Examples

Example 1: Patent application lodged after 1 April 2005

A Co files for a patent on a new type of printing press. It lodges an application in New Zealand with a complete specification of the invention on 1 June 2005. The patent is granted on 15 February 2008. The depreciation rate for the patent application and the patent (once granted) would be calculated as follows:

Depreciation rate for the patent application (for the period the application is pending) under section EE 27C

2005-06 income year (1 April 2005 to 31 March 2006)
= 10 months / 240 months = 0.04 [June 2005 to March 2006]

2006-07 income year (1 April 2006 to 31 March 2007)
= 12 months / 240 months = 0.05

2007-08 income year (1 April 2007 to 31 March 2008) [period up to grant date –
= 10 months / 240 months = 0.04* April 2007 to January 2008]

Depreciation rate for the patent (for the period after the patent application is granted) under section EE 27D

2007-08 income year (1 April 2007 to 31 March 2008) [period from date of grant –
= 2 months / 240 months = 0.01* February 2008 to March 2008]

2008-09 income year (1 April 2008 to 31 March 2009) and subsequent years
= 12 months / 240 months = 0.05

* the total depreciation rate for the 2007-08 income year would be 0.05 (0.04 + 0.01)

Example 2: Patent application lodged prior to 1 April 2005

Z Co filed for a patent with a complete specification on a new type of cutting device on 15 January 2003. The patent is granted on 9 June 2006. The depreciation rate for this patent would be calculated as follows, under section EE 27B:

First income year of use (2006-07)

Depreciation "catch-up": 41 months / 240 months = 0.17 [January 2003 to May 2006]

Annual rate for the year: 10 months / 240 months = 0.04 [June 2006 to March 2007]

Subsequent income years (2007-08 +)

Annual rate for the year: 12 months / 240 months = 0.05

PLANT VARIETY RIGHTS

Sections CC 9(2)(a), EE 27, EE 27E, EE 52(4), OB 1 and Schedule 17 of the Income Tax Act 2004

Plant variety rights granted and rights to use plant variety rights acquired in the 2005-06 or a subsequent income year have been made depreciable intangible property.

Background

A grant of plant variety rights gives the holder the exclusive right to produce for sale and to sell propagated material of the plant variety for a period of 20 or 23 years, depending on the plant material (under New Zealand legislation). Legal life begins from the date of grant.

Under the previous rules, plant variety rights and the right to use plant variety rights were not depreciable intangible property. Plant variety rights have now been listed in Schedule 17 of the Income Tax Act 2004 and will be fixed-life intangible property with depreciation over the property's legal life. The right to use plant variety rights has also been included on Schedule 17.

On the recommendation of the Finance and Expenditure Committee, a number of improvements were made to the provisions as originally introduced. They include:

- allowing a "catch-up" of depreciation for the period an application of plant variety rights is pending (the provisional protection phase) in the income year of grant; and
- clarifying that intellectual property protection granted in foreign jurisdictions that effectively provides protection over plant varieties (but are not explicitly called plant variety rights) falls within the scope of the change.

The legislation also clarifies that royalties from the use of plant variety rights and rights to use plant variety rights are taxable.

Key features

Schedule 17 of the Income Tax Act 2004 has been amended by inserting plant variety rights (or similar protection offshore) and the right to use plant variety rights as paragraphs 11 and 12. A definition of "plant variety rights" has also been included in section OB 1 of the Income Tax Act 2004.

New section EE 27E of the Income Tax Act 2004 allows a depreciation "catch-up" for plant variety rights that have been given provisional protection that are granted in the 2005-06 or a subsequent income year. The "catch-up" relates to the period the plant variety right has been given provisional protection. Consequential amendments have been made to sections EE 27 and EE 52(4).

The "royalty" definition in section CC 9(2)(a) has been amended to include a reference to "plant variety rights".

Application date

The changes to allow depreciation in respect of plant variety rights and the right to use plant variety rights will apply to plant variety rights granted, and rights to use plant variety rights acquired, in the 2005-06 and subsequent income years.

Example

Fruit Co files for a plant variety on a new type of apple on 1 April 2006. The plant variety right is granted on 1 January 2008. The plant variety right has a legal life of 20 years (240 months) beginning from the date of grant. During the consideration of the application the new variety of apple has provisional protection.

First income year of use (2007-08)
Depreciation "catch-up": 21 months / (240 months + 21 months) = 0.08

Annual rate for the year: 3 months / (240 months + 21 months) = 0.01

Subsequent income years (2008-09 +)
Annual rate for the year: 12 months / (240 months + 21 months) = 0.05

LOSSES ON BUILDINGS

Sections EE 32(1) and EE 41(2) of the Income Tax Act 2004

A deduction is to be allowed for losses on buildings when a building is irreparably damaged and rendered useless for the purposes of deriving income and, the damage is not caused by the owner or a related party (or their failure to act). This new provision applies if the building is irreparably damaged in the 2005-06 or a subsequent income year.

Background

No deductions were previously allowed for losses on buildings (except when the building was a temporary building or when a building was destroyed as the result of a "qualifying event" – for example, the central New Zealand floods of early 2004).

The policy intent of this change is for a loss to be allowed when an unexpected event results in a taxpayer's building being irreparably damaged and rendered useless, when the damage is not caused by the actions of the person or failure to act (or the actions or inaction of the taxpayer's agents). The unexpected event could be a natural disaster

such as an earthquake, or an event like a fire. It does not include changes to regulation (for example, health and safety) that make a building obsolete and require it to be knocked down. The event must have caused damage to the building. What is meant by "irreparably damaged" and "rendered useless" is that the building has no continuing economic value for the taxpayer. When a building is irreparably damaged and rendered useless, a deduction arises irrespective of whether the building is still standing and needs to be disposed of by the taxpayer or whether the taxpayer chooses not to dispose of the building.

Key features

Sections EE 32(1) and EE 41(2) of the Income Tax Act 2004 have been amended to allow a deduction for losses on buildings when a building is irreparably damaged and rendered useless for the purpose of deriving income and the damage occurs in the 2005-06 or a subsequent income year.

Application date

The changes apply to buildings that are irreparably damaged in the 2005-06 or a subsequent income year.

Examples

Example 1: Floods

Joe owns a warehouse that is used in his import/export business. On 1 July 2006 extreme climatic conditions cause flash flooding which results in significant damage to the warehouse. An independent assessor concludes that Joe's warehouse cannot be salvaged. In this circumstance, Joe would be able to claim a deduction for the remaining book value of the building (the loss) under section EE 41.

Example 2: Fire

Anne owns a rental property. On 7 October 2005, a fire which started on neighbouring premises spreads to her property, resulting in significant damage. The insurance company finds that Anne's premises cannot be salvaged. In this circumstance, she would be able to claim a deduction for the remaining book value of the building (the loss) under section EE 41. [Note: any insurance proceeds would be deemed consideration.]

Example 3: Fire (negligence on part of building owner)

Martin owns a workshop that is used to manufacture wooden furniture. Fire safety regulations require that the workshop be fitted with fire safety devices such as sprinklers, smoke alarms and fire extinguishers. A safety check of the premises on 30 November 2005 reveals that the sprinklers are not in working order. On 5 December 2005 a fire that is started by an electrical fault causes significant damage to the workshop. The insurance assessor concludes that the damage would not have been irreparable if the sprinklers were in working order. In this situation, Martin would not be able to claim a deduction for the loss as he has not taken reasonable care in ensuring the workshop is safe. The likelihood of the workshop being irreparably damaged is not unexpected as his inaction in not getting the sprinklers in working order had contributed to the result.

Example 4: Failure to maintain a building

John owns a building that for a long time has housed high-end apartments that have been let on short-term leases. However, owing to a combination of changing tastes for high-rise living and changes to the surrounding neighbourhood, John has recently struggled to let a majority of the apartments. The land on which the building is situated is, however, relatively valuable and John sees other opportunities for use of the land. However, he recognises that voluntary demolition of the building would result in the remaining tax-book value being lost (as no deduction is allowed generally on disposal of a building). Instead, he chooses to let the building fall into a state of disrepair. The City orders that the building be demolished for health and safety reasons. In this scenario, John would not be able to claim a deduction for the loss on demolition of the building because his inaction has contributed to his building requiring to be demolished for health and safety reasons.

SPECIAL TAX DEPRECIATION RATES

Sections EE 12 and EE 28 of the Income Tax Act 2004 and sections 91AAG(2), 91AAG(3), 91AAG(5B) and 91AAM(2) of the Tax Administration Act 1994

Changes to the special tax depreciation rules:

- extend the rules to apply to fixed-life intangible property (such as patents);
- clarify that the Commissioner may have regard to a range of factors in determining the estimated useful life of an asset;

- allow the Commissioner to prescribe a special tax depreciation rate using a straight-line formula in addition to the diminishing value formula;
- allow the Commissioner to prescribe a single special tax depreciation rate for items of the same kind that are subject to the same circumstances that underlie a special tax depreciation rate; and
- allow the Commissioner to prescribe a special or provisional tax depreciation rate outside the six-month time limit if the taxpayer involved agrees to this.

Background

Under the special tax depreciation rules, taxpayers can apply for depreciation rates that are higher (or lower) than those prescribed by Inland Revenue if they consider the prescribed general depreciation rate is substantially different from the rate that should apply. This may arise, for example, if depreciable property is being used in a way that is different from that considered by Inland Revenue when determining a general economic depreciation rate for the property.

The changes allow the Commissioner greater flexibility in considering special tax depreciation rate applications if he is reasonably satisfied that, in the circumstances, a more accurate estimate of economic life, to the estimate of economic life used to prescribe the general tax depreciation rate (estimated useful life), is applicable.

One of the main changes is to extend the availability of special tax depreciation rates to what is currently fixed-life intangible property (that is, depreciable intangible property which must currently be depreciated over its legal life, such as patents). Taxpayers are now able to approach the Commissioner for a special tax depreciation rate for these assets.

Another change allows the Commissioner to consider a broad range of factors when determining what an accurate estimate of economic life should be. This change in particular is designed to make it easier for the Commissioner to consider the impact of events outside a taxpayer's control which may curtail an asset's useful life (and result in the asset not being able to be salvaged or used). Examples include when the regulatory environment changes so an asset can no longer be used lawfully (for example, environmental legislation which outlaws the use of a particular type of machine) or when the raw materials that are used as an input into the asset are expected to run out. Another example is when the rate of technological obsolescence for an asset is significantly higher than was originally envisaged.

It is worth noting that the Commissioner's general view (*TIB* Vol 10, No 1 January 1998) is that the "whole of life" approach for determining the estimated useful lives of assets is the appropriate benchmark for setting tax depreciation rates. This view was supported by the Finance and Expenditure Committee and will continue to be the case under the changes to the special tax depreciation rates.

Other changes ensure that the Commissioner can prescribe a special tax depreciation rate using the straight-line method from the outset if a taxpayer requests this. Under the previous rules, the Commissioner was required to issue a special tax depreciation rate using the diminishing value formula (with a straight-line equivalent then having to be calculated).

On the recommendation of the Finance and Expenditure Committee, the legislation has been amended to allow the Commissioner to prescribe a single special tax depreciation rate for a group of identical assets that are all subject to the same special circumstances. For example, a set of five printing presses that because of special circumstances are all expected to last less than their prescribed economic life. Previously, taxpayers had to lodge a separate application for each press, even though the rate allowed would be the same for each item. Now the taxpayer needs to only lodge a single application for the group of assets.

Finally, changes have been made to allow the Commissioner to prescribe a special or provisional tax depreciation rate outside the six-month time limit for issuing such rates, if the taxpayer agrees to this. This change recognises that certain special and provisional tax depreciation rate applications are complex and may require a period longer than six months to be resolved (for example, if they require the input of expert valuers). One of the concerns raised in submissions to the Finance and Expenditure Committee with this change was the status of tax assessments where a special or provisional rate has been applied for and the taxpayer agrees to an extension of time, but such an extension results in a tax assessment being made before the issue of a rate. In these circumstances, taxpayers should use the relevant Commissioner-prescribed rate for the purposes of the assessment. Then, if the application for a special or provisional deprecation rate is granted, and it covers the income year at issue, taxpayers can make a request to the Commissioner under section 113 of the Tax Administration Act 1994 for an amendment to that assessment.

Key features

Section EE 28 of the Income Tax Act 2004 has been amended to extend the special tax depreciation rules to apply to fixed-life intangible property such as patents. Section EE 12(1) has been amended as a result.

Section 91AAG(2) of the Tax Administration Act 1994 has been amended to clarify that the Commissioner may have regard to a range of factors in determining the estimated useful life of an asset.

Section 91AAG(3) has been amended to allow the Commissioner to prescribe a special tax depreciation rate using a straight-line formula in addition to the diminishing value formula.

On the recommendation of the Finance and Expenditure Committee, section 91AAG(5B) has been added to allow the Commissioner to prescribe a single special tax depreciation rate for items of the same kind that are subject to the same circumstances that underlie a special tax depreciation rate.

Section 91AAM(2) has been amended to allow the Commissioner to prescribe a special or provisional tax depreciation rate outside the six-month time limit if the taxpayer agrees to this.

Application date

The amendments will apply to applications for special tax depreciation rates that are made in the 2005-06 and subsequent income years. The amendment to the six-month time limit also applies to provisional tax depreciation rate applications made in the 2005-06 and subsequent income years.

COSTS ASSOCIATED WITH FAILED OR WITHDRAWN RESOURCE CONSENTS

On the recommendation of the Finance and Expenditure Committee, section DB 13B of the Income Tax Act 2004 has been amended to treat the costs incurred on a failed or withdrawn resource consent application as deductible if those costs would have formed part of the cost of depreciable property, or would otherwise have been allowed as a deduction, if a resource consent had been granted. Section DJ 14B in the Income Tax Act 1994 has also been amended accordingly.

DEATH AND ASSET TRANSFERS

Subpart FI and sections CZ 6, EC 4, EE 34, EE 38, EE 40, EH 5, EH 19, EH 50, EH 67, EW 29, EW 36, EW 39, EW 41, EW 44, EX 55, FB 3, GD 2 and GD 14 of the Income Tax Act 2004 and the definition of "date interest starts" in section 120C(1) of the Tax Administration Act 1994

Generic rules have been introduced to clarify the income tax treatment of "in kind" or "in specie" distributions from companies and trusts, gifts, and transfers of assets and liabilities on a taxpayer's death. Such distributions, gifts and transfers are treated as disposals and acquisitions at market value. The new rules have implications only to the extent the property is inside the tax base to start with.

The effect of the new rules on the estates of deceased individuals is that there will generally be two market value transfers: one at the time of the taxpayer's death, and one on the subsequent distribution of the assets to beneficiaries. A number of exclusions to the market value rule reduce compliance costs.

Background

Tax law in the area of "in kind" distributions from companies and trusts, gifts and transfers on the death of a taxpayer has been neither clear nor consistent. Cases in recent years highlighted this lack of clarity, and there have been repeated calls to clarify the tax treatment of assets and liabilities on the death of a taxpayer and their subsequent distribution to the beneficiaries. For example, a beneficiary had no depreciation cost base for assets distributed by a trust, although the trustees were required to treat the distribution of the assets as a disposal at market value. These issues were raised by the Valabh Committee in its 1992 report, *Tax accounting issues*.

An officials' issue paper, *Tax implications of certain asset transfers*, was published in April 2003, and the proposals in that paper were modified as a result of submissions received.

Key features

The new generic rules are provided by new subpart FI of the Income Tax Act 2004. Assets and liabilities distributed or transferred are deemed to be a disposal and acquisition at market value.

Unless an exception applies, there will be two valuation points in respect of each deceased individual's estate: one at the date of death, and the other when the estate is distributed. The exceptions are:

- Section FI 4 provides that assets and liabilities that pass to a spouse or de facto partner of a deceased person can be transferred at their tax book value, as long as all assets of the deceased that were in the tax base pass to the spouse or de facto partner or another person who is a relative within the second degree of relationship. (Transferring assets at their tax book value is known as rollover relief.)
- Section FI 5 provides for simple estates when assets are left either to charity or to relatives within the second degree of the deceased taxpayer. Rollover relief will apply on the distribution of the estate. The transfer of the assets from the deceased to the administrator or executor of the estate will be at market value, unless any of the other exceptions apply.
- Both of these exceptions will continue to apply if there are legacies to third parties of assets that are not in the tax base.
- Section FI 6 provides rollover relief both on the date of death and when the estate is distributed for forestry assets if the beneficiaries of the estate are relatives to within the second degree of relationship to the deceased.

In addition, to reduce compliance costs, certain assets can be valued at cost rather than market value:

- Section FI 8 provides that unexpired accrual expenditure continues to be valued at cost. The valuation date is treated as the end of the income year.
- Section FI 11 provides that when an estate is a cash basis holder, financial arrangements are valued at cost both on the date of death and when the estate is distributed.

Generally, a taxpayer's death does not, in itself, lead to an asset being brought into the tax base. While the rule applies to all assets, it has relevance only to the extent the assets are already in the tax base. A particular example of this is the treatment of land held on capital account, the proceeds of which would be assessable if the property was sold within 10 years of acquisition. Section FI 7 ensures that death by itself does not trigger this 10-year rule.

Use-of-money interest will not be imposed on a deceased individual's tax liability in the year of death, so long as all tax due is paid by the due dates.

Sections FI 9 and FI 10 are transitional provisions that ensure that the tax treatment of past deaths and distributions from trusts and estates are not to be disturbed when:

- the tax base is protected by the position that was taken, either because the tax book values of assets and liabilities were rolled over, or because a market value exercise was done; and
- the beneficiaries of the trust or estate are limited to persons that are New Zealand-resident for tax purposes and are not exempt from income tax because they are charities; and
- the underlying law was not clear.

Application date

The new rules apply prospectively and come into force on 1 October 2005.

Detailed analysis

Section FI 1: Disposals and resulting acquisitions to which subpart FI applies

To ensure comprehensive and generic rules, the new subpart provides a disposal value and an acquisition cost price of property that includes:

- distributions from a trustee to the beneficiary of a trust;
- "in kind" or "in specie" distributions from a company to a shareholder that are dividends;
- gifts;
- transfers to an administrator or executor or trustee of a deceased estate;
- distributions by an administrator, executor or trustee of a deceased estate to a beneficiary; and
- a settlement from one trust to another.

Section FI 2: Disposal and resulting acquisition of property treated as occurring at market value

Distributions and transfers to which subpart FI refers are treated as disposals and acquisitions at market value. The same market value that is used for the disposal must be used for the acquisition.

Section FI 3: Date on which disposal and resulting acquisition are treated as occurring

The date of the disposal and acquisition for tax purposes will generally be the date the person disposes of the property.

Subsection (2) provides that transfers upon death are treated as occurring immediately before death.

Section FI 4: Disposal and resulting acquisition of property by spouse or de facto partner of the deceased taxpayer

Assets and liabilities that pass to a spouse or de facto partner on the death of a taxpayer are transferred at tax book values as long as the beneficiaries of the rest of the property that is in the deceased's tax base are limited to family members who are within the second degree of relationship to the deceased person. It does not matter who receives assets that are not in the tax base. Property that is within the tax base is:

- revenue account property;
- an interest in a foreign investment fund;
- financial arrangements which were not accounted for by the deceased taxpayer as a cash-basis person; and
- assets upon which depreciation has been claimed.

The rationale for this relief is that it appropriately replicates the Property (Relationships) Act 1976.

Section FI 5: Distributions of property to close relatives and charities

When certain conditions are met, a distribution from the administrator or executor to the beneficiaries is transferred at tax book values. The conditions for this exception applying are:

- the only beneficiaries of an estate are persons related to the deceased to the second degree, or are charities; and
- the estate does not establish any life interests; and
- the terms of the will or intestacy require that no property of the deceased taxpayer be held in trust; and

- in the tax year during which the property is subject to administration or executorship or in which the property is held in trust for this purpose, the net income of the estate is distributed beneficially to the maximum extent possible.

This relief will not be affected if there are legacies of assets that are not in the tax base to persons who are not relatives. The spouse or de facto partner relief takes precedence over this relief, except when charities receive assets that are within the tax base. It is intended to reduce compliance costs.

Section FI 6: Disposal and resulting acquisition of property that is standing timber

When timber, standing timber, or a right to take timber owned by a deceased person is left to a person who is related to the second degree, the transfer to the administrator or executor of the estate and the subsequent transfer to the beneficiary is at the tax book value.

This exclusion recognises that immature forests, in particular, are difficult to value.

Section FI 7: Relationship of section FI 2(2) to subpart CB

The subpart CB 10-year "tainting" rules (sections CB 7, CB 8, CB 9 and CB 12) do not apply to the transfer of assets and liabilities to the administrator or executor of the estate (section FI 1(3)(d) transactions) and the subsequent transfer to the beneficiaries (section FI 1(3)(e) transactions) if the property passes to a person who is related to the deceased taxpayer within the second degree of relationship.

If the relief provided by section FI 8(1) and (2) does not apply, section FI 8(3) provides that a deduction will be allowed against the proceeds of the property, for the original cost of the land to the deceased person, plus all other costs incurred by the deceased person, the administrator or executor or the beneficiary.

Section FI 8: Relationship of subpart FI to unexpired prepayments

Property that is subject to section EA 3 (Prepayments) is valued at cost, rather than market value, when it is transferred to the administrator or executor and when it is subsequently transferred to the beneficiary. The valuation date is treated as the end of an income year.

This provision will reduce compliance costs.

Section FI 9 and 10: Death or trust distributions before 1 October 2005

Section FI 9 and 10, when read together with the general savings rule in the Income Tax Act 2004 (subpart YA), provide that certain past tax treatments are saved, generally when the past treatment was uncertain and the tax base is not at risk.

Section FI 9 applies when the following criteria are met:

- The taxpayer died before 1 October 2005.
- The beneficiaries are New Zealand-resident for tax purposes and are not exempt from income tax because they are charities.
- The Income Tax Act does not explicitly specify a treatment for both the deceased taxpayer and the executor or trustee.

If the same valuation method was used for both the disposal by the deceased taxpayer and the acquisition by the administrator or executor, and that valuation was either at market value or a rollover, it will be accepted as appropriate.

Section FI 10 provides the same rules for distribution from trusts.

Section FI 11: Disposal of certain financial arrangements on death

Financial arrangements will be valued at cost, both upon the death of the taxpayer, and at the time of distribution to beneficiaries, if the deceased taxpayer's estate is a cash-basis person. For the estate to be treated as a cash-basis person, the deceased taxpayer would need to be a cash-basis person at the date of death.

Use-of-money interest

The definition of "date interest starts" in section 120C of the Tax Administration Act 1994 has been amended to restrict the imposition use-of-money interest on a deceased taxpayer's tax liability in the year of death, as long as provisional and terminal tax payments are made by due date. Although the amendment provides that the concession will apply only to dispositions to which section FI 4 (disposal and resulting acquisition of property by spouse or de facto partner) of the deceased taxpayer applies, the policy intention is that it should apply to all estates. This will be corrected in the next tax bill.

This is a concessionary measure which ensures that estates will not incur unexpected use-of-money interest liabilities when a taxpayer's death triggers a tax liability.

Consequential amendments

Subpart FI is a comprehensive set of rules which provide for the tax treatment of "in kind" or "in specie" distributions, including the transfer of assets upon a taxpayer's death. Accordingly, a number of specific provisions which address specific transactions have been repealed. Other sections are being amended to make them consistent with the new rules.

Sections CZ 6(3), EC 4, EE 40(7), EW 29(13), EW 36(1)(b)(i), EW 39, EW 41(1)(b)(i), EW 44, EX 55, and GD 2 have been repealed. Sections EE 34, EE 38, EH 5(4), EH 19(2), EH 50(2), EH 67(4), FB 3, and GD 14(3)(c) are amended.

Section EE 34 provides that a taxpayer who acquires depreciable property from an associated person cannot claim more depreciation on that property than the associated person would have been able to had they retained the property. Subject to certain exceptions, the taxpayer's depreciation base is limited to the original cost of the property incurred by the associated vendor for anti-avoidance reasons.

As death is not a planned event there is no concern about anti-avoidance. When a rollover does not apply, the estate should use market value if that is appropriate. New subsection (6) has been added to section EE 34 to ensure this.

If property is disposed of for less than its market value, section EE 38 deems the consideration to be the market value of the property. New subsection (2B) provides that the market value rules do not apply if either of the rollover provisions, sections FI 4 or FI 5 apply.

Sections EH 5(4), EH 19(2), EH 50(2) and EH 67(4) are amended so that they continue to operate as if section FI 3 (date on which the disposal and resulting acquisition is treated as occurring) had not been enacted.

Section FB 3 is amended to make it clear that it does not apply when the rollover provisions of sections FI 4 to FI 6 apply.

Section GD 14(3)(c) is amended because subparagraph (ii) is no longer necessary, given the new rules for distributions.

TAX RECOVERY PROVISION: APPLICATION TO CIVIL PENALTIES AND INTEREST

Section HK 11 of the Income Tax Act 2004

The law has been clarified to ensure that the tax recovery provision, section HK 11 of the Income Tax Act 2004, applies to civil penalties and use-of-money interest.

Background

Section HK 11 of the Income Tax Act 2004 is directed at arrangements which deplete a company's assets so that it is unable to meet its tax liabilities. The company itself is often liquidated as part of the arrangement, or simply because the company serves no useful purpose after a transaction is completed.

Under section HK 11, the directors and shareholders of a company can be made liable, in certain circumstances, for the unsatisfied income tax and GST liabilities of the company. Broadly, these circumstances are when:

- an arrangement has been entered into by the company which has the effect of leaving it unable to meet its income tax liability;
- a director making reasonable enquiries would have been aware of this effect; and
- a purpose of the arrangement was to have that effect.

Key features

The tax recovery provision, section HK 11 of the Income Tax Act 2004, makes the directors and shareholders of a company liable in certain circumstances for income tax payable by the company if it is left with insufficient assets to meet its liability. This provision also applies to a company's GST liabilities.

The policy intent of section HK 11 is that it should allow Inland Revenue to collect unpaid civil penalties and use-of-money interest imposed on companies from their directors and shareholders if the requirements of that provision are satisfied. However, there was previously some uncertainty that the law achieved this policy intent.

A clarifying amendment has been made to section HK 11 to ensure that it applies to civil penalties and use-of-money interest. This clarifying amendment is in line with the policy intent of the tax recovery provision.

Application date

The amendment applies from the date of enactment, 21 June 2005.

EXCESS IMPUTATION CREDITS

Sections LB 1 and LB 2 of the Income Tax Act 2004 and sections 33A and 177C of the Tax Administration Act 1994

Excess imputation credits received by individuals (natural persons) and unincorporated bodies must now be carried forward instead of being converted into a net loss. This ensures that the benefit of the credits is equal to the tax paid.

Background

Imputation credits received by taxpayers in excess of those required to meet their tax liability for the tax year were previously converted to a deemed net loss. This was carried forward and offset against net income in the next income year.

The benefit of the net loss when claimed would ideally equal the value of the imputation credit. For taxpayers such as individuals, whose marginal tax rate depends on their taxable income in each year, no single rate of conversion to a net loss could achieve this, so a "middle" effective marginal tax rate of 28% was used. The rate used declined over time and is now 21%, whereas the top tax rate is 39%. This has increased the disparity between the value of imputation credits and their potential value if converted to a net loss.

Key features

Section LB 2 of the Income Tax Act 2004 has been amended so that excess imputation credits received by an individual or unincorporated body are carried forward to the next income year. Carried-forward imputation credits remain "convertible credits" under section OB 1, and so will offset tax liabilities in the same order as "new" imputation credits under section BC 10.

Under an amendment to section 33A of the Tax Administration Act 1994, taxpayers with excess imputation credits will be required to file a tax return. This is consistent with requirements for taxpayers with a net loss. Based on the information it has, Inland Revenue intends to inform taxpayers of the value of any excess credits carried forward.

Under section 177C of the Tax Administration Act 1994 the Commissioner, when writing off an outstanding amount of tax, extinguishes any net loss available to the taxpayer up to the value of the outstanding tax by dividing the amount written off by 33% and reducing the net loss by that amount. Under an amendment to that section, the Commissioner will then extinguish any carried-forward excess credits of the taxpayer up to the value of the remaining outstanding tax being written off (if any).

Application date

The amendments apply to imputation credits received in the 2005-06 and later tax years.

RESIDENT WITHHOLDING TAX AND OFFSHORE UNIT TRUSTS

Sections LD 3, NF 2(1), NF 2(1A), NF 2(1AB), NF 2(1B), NF 2AA, NF 2A(1), NF 2A(3) and NF 4(9) of the Income Tax Act 2004 and the Income Tax Act 1994; sections 25(11), 26(1) and (2), 27(1), 33A(1)(b)(iv), 33A(1)(b)(x)(B), 50 and 51(6) of the Tax Administration Act 1994

The resident withholding tax (RWT) rules in the Income Tax Act have been amended to establish an RWT "proxy" for the payer and the recipient of the resident withholding income when the payer is non-resident. The "proxy" must pay to the Commissioner the RWT calculated in relation to the resident withholding income.

The use of the new RWT proxy mechanism is voluntary for both the RWT proxy and the recipient of the resident withholding income. In addition, the recipient can elect the correct marginal tax rate.

The amendments were introduced by Supplementary Order Paper 337 at the select committee stage of the legislative process.

Background

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 enacted in December 2004 resulted in distributions from offshore unit trusts that were previously treated as "non-taxable bonus issues" for New Zealand tax purposes being treated as dividends and taxed accordingly.

As a consequence, individual investors in offshore unit trusts derive a dividend, from which no foreign or New Zealand tax has been withheld. These investors have a New Zealand income tax liability and may be required to file an income tax return.

Ideally the RWT rules should allow fund managers to withhold tax on behalf of investors. The RWT rules require the deduction of a withholding tax from interest and dividends paid to New Zealand residents. RWT is deducted at source at the time the interest or dividend income is paid, thus eliminating the need in many cases to file an income tax return because the correct amount of tax will have been withheld.

The income tax legislation did not previously allow New Zealand fund managers, who are not agents, to elect to be subject to the RWT rules in relation to investments in offshore unit trusts by New Zealand residents.

The amendments will make it easier for individuals to meet their tax obligations accurately, lowering compliance and administration costs. A key feature of the new arrangement is that it is voluntary. The decision to offer the withholding facility is a matter for each fund manager to consider.

Key features

The RWT rules have been amended to allow:

- New Zealand fund managers to elect to offer a withholding tax facility (to be an RWT "proxy");
- the correct marginal tax rate to be nominated when an investor elects to use the withholding tax facility; and
- the requirement that the investor files an annual income tax return to be removed.

Application date

The amendments apply from 21 December 2004.

Detailed analysis

Liability to pay resident withholding tax

Section NF 2(1A)(b) establishes a liability to pay RWT to the Commissioner if a person is an RWT proxy for the payer and recipient of the resident withholding income. It recognises that although the RWT proxy is not the payer of the resident withholding income, the proxy must, nevertheless, pay to the Commissioner the RWT calculated in relation to that income.

Section NF 2(1A)(a) preserves the existing position for all other instances where the person who makes the payment of resident withholding income must deduct the RWT from the resident withholding income and pay the RWT to the Commissioner.

New section NF 2(1B) prescribes the formula to work out the amount of RWT to be paid to the Commissioner by the RWT proxy when resident withholding income in the form of a dividend is paid. The formula ensures that the RWT is calculated in relation to the net amount that is paid to the recipient. The formula is:

$$\frac{a \times b}{1 - a}$$

Where:

a is the appropriate rate of RWT, expressed as a percentage, specified in Schedule 14, clause 1

b is the amount paid to the recipient of the dividend.

For example, if the recipient's marginal tax rate is 33% and the recipient receives 67 cents, then the amount of resident withholding income is $1. The formula calculates the amount of RWT as follows:

$\frac{.33 \times 67}{1 - .33}$ = 33 cents of RWT is paid to the Commissioner

The formula therefore ensures that the correct amount of RWT is paid to the Commissioner.

Election to be an RWT proxy

New section NF 2AA has been inserted to prescribe how a person elects to be an RWT proxy.

A person is an RWT proxy if:

- the proxy gives to the Commissioner a notice of election;
- the payer is a non-resident unit trust;
- the recipient is a natural person or a trustee of a qualifying trust;
- the recipient has asked the RWT proxy to act as a proxy;
- the proxy has agreed;
- the resident withholding income is a dividend; and
- the payment is made during the term of the election.

A notice of election must be in writing and contain:

- the election to be an RWT proxy for dividends distributed by the payer;
- the name and address of the payer; and
- the date from which the election is effective.

The election is effective from the date nominated in the notice until the Commissioner receives written notice from the proxy that the election is cancelled.

Election to apply appropriate rate of deduction

Section NF 2A(1) has been amended to allow a recipient to elect that an RWT proxy apply the appropriate RWT rate specified in Schedule 14, clause 1(a), (b) or (c).

Payment of resident withholding tax to Commissioner

Section NF 4, concerning the payment of RWT deductions to the Commissioner, has been amended to incorporate the RWT proxy mechanism.

Resident withholding tax deductions to be credited against income tax assessed

Section LD 3 has been amended to ensure that the payment of RWT by an RWT proxy in relation to resident withholding income can be credited against the income tax liability of the recipient of the resident withholding income.

Consequential amendments to the Tax Administration Act 1994

To ensure that the RWT proxy mechanism is subject to the administrative requirements in the Tax Administration Act 1994 relating to RWT, sections 25(11), 26(1) and (2), 27(1), 50 and 51(6) have been consequentially amended. In general, this has been achieved by ensuring the payer of the RWT – either by the RWT proxy or the payer of the resident withholding income – is subject to these requirements.

Annual returns of income not required

Section 33A(1)(b)(iv) has been amended to provide that an annual income tax return is required when a taxpayer has not had the correct amount of tax withheld from interest or a dividend subject to the RWT proxy rules, where that amount is more than $200.

Section 33A(1)(b)(x) requires that an income tax return be filed when a taxpayer has, in effect, received more

than $200 of foreign interest or dividends, irrespective of whether the correct amount of New Zealand tax has been paid on that income. This provision has been amended to ensure that it does not apply to resident withholding income subject to the RWT proxy rules.

In section 33A(2), paragraphs (cb)(ii) and (f) have been repealed because they are redundant. Their effect is already achieved in section 33A(1).

DETERMINATION OF RESIDENCE OF COOK ISLAND NATIONAL SUPERANNUATION FUND

Sections OE 2(1) and OE (1B) of the Income Tax Act 1994 and the Income Tax Act 2004

The Income Tax Act 1994 and Income Tax Act 2004 have been amended to treat the Cook Island National Superannuation Fund as a non-resident for New Zealand tax purposes so that the Fund will be liable for New Zealand tax only on New Zealand-sourced income.

Background

The Fund is a compulsory national superannuation fund established by Cook Islands legislation. It was established to provide all employees and self-employed people residing in the Cook Islands with a pension in retirement. Contributions to the Fund are compulsory for employers and employees unless contributions are made to a New Zealand superannuation fund. The Fund is governed by a trust deed and the Public Trust of New Zealand has been appointed trustee of the Fund.

The current governance structure of the Fund with the Public Trust being trustee potentially gave rise to unintended consequences under New Zealand's tax legislation. As a result, the Fund could have been deemed a New Zealand-resident company and therefore subject to New Zealand tax on its worldwide income. Consequently, the Fund sought a legislative solution to deal with this unintended tax effect.

Key features

Sections OE 2(1) of the Income Tax Act 1994 and the Income Tax Act 2004 provide the requirements for a resident company. New section OE (1B) provides an exception when a company is acting as a trustee of the Fund. A company acting in this capacity is treated as being non-resident in New Zealand for Income Tax Act purposes.

Application date

The amendment applies retrospectively from 1 July 2001, the date on which the Fund started.

RIGHT OF NON-DISCLOSURE FOR TAX ADVICE

Sections 17A, 20B-20G, and 81B of the Tax Administration Act 1994

A statutory right not to disclose certain confidential documents, has been introduced for tax advice provided by tax advisors. It applies to communications between advisors and taxpayers for the main purpose of providing or receiving tax advice.

The non-disclosure right is subject to a number of exclusions such as for factual information, debt collection advice, accounting and tax work papers and matters of fraud. Tax advice does not include such matters as valuation and investment advice. The amendments do not affect legal professional privilege.

Inland Revenue has issued a Standard Practice Statement providing guidelines on how the non-disclosure right will operate.

Background

Under the Tax Administration Act 1994, professional privilege has been available to lawyers for confidential communications with their clients about tax matters. This means that information that is subject to privilege is not required to be disclosed to Inland Revenue. The same right of non-disclosure has not been available to chartered accountants and other tax advisors who have a similar tax advice function to that of lawyers. There have been administrative protocols that govern the means by which Inland Revenue should seek access to information held by accountants but no statutory right of non-disclosure.

However, accountants should be able to give candid and independent advice to their clients, as lawyers do, without the need to disclose that advice to Inland Revenue. The benefit of enabling this to occur is that the advice can promote voluntary compliance by taxpayers with the tax system and give rise to a consequent reduction in compliance and administrative costs.

In May 2002 a government discussion document, *Tax and Privilege: a proposed new structure*, was released for public consultation. The new amendments, while aiming to achieve the same objectives, differ from the earlier proposals set out in the 2002 discussion document.

Key features

New section 20B of the Tax Administration Act 1994 introduces a non-disclosure right for certain confidential documents created between tax advisors and their clients when the Commissioner is seeking disclosure of these documents under the information-gathering powers contained in sections 16–19 of the Tax Administration Act 1994. Such documents ("tax advice documents") are subject to the non-disclosure right if they are brought

into existence for the main purpose of giving or receiving advice on New Zealand tax laws. A document that is created for the purpose of committing or promoting an illegal or wrongful act such as fraud does not qualify for the right of non-disclosure.

The right of non-disclosure belongs to the affected taxpayer. This means that taxpayers may withdraw the non-disclosure claim if they choose to provide the relevant tax advice documents to Inland Revenue.

To qualify for the non-disclosure right, the taxpayer's advisor who provided the tax advice needs to be subject to the code of conduct and disciplinary processes of an organisation (an "approved advisor group") that has been approved by Inland Revenue and meets certain other criteria.

New section 20D sets out the rules for claiming the right of non-disclosure. It must be claimed in writing and must include a brief description of the document and the name of the tax advisor who provided the tax advice. The taxpayer (or the tax advisor on the taxpayer's behalf) will need to make the claim within a specific period. This is generally within 28 days from the date that the Commissioner issued the information demand.

New section 20F provides that certain information ("tax contextual information") must be disclosed from the tax advice documents if the Commissioner requires such a disclosure. If it is necessary for proper administration of the revenue, a request for the tax contextual information may be made at the same time as the original information demand is issued.

In most cases, however, when a claim for non-disclosure is made in response to an information demand, only those documents not subject to the non-disclosure right will be required to be produced initially. Inland Revenue will assess that material provided it includes the details provided in the claim for non-disclosure to determine whether it is sufficient to complete the investigation. Disclosure of tax contextual information will be required when the information provided is insufficient.

Examples of tax contextual information are:

- factual information relating to transactions entered into by the taxpayer, including information about the purpose of the transaction;
- accounting and tax work papers that contain information which supports the financial statements and/or the tax return;
- matters concerning the collection of tax debts.

This information must be disclosed by way of a statutory declaration by the tax advisor in a form prescribed by Inland Revenue. This form is the IR 520.

A number of remedies are available if the progress of an investigation is deliberately impeded through abuse of the non-disclosure rules. If a tax advisor is convicted of any of these offences, a court may order that the advisor be barred from making statutory declarations of tax contextual information.

The secrecy provisions have also been amended to allow Inland Revenue to advise the approved advisor group if a recognised tax agent breaches the rules relating to non-disclosure – for example, by making a false statutory declaration.

Inland Revenue has issued a Standard Practice Statement providing guidelines on how the non-disclosure right will operate.

Application date

The new non-disclosure right will apply to requests for information made after the date of enactment.

Detailed analysis

Section 20B: No requirement to disclose tax advice document

Certain communications are not required to be disclosed under Inland Revenue's information-gathering provisions (sections 16–19 of the Tax Administration Act).

The non-disclosure right applies to a "book or document" that is a "tax advice document". The term "book or document" is defined to include:

> "... all books, accounts, rolls, records, registers and papers, and other documents, and all photographic plates, microfilms, photostatic negatives, prints, tapes, discs, computer reels, perforated rolls or any other type of record whatever."

The definition includes both paper and electronic communications such as letters, reports, memos, file-notes, mails and electronically stored data.

Under section 20B(2) a document is eligible to be a tax advice document if it is:

- confidential; and
- created by a person for the main purpose of instructing a tax advisor who is a member of an approved advisor group to provide advice on tax laws; or
- created by a tax advisor, or an employee of a tax advisor's firm, if the document was brought into existence for the main purpose of:
  - recording research and analysis that is performed for the main purpose of enabling the tax advisor to give tax advice on tax laws to a taxpayer about the taxpayer's own affairs; or
  - giving advice on tax laws by the tax advisor to a taxpayer about the taxpayer's own affairs, or recording the advice given.

The term "tax law" is a defined term in section 3 of the Tax Administration Act and means:

- a provision of the Inland Revenue Acts or an Act that an Inland Revenue Act replaces;
- an Order in Council or a regulation made under another tax law;
- a non-disputable decision; and
- in relation to an obligation to provide a tax return or a tax form, also includes a provision of the Accident Rehabilitation and Compensation Insurance Act 1992 or a regulation made under that Act or the Accident Insurance Act 1998 or a regulation made under that Act or the Injury Prevention Rehabilitation and Compensation Act 2001 or a regulation made under that Act.

Accordingly, the tax advice must be about New Zealand tax rules, as they affect the taxpayer in question. Advice about the effect and application of tax laws in other jurisdictions will not be subject to the non-disclosure right.

Advice given for the furtherance of illegal or wrongful acts, or in relation to impending or future illegal or wrongful acts, is specifically excluded from the non-disclosure right by section 20B(2)(c). This includes fraud and tax evasion.

Under subsection (3) a tax advice document must satisfy the following criteria:

- it must be eligible to be a tax advice document under subsection (2), as described above; and
- a valid claim for non-disclosure must be made under section 20D, and the taxpayer on whose behalf the non-disclosure right is claimed must satisfy the requirements of section 20E (attachments to tax advice documents) and section 20F (disclosure of tax contextual information) if required.

The term "tax advisor" is defined in subsection (4) as a natural person who is subject to the code of conduct and disciplinary processes of an "approved advisor group".

Section 20C: Treatment of document

Documents that may be eligible for the non-disclosure right will be treated as tax advice documents from the time an information demand is made. If no claim for the right is made, this status will cease when the taxpayer informs Inland Revenue that no claim is to be made, or on the date the claim is required to be made by.

If a claim is made for the non-disclosure right, the status as a tax advice document will cease when:

- the District Court rules that the document is not a tax advice document; or
- the taxpayer agrees in writing that the document is not a tax advice document; or
- the taxpayer withdraws the claim; or
- the approved advisor group advises that the tax advisor was not a member of the group at the relevant time.

While a document is treated as a tax advice document, a copy of the tax advice document must be held by the tax advisor in a secure place.

Section 20D: Claim that document is a tax advice document

Consistent with the fact that the non-disclosure right belongs to the taxpayer, a claim for the right must be made by the taxpayer or the tax advisor on the taxpayer's behalf. If the tax advisor makes the claim, he or she must certify that they are authorised to act on the taxpayer's behalf.

If the tax advice document was prepared by the taxpayer, the claim must include a brief description of the form and contents of the document, the name of the tax advisor and the date of the document. If the tax advice document was prepared by the tax advisor, the claim must include a brief description of the form and content of the document, the name of the tax advisor, the name of the approved advisor group, the statute and type of revenue to which the advice relates, and the date of the document.

A claim relating to an information demand under section 16 (Commissioner may access premises to obtain information) or section 16B (Powers to remove and copy documents) must be made by the day on which Inland Revenue exercises the right to inspection or removal, or a later date that has been agreed by the Commissioner.

If the information demand is issued under section 17 (Information to be furnished on request of Commissioner) the claim must be made by the later of the date when information is required to be provided, or 28 days after the date in the information demand.

If the information demand is made under section 17A (Court orders for production of information or return), section 18 (Inquiry before a District Court Judge) or section 19 (Inquiry by Commissioner) the claim for the non-disclosure right must be made by the date when the information is required to be produced.

Section 20E: Document included in tax advice document

Attachments that exist independently of the tax advice document (created for a different purpose than the tax advice subject to non-disclosure) will not be protected unless they qualify for non-disclosure in their own right. For example, a sale and purchase agreement attached to a non-disclosable document would not be subject to non-disclosure. However, attachments that form part of the non-disclosable document (and do not have separate existence) will be treated as part of the tax advice document.

Section 20F: Tax contextual information

Even though the tax advice document is protected from disclosure, a description of tax contextual information included in the document may need to be disclosed by way of a statutory declaration made by an authorised tax advisor. The statutory declaration should reflect the tax advisor's view of the relevant transaction. If the tax advisor wishes to disclose the information verbatim from the tax advice document, this is acceptable.

Generally, the initial information demand will not include a requirement to disclose tax contextual information. However, such a requirement may apply if it is considered necessary for the proper administration of the revenue. In most cases, a demand for tax contextual information will not be made until the disclosable material and a claim for non-disclosure has been received and analysed. Generally only if that material does not provide sufficient information to complete the investigation will a subsequent demand be made for the disclosure of the tax contextual information from the tax advice documents.

If an information demand is made under section 16 (Commissioner may access premises to obtain information) or section 16B (Power to remove and copy documents) and the taxpayer claims the right of non-disclosure, the taxpayer (via their authorised tax advisor) will be required to disclose the tax contextual information from those tax advice documents by the date determined by the Commissioner.

If the original information demand is made under section 17 (Information to be furnished on request of Commissioner) the description of tax contextual information must be provided by the later of:

- the date prescribed by the Commissioner; or
- 28 days after the date given in the information demand requiring disclosure of the tax contextual information.

If the information demand is made under section 17A (Court orders for production of information or return), section 18 (Inquiry before a District Court Judge) or section 19 (Inquiry by Commissioner) the disclosure must be made by the date when the information is required to be produced.

"Tax contextual information" means:

- facts or assumptions which are provided to a taxpayer in contemplation of actual transactions entered into by the taxpayer, or a similar transaction being investigated by Inland Revenue;
- steps involved in the performance of a transaction actually entered into by the taxpayer, or a similar transaction being investigated by Inland Revenue;
- advice that does not concern the operation and effect of tax laws (for example, valuation and investment advice);
- advice on the collection of tax debts;
- facts or assumptions relating to non-tax advice; and
- accounting and tax work papers that contain information which supports the financial statements and/or a tax return of a taxpayer.

The statutory declaration must be made by a tax advisor who has authority to act on behalf of the taxpayer, and has not been barred from making statutory declarations. A court could bar the advisor if he or she is convicted of an offence under:

- section 111 of the Crimes Act 1961 (false statements or declarations);
- section 143(1)(b) of the Tax Administration Act 1994 (not supplying information when required to do so by a tax law);
- section 143A(1)(b) or (c) of the Tax Administration Act 1994 (knowingly not supplying information when required to do so by a tax law, or providing altered, false, incomplete or misleading information);
- section 143B(1)(b) or (c) of the Tax Administration Act 1994 (knowingly not supplying information for the purpose of evading tax, or providing altered, false, incomplete or misleading information); or
- section 143H of the Tax Administration Act 1994 (obstruction).

Section 20G: Challenges

The taxpayer or Inland Revenue can apply to a District Court Judge for an order determining whether:

- the document is a tax advice document; or
- information provided is tax contextual information; or
- a more detailed or better description of tax contextual information is required.

The District Court judge may require the document to be produced to the court.

An application for the court order may be made in the course of a section 18 inquiry to the judge who is holding the inquiry.

Secrecy

New section 81B provides that Inland Revenue may divulge information to an approved advisor group about a member who breaches the non-disclosure rules. This will allow the approved advisor group to take disciplinary action, if required against the offending tax advisor

Consequential amendments

Section 17A, which relates to court orders for production of information or returns, is being amended. Currently, under subsection (7), a court may order that information should be produced to the court and reviewed in order to determine whether an order should be made for the information to be provided to Inland Revenue, and whether the information is subject to legal professional privilege. Subsection (7) has been amended to provide a similar rule in relation to the non-disclosure right.

PAID PARENTAL LEAVE – INFORMATION EXCHANGE BETWEEN INLAND REVENUE AND THE DEPARTMENT OF LABOUR

Sections 81(4)(q), 85H and 85I of the Tax Administration Act 1994 and Schedule 3 of the Privacy Act 1993

The secrecy provisions have been amended to allow Inland Revenue to use taxpayer-specific information to identify applicants who may be ineligible to receive paid parental leave (PPL) or a parental tax credit, or who may have received an overpayment.

The amendments also allow Inland Revenue to communicate taxpayer-specific information to the Department of Labour so any discrepancies can be investigated and resolved.

Background

As part of the implementation of the PPL scheme in 2002, certain validation checks were developed using information collected as part of the administration of the tax system, to ensure that the scheme was not subject to misuse. The checks were designed to indicate whether:

- an employment relationship exists between a PPL applicant and the employer from whom the applicant claims to be taking leave;
- an applicant returned to work for the employer from whom she claimed to be taking leave during the PPL payment period;
- an applicant claimed, or made an application for, both PPL and the parental tax credit for the same child.

It transpired that Inland Revenue did not have the legislative authority to use information collected or obtained as part of the administration of the Revenue Acts, for PPL purposes. The Parental Leave and Employment Protection Act 1987, which provides for the payment of PPL, is not a Revenue Act. Inland Revenue has been delegated under the Parental Leave and Employment Protection Act aspects of the administration of the PPL scheme, such as processing applications and making payments.

Key features

New section 85H of the Tax Administration Act 1994 allows Inland Revenue to compare taxpayer-specific information with information provided by an applicant, to identify applicants who may be ineligible to receive PPL or who may have received an overpayment. When these checks reveal a possible discrepancy, Inland Revenue can communicate taxpayer-specific information relating to the applicant to the Department of Labour for further investigation.

New section 85I allows Inland Revenue to compare taxpayer-specific information with information provided by an applicant, to identify applicants who have applied for a parental tax credit and PPL for the same child. When someone has applied for both payments, Inland Revenue will decline the application for either PPL or the parental tax credit.

New section 81(4)(q) of the Tax Administration Act provides a specific exemption from the requirement that Inland Revenue maintain the secrecy of taxpayer information, for the purposes of section 85H of the Act.

Application date

The amendments apply from 21 June 2005, the date of enactment.

PUBLICATION OF TAX OFFENDERS' NAMES

Section 146 of the Tax Administration Act 1994

Section 146 of the Tax Administration Act has been repealed, removing the requirement for the Commissioner to publish the names of serious tax offenders.

Background

The previous name publishing rules were intended to act as a deterrent to tax offending, thereby improving taxpayer compliance. Empirical evidence, however, is inconclusive about the effectiveness of such rules.

The rules also tended to be excessively harsh on some taxpayers – for example, those who evade for small sums, or are one-off offenders. This was because the rules were inflexible in both their scope and application. Name publication has only one level of punishment, irrespective of the magnitude of the offence, and applies to various

offences with potentially differing levels of culpability. As a result, there is no ability to tailor the punishment to either the type or the magnitude of the offence.

Nevertheless, some benefits are still seen in publishing names of offenders. These benefits are greatest in cases where a court has imposed a sanction. As such, the Commissioner will, when appropriate, seek publicity after court imposed sanctions. Having an independent body determine a taxpayer's wrongdoing ensures the objectivity of the process, while creating a threshold to ensure that the punishment is not disproportionate to the offence.

Key features

An amendment has been made repealing section 146 of the Tax Administration Act 1994.

Application date

The amendment applies retrospectively to taxpayers whose names were due for publication, but had not yet been published at the time of enactment.

GST AND THE FIRE SERVICE LEVY

Section 5(6AB) of the Goods and Services Tax Act 1985

An amendment clarifies that payment of the fire service levy is consideration for the supply of goods and services made by the New Zealand Fire Service Commission.

Background

The fire service levy is payable on all contracts of fire insurance covering New Zealand property and is used to fund the activities of the New Zealand Fire Service Commission. The levy has been collected since 1 July 1986. Concerns were raised about the application of GST to the levy because it was unclear if it could be regarded as a premium for a contract of insurance. It was also unclear if the provision of services by the Fire Service was a statutory obligation or a contractual one.

Under the GST Act and relevant case law, GST is imposed when there is a sufficient connection between a payment and any supply of goods and services made in return for the payment. Payment of a levy under a statutory obligation can create uncertainty around the requisite connection between payment of the levy and any supply of goods and services.

Section 5(6AB) deals with these uncertainties by specifying that payment of the fire service levy is consideration for the supply of goods and services by the New Zealand Fire Service Commission to the person who takes out fire insurance covering New Zealand property (the insured). The new section is intended to preserve the status quo concerning the collection of GST on the fire service levy since 1 October 1986 when GST began.

Key features

Section 5(6AB) clarifies that the payment of the fire service levy by an insured person is consideration for a supply of goods and services by the New Zealand Fire Service Commission.

Penalties, penalty interest or default interest charged under the Fire Services Act 1975 on insurers are not included within the scope of section 5(6AB). The GST treatment of such charges will depend on the application (or not) of the exemption for penalty interest under section 14 of the GST Act and/or ordinary principles.

Application date

The amendment applies from 1 October 1986.

GST DEREGISTRATION FOR NON-RESIDENTS

Section 52(7) of the Goods and Services Tax Act 1985

The Commissioner has been given the discretion to deregister non-residents who do not carry on a taxable activity in New Zealand, to prevent the inappropriate refund of GST on their purchases in New Zealand.

Background

The GST Act allows non-residents to register in New Zealand for GST purposes without carrying on any taxable activity in New Zealand if they carry on a taxable activity overseas. They do this so they can get input tax credits for their expenditure in New Zealand, which may be an appropriate treatment in some cases. For example, when a person intends to carry on a business activity in New Zealand in the next 12 months, but is in the process of getting ready for that activity, GST refunds should be allowed.

When non-residents have only a passing or temporary presence in New Zealand, however, it is not desirable, from a policy perspective, to allow them a refund of the GST on their purchases in New Zealand. An example of when a refund is not appropriate is when an entity not resident in New Zealand supplies services in New Zealand for which it charges nil consideration. The entity carries on no taxable activity in New Zealand, but can register for GST purposes in New Zealand because it is carrying on a taxable activity overseas.

A non-resident should not be able to claim a GST refund for making supplies in New Zealand for which it does

not charge anyone. The entity's profile is the same as a final consumer, yet, for purposes of GST it is treated as a business. This meant it could previously claim back the GST on its purchases – often of an entertainment or accommodation nature – in New Zealand. The amendment gives the Commissioner of Inland Revenue the discretion to deregister a taxpayer in appropriate cases.

New Zealand already collects GST from non-resident businesses that have only a passing connection with New Zealand. The amendment buttresses this power as it will discourage non-residents who are in New Zealand temporarily and have no intention of carrying on a taxable activity in New Zealand from registering for GST in order to claim the GST back on their purchases in New Zealand.

Key features

The Commissioner, under section 52 of the Goods and Services Tax Act 1985, is able to cancel the registration of a non-resident who does not carry on a taxable activity in New Zealand. The effect of this deregistration is that the non-resident will not be able to claim back the GST incurred on the goods and services it purchases in New Zealand or it will trigger a supply and consequent output tax liability under section 5(3).

Consistent with other deregistration provisions, this deregistration could have effect back to the date on which the non-resident was registered for GST in New Zealand if a taxable activity was never carried on in New Zealand from that date.

The amendment is directed primarily at non-residents who have only a passing or temporary connection with New Zealand and who should be treated as final consumers of the goods and services they purchase in New Zealand and are therefore not entitled to a GST refund.

Inland Revenue will prepare guidelines explaining the circumstances when the discretion to deregister a non-resident will be exercised and when it will not. For example, the discretion will be exercised to prevent non-residents who are temporarily in New Zealand and do not carry on or intend to carry on any taxable activity in New Zealand, and whose only supplies in New Zealand are made for nil consideration, from having the GST on their purchases in New Zealand refunded. The discretion will not be exercised if the non-resident intends to carry on a taxable activity in New Zealand and registers before beginning operations in New Zealand.

Application date

The amendment applies to persons who register for GST on or after the date of enactment, 21 June 2005.

REMEDIAL ISSUES

REWRITE AMENDMENTS

Sections DZ 13, EH 37, EH 81, LE 3(3), OB 1 and Schedule 22A

Remedial changes have been made to the Income Tax Act 2004 on the recommendation of the Rewrite Advisory Panel. The amendments ensure that provisions in the 2004 Act:

- have the same legal outcome as would be obtained under their corresponding provisions in the Income Tax Act 1994; or
- appropriately identify the provision as an intended change in Schedule 22A.

Background

At the time of enactment of the Income Tax Act 2004, the Finance and Expenditure Committee expressed concern that the new legislation could contain unintended policy changes. To alleviate that concern, the committee recommended that a panel of tax specialists be appointed to review any submission that the 2004 Act contained an unintended policy change. An unintended policy change is one that gives rise to a different outcome from the corresponding provision in the Income Tax Act 1994. The Rewrite Advisory Panel accepted this review role.

These remedial amendments arise from this review and were added to the bill at the select committee stage of the legislative process.

Key features

The provisions affected are section DZ 13 (unamortised balances of expenditures in farming and agricultural sector), sections EH 37 and EH 81 (income equalisation schemes), section LE 3(3) (section LE 3 holding companies), the definition of "beneficiary income" in section OB 1, and Schedule 22A.

Application dates

The amendments are retrospective and apply from the beginning of the income year corresponding to the 2005-06 tax year.

Detailed analysis

Section DZ 13 and Schedule 22A

Section DZ 13 has been amended to more clearly reflect an intended policy change.

Following the repeal of the 1994 Act, section DZ 13 of the 2004 Act was introduced to ensure that a person can

continue to be allowed a deduction for the unamortised balance of certain types of expenditure to which section DO 4 of the 1994 Act applied.

Section DO 4 of the 1994 Act allowed a deduction for certain types of farming and agricultural expenditure but required that deduction to be spread over a number of years. It contained the current spreading rules and two different set of amortisation rules for qualifying expenditure incurred in the 1995 and prior tax years.

Most of these expenditures from the 1995 and earlier tax years were expected to be fully amortised by the end of the 2005 tax year. However, because the amortisation of the expenditure could occur only if the expenditure was "of benefit to the business" in a tax year, there was a possibility that a person may have an unexpired balance of these qualifying expenditures at the end of the 2005 tax year. As the 2004 Act repealed section DO 4 of the 1994 Act, a new rule was required in the 2004 Act to ensure that a person could amortise any remaining balance of these earlier expenditures.

Therefore section DZ 13 was enacted to ensure that unamortised farming and agricultural expenditures incurred in the 1995 and earlier tax years can be allocated to a tax year occurring after commencement of the 2004 Act. As these expenditures are very long-dated, it was also considered appropriate for section DZ 13 to provide a way to terminate those earlier amortisation rules.

The policy intention for section DZ 13 was to provide for a person's unamortised balance of these qualifying expenditures at the end of the 2005 tax year to be allocated to the first tax year after commencement of the 2004 Act in which the "benefit to the business" test was satisfied. However, the provision as originally enacted was unclear and did not achieve this purpose, with the result that the unamortised balances could not be allocated to any tax year.

The amendment to section DZ 13 ensures that a person is allowed a deduction for the amount of the unamortised balance of these qualifying expenditures at the end of the person's 2004-05 tax year. This deduction is then allocated to the first income year after commencement of the 2004 Act in which the unamortised expenditure satisfies the criteria of "being of benefit to the business".

In addition, section DZ 13 was inadvertently omitted from Schedule 22A of the 2004 Act (the Schedule that contains a list of the intended changes made in the 2004 Act). The amendment also corrects that omission.

Sections EH 37 and EH 81

The definition in section OB 1 of "specified period" as it relates to the income equalisation scheme has been amended to correct an inadvertent change in wording.

The definition of "specified period" in the 2004 Act contained an unintended change in that it changed the timing of the "specified period" to 30 September each year, being six months after 31 March each year. Under the 1994 Act the "specified period" ended six months after the person's balance date for income tax purposes.

The correct policy is that deposits to the income equalisation scheme should be made within six months of the end of a person's balance date for income tax purposes. The amendment ensures that the 2004 Act continues that intended policy outcome.

Section LE 3 holding companies

Section LE 3(3)(e) has been amended to ensure that the tax outcome under the 2004 Act is the same as the 1994 Act.

Section LE 3 is part of the foreign investor tax credit rules and is intended to ensure that dividends paid by a New Zealand-resident company to its non-resident shareholders have an effective New Zealand tax rate of no greater than 33%. This is achieved by providing the resident company paying the dividend with a foreign investor tax credit, which is then subtracted from the company's income tax liability for that tax year.

When the investment into New Zealand is through a New Zealand-resident holding company, however, that company may have insufficient taxable income to utilise the foreign-investor tax credit. This will occur, for example, when all dividends the holding company receives from the New Zealand group of companies are either fully imputed dividends or exempt dividends.

This problem was addressed by section LE 3 of the 1994 Act. Under section LE 3, and only for the purpose of the foreign investor tax credit rules, the New Zealand-resident holding company is treated in a similar way to a non-resident in relation to dividends it derives from its New Zealand group of companies.

This section LE 3 concession is limited to a holding company that derives dividends that are of the types listed in section CB 10 of the 1994 Act. Section LE 3(3)(e) in the 2004 Act, as originally enacted, inadvertently changed the effect of the law by treating the section LE 3 holding company status as revoked if it derives dividends of any type referred to in sections CW 9 to CW 11 of the 2004 Act (the corresponding provisions to section CB 10 of the 1994 Act).

Section LE 3(3)(e) has been amended to restore the outcome that was achieved under the 1994 Act.

Beneficiary income

In section OB 1, the definition of "beneficiary income", in paragraph (b)(ii), has been amended to cross-refer to section CC 3(2).

The cross-reference to section CC 3, as originally enacted in the 2004 Act, was too broad and potentially led to the result that no accrual income could be included in

beneficiary income. The correct policy is that for taxation purposes, beneficiary income does not include income derived by a trustee from the forgiveness of a debt owed by the trustee, but otherwise may include accrual income.

The amendment corrects this position by ensuring the cross-reference is to section CC 3(2), which relates only to certain types of debt forgiveness.

MISCELLANEOUS REMEDIAL AMENDMENTS

Disclosure provision for premiums paid to non-resident insurers

Section FC 17 of the Income Tax Act 1994

The double tax agreement between New Zealand and The Netherlands was recently amended to close a tax avoidance opportunity involving the payment of cross-border insurance premiums. As a result, a special disclosure provision in section FC 17 of the Income Tax Act 2004 requiring the disclosure to the Commissioner of premiums paid to residents of The Netherlands became unnecessary. This provision has therefore been repealed with effect from 1 April 2005, the same application date as the related amendment to the double tax agreement.

Redundant foreign tax credit provision

Section LC 15 of the Income Tax Act 2004

The dividends Article in the double tax agreement between New Zealand and the United Kingdom was recently replaced, with application from the 2005-06 income year. Section LC 15 of the Income Tax Act 2004, which related to the claiming of foreign tax credits from the United Kingdom, was relevant only for the purposes of the previous dividends Article, which allowed New Zealand-resident individuals a tax credit in the United Kingdom. (The new dividends Article follows the standard New Zealand model and does not allow such a credit.) The redundant section LC 15 has therefore been repealed, with application from the date the Income Tax Act 2004 came into effect, the same application date as the new dividends Article.

Redundant provisional tax provisions

Section MB 2 of the Income Tax Act 2004

Section MB 2(1)(aa) and (ab) of the Income Tax Act 2004, which related to provisional tax payments, were redundant and have been repealed with application from the commencement of the Income Tax Act 2004. These provisions were first enacted in 1998, with application to provisional tax payments for the 1998-99 income year only, and should not have been re-enacted as part of the Income Tax Act 2004.

Dividend withholding payment credit cross-references

Sections ME 5 and MG 5 of the Income Tax Act 2004

Sections ME 5(1)(h) and MG 5(1)(e) of the Income Tax Act 2004, which relate to debiting imputation credit and dividend withholding payment accounts, contained an incorrect cross-reference. The reference to “section LD 8(1)(a)” has been replaced with “section LD 8(1)(c)”, with application from the date the Income Tax Act 2004 came into effect.

Resident withholding tax exemption for community trusts

Section NF 9 of the Income Tax Act 1994 and the Income Tax Act 2004

An income tax exemption for trustees of community trusts – section CB 4(1)(m) of the Income Tax Act 1994 – was enacted by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 with application from the 2004-05 income year. An amendment allowing a resident withholding tax exemption certificate to be issued to a trustee of a community trust has been made to section NF 9 of the Income Tax Act 1994 to match this income tax exemption, to apply from the 2004-05 income year. An equivalent amendment has also been made to the Income Tax Act 2004.

Late payment penalty cross-reference

Section NH 3 of the Income Tax Act 2004

Section NH 3(4) of the Income Tax Act 2004, relating to the disallowance by the Commissioner of an election by a company to satisfy a dividend withholding payment liability by reducing a net loss, contained a reference to an additional tax penalty imposed under former section 150 of the Tax Administration Act 1994. The reference was redundant and has been replaced by a reference to late payment penalty imposed under section 139B of the Tax Administration Act 1994, with application from the date the Income Tax Act 2004 came into effect.

Definition of “finance lease”

Section OB 1 of the Income Tax Act 1994 and sections FC 8B and OB 1 of the Income Tax Act 2004

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 amended the finance lease rules in the Income Tax Act 1994 and Income Tax Act 2004.

Some of the amendments made to the Income Tax Act 2004 were not consistent with leasing terminology used in other provisions in that Act. Several minor changes have therefore been made to ensure consistency of terminology.

- The various references to "lease term" in the definition of "finance lease" in section OB 1 and in section FC 8B(2) and (3) have been replaced with "term of the lease".
- The use of the term "personal property lease asset" in the definition of "finance lease" in section OB 1 of the Income Tax Act 2004 has been standardised.
- The reference to the term "lease payments" in the definition of "finance lease" in section OB 1 of the Income Tax Act 2004 has been replaced with "personal property lease payments".

Several features of the definitions of "finance lease" in the Income Tax Act 1994 and Income Tax Act 2004 have also been amended for consistency purposes.

- The requirement that the definition in the Income Tax Act 1994 applies to leases entered into on or after 20 May 1999 has been reinstated.
- The requirement that it be ascertained whether a leasing arrangement is a finance lease at the time the lease is entered into has been amended to apply to all limbs of the definition, except an arrangement involving a lease term that is more than 75% of the lease asset's estimated useful life. This exception is necessary because consecutive or successive leases may satisfy the 75% requirement only some time after the beginning of the lease.

The amendments to the Income Tax Act 2004 apply from the date the Act came into effect while the amendments to the Income Tax Act 1994 apply for arrangements entered into on or after 29 March 2004.

Definition of "net loss"

Section OB 1 of the Income Tax Act 1994 and the Income Tax Act 2004

The definition of "net loss" in section OB 1 of the Income Tax Act 2004 contained two drafting errors. First, the cross-reference to "section 177C(4)" of the Tax Administration Act was incorrect and has been replaced with "section 177C(5)". Secondly, the reference to the amount "written off" by the Commissioner has been replaced by a reference to the amount "extinguished" by the Commissioner, in order to align the definition with the correct terminology used in section 177C. These amendments apply from the date the Income Tax Act 2004 came into effect. An equivalent amendment to the second amendment has been made to the definition of "net loss" in section OB 1 of the Income Tax Act 1994, with application from 1 July 2002.

Superannuation fund expense transfers

Section DI 3 of the Income Tax Act 1994

A master superannuation fund is now allowed to elect in which year (2000-01 or 2001-02) it will deduct certain expenses of a member fund. The amendment deals with a timing anomaly that arose from an amendment to section DI 3 in 2001. Master funds previously deducted the expenses on the day they were incurred but, after the change, deducted the expenses in the income year in which they were incurred. Master funds could not deduct 2000-01 member fund expenditure incurred after their 2000-01 balance date.

Small claims jurisdiction of Taxation Review Authority

Section 89E of the Tax Administration Act 1994

Section 89E allows taxpayers to elect in their notice of proposed adjustment (NOPA) to have their dispute heard in the small claims jurisdiction of the Taxation Review Authority in certain circumstances. Section 89E refers to a NOPA issued under section 89D (a taxpayer NOPA to an Inland Revenue assessment) but not section 89DA (a taxpayer NOPA to a self-assessment). Section 89E has therefore been amended to include a cross-reference to section 89DA to ensure that taxpayers can elect to use the small claims jurisdiction of the Taxation Review Authority in self-assessment situations. The amendment applies for disputes that are begun under Part 4A of the Tax Administration Act on or after 1 April 2005.

Redundant binding rulings provision

Section 91E of the Tax Administration Act 1994

Section 91E(6) contained a definition of "assessment" for the purposes of the Commissioner making a private ruling. This definition was redundant, because of the general definition of "assessment" in section 3 of the Tax Administration Act, and has therefore been repealed, with application from the date of enactment.

Non-filing taxpayers

Sections 92 and 108 of the Tax Administration Act 1994

Sections 92(4) and 108(1B) were enacted as part of the self-assessment amendments in 2001 and were intended to ensure that the tax position of a non-filing taxpayer for an income year becomes certain and final in the same way as for filing taxpayers. These provisions became unnecessary under section BC 1(1) of the Income Tax Act 2004, which provides that the income tax liability of a non-filing taxpayer is the total tax withheld in respect of the taxpayer; this ensures that the tax position of a

non-filing taxpayer becomes certain and final. Accordingly, sections 92(4) and 108(1B) have been repealed, with application from the 2005-06 income year.

Use-of-money interest for income statement recipients

Section 120C of the Tax Administration Act 1994

The provisions concerning the calculation of use-of-money interest in relation to income statement recipients could previously produce incorrect results. In particular, paragraph (b)(iii) of the definition of "interest period" in section 120C(1) of the Tax Administration Act 1994 did not work properly in some cases and could result in an interest end-date that was before the interest start-date. The provision was also unnecessary as the general provisions cater adequately for income statement recipients. Accordingly, the provision has been repealed, with application from the 2004-05 income year.

Updating unacceptable tax position provisions

Section 141B of the Tax Administration Act 1994

Section 141B is concerned with the imposition of shortfall penalties in relation to unacceptable tax positions. Before 1 April 2003 the provision was concerned with unacceptable interpretations of tax laws. Section 141B(5) and (6) has been updated to take into account this change of approach in section 141B from unacceptable interpretation to unacceptable tax position. The amendments apply from the date of enactment, 21 December 2004.

Reduction of penalties for previous behaviour

Section 141FB of the Tax Administration Act 1994

Section 141FB(5) allows tax shortfalls to be grouped and effectively treated as a single penalty. This provision has been amended to allow all grouped tax shortfalls to qualify for the reduction for previous behaviour. The amendment has the same application date as the new section 141FB – 21 December 2004.

GST on imports

Section 12 of the Goods and Services Tax Act 1985

Section 12, which relates to the imposition of GST on imports, has had a minor clarifying amendment made to it. The change involved making the input tax terminology in section 12(4)(d)(ii) consistent with the approach used in section 12(4)(c) by referring to an "input tax deduction" under section 20(3). The amendment applies from the date of enactment, 21 June 2005.

Adjustment provision

Section 25 of the Goods and Services Tax Act 1985

Section 25(2)(a) previously referred to "tax charged by the supplier", which was incorrect because it is the GST Act itself that charges tax on supplies. A clarifying amendment has been made to correct the error by adopting the approach used in section 25(4), with application from the date of enactment, 21 June 2005.

Factored debts provision

Section 26A of the Goods and Services Tax Act 1985

Section 26A requires registered persons who account for GST on a payments basis to pay GST on the remaining book value of a debt when it is factored. This provision has been restructured to integrate it with the calculation of tax payable in section 20 of the GST Act, with application from the date of enactment, 21 June 2005.

Refund of excess tax

Section 45 of the Goods and Services Tax Act 1985

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 amended the timeframes within which tax refunds are allowed under the Income Tax Act 1994, Income Tax Act 2004 and section 45 of the Goods and Services Tax Act 1985.

The terminology used in the new refund provision in section 45 of the Goods and Services Tax Act 1985 has been amended where appropriate to align with the terminology used in the new refund provisions in the Income Tax Act 2004.

The amendments have the same application date as the new section 45 of the GST Act and apply to taxable periods beginning on or after 1 April 2005.

Meaning of "precedent"

Section 13B of the Taxation Review Authorities Act 1994

A definition of "precedent" has been recently included in the Taxation Review Authorities Regulations 1998 to clarify that a "precedent" case is one that has wider implications for other taxpayers. For consistency, a similar amendment has been included in the Taxation Review Authorities Act 1994, where "precedent" is referred to in section 13B(1)(b). The amendment applies for disputes that are begun on or after 1 April 2005.

OTHER LEGISLATION

THE CHARITIES ACT 2005 – TAX IMPLICATIONS

The new Charities Act enacted in April 2005 established a Charities Commission which came into being on 1 July 2005. The Commission is required to provide a registration and monitoring system for charitable organisations and support and education to the charitable sector.

Several changes have been made to the Income Tax Act 2004, Tax Administration Act 1994 and the Estate and Gift Duties Act 1968 as a result of the passing of the Act.

The registration of charities is planned to start in late 2006. The registration system will be called the "Charities Register". The Commission will communicate with the charitable sector as it moves closer to opening this Charities Register and will support organisations wanting to register.

This article discusses the Charities Commission and the associated tax changes.

Background

The Charities Act arose out of concern that the charitable sector needed to be more accountable for, and transparent in, its actions to the donating public, funders and the government. The government decided to introduce a number of legal requirements intended to ensure a greater degree of transparency and accountability. The most significant development was the decision to establish a register of charitable organisations. Another initiative was the requirement that charitable organisations file an annual return.

The need for changes was first raised in the June 2001 discussion document *Tax and Charities*. The government subsequently set up a working party which recommended establishing a charities commission.

Key features

The definition of "charitable purpose"

The Charities Act does not change the well-established common law definition of "charitable purpose" and, in fact, uses that definition as the basis for determining to whom the Act applies. Under the common law definition, the four categories of charitable purpose are:

- the advancement of education;
- the advancement of religion;
- the relief of poverty; and
- benefit to the community.

The role of the Charities Commission

In keeping with the dual objectives of establishing a registration and monitoring system for charitable organisations, and providing support and education to the charitable sector, the Commission has been given a varied range of functions, including:

- promotion of public trust and confidence in the charitable sector;
- encouragement of the effective use of charitable resources;
- education of charitable organisations about matters of good governance and management;
- deciding applications for registration as a charitable entity;
- monitoring entities to ensure they continue to qualify for registration;
- collecting and processing annual returns submitted by charitable entities;
- reporting and making recommendations about charitable sector matters; and
- stimulating and promoting research about the charitable sector.

A charitable entity's purposes must fall into at least one of these categories. Furthermore, in carrying out this purpose the charitable entity must, with the exception of the relief of poverty, benefit an appreciably significant section of the community (public benefit test).

The Charities Act indicates that a charitable entity will not be disqualified from registering if it also has a secondary or supplementary non-charitable function (such as advocacy) as part of its charitable purpose. Arguably this is merely a clarification of current law.

Benefits associated with registration

Registration with the Commission will be voluntary and will not alter a charity's legal status. An unregistered charitable entity will still be able to call itself a charity and collect funds from the public. However, there will be benefits for charitable entities registered by the Commission:

- *Tax-exempt status*

  Registration is voluntary. However, a charitable organisation is required to register to maintain the tax benefits currently available to charities. These benefits include:

- an exemption from income tax for non-business income derived by charities (section CW 34 of the Income Tax Act 2004);
- an exemption for business income derived by or in support of charities (section CW 35 of the Income Tax Act 2004);
- rebates for individuals and deductions for companies and Maori authorities for charitable donations; and
- exemption from gift duty.

Amendments to the Income Tax Act 2004 and Estate and Gift Duties Act 1968 mean that only charities registered with the Commission will be exempt from income tax and gifts made to them will be exempt from gift duty.

- *Being listed on the Charities Register*

  Only entities registered with the Commission can call themselves registered charitable entities. Certain information about each registered entity will be publicly available by searching the Register. The Register will be at www.charities.govt.nz once it is open.

- *Getting a registration number*

  The Commission will give registered charitable entities a registration number. Charitable organisations can display this number on promotional material. This will tell the public and funding organisations that the charity has met the requirements for registration.

- *Information on the charitable sector*

  By registering, charitable organisations will provide the Commission with information on the charitable sector in New Zealand. This, in turn, will help the Commission fulfil its education and support function to the sector and public.

- *Attending the Commission's annual meetings*

  The Commission will hold annual meetings that can be attended by registered charitable organisations. The meetings will give charitable organisations an opportunity to have a say in the work of the Commission.

Obligations associated with registration

To register, charitable organisations must:

- submit a copy of their rules;
- provide information about their current and proposed charitable activities;
- register the officers of the organisation;
- file an annual return within six months of their nominated balance date; and
- notify the Commission if certain information about their organisation changes.

If a registered charitable entity does not comply with the Act, the Commission has the authority if necessary, to:

- impose administrative penalties;
- issue warning notices;
- publicise instances of non-compliance;
- undertake further investigations; and
- deregister charities if necessary.

The Commission will also have the authority to ensure registered charitable organisations are fulfilling their described purpose and complying with the Act.

Tax implications

Given the link between registration and tax-exemption, the charities that can register are primarily those that would also qualify for the exemption from income tax for non-business income derived by those organisations, as set out in section CW 34 of the Income Tax Act 2004. In addition, some entities will be automatically registered.

Correspondingly, sections CW 34 and CW 35 of the Income Tax Act 2004 have been amended to limit their application to entities registered as registered charitable entities. Likewise, the gift duty exemption on gifts made to charities has been amended to apply only to societies, institutions and trustees of trusts who are registered as charitable entities.

The secrecy provisions in the Tax Administration Act 1994 have been relaxed to enable Inland Revenue to share information with the Commission.

Inter-departmental responsibilities

As the agency responsible for the registration of charities, the Charities Commission will determine whether the organisation's purposes are charitable at law. Inland Revenue will continue to be responsible for ensuring that charitable organisations are eligible for various tax exemptions. Inland Revenue is working with the Commission using a "one-stop shop" framework to develop a process so that, as a consequence of registration with the Commission, an organisation will be treated as being eligible for the tax exemptions. Inland Revenue will retain the ability to undertake tax audits to ensure an organisation is charitable and complying with tax legislation. The Department of Internal Affairs is the department responsible for the Commission.

Donee status

This change in classification means the Commission is not required to give effect to government policy but is instead required to have regard to government policy when directed by the responsible minister. As it was

not considered appropriate for the Commission to make decisions that impact on the revenue base, the proposed function of registering all donee organisations remains with Inland Revenue.

Therefore there have been no legislative changes to the provisions that enable individuals to claim rebates, and companies to claim deductions, in relation to their charitable donations. This means that, in accordance with section KC 5 of the Income Tax Act 2004, responsibility for assessing donee status remains with Inland Revenue for entities operating domestically, and with Parliament for entities with overseas charitable purposes.

The fact that various functions remain with Inland Revenue does not necessarily mean that an entity will have to apply separately to Inland Revenue for the exemptions when it makes a registration application to the Charities Commission. An integrated process is being developed so that as a consequence of registration with the Commission an organisation will be eligible for donee status. Organisations seeking donee status that are not charities will need to deal with Inland Revenue.

Application date

The establishment of the Charities Commission on 1 July 2005, the amendments to the Income Tax Act 2004, Tax Administration Act 1994 and the Gift Duties Act 1968 will come into force through an Order in Council. The Charities Act provides that one or more Orders may be made bringing different provisions into force on different dates. The registration process is planned to be up and running in 2006. The tax provisions are likely to apply following the registration process, in the 2007-08 income year.

Detailed analysis of tax implications

Register of charitable entities

Section 13 of the Charities Act details the essential requirements that must be met by a charity before it can be registered by the Commission. Given the intent to have the same test for registration as for the charities' general income tax exemption, the registration test in section 13(1) reflects the current wording in section CW34 (1)(a) and (b) of the Income Tax Act 2004, which provides an exemption for non-business income of charities, whether they are trusts, societies or institutions.

Under section 13(1) an entity qualifies for registration as a charitable entity if,

(a) in the case of the trustees of a trust, the trust is of a kind in relation to which an amount of income is derived by the trustees in trust for charitable purposes; and

(b) in the case of a society or an institution, the society or institution –

  (i) is established and maintained exclusively for charitable purposes; and

  (ii) is not carried on for the private pecuniary profit of any individual.

In addition, section 13(2)(a) and (3) of the Act allows a binding ruling issued under the Tax Administration Act 1994 to be determinative of whether the income of the entity has been derived for charitable purposes in accordance with the Income Tax Act 2004. This saves a charity that has a binding ruling the compliance costs of having to apply for registration. But once the ruling ceases to apply the Commission can assess the organisation's status in the same way as that of other applicants. Under section 13(4) automatic registration ceases if the period for which the ruling applies expires, or if the ruling no longer applies to the entity, or if the repeal or amendment of a taxation law changes the way the taxation law applies in the ruling.

Similarly, section 13(2)(b) of the Charities Act provides that if the income derived by the trustees is deemed to be income derived by trustees in trust for charitable purposes, under section 24B of the Maori Trust Boards Act 1955, this is sufficient for automatic registration.

Section 14 of the Charities Act enables the Commission to make reasonable assumptions about the future derivation of income by an entity when an entity is newly established and has not yet derived income for charitable purposes. Also, section 20 of the Act allows for the backdating of registration to enable registration to apply from when a gift is made to establish a trust.

An entity cannot register, however, if under the Terrorism Suppression Act 2002 it is designated as a terrorist entity or an associated entity, or is convicted of an offence under section 7 of that Act.

Businesses carried on for charitable purposes

The Charities Act does not provide for the separate registration of businesses carried on by, or for, the benefit of charities. This means that a business that is carried on by a separate legal entity from the charity to which its profits are applied generally cannot register as a charitable entity unless it meets the general charitable purpose tests in the Act in its own right. Not being registered, however, does not negate the need for the business to observe the requirements in section CW 35 of the Income Tax Act 2004 if its income is to be exempt from income tax. Likewise, a registered charitable entity that derives business income in its own right must also meet the requirements of section CW 35.

Income tax exemption limited to registered charitable entities

Both sections CW 34 and 35 of the Income Tax Act 2004 have been amended to limit their application to entities

registered as charitable entities (see sections 65 and 66 of the Charities Act. This means, for example, in the case of a business carried on separately from a charity, that the income of the business must be derived for the benefit of a registered charitable entity. Charitable income tax exemptions do not apply to council-controlled organisations or local authorities for income derived from council-controlled organisations.

Additional definitions

Section 68 of the Charities Act adds a definition of "registered as a charitable entity" to section OB 1 of the Income Tax Act 2004, and section 70 of the Charities Act adds a definition of "Charities Commission" to section 3(1) of the Tax Administration Act 1994.

Charitable bequests

Section CW 36 of the Income Tax Act 2004 provides an income tax exemption for income earned by charitable bequests. Section 66 of the Charities Act amends section CW 36 of the Income Tax Act 2004 to provide a grace period for entities receiving charitable bequests before they need to register with the Commission. This provision deals with the situation where, for example, a bequest creates a charitable trust and it takes over a year for the estate to be settled. In such cases, registration as a charitable entity is not required until the end of the income year following the income year in which the person making the bequest died. After that time, income will be taxable unless the entity is registered.

Information sharing

Section 81(4) of the Tax Administration Act 1994 outlines the circumstances when the Commissioner of Inland Revenue may disclose information that would otherwise be subject to the tax secrecy provisions. Section 71 of the Charities Act extends section 81(4) to allow for information to be shared with the Charities Commission provided the person is authorised by the Commission to receive the information and the Commissioner of Inland Revenue considers that:

- it is not undesirable to disclose the information; and
- the information is reasonably necessary to enable the person to carry out their duties as lawfully conferred by the Charities Commission.

This relaxation of the secrecy provisions will, for example, enable Inland Revenue to pass on to the Commission its list of entities that have sought confirmation of their charitable status over the years, thereby streamlining part of the registration process.

Conversely, section 30 of the Charities Act enables the Commission to share registry information or documents with Inland Revenue when doing so is for the purpose of assisting the exercise of powers or functions under the Inland Revenue Acts. This will help to achieve a more integrated approach between registration and qualification for a range of tax exemptions.

Estate and Gift Duties Act

Section 73(1) of the Estate and Gift Duties Act 1968 has been amended by section 72 of the Charities Act so that the gift duty exemption applies only to gifts made to societies, institutions and trustees of trusts who are registered as charitable entities.

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, Court of Appeal, Privy Council and the Supreme Court.

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.

CERTAIN ACC "INTEREST" RECEIPTS EXEMPT FROM TAX

Case:	CIR v Buis and Burston
Decision date:	14 June 2005
Act:	Accident Rehabilitation and Compensation Insurance Act 1992, Income Tax Act 1994
Keywords:	interest, ACC payments/receipts, penalty payments

Summary

Payments of "interest" by the Accident Compensation Corporation (ACC) under a specific ACC provision are exempt from tax in the hands of the recipient.

Facts

This judgment is from an appeal by the Commissioner of the TRA cases W54 & W58. It involved two taxpayers who received earnings related compensation from ACC. Payment to the taxpayers was delayed due to a dispute between them and ACC.

As a result of the delay, the taxpayers were awarded a lump sum payment of interest for late payment of the compensation (under section 72 of the Accident Rehabilitation and Compensation Insurance Act 1992 (ARCIA)).

The Commissioner assessed both interest payments as assessable income.

Decision

Section 76

Section 76 of the ARCIA provides a statutory framework for when certain ACC payments were taxable or exempt from tax. The Judge found that section 76 referred to compensation in relation to accidents. The section 72 payments were not paid as a result of any accident and so section 76 did not apply.

The Judge was of the view that payments under section 72 were in the nature of a penalty against the ACC for not paying out compensation when it should have.

CD5

The IRD argued in support of its submission that:

> "The question is whether a statutory penalty imposed to discourage administrative delays is in the hands of the recipient gross income under ordinary concepts".

The Judge found that the payment in the hands of the taxpayers was in the nature of penalty payments and therefore capital.

Furthermore the Judge noted that there were no withholding tax obligations, no reporting obligations and no procedural mechanisms between ACC and Inland Revenue.

For these reasons the appeal was dismissed.

TAXPAYER'S FAILURE TO PURSUE APPEAL RESULTS IN DISMISSAL FOR WANT OF PROSECUTION

Case:	TJ Power v CIR
Decision date:	22 July 2005
Act:	Income Tax Act 1976, High Court Rules
Keywords:	Case on Appeal, want of prosecution

Summary

The taxpayer sought to appeal a TRA decision but failed to pursue its appeal in a businesslike manner, resulting in the dismissal of the appeal for want of prosecution.

Facts

The taxpayer was unsuccessful before the TRA in *Case M83* (1990) 12 NZTC 2,498. The taxpayer wished to appeal from the TRA and requested a transcript of the evidence. However there was debate as to who pays for such a transcript until 1993 when the TRA advised the tapes of the evidence had been lost (thus no transcript would be available).

The taxpayer did prepare a draft case on appeal from the TRA but its form was so unacceptable to the TRA (which had to sign the case as it originates from the TRA) that it requested the CIR to prepare the case on appeal. It was this compromise document that was eventually filed with the High Court in 1996.

Thereafter no steps were taken to process the appeal by the taxpayer until 2004 when the taxpayer, through its agent, wrote to the TRA asking for the transcript again. The Commissioner then requested the appeal be dismissed for want of prosecution. The taxpayer opposed this and sought a re-hearing of the case at the TRA (with new witnesses).

Decision

Courtney J concluded that there were three tests the CIR had to satisfy to get the appeal dismissed for want of prosecution (then r718B now r 478 High Court Rules):

- *There is inordinate delay in progressing the appeal*. On these facts the Court considered the delay from 1996 (when the appeal was filed) to present was inordinate;
- *The delay was inexcusable*. The Court concluded there was no reasonable excuse for the delay (indeed that no excuse at all had been offered by the taxpayer);
- *There is serious prejudice to the respondent*. The Court considered the Commissioner as respondent had been seriously prejudiced as there was no payment of the debt and interest was not accruing to it (given the original decision predated the interest regime).

The appeal was dismissed for want of prosecution.

Courtney J also dismissed the taxpayer's application for the matter to be remitted back to the TRA on the basis that the delay seriously prejudiced the Commissioner (in getting evidence from witness some 20 to 30 years after the events) and that to allow a new witness to be called by the taxpayer was "grossly unfair" to the Commissioner. It was considered "highly relevant" that it was the taxpayer's own dilatory behaviour that put the parties into this position.

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September 2005

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

October 2005

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

31 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendars 2004–2005 and 2005–2006*. These calendars reflect the due dates for small employers only—less than $100,0000 PAYE and SSCWT deductions per annum.

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