TAX INFORMATION BULLETIN

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GET YOUR TIB SOONER ON THE INTERNET

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 **tibdatabase@ird.govt.nz** with your name, details and the number recorded at the bottom of the mailing label.

QUESTION WE'VE BEEN ASKED

This section of the *TIB* sets out answers to some enquiries we've received. We publish these as they may be of general interest to readers. A general similarity to items published here will not necessarily lead to the same tax result. Each case should be considered on its own facts.

Correction to earlier item

THRESHOLD TO ACCOUNT FOR GST ON A PAYMENTS BASIS

On page 17 of *Tax Information Bulletin* Vol 18, No 4 (May 2006) there is an item stating that the taxable supplies threshold for accounting for GST on a payments basis is to be read as GST-exclusive. The equivalent GST-inclusive amount should, on current rates, be read as $1,462,500, not $1,625,000 as previously advised.

We apologise for any inconvenience this may have caused.

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 06/01

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 LetterBox Channel Limited ("LBC"), a wholly owned subsidiary of New Zealand Post Limited.

Taxation Law

All legislative references are to the Income Tax Act 2004 ("the ITA") unless otherwise stated.

This Ruling applies in respect of sections DA 2(4), CE 1; definitions of "employment income", "extra pay", "income from employment", "salary or wages", and "withholding payment" in section OB 1; the definition of "source deduction payment" in section OB 2(1); the definition of "PAYE rules" in section OB 1, regulation 4(1) and clause 5(d) of Part A of the Schedule to The Income Tax (Withholding Payments) Regulations 1979 ("the Regulations"); and section 6(3)(b) of the Goods and Services Tax Act 1985 ("The GST Act").

The Arrangement to which this Ruling applies

The Arrangement is the engagement of persons ("the Runners") by Franchisees pursuant to a standard form contract for the delivery of newspapers, leaflets, brochures, catalogues, advertising material, samples and other such items to households and other premises throughout New Zealand. Further details of the Arrangement are set out in the paragraphs below.

1. LBC carries on the business of distributing newspapers, leaflets, brochures, catalogues, advertising material, samples and other such items to households and other premises throughout New Zealand.
2. LBC intends to implement a franchise model under which Franchisees will engage the Runners pursuant to a standard form contract, the conditions contained in which are required to be agreed to by the Runners when entering into the contact ("the Contract").
3. The Contract requires Runners to deliver particular items within a specified period, to each house, flat or other premises located within a designated area, by placing one of each item in each letter box (or other specified location). The Runners are paid specified rates per item delivered.
4. The Contract is attached to this Ruling as Appendix I.
5. The items delivered by the Runners pursuant to the Contract are not items the carrying of which requires LBC or the relevant Franchisee to be registered as a postal operator under the Postal Services Act 1998.

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

- The relationship between a Franchisee and the Runners is, and during the period of this Ruling will continue to be, entirely in accordance with the Contract affixed to this Ruling as Appendix I, and there are no other collateral contracts, agreements, terms or conditions, written or otherwise, relating to the engagement of the Runners.

How the Taxation Laws apply to the Arrangement

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

- For the purposes of the PAYE rules, any payment made to a Runner by a Franchisee pursuant to the Contract will not be "salary or wages" or "extra pay" within the meaning of those terms as defined

in section OB 1. To the extent that any such payment is also not a "withholding payment" it will therefore not be a "source deduction payment" as defined in section OB 2(1), for the purposes of the PAYE rules.

- For the purposes of sections DA 2(4) and CE 1, any payment made to a Runner by a Franchisee pursuant to the Contract will not be "income from employment" or "employment income" as those terms are defined in section OB 1.
- For the purposes of the PAYE rules, any payment made to a Runner by a Franchisee pursuant to the Contract will not be a "withholding payment" as defined in section OB 1.
- For the purposes of the PAYE rules, any payment made to a Runner by a Franchisee pursuant to the Contract will not fall within the class of payment specified in clause 5(d) of Part A of the Schedule to the Regulations and will not be declared to be a "withholding payment" by regulation 4(1) of the Regulations.
- For the purposes of the GST Act, the provision of services by any Runner to a Franchisee under the Contract will not be excluded from the definition of "taxable activity" in section 6 of that Act by section 6(3)(b) of that Act.

The period or income year for which this Ruling applies

This Ruling will apply for the period 1 January 2006 to 31 December 2011

This Ruling is signed on the 8th day of March 2006 by:

Maryanne Hansen
Manager, Corporates

Appendix 1

«Fr_Co_Name» FRANCHISEE LIMITED

CONTRACT FOR SERVICES
(Delivery of papers/circulars etc)

The delivery of circulars has become part of our Kiwi culture. As a delivery contractor you will provide a vital role in delivery of circular advertising, free newspapers and samples etc to households in your area. «Fr_Co_Name» believes that New Zealand's future depends on an entrepreneurial spirit. «Fr_Co_Name» looks forward to your contribution to this vision and sharing in the benefits of being in business with «Fr_Co_Name».

PARTIES

1. «Fr_Co_Name» Franchisee Limited, a duly incorporated company having its registered office at «Fr_Co_Regd_Add», ("«Fr_Co_Name»")
2. «Pers_Name» of«PERS__STREET», «PERS__TOWN__SUBURB», «PERS__CITY» ("the Contractor" or "you")

«Fr_Co_Name» is pleased to engage you as a delivery contractor from [insert Go Live date] on the terms and conditions set out in this contract.

DELIVERIES
You agree to:

- deliver all papers/circulars etc, received by you from «Fr_Co_Name» to the letterboxes on your Run, within the timeframes required by «Fr_Co_Name» and in accordance with the 'important things to do' and 'important things not to do' attached to this contract in **Schedule 1** ("**the Deliveries**"). (A map indicating the location of your Run is attached at **Schedule 3**);
- use reasonable care in making the Deliveries;
- ensure that any of your other commitments do not affect your obligations to «Fr_Co_Name» and
- comply with any applicable legislation including that related to tax and health and safety.

DELIVERY TIMEFRAMES
You agree to make the Deliveries within the timeframes communicated by «Fr_Co_Name» to meet the needs of Letterbox Channel's customers - exactly when you do the Deliveries within these timeframes is up to you.

DELIVERY EQUIPMENT
You are responsible for providing, at your expense, your own delivery equipment, such as bags, vehicles, footwear and wet weather gear. You are also responsible for ensuring that such equipment is well maintained, safe, and fit for its purpose.

PAYMENT
You will be paid for performing the Deliveries at the rates set out in the attached **Schedule 2**.

«Fr_Co_Name» will provide you with a draft monthly invoice for your contracted Deliveries. Upon receipt you are required to check the invoice details and advise «Fr_Co_Name» immediately of any errors in the information. Payment will be made by way of direct credit to your bank account within [insert time period]. An example of the form to be used for invoicing is at **Schedule 4**.

The fees specified in **Schedule 2** are the only amounts payable to you in respect of the Deliveries and are inclusive of all taxes (except GST) and other duties or levies.

TAXATION
You are solely responsible for your own Accident Compensation levies, income tax liabilities and GST liabilities or other income related payment or deductions that may be legislated from time to time.

You will register for GST with the Inland Revenue Department if required to do so. The current threshold for this is $40,000. You should refer any questions about this directly to the IRD. If you are GST registered please include your GST number at **Schedule 6.**

If you include your IRD number at **Schedule 6**, «Fr_Co_Name» will withhold income tax from its payments to you at the rate of 15% and remit it to the IRD on your behalf, unless you elect otherwise.

1

TERMINATION OF CONTRACT

Either you or «Fr_Co_Name» may terminate this contract for any reason whatsoever by giving two weeks' notice in writing. However, if «Fr_Co_Name» believes that you are in serious breach of this contract then «Fr_Co_Name» may terminate this contract immediately without notice. 'Serious breach' includes, but is not limited to:

- dumping papers/circulars;
- incomplete or late Deliveries;
- engaging in conduct which is, or may be, likely to injure the reputation or interests of «Fr_Co_Name» or the advertisers whose material you are delivering, or bring, or potentially bring, «Fr_Co_Name» into disrepute.

STATUS OF CONTRACTOR

You are engaged by «Fr_Co_Name» under a contract for services, which means that you are an independent contractor. This contract does not therefore create an employment relationship between you and «Fr_Co_Name».

You are free to accept other engagements or work while you are engaged by «Fr_Co_Name». However you agree not to undertake other work which conflicts with, or may conflict with, the interests of «Fr_Co_Name».

NO LIABILITY

You will undertake the Deliveries at your own risk. This means that «Fr_Co_Name» will not be liable to you (or any other person) for any loss resulting from your deliberate actions, your negligence, or where you breach any term of this Contract.

«Fr_Co_Name» CONTACT

«Fr_Co_Name» may appoint a supervisor to oversee your Run. Where this occurs the «Fr_Co_Name»'s supervisor will be your first point of call for all issues. If a supervisor has been engaged in your area their contact details will be included in **Schedule 2**.

DELIVERY OPTIONS

It is your responsibility to carry out the Deliveries as required under this contract. If you are sick or not able to personally carry out the Deliveries then you must arrange for others (such as a friend or family member) to do so. When you do this, you will be solely responsible for payment and all other obligations to others who assist you in this way. If you are unable to meet your contractual obligations to ensure the product is delivered within the Delivery window then you must notify «Fr_Co_Name» immediately.

FREQUENCY OF DELIVERIES

«Fr_Co_Name» does not guarantee any minimum amount of Deliveries as the volume of material available for distribution will vary depending on the time of year and needs of Letterbox Channel's customers – «Fr_Co_Name» will do its best to advise you of anticipated volumes as far in advance as possible.

COMPETITIONS

You and your immediate family members may be prevented from entering competitions advertised in material delivered by you, under the terms and conditions of those competitions.

ISSUES

If issues arise between «Fr_Co_Name» and you, both parties agree to raise and discuss issues in an open manner. If any outstanding issues are not able to be worked out between us, you agree to attend mediation in a further attempt to try and resolve them. If the issues are still unresolved after mediation has taken place, either you or «Fr_Co_Name» can refer them to the Disputes Tribunal for a binding decision to be made if the claim is for an amount less than $12,000. If the matter remains unresolved, the matter can be referred to the District Court for a binding ruling. If the amount claimed is greater then $12,000 then the matter can be referred to the District Court for a binding decision. The process to be followed is outlined further in **Schedule 5**.

HEALTH AND SAFETY

While «Fr_Co_Name» will make reasonable efforts to ensure that you operate safely, you are required to take all practical steps to ensure your own safety, and the safety of others and inform «Fr_Co_Name» immediately if any safety issues arise. You will be provided with a copy of «Fr_Co_Name»'s health and safety materials and are required to observe «Fr_Co_Name»'s policies and procedures at all times.

NOTICES

Every notice given under or in connection with this contract must be given in writing to the address of the other party as specified in **Schedule 3**.

2

COMPLETE AGREEMENT

Please sign the second copy of this contract, completing the details in Schedule 6 and return in the enclosed reply paid envelope.

This contract is the full and entire agreement between you and «Fr_Co_Name» and supersedes all previous written and oral agreements, representations and contracts between you and «Fr_Co_Name».

SIGNED for and on behalf of «Fr_Co_Name» Franchisee Limited
by:

____
name of authorised signatory

____
position

____
date

«Pers_Name» by:

____
Signature of Contractor

____
Signature of Witness

____
Name of Witness

____
Occupation of Witness

____
City/town of residence]

SIGNATURE OF PARENT OR GUARDIAN:

Where the Delivery Contractor is under the age of 15 years, this contract must be counter-signed by a parent or guardian. In signing this contract in the place indicated below, the parent or guardian declares that he or she understands and has explained the terms of this contract to the Delivery Contractor.

____
Name of Parent or Guardian

____
Signature of Parent or Guardian

Date: ____________

3

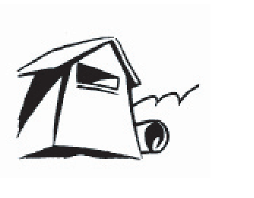
SCHEDULE 1

CONTRACTED SERVICES

«SUPERVISOR_OR_FRANCHISEE_CONTACT_NAME»

CONTACT NUMBER: «SUPERVISOR_OR_FRANCHISEE_CONTACT_PHONE»

IMPORTANT THINGS TO DO

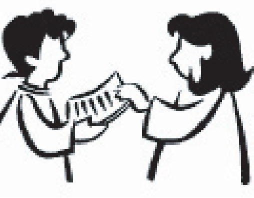


DO deliver to every letterbox at every house or flat in the area given to you. Read the map or street list given to you carefully. Put the circulars RIGHT INSIDE each letterbox. This stops the circulars getting wet, or being blown away.

DO start and finish as instructed. Your Franchisee/supervisor will inform you of the delivery windows for each circular. Deliveries must be made within these timeframes, however exactly when you deliver is up to you. From time to time you will receive instructions for a special delivery involving tighter than normal timeframes.

DO ask your Franchisee/supervisor for more papers when new houses or flats appear in your area. If you run short of circulars you MUST contact your Franchisee/supervisor and advise them.

DO notify your Franchisee/supervisor if you are unable to complete your delivery.



DO comply with directions given by your Franchisee/Supervisor about particular deliveries.

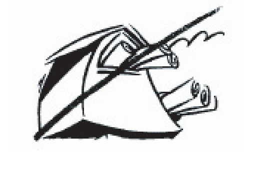
DO contact your Franchisee/supervisor for any questions or problems you have about deliveries, or anything else at all that you are not sure about. Your Franchisee is there to help you.

DO discuss as soon as possible with your franchisee/supervisor, any bad encounters with dogs, or any interference with material after you have delivered it. You will be asked to complete an incident/accident report.

IMPORTANT THINGS NOT TO DO

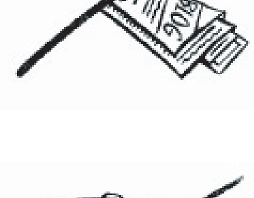
DON'T use the newspaper tube unless specifically instructed to do so. Never leave material on top of the letterbox, dropped on the lawn or in the hedge.

DON'T deliver to letter boxes bearing "NO CIRCULARS" type signs unless specifically instructed to do so by your Franchisee/supervisor. If unsure, please ask them



DON'T deliver to letter boxes that are obviously not being cleared.

DON'T fold one circular inside another. Each item must be kept separate. It is OK to pre-fold and "stack" the items on top of each other but NOT inside each other



DON'T throw away excess circulars. If you are getting too many, there must be a reason – talk to your Franchisee. If you run short of circulars, call them – they normally have spares. ALL SURPLUS circulars must be returned to your Franchisee/supervisor for disposal.

DON'T deliver after dark and please be careful crossing roads. If you have someone annoying you or any concerns about someone's behaviour during your delivery round, please discuss it immediately with your parents or the local police. Tell your Franchisee/ supervisor next. Only continue with your delivery if you feel it is safe to do so.

DON'T DUMP papers or circulars. If you do, your contract will be terminated without notice and you may be required to pay the cost of cleaning up as well as the cost of the circulars.

4

SCHEDULE 2

DELIVERY CONTRACTOR FEES FOR DELIVERY SERVICES

Each of the Contractor's fees for making the Deliveries for «Fr_Co_Name» will be calculated as follows:

[Insert 1 and/or 2 if applicable]

1. EXISTING BUSINESS

These are the rates applying to a Delivery Contractor previously employed by Letterbox Channel, for existing business, which is any business which had transacted with Letterbox Channel in the 12 months preceding the franchisee becoming operational and in respect of which the Delivery Contractor made deliveries in that 12 month period. These rates apply from commencement of this contract until 31 March 2008, after which time they expire and new rates will be set by your Franchisee by notice to you.

[Insert basis on which fees will be calculated]

2. NEW BUSINESS

For all new business, which does not meet the criteria described above, the following delivery rates will be applied from the commencement of this contract.

[Insert basis on which fees will be calculated]

3. NOTICES

All notices will be served on the parties at the following addresses:

«Fr_Co_Name» Franchisee Limited:

[Name]	Phone: [ ]
[full address]	Fax: [ ]

The Delivery Contractor:

[Insert name]	Phone: [ ]
[full address]	Fax: [ ]

4. «FR_CO_NAME» CONTACT

«SUPERVISOR_OR_FRANCHISEE_CONTACT_NAME»

Contact Number: «SUPERVISOR_OR_FRANCHISEE_CONTACT_PHONE»

5

SCHEDULE 3

MAP OF CONTRACTED RUN

Geographical Map Of Contracted Run

6

SCHEDULE 4
EXAMPLE

DELIVERY CONTRACTOR TAX INVOICE

Delivery Contractor's Name
Delivery Contractor's physical address

Page	:	x
P/E Date	:	dd/mm/yyyy
Invoice No	:	x
IRD No	:	xxxxxxxx
Contractor No	:	xxxxx
Franchise	:	«Fr_Co_Name» Franchise

Run No	Job No	Job Name	Date	Qty	Job Rate	Total Due

TOTAL GROSS TAXABLE AMOUNT (incl GST if any) $ 00.00 000.00 YTD

TAX WITHHELD @ 15% $ YTD

TOTAL NET AMOUNT $

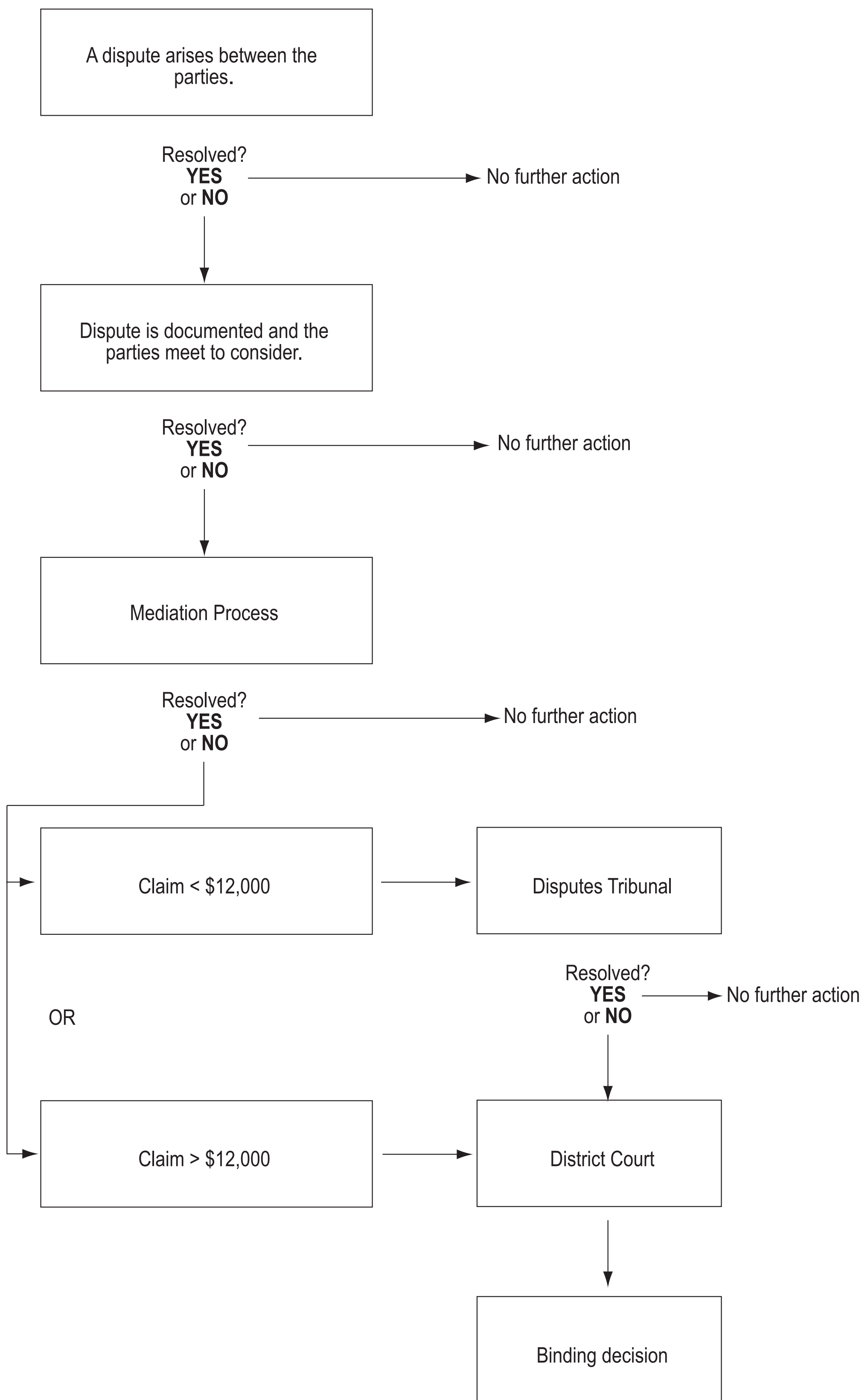
=========

Please check your invoice

7

SCHEDULE 5

Flowchart for handling disputes:



8

SCHEDULE 6

DELIVERY CONTRACTOR DETAILS *

1. DELIVERY CONTRACTOR PERSONAL DETAILS

Surname:

....

First Names:

....

Address:

....

....

....

Telephone Number:

Area Code ( ) Number...

If age is under 16 years of age, please give date of birth: / / /
(dd) (mm) (year)

2. DELIVERY CONTRACTOR BANK ACCOUNT DETAILS

[please attach a bank deposit slip or fill out the section below]

Name on Account:

....

Name of Bank:

....

Bank/Branch Account Number Suffix

| | | | | | | | | | | | | | | – | | | |

Please check your account number carefully. If unsure please check with your Bank.

3. INLAND REVENUE INFORMATION

IRD/GST No. (to be able to deduct tax)

| | | ■ | | | | ■ | | | |

4. INSTRUCTIONS NOT TO DEDUCT TAX

I do NOT want .... Franchisee Limited to deduct income tax from my monthly payment and remit it on my behalf to the IRD.

Signature: ....

Date: ....

** Your details will be provided to the Letterbox Channel for invoice processing, but will otherwise be kept confidential.*

9

PRODUCT RULING – BR PRD 06/02

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 LetterBox Channel Limited ("LBC"), a wholly owned subsidiary of New Zealand Post Limited.

Taxation Law

All legislative references are to the Income Tax Act 2004 ("the ITA") unless otherwise stated.

This Ruling applies in respect of sections DA 2(4), CE 1; definitions of "employment income", "extra pay", "income from employment", "salary or wages", and "withholding payment" in section OB 1; the definition of "source deduction payment" in section OB 2(1); the definition of "PAYE rules" in section OB 1, regulation 4(1) and clause 5(d) of Part A of the Schedule to The Income Tax (Withholding Payments) Regulations 1979 ("the Regulations"); and section 6(3)(b) of the Goods and Services Tax Act 1985 ('The GST Act').

The Arrangement to which this Ruling applies

The Arrangement is the engagement of persons ("the Supervisors") by Franchisees pursuant to a standard form contract for facilitation of the distribution of circular advertising, free newspapers and samples etc, through the management of Runners and administration of the services provided by the Franchisee to its clients. Further details of the Arrangement are set out in the paragraphs below.

1. LBC carries on the business of distributing newspapers, leaflets, brochures, catalogues, advertising material, samples and other such items (unaddressed mail) to households and other premises throughout New Zealand.

2. LBC intends to implement a franchise model under which Franchisees will engage the Supervisors pursuant to a standard form contract, the conditions contained in which are required to be agreed to by the Supervisors when entering into the contact ("the Contract").

3. The Contract requires Supervisors to facilitate the distribution of the unaddressed mail through oversight of Runners and administration of the delivery services provided by the Franchisee. The Supervisors are paid specified rates for the services they provide.

4. Supervisors will essentially fall into two categories:

   (a) those that are engaged by a Franchisee to operate in rural and regional towns where the Franchisee is not based ("Remote Town locations"); and

   (b) those that are engaged by a Franchisee to operate in cities and towns where the Franchisee is based ("Base City locations").

5. Supervisors in Remote Town locations will own and supply all the equipment necessary to perform the services, and they are likely to have other business interests in addition to their role as a Supervisor in a Remote Town location. Franchisees will engage these Supervisors pursuant to the Contract.

6. Supervisors in Base City locations will usually either:

   (a) be "Labour Processing Supervisors" (i.e. provide the processing and administrative services listed at Schedule 1 of the Contract); or

   (b) be "Physical Transport Supervisors" (i.e. provide the collection, transportation and physical delivery services listed at Schedule 1 of the Contract).

7. The Labour Processing Supervisors are unlikely to be suited to an independent contractor relationship, as their role will likely be of a full time nature situated at the Franchisee's premises, primarily under the instruction of the Franchisee. Franchisees will usually engage these Supervisors as employees.

8. However, the nature of the activities undertaken by Physical Transport Supervisors would be suited to independent contractor relationships. For Base City Locations, the collection and delivery services will be significant due to the high number of runs in these locations. It is likely that a Franchisee will contract multiple Physical Transport Supervisors due to the volume and time factors. This will generally not be a full time role for these Supervisors. They will own and supply all the equipment necessary to perform the services, and they are likely to have other business interests in addition to their role as a Physical Transport Supervisor. Accordingly, Franchisees will engage these Supervisors pursuant to the Contract.

9. The Contract is affixed to this Ruling as Appendix I.

10. The items, the collection and delivery of which is managed by the Supervisor pursuant to the Contract, are not items the carriage of which requires LBC or the relevant Franchisee to be registered as a postal operator under the Postal Services Act 1998.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

- The relationship between a Franchisee and the Supervisor is, and during the period of this Ruling will continue to be, entirely in accordance with the Contract affixed to this Ruling as Appendix I, and there are no other collateral contracts, agreements, terms or conditions, written or otherwise, relating to the engagement of the Supervisor.
- LBC has identified that Franchisees may engage Supervisors to carry out certain processing and administrative services on terms which, at law, should be characterised as a contract of service. In particular, paragraphs 6 and 7 of the Arrangement set out an example of such an arrangement, being the engagement of Labour Processing Supervisors in Base City locations which may not be suited to an independent contractor relationship. This Ruling does not apply to Labour Processing Supervisors in Base City locations who have entered into the Contract but who, at law, are employees carrying out the services under a contract of service.

How the Taxation Laws apply to the Arrangement

Subject in all respects to the conditions stated above, the Taxation Laws apply to the Arrangement as follows:

- For the purposes of the PAYE rules, any payment made to a Supervisor by a Franchisee pursuant to the Contract will not be "salary or wages" or "extra pay" within the meaning of those terms as defined in section OB 1. To the extent that any such payment is also not a "withholding payment" it will therefore not be a "source deduction payment" as defined in section OB 2(1), for the purposes of the PAYE rules.
- For the purposes of sections DA 2(4) and CE 1, any payment made to a Supervisor by a Franchisee pursuant to the Contract will not be "income from employment' or "employment income" as those terms are defined in section OB 1.
- For the purposes of the PAYE rules, any payment made to a Supervisor by a Franchisee pursuant to the Contract will not be a "withholding payment' as defined in section OB 1.
- For the purposes of the PAYE rules, any payment made to a Supervisor by a Franchisee pursuant to the Contract will not fall within the class of payment specified in clause 5(d) of Part A of the Schedule to the Regulations and will not be declared to be a "withholding payment" by regulation 4(1) of the Regulations.
- For the purposes of the GST Act, the provision of services by any Supervisor to a Franchisee under the Contract will not be excluded from the definition of "taxable activity" in section 6 of that Act by section 6(3)(b) of that Act.

The period or income year for which this Ruling applies

This Ruling will apply for the period 1 January 2006 to 31 December 2011.

This Ruling is signed by me on the 8th day of March 2006.

Maryanne Hansen
Manager, Corporates

Appendix 1

«FR_CO_NAME» FRANCHISEE LIMITED

CONTRACT FOR SERVICES
(Supervise delivery of papers/circulars etc)

The delivery of circulars is part of our Kiwi culture. Being a Contractor to a Franchise which distributes papers and circulars gives you the chance to be your own boss and run your own business. It is flexible and results based - you get out what you put in.

As a Contractor to the Franchise, you will facilitate the distribution of circular advertising, free newspapers and samples etc through the management of Contracted Runners and administration of the services «FR_CO_NAME» provides for its clients. «FR_CO_NAME» believes that New Zealand's future depends on an entrepreneurial spirit. «FR_CO_NAME» looks forward to your contribution to this vision and sharing in the benefits of being in business with «FR_CO_NAME».

PARTIES

1. «FR_CO_NAME» Franchisee Limited, a duly incorporated company having its registered office at «FR_CO_REGD_ADD» ("«FR_CO_NAME»")
2. «PERS__NAME» of «PERS__STREET» «PERS__TOWN__SUBURB» «PERS__CITY» ("the Contractor" or "you")

«FR_CO_NAME» is pleased to engage you as a Contractor from [insert "go live" date] on the terms and conditions set out in this contract.

SERVICES

You are required to complete the Services that are set out in the attached **Schedule 1**. Please read the Schedule carefully and ask «FR_CO_NAME» if you have any questions in relation to the Services.

In completing the Services you will:

- ensure that your other business commitments do not affect your obligations to «FR_CO_NAME»; and
- comply with any applicable legislation including that related to tax and health and safety.

EQUIPMENT

You are responsible for providing, at your expense, your own equipment, such as personal office supplies, telephone, vehicles and wet weather gear. You are also responsible for ensuring that such equipment is well maintained, safe and fit for its purpose.

PAYMENT

You will be paid for performing the Services at the rates set out in **Schedule 2**.

You will need to submit monthly invoices to «FR_CO_NAME»«DIST__NAME» for the Services you have completed. Once you have submitted correct and completed invoices to «FR_CO_NAME» then payment will be made by way of direct credit to your bank account within [insert time period]. An example of the form to be used for invoicing is at **Schedule 4**. «FR_CO_NAME» will provide you with a draft invoice statement at the end of each month and you will be required to check the details and sign and resubmit the invoice to «FR_CO_NAME» if the payment details are correct.

The fees specified in **Schedule 2** are the only amounts payable to you in respect of the Services and are inclusive of all taxes (except GST) and other duties or levies.

In the event of any dispute over invoiced services «FR_CO_NAME» may withhold the portion of the invoice that relates to the dispute pending resolution, provided that this facility shall not be used as a penalty and shall reflect only the relative value of the contracted services in dispute.

TAXATION

You are solely responsible for your own Accident Compensation levies, income tax liabilities and GST liabilities or other income related payment or deductions that may be legislated from time to time.

You will register for GST with the Inland Revenue Department if required to do so. The current threshold for this is $40,000. You should refer any questions about this directly to the IRD. If you are GST registered please include your GST number at **Schedule 6**.

1

You are responsible for the payment of your own taxes on payments made to you by «FR_CO_NAME» under this contract. «FR_CO_NAME» may be required to withhold taxes from its payments to you. If this is the case, the payment made to you by «FR_CO_NAME» will be reduced to the extent that tax is withheld. If «FR_CO_NAME» wrongly fails to withhold tax from payments to you, it will be entitled to recover such amounts from you.

TERMINATION OF CONTRACT

Either you or «FR_CO_NAME» may terminate this contract for any reasons whatsoever by giving four weeks notice in writing. However, if «FR_CO_NAME» believes that you are in serious breach of this contract then «FR_CO_NAME» may terminate this contract immediately without notice. 'Serious breach' includes, but is not limited to:

- dumping papers/circulars;
- failing to properly monitor and manage the deliveries undertaken by the Contracted Runners;
- inappropriate behaviour towards a Contracted Runner;
- theft or fraudulent or dishonest activities;
- incomplete or late completion of the Services, including late deliveries to the Contracted Runners;
- engaging in conduct which is, or may be, likely to injure the reputation or interests of «FR_CO_NAME» or the advertisers whose material you are delivering, or bring, or potentially bring, «FR_CO_NAME» into disrepute.

STATUS OF CONTRACTOR

You are engaged by «FR_CO_NAME» under a contract for services, which means that you are an independent contractor. The terms of this contract or its operation do not therefore create an employment relationship between you and «FR_CO_NAME».

You are free to accept other engagements or work while you are engaged by «FR_CO_NAME». However you agree not to undertake other work which conflicts with, or may conflict with, the interests of «FR_CO_NAME» (including it's relationships with clients or advertisers).

NO LIABILITY

You will undertake the Services at your own risk. This means that «FR_CO_NAME» will not be liable to you (or any other person) for any loss resulting from your deliberate actions, your negligence, or where you breach any term of this Contract.

DELIVERY OPTIONS

It is your responsibility to carry out the Services as required under this contract. If you are sick or not able to personally carry out the Services then you must arrange for someone else (such as a sub contractor or friend or family member) to do so. When you do this, you will be solely responsible for payment and all other obligations to others who assist you in this way.

FREQUENCY OF DELIVERIES

«FR_CO_NAME» does not guarantee any minimum amount of material for which you will carry out the Services. The volume of material available for distribution will vary depending on the time of year and needs of Letterbox Channel's customers. «FR_CO_NAME» will do its best to advise you of anticipated volumes as far in advance as possible.

COMPETITIONS

You and your immediate family members may be prevented from entering competitions advertised in material delivered by you to the Contracted Runners, by the terms and conditions of those competitions.

ISSUES

If issues arise between «FR_CO_NAME» and you, both parties agree to raise and discuss issues in an open manner. If any outstanding issues are not able to be worked out between us, you agree to attend mediation in a further attempt to try and resolve them. If the issues are still unresolved after mediation has taken place, either you or «FR_CO_NAME» can refer them to the Disputes Tribunal for a binding decision to be made if the claim is for an amount less than $12,000. If the matter remains unresolved, the matter can be referred to the District Court for a binding ruling. If the amount claimed is greater then $12,000 then the matter can be referred to the District Court for a binding decision. The process to be followed is outlined further in Schedule 5.

HEALTH AND SAFETY

While «FR_CO_NAME» will make reasonable efforts to ensure that you operate safely, you are required to take all practical steps to ensure your own safety, and the safety of others (including the Contracted Runners) and inform «FR_CO_NAME» immediately if issues arise. You will be provided with a copy of «FR_CO_NAME»'s health and safety materials and are required to observe «FR_CO_NAME»'s policies and procedures at all times.

2

NOTICES
Every notice to be given under or in comnnection with this Contract must be given in writing to the address of the other party as specified in Schedule 2.

COMPLETE AGREEMENT
Please sign the second copy of this contract, completing the details in Schedule 6 and return in the enclosed reply paid envelope.

This contract is the full and entire agreement between you and «FR_CO_NAME» and supersedes all previous written and oral agreements, representations and contracts between you and «FR_CO_NAME».

SIGNED for and on behalf of «FR_CO_NAME» Franchisee Limited
by:

----

name of authorised signatory

----

position

----

date

by: «PERS__NAME»

Signature of Contractor

Signature of Witness

Name of Witness

Occupation of Witness

City/town of residence]

3

SCHEDULE 1

CONTRACTED SERVICES

You are engaged as a contractor to oversee the delivery of material by Contracted Runners in a defined area (as set out in Schedule 3) and complete related tasks.

The Services you are to perform fall into the following categories:

- Collection – either physically collecting the bulk product from LBC's premises and transporting it back to either your own or «FR_CO_NAME»'s premises for further processing, or oversight of this activity.
- Processing – either physically bundling and strapping the bulk product into runs, including the attachment of consignment notes to the bundles of circulars, or oversight of this activity
- Transport to Round – either physical transportation of the bundled product from either your own or «FR_CO_NAME»'s premises to the Contracted Runners premises or oversight of this activity.
- Physical Delivery – oversight of the physical delivery of the individual items by the Contracted Runners to nominated individual delivery points.
- Administration – administration of the activities and runners as agreed between you and «FR_CO_NAME»

«FR_CO_NAME» and you will agree which tasks are required for which runs prior to the contract being finalised. The schedule of tasks will be included in this contract as an appendix as per the table below.

Run Number	Collection	Processing	Transport to Round	Physical Delivery	Administration
«RUN»	Yes/No	Yes/No	Yes/No	Yes/No	Yes/No

SCHEDULE 2

1. FEES FOR CONTRACTED SERVICES

[Insert basis on which fees will be calculated]

2. NOTICES

All notices will be served on the parties at the following addresses:

«FR_CO_NAME» Franchisee Limited:

[Name]	Phone:	[ ]
[full address]	Fax:	[ ]

The Contractor:

[Name]	Phone:	[ ]
[full address]	Fax:	[ ]

3. Name of «FR_CO_NAME» Contact:

«SUPERVISOR_OR_FRANCHISEE_CONTACT_NAME»:

Contact Number: «SUPERVISOR_OR_FRANCHISEE_CONTACT_PHONE»

5

SCHEDULE 3

MAP OF CONTRACTED AREA OF SUPERVISION

The Franchisee will provide you with maps of the individual runs.

6

SCHEDULE 4

Insert Supervisor Contractor's Name (For a Supervisor)

Insert Contractor's physical Address

TAX INVOICE

«FR_CO_NAME»Franchise Limited	Date:	(insert date of invoice)
«FR_CO_REGD_ADD»	Invoice Number:	(insert Invoice no.)
	GST Number:	(insert contractor's GST number, if applicable)
ATTN: «FR_NAME»	Contractor:	«PERS__NAME»

Particular	Quantity	Rate	Total
Collection Fee			
Processing Fee			
Transport to Rounds Fee			
Physical Delivery Fee			
Administration Fee			
Sub Total			
Invoice Total			

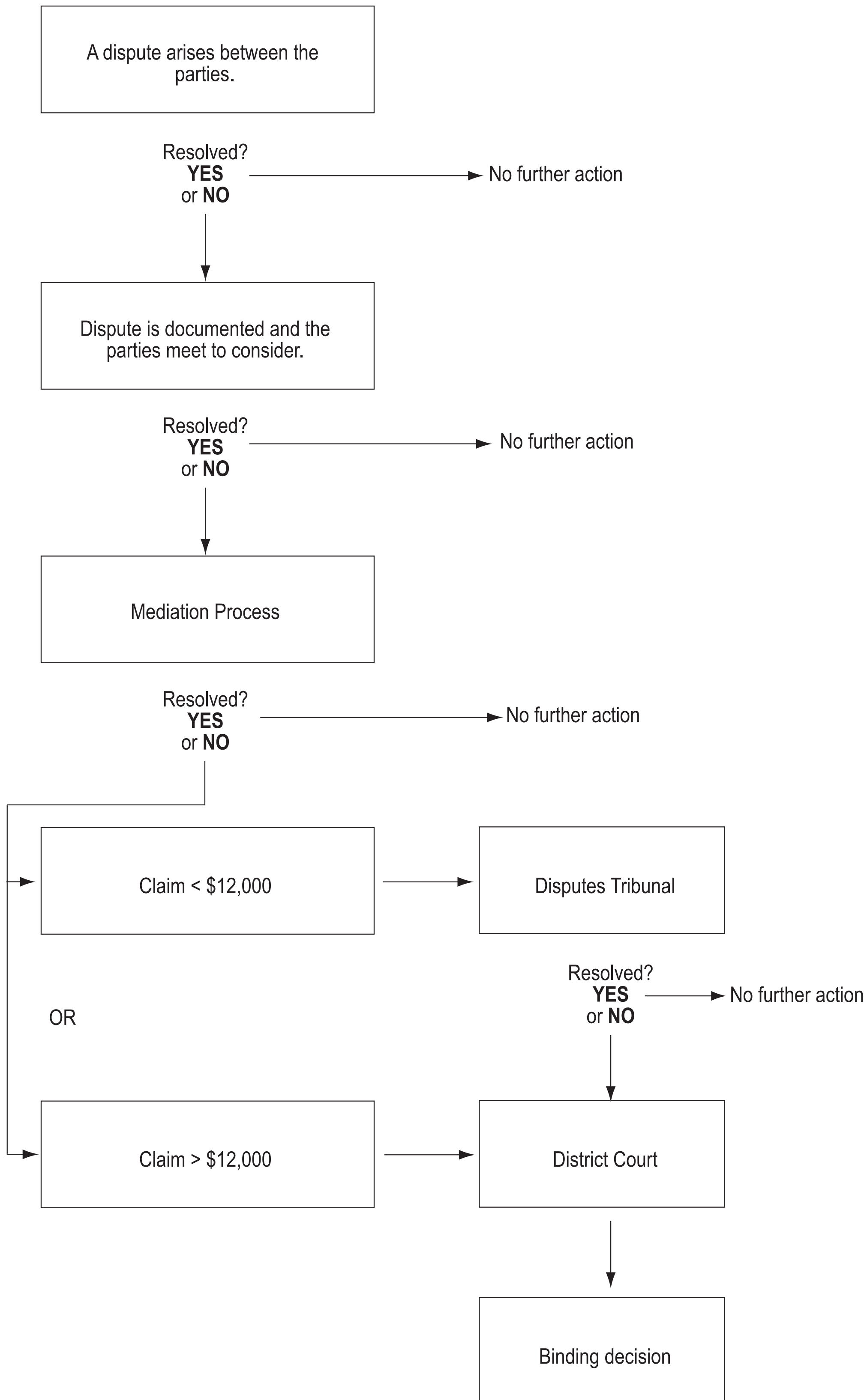
Payments will be made by direct credit to account (insert bank account details) within [insert time period]

Signature of Contractor:-- Dated: ---------------------

7

SCHEDULE 5

Flowchart for handling dispute



8

SCHEDULE 6

SUPERVISOR CONTRACTOR DETAILS*

1. SUPERVISOR CONTRACTOR PERSONAL DETAILS

Surname:
....

First Names:
....

Address:
....

....

....

Telephone Number:

Area Code ( ) Number..

2. SUPERVISOR CONTRACTOR BANK ACCOUNT DETAILS
[please attach a bank deposit slip or fill out the section below]

Full Name:
....

Name of Bank:
....

Bank/Branch Account Number Suffix

| | | | | | | | | | | | | | | – | | | |

Please check your account number carefully. If unsure please check with your Bank.

3. INLAND REVENUE INFORMATION
GST No.

* *Your details will be provided to the Letterbox Channel for invoice processing, but will otherwise be kept confidential.*

DEBT FACTORING ARRANGEMENTS AND GST

PUBLIC RULING – BR PUB 06/01

Note (not part of ruling): This Ruling is essentially the same as Public Ruling BR Pub 00/07, previously published in *Tax Information Bulletin* Vol 12, No 8 (August 2000). BR Pub 00/07 applied from 1 August 2000 to 31 July 2005. Some minor changes have been made to the description of the arrangement in the new ruling. Some issues that were covered in the commentary to the previous ruling are now covered comprehensively in Public Ruling BR Pub 05/01 "Bad debts – writing off debts as bad for GST and income tax purposes" published in *Tax Information Bulletin* Vol 17, No 2 (March 2005). BR Pub 06/01 is to apply on 1 August 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 8(1), 20(3) and 26(1).

The Arrangement to which this Ruling applies

The Arrangement is the sale, by a GST registered person (the "Assignor") on an invoice basis, to a third party ("the Factor"), on a recourse or non-recourse basis, of an outstanding debt at a price less than the debt's face value.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The difference between the face value of the debt and the price received from the Factor is not a bad debt for the purposes of section 26. Accordingly, section 26 has no application and the registered person cannot claim an output tax deduction under section 20(3)(a)(iii); and
- If a portion of a debt is written-off before it is sold to the Factor, then whether this write-off meets the requirements of section 26(1) depends on whether the amount written off was "bad" according to the conventional tests as outlined in Public Ruling BR Pub 05/01.

The period for which this Ruling applies

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

This Ruling is signed by me on the 19th day of April 2006.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 06/01

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 06/01 ("the Ruling").

Background

Section 26 and section 20(3)(a)(iii) of the Goods and Services Tax Act 1985 ("the Act") allow a registered person to make a deduction from output tax if the registered person has made a taxable supply, returned output tax in respect of that taxable supply, and subsequently written off as a bad debt, all or part of the debt.

If a registered person factors (i.e. sells) a debt owing for less than its face value to a third party ("the Factor"), the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount written off as a bad debt.

A debt can be factored either on a recourse basis or on a non-recourse basis. Debt factoring on a non-recourse basis means that the Factor has no claim back to the Assignor if the debts sold to him or her become doubtful or uncollectable (i.e. the Factor assumes all of the risk). In contrast, debt factoring on a recourse basis means that the Factor has some form of claim back to the Assignor if the debts sold to them prove to be doubtful or uncollectible.

Debt factoring was previously dealt with in PIB No 164 (August 1987) "GST and debt collection agencies – debt factoring" and in Technical Rulings paragraph 104.9.4 under an identical heading. Those statements concluded that if a registered person accounting for GST on an invoice basis subsequently sold a debt for less than its face value, the Commissioner would allow the registered person a bad debt deduction under section 26 for the difference between the debt's face value and the sale proceeds. The inference being that the difference between the two amounts was a bad debt.

Barber DJ in *Case T27* (1997) 18 NZTC 8,188 reached a different conclusion from that set out in PIB No 164 and Technical Rulings paragraph 104.9.4. In particular, the

Taxation Review Authority ("TRA") concluded that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt.

Public Ruling BR Pub 00/07 changed and superseded the earlier policy set out in PIB No 164 and Technical Rulings paragraph 104.9.4. BR Pub 00/07 confirmed that the Commissioner accepted the view of Barber DJ in *Case T27*. In particular, it is now the Commissioner's view that if a registered person factors a debt owing for less than its face value, the difference between the face value of the debt and the amount received from the Factor is not a bad debt. Accordingly, section 26 has no application, and a registered person cannot claim a deduction from output tax under section 20(3)(a)(iii). This Ruling replaces BR Pub 00/07.

The Ruling only applies in respect of taxpayers registered for GST on an invoice basis. Under section 26A taxpayers registered for GST on a payments basis are required to pay GST on the remaining book value of a debt when it is factored. Section 26A, therefore, establishes parity between the two GST accounting bases.

Legislation

Section 8(1) 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 9(1) states:

Subject to this Act, for the purposes of this Act a supply of goods and services shall be deemed to take place at the earlier of the time an invoice is issued by the supplier or the recipient or the time any payment is received by the supplier, in respect of that supply.

Section 20 states:

(1) In respect of each taxable period every registered person shall calculate the amount of tax payable by that registered person in accordance with the provisions of this section.

…

(3) Subject to this section, in calculating the amount of tax payable in respect of each taxable period, there shall be deducted from the amount of output tax of a registered person attributable to the taxable period—

(a) In the case of a registered person who is required to account for tax payable on an invoice basis pursuant to section 19 of this Act, the amount of the following:

(i) Input tax in relation to the supply of goods and services (not being a supply of secondhand goods to which section 3A(1)(c) of the **input tax** definition applies), made to that registered person during that taxable period:

(ia) Input tax in relation to the supply of secondhand goods to which section 3A(1)(c) of the **input tax** definition applies, to the extent that a payment in respect of that supply has been made during that taxable period:

(ii) Input tax invoiced or paid, whichever is the earlier, pursuant to section 12 of this Act during that taxable period:

(iii) Any amount calculated in accordance with any one of sections 25(2)(b), 25(5), 25AA(2)(b) or 25AA(3)(b); and

(b) In the case of a registered person who is required to account for tax payable on a payments basis or a hybrid basis pursuant to section 19 of this Act, the amount of the following:

(i) Input tax in relation to the supply of goods and services made to that registered person, being a supply of goods and services which is deemed to take place pursuant to section 9(1) or section 9(3)(a) or section 9(3)(aa) or section 9(6) of this Act, to the extent that a payment in respect of that supply has been made during the taxable period:

(ii) Input tax paid pursuant to section 12 of this Act during that taxable period:

(iii) Input tax in relation to the supply of goods and services made during that taxable period to that registered person, not being a supply of goods and services to which subparagraph (i) of this paragraph applies:

(iv) Any amount calculated in accordance with any one of sections 25(2)(b), 25(5), 25AA(2)(b) or 25AA(3)(b), to the extent that a payment has been made in respect of that amount, …

The provision relating to bad debts is in section 26, which states:

(1) Where a registered person—

(a) Has made a taxable supply for consideration in money; and

(b) Has furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under this Act; and

(c) Has written off as a bad debt the whole or part of the consideration not paid to that person,—

that registered person shall make a deduction under section 20(3) of this Act of that portion of the amount

of tax charged in relation to that supply as the amount written off as a bad debt bears to the total consideration for the supply:

Provided that where goods are supplied under a hire purchase agreement, the registered person shall only make a deduction under section 20(3) of this Act of the tax fraction (being the tax fraction applicable at the time that the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement:

(1AA) Subsection (1) also applies if a registered person sells a debt to a third party and then reacquires the debt.

…

Section 3(1) defines "financial services" as follows:

For the purposes of this Act, the term **financial services** means any one or more of the following activities:

(a) The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise):

(b) The issue, payment, collection, or transfer of ownership of a cheque or letter of credit:

(c) The issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security:

(d) The issue, allotment, or transfer of ownership of an equity security or a participatory security:

(e) Underwriting or sub underwriting the issue of an equity security, debt security, or participatory security:

(f) The provision of credit under a credit contract:

(g) The renewal or variation of a debt security, equity security, participatory security, or credit contract:

(h) The provision, taking, variation, or release of a guarantee, indemnity, security, or bond in respect of the performance of obligations under a cheque, credit contract, equity security, debt security, or participatory security, or in respect of the activities specified in paragraphs (b) to (g) of this subsection:

(i) The provision, or transfer of ownership, of a life insurance contract or the provision of re insurance in respect of any such contract:

(j) The provision, or transfer of ownership, of an interest in a superannuation scheme, or the management of a superannuation scheme:

(k) The provision or assignment of a futures contract through a defined market or at arm's length if—

(i) The contract does not provide for the delivery of a commodity; or

(ii) The contract provides for the delivery of a commodity and the supply of the commodity is an exempt supply; or

(iii) The contract provides for the delivery of money:

(kaa) The provision of a financial option:

(ka) The payment or collection of any amount of interest, principal, dividend, or other amount whatever in respect of any debt security, equity security, participatory security, credit contract, contract of life insurance, superannuation scheme, or futures contract:

(l) Agreeing to do, or arranging, any of the activities specified in paragraphs (a) to (ka) of this subsection, other than advising thereon.

Application of the Legislation

Under section 26, a registered person can make a deduction under section 20(3)(a)(iii) if that person has:

- made a taxable supply for consideration; and
- furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under the Act; and
- written off as a bad debt the whole or part of the consideration not paid to that person.

The amount that may be deducted is the same amount of GST charged as the amount written off bears to the total consideration for the supply. If the supply is the supply of goods under a hire purchase agreement, the proviso to section 26 limits the deduction to the portion of the amount written off as the cash price bears to the total amount payable under the hire purchase agreement.

Further, section 26 does not apply to a registered person accounting on a payments basis under section 19 or 19A, unless either section 9(2)(b) (door to door sales) or section 9(3)(b) (hire purchase agreements) applies to the supply.

Section 26 only applies when the registered person has already accounted for GST on a supply and subsequently has written off as a bad debt the whole or part of the consideration not paid to that person.

If a registered person factors a debt owing for less than its face value, the issue arises whether the difference between the face value of the debt and the amount received from the Factor can be an amount "written off as a bad debt".

The term "bad debt" is not defined in the Act. Whether the debt is written off as "bad", according to the requirements in section 26(1), depends on the application of the tests outlined in Public Ruling BR Pub 05/01 "Bad debts – writing off debts as bad for GST and income tax purposes" published in *Tax Information Bulletin* Vol 17, No 2 (March 2005).

Public Ruling BR Pub 05/01 confirms that a debt (or part of a debt) is a bad debt where:

- an existing debt is owing to the taxpayer; and
- the debt is adjudged as "bad" when a reasonably

prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid; and

- the bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer.

The debt must exist

Cases indicate that before a debt can be written off, a debt must be in existence at the time the debt is written off (*Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263 and *GE Crane Sales Pty Ltd v FC of T* 71 ATC 4268). Accordingly, for section 26 to apply, the registered person must be able to show that at the time of writing off the debt, a debt was then in existence.

In terms of non-recourse debt factoring, at the time the debt is sold, the debt between the registered person and debtor is extinguished and replaced with a separate and distinct debt between the Factor and debtor. In such situations no debt exists at the time the amount is written off, which will be after sale of the debt. Therefore, after the sale of the debt to the Factor, no further debt exists and according to both *Budget Rent A Car Ltd* and *G E Crane Sales Pty Ltd* no amount can be written off as a bad debt.

In terms of recourse debt factoring arrangements when a debt is sold by the Assignor on a recourse basis, the title to the debt passes to the Factor unless the Factor exercises a recourse option or right by which the debt can be transferred back to the Assignor. Therefore, until the recourse is exercised and the debt is transferred back, a bad debt deduction is not available under section 26(1), as after the sale there is no debt owed to the Assignor.

However, if the Factor exercises an option or right to transfer some portion of the debt back to the Assignor after the sale then, once this has occurred, a debt exists that is owed to the Assignor that may be able to be written off by the Assignor. Whether it can be written off depends on the application of the tests for determining whether a debt is bad in BR Pub 05/01.

The debt must be "bad"

When assessing whether a bad debt exists, BR Pub 05/01 indicates that a debt is bad when a reasonably prudent commercial person would have concluded, based on the information available about the debtor's ability to repay the debt, that there is no reasonable likelihood that the debt will be paid. In the absence of such a circumstance, if a registered person chooses to sell a debt for below its face value, no bad debt exists and no deduction is available under section 20(3)(a)(iii).

The debt must be "written off"

BR Pub 05/01 establishes that, to write-off a debt as bad under section 26(1), reasonable steps must be taken to determine whether that particular debt owed by that particular debtor is likely to be paid (Case P53 (1992) 14 NZTC 4370 and *Budget Rent A Car v C of IR* (1995) 17 NZTC 12263).

Writing-off a portion of debt on this basis involves seeking a deduction for the provision for doubtful debts. As noted in BR Pub 05/01, the GST Act does not allow a deduction for the provision for doubtful debts.

Writing off the debt before sale to the Factor

In the past we have received submissions which noted that the issue of whether the discount to the Factor might be written off as a bad debt under section 26(1) would not arise if this amount were written off prior to the sale of the debt to the Factor.

The Commissioner agrees that this is the case. If a portion of a debt is written off before it is sold to the Factor, then whether the debt is written off as bad according to the requirements in section 26(1) depends on the application of the tests outlined in Public Ruling BR Pub 05/01.

In conclusion, the Commissioner believes that the difference between the face value of the debt and the amount received from the Factor cannot be an amount written off as a bad debt under section 26. Rather than being a bad debt, the discount from face value is simply a result of the process of agreeing the consideration for the debts that is acceptable to both the Assignor and the Factor. The reasons for this view are:

- Cases considering the meaning of bad debt focus on whether the creditor can recover the outstanding amounts owing. That is, a bad debt arises when the creditor is unable or unlikely to recover the debt owing. If the creditor could recover the full amount owing but chooses not to (as in a debt factoring situation), any "loss" suffered by the creditor is not due to a bad debt.
- Cases also indicate that for an amount to be written off as a bad debt, a debt must exist at the time the debt is written off. If a registered person factors a debt, no further debt exists between the registered person and debtor, and no amount can be written off as a bad debt.

SECTION GD 10 – INCOME TAX ACT 2004 – RENT DEEMED TO BE PAYABLE BY THE LESSEE

PUBLIC RULING – BR PUB 06/02

Note (not part of ruling): The ruling is a reissue of Public Ruling BR Pub 01/03, issued on 10 April 2001. The Commissioner's view, as expressed in this ruling, is not intended to differ from BR Pub 01/03. Any changes between this ruling and the previous ruling are only intended to assist the reader's understanding and reflect the new terminology used in the Income Tax Act 2004.

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

Taxation Law

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

This Ruling applies in respect of sections GD 10, DA 1 and DA 2.

The Arrangement to which this Ruling applies

The Arrangement to which this Ruling applies is a "lease" of property (whether real property or personal property) at less than an "adequate rent," only if and to the extent the leased property is used by the lessee, in the derivation of assessable income or exempt income.

This Ruling applies where any property, owned by any person or by two or more persons (whether jointly or in common) or by any partnership, is leased:

- to a "relative" of any of those persons or of any member of the partnership, or
- to a "related company", or
- by a company to any person.

For the purposes of this Ruling, the terms "lease", "adequate rent", and "related company" have the meanings attributed to them by section GD 10(4), and "relative" has the meaning attributed to it by section OB 1.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

For the purposes of section DA 1, rent deemed under section GD 10 to be payable by the lessee to the lessor is expenditure incurred by the lessee.

The period for which this Ruling applies

This Ruling will apply for an indefinite period to leases entered into on or following 1 February 2006.

This Ruling is signed by me on the 28th day of April 2006.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 06/02

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 06/02 ("the Ruling").

Background

Section GD 10 applies to leases between a lessor and certain specified classes of lessee, where the rent payable under the lease is "less than an adequate rent". Section GD 10 allows the Commissioner to notionally increase the amount of rent payable by the lessee to the lessor, to an amount equal to an "adequate rent". The section deems the rent thus payable to be income derived by the lessor on the days the rent is deemed to be payable.

Section GD 10 is directed against tax avoidance. It controls the shifting of income between family members to take advantage of different marginal tax rates, but is not limited to familial transactions. Progressive tax scales give advantages to the family unit to spread income, resulting in a reduction in the overall amount of tax paid by that unit, or the rate of tax applying to an income stream. Section GD 10 operates to limit this opportunity when related parties lease income-producing property. The effect of deeming income to be derived, based on a rent that should have been paid rather than what was paid, unwinds any advantage.

Section GD 10 applies where property (both personal and real), owned by any person or by two or more persons (whether jointly or in common) or by any partnership, is leased:

- to a relative of any of those persons
- to a relative of any member of the partnership

- to a related company
- by a company to any person

and the rent is either less than an adequate rent for the property or the lease makes no provision for the payment of rent.

Where those circumstances apply, section GD 10 allows the Commissioner to determine an amount of "adequate rent", being in broad terms an amount of rent considered by the Commissioner to be adequate for the property being leased. This Ruling does not consider the basis of such a determination or what is meant by either adequate or inadequate rent.

Under section GD 10, the amount of adequate rent so determined is deemed to be payable by the lessee to the lessor, and is deemed to be income derived by the lessor.

This Ruling considers the position of the lessee and, specifically, whether the adequate rent, that is deemed payable by the lessee to the lessor, is also an amount deemed payable by the lessee for the purposes of sections DA 1 and DA 2.

The Ruling concludes that rent deemed to be payable is an expenditure or loss incurred by the lessee under section DA 1(1). For the rental to be deductible by the lessee, the expenditure or loss must meet all of the requirements of the "general permission" in section DA 1 and not be excluded by the "general limitations" in section DA 2.

Legislation

DA 1 GENERAL PERMISSION

DA 1(1) NEXUS WITH INCOME A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is -

(a) incurred by them in deriving -

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving -

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

DA 1(2) GENERAL PERMISSION Subsection (1) is called the **general permission**.

Defined in this Act: amount, assessable income, business, deduction, depreciation loss, excluded income, general permission, loss,

DA 2 GENERAL LIMITATIONS

DA 2(1) CAPITAL LIMITATION

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

DA 2(2) PRIVATE LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

DA 2(3) EXEMPT INCOME LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

DA 2(4) EMPLOYMENT LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the **employment limitation**.

DA 2(5) WITHHOLDING TAX LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving schedular income subject to final withholding. This rule is called the **withholding tax limitation**.

DA 2(6) NON-RESIDENTS' FOREIGN-SOURCED INCOME LIMITATION A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the **non-residents' foreign-sourced income limitation**.

DA 2(7) RELATIONSHIP OF GENERAL LIMITATIONS TO GENERAL PERMISSION Each of the general limitations in this section overrides the general permission.

Defined in this Act: amount, capital limitation, deduction, employment limitation, exempt income, exempt income limitation, general limitation, general permission, income from employment, loss, non-residents' foreign-sourced income, non-residents' foreign-sourced income limitation, private limitation, schedular income subject to final withholding, withholding tax limitation.

GD 10 LEASES FOR INADEQUATE RENT

GD 10 1) [Deemed adequate rental] Where any property owned by any person or by two or more persons (whether jointly or in common) or by any partnership is leased to a relative of any of those persons or of any member of the partnership or to a related company or by a company to any person and the rent is less than an adequate rent for that property or the lease makes no provision for the payment of rent, -

(a) there is deemed to be payable under the lease a rent that is equal to an adequate rent for the property, and that rent is deemed to be payable by the lessee to the lessor on the days provided in the lease for payment of the rent, or, if no rent is payable under the lease, on each day of the term of the lease on a pro rata basis, and is deemed to be income derived by the lessor on the days on which the rent is deemed to be payable under this paragraph; and

(b) the rent deemed to be payable under paragraph (a) is deemed to accrue from day to day during the period in respect of which it is payable, and is apportionable accordingly.

GD 10(2) [Use of property] This section applies with respect to any leased property only if and to the extent that it is used by the lessee in the derivation of assessable income or exempt income.

GD 10(3) [Section to apply] This section applies whether the lease was granted before or after the commencement of the tax year.

GD 10(4) [Definitions] In this section, -
adequate rent in relation to any property, means the amount of rent that the Commissioner determines to be adequate for that property during the period in respect of which the determination is made.

lease means a tenancy of any duration, whether in writing or otherwise; and includes a sublease; and also includes a bailment; and **lessor** and **lessee** have corresponding meanings.

related company means a company that is under the control of the lessor or any relative or relatives of the lessor or any 1 or more of them, or, where there are several lessors or the lessor is a partnership, under the control of any of the lessors or partners or any relative or relatives of any of the lessors or partners.

rent includes any premium or other consideration for the lease.

"RELATIVE"
The definition of relative was amended by section 3(1) of the Income Tax Amendment Act 2005. The amendment added "civil union" to paragraph (c)(ii), this came into force on 26th April 2005.

Section 3(2) of the Amendment Act also provides for a future amendment to OB 1 by replacing the expression "marriage or civil union" in paragraph (c)(ii) with the expression "marriage, civil union or de facto relationship". This amendment comes into force 1 April 2007.

OB 1 "RELATIVE"
…

(c) except in the provisions referred to in paragraphs (a) and (b), means a person connected with another person by -
  (i) blood relationship, that is, one is within the fourth degree of relationship to the other:
  (ii) marriage or other partnership, that is, one is in a marriage or civil union with the other or with a person who is connected by blood relationship to the other
  (iii) adoption, that is, one has been adopted as a child of the other or as a child of a person who is within the third degree of relationship to the other:

(d) except in the provisions referred to in paragraphs (a) and (b), includes a trustee of a trust under which a relative has benefited or is eligible to benefit

Application of the legislation

How section GD 10 operates

When does the section apply?

Section GD 10 operates, in limited circumstances, following a determination by the Commissioner. For section GD 10 to apply, the following requirements must be satisfied:

- There must be the leasing of property
- The owner of the property must be:
  - a person (as defined in the Interpretation Act 1999, and includes a company), or
  - any two or more persons (whether jointly or in common), or
  - a partnership.
- The lessee must be:
  - a relative of an owner (where the owner is a natural person), or
  - a relative of any member of the partnership that owns the property, or
  - a related company of the owner, or
  - where the lessor is a company, any person.
- The stipulated rent must be less than adequate or the lease must be silent on the payment of rent.
- The lessee must use the property in the derivation of assessable income or exempt income.

What leased property is covered?

"Property" is not defined for the purposes of section GD 10, but in the Commissioner's view it includes both real property (land and buildings) and personal property (property other than land and buildings). This is the usual legal meaning of "property". The definition of "lease" in section GD 10 supports this interpretation.

"Lease" is defined in section GD 10(4) as a tenancy of any duration, including a sublease, and a bailment. A lease and a tenancy usually only relate to land, i.e. real property. A bailment only ever refers to personal property. Therefore, it is clear that section GD 10 is intended to apply to, and the word "property" is meant to refer to, both real and personal property.

Who is a relative?

"Relative" is defined in section OB 1. A relative is a person connected with another person by "blood relationship", adoption, marriage or other partnership, that is, one is in a marriage or civil union with the other or with a person who is connected by blood relationship to the other. "Blood relationship" means a relationship that is within the fourth degree which is ascertained by counting the relationship steps between the two people. For example, A and B are first cousins, so they are within the fourth degree of relationship, as follows:

A – A's parent (1) – grandparent (2) – B's parent (3) – B(4).

Any person who marries or is in a civil union with another person, within the fourth degree of relationship, automatically assumes the same relationship. For example, B's spouse is within the fourth degree of relationship to A. Similarly, both A and B's spouses are within the fourth degree of relationship to each other.

Children adopted by a person within the third degree of relationship are also relatives.

The deeming effect of section GD 10

If the section applies to a transaction, section GD 10(1)(a) explicitly deems:

- an adequate rent to be payable under the lease
- that adequate rent to be payable by the lessee to the lessor on the days provided in the lease for rent payment, or, if no rent is payable under the lease, on each day of the term of the lease on a pro rata basis; and
- the rent to be income derived by the lessor on the days on which the rent is deemed to be payable.

"Deemed" means adding to the normal meaning of words

If the Commissioner determines an adequate rent, the amount of rent payable by the lessee to the lessor is increased by the deeming effect of section GD 10, to reflect the Commissioner's determination. In a Canadian decision, *R v Verrette* [1978] 2 S.C.R. 838 at page 845, the Supreme Court of Canada gave a useful description of the legal effect of a deeming provision. It said:

> A deeming provision is a statutory fiction; as a rule it implicitly admits that a thing is not what it is deemed to be but decrees that for some particular purpose it shall be taken as if it were that thing although it is not or there is doubt as to whether it is. A deeming provision artificially imports into a word or expression an additional meaning which they would not otherwise convey beside the normal meaning which they retain where they are used; it plays a function of enlargement analogous to the word "includes" in certain definitions; however, "includes" would be logically inappropriate and would sound unreal because of the fictional aspect of the provision.

In this case, section GD 10 deems an amount of adequate rent to be payable, even though in terms of the contract between the lessor and the lessee it is not. The section then further deems the fictional rent to be payable on specified days and finally deems the rent to be income derived by the lessor.

The section applies to a lessee

Although the section deems the rent determined by the Commissioner to be income derived by the lessor, it does not expressly state that the deemed rent is expenditure incurred by the lessee. The absence of a specified mirror treatment for the lessee could arguably support an interpretation of the section based on the proposition that it does not apply to a lessee. However, in the Commissioner's view, this is not a correct interpretation because:

1. An adequate rent is deemed by the section to be payable under the lease. The section further deems the rent to be payable by the lessee to the lessor.
2. The application of the section is dependent on the lessee's use of the leased property for the derivation of assessable income or exempt income.
3. Section GD 10(2) is directly concerned with the use of leased property by the lessee in the derivation of assessable or exempt income.
4. Section GD 10 was originally introduced as section 17 of the Land and Income Tax Amendment Act 1951. Introductory Notes supplied to the Minister on introduction of the Bill said:

> This clause is designed to cover the position where a taxpayer owning an income producing property, enters into a lease under which a relative becomes entitled to the full rent or income from the property, and is required to pay to the lessor only a nominal or peppercorn rental.
> …The provisions of the clause will not be applied to bona fide leases of property, even though the lessee is a relative, and will be operated by the Commissioner only where it is evident that the lease has the effect of transferring income from the taxpayer to a relative.

This demonstrates that the purpose of the provision was to prevent income splitting and the consequential reduction of tax paid. Allowing a deduction to the lessee would not negate this purpose.

The above points also support the conclusion that section GD 10 is intended to apply to both the lessee and lessor in the relevant transaction.

Deeming not limited to section GD 10

The application of the deeming provisions contained in section GD 10 is not limited by the inclusion of any qualification. Elsewhere in the Act, where the effect of a provision is intended to be restricted, such sections contain a qualification such as, "For the purposes of this section…". Section GD 10 is not an independent charging provision, and must be read in conjunction with other relevant parts of the Act. For example, rent is included in income by section CC 1. The deemed rent is therefore relevant for other purposes of the Act such as for section DA 1.

Section DA 1: "incurred" requires a legal obligation to pay

An amount is an allowable deduction under section DA 1, only if it is "incurred" by the taxpayer. For the deemed adequate rent to be an allowable deduction, it must have been "incurred" by the lessee.

The term "incurred" has been held to mean that the taxpayer has either paid the expenditure or loss, or is otherwise definitively committed to pay it: (see *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351). A taxpayer is said to be definitively committed when a legal obligation to make a payment in the future can be said to have accrued.

Section GD 10 does not specifically deem the adequate rent to have been incurred by the lessee. Rather, the section deems the rent to be payable. In *Re Howell's Application* [1972] Ch. 509, the phrase "payable by way

of rent" was interpreted as meaning "… rent the tenant is under an enforceable obligation to pay…". New Zealand courts have taken the same view. In *AM Bisley & Co Ltd v C of IR* (1985) 7 NZTC 5,082 at page 5,096, Henry J said:

> …that the expenditure is not payable until some future date does not of itself destroy its nature as an existing obligation.

Therefore, where an amount is said to be "payable", it means that the payer has an enforceable obligation to pay the amount, even where that obligation does not crystallise until some future date.

Under section GD 10(1)(a), an adequate rent is deemed to be payable on the days provided in the lease for payment, or on each day of the term of the lease on a pro rata basis. This means that the Act operates as if there was an obligation to pay the rent. The Commissioner's view is that deeming the amount to be payable has the same effect as deeming that a legal obligation has been created and, therefore, as far as section DA 1(1) is concerned an expenditure has been incurred.

The obligation in *Bisley* was an existing legal obligation to make expenditure that became payable on a future date. Thus, there are two types of expenditure that qualify as "incurred": existing legal obligations payable now, and those that will become payable in the future. For expenditure either to be payable or to become payable, there must be an existing obligation to pay either now or later. Rent deemed to be payable falls within the first category i.e. an existing legal obligation payable now, and is clearly "incurred".

The nexus between expenditure and income is not affected by deeming

If the leased property is used in the derivation of assessable or exempt income, any rental deemed payable by the lessee, including a less than adequate rent, is deemed "incurred" by the lessee for the purposes of section DA 1(1). However, the ruling does not go so far as to deem deductibility.

For the deemed "incurred" rental to be deductible by the lessee the expenditure must also meet the express requirements of section DA 1 and not be excluded by the "general limitations" (section DA 2):

- The expenditure must have a "nexus with income" in terms of section DA 1(1) and be incurred by the lessee in "deriving" "assessable" or "excluded" income (section DA 1(1)(a)) or, incurred by them "in the course of carrying on a business" for the purpose of deriving "assessable" or "excluded" income (section DA 1(1)(b)).
- The expenditure must not be excluded from being deductible due to the "general limitations" of section DA 2.

Conclusion

Rent deemed to be payable, under section GD 10, is expenditure incurred by the lessee under section DA 1(1).

Examples

Example 1

A (lessor) leases a flat to her daughter B (lessee) for $10 per week. B then rents it to tenants for $400 per week. A has other income of $50,000 and is on a marginal tax rate of 33 cents in the dollar. B has no other income and pays 19.5 cents in the dollar. As B's tax bracket is lower than A's, there is less tax being paid overall than if A rented the flat to the tenants directly.

The Commissioner may determine that an adequate rent is higher than $10 per week. Section GD 10 will apply to deem the adequate rent to be the rent payable by B to A. The adequate rent is deemed to be income derived by A. The rent deemed payable is expenditure "incurred" by B, as there is deemed to be a legal obligation to pay.

Example 2

C Ltd, a company (lessor) leases a property to X (lessee), a charitable body, at an inadequate rental. X uses the property in the derivation of exempt income.

A "person" includes a company and an unincorporated body of persons (section 29 Interpretation Act 1999) and therefore X. Section GD 10(1) applies to a lease of property "by a company to any person" at a less than adequate rent. Under subsection (2), the section applies to the extent that the property is used by the lessee in the derivation of assessable income or exempt income. Therefore, an adequate rent determined by the Commissioner is deemed payable and is also deemed to have been "incurred" by X for the purpose of section DA 1.

However, in this example, the "exempt income limitation" rule in section DA 2(3) will operate to deny X any deduction, because the expenditure is incurred in deriving exempt income.

LEGISLATION AND DETERMINATIONS

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

GENERAL DEPRECIATION DETERMINATION DEP54

This determination may be cited as "Determination DEP54: Tax Depreciation Rates General Determination Number 54".

1. Application

This determination applies to taxpayers who own depreciable property of the kind referred to in paragraph 2 below and applies for income years corresponding to the 2005–06 and subsequent tax years.

2. Determination

Pursuant to section 91AAF of the Tax Administration Act 1994, I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended), hereinafter referred to as "DEP1", by inserting the diminishing value and straight-line economic depreciation rates as follows:

- In respect of the kinds of items of depreciable property for which the economic rate of depreciation is set under section EE 25B of the Income Tax Act 2004, and being a kind of item of depreciable property that is a general asset class as specified in DEP1 having an estimated useful life, applicable diminishing value banded depreciation rate and straight-line equivalent banded depreciation rate listed in columns 1, 2 and 3 respectively below, by inserting the respective diminishing value and straight-line depreciation rates listed in columns 4 and 5 below:

1	2	3	4	5
Estimated useful life (years)	**DV banded dep'n rate (%)**	**SL equiv banded dep'n rate (%)**	**DEP54 DV banded dep'n rate (%)**	**DEP54 SL equiv banded dep'n rate (%)**
100	2	1.5	2	1.5
50	4	3	4	3
33.3	6	4	6	4
25	7.5	5.5	8	6
20	9.5	6.5	10	7
15.5	12	8	13	8.5
12.5	15	10	16	10.5
10	18	12.5	20	13.5
8	22	15.5	25	17.5
6.66	26	18	30	21
5	33	24	40	30
4	40	30	50	40
3	50	40	67	67
2	63.5	63.5	100	100
1	100	100	100	100

- In respect of the kinds of items of depreciable property for which the economic rate of depreciation is set under section EE 25C of the Income Tax Act 2004, and being a kind of item of depreciable property that is a general asset class as specified in DEP1 having an estimated useful life, applicable diminishing value banded depreciation rate and straight-line equivalent banded depreciation rate listed in columns 1, 2 and 3 respectively below, by inserting the respective diminishing value and straight-line depreciation rates listed in columns 4 and 5 below

1	2	3	4	5
Estimated useful life (years)	**DV banded dep'n rate (%)**	**SL equiv banded dep'n rate (%)**	**DEP54 DV equiv banded dep'n rate (%)**	**DEP54 SL banded dep'n rate (%)**
100	2	1.5	1.3	1
50	4	3	3	2
33.3	6	4	4.5	3
25	7.5	5.5	6.5	4
20	9.5	6.5	8.5	5
15.5	12	8	11	6.5
12.5	15	10	13.5	8

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 2004.

This determination is signed by me on the 27th day of April 2006.

Susan Price
Senior Tax Counsel

CPI ADJUSTMENT 06/01 FOR DETERMINATION DET–001:

Standard-cost household service for childcare providers

In accordance with the provisions of Determination DET 001, as published in *Tax Information Bulletin* Vol 16, No 4 (May 2004), Inland Revenue advises that, for the 2006 income year:

(a) the *variable standard-cost* component has increased from $2.74 to $2.83 per hour per child; and

(b) the *administration and record keeping fixed standard-cost* component has increased from $267 to $276 per annum, for a full 52 weeks of childcare services provided.

The above amounts have been adjusted in accordance with the annual movement of the All Groups Consumers Price Index for the twelve months to March 2006, which showed an increase of 3.3%. For childcare providers who have a standard 31 March balance date, the new amounts apply for the period from 1 April 2005 to 31 March 2006.

PRELIMINARY CPI ADJUSTMENT – CPI 06/02 FOR DETERMINATION DET–05/03:

Standard-cost household service for boarding service providers

In accordance with the provisions of Determination DET 05/03, as published in *Tax Information Bulletin* Vol 17, No 10 (December 2005), Inland Revenue advises that the preliminary *weekly standard-cost* component for the 2007 income year, is to be adjusted as follows:

(a) The *weekly standard-cost* for one to two boarders will increase from $200 each to $207 each.

(b) The *weekly standard-cost* for third and subsequent number of boarders will increase from $162 each to $168 each.

The above amounts have been adjusted in accordance with the annual movement of the All Groups Consumers Price Index for the twelve months to March 2006, which showed an increase of 3.3%. For boarding service providers who have a standard 31 March balance date, the new amounts apply for the period from 1 April 2006 to 31 March 2007. These adjusted amounts are intended as a preliminary indication of the likely levels of weekly standard-costs. These figures will be further adjusted, to apply retrospectively to the 2007 income year, based on the All Groups Consumers Price Index movement for the twelve months ending March 2007, when available.

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.

LAQC LOSSES MUST BE ATTRIBUTED

Case:	New Zealand Ostrich Export Company Limited v The Commissioner of Inland Revenue
Decision date:	21 March 2006
Act:	Income Tax Act 1994, sections IG 2, HG 16
Keywords:	LAQC, loss offset provisions, group loss provisions

Summary

All losses incurred by an LAQC must be attributed. The net loss for attribution cannot be partly reduced by an offset against the income of a profit company under the loss offset provisions.

Facts

This was an appeal by the Taxpayer against a decision of the TRA reported as Case X14 (2005) 22 NZTC 12,194. The Taxpayer was an LAQC. It incurred a tax loss of $1,200,526.09 for the year ended 31 March 2002.

The Taxpayer elected to offset $44,426 of the loss for the 2002 year to other companies within the group under the group loss provisions. The remaining $1,156,199.09 was attributed to its shareholders in terms of section HG 16.

The Commissioner contended the loss offset rules applicable to LAQCs override the general provision applying to offset of losses between members of a group of companies. The result was that he required all losses to be attributed under the LAQC rules. The TRA upheld the assessment.

Decision

The appellant contended that the term "net loss" in section HG 16 referred to the tax loss of $1,200,526.09 included "a net loss after reduction in that loss by the application of section IG 2". The Commissioner contended that the entire amount of that sum is the "net loss" referred to in section HG 16(1).

The Court noted that the term "net loss" has been defined in a very simple way to be the difference between available deductible expenses and gross income. If the meaning of "net loss" in section HG 16(1) is expanded to allow for reduction of that loss by an offset election under section IG 2(2)(i) then that does more that just qualify the definition, it changes the meaning of it completely.

The Court concluded by observing that sections HG 10 and IG 2 and HG 16 can co-exist. The correct interpretation of section HG 16 is that it has the effect of passing through the losses of the LAQC to the shareholders where losses accrue after the election. If there is no election, then sections HG 10 and IG 2 can be used.

TAXPAYER UNSUCCESSFUL IN ATTEMPT TO COMPEL COMMISSIONER TO ACCEPT AND ALLOW LATE OBJECTION

Case:	FB Duvall v The Commissioner of Inland Revenue
Decision date:	22 March 2006
Act:	GST Act 1985, Tax Administration Act 1994
Keywords:	GST, late objection, case stated

Summary

Neither the taxpayer nor the TRA could determine an objection for the Commissioner, regardless of the delay in determining the objection

Facts

This was an appeal from the High Court (reported at (2005) 22 NZTC 19,142).

The Taxpayer filed GST returns in 1990 to 1994 which were accepted by the Commissioner. Subsequently and relying upon dicta from another Taxpayer's case,

the Taxpayer sought to file amended returns in 1998 purporting to claim back the outputs accounted for but not to reverse any inputs received. At the time this was done the Taxpayer was already in litigation over the same issue with the Commissioner. The Commissioner wrote to the Taxpayer advising that no action would be taken on the amended returns until the litigation involving other periods was resolved.

At the Court of Appeal the earlier litigation was resolved in the Taxpayer's favour but on a procedural point. The substantive issue (the ability to claim back outputs without addressing inputs claimed) was not addressed (see (2000) 19 NZTC 15,658). The only substantive case on this issue was determined in the Commissioner's favour at the TRA (reported as *Case Q34* (1993) 15 NZTC 5,159).

The Taxpayer's amended returns were never assessed or addressed by the Commissioner. In 2000 the Taxpayer requested a case stated. The Commissioner filed a case stated and specifically raised the issues of the status of the case stated where there had been no decision to accept a late objection, nor a determination of that objection. It also raised the status of the input tax credits claimed.

The Commissioner successfully appealed the TRA decision allowing the Taxpayer's objection under its "curative jurisdiction". The Taxpayer appealed to the Court of Appeal

Decision

The Court of Appeal dismissed the appeal. It was considered the Commissioner's letter did not accept the late objections. Accordingly these "objections" had never been determined by the Commissioner and thus no right to request a case stated arose. Further as the case stated which was filed expressly raised the jurisdictional point that the case stated itself was not a determination of the as yet unaccepted late objections and accordingly the TRA never had jurisdiction to determine the objection.

In addressing the delay the Court suggested that judicial review was the proper course of action.

APPLICATION FOR RECALL

Case:	Clarence John Faloon v The Commissioner of Inland Revenue
Decision date:	30 March 2006
Act:	Tax Administration Act 1994
Keywords:	Recall Jurisdiction, High Court Rules, Re litigate Statement of Claim.

Summary

The Taxpayer sought an order recalling a prior High Court judgment of Asher J. The taxpayer essentially re-litigated his complaints contained in his Statement of Claim from Asher J's prior judgment. Referring to the leading case on recall of Wild CJ in *Wild CJ in Horowhenua County v Nash (No 2)* [1968] NZLR 632, Asher J found that there was no proper basis in which the taxpayer can recall the judgment

Facts

The Taxpayer filed a statement of claim in the High Court which related to a challenge under s 138F of the TAA 1994 to an assessment of gift duty made by the Commissioner. The claim alleged that the Commissioner had erred in his assessment, and sought directions to alter his decision.

The Commissioner sought to strike out the Taxpayer's claim on the basis that the Taxpayer had no reasonable cause of action against the Commissioner. The proceedings were struck out because Asher J found the Taxpayer had no status to bring the proceeding and he was not a party to the easement in respect of which the ruling was sought, and could not have been regarded as a "Disputant". The judgment for this decision was received on 7 November 2005.

The present proceedings involve the Taxpayer seeking an order recalling Asher J's judgment of 7 November 2005. The Taxpayer's application was made in reliance on Rule 542(3) of the High Court Rules. The Taxpayer's application challenged the judgment of 7 November 2005 and raised numerous points which essentially challenge the conclusions reached, and reiterated his prior Statement of Claim.

The Commissioner filed a Notice of Opposition which did not engage upon the substantive issues raised by the Taxpayer but focused on Rule 542(3). In essence, the Commissioner asserted that the recall jurisdiction was not properly invoked.

The Taxpayer criticised the Commissioner's Notice of Opposition asserting that it had not gone through the notice of application and admitted or denied all of the facts set out therein.

Decision

Asher J looked at when a decision may be recalled. An application for recall comes under Rule 542(3) of the High Court Rules.

This rule does not set out a guide as to the basis upon which a judgment can be recalled, or indeed what the recall of a judgment empowers a Judge to do. However, the leading case on recall is that of Wild CJ in *Horowhenua County v Nash (No 2)* [1968] NZLR 632.

Horowhenua County v Nash (No 2) provided for three categories of recall the third of which gives the Court the ability to recall a judgment for any very special reason which justice requires, and thereby avoid an injustice, or what might otherwise be a more cumbersome and expensive process, such as a retrial.

No attempt has been made to further define the third category. In *Brake v Boote* (1991) 4 PRNZ 86, the third category was used as the basis for recalling a judgment, the judge considered that on a very special occasion where a judge failed to determine an issue which was properly before the Court, the jurisdiction could be used to correct that error.

While the third category is not defined with particularity in the judgments, it is quite clear that the direction to recall must be exercised with circumspection, and it must not in any way be seen as a substitute for appeal. There are some things which the power of recall does not extend to. It does not extend to a party recasting arguments previously given, and re-presenting them in a new form. It does not extend to putting forward further arguments that could have been raised at an earlier hearing but were not.

The Taxpayer, in his application, sought to do all these things. None of the matters raised in his notice of application and affidavit in support related to developments since the judgment, or a legislative provision or authoritative decision of plain relevance which was not referred to. The judgment, being to strike out the statement of claim, was in terms of the order made quite simple and uncomplicated. His Honour held that what the Taxpayer sought in this application was to re-litigate his complaints contained in his statement of claim that was struck out by the High Court on 7 November 2005. No proper basis was put forward by Taxpayer for the recall of the 7 November 2005 judgment.

Asher J also found that the Commissioner's Notice of Opposition complied with Rule 244. Asher J noted that a Notice of Opposition must state the respondent's intention to oppose the application and the grounds of opposition, and contain a reference to any particular provision of an enactment or principle of law or judicial decision on which the respondent relies (Rule 244(3)). It does not have to have the function of a statement of defence, and respond to all the affirmative assertions contained in a Notice of Opposition

The Taxpayer's application to recall Asher J's decision of 7 November 2005 was therefore dismissed.

PROCEEDINGS STRUCK OUT FOR EXCEEDING JURISDICTION

Case:	Graham Ashley Robert Palmer v The Commissioner of Inland Revenue
Decision date:	31 March 2006
Act:	District Courts Act 1947; District Courts Rule 1992
Keywords:	Strike out pleadings, jurisdiction of District Court

Summary

The District Court struck out causes of action 3,4,5 & 6 of the Taxpayer's Statement of Claim under the proviso to section 44 District Courts Act 1947 as the aggregate of the causes of action in the proceeding exceeded the District Court's jurisdiction of $200,000 and the Taxpayer knew his claim exceeded the jurisdiction.

Decision

The Taxpayer's proceeding, claiming under six different causes of action, collectively amounted to $8,946,716.49 plus interest for damages arising from the Commissioner stopping two cheques for GST refunds; one for $29,013.21 in 1996 and the other for $59,422.03 in 1998. The jurisdiction of the District Court is limited to $200,000. The Court held that that jurisdiction is exceeded where there a number of causes of action which, although individually involving less than $200,000, exceed that amount in the aggregate. Under the proviso to section 44 of the District Courts Act, where a plaintiff knew that the jurisdiction was exceeded, the Court can strike out the proceedings. The Court found that the Taxpayer made a deliberate and calculated decision to ignore the jurisdiction limit and struck out causes of action 3, 4, 5 & 6; leaving the causes of action for each of the stopped cheques.

REWRITE ADVISORY PANEL

SUMMARY OF UNINTENDED LEGISLATIVE CHANGE SUBMISSIONS WHERE REWRITE ADVISORY PANEL CONSIDERED THERE IS NO UNINTENDED LEGISLATIVE CHANGE

As part of the implementation of the Income Tax Act 2004, a process was developed to refer potential Unintended Legislative Change issues arising as a result of the rewritten parts of the Income Tax Act, to the Rewrite Advisory Panel chaired by Sir Ivor Richardson.

The process is set out in RAP 001 (*Tax Information Bulletin* Vol 16, No 6 – July 2004) and also on the RAP website at **www.rewriteadvisory.govt.nz**

The following is a list of potential unintended legislative change submissions where the Rewrite Advisory Panel considered there was no unintended legislative change arising under the Income Tax Act 2004. In other words, the 2004 Act has the same outcome as the corresponding provisions in the 1994 Act or there is a notified policy change set out in Schedule 22A of the 2004 Act. As well as the changes identified below there are a number of submissions where the Panel has agreed that an unintended change has occurred, and these will be set out in the TIBs for the amendment Acts in which the corrections to the law have been made. All legislative references are to the Income Tax Act (both the 1994 and 2004 Acts) unless otherwise specified.

Section 2004:	**CD 14 (Submission 003)**
Section 1994:	CF 3 (1)(b)
Description:	Section CF 3 (1)(b), when dealing with the carve out for returns of capital by companies, applies to cancellations of shares in whole but not in part. It seems that the reference to cancellation (in whole but not in part) has not been carried over to the 2004 Act.
Outcome:	The Panel considers that there is no unintended legislative change under section CD 14 of the Income Tax Act and therefore no amendments are required in respect of CD 14 of the Income Tax Act 2004.

Section 2004:	**CB 9 (Submission 007)**
Section 1994:	section CD 1(2)(d)
Description:	Example: Trust is set up for Mum, Dad (neither in the property game nor in the business of erecting buildings) and children. Trust buys rental property. Children grow up. Child 2 becomes a builder eventually going into the business of erecting buildings. Twenty years on non-minor improvements are built (not necessarily by Child 2, who could even be resident overseas) on the property. Five years after that the property is sold having been rented out all that time. Under the ITA 1994, the sale of the property is not taxable as there was no-one in the business of erecting buildings at the time the property was acquired. Under the ITA 2004 the sale is taxable as: • Child 2 is in the business of erecting buildings when the non-minor improvements are begun, • Child 2 is **associated** with the Trust as a beneficiary, and • the property is sold within 10 years of the improvements being undertaken.
Outcome:	This submission relates to an intended change which is included in Schedule 22A of the ITA 2004. The exposure draft relating to this item can be viewed at **http://pad/external/publications/files/rewrite/index.html**

Section 2004:	**CB 11(1) (Submission 008)**
Section 1994:	CD 1(2)(g)
Description:	Under this section any development work of a significant nature is taxed on the total value of the land transaction, rather than being taxed on the extent of the amount derived from the scheme, as would be the case under the 1994 act. This is clearly an unintentional change.
Outcome:	The Panel is not persuaded that an unintended change arises in respect of section CB 11(1) of the ITA 2004. The Panel: i. when all or part of a property enters into a scheme for development and when property is withdrawn from a scheme. ii. recommends a retrospective amendment to the ITA 2004 if an unintended legislative change is confirmed in the light of the Panel's view of the preceding legislation as capturing only the gain in respect of such property and so on revenue account during that period. (Refer to Submission 033.)

Section 2004:	**OB 1 (Submission 010)**
Section 1994:	OB 1 and definition of person
Description:	The ITA 2004 no longer includes, in section OB 1, a general definition of "person". Under the ITA 1994, "person" was defined to include "a company and a local or public authority; and also includes an unincorporated body of persons:". The ITA 2004 includes no such definition, which is odd considering the increased emphasis in the new Act on the term "person", rather than "taxpayer".
Outcome:	This issue was explained in the *Tax Information Bulletin* Vol 16, No 5 (June 2004). The definition of "person" in the Interpretation Act applies and given that definition, there is no change in outcome, and no unintended legislative change.

Section 2004:	**CD 33(2)(c) (Submission 012)**
Section 1994:	CF (3)(7)
Description:	Section CD 33(2)(c) does not specify application of "capital gain amount" and it should link to the definition of "capital gains"
Outcome:	The Panel considers that there is no unintended legislative change in respect of section CD 33(2)(c). The Panel considers that the application of "capital gain amount" can be implied from the current definition of "capital gains". However, the Panel has asked Inland Revenue to consider clarifying the legislation by inserting the word "amounts" in the definition of "capital gains" in sectionCD 33(2)(c). This clarification has been enacted in the Taxation (Depreciation, Payment Dates Alignment, FBT and Miscellaneous Provisions) Act which received the Royal Assent on 3/04/06.

Section 2004:	**CB 14(2) (Submission 013)**
Section 1994:	CD 1(3)(b)
Description:	Section CB 14(2) of the ITA 2004 states the exclusion applies to: "…the land that has the dwelling house on it." In CD 1(3)(b) of the ITA1994 it was clear the land that was excluded was only the dwelling house itself. It is unclear if CB 14(2) restricts the exclusion to the dwelling house only as it refers to "the land that has the dwelling house on it". Does this now mean that the exclusion will apply to the dwelling house, or the dwelling house and curtilage or the dwelling house and the land in the certificate of title on which the dwelling house is situated.

Outcome:	The Panel considers there is no unintended legislative change in this instance. However, the Panel recommended that the legislation would benefit from clarification and the submission has been referred to Inland Revenue's Policy Advice Division.

Section 2004:	**CB 6(1)(c) and CB 9(1) and (2) (Submission 15)**
Section 1994:	CD 1(2)(d). Section CD 1(2)(d)
Description:	The omission of the minor nature clause from CB 6(1)(c) and CB 9(1) and (2) results in an unintended change.
Outcome:	The Panel considers there is no unintended legislative change under sections CB 6(1)(c) and CB 9(1) and (2) of the ITA 2004.

Section 2004:	**CE 1 (Submission 016)**
Section 1994:	OB 1 definition of monetary remuneration
Description:	The definition of monetary remuneration in relation to the provision of accommodation has been narrowed from including "board or lodging, or the use of a house or quarters.." to "the market value of board...". The normal definition of board is much narrower than the words in the old section and would not incorporate the provision of a house.
Outcome:	The Panel considers no unintended legislative change arises in this instance.

Section 2004:	**DB 36 (Submission 21)**
Section 1994:	Section DJ 22
Description:	Under the 1994 Act deductions are denied for bribes paid to all public officials (whether the official is a New Zealand or a foreign public official). Under the 2004 Act deductions are denied for bribes paid to New Zealand officials. However, deduction are only denied for bribes paid to foreign public officials where it is an offence under the laws of the foreign country.
Outcome:	The Panel considers no unintended legislative change arises in this instance.

Section 2004:	**FE 6(5) and (6) and FE 7(1) and (2) (Submission 025)**
Section 1994:	Sections FE 6 and FE 7
Description:	tax year and income year
Outcome:	The Panel considers that there is no unintended legislative change in this instance. The Panel recommends that the terms "tax year" and "income year" be reviewed to ensure that they give the appropriate outcomes in all places where they are used in the Act.

Section 2004:	**BB 2, LD 7, MB 2, OB 1 ("provisional taxpayer") (Submission 030)**
Section 1994:	BB 2(2), section LD 7, subpart MB and the definition of "provisional taxpayer" in section OB 1
Description:	The ITA 2004's reference to "tax year" in section BB 2(3), section LD 7, subpart MB and in the definition of "provisional taxpayer" in section OB 1 results in an unintended change. The sections should refer to "income year".
Outcome:	The Panel considers that there has not been an unintended legislative change in this instance. Please note, the use of the terms, "tax year" and "income year" in the Income Tax Act 2004 are being reviewed by Inland Revenue's Policy Advice Division.

Section 2004:	**CB 11(1) (Submission 33)**
Section 1994:	CD 1(2)(g)
Description:	The issue described in submission number 008 also arises in relation to major projects involving the development of land that is to be retained after the completion of the development as a long-term rental investment.
Outcome:	The Panel considers that no unintended legislative change arises in this instance. CIR to provide a statement of how he will apply the law.

Section 2004:	**Section CE2 has been omitted (Submission 034)**
Section 1994:	Section CE2 was omitted from the ITA 1994. The equivalent section in the 1974 Act was section 74(2)(a).
Description:	Section CE2 has been omitted. From 1916 this has been the main assessment section for farmers. It is not correct to classify farming as a business. The prime objective of the farmer is to maintain the land and the associated assets. A large proportion of a farmer's costs are not directly matched with the specific amounts of income earned each day or period, but apply to future income. It is a very extended argument to accurately arrive at a valid income figure for the farming sector because the 12-month period of assessment does not coincide with most farming cycles. There are many examples of land use which are quasi-business or not a business, or are of a pioneering nature that today could fail to be classified as a business if this omission is not corrected and such classification is left to the discretion of IRD staff. It is important to note that the technical rulings which IRD staff operate under ie "clause 51.4 BUSINESS CRITERIA" are flawed as it ignored Section CE2 and does not recognise the 1983 Court of Appeal decision Grieve v CIR which clearly set out the operation of the various Acts in this area.
Outcome:	The Panel considers that there is no unintended legislative change arising in respect of the omission of section CE 2 from the ITA 2004 Act in respect of the taxation of farming.

Section 2004:	**DC 9(2) (Submission 036)**
Section 1994:	DF 10(2)
Description:	Section DC 9(2) of the ITA 2004 provides that, if the seller and buyer are not associated persons at the time of the sale, (a) the seller is allowed a deduction, in the income year of the sale, for any part of the amount that remains contingent on the employee continuing in employment or any similar factor; and (b) the seller is treated under section EA 4(4) as having paid the amount at the time of sale. This is a more onerous requirement than that which is set under the 1994 Act.
Outcome:	The Panel considers that there has not been an unintended legislative change in this instance.

Section 2004:	**CB 11(1)(iv) (Submission 038)**
Section 1994:	CD 1 (2)(g)
Description:	The last item in the list of Section CB 11(1)(iv), "roading", contains a trailing comma unlike previous legislation where the comma on the last list item is absent. The effect of this extra comma is that the nexus with major projects is severed and each list item is now independent of the requirement to be contained within the definition of work customarily undertaken in major projects. Thus for example significant expenditure on earthworks alone is enough to be caught by this section.
Outcome:	The Panel considers that there has not been an unintended legislative change in this instance.

Section 2004:	**CG 4 (Submission 039)**
Section 1994:	DJ 1
Description:	Section CG 4 of the Income Tax Act 2004 treats as income amounts recovered when "the person recovers some or all of the expenditure or loss, whether through insurance, indemnity, or otherwise".
Outcome:	The Panel considers that there is no unintended legislative change arising in respect of section CG 4(1) of the ITA 2004.

Section 2004:	**CB 5, CB 6, CB 7, CB 8, CB 9, CB 10, OD 8(4) (Submission 040)**
Section 1994:	CD1(2)(b) to (g), OD 8(4)
Description:	The taxing provisions of CB make reference to the gross income of a person such as CB 6(1)(a)(i) "at the time person A acquired the land they…" The definitions of taxpayer and person remain the same as those of the 1994 Act. A taxpayer is defined in OB 1 as "a person who is, or may be liable to perform or comply with an obligation imposed by this Act". A person is undefined for the purposes of the 2004 Act.
Outcome:	The Panel considers that there was no unintended legislative change arising in respect of section CB 6(1)(a) of the ITA 2004.

Section 2004:	**LD (Submission 041)**
Section 1994:	OB 1"income year", and Part LD
Description:	References to "income year" have been replaced with "tax year" which have different defined meanings. In Part LD this results in unintended changes (and may lead to withholding of credits by the Commissioner).
Outcome:	The Panel considers that there has not been an unintended legislative change in this instance. The Panel recommended that the points raised in the submission be referred to Inland Revenue's Policy Advice Division to consider as part of their review of the terms "tax year" and "income year".

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

SPS 06/01 – DISCRETION TO CANCEL OR NOT ASSESS SHORTFALL PENALTIES FOR TAKING AN UNACCEPTABLE TAX POSITION

Introduction

1. This Standard Practice Statement (SPS) sets out Inland Revenue's practice for exercising the Commissioner's discretion to:

   - cancel a previously assessed shortfall penalty for taking an unacceptable tax position, and/or
   - not assess a shortfall penalty that would otherwise be assessed for taking an unacceptable tax position

   in circumstances when the Commissioner is satisfied that certain criteria are met.

2. For the purpose of this SPS, the term "UTP penalty" refers to a shortfall penalty assessed for taking an unacceptable tax position under section 141B of the Tax Administration Act 1994 (TAA).

3. Unless specified otherwise, all legislative references in this SPS refer to the TAA.

Application

4. This SPS applies to taxpayers:

   - who have been assessed a UTP penalty before 1 April 2006, and/or
   - who may (but for exercise of the discretion) be assessed a UTP penalty on or after 1 April 2006

   for tax positions taken after 1 April 2003.

Standard Practice

5. From 1 April 2006, pursuant to section 141KB, the Commissioner can determine:

   - whether or not to cancel a UTP penalty that has been assessed before 1 April 2006, and
   - whether or not to assess a UTP penalty that would otherwise be assessed on or after 1 April 2006.

6. In order for the Commissioner to consider cancelling a UTP penalty that has been assessed prior to 1 April 2006, the taxpayer must make a request in writing. The request must be received by Inland Revenue before 1 October 2006.

7. The Commissioner will cancel or decide not to assess a UTP penalty if satisfied that the following three criteria of section 141KB(2)(a) are met:

   - that "a clear mistake or simple oversight" caused the taxpayer to take the unacceptable tax position to which the UTP penalty related, or would relate if the UTP penalty were to be assessed, and
   - either:
     - the tax shortfall is voluntarily disclosed to the Commissioner prior to the notification of a pending tax audit or investigation (in terms of section 141G(1)(a)), or
     - the tax shortfall is a temporary tax shortfall (in terms of section 141I(3)), and
   - it is appropriate that the taxpayer not be liable to pay a UTP penalty.

8. When the Commissioner cancels or decides not to assess a UTP penalty under section 141KB(1), the Commissioner may consider that the taxpayer is instead liable to pay a shortfall penalty for lack of reasonable care under section 141A. The date of imposing a shortfall penalty for lack of reasonable care, if applicable, is the same as the date of the Commissioner's decision under section 141KB(1).

Background

9. The UTP penalty legislation (section 141B) was enacted (as an amendment to the former "unacceptable interpretation" penalty) in 2003, because under the former penalty (for taking an unacceptable interpretation) taxpayers could choose not to interpret the legislation on a complex tax issue as a means of avoiding possible shortfall penalties. However, experience with the UTP penalty has shown that it gives rise to some unintended penalty outcomes. In some cases, the penalty discourages voluntary compliance by taxpayers who discover a clear mistake or simple oversight.

10. The government has recognised the problems caused by the UTP penalty and introduced section 141KB to give the Commissioner discretion in the

assessment of a UTP penalty when the tax shortfall has arisen from a clear mistake or simple oversight. In exercising this discretion in practice, the Commissioner's intention is to ensure the discretion is applied consistently with the background to its enactment and to encourage voluntary disclosure of mistakes and oversights, and their efficient correction, and thus promote voluntary compliance.

11. Section 141KB applies from 1 April 2006, but to overcome previous unintended outcomes, the section has retrospective effect to 1 April 2003.

12. Taxpayers are still obliged to ensure that, when viewed objectively, their tax positions meet the standard of being about as likely as not to be correct. However, section 141KB means that, generally, taxpayers who make a pre-notification voluntary disclosure in relation to tax shortfalls that have arisen from clear mistakes or simple oversights will not be liable for UTP penalties.

Legislation

13. The relevant legislative provisions are:

- the definitions of "tax position", "disputable decision" and "response period" in section 3(1),
- sections 14, 89D, 141A, 141B, 141FB, 141G, 141H, 141I, 141KB, and
- sections CC 8 and EF 4 of the Income Tax Act 2004.

Discussion

Operation of the UTP penalty

14. Section 141B provides that a shortfall penalty will be imposed if a taxpayer takes an unacceptable tax position.

15. An unacceptable tax position is one taken by a taxpayer that, when "viewed objectively, fails to meet the standard of being about as likely as not to be correct". This standard has been recognised as applying to a wide range of tax positions including tax positions that are simply incorrect as a result of inadvertence.

16. For a UTP penalty to be assessed, the tax shortfall must be more than both:

- $20,000, and
- the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.

17. The shortfall penalty payable is 20% of the resulting tax shortfall. However, the penalty may be reduced because of:

- a voluntary disclosure under section 141G, and/or
- a temporary tax shortfall under section 141I, and/or
- the taxpayer's previous behaviour under section 141FB, and/or
- disclosure of an unacceptable tax position under section 141H.

18. Please refer to Interpretation Statement *IS0055* titled *Shortfall penalty – unacceptable interpretation and unacceptable tax position* (which was published in *Tax Information Bulletin* Vol. 17, No. 9 (November 2005) and is available on Inland Revenue's website at www.ird.govt.nz) for further details on Inland Revenue's practice in assessing UTP penalties.

The Commissioner's discretion under section 141KB

19. The Commissioner may exercise the new discretion under section 141KB(1) to cancel a previously assessed UTP penalty (i.e. assessed before 1 April 2006) or not assess a UTP penalty that would otherwise be assessed from 1 April 2006 in respect of a tax position taken after 1 April 2003.

20. Section 141KB reads:

(1) The Commissioner may decide in the circumstances given by subsection (2) that a taxpayer is not liable to pay a shortfall penalty that would otherwise be imposed by section 141B in relation to a tax position.

(2) The Commissioner may exercise the discretion given by subsection (1) if—

(a) the Commissioner is satisfied that—

(i) the tax position is taken as a result of a clear mistake or simple oversight; and

(ii) the tax shortfall arising from the tax position is or would be subject to a reduced penalty under section 141G(1)(a) as a result of a voluntary disclosure or is a temporary tax shortfall under section 141I(3); and

(iii) it is appropriate that the taxpayer not be liable to pay a shortfall penalty under section 141B in relation to the tax position; and

(b) the Commissioner—

(i) does not assess the shortfall penalty before exercising the discretion:

(ii) assesses the shortfall penalty before 1 April 2006 and receives before

1 October 2006 a written request from the taxpayer for a decision under subsection (1).

(3) If the Commissioner decides under subsection (1) that a taxpayer is not liable to pay a shortfall penalty that the Commissioner has assessed, the assessment of the shortfall penalty is treated as not having been made.

(4) If the Commissioner decides under subsection (1) that a taxpayer is not liable to pay a shortfall penalty that would otherwise be imposed by section 141B in relation to a tax position, the taxpayer is not excluded from liability to pay a shortfall penalty under section 141A in relation to the tax position.

Taxpayers' requests for cancellation of UTP penalties assessed before 1 April 2006

21. A taxpayer may request cancellation of a UTP penalty assessed before 1 April 2006. Their request must be:

- made in writing, and
- received by Inland Revenue before 1 October 2006.

The taxpayer's request should be sent to their nearest Inland Revenue office. The addresses of Inland Revenue offices can be obtained from Inland Revenue's website at www.ird.govt.nz.

22. To enable the Commissioner to consider all relevant information in exercising the discretion under section 141KB, the written request should include:

- a description of the circumstances leading to the tax shortfall, including the relevant background facts that led to the assessment of the UTP penalty under section 141B,
- references to any relevant correspondence with the Commissioner, and
- any other information that the taxpayer considers relevant to the Commissioner's decision under section 141KB.

23. The request for a cancellation of a UTP penalty should include a discussion on how the three criteria of section 141KB(2)(a) in paragraphs 28 to 66 relate to the facts and circumstances of the case at hand. The commentary below will assist.

24. When the taxpayer makes a written request for the Commissioner to exercise the discretion under section 141KB, the Commissioner will advise the taxpayer in writing of his decision. The matter will be subject to a degree of priority, depending upon the volumes and the need to maintain consistency.

The criteria for cancelling UTP penalties

25. The Commissioner must be satisfied that the following three criteria are met in order to exercise the discretion and cancel a UTP penalty that has been assessed. The three criteria are:

- that a "clear mistake or simple oversight" caused the taxpayer to take the tax position to which the UTP penalty relates (please see paragraphs 28 to 42 for details on what the Commissioner considers constitutes a "clear mistake or simple oversight" in the context of section 141KB), and
- that the tax shortfall is voluntarily disclosed prior to the notification of a pending tax audit or investigation under section 141G(1)(a) or is a temporary tax shortfall under section 141I(3) (please see paragraphs 43 to 55 for details), and
- that it is appropriate that the taxpayer not be liable to pay the UTP penalty (the meaning of "appropriate" in the context of section 141KB is explained further in paragraphs 56 to 66).

Assessment of UTP penalties from 1 April 2006

26. From 1 April 2006, the Commissioner has discretion in determining whether or not to assess a UTP penalty if certain criteria are met. As stated in paragraph 10 of this SPS, the Commissioner will exercise the discretion in the spirit in which section 141KB was enacted, to make sure that tax shortfalls which meet the criteria can be properly identified and corrected without incurring a UTP penalty. In considering whether or not to assess a UTP penalty, the Commissioner will always consider the objectives of section 141KB and whether he is satisfied that the three criteria set out in section 141KB(2)(a) are met (please see paragraph 25 for details).

27. However, if taxpayers do not believe that the discretion has been properly considered, and a UTP penalty is to be assessed, they should draw the matter to the attention of Inland Revenue as soon as possible following receipt of the Commissioner's notification of a UTP.

The three criteria in section 141KB(2)(a)

Criterion 1: the tax shortfall is caused by "a clear mistake or simple oversight"

28. The term "a clear mistake or simple oversight" is not defined in the TAA. To the extent that the term relates to the assessment of a UTP penalty under section 141B, or the non-assessment/cancellation of a UTP penalty under section 141KB, the term should be read in the context of that provision's objective, and the Commissioner will adopt a broad approach to the words.

29. However, not all mistakes or oversights will qualify for the application of section 141KB. The Commissioner considers that the sort of mistake or oversight contemplated must be an inadvertent one. That is, had the taxpayer known of the mistake or oversight, they would not have taken the tax position that they took. A tax shortfall which is the result of a deliberate interpretation will not qualify. Furthermore, the existence of the mistake or oversight should be plain and obvious on review.

30. The term "clear mistake or simple oversight" can also apply to situations when a particular outcome is intended, but that outcome later turns out not to be achieved, as a result of a miscalculation, misunderstanding or unintentional omission.

31. The Commissioner considers that the words "clear" and "simple" apply to the mistake or oversight, and not to the underlying transaction to which the mistake or oversight relates. That is, it is possible for section 141KB to apply in respect of a complex transaction, when an incorrect tax position is taken as a result of a clear mistake or simple oversight. For example, in a company shareholder restructure, a breach of shareholder continuity was not identified as a result of a mistake in determining the change in shareholding percentages with the result that tax losses were incorrectly carried forward. The restructure was complex, but a clear mistake resulted in an incorrect tax position.

32. Whether the Commissioner is satisfied that the taxpayer's tax position is caused by a "clear" mistake or "simple" oversight will be determined on a case-by-case basis. As the nature of the enquiry is in determining whether there is a mistake or oversight, the Commissioner expects that, once discovered, the reason for the mistake must be clearly identifiable and understood. Similarly if a matter is an oversight, it should be an uncomplicated process to explain that and how the mistake led to the tax shortfall.

33. For example, a taxpayer purchased some land and was informed by the vendor's solicitor that the vendor was registered for GST and a tax invoice was to be issued. The taxpayer's accountant relied on this advice and filed a GST return claiming the full amount of input tax. It was later established that while the vendor was GST registered, the land did not form part of the vendor's taxable activity, but was held in the vendor's personal capacity. In this example, the taxpayer's tax position in claiming the input tax was deliberately taken, but the taxpayer had acted on a misunderstanding that resulted in an incorrect tax position. The Commissioner is satisfied that the incorrect tax position taken was as a result of a clear mistake.

34. A "clear mistake" in the context of sections 141B and 141KB could include (but is not limited to) "a mistake in the calculation or recording of numbers in a return." Such mistakes, however, should be considered in terms of section 141B(1B), and do not result in a UTP penalty in the first place. If section 141B(1B) applies, there should be no need to consider section 141KB in these types of cases.

35. For further details on mistakes "in the calculation or recording of numbers in a return", please refer to an article entitled "Tax compliance, standards and penalties" in the *Tax Information Bulletin*, Vol. 15, No. 5 (May 2003) and Interpretation Statement *IS0055* titled *Shortfall penalty – unacceptable interpretation and unacceptable tax position*. Both the article and the Interpretation Statement are also available on Inland Revenue's website at www.ird.govt.nz.

A mistake of law or mistake of fact may be "a clear mistake or simple oversight"

36. Section 141KB(2)(a)(i) does not distinguish between a "mistake of fact" and a "mistake of law". The Commissioner does not intend to draw a distinction between these concepts (which can often be merged), so that overlooking or completely misunderstanding a statutory requirement could qualify as a clear mistake.

37. For example, a taxpayer changed their GST accounting treatment from the payments to invoice basis, and incorrectly assumed the change took effect from the commencement of the GST return period in which the election was made, rather than the GST return period immediately following approval by the Commissioner.

38. As stated in paragraph 29, a tax position that was inadvertent or that was taken in circumstances when, had the taxpayer known of the mistake or oversight, they would not have taken the tax position they took, will often suggest that there was a mistake.

39. The Commissioner also considers that, generally, no "clear mistake or simple oversight" will be present in the following circumstances:

    - *Not knowing the law*: there is no clear mistake or simple oversight simply because a taxpayer does not know the law. Taxpayers have a duty to be aware of their obligations. Furthermore, knowingly choosing not to refer to the relevant tax law when taking a tax position, i.e. knowingly turning a blind eye to the law, is also something not contemplated by the discretion. However, knowingly choosing not to interpret the law would not apply to circumstances when the taxpayer can show they have taken steps to find out what the law requires but have genuinely overlooked a relevant law.

- *Knowing the law but choosing to ignore it*: in the same vein, a taxpayer cannot be said to have made a clear mistake or simple oversight if they were aware of their responsibilities but chose to ignore them. For example, a taxpayer was aware that they were not permitted to value closing trading stock at market value unless the value was less than the cost, and did not adjust the closing trading stock value back to cost when completing their income tax return.

"Timing" differences may be "a clear mistake or simple oversight"

40. By way of a further example, the Commissioner considers that a "clear mistake or simple oversight" may include mistakes or oversights resulting in "timing" differences for taxation purposes. The inclusion of "timing" differences in what might constitute a "clear mistake or simple oversight" is in any event implied by the reference to "a temporary tax shortfall" in section 141KB(2)(a)(ii).

The discretion may apply to mistakes or oversights that relate to multiple tax types, tax periods or other taxpayers in some cases

41. To avoid doubt on the issue, a taxpayer's mistake or oversight can relate to one or more revenue types, or one or more tax periods, or taxpayers. For example, as mentioned in paragraph 31 above, the breach of shareholder continuity may have meant that tax losses have been incorrectly carried forward for several income years. They may have also been incorrectly applied against the taxable income of other companies in the same group of companies. Despite this, so long as the Commissioner considers the criteria of section 141KB are met, the Commissioner will exercise the discretion and either cancel or not assess the UTP penalties.

42. To continue the example in paragraph 31, the losses had been offset against foreign dividend withholding payments. The same mistake caused the taxpayer to take incorrect tax positions in more than one revenue type. Despite this, so long as the Commissioner considers that the criteria of section 141KB are met, the Commissioner will exercise the discretion and either cancel or not assess the UTP penalties.

Criterion 2: the taxpayer makes a voluntary disclosure or the shortfall is a temporary tax shortfall

43. In order to satisfy the Commissioner that the criterion of section 141KB(2)(a)(ii) is met, a taxpayer must be able to show that the tax position to which the UTP penalty relates:

- is subject to a voluntary disclosure prior to the notification of a pending tax audit or investigation ("pre-notification disclosure") under section 141G(1)(a), or
- is a temporary tax shortfall under section 141I(3).

Voluntary disclosure

44. For a UTP penalty assessed before 1 April 2006 or a UTP penalty that would otherwise be assessed on or after 1 April 2006, section 141KB(2)(a)(ii) is met if the tax position to which the UTP penalty relates has been or would be reduced by 75% for a pre-notification disclosure under section 141G(1)(a).

45. Section 141G(1)(a) reads:

> A shortfall penalty payable by a taxpayer under any of sections 141A to 141EB may be reduced if, in the Commissioner's opinion, the taxpayer makes a full voluntary disclosure to the Commissioner of all the details of the tax shortfall, either—
>
> (a) Before the taxpayer is first notified of a pending tax audit or investigation (referred to in this section as "pre-notification disclosure") …

46. The following SPSs set out the Commissioner's practice on reducing shortfall penalties for voluntary disclosure and pre-notification disclosures:

- *INV 251 Voluntary Disclosures*, and
- *INV 260 Notification of a Pending Audit or Investigation*

These SPSs were published in *Tax Information Bulletins* Vol. 14, No. 4 (April 2002) and Vol. 12, No. 2 (February 2000) respectively and are available on Inland Revenue's website at www.ird.govt.nz. Note that SPS *INV 260* has expired, but still generally indicates current practice.

47. As noted in SPS *INV 251*, the tax system is based on voluntary compliance, and relies on taxpayers meeting their obligations under the tax laws. The voluntary disclosure system provides an incentive to taxpayers to determine their correct tax liability. It is also recognised that the tax system also benefits from voluntary admissions of irregularities and other co-operation by taxpayers.

48. Inland Revenue now also allows taxpayers to make full voluntary disclosure of tax shortfalls by email on Inland Revenue's Online Correspondence Service. In the context of this SPS, it has been decided that disclosures by email or ordinary correspondence will be accepted, provided that they are clear in their terms. That is, form IR281 need not be used.

Notification of audit or investigation

49. It is the Commissioner's intention to give sufficient opportunities for taxpayers to disclose mistakes in the period before a decision is taken to commence an investigation (and before it commences). Clear wording is to be used in any communication to taxpayers when a decision to investigate has been made. Requests for information to enable the Commissioner to decide whether to investigate are not themselves part of an investigation.

50. The Commissioner's practice of undertaking an audit activity after a return has been filed, such as some GST refund checks, may limit the opportunity for a taxpayer to make a pre-notification disclosure under section 141G(1)(a). Taxpayers and agents filing returns will therefore have to be aware that section 141KB may not give relief in all cases. However, if taxpayers and/or their agents can show that they have taken steps to permanently reverse or correct the tax shortfall (prior to the notification of the audit or investigation), the tax shortfall may be a temporary tax shortfall pursuant to the Commissioner's current practices. Provided that all other criteria in section 141KB(2)(a) are met, the Commissioner will exercise the discretion to cancel or not assess the UTP penalty. (Please see the discussion on temporary tax shortfalls in paragraphs 52 to 55.)

51. The Commissioner may give notice of a pending tax audit or investigation by post. In such cases the taxpayer will be regarded as having been notified of the audit or investigation if the notice meets the requirements of section 14(8) and section 14(9).

Temporary tax shortfall

52. For a UTP penalty assessed before 1 April 2006 or a UTP penalty that would otherwise be assessed on or after 1 April 2006, section 141KB(2)(a)(ii) is met if the tax position to which the UTP penalty relates has been or would be reduced by 75% for a temporary tax shortfall under section 141I(3).

53. The term "temporary tax shortfall" is defined by section 141I(3) as follows:

> A tax shortfall is a temporary tax shortfall for a return period if the Commissioner is satisfied that—
>
> (a) The tax shortfall has been permanently reversed or corrected in an earlier or later return period, so that (disregarding penalties or interest) the taxpayer pays the correct amount of tax or calculates and returns the correct tax liability in respect of the item or matter that gave rise to the tax shortfall; and
>
> (b) No tax shortfall will arise in a later return period in respect of a similar item or matter; and
>
> (c) No arrangement exists in any return period which has the purpose or effect of creating a further related tax deferral or advantage; and
>
> (d) The tax shortfall was permanently reversed or corrected before the taxpayer is first notified of a pending tax audit or investigation.

SPS *INV 231 Temporary Shortfall – Permanent Reversal* sets out Inland Revenue's practice on what constitutes a temporary tax shortfall. This SPS was published in *Tax Information Bulletin* Vol. 11, No. 8 (September 1999) and is available on Inland Revenue's website at www.ird.govt.nz.

54. The Commissioner considers that a tax shortfall has been permanently reversed or corrected if:
    - it appears from the taxpayer's actions that the steps taken by the taxpayer have or will remedy the tax shortfall, or
    - through operation of law or circumstances, the matter will reverse itself.

55. The Commissioner's practice has been to accept that the tax shortfall is temporary if on inquiry (not being an audit or investigation) he is satisfied that steps are being taken to correct the shortfall in the next relevant return. For example, an incorrect input tax credit claimed in respect of a transaction that was zero-rated. If the tax shortfall is corrected and the tax is paid in the next GST return period, or earlier, the initial tax shortfall will be regarded as being temporary.

Criterion 3: the Commissioner is satisfied that it is "appropriate" to cancel or not to impose a UTP penalty

56. The discretion under section 141KB(1) will be exercised if the Commissioner is satisfied that all three criteria in section 141KB(2)(a) are met. Pursuant to section 141KB(2)(a)(iii), the Commissioner may decline to exercise the discretion if the Commissioner is satisfied that it would not be appropriate to do so, although the circumstances in which this will arise will be rare.

57. The legislation does not define what is meant by "appropriate". In considering whether it is appropriate to exercise the discretion under section 141KB, the Commissioner will have regard to the facts of each case, in light of the purpose of section 141KB, which is a concessionary discretion.

58. The Commissioner will also consider the overriding obligations in section 6 to protect the integrity of the tax system and in section 6A(3) to collect the highest net revenue over time, and in particular the importance of promoting voluntary compliance by all taxpayers.

59. The Commissioner considers that it is very important to create the right conditions for

encouraging voluntary disclosure in particular and compliance in general. The following factors (not being an exhaustive list) could be relevant on a case-by-case basis in deciding whether or not to apply the discretion under section 141KB:

- the steps taken to rectify the incorrect tax position to which the UTP penalty relates. For example, requesting a reassessment to reflect the correct tax position and/or meeting any payments due, and
- whether and the extent to which the taxpayer has been assessed for similar shortfall penalties, and the nature of those penalties. If the taxpayer is consistently incurring shortfall penalties, this may illustrate the taxpayer's general approach to tax compliance, which is not consistent with the exercise of the discretion in the taxpayer's favour.

Taxpayers' efforts to rectify the incorrect tax position to which the UTP penalty relates

60. It is envisaged that the taxpayer will make a voluntary disclosure of the tax shortfall as soon as practicable, and take reasonable steps to rectify the position (for example, by paying the correct amount of tax.) There are instances of this occurring before the original due date for filing. In such cases, where the other criteria of section 141KB(2)(a) are met, it can be assumed that it is appropriate to cancel or not to impose the UTP penalty.

Taxpayer repeatedly makes similar clear mistakes or simple oversights

61. Section 141KB is intended to promote voluntary compliance by taxpayers. In cases when the taxpayer repeatedly makes similar clear mistakes or simple oversights, there is unlikely to be any reason to positively exercise the discretion.

62. That is, there may be circumstances that may indicate that voluntary compliance by taxpayers in general, as well as the particular taxpayer, may not be promoted by exercise of the discretion, in particular when the mistake or oversight has occurred before, and has been drawn to the taxpayer's attention, yet the mistake or oversight has been repeated. (Generally this might also bring the matter into the realm of the shortfall penalty for lack of reasonable care.)

63. For example, a taxpayer imports a piece of machinery and pays GST to NZ Customs. In preparing the GST return, the taxpayer includes that GST paid to NZ Customs as an input tax adjustment in their return, but also includes the amount paid to their overseas supplier in their total purchases for the period – thereby claiming a GST input tax credit twice. The mistake is voluntarily disclosed and corrected. The discretion under section 141KB is applied and no UTP penalty is assessed. However, a few months later, when another piece of machinery is imported, the same mistake is made. In this second case, it cannot be presumed that because the mistake is disclosed and corrected that the Commissioner will consider it "appropriate" to apply the discretion.

64. This is not to suggest, however, that the provisions of section 141KB should be applied only once in respect of a particular type of mistake or oversight.

65. In some cases, it may still be appropriate for the Commissioner to cancel or not to assess a UTP penalty when the taxpayer concerned has a reasonable compliance history but has the occasional lapse – for example due to a change in staff. Sometimes there are special or unique circumstances giving rise to the tax shortfall, and the Commissioner will take this into account.

66. Whether a taxpayer makes similar mistakes is not determined by the wider tax compliance history of the taxpayer. For example a previously non-compliant taxpayer (for example, a taxpayer convicted of knowledge and evasion offences under sections 143A and 143B) now usually meets all their tax obligations, except on this occasion, when the taxpayer makes a clear mistake that results in a UTP penalty. Provided that the other criteria of section 141KB(2)(a) are met, it is appropriate for the Commissioner to decide not to impose the UTP penalty on the taxpayer.

Retrospective effect of cancellation of UTP penalties assessed before 1 April 2006

67. Pursuant to section 141KB(3), when the Commissioner cancels a UTP penalty that was assessed before 1 April 2006, the cancellation is retrospective. In other words, the cancellation has the same effective date as the date on which the UTP penalty was assessed. Thus, if the taxpayer has already paid the UTP penalty, the cancellation of the UTP penalty will result in an overpayment of tax as at that date and Inland Revenue will pay use of money interest ("UOMI").

68. Any credit UOMI arising from the cancellation of the UTP penalty forms part of the taxpayer's income under section CC 8 of the Income Tax Act 2004. It is allocated to the income year in which the Commissioner pays the UOMI under section EF 4 of the Income Tax Act 2004.

69. Inland Revenue will discuss with the taxpayer how the overpayment (including any late payment penalties if any) and the credit UOMI should be applied. This may include refunding the overpaid amount to the taxpayer or offsetting that amount against other outstanding tax (if any) or both.

70. If the taxpayer has not paid the UTP penalty, the Commissioner's cancellation of the penalty under section 141KB(1) means that any late payment penalties and debit UOMI accrued on the UTP penalty will be reversed.

Shortfall penalty for lack of reasonable care may still apply

71. Section 141KB(4) provides that when the Commissioner decides to cancel or not to assess a UTP penalty that would otherwise be assessed but for section 141KB(1), the Commissioner is not precluded from assessing a shortfall penalty for lack of reasonable care ("LORC" penalty) under section 141A.

72. Despite section 141KB(4) there is no ability to apply a LORC penalty retrospectively. Section 141A(5) states that when a LORC penalty applies, the liability for the shortfall penalty is treated as arising on the date of the Commissioner's decision to cancel or not to assess the UTP penalty under section 141KB(1).

73. Please refer to Interpretation Statement *IS0053* titled *Shortfall penalty for not taking reasonable care* (which was published in *Tax Information Bulletin* Vol. 17, No. 9 (November 2005) and is available on Inland Revenue's website at www.ird.govt.nz) for further details on Inland Revenue's practice in assessing LORC penalties.

Taxpayer's right to dispute the Commissioner's decision under section 141KB(1)

74. The exercise of the Commissioner's discretion under section 141KB(1) is a "disputable decision" as defined in section 3(1). Thus, if a taxpayer disagrees with the Commissioner's decision not to cancel or wishes to dispute a decision to assess a UTP penalty, the taxpayer may issue a notice of proposed adjustment (NOPA) to the Commissioner under section 89D(3). The NOPA must be issued within the applicable response period. (Please refer to *SPS 05/04 Disputes resolution process commenced by taxpayers*. This SPS was published in *Tax Information Bulletin* Vol. 17, No. 3 (April 2005) and is available on Inland Revenue's website at www.ird.govt.nz).

Examples

75. The following examples are included for illustrative purposes only. They illustrate circumstances when the Commissioner will exercise his discretion positively under section 141KB.

Example 1 Unrelated third party mistake

76. Mr X is a property developer registered for GST on a two-monthly invoice basis. Mr X purchases commercial property on 1 March 2004 and settlement occurs on 31 March 2004. The vendor's solicitor prepares the tax invoice for the transaction and makes a mistake in calculating the GST amount on the tax invoice. The tax invoice is forwarded to Mr X's accountant who prepares the GST return including the incorrect GST amount. The accountant has no direct involvement in Mr X's property development business apart from preparing his GST returns. The accountant forwards the GST return to Mr X to sign and file. Mr X is required to pay GST for the period ending 31 March 2004 as a result of two commercial properties he has sold during the period. The mistake in the tax invoice is not detected and Mr X sends the GST return to Inland Revenue. Mr X discovers the mistake the following week when he is reconciling his bank statements for the period. Mr X immediately makes a voluntary disclosure to Inland Revenue. The Commissioner assesses a UTP penalty on Mr X.

77. Mr X makes a written request to the Commissioner to exercise his discretion under section 141KB of the TAA.

Application of section 141KB

78. Mr X has made a voluntary disclosure prior to any notification of a pending audit or investigation.

79. In the Commissioner's opinion, the unacceptable tax position taken by Mr X was made as a result of a clear mistake in his GST return. This mistake resulted from a mistake made by an unrelated third party in calculating the GST amount on the tax invoice for the sale of the commercial property.

80. The Commissioner would be satisfied that it is appropriate in this case for Mr X to not be liable to pay a UTP penalty.

81. Based on the above circumstances, the Commissioner would cancel the UTP penalty because he is satisfied that the three criteria in section 141KB are met. The cancellation would be effective on the same date as the UTP penalty assessment was made.

Example 2 Clear mistake by omission

82. The ABC Trust (ABC) sold some farm machinery through an auctioneer in September 2004. GST was charged on the sale. ABC accounts for GST on the payments basis and settlement occurred in September 2004 when the money was deposited in ABC's bank by the auctioneer, but a statement from the auctioneer was not received until 22 October 2004. ABC had filed its two-monthly GST return to 30 September 2004 on 20 October 2004 but omitted the sale of the farm machinery.

83. ABC made a voluntary disclosure as to the omission on 29 October 2004 and at the same time (on the due date) made the correct payment of GST.

84. Inland Revenue assessed a UTP penalty. The taxpayer has written to the Commissioner requesting the penalty be cancelled under section 141KB.

Application of section 141KB

85. ABC has made a voluntary disclosure of the tax shortfall and also made payment of the GST by the due date.

86. In the Commissioner's opinion, the omission of the sale of the farm machinery was the result of a clear mistake or simple oversight due to the delay in receiving the auctioneer's statement.

87. The Commissioner is satisfied that it is appropriate for the taxpayer to not be liable to pay a UTP penalty and would exercise the discretion under section 141KB.

88. Based on the above circumstances, the Commissioner would cancel the UTP penalty because he is satisfied that the three criteria in section 141KB are met. The cancellation would be effective on the same date as the UTP penalty assessment was made.

This Standard Practice Statement is signed on 27 April 2006.

Graham Tubb
National Manager
Technical Standards

SPS 06/02 – WRITING OFF OUTSTANDING TAX

Introduction

1. This Standard Practice Statement (SPS) sets out Inland Revenue's practice for granting financial relief by permanently writing off outstanding tax.

Contents

2. Set out below are the headings of key issues discussed in this SPS:

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Application

3. This SPS applies to all write-offs of outstanding tax from 10 May 2006. It replaces SPS *RDC 620 Writing off tax debt* originally published in Vol 14, No 11 (November 2002) and other past Inland Revenue practices.

4. This SPS does not apply to financial support as defined in section 2(1) of the Child Support Act 1991 (ie child support payable and/or domestic maintenance payable under that Act) or to student loan repayment obligations. However, this SPS applies to an amount payable by a payer, as defined in section 153 of the Child Support Act 1991, under Part X of that Act.

5. Please refer to *SPS 05/11 Instalment arrangements for payment of tax debt* for further details on Inland Revenue's practice on providing relief under sections 177, 177A and 177B of the Tax Administration Act 1994 (TAA). The SPS was published in *Tax Information Bulletin* Vol 17, No 10 (December 2005) and is available on Inland Revenue's website at www.ird.govt.nz.

6. Unless specified otherwise, all legislative references in this SPS refer to the TAA.

Summary

7. Taxpayers who cannot afford to pay their tax may apply to Inland Revenue for financial relief under section 177(1).

8. Inland Revenue will negotiate with taxpayers to determine as soon as possible whether or not the taxpayers are eligible for financial relief and to what extent. Where Inland Revenue is unable to make an immediate decision on granting relief, the taxpayers may be required to provide additional relevant information (such as financial information) and will be required to file outstanding returns in support of the application.

9. Inland Revenue may write off amounts that cannot be recovered. Furthermore, Inland Revenue must write off outstanding tax due to:

   - bankruptcy, or
   - liquidation, or
   - when a taxpayer's estate has been distributed.

10. An amount written off may be reinstated if:

    - Inland Revenue receives, by operation of law, additional funds in respect of a taxpayer after the taxpayer becomes bankrupt, is liquidated or if additional funds due to the taxpayer's estate are discovered after the taxpayer's estate has been distributed (section 177C(4)), or
    - the outstanding tax was written off on the grounds of serious hardship and the taxpayer for whom the outstanding tax was written off is adjudged bankrupt or placed in liquidation within a year of the amount being written off (section 177C(7)(a) and (b)), or
    - the outstanding tax was written off on the basis of false or misleading information provided by the taxpayer (section 177C(7)(c)).

11. Inland Revenue cannot write off outstanding tax if the taxpayer was liable to pay a shortfall penalty for taking an abusive tax position under section 141D(2) or evasion under section 141E(1) or a similar act in relation to the outstanding tax.

12. Subject to Inland Revenue's power to reverse a write-off under section 177C, Inland Revenue now writes off outstanding tax permanently. Inland Revenue will not provisionally write off outstanding tax.

Background

13. Since the publication of SPS *RDC 620 Writing off tax debt,* sections 14, 177(1), 177A(3) and 177C(6) have been amended. Sections 14B, 177C(5B) and 177C(5C) have also been inserted into the TAA.

14. Furthermore, the High Court decisions in *Raynel v CIR* (2004) 21 NZTC 18,583, *Clarke & Money v CIR* (2005) 22 NZTC 19,165, *McLean v CIR* (2005) 22 NZTC 19,231, *W v CIR* (2005) 22 NZTC 19,602 and *Rogerson v CIR* (2005) 22 NZTC 19,260 have clarified how Inland Revenue may exercise the discretion under sections 177(1) and 177C and explained their relationship with sections 6 and 6A.

15. This SPS sets out Inland Revenue's standard practice in light of these legislative changes and the recent case law.

Legislation

16. The relevant legislative provisions are:

    - section LB 2 of the Income Tax Act 2004, and
    - sections 14B, 138E, 139B, 139BA, 141D, 141E, 174AA, 176, 177, 177A to 177C.

Discussion

Maximising recovery of outstanding tax

17. Inland Revenue has a duty to maximise the recovery of outstanding tax from a taxpayer pursuant to section 176(1). Inland Revenue is therefore obliged to compare the value of the likely recovery from accepting taxpayers' proposals with any other viable options for recovery. In

some cases, it is clear which option will maximise recovery. In other cases, there may be options that could yield similar returns. Accordingly, it is necessary to determine which option will maximise recovery.

The relationship between sections 6(1), 6A and 176(1)

18. While Inland Revenue must maximise recovery of outstanding tax from taxpayers, this duty is subject to the overriding obligations in section 6 to protect the integrity of the tax system and section 6A to collect over time the highest net revenue that is practicable within the law.

19. In *Raynel v CIR*, Randerson J referred to the following general principles in respect of sections 6 and 6A:

    - Section 6A(3) is to prevail over other provisions in the Inland Revenue Acts including section 176.
    - The obligation to collect the highest net revenue is not absolute. Inland Revenue is only required to take steps to recover that are practicable and lawful.
    - Inland Revenue is required to have regard to the resources available, the importance of promoting compliance (especially voluntary compliance) by all taxpayers, and the compliance costs incurred by taxpayers.
    - Sections 6 and 6A(3)(b) emphasise that there is a broader public interest in the integrity of the tax system and in ensuring that taxpayers meet their obligations.

20. Section 176(1) is to be read subject to section 6 and section 6A(3). Section 176(1) does not relieve Inland Revenue officers of their duties under section 6(1) to use their best endeavours to protect "the integrity of the tax system" and under section 6A to collect over time the highest net revenue that is practicable within the law. Although Inland Revenue will consider each application for financial relief on its own merits, the duty to protect the integrity of the tax system will in certain cases require Inland Revenue to take action that (in the short term) might not be considered to maximise recovery of the revenue.

21. When a negotiated agreement for payment of all or part of the outstanding tax would yield more than bankruptcy or liquidation action, Inland Revenue will usually enter into the negotiated agreement. Any amount not recoverable under the agreement will be written off at the time the agreement is entered into. However, as Randerson J noted in *Raynel v CIR* Inland Revenue may take enforcement actions against the taxpayer and may not enter into a negotiated agreement. This would be done, for example to preserve the integrity of the tax system and promote voluntary compliance by other taxpayers. This may be where there is a "flagrant and on-going failure to comply with the taxpayer's obligations and where recovery is dubious or is likely to result only in a relatively minor proportion of the overall debt being recovered."

22. For example, a taxpayer has outstanding tax of $100,000 and makes an offer of $75,000 to settle the arrears over a period of three years. Inland Revenue considers that bankruptcy would only yield $50,000 and that there are no other viable avenues for recovery. In this instance, Inland Revenue would consider writing off $25,000 and entering into an instalment arrangement over three years for $75,000.

The financial relief application

23. Taxpayers may apply for financial relief pursuant to section 177(1). The financial relief may be in the form of:

    - an instalment arrangement for all of the outstanding tax, or
    - an instalment arrangement for part of the outstanding tax and a write-off of the remaining balance (a partial write-off), or
    - a write-off of all of the outstanding tax.

    (Please also refer to *SPS 05/11 Instalment arrangements for the payment of tax debt*.)

24. Taxpayers can apply by telephone or in writing (including by facsimile and secure email on Inland Revenue's Online Correspondence Service) for a write-off of outstanding tax on the grounds of serious hardship.

25. In some cases, Inland Revenue will require taxpayers to apply for financial relief by notice in writing under section 177(2). For example, where the taxpayer's serious hardship is caused by a number of factors which require evidence in writing or where the taxpayer has related parties, such as a partnership or company, that have outstanding tax to pay. Pursuant to section 14B, where taxpayers are required to apply for financial relief by giving notice in writing to Inland Revenue, the taxpayers may do so by:

    - delivering the notice in person to an Inland Revenue office, or
    - issuing the notice by facsimile to an Inland Revenue office, or
    - sending an email on Inland Revenue's Online Correspondence Service, or
    - sending the notice to an Inland Revenue office by post.

Considering the taxpayer's application

26. Upon receipt of an application for writing off outstanding tax, Inland Revenue may:

(a) Accept the taxpayer's request.

Once the request is accepted and outstanding tax is written off, the taxpayer will receive written notification. This will include:

- the tax type(s), the relevant period(s) and the amount(s) of outstanding tax written off, and
- the remaining net losses and/or excess imputation credits carried forward, after these have been extinguished, and/or
- the outstanding tax under an instalment arrangement plus interest, when a taxpayer is granted a partial write-off of outstanding tax and the balance remaining is placed under an instalment arrangement.

However, the written notification will not include the exact amount of interest payable by the taxpayer under the instalment arrangement. This is because the total amount of interest payable may vary with the interest rate and/or increased instalment payments during the course of the arrangement.

When a taxpayer proposes to make a lump sum payment in full settlement of outstanding tax on a specific future date, Inland Revenue will notify the taxpayer in writing of the total amount of outstanding tax and interest that the taxpayer must pay on that date.

(b) Seek further information from the taxpayer.

When considering an application for serious hardship, Inland Revenue must assess the taxpayer's financial circumstances based on the information provided. Inland Revenue may ask taxpayers to provide additional information and will also require them to file any outstanding returns.

Inland Revenue must, under section 6(1), have regard to protecting the integrity of the tax system to ensure fairness to all taxpayers.

If additional information is required, Inland Revenue will allow the taxpayer reasonable further time to comply with the request. However, if the taxpayer provides the required information outside the time allowed, the receipt of the information will be treated as a new request for financial relief.

For example, a taxpayer has outstanding income tax for the 2004 tax year. The taxpayer applies for outstanding tax to be written off on the grounds of serious hardship. The taxpayer's income tax return for the 2004 tax year shows a net loss carried forward. However, the 2003 income tax return is yet to be filed. Inland Revenue may require the taxpayer to provide additional information such as the calculation of the net loss and to file the income tax return in the 2003 tax year before accepting the taxpayer's request for financial relief.

(c) Make a counter offer.

When a taxpayer requests a write-off of outstanding tax, Inland Revenue may make a counter offer to the taxpayer. This will occur when Inland Revenue considers the taxpayer can afford to make a lump sum payment or enter into an instalment arrangement for part of the outstanding tax and therefore a partial write-off is more appropriate.

(d) Decline the taxpayer's request.

Inland Revenue may decline to accept a taxpayer's request for a write-off if it is considered that the taxpayer is able to pay the outstanding tax in full. For example, a taxpayer has term deposits or other investments or the ability to borrow sufficient funds to pay the outstanding tax.

Inland Revenue may also decline to accept a taxpayer's request for a write-off if the taxpayer has not provided sufficient information to support their request.

Where Inland Revenue declines the taxpayer's request for financial relief, both initial and incremental late payment penalties will be imposed and interest will accrue as if the taxpayer had not made the request.

Instances where Inland Revenue must write off outstanding tax

27. Inland Revenue must write off amounts that cannot be recovered from a natural person due to bankruptcy.

28. When a person is bankrupt, Inland Revenue will write off outstanding tax that cannot be recovered upon receipt of:

- a final dividend, or
- advice from the Official Assignee that there will be no dividend to Inland Revenue,

provided that Inland Revenue does not challenge the Official Assignee's advice. Furthermore, pursuant to section 177C(2)(b), Inland Revenue must write off a company's outstanding tax that cannot be recovered if the company is in liquidation. Please refer to paragraph 54 for more details.

29. When an estate has been distributed, Inland Revenue must write off the outstanding tax upon receipt of confirmation from the administrator that the estate has been distributed.

Writing off outstanding tax of taxpayers (being natural persons) due to serious hardship

30. Taxpayers (being natural persons) applying for financial relief on the grounds of serious hardship pursuant to section 177(1) should explain why recovery would place them in serious hardship. The application should include supporting financial information.

31. Written applications will not be required when it is evident from information already available that recovery would place the taxpayers in serious hardship. This may happen where taxpayers request relief by way of an instalment arrangement but an examination of the information obtained reveals that repayment, even by way of an instalment arrangement, would place the taxpayers in serious hardship.

32. Inland Revenue will consider each application made pursuant to section 177(1) on its own merits, subject to the overriding obligations in section 6 to protect the integrity of the tax system and section 6A to collect over time the highest net revenue that is practicable within the law.

33. Section 177A defines "serious hardship". In order for Inland Revenue to determine if an individual would be placed in serious hardship, Inland Revenue will request relevant details of the person's financial position. These may include and are not limited to:
    - details of income and expenditure,
    - assets and liabilities,
    - a 12-month cash flow projection,
    - asset valuations,
    - a statement of financial performance,
    - a statement of financial position,
    - a list of debtors and creditors.

34. Pursuant to section 177A(1)(a) in considering whether taxpayers, being natural persons, will be placed in serious hardship, Inland Revenue will have regard to the following:
    - whether the taxpayers will be unable to meet minimum living expenses according to normal community standards, or
    - the cost of medical treatment for an illness or injury of the taxpayers or the taxpayers' dependants, or
    - a serious illness suffered by the taxpayers or the taxpayers' dependants, or
    - the cost of education for the taxpayers' dependants.

35. Whether a person is a taxpayer's "dependant" for the purposes of paragraph 34 will be determined on a case-by-case basis. In determining dependency issues, Inland Revenue will consider:
    - whether the person is dependent on the taxpayer for financial support, and
    - what degree of financial support is provided by the taxpayer, and
    - to what extent providing financial support affects the taxpayer's ability to meet minimum living expenses according to normal community standards.

36. Pursuant to section 176(2)(b), Inland Revenue may not recover outstanding tax to the extent that the recovery would place taxpayers, being natural persons, in serious hardship. However, where taxpayers apply for financial relief and their financial difficulties are a result of their obligation to pay outstanding tax, the taxpayers will not meet the grounds for serious hardship under section 177A(1)(a). This is because serious hardship does not include financial difficulties that arise from the taxpayer's obligation to pay tax under section 177A(1)(b). The serious hardship rules should not be regarded as a means of avoiding the obligation to pay tax. To allow otherwise would compromise the integrity of the tax system.

37. Pursuant to section 177A(1)(b), serious hardship does not include financial difficulties that arise because:
    - the taxpayers are obligated to pay tax, or
    - the taxpayers may become bankrupt, or
    - the taxpayers' or the taxpayers' dependants' social activities and entertainment may be limited, or
    - the taxpayers are unable to afford goods or services that are expensive or of a high quality or standard according to normal community standards.

38. Regarding the last bullet point in paragraph 37, while normal community standards must be considered in the context of the wider community of all New Zealand, the actual expenditure of taxpayers in different parts of the country may vary due to, for example higher or lower housing costs, commodity or travel expenses. When calculating taxpayers' minimum living expenses, Inland Revenue will consider the costs of food, heating and accommodation in accordance with normal community standards based on information provided on a geographical basis by Statistics New Zealand.

39. In some situations, a decision on financial relief can be made immediately. In others, further information may be required. Pursuant to section 177(4), taxpayers must provide the information within 20 working days (although a longer period may be allowed by Inland Revenue). Incremental late payment penalties will not be imposed under section 139B(2B) during this period, provided financial relief is granted. If taxpayers request the write-off before the payment due date, the 4% initial late payment penalty under section 139B(2A)(b) will also not be imposed. However, interest will continue to accrue on a daily basis. (Please refer to *SPS 05/10 Remission of penalties and interest*, which was published in *Tax Information Bulletin* Vol 17, No 9 (November 2005) and is available on Inland Revenue's website at www.ird.govt.nz.)

40. In some instances, taxpayers may be able to pay part of the outstanding tax, but recovery of the full amount would place the taxpayer in serious hardship. In these cases, Inland Revenue will negotiate a lump sum payment or an instalment arrangement with the taxpayers and write off the irrecoverable amount. The irrecoverable amount will be written off at the time the instalment arrangement is entered into.

41. For example, a taxpayer has outstanding tax of $8,000 and has been putting funds aside to clear this amount by the due date. However, at the due date they have only managed to save $2,000 towards this amount. Due to the taxpayer's financial circumstances, any payment over and above the $2,000 they have saved would cause difficulty in meeting their day-to-day living expenses. Inland Revenue accepts the lump sum payment of $2,000 and writes off the balance on the grounds of serious hardship as it is not feasible for Inland Revenue to enter into an instalment arrangement for payment of the outstanding $6,000.

Factors relevant to the consideration of financial relief

42. Inland Revenue may have regard to a number of factors when considering applications for financial relief. In *Clarke & Money v CIR*, Priestley J referred to the following factors as relevant to the exercise of the discretion under section 177:

    (a) the circumstances which led to the taxpayers' outstanding tax,

    (b) the nature and extent of the taxpayers' co-operation and negotiating stance,

    (c) the speed with which the taxpayers have provided requested information, and the extent of that information, and

    (d) Inland Revenue's duties under sections 6 and 6A.

43. In *Raynel v CIR*, Randerson J noted that where there has been a flagrant and on-going failure to comply with the taxpayers' obligations and where recovery is dubious or is likely to result only in a relatively minor proportion of the overall outstanding tax being recovered, Inland Revenue may be justified in initiating or continuing enforcement proceedings to secure the wider interests identified by the legislation.

44. In *Rogerson v CIR*, Potter J held that Inland Revenue is entitled to consider the whole history of compliance and non-compliance by the taxpayer in the context of the obligation to preserve the integrity of the tax system.

45. Pursuant to section 138E(1)(e)(iv), there is no statutory right to challenge or object to any decision of Inland Revenue to grant or cancel relief. However, if taxpayers do not agree with Inland Revenue's decision not to grant relief, the taxpayers may request that the decision be reviewed by the officer involved or their superior officer. The decision may also be reviewed by the Ombudsman or by way of judicial review.

Net present value calculation

46. Whilst unnecessary in most circumstances, one method of distinguishing between alternative repayment options is to apply a net present value calculation.

47. A net present value calculation recognises the time value of money, as well as the probability of payment (risk). The proposed payments are discounted for the time value of money and for the likelihood of receiving the money. Inland Revenue needs to determine the amount, date, and probability of each payment and apply an appropriate discount rate. The discount rate is calculated from published government stock rates.

48. Inland Revenue uses a calculation that multiplies the amount of payment by the probability of payment (for risk), divided by the discount factor appropriate to the term (for interest).

49. Please refer to the appendix to *Tax Information Bulletin* Vol 6, No 14 (June 1995) for:

    - the methodologies for determining the discount rate, probabilities of payment and net present value, and
    - examples of assessments of the probabilities of payment being made in particular circumstances.

Writing off a company's outstanding tax

50. Serious hardship generally applies to natural persons only. A company cannot apply for outstanding tax to be written off on the grounds of serious hardship. However, Inland Revenue may take into account whether the recovery of outstanding tax would place a shareholder who owns, or two shareholders who jointly own, 50% or more of the shares in a company or a shareholder-employee of a close company in serious hardship.

51. A "close company" for these purposes means a company which has five or fewer natural persons whose voting interest(s) or market value interest(s) in the company exceed 50% and is not a special corporate entity.

52. Pursuant to section 177C(1), Inland Revenue may also write off a company's outstanding tax if it is consistent with the duty to maximise recovery under section 176(1), subject to the overriding obligations in section 6 to protect the integrity of the tax system and section 6A to collect over time the highest net revenue that is practicable within the law. In some cases, Inland Revenue may enter into an instalment arrangement for part of the company's outstanding tax and then write off the remaining balance.

53. For example, a close company owes outstanding tax of $300,000 and its only asset is a debit balance in the principal shareholder's current account of $300,000. If the company were placed into liquidation, the $300,000 in the current account would be called up. The shareholder's personal assets are a house valued at $290,000 and a car valued at $7,000. Inland Revenue recognises that any action taken to liquidate this company could place the shareholder in serious hardship. The company agrees to pay to Inland Revenue the sum of $220,000, borrowed against the principal shareholder's home. The balance of the outstanding tax will be written off, as collection of the amount would cause the shareholder serious hardship.

54. When a company is in liquidation, Inland Revenue will write off outstanding tax that cannot be recovered upon receipt of:

    - a final distribution, or
    - advice from the liquidator that there will be no distribution to Inland Revenue,

    provided that Inland Revenue does not challenge the liquidator's advice.

Struck-off companies

55. Inland Revenue officers may discuss with a person who was, immediately before a company was removed from the New Zealand register at the Companies Office (commonly known as "struck-off"), a director or authorised officer of the company, matters relating to outstanding returns and tax arising prior to the company being struck off.

56. Inland Revenue will consider an application for writing off outstanding tax by a shareholder, director or authorised officer of a struck-off company after they have restored the company's New Zealand register at the Companies Office.

57. Inland Revenue cannot consider an application for financial relief of a struck-off company prior to the restoration of the company's New Zealand register. This is because the struck-off company ceases to be a person and therefore is not a taxpayer when it has been removed from the New Zealand register. In some cases, Inland Revenue may restore the company to the New Zealand register for purposes such as recovering outstanding tax or prosecuting company directors for failing to account for PAYE.

58. In other cases, Inland Revenue may not restore the company to the New Zealand register. Inland Revenue may apply to the High Court for an appointment of a liquidator to liquidate the struck-off company under section 327 of the Companies Act 1993. For example, Inland Revenue may do so even if there is no prospect of recovering the outstanding tax from the struck-off company. (Please refer to paragraph 54 regarding writing off the outstanding tax of a liquidated company).

59. However, Inland Revenue may also consider a write-off of a struck-off company's outstanding tax that cannot be recovered pursuant to section 177C subject to the overriding obligations in section 6 to protect the integrity of the tax system and section 6A to collect over time the highest net revenue that is practicable within the law.

Writing off a trust's outstanding tax

60. A trust cannot apply for outstanding tax to be written off on the grounds of serious hardship pursuant to section 177(1)(a) either itself and/or by its trustees. Serious hardship generally applies to natural persons only and the Commissioner generally considers that a trustee of a trust is not acting as a natural person in that capacity.

61. However, Inland Revenue may consider writing off a trust's outstanding tax pursuant to section 177C(1) if that tax cannot be recovered. In determining whether a trust's outstanding tax is irrecoverable, Inland Revenue will also consider whether the trustees can satisfy the outstanding tax in their capacity as trustees or personally. If Inland Revenue cannot recover the outstanding tax from the trust or its trustees, the outstanding tax will be considered as irrecoverable for the purposes of section 177C(1).

62. Inland Revenue will exercise its discretion to write off under section 177C(1) on a case-by-case basis and subject to the obligations in section 6 to protect

the integrity of the tax system and section 6A to collect over time the highest net revenue that is practicable within the law.

Inefficient use of Inland Revenue's resources

63. If Inland Revenue considers that recovery of part, or all of the outstanding tax would not represent an efficient use of administrative resources, then pursuant to section 176(2)(a), the outstanding tax would not be written off.

64. This is consistent with Inland Revenue's duty pursuant to section 6A(3) to collect over time the highest net revenue that is practicable within the law having regard to the resources available to Inland Revenue.

65. However, taxpayers cannot require that outstanding tax be written off simply because they consider that collection would result in an inefficient use of Inland Revenue's resources. The provision of relief under section 176(2)(a) is discretionary and acknowledges that Inland Revenue has limited resources to collect outstanding tax and, in some instances, the cost of collection may be higher than the outstanding tax. A decision to write off on the basis that recovery would represent an inefficient use of Inland Revenue's resources will be made on a case-by-case basis. Again, pursuant to section 6A(3)(b), Inland Revenue will consider the effect of the proposed write-off on overall compliance, from an efficiency perspective.

Writing off small amounts of outstanding tax

66. Inland Revenue may permanently write off outstanding tax under section 174AA(a) where the balance of the tax payable is not more than $20. In exercising its discretion Inland Revenue may consider the factors referred to in this SPS.

67. Inland Revenue can only reverse a write-off or reinstate outstanding tax under section 177C. Inland Revenue will not reinstate outstanding tax written off under section 174AA(a).

Net losses and excess imputation credits

68. From the 2005-06 income year onwards, pursuant to section LB 2(3B) and (3C) of the Income Tax Act 2004, a taxpayer, who is not:

    (a) a company,

    (b) a trustee (other than the Māori trustee),

    (c) a Māori authority, or

    (d) a taxpayer whose imputation credits giving rise to the credit of tax is category A income of the trustee of a group investment fund,

    must carry any excess imputation credits forward. In determining such a taxpayer's application for writing off outstanding tax, Inland Revenue will consider whether the taxpayer has net losses and/or excess imputation credits carried forward from a previous year.

69. Pursuant to section 177C(5), if Inland Revenue writes off outstanding tax for a taxpayer with net losses, Inland Revenue must extinguish all or part of the taxpayer's net losses, by dividing the amount written off by 33% and reducing the net losses by that amount.

70. If the taxpayers have excess imputation credits carried forward from a previous year, then pursuant to section 177C(5B) all or part of these tax credits will be extinguished on a dollar-for-dollar basis when outstanding tax is written off.

71. When the taxpayers (except those listed in paragraph 72) have both net losses and excess imputation credits carried forward from a previous year, the net losses will be extinguished first. It should be noted that the taxpayers' net losses and/or excess imputation credits can be extinguished even if the outstanding tax written off is of a type other than income tax.

72. For a taxpayer who is:

    (a) a company,

    (b) a trustee (other than the Māori trustee),

    (c) a Māori authority, or

    (d) a taxpayer whose imputation credits giving rise to the credit of tax is category A income of the trustee of a group investment fund,

    only net losses will be extinguished if the taxpayer applies for writing off outstanding tax and Inland Revenue accepts the application.

73. Taxpayers must file all earlier outstanding tax returns (ie outstanding returns relating to tax years prior to the tax year in which the outstanding tax arises) before their application for a write-off of outstanding tax will be considered. Any net losses and/or excess imputation credits will not be extinguished under section 177C(5) and (5B) until all outstanding tax returns are filed. Inland Revenue may then calculate the net losses using the taxpayers' most recently filed income tax return.

74. For example, in July 2005, a taxpayer applies for writing off their outstanding income tax for the 2005 tax year. The taxpayer's 2002 income tax return shows net losses carried forward to the 2003 tax year. However, the 2003 and 2004 income tax returns remain outstanding. The outstanding tax will not be written off and the net losses will not be extinguished until the 2003 and 2004 income tax returns are filed.

Instances where the Inland Revenue cannot write off outstanding tax

75. Pursuant to section 177C(3), Inland Revenue cannot write off outstanding tax if the taxpayer was liable to pay, in relation to that outstanding tax, a shortfall penalty for, either taking an abusive tax position under section 141D(2) or evasion under section 141E(1) or a similar act. This means that recovery action to collect both the shortfall penalty and the underlying tax will continue even if recovery would place a taxpayer in serious hardship.

76. Inland Revenue will distinguish between outstanding tax arising from such assessments and other arrears so that part of the taxpayer's total outstanding tax may be written off if the required criteria are met, leaving the tax to which the shortfall penalty applies and the penalty itself outstanding. The outstanding tax that cannot be written off due to section 177C(3) also includes late filing and payment penalties imposed, and use-of-money interest accruing, on the underlying tax that was subject to the shortfall penalty for evasion or taking an abusive tax position.

77. Inland Revenue must protect the integrity of the tax system while also trying to maximise recovery of outstanding tax. (Please refer to paragraphs 18 to 22 for the discussion on the relationship between sections 6(1), 6A and 176(1).) Where section 177C(3) applies, Inland Revenue will consider other options for recovering the underlying tax and shortfall penalty, such as an instalment arrangement if negotiated by the taxpayer. Please refer to *SPS 05/11 Instalment arrangements for the payment of tax debt*.

78. For example, a taxpayer has outstanding GST for the 31 March 2004 return period and also has outstanding income tax for the 2004 tax year including a shortfall penalty for taking an abusive tax position. In this instance, where the criteria for serious hardship are met, the outstanding GST can be written off. However, the outstanding income tax will not be written off, regardless of whether recovery will cause serious hardship.

79. The application of section 177C(3) is suspended when taxpayers challenge the imposition of a shortfall penalty for taking an abusive tax position or evasion in a hearing authority. This is because the taxpayers are not liable to pay the shortfall penalty during the challenge. However, Inland Revenue will not consider writing off the taxpayers' outstanding tax until after the hearing authority has ruled on the issue of the imposition of the shortfall penalty.

Reinstatement of outstanding tax

80. Pursuant to section 177C(4) Inland Revenue may only reinstate all or part of outstanding tax that has been written off if Inland Revenue receives, by operation of law, additional funds in respect of the taxpayer:

- after the taxpayer has become bankrupt or has been liquidated, or
- if additional funds due to the taxpayer's estate are discovered after the taxpayer's estate has been distributed.

81. For example, Inland Revenue writes off a bankrupt taxpayer's outstanding tax under section 177C(2) after the Official Assignee declares that no dividend will be payable and closes the file. The Official Assignee subsequently discovers a previously unknown bank account with a credit balance. The Official Assignee makes a dividend payment to the creditors. In this instance Inland Revenue will reinstate the outstanding tax under section 177C(4) and credit the dividend received to the taxpayer's account.

Reversal of write-off

82. In addition to section 177C(4), section 177C(7) allows Inland Revenue to reverse a write-off in the following circumstances:

- the taxpayer, being a natural person, declares bankruptcy within a year of the outstanding tax being written off on the grounds of serious hardship.
- the taxpayer, being a natural person, is subject to bankruptcy proceedings brought by a creditor within a year of the outstanding tax being written off on the grounds of serious hardship.
- the taxpayer, being a company, is liquidated within a year of the outstanding tax being written off on the grounds of serious hardship.
- the taxpayer, being a company, is in the course of being liquidated within a year of the outstanding tax being written off on the grounds of serious hardship.
- the outstanding tax was written off on the basis of false or misleading information provided by the taxpayer, for example, where a taxpayer has unreasonably overstated outgoings or understated income or where a taxpayer has a vested right to income or assets of a trust, and this was not disclosed to Inland Revenue.

Standard Practice

83. Upon receipt of taxpayers' applications for writing off outstanding tax, Inland Revenue has four options:

(a) accept the taxpayers' request, or

(b) seek further information from the taxpayers, or

(c) make a counter offer, or

(d) decline the request.

84. Inland Revenue will take into account the following factors when considering taxpayers' applications for a write-off of outstanding tax:

(a) Whether the proposal will place the taxpayers, being natural persons, in serious hardship.

(b) Whether the value of the taxpayers' proposals when compared to other options would maximise the recovery of outstanding tax from the taxpayers.

(c) Whether the taxpayers are in a position to pay all or part of the outstanding tax immediately.

(d) Whether the taxpayers have filed all required returns.

(e) Whether other relevant factors exist (such as those identified in paragraphs 42 to 45).

85. When considering taxpayers' applications, Inland Revenue may require the taxpayers to provide additional information within 20 working days (or such longer period that may be allowed by Inland Revenue). This may include financial information and will include the filing of any outstanding returns.

86. Taxpayers must provide the required information within the allowed timeframe. Information received outside the allowed timeframe will be treated as a new request for financial relief. If Inland Revenue subsequently declines to grant financial relief to the taxpayers, both initial and incremental late payment penalties will be imposed and interest will accrue as if the request for financial relief had not been made.

87. Inland Revenue may permanently write off outstanding tax under section 174AA(a) where the balance of the tax payable is not more than $20.00. In exercising the discretion Inland Revenue may consider the factors referred to in this SPS.

88. Inland Revenue cannot write off outstanding tax if the taxpayers were liable to pay a shortfall penalty for taking an abusive tax position under section 141D(2) or evasion under section 141E(1) or a similar act in relation to the outstanding tax.

89. A trust cannot apply for outstanding tax to be written off on the grounds of serious hardship pursuant to section 177(1)(a) either itself and/or by its trustees. Serious hardship applies to natural persons only and the Commissioner generally considers that a trustee of a trust is not acting as a natural person in that capacity.

90. However, Inland Revenue may consider writing off a trust's outstanding tax pursuant to section 177C(1) if that tax cannot be recovered. In determining whether a trust's outstanding tax is irrecoverable, Inland Revenue will also consider whether the trustees can satisfy the outstanding tax in their capacity as trustees or personally. If Inland Revenue cannot recover the outstanding tax from the trust or its trustees, the outstanding tax will be considered as irrecoverable for the purposes of section 177C(1).

91. When writing off outstanding tax, Inland Revenue must extinguish all or part of any net losses carried forward from the taxpayers' most recent income tax return and/or any excess imputation credits.

92. Where the taxpayers (except those listed in paragraph 72 of the SPS) have both net losses and excess imputation credits carried forward from a previous year, the net losses will be extinguished first.

93. Taxpayers must file all earlier outstanding tax returns before their applications for a write-off of outstanding tax will be considered. Any available net losses and/or excess imputation credits will not be extinguished under section 177C(5) and (5B) until all outstanding tax returns are filed. Inland Revenue may then calculate the net losses using the taxpayers' most recently filed income tax returns.

94. When Inland Revenue writes off outstanding tax, the taxpayers will be notified in writing of the financial relief granted and of the remaining value of any net losses or excess imputation credits carried forward.

95. Pursuant to section 138E(1)(e)(iv), there is no statutory right to challenge or object to any decision of Inland Revenue to grant or cancel relief. However, if taxpayers do not agree with Inland Revenue's decision not to grant relief, the taxpayers may request that the decision be reviewed by the officer involved or their superior officer. The decision may also be reviewed by the Ombudsman or by way of judicial review.

This Standard Practice Statement is signed on 10 May 2006.

Graham Tubb
National Manager, Technical Standards

NEW LEGISLATION

TAXATION (DEPRECIATION, PAYMENT DATES ALIGNMENT, FBT, AND MISCELLANEOUS PROVISIONS) ACT 2006

The Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Bill was introduced into Parliament on 19 May 2005. The bill received its first reading on 9 June 2005, the second reading on 16 March 2006 and the third reading on 22 March 2006. The resulting Act received Royal assent on 3 April 2006.

It amends the Income Tax Act 1994, Income Tax Act 2004, Tax Administration Act 1994 and the Goods and Services Tax Act 1985.

DEPRECIATION RATES

Sections EE 25, EE 25B, EE 25C, EE 25D, EE 25E, EE 26B, EE 31, EE 37, EE 58, EZ 21B, GC 6, and Schedule 11B of the Income Tax Act 2004, sections 91 AAF(1) and 91 AAG of the Tax Administration Act 1994 and section EG 16 of the Income Tax Act 1994

The Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006 amends the previous tax depreciation rules. The most significant changes are to the way that economic rates are set by the Commissioner.

Economic rates are part of the process that the Commissioner must use when setting depreciation rates for items of plant or equipment and buildings. Economic rates for buildings are now worked out using a straight-line method, with a diminishing value equivalent. For most items of plant or equipment, economic rates are now calculated used the double declining balance method, with a straight-line equivalent.

There has also been a change to the value at which capital purchases can be expensed. To reduce business compliance costs, the low-value asset thresholds increase from $200 to $500. The higher thresholds are intended to reduce the number of low-value purchases that must be capitalised and depreciated.

Background

Depreciation is an allowance to take account of the fact that assets used in a business eventually wear out or become out of date, even though they are maintained and repaired. This decline in value is recognised for tax purposes by allowing a deduction against income for each income year that the asset is used in the business.

A 2004 issues paper, *Repairs and maintenance of the tax depreciation rules*, examined a number of issues relating to the tax depreciation rules. The issues paper concluded that while the depreciation rules were generally sound, a number of changes would make the depreciation rules more neutral. A key change was to the method used to calculate economic rates because of concerns that it created an unintended investment bias favouring investment in longer-lived assets.

Application dates

New methods for calculating economic rates apply to depreciable assets from the beginning of the 2005–06 income year. The new methods apply to plant and equipment acquired on or after 1 April 2005 and to buildings acquired on or after 19 May 2005.

Key features

There is no change to the way depreciation rates are calculated for fixed-life intangible property or excluded depreciable property. The changes only apply to plant or equipment and buildings.

Plant and equipment

Economic rates for short-lived plant and equipment are now more consistent with those applying to longer-lived plant and equipment. Rates for shorter-lived equipment are calculated using the double declining balance method. The result is higher economic rates for shorter-lived plant and equipment, with no increase in rates for longer-lived assets.

The new double declining balance method does not apply to some types of aircraft, cars, taxis, and minibuses, unless the motor vehicle is used for short-term hire. The double declining balance method also does not apply to plant and equipment that is expected to have a scrap or residual value greater than 13.5% of cost. Economic rates for these assets are set under separate rules.

The new methods of calculating the economic rate applies to plant and equipment acquired on or after 1 April 2005 and from 2005–06 onwards.

Buildings

Economic rates for buildings are calculated using the straight-line method. An equivalent diminishing value rate can also be used. These rules apply to buildings acquired on or after 19 May 2005 and from the 2005–06 and subsequent income years.

Low-value asset thresholds

To reduce some of the compliance costs to business having to maintain fixed-asset registers, the low-value asset thresholds increase from $200 to $500. Purchases of capital assets that cost below $500 will be able to be expensed in the year in that the expenditure is incurred. The idea is to reduce the number of assets that businesses must annually account for on their fixed-asset registers. The increase applies to assets acquired on or after 19 May 2005.

Detailed analysis

The amendments alter the way that economic rates are calculated rather than changing the basic structure of the tax depreciation rules. The changes do not change the way that tax depreciation rates are calculated for fixed-life intangible property.

Application dates – section EE 25

The changes do not alter economic rates for assets acquired before 1 April 2005, in the case of plant or equipment, and before 19 May 2005 in the case of buildings. The changes apply from 1 April 2005 for plant or equipment and after 19 May 2005 for a building and from the 2005–06 year onwards.

A number of limited concessions have been provided in the legislation that affect the general application dates. These relate to an election to use the old rates for plant and equipment purchased before the 2006–07 year and to building purchases and transfers in certain circumstances.

The methods of setting economic rates – sections EE 25B to EE 25E

There are now four methods of calculating the economic rate. The new rates apply from the beginning of the 2005–06 income year. The new methods apply to plant and equipment purchased on or after 1 April 2005 and buildings acquired after 19 May 2005. Each method and the assets to which it applies are discussed in more detail below.

Economic rates for plant or equipment – section EE 25B

Section EE 25B sets the economic rate for an item of plant or equipment with a residual value of less than or equal to 13.5% of cost. Taxpayers should not use this section to work out economic depreciation rates for items of depreciable property that are: aeroplanes (excluding aeroplanes used for top-dressing or spraying); fixed-life intangible property; excluded depreciable property; buildings; cars, taxis, and minibuses (unless it is not available for short-term hire of less than one month); or plant or equipment that has a residual value greater than 13.5% of cost.

The rate that the Commissioner initially calculates is a diminishing value rate, which is rounded to the nearest banded rate. The banded diminishing value rate and the equivalent straight-line rate are set out in Schedule 11B.

A taxpayer acquiring an item of plant and equipment on or after 1 April 2005 and in their 2005–06 or subsequent income year, must use the economic depreciation rate calculated by the formula in section EE 25B(5). To work out this rate a taxpayer enters the estimated useful life of the asset into the double declining balance formula. The formula is expressed as 2/estimated useful life. The Commissioner's assessment of an asset's useful life, and any residual value, should be contained in determinations on depreciable assets.

Example

The estimated useful life of a helicopter is 20 years and 4 years for a laptop computer. Both have residual values of 13.5% or less. The diminishing value economic rate for each type of asset will be 2/20 = 10% and 2/4 = 50% respectively. The corresponding straight-line equivalent rates given by Schedule 11B are 7% and 40%.

Depreciation loading is added to the economic rate to work out the annual depreciation rate for a new item of plant and equipment. Assets that do not qualify for depreciation loading are items that have previously been held or used as depreciable property in New Zealand, buildings, imported used cars and international aircraft. For these assets, the banded economic rate equals the depreciation rate. For assets with estimated useful lives of less than two years, the total depreciation deduction is limited to the assets' cost because of sections EE 14(1) and EE 15.

Economic rates for buildings – section EE 25C

Section EE 25C sets the economic rate for an item of depreciable property that is a building.

"Building" is not a defined term in the Income Tax Act 2004. Guidance on whether a structure is considered a building is given in Inland Revenue's depreciation guides. The Commissioner is undertaking a project to more clearly define a building.

The Commissioner initially calculates the straight-line economic rate for a building. This is rounded to the nearest banded straight-line rate for buildings and the equivalent diminishing value rate is set out in Schedule 11B.

Generally, a taxpayer acquiring a building after 19 May 2005 must in their 2005–06 and subsequent income years use the economic rate calculated by the formula in section EE 25C(4). However, there are two exceptions to this rule. These relate to contracts to purchase buildings signed before 19 May 2005 and transfers of buildings between associated persons. These are discussed in more detail below in *Exceptions to the general application dates*.

The formula for the straight-line economic rate is 1/estimated useful life. The Commissioner has worked

out an estimate of the useful life for each type of building. Again, these are contained in Determination DEP 1.

> **Example**
>
> The estimated useful life of a rental property is 50 years. The straight-line economic rate for this building will be 1/50 = 2%. Schedule 11B provides the corresponding diminishing value equivalent rate of 3%.

Economic rates for certain aircraft and types of motor vehicle – section EE 25D

Section EE 25D sets the economic rate for items of depreciable property that are types of aircraft or types of motor vehicle. This section arose out of concerns that applying the double declining balance method to these types of assets would result in overly generous economic rates.

This section sets the economic rate for fixed-wing aircraft used in New Zealand, excluding aircraft used for top-dressing or spraying, gliders (as aircraft must be self-propelled), international aircraft and helicopters. It also applies to motor vehicles designed exclusively or mainly to carry 12 or fewer people. This includes cars, minibuses and taxis. It does not include motor vehicles used for short-term hire (less than one month) which have their economic rates worked out under section EE 25B.

The economic rates for domestic aircraft are 10% diminishing value and 7% straight-line. For passenger-carrying motor vehicles, the rates are 30% diminishing value and 21% straight-line.

Since the legislation was passed, the Minister of Revenue has announced that amendments will be made to the section EE 25D to clarify those assets that have their economic rates set under this section. These changes are proposed to apply from the 2005–06 year.

Economic rates for plant or equipment with residual values greater than 13.5% of cost – section EE 25E

Section EE 25E sets the diminishing value economic rate for items of plant or equipment that are estimated to have residual values greater than 13.5% of cost. This section allows the Commissioner to avoid setting overly generous economic rates for such plant or equipment.

> **Example**
>
> The Commissioner estimates that international ocean-going yachts have an estimated useful life of six years. They are typically sold at the end of six years for an amount equal to 40% of original cost. Applying this formula in section EE 25E (1 – (40/100)1/6 = 14%) the economic rate is 15% when rounded to the nearest banded diminishing value rate in Schedule 11. The straight-line equivalent rate is 10%.
>
> If the section EE 25B formula had been applied, the diminishing value economic rate would have been 30%, which is out of line with the reduction in value suffered by the business.

Exceptions to the general application dates

There are a number of exceptions to the general application dates. Each of these exceptions is discussed below.

Election to calculate economic rates in accordance with the old rules – section EE 26B

The legislation was not enacted until April 2006. This section allows a taxpayer to elect to apply the old depreciation rates to plant or equipment purchased on or after 1 April 2005 and before the beginning of their 2006–07 income year. Under this section, a taxpayer can avoid the cost of having to adjust tax depreciation rates for these assets if they have used the earlier method of setting the economic rate to calculate tax depreciation deductions for the 2005–06 income year. Requiring all taxpayers to go back and adjust depreciation rates on these assets could impose a significant compliance cost.

Therefore, section EE 26B allows a taxpayer to elect in their 2005–06 return the old method of calculating the economic rates for plant or equipment purchased on or after 1 April 2005 and before the beginning of their 2006–07 income year. Using this election results in economic rates for these assets being calculated in accordance with section EZ 21B and not sections EE 25B, EE 25D, or EE 25E. If such an election has been made, these assets must continue to be depreciated according to the old economic rates until they are sold, scrapped or are no longer used by the business.

> **Example**
>
> A standard balance taxpayer purchases $1 million worth of plant and equipment during the 2005–06 income year. At the end of each month, new purchases are entered into the firm's asset register and the then current law applied to work out depreciation deductions. To avoid the cost of having to go back and re-calculate economic rates for all the plant and equipment purchased during the 2005–06 year, the taxpayer elects to continue to use the old method of calculating economic rates for these assets and must continue to depreciate these assets on this basis for subsequent income years.

Purchases of plant or equipment made on or after the start of a taxpayer's 2006–07 income year must have their economic rate worked out under either sections EE 25B, EE 25D or EE 25E.

Binding contracts to purchase a building signed before 19 May 2005 – section EE 25C

The old economic rate method in section EZ 21B is used if a binding contract to purchase or construct a building was entered into before 19 May 2005. However, if the building or the ownership interest in a building yet to be built is subsequently on-sold, section EE 25C applies because the building would be a new acquisition.

Example

As at 18 May 2005, Bravo Limited has a binding contract with Building Co Limited to build a new 10,000 sq metre head office. The building is scheduled to be finished in May 2006. Because the contract was entered into before 19 May 2005, the earlier method of working out the economic rate applies once the building is available for use. In April 2006, Bravo Limited sells the nearly completed building. The new building owner must calculate the building's economic rate according to the formula in section EE 25C.

Transfer of buildings and limited concessions – section EZ 21B

Section EZ 21B saves the old method for calculating an asset's economic rate for assets purchased before these changes were made. It also provides a number of concessions that preserve the old higher economic rates in certain limited circumstances for building transfers.

The transfer of a building to another person that takes place on or after 19 May 2005 will generally mean that the new owner has a lower economic rate for the building that the previous owner. However, the law provides for two exceptions to this general principle.

The first is in the case of transfers between companies where there is 100% common ownership. In the case of a building that is transferred from one company within a wholly-owned group to another company within the same group, the economic rate is worked out in accordance with section EZ 21B. The result is no change in the building depreciation rate.

Example

Bravo Limited wholly owns four other companies, Alpha, Charlie, Delta, and Echo. They are planning to re-organise the group and create a new company, Foxtrot Limited, to manage and administer the group's properties. The restructuring is set to occur at the beginning of the 2008 income year. Because section EZ 21B applies to buildings transferred within a wholly owned group of companies, the previous method of calculating economic rates applies. The result is no change to the building's depreciation rate.

The savings provision also applies to individuals when the building transferred is relationship property. This means that the economic rate for a building transferred between wives and husbands, de facto partners or same-sex partners is worked out according to EZ 21B.

Example

In 2004, Ben and Jen purchased a one-bedroom apartment and rented this out. Ben is killed in an accident in early 2006. Jen receives Ben's interest in the rental property. Under the savings provision, Jen

(cont)

can still use the earlier economic rate, meaning no change to the building depreciation rate for the one-bedroom apartment.

Deductions for low-value assets – section EE 31 and section EG 16(1)

New sections EE 31(1) and (1B) have been inserted to give effect to the increase in the low-value asset threshold from $200 to $500. The new $500 threshold applies for the cost of assets acquired on or after 19 May 2005. There are no other changes to the previous low-value asset rules.

Taxpayers can claim a deduction for the cost of assets purchased for $500 or less provided that:

- they are not purchased from the same supplier at the same time as other assets to which the same depreciation rate applies, unless the entire purchase costs less than $500; and
- the assets will not become part of a larger item of depreciable property – for example, expenditure on material to build a new wall in the taxpayer's factory; and
- the costs of those assets are not deductible under another provision of the Act.

Section EG 16 in the Income Tax Act 1994 has also been amended so that late-balance date taxpayers can take advantage of the increased thresholds.

Commissioner's power to deny a deduction – section GC 6

Section GC 6 denies a depreciation deduction if the Commissioner is of the opinion that certain arrangements have been entered into to allow a taxpayer to obtain a depreciation deduction contrary to the intent of the Act. This section could be applied when taxpayers sell and re-acquire assets in order to obtain the benefit of the higher depreciation rates.

Other changes

Sections 91 AAF and 91 AAG of the Tax Administration Act 1994 have been amended to reflect the changes to the methods used to calculate economic rates. These changes allow the Commissioner to consider and select the most appropriate method of calculating an asset's economic rate when making a determination about an asset's depreciation rate.

Section EE 38 has been amended so that nil or negative consideration is allowed for the purpose of sections EE 41 to EE 44. Inserting subsection (1B) in section EE 38 means that all asset disposal costs are deductible in full. These costs can be significant if an asset has no scrap value. For example, Resource Management Act consents

sometimes require demolition costs to be incurred when the asset is no longer used. Allowing a deduction for the cost of demolition and disposal is the economically correct outcome. This change may remove an artificial impediment to more environmentally friendly asset disposal practices. This change applies to asset disposals from the 2005–06 income year.

Section EE 58 is amended to include references to the new sections EE 25B to EE 25E in the definition of "economic rate".

An error in section EE 41(3), which excluded buildings from the depreciation claw-back provisions in section EE 41(1), has been corrected by replacing the reference to "section" in EE 41(3) to "subsection (2)". This has effect from the 2005–06 and later tax years.

ALIGNING PROVISIONAL TAX PAYMENTS WITH GST

BASING PROVISIONAL TAX PAYMENTS ON A PERCENTAGE OF GST TAXABLE SUPPLIES

Sections EF 3(3), HB 1(5)b), HG 12(2)(c), IZ 7(b), parts MB, MC 1(1), MD 2, MD 2B(3), ME 5(1)(d), ME 5(2)(d), ME 11(1)(b), ME 11(2)(b), ME 12(1)(c), ME 13(6)(e), MK 4(1)(b), MK 5, MZ 8, MZ 9, NC 20(1), NG 17(2), OB 1, OB 6(3)(k), and Schedule 13 (parts A and B) of the Income Tax Act 2004; sections 3, 39, 39B, 119(1), 120C(1), 120K, 120L(1), 120B(b), 120Q, 139C(1), 140D(2)(d) and (3)(d), 140DB(2)(b), 141E, 173(p)(2), 173Q and 173R of the Tax Administration Act 1994; sections 2, 15, 15AB, 15B, 15C, 15D, 15E, 16, 16B, 17, 53(1)(c), 55(7)(b), 56(6) and 78A of the Goods and Services Tax Act 1985 and section 28(3) of the Student Loan Scheme Act 1992

The provisional tax rules have been amended to make paying provisional tax easier for small businesses. The changes will combine the payment of provisional tax with GST, thereby reducing the number of interactions taxpayers have with Inland Revenue. The changes will mean both tax payments can be made on the one form and will enable taxpayers who have a GST refund to offset the refund amount against their provisional tax liability.

Currently GST is due on the last working day of the month, which can cause confusion for taxpayers. To ensure consistency of due dates across all months, the GST due date will change to the 28th of the month.

Also, taxpayers who qualify to use the GST ratio method for calculating provisional tax instalments will be able to match their provisional tax payments with their cashflow.

The GST due date change will apply to taxable periods ending on or after 31 March 2007. Aligning provisional tax payment dates to GST due dates and the GST ratio method to base provisional tax payments on a percentage of GST taxable supplies will apply from the 2008–09 income year.

Background

Complying with the tax system can be particularly burdensome for small businesses. To identify what small and medium-sized businesses saw as the most problematic compliance issues for them, Inland Revenue undertook extensive consultations with small and medium-sized enterprises (SMEs) in 2002.

The research found that 70% of those surveyed considered tax to be the largest contributor to business compliance costs. In dealing with the tax system the top four tax compliance issues facing SMEs were:

- the time spent filling in forms;
- provisional tax not being aligned with cashflow;
- good compliance history not being considered; and
- penalties and interest.

To address these concerns a government discussion document, *Making tax easier for small businesses*, was released on 17 September 2003. The proposals contained in the discussion document included aligning the provisional tax and GST payment dates and providing another means to calculate provisional tax by basing provisional tax payments on a percentage of a business's GST turnover.

Aligning payment dates reduces the amount of time required to complete forms and the number of payment dates a taxpayer has to remember.

Aligning payment dates also made it easier to introduce the GST "ratio" method which bases provisional tax payments on a percentage of GST taxable supplies so taxpayers are required to undertake the provisional tax calculations just once from figures in their GST return. The GST ratio method enables provisional tax payments to be aligned with a business's cashflow and reduces their exposure to use-of-money interest.

Key features

Part MB of the Income Tax Act 2004, sections 120C and 120K of the Tax Administration Act 1994, and sections 15 and 16 of the Goods and Services Tax Act 1985 have been rewritten to incorporate the new changes. This *Tax Information Bulletin* item focuses on the major changes to the new rules. The key features of the new provisional tax and GST rules are as follows.

Changes to the GST due date

Under section 6 of the Goods and Services Tax Act, the GST due date will change from the last working day to the 28th of the month, except when the due date

is 28 December. In this case, the due date moves to 15 January. This change will apply to taxable periods ending on or after 31 March 2007.

Aligning provisional tax payments with GST payments

Under sections MB 8 and MB 11 to 14, Schedule 13 and section 139C of the Tax Administration Act, provisional tax payments will be aligned with GST payment dates. Provisional taxpayers who are registered for GST on a two-monthly basis will pay provisional tax on their 2nd, 4th and 6th GST returns for the year. Taxpayers who pay GST monthly will pay provisional tax on their 4th, 8th and 12th GST return for the year. For example, a March balance date taxpayer will pay provisional tax on 28 August, 15 January and 28 April. Taxpayers who account for GST on a six-monthly basis will only have to pay their provisional tax twice a year with their GST.

Provisional taxpayers who are not registered for GST will pay provisional tax on the 28th day of the 5th, 9th and 13th months after balance date. That is 28 August, 15 January, and 28 April for a March balance date taxpayer.

Schedule 13 of the Income Tax Act 2004 has been replaced to reflect the new payment dates. The Schedule also provides the provisional tax due dates for taxpayers with balance dates other than March.

Voluntary payments of provisional tax can be made at any time. Taxpayers on monthly or two-monthly GST taxable periods can make voluntary payments on their GST form in the months when they are not required to make compulsory provisional tax payments.

Also as a result of combining the two taxes on the one GST form, taxpayers with a GST refund will be able to offset the refund against their provisional tax liability.

When a taxpayer offsets their GST refund against their provisional tax liability and their GST refund is subsequently reassessed resulting in the refund being reduced, the taxpayer will be given at least 30 days after the notice of reassessment is issued to pay the tax shortfall before the late payment penalty is imposed.

Example 1: Six-monthly GST payments

Current position
John is a builder whose taxable supplies are under $250,000 and therefore he pays GST on a six-month basis. John pays GST on the last working day of October and April each year. John's tax year is 1 April to 31 March. He currently pays provisional tax three times a year on the 7th of July, November and March.

Every year John has to make five different tax payments – two GST and three provisional tax, and although the dates of provisional tax payments stay the same (7th of the month), the dates for GST tax payments can vary.

(Cont)

Under the new rules
Under the new rules, John will still pay GST twice a year – in October and April. However, the due date for making GST payments will become the 28th of the month of payment.

John will have fewer provisional tax payments to make – from three down to two, paid together with his GST on 28 October and 28 April.

This change will reduce the time that John has to spend making tax payments and will ease his compliance burden. It will also create certainty about the dates when tax is due. Finally, he will be able to keep his money for longer or may make any additional voluntary payments at any time. He will receive use-of-money interest for any voluntary payments made.

Example 2: Two-monthly and monthly GST payments

Current position
Mark is a panel beater who pays GST two-monthly. Mark's GST taxable periods end on the last day of January, March, May, July, September and November. His income tax balance date is 31 March and he pays provisional tax three times a year on 7th of July, November and March.

Mark currently makes nine annual tax payments – six GST payments and three provisional tax payments. The new rules will change this.

Under the new rules
Under the new rules all two-monthly GST taxpayers will make three compulsory provisional tax payments on the 28th day of the 5th, 9th and 13th months after their balance date. Also, the GST payment date will change from the last working day of the month to the 28th day of the month.

Mark will have six annual tax payments to make:

- 28 June – GST payment
- 28 August – GST payment and compulsory provisional tax payment
- 28 October – GST payment
- 15 January (as 28 December is over the Christmas period) – GST payment and compulsory provisional tax payment
- 28 February – GST payment

- 28 April – GST payment and compulsory provisional tax payment.

Aligning GST taxable periods: Section 15B of the Goods and Services Tax Act

The vast majority of GST-registered taxpayers have their GST taxable periods aligned to their balance date. However, a small percentage of GST-registered persons whose GST taxable periods are not aligned to their balance date will be required to align their GST taxable periods. Inland Revenue will contact those taxpayers affected. This will occur during the 2007–08 income year.

Changing taxable periods: Sections MB 8, MB 26–27, and sections 15C and 15D of the Goods and Services Tax Act

As provisional tax payments are linked to GST taxable periods, when a taxpayer changes GST taxable periods, or is required to change taxable periods, their provisional tax payments would also change. When a taxpayer changes GST taxable periods they continue on the old cycle until the end of the old taxable period cycle matches up with the beginning of the new cycle. For example, a March balance date taxpayer who accounts for GST on a two-monthly basis (ending January, March, May, July, September, and November) applies during May to change to a six-monthly basis. Although they applied in May they continue to pay GST on a two-monthly basis until the end of September. They would then change to a six-monthly basis from 1 October onwards. For that income year they would make two provisional tax payments on 28 August (on their two-monthly return) and again on 28 April (on their six-monthly return). The legislation also includes examples of changes in taxable periods – see sections MB 26 and MB 27.[1]

When a taxpayer changes their taxable periods and an instalment date under the old payment cycle was an interest instalment date on which use-of-money interest applied, then it remains an interest instalment date regardless of the fact that it was paid after the new GST taxable period begins. For example, Bridget changes from a six-monthly GST taxable period to two-monthly taxable periods with effect from 1 October. She is required to make a provisional tax payment on 28 October. As this payment due was an interest instalment payment on which use-of-money interest applied under the old payment cycle, it remains an interest instalment payment.

Registering for GST or cancelling GST registration: Section MB 25

When a provisional taxpayer registers for GST on a monthly or two-monthly basis part way through the year, their provisional tax payments do not change as they are due on the same due dates for payment of GST with regard to:

- the 2nd, 4th and 6th GST returns for a two-monthly GST payer; or
- the 4th, 8th and 12th GST returns for a monthly GST payer.

However, taxpayers who register for GST and elect to account for GST on a six-monthly basis will pay provisional tax on the old basis until the beginning of their six-monthly period. For example, Mary begins GST on 1 July and elects to be on a six-monthly basis. Her balance date is 31 March and she will pay provisional tax on the old payments basis until the end of September when she will begin paying provisional tax on a six-monthly basis. Provisional tax payments will therefore be due on 28 August (old basis) and 28 April (new basis).

When a taxpayer who accounts for GST on a six-monthly basis deregisters, following deregistration they will pay provisional tax three times a year on the standard provisional tax dates (28 August, 15 January and 28 April). The next payment will be due on whichever of the three standard provisional tax payment dates occurs 30 days after the taxpayer deregisters. For example, Denis has a March balance date and pays GST on a six-monthly basis. On 11 October Denis deregisters for GST. He makes the 28 October payment on the old basis and then his next provisional tax payments are due on 15 January and 28 April.

GST ratio method

Calculate provisional tax using the GST ratio method: Sections MB 7, MB15-MB 18

Another option has been introduced for the calculation of provisional tax – basing provisional tax payments on a percentage of GST taxable supplies. At present, taxpayers can choose whether to base their provisional tax either on the standard method of 105% of last year's residual tax or to estimate their provisional tax. Starting from the 2008–09 income year some provisional taxpayers will be able to base their provisional tax payments on a percentage of their GST taxable supplies. This provides taxpayers with another method of calculating their provisional tax which may be better suited to their particular circumstances.

This option addresses concerns taxpayers had with provisional tax payments not being aligned with cashflow and also reduces the taxpayer's exposure to use-of-money interest.

Businesses whose income is declining or taxpayers whose income fluctuates during the year may benefit from this method. However, this method of calculating provisional tax liability will not benefit everyone. Taxpayers should seek financial advice or satisfy themselves as to the benefits before deciding on whether to adopt the ratio method.

Section MB 15 outlines the qualification criteria that a taxpayer must fulfil in order to use this calculation method. Taxpayers will qualify if:

- the taxpayer's residual income tax liability for the previous year exceeds $2,500 and does not exceed $150,000; and

[1] Note that there is an error in the examples at the end of section MB 27 of the Act. The references to 20 January in the examples should refer to 15 January. This error will be corrected in the next amendment Act.

- the taxpayer was registered for GST for the whole of the previous tax year and the previous year was not a year in which they began a taxable activity; and
- their ratio for the current year is between 0 – 100%, and
- for the current tax year the taxpayer files GST returns on a monthly or two-monthly basis.

To use the GST ratio method taxpayers must fulfil the above criteria and forward an election to the Commissioner before the beginning of the income year. The Commissioner will calculate the ratio and advise the taxpayer of their rate before their first provisional tax payment due date.

When a taxpayer chooses to use the GST ratio method they are required to make six provisional tax payments (every two months) along with GST. Monthly GST payers would pay provisional tax on every second GST return.

Under section MB 15, a taxpayer must discontinue the use of the GST ratio method if:

- the taxpayer's GST registration ends in the current tax year; or
- as a result of a reassessment they no longer qualify; or
- the taxpayer changes their taxable period to a six-monthly taxable period; or
- the taxpayer has failed to file a GST return by the due date and the return is still not filed within 60 days of the due date.

A taxpayer can also elect to discontinue the use of the GST ratio method at any time.

If a taxpayer discontinues the use of the GST ratio method before the first provisional tax instalment date, they can elect to use the standard or estimation method of calculating provisional tax. However, if a person discontinues the use of the GST ratio method after the first provisional tax instalment date, the taxpayer is required to estimate their provisional tax payments for the remainder of the income year.

Calculation of ratio: Section MB 7

Once the taxpayer elects to use the GST ratio, Inland Revenue will calculate the ratio and advise the taxpayer. The ratio is based on the taxpayer's residual income tax liability for the previous year divided by their taxable supplies figures for that year, expressed as a percentage and rounded to the whole percentage figure.

$$\frac{\text{Residual income tax for previous tax year}}{\text{Total GST taxable supplies for corresponding income year}} \times 100$$

(the resulting percentage is rounded to the whole percentage number)

When information on residual income tax or GST taxable supplies is not available for the previous income year, the taxpayer would use the information for the year and corresponding income year before the previous income year.

However, if the previous year or year before the previous year is a transitional year the taxpayer should ignore the transitional year and use the residual income tax and GST taxable supplies figures for the year before the transitional year.

Calculation of provisional tax liability: Sections MB 10 and MB 18

To calculate provisional tax payments the taxpayer multiplies the ratio by their total taxable supplies for the two-month period (monthly payers will add the taxable supplies for two return periods).

When a taxpayer sells an asset they can elect to take account of the sale in calculating both the current year's provisional tax liability and the calculation of the GST ratio in the following year. To make the adjustment the asset has to exceed the greater of 5% of the taxpayer's taxable supplies for the previous 12 months or $1,000.

Example 3: Calculating provisional tax using the GST ratio method

Angela sells second-hand computers over the internet and meets all the criteria to qualify for the new rule. Angela is a two-monthly GST payer and decided that she wants to base her provisional tax on her GST taxable supplies starting in the 2008–2009 income year.

The Commissioner advises Angela that her ratio is 8%. This is calculated from her residual income tax and taxable supplies figures for the 2006–07 income year. Her residual income tax and taxable supplies for that year were $20,000 and $250,000 respectively. By dividing the residual income tax figure by taxable supplies and expressing the result as a percentage, we get the ratio of 8% (20,000/250,000 × 100 = 8%).

Angela must apply the ratio to each of her GST period's taxable supplies to determine the amount of provisional tax payable. Angela's taxable supplies for her first GST period amount to $13,000 and her provisional tax liability for that period will be $1,040 (13,000 × 8% = $1,040). The same formula must be used to calculate her provisional tax liability for the other five GST periods.

Use-of-money interest: Section MB 28, section 120C and 120K of the Tax Administration Act

Section 120K of the Tax Administration Act has been replaced with sections 120KB to KE which set the due dates for provisional tax instalments for the purposes of calculating use-of-money interest.

Taxpayers who apply the ratio method correctly and pay the provisional tax calculated using the GST ratio method will be safe-harboured from use-of-money interest if their provisional tax payments fall short of the end-of-year liability. On the other hand, they will not receive use-of-money interest if they pay too much provisional tax during the year as a result of using the GST ratio method

If the taxpayer elects out of the GST ratio method after the first instalment, they will be required to estimate their provisional tax liability for the rest of the year and will be liable to use-of-money interest.

When a taxpayer is liable to use-of-money interest on provisional tax payments, then the three compulsory provisional tax payments (two payment dates for six-monthly GST filers) will be subject to use-of-money interest. If a taxpayer subject to use-of-money interest changes their balance date, they will be subject to use-of-money interest on each of the compulsory instalments for the transitional year. The number of instalments in the transitional year may be more or less than three instalments. Schedule 13, Part B sets out the number of compulsory instalments for transitional years of differing periods.

The use-of-money interest provisions have been amended to ensure that where a taxpayer makes a voluntary payment of provisional tax they will receive interest from the day after the date of payment. The amendment ensures that interest is paid even where the payment is made before the first provisional tax instalment date.

Changing income tax balance date: Sections MB 19–24 and sections 15B–15D of the Goods and Services Tax Act

When a taxpayer changes their balance date, until the new balance date is reached the taxpayer must continue to pay provisional tax on the instalment dates that applied before the change of balance date. Once the new balance date is reached the taxpayer pays provisional tax on the instalment dates relating to the new balance date.

Instalments of provisional tax in this transitional year are due on the 28th of the months specified in Schedule 13, Part B and the final instalment is due on the 28th of the month following the final month in the transitional year or 15 January where November is the final month.

The provisions relating to the calculation of provisional tax liability using the standard and estimation options are similar. However, the legislation introduces rules for the calculation of provisional tax in the transitional year for those taxpayers who use the GST ratio method. When a taxpayer changes their balance date and moves from a set of instalment dates in even-numbered months to a set of instalments in odd-numbered months or vice versa, there will be a one-month period when GST and provisional tax are due before they change to their new balance date. The taxpayer will determine the amount of provisional tax due for this period by applying the ratio to the one-month's GST taxable supplies.

When a taxpayer (other than a GST ratio method taxpayer) changes their balance date and their GST taxable periods do not align with their new balance date, the taxpayer must change their GST taxable periods to align with the new balance date. This is achieved by truncating the last taxable period before the new balance date so that the taxable periods and income year end on the same date.

Other changes

The legislation has been amended to provide taxpayers with the option of advising Inland Revenue by phone when requesting a change in a GST taxable period, seeking a refund of the amount of provisional tax paid, or providing an estimate of their provisional tax liability.

Also, the threshold above which taxpayers are liable to pay provisional tax has been clarified. The previous legislation was unclear about whether a person whose residual income tax was exactly $2,500 was liable for provisional tax. The legislative changes make it clear that a provisional taxpayer is one whose residual income tax liability is more than $2,500.

Consolidated groups using the GST ratio method: Sections MB 29–32

When a consolidated group using the GST ratio method to calculate provisional tax is joined by a new member at the start of the income year, the group can continue to use the GST ratio method if the group meets the GST ratio method qualifying criteria – including the residual income tax threshold (residual income tax greater than $2,500 and less than or equal to $150,000). Inland Revenue will need to recalculate the ratio percentage based on including the residual income tax and GST taxable supplies figures for the new member.

If, part way through a year, a new member joins a consolidated group using the GST ratio method, then even though the group may now exceed the maximum residual income tax threshold of $150,000, the group can continue to use the ratio method until the end of the year. Inland Revenue would need to recalculate the ratio percentage based on including the residual income tax and GST taxable supplies figures of the new member. The new ratio would apply to provisional tax payments that are due after the date that the new member joined.

When a consolidated group that is not using the GST ratio method is joined after the start of the income year by a new member that is using the GST ratio method, the consolidated group cannot start using the ratio method part-way through the year.

GST Act changes

Amendments have also been made to the Goods and Services Tax Act. Section 15AB is a transitional provision inserted to require registered persons to align their GST taxable periods to their income tax balance date. The section applies to the 2007–08 year.

With effect from the 2008–09 income year, sections 15 and 15AB will be replaced with sections 15 to 15E which deal with taxable periods and changes to taxable periods, as a result of paying provisional tax payments along with GST payments.

Section 16 will be replaced with a new section which changes the due dates for GST returns to the 28th of the month except 28 December when payment becomes due on 15 January. When a registered person ceases being registered, the due date of their final return will be changed to the 28th of the month following the end for their final taxable period (or 15 January if the month following their final taxable period is December). The changes to section 16 apply to taxable periods ending on or after 31 March 2007.

Student Loan Scheme Act changes

As a result of the introduction of different provisional tax payment dates, the Student Loan Scheme Act 1992 (section 28(3)) has been amended to clarify that student loan repayments will be due on three fixed payment dates, being the 5th, 9th and 13th months after balance date. For taxpayers with a March balance date these dates will be 28 August, 15 January and 28 April. This is irrespective of whether the taxpayer pays provisional tax on those dates. This change applies to the 2008–09 and subsequent tax years.

Application dates

These new rules will apply from the following dates:

- The change to the GST due date will apply to taxable periods ending on or after 31 March 2007.
- Aligning provisional tax payment dates to GST payment dates will apply from the 2008–09 income year.
- The ratio method of basing provisional tax payments on a percentage of GST taxable supplies will apply from the 2008–09 income year.

Further examples are contained in the legislation to illustrate the application of the changes, together with a table of the legislative linkages (see section MB 8).

Tax agent workloads

As a result of tax agent clients having their GST taxable periods aligned to their income tax balance dates, some tax agents may experience their workloads being unduly concentrated around certain dates.

When a tax agent meets the following criteria, Inland Revenue will consider (with their client's permission) altering the client's balance date by a month to smooth the tax agent's workflow.

The criteria to be met are:

- the number of clients forced to align their taxable periods relative to the agent's total number of clients must be significant; and
- the tax agent can demonstrate that the forced alignment has resulted in their filing profile being significantly concentrated around certain dates – for example, moving from a 60/40 split to an 80/20 split; and
- that the imbalance would cause the tax agent significant difficulties in meeting their obligations.

Inland Revenue would consider relaxing the balance date by a month for clients who have had their GST periods aligned to their balance date. The client would need to agree to such an arrangement before the balance date would be changed.

In these cases the tax agent would need to apply to Inland Revenue for a relaxation of their client's balance date during the 2007–08 income year, being the year that the alignment takes effect. This would only be a temporary measure as once the alignment has occurred there would be no need to relax the balance dates further.

PAYE SUBSIDY FOR SMALL BUSINESSES

Sections NBB 1 to NBB 7, OB 1 of the Income Tax Act 2004 and sections 3(a)(xiii) and 3(o), 185(1)(f) and (g), 185C, and 185D of the Tax Administration Act 1994

Changes have been made to the Income Tax Act 2004 and the Tax Administration Act 1994 to enable Inland Revenue to subsidise the use of payroll agents to meet the PAYE obligations of small businesses.

Under the new rules, the government will subsidise or partly subsidise the cost of an employer engaging a payroll intermediary. The subsidy will be available for up to five employees of a particular employer per month.

To obtain the subsidy an employer must engage a listed PAYE intermediary. The listed PAYE intermediary will be eligible to receive a subsidy from the government.

Background

Consultation conducted by the government showed that many small businesses consider the time spent keeping up to date with PAYE and calculating deductions could be better spent running their business.

The PAYE subsidy proposal was a simplification initiative outlined in 2003 in the discussion document, *Making tax easier for small businesses*. It provides a subsidy to payroll intermediaries for meeting PAYE obligations on behalf of small employers.

"PAYE intermediaries" are Inland Revenue accredited incorporated or unincorporated entities acting as intermediaries between employers and Inland Revenue. Under the current rules, employers provide the intermediary with payroll information about their

employees and the gross wages to the intermediary. The intermediary is then responsible for calculating the PAYE deductions, meeting all return filing requirements and paying both the employees and Inland Revenue.

It is expected that the subsidy will encourage small employers to use PAYE intermediaries for meeting their PAYE obligations. The foreseeable benefits of this include:

- the reduction of compliance costs for small businesses;
- improvement of the PAYE system in general – payroll intermediaries would provide services to a large number of employers, using their skills and technology to increase the accuracy and timeliness of returns. The improved quality of the PAYE compliance will benefit employers whose exposure to penalties for non-compliance will be reduced;
- the outsourcing of compliance obligations faced by small businesses will allow small employers to focus their efforts on their business, rather than compliance activities;
- an improvement in the timeliness of payments and quality of information supplied to Inland Revenue and the reduction in penalties imposed on small business.

To establish a subsidy regime, legislative changes have been made.

The decision on the final amount and structure of the subsidy will be set by regulation.

Key features

Listed PAYE intermediaries

New section NBB 2 of the Income Tax Act specifies the conditions that must be fulfilled for PAYE intermediaries to be registered as a listed PAYE intermediary. The significance of the registration lies in the fact that only “listed” PAYE intermediaries are eligible to receive a subsidy. The conditions for becoming a listed PAYE intermediary include the following requirements:

- The applicant is an accredited PAYE intermediary under subpart NBA of the Income Tax Act. This requirement suggests that a prospective listed PAYE intermediary must be able to comply with the requirements imposed on “accredited” PAYE intermediaries in addition to the requirements imposed by the new legislation.
- The applicant who has already acted as an accredited PAYE intermediary for an employer has done so in a correct manner.
- The applicant has available the administrative and IT systems necessary to perform the obligations of a listed PAYE intermediary.

Inland Revenue may specify a period for which a person is accredited as a listed PAYE intermediary.

New section NBB 3 of the Income Tax Act describes the ongoing obligations of listed PAYE intermediaries. The obligations include:

- continuing to maintain the status of, and perform the obligations imposed on, an accredited PAYE intermediary;
- continuing to perform the obligations imposed on a listed PAYE intermediary in section NBB 2(1)(c) to (g), as described above in relation to section NBB 2;
- maintaining the required administrative and IT systems;
- correctly returning the subsidy claim form;
- keeping the records necessary to verify the information contained in each subsidy claim form.

New section NBB 4 of the Income Tax Act describes circumstances when the listing of a listed PAYE intermediary can be revoked and the process that must be followed to achieve the revocation. Generally, the listing may be revoked if the intermediary fails to comply with the requirements imposed on listed PAYE intermediaries or ceases to comply with the requirements that are necessary for being given accreditation as a listed PAYE intermediary.

In addition, section NBB 4 states that the Commissioner may give notice to a listed PAYE intermediary of his intention to revoke the listing and the reasons for the intended revocation. If the listed PAYE intermediary does not resolve the matters listed in the notice of intended revocation to the satisfaction of the Commissioner within 30 days, the Commissioner may give 14 days’ notice of revocation. At the expiration of the notice of revocation, the listing of the listed PAYE intermediary is revoked.

The subsidy claim

New section NBB 5 of the Income Tax Act specifies that a listed PAYE intermediary subsidy claim form must be filed within one month of the date of filing of the employer monthly schedule to which it relates.

The Commissioner is allowed, within two years of receipt of the claim form, to make changes to the particulars of the form to correct any errors that the Commissioner may have found. The Commissioner would then give the listed intermediary 14 days’ notice of the proposed amendments. An overpayment or underpayment that results from the amendment must be paid by the listed PAYE intermediary or the Commissioner within 30 days of the giving of the Commissioner’s notice of the amendments. Alternatively, the Commissioner may elect to offset an overpayment against a claim for payment of the subsidy made after expiry of the 14-day notice period.

New section NBB 6 of the Income Tax Act specifies the conditions and the process that Inland Revenue

will follow when paying a subsidy to a listed PAYE intermediary. A subsidy will be paid to a listed PAYE intermediary, working for a small employer, if the intermediary:

- has contracted with the employer for the provision of those services; and
- has met the obligations of the listed PAYE intermediary under subpart NBA of the Income Tax Act 2004, such as making the necessary tax deductions to the Commissioner and delivering an employer monthly schedule in relation to the employer; and
- files a correct subsidy claim form.

If it is satisfied that the subsidy should be paid, Inland Revenue will then pay the subsidy within 30 days of receipt of the following:

- the employer monthly schedule to which the listed PAYE intermediary claim form relates;
- payment of the PAYE deductions to which the listed PAYE intermediary claim form relates;
- the listed PAYE intermediary claim form.

The subsidy will be paid by Inland Revenue by electronic means. Within 14 days of the subsidy payment, Inland Revenue will provide the intermediary with particulars of the subsidy payment in electronic form.

Section NBB 6 also authorises the Governor-General to make regulations to prescribe the amount of the subsidy.

New section NBB 7 of the Income Tax Act governs the termination of an employer's arrangements with a listed PAYE intermediary. The section prescribes that either the employer or the listed PAYE intermediary may give notice of termination. The section also provides that if a listed PAYE intermediary ceases to act for an employer while still being in possession of the employer's funds, it must continue to act as a listed PAYE intermediary for the employer in relation to those funds.

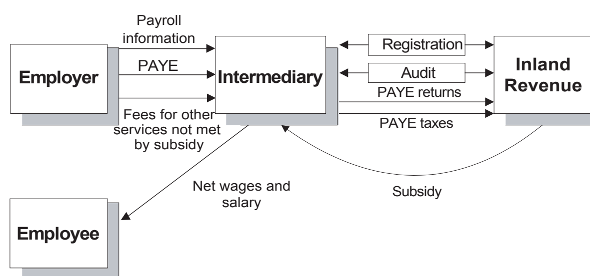
Section OB 1 of the Income Tax Act defines a "listed PAYE intermediary claim form" as being in an electronic format and showing:

- the tax file number of the listed PAYE intermediary;
- the tax file number and name of each employer for which a subsidy is being claimed;
- the tax file number and name of each employee of each employer for which a subsidy is being claimed;
- the pay period to which the claim form relates;
- the pay frequency of each employee in that pay period;
- the number of source deduction payments made by the listed PAYE intermediary for each employee in the period to which the form relates; and
- the amount of subsidy that the listed PAYE intermediary is claiming for the period the form relates to.

This information will assist Inland Revenue to calculate the correct amount of the subsidy that can be paid to the listed PAYE intermediary.

Example

The interactions between employers, employees, listed PAYE intermediaries and Inland Revenue under the amended proposal are outlined in the diagram below:



Application date

The provisions apply from 1 October 2006.

FRINGE BENEFIT TAX

Sections CE 2, CE 5, CE 11, CX 6B, CX 17(2), CX 18B, CX 20, CX 20B, CX 21(2) and (3), CX 26B, CX 27B, DB 45, GC 17B, OB 1, OB 6, ND 1A, ND 1AB, ND 1, ND 1DB, ND 1IB, ND 1K, ND 1Q, ND 2(3), ND 8B, ND 13, ND 14 and Schedule 2 of the Income Tax Act 2004

Amendments to the Income Tax Act 2004 give effect to a set of changes to fringe benefit tax (FBT). The changes are designed to reduce compliance costs and remove anomalies in the rules while maintaining the objectives of FBT. Several changes also remove an FBT liability when the fringe benefits are small relative to the compliance costs involved. This means that fewer small businesses will need to file FBT returns on minor benefits that are part of normal business activities.

Background

FBT was introduced in 1985 in response to a growing trend in the 1980s for businesses to provide in-kind benefits in lieu of cash remuneration. By taxing fringe benefits, FBT was intended to buttress the PAYE system so that all forms of remuneration were taxed equally. FBT is, in effect, a tax on employee benefits, but for compliance cost-reduction reasons liability to pay the tax falls on employers.

Although there have been specific changes to the FBT rules, the FBT system has remained largely unchanged over the past 20 years. A review began in October 2002 when the government called for taxpayers to identify areas they wished to be addressed, and a discussion document, *Streamlining the taxation of fringe benefits*, was released in December 2003. Over 60 submissions were received, and officials undertook specific consultation with key submitters. A range of submissions was also received on the subsequent draft legislation and these were considered by the Finance and Expenditure Select Committee during the bill's passage through the House.

Key features

Motor vehicles

- Through amendments to section ND 1A and Schedule 2, employers now have the choice of calculating the value of a motor vehicle fringe benefit based on the vehicle's tax value for depreciation purposes (subject to a minimum value) or, as at present, its cost.
- Amendments to Schedule 2 reduce the valuation rate applying to motor vehicles to 20% of cost. The previous annual valuation rate was 24% of their cost. This means that for those employers who pay FBT quarterly, the rate has reduced from 6% to 5%. The equivalent rate under the alternative tax value option is 36% (or 9% if FBT is paid quarterly). This reduction is in recognition of lower real motoring costs since the rate was set in the mid-1980s.
- Other amendments to Schedule 2 better align the treatment of leased vehicles with that of owned vehicles so that the fringe benefit from a leased vehicle is based on its cost or tax value rather than, as previously, its market value. This removes the incentive for leases to be used to reduce an FBT liability.
- Similarly, new section CX 6B ensures that FBT cannot be avoided by employees leasing their own vehicles to their employers and "suspending" the leases when private use occurs through such arrangements as "9-to-5" and "flip-flop" leases. But a deduction for all costs incurred by the employee is now allowed under new section DB 45.
- New section ND 1AB enables employers to elect the start time for an FBT day. This is to ensure that two days' FBT liability is not incurred when a vehicle is occasionally taken home overnight and returned the next morning. An election applies to all vehicles and normally lasts for two years.

Other changes

- New section ND 1DB has been amended to allow lenders to the general public, such as banks and financial institutions, the additional option of using the relevant market interest rate as the benchmark for valuing the benefit from their loans to employees.
- Amendments to section ND 1Q increase the minimum-value thresholds that have to be exceeded before unclassified fringe benefits are subject to FBT. The employee minimum value threshold has been increased to $200 per quarter and the employer minimum value threshold has been increased to $15,000 per annum.
- New section CX 18B allows the private use of an employer-owned or leased business tool, such as a cellphone or laptop, to be exempt from FBT when the tool is provided mainly for business purposes, as long as its cost price does not exceed $5,000.
- Previously, benefits that might arise as a result of employers carrying out their health and safety obligations (for example, health checks) fell within the scope of FBT if they were not provided on the premises of the employer. New section CX 20B allows these benefits to be exempt from FBT irrespective of whether the benefits are provided on or off the employer's premises.
- New section CX 26B exempts income protection insurance premiums paid by employers on behalf of their employees from being a fringe benefit provided any claims under the policies are treated as assessable income of the employees.
- Amendments to sections CX 20(1) and (2) extend the "on-premises" exemption to the premises of other companies in the same group when there is 66% or greater common ownership with the employer company.
- Similarly, as a result of an amendment to the definition of "subsidised transport" any benefits provided by a public transport operator to employees of other companies within the operator's group of companies can be valued at the same rate as that which the public transport operator would be able to use in relation to its staff for FBT purposes.
- An amendment to section CX 9 ensures that fringe benefits that arise from advances against salary and wages are now exempt from FBT when the aggregate amount of outstanding advances to an employee does not exceed $2,000 and the advances are not part of an employment package.
- Section OB 6 has been amended so the Income Tax Act's general anti-avoidance rule also applies to FBT.
- New section CX 27B and an amendment to section ND 1K clarify that FBT does not apply to benefits that arise when an employer secures bulk discounts or provides services to employees provided the price paid for the goods or services is no less than that available to other comparable-sized groups on an arm's-length basis.

- Section CX 21 has been amended to specifically exclude the provision of credit cards and other short-term charge facilities from the exemption that charities have from FBT when the aggregate value of the benefits in a year exceeds 5% of an employee's salary or wages.
- Section CX 17 has been amended to provide an exemption from FBT when an employer pays for a member of an employee's family to travel to visit the employee. This exemption is limited to the amount that would have been exempt from FBT if the employee had made the visit.
- An amendment to section CE 2 clarifies that share options cancelled in exchange for cash are a "disposal" and therefore covered by the employment income provisions of the Act.
- Amendments to sections ND 2(3), ND 13 and ND 14 provide more administrative flexibility in relation to elections to pay FBT on a quarterly, annual or income-year basis. An election to pay FBT quarterly can now be made at the time of filing irrespective of whether FBT is actually paid, and an election to change to paying FBT annually or on an income-year basis[2] can be made by telephone rather than having to be in writing.
- Another amendment to section ND 14 ensures that when a small close company with a non-standard balance date chooses to pay FBT on an income-year basis rather than quarterly it is required to undertake the section ND 10 quarterly payment calculation in relation to any incomplete year that arises by virtue of the election.
- New section ND 8(3) allows employers that cease to employ staff during the year, and have no intention of replacing them, the option of applying the 64% FBT rate rather than the multi-rate for their final quarterly return.

Application date

The amendments apply from 1 April 2006 or, if an employer pays FBT on an income-year basis, from the income year beginning on or after that date.

Detailed analysis

Motor vehicles

The issue most frequently raised in consultation on the FBT review concerned the valuation of motor vehicles.

Valuation basis

A motor vehicle fringe benefit is calculated on a quarterly or annual basis by taking a set percentage, which reflects the costs of motoring, and multiplying it by the original cost of the vehicle. The result is reduced by the number of days in which the vehicle is not available for private use. Some taxpayers perceived this approach to be unfair because the FBT liability remains constant while the vehicle declines in value over time.

To address this issue, subsections ND 1A(1B)-(1D) have been added and Part A of Schedule 2 has been amended. These changes enable employers to use a motor vehicle's depreciated value (tax value) as the basis for valuing the fringe benefit, but at a higher rate than under the cost price option. A higher rate is needed to produce the same overall tax result as the rate takes into consideration all the costs, including depreciation, over the average period a vehicle is held privately (five years). Expressing these costs as a percentage of a lower base results in a higher percentage. However, the overall FBT liability, while higher in earlier years, is lower in later years.

Under the tax value method there is a minimum tax value of $8,333 to reflect the on-going benefits that an employer-provided vehicle affords even when it has depreciated significantly. This is because the employee still continues to save the costs of running a vehicle.

"Tax value" is defined in relation to subpart EE (depreciation), and is the depreciated value at the beginning of the relevant tax or income year as determined under that subpart, unless the vehicle has been acquired after during the year in which case the vehicle's cost is used.

Example

Assuming that the vehicle was held for the whole year:

1. For the owner of a vehicle with a balance date of 31 March who is completing a quarterly FBT return for the period April–June 2006, the tax value would be the vehicle's depreciated value at the beginning of the 2006–07 tax year, that is, as at 1 April 2006. This value would also apply to the September 2006, December 2006 and March 2007 FBT returns.

2. For the owner of a vehicle with a balance date of 30 June who is completing a quarterly FBT return for the period April–June 2006, the tax value would be the vehicle's depreciated value at the beginning of the 2005–06 tax year, that is, as at 1 July 2006. For the September 2006 quarter's FBT return, the tax value would be the depreciated value as at 1 July 2007.

Assuming that the vehicle was acquired on 7 December 2005 at a cost of $30,000:

In case (1) the tax value for the June 2006 FBT quarter's return would be its depreciated value as at 1 April 2006 whereas in case (2) its tax value would be its cost price of $30,000.

2 An income basis will differ from an annual basis when the employer has other than a 31 March balance date.

As has been the case with the cost price method, the tax value is inclusive of any GST paid on the acquisition of the vehicle. If the employer wishes to use a GST-exclusive price or value then the valuation rate is proportionately increased to ensure that the same amount of FBT is paid.

Amendments to Schedule 2, Part A(1) reduce the percentage applied to a vehicle's cost price to 20% annually or to 5% quarterly (previous rates were 24% and 6% respectively). The equivalent percentage using the tax value as the base is 36% annually and 9% quarterly.

Example comparing the rates and methods

Company Zed buys a new Holden Commodore for $63,000 GST-inclusive and makes it available for employee John's use. The table below provides a comparison of the taxable value on which the FBT liability is based before and after the legislation change.

Taxable value calculation under each option

Cost price option before 1 April 2006	Days available for private use x (cost price of vehicle x 6%) / days in quarter	=	Taxable value
	$\frac{90 \times (\$63{,}000 \times 6\%)}{90}$	=	$3,780
Cost price option from 1 April 2006[1]	Days available for private use x (cost price of vehicle x 5%) / days in quarter	=	Taxable value
	$\frac{90 \times (\$63{,}000 \times 5\%)}{90}$	=	$3,150
New tax value option from 1 April 2006[1]	Days available for private use x (book value of vehicle x 9%) / days in quarter	=	Taxable value
	$\frac{90 \times (\$63{,}000 \times 9\%)}{90}$	=	$5,670

[1] Or from the beginning of the income year beginning on or after 1 April 2006 if the taxpayer returns FBT on an income year basis.

Taking the example above and assuming the vehicle is purchased on 1 April 2006 and is made available to the employee from that day, the tables below show the FBT payable using the new valuation rates, firstly under the cost price option and then under the tax value option.

Although the fifth and subsequent years will produce ongoing savings, an employer will pay significantly more FBT in the first three years under the tax value option.

Year ending 31 March	Original cost price of vehicle	Taxable value (cost price of vehicle x 5% x days available in quarter divided by days in quarter)		Annual taxable value on which FBT is payable
2007	$63,000	4 quarters @ $3,150	=	$12,600
2008	$63,000	4 quarters @ $3,150	=	$12,600
2009	$63,000	4 quarters @ $3,150	=	$12,600
2010	$63,000	4 quarters @ $3,150	=	$12,600
2011	$63,000	4 quarters @ $3,150	=	$12,600
2012	$63,000	4 quarters @ $3,150	=	$12,600
2013	$63,000	4 quarters @ $3,150	=	$12,600

Year ending 31 March	Tax book value of vehicle depreciated at 36% DV per annum	Taxable value (book value of vehicle x 9% x days available in quarter divided by days in quarter)		Annual taxable value on which FBT is payable
2007	$63,000.00	4 quarters @ $5,670	=	$22,680
2008	$40,320.00	4 quarters @ $3,629	=	$14,515
2009	$25,805.00	4 quarters @ $2,322	=	$ 9,290
2010	$16,515.00	4 quarters @ $1,486	=	$ 5,945
2011	$10,570.00	4 quarters @ $951	=	$ 3,805
2012	$ 6,765.00*	4 quarters @ $750	=	$ 3,000
2013	$ 4,329.00*	4 quarters @ $750	=	$ 3,000

* The minimum value of $8,333 must be used to calculate the taxable value once the vehicle's tax book value has depreciated to less than that amount.

Leased vehicles aligned with owned vehicles

FBT on leased vehicles was previously assessed on the vehicle's market value at the beginning of the lease. This meant that leasing a vehicle on a yearly basis could produce a lower FBT impost by setting a new (lower) market value annually.

Changes to Schedule 2, Part A(1)(b) remove the incentive to lease vehicles by providing lessees with the same options as proposed for owners – in other words, a rate of 20% on the cost price or a rate of 36% on the tax value of the vehicle.

In both cases it is the cost price and tax value of the owner/lessor that is relevant. To reduce compliance costs for lessees, a lessee can request the relevant cost price or tax value from the lessor and under Schedule 2, Part A(8) the lessor is required to disclose this information.

Previously leased vehicles

The only case when market value can now be used is when a previously leased vehicle is leased again to a completely separate party. In such cases the market value becomes the cost price (see Schedule 2, Part A(7)). To qualify:

- the new lessee cannot be associated with the previous lessee or with the lessor or owner of the vehicle;
- the employee cannot be the lessor or owner of the vehicle or associated with the lessor owner of the vehicle.

Switching between methods

Having made their choice between the cost and tax value options in the initial FBT return for the vehicle, employers must continue to use their chosen option until either:

- the vehicle is sold; or
- the vehicle ceases to be leased; or
- a period of five years has elapsed from the beginning of the initial return.

This means that vehicles that were already subject to FBT before 1 April 2006 can be valued after 1 April 2006 under the tax value option if they have already been valued for FBT purposes for a period of five years at cost.

9-to-5 and flip-flop leases

New sections further align leased vehicles with owned vehicles by addressing "9-to-5" and "flip-flop" leases. Over the past decade an increasing number of employees (usually shareholder-employees) have entered into arrangements to lease their own vehicles to their employers for business use during specified hours (usually 9 a.m. to 5 p.m.) in exchange for a market rental. The objective of the leases is to enable the employees to enjoy private use of the vehicles when they are not being used for business purposes. Because the leases are in effect "suspended" when private use occurs, the argument is made that there is no FBT liability.

Changes have been made to ensure that these types of leases are subject to FBT. Under new section CX 6B, when there is agreement or an arrangement between an employer and an employee transferring a right to use a motor vehicle to the employer, the employer is treated as having a right to use that motor vehicle for a period when the employee uses the vehicle privately or has the right to use the vehicle privately. This rule also extends to persons associated with the employer.

<u>Full deduction of costs available</u>

Under section DB 45 parties to 9-to-5 and flip-flop leases can now fully deduct their private motoring costs for vehicles covered by the leases when the expenses have been incurred during a period for which the employer or associated person is treated as having a right to use the vehicle. This provides consistency with other situations when FBT applies. Previously, an employee/lessee could only deduct expenses that were business-related.

<u>Reimbursement for use of a private motor vehicle</u>

Lessees should note that Inland Revenue has also recently clarified the options that are available in relation to reimbursing employees, including shareholder-employees, for the use of their private motor vehicles for business purposes. The reimbursement options are discussed more in the Remedial Matters section of this TIB.

Employers able to elect start time of an FBT day

If a vehicle is available for private use at any time during the day, it is considered to be available for the whole day. This means that if an employee takes a vehicle home at night to take it to another work site the following morning, the vehicle is regarded as being available for private use for two days.

New section ND 1AB means an FBT day is now defined as any 24-hour period rather than a calendar day.

An election applies across all the employer's vehicles and lasts for two years, although section ND 1AB(6) enables the Commissioner to accept a change if an employer can show that there has been a material change in circumstance. An election has to be made to the Commissioner at the same time as the return to which it relates is provided. If an employer makes no election, the current treatment of a calendar day would apply.

Example

An employee finishes work at 6pm and travels home, returning the vehicle at 8am the next day. Previously, as a "day" was based on a calendar day, two days FBT would have been incurred. If the employer now elects a start time of 6pm for the start of the 24-hour period, only one day's FBT would be incurred on this vehicle.

Other issues

Loans to employees

Generally, the value of a fringe benefit arising from an employee loan is the amount by which interest calculated according to the FBT prescribed rate of interest exceeds actual interest paid. The prescribed rate is set by Order in Council before each quarter begins but uses data from the previous quarter. This means the prescribed rate can become out of date, resulting in fringe benefits arising even when current market rates of interest are charged. Accordingly, under the revised section ND 1D and new section ND 1DB employers, such as banks or financial institutions, who are in the business of lending money to members of the public now have the option of using market rates rather than the prescribed rates. Certain criteria apply to what constitutes a market rate. An election to use a market rate need not apply to all loans but an employer will need to identify which classes of loans are covered by their election if it is to be applied selectively.

For all other employers the value of the loans must continue to be calculated using the prescribed rates.

<u>Market interest calculation</u>

The market rate is, in effect, the rate that the lender charges other comparable groups of a sufficient size on

an arm's-length basis. Specifically, section ND 1DB requires that the comparable group meets the following requirements:

- the group is assessed as having a comparable credit risk to the employee group;
- membership of the group arises from factors that do not include a link between a member and the employer; and
- the group is big enough to ensure the transaction is completed on an arm's-length basis.

Depending on the circumstances, this is intended to be sufficiently wide to cover rates offered to the general public as well as rates offered to groups that are unrelated but comparable to the employee group.

Example

A bank provides loan facilities which are not offered to customers. However, they are identical to those offered to employees of a government department. The market interest rate would be the rate offered to the group of government employees.

Switching between valuation options

When an employer has chosen the market rate method of calculating interest they must use that method for the income year to which the choice relates and for the following income year. If they wish to subsequently change back to using the prescribed rate, they must advise Inland Revenue at least one year before the beginning of the income year in which the change will take place.

Wage advances

Loans which are provided by employers as an advance against future salary or wages will not incur an FBT liability provided the aggregate amount outstanding for an employee does not exceed $2,000 and the contract of employment does not require the employer to make the advance. The latter requirement is to ensure that the loan has not been provided to the employee as part of an employment package.

Example

An employee asks his employer for an emergency advance of $1,500 against next month's salary to get his car repaired. The employer provides this advance which is repaid over a period of six months. No fringe benefit tax arises.

The exemption does not apply to loans which have been secured against real property, such as a mortgage.

Minimum thresholds

Employers are not required to return FBT on miscellaneous (known as unclassified) fringe benefits that do not exceed certain thresholds. This exemption does not apply to fringe benefits such as motor vehicles and loans, which are specifically listed in sections CX 6 to CX 15.

Section ND 1Q has been amended to substantially increase both the employee and employer minimum thresholds. A comparison of the old and new thresholds is provided below. Raising the thresholds should generally lower compliance costs for employers who provide only small miscellaneous fringe benefits (such as most Christmas gifts) as these benefits would then fall out of the FBT net.

Return period	Periods up to 31 March 2006	Periods after 1 April 2006
Quarterly exemption per employee	$ 75	$ 200
Quarterly exemption per employer	$ 450	$ 15,000 per maxium*
Annual exemption per employee	$ 300	$ 800
Annual exemption per employer	$1,800	$15,000

* this takes into consideration the benefits paid in the current and preceding three quarters

The revised employer threshold has been set to effectively exclude miscellaneous fringe benefits provided by small and medium-sized businesses (20 employees or fewer). Also, employers who are required to file quarterly returns now have more flexibility in terms of providing unclassified benefits and not incurring FBT, given that the employer threshold is now expressed on an annual basis. The maximum amount of $15,000 is a rolling total and takes into account the benefits provided in the current quarter and the three previous quarters.

Example

In the quarter up to the new thresholds applying, an employer has provided unclassified fringe benefits in excess of the employer allowance of $450 per quarter and has therefore paid FBT for all of those quarters. The employer provided benefits of:

$3,000 in the September 2005 quarter

$5,000 in the December 2005 quarter

$2,000 in the March 2006 quarter, a total of $10,000.

In the June 2006 quarter the employer can provide up to $5,000 in unclassified benefits without FBT applying to that quarter's benefits. Assuming that the employer does this, then in the September 2006 quarter, the employer can provide $3,000 in unclassified benefits before FBT applies to those $3,000 of benefits.

Example

In the quarter up to the new thresholds applying an employer has provided unclassified fringe benefits up to the employer allowance of $450 per quarter. The employer has therefore provided benefits of $450 in each of the September 2005, December 2005 and March 2006 quarters, a total of $1,350.

The employer can provide up to $13,650 (i.e. $15,000-$1,350) in unclassified benefits in the June 2006 quarter without FBT applying to that quarter's benefits. Assuming that the employer does this, the employer can then provide $450 of unclassified fringe benefits in the September 2006 quarter before FBT applies to those $450 of benefits.

Business tools

The government noted that it is difficult and costly for employers to monitor and value the incidental private use of small items such as laptops and cellphones when they are provided by employers mainly as business tools. The difficulty in measuring any private benefits that do arise effectively precludes them from being encompassed in the minimum value thresholds.

Accordingly, new section CX 18B specifically exempts the private use (and availability for private use) of a business tool from FBT when the tool is provided for mainly business use and its cost does not exceed $5,000. If a business tool is kept at the employee's home rather than being returned to the employer's premises it will still qualify for the exemption if the employee performs a significant portion of his or her employment duties at home. A business tool is defined in section OB 1 as an item that is used by an employee in the performance of their work duties and in the absence of section CX 18B would give rise to an unclassified benefit.

Example

An employer provides a notebook costing $3,500 to an employee because the employee carries out much of her work away from the employer's head office. Occasionally the employee's children use the notebook to play games in the evenings. This private benefit will now be exempt because the notepad was provided mainly for work purposes.

The same employer also provides the employee with a cellphone so that the employee can be readily contacted for business purposes. The cost of making private calls can be covered by the exemption when that private use of the phone is incidental. Alternatively, it may be exempted under the minimum value threshold depending on what other unclassified benefits are provided.

Specific exemption of employer health and safety-related benefits

Incidental private benefits can arise as a result of employers carrying out actions to meet their health and safety obligations. Previously such benefits could incur an FBT liability if the actions were done outside the employer's premises but would be exempt if the benefits were provided on the employer's premises. There was considered to be no logical reason for this distinction. Therefore, new section CX 20B provides an exemption in all cases.

Under that exemption, employers who are undertaking hazard management, such as the provision of protective clothing or health checks, will not incur an FBT liability in respect of any benefits that arise out of that management irrespective of where the benefit is provided.

To qualify, the measures must be aimed at addressing hazard management in the work place as contemplated in the Health and Safety in Employment Act. It does not extend to items such as gym memberships or employer-paid health insurance premiums.

Example

An employer offers influenza injections to employees. The injections can be provided either at work or at the doctor's surgery without any FBT liability arising.

Extension of "on-premises" exemption to group company employees

Previously, the exemption from FBT for benefits provided on an employer's premises did not necessarily extend to the premises of another member of a group of companies. For example, an employee could be employed by one member company, but receive a benefit on the premises of another member company while on a secondment. This benefit would have been subject to FBT.

In recognition that entities within a group may operate more like a single economic entity, the general "on-premises" exemption in section CX 20 has been extended to include the premises of other companies in the same group that share 66% or greater common ownership with the employer company.

Benefits provided by public transport operators

A related change is that as a result of an amendment to the definition of "subsidised transport" any benefits provided by a public transport operator to employees of other companies within the operator's group of companies can be valued at the same rate as that which the public transport operator would be able to use in relation to its staff for FBT purposes.

Income protection insurance

The FBT treatment of income protection insurance policies should put the employee in the same position as

if the employer had paid the employee a cash amount, and the employee had then paid the premium directly. Previously, this was not the case. Employees who paid the premium directly were eligible for a deduction for the premium paid, on the basis that it was to ensure future income, but employees did not receive a deduction when the employer was liable to pay the premium on their behalf.

New section CX 26B exempts income protection insurance premiums paid by employers on behalf of their employees from being a fringe benefit, provided any claims under the policies are treated as assessable income of the employees. This achieves a similar result to an employee receiving a deduction, but with lower compliance costs as the employee does not need to make a separate deduction claim because of the fringe benefit exemption.

Consequential amendments include:

- An amendment to section CE 5 which excludes the amount of the premium that the employer is liable to pay from being expenditure on account of an employee.
- New section CE 11 clarifies that an amount derived under the policy is income to the employee.

Example

Employer Y has arranged with a private insurer to provide income protection insurance for his employees and is liable to pay the premiums on that insurance. This is a private benefit for the employees but it is now exempt from FBT provided that, should there be a payout on the policy, the payout would be treated as income to the employee.

Application of the general anti-avoidance rule

FBT has its own anti-avoidance provisions in the Income Tax Act. However, unlike many other specific anti-avoidance rules, they were not also bolstered by the Act's general anti-avoidance rule (see section BG 1), which enables a tax avoidance arrangement to be voided and any associated tax advantage to be counteracted. The omission arose because of the wording in section BG 1, when read in conjunction with section OB 6 (definition of income tax). Section BG 1 voided arrangements for income tax purposes but section OB 6 specifically excluded FBT from the definition of income tax.

Section OB 6 has been amended to make FBT income tax for the purposes of section BG 1. A new section GC 17B enables the Commissioner to alter a person's tax liability when an arrangement involving FBT is voided by section BG 1.

This change means that arrangements to which the specific anti-avoidance rules do not apply might still be treated as avoidance.

Bulk discounts and services to employees

Previously, if an employer entered into an arrangement with a third party to provide employees with a benefit, the employer was deemed to have provided a fringe benefit even if the employees could have been in a group unrelated to their employment and still received a comparable discount.

Under new section CX 27B, a fringe benefit will not be incurred by the employer when the third party offers at least the same, if not more of, a discount to a group of individuals that:

- has negotiated their discount on an arm's-length basis, and
- does not include the group of employees; and
- is comparable in number to the group of employees.

Example

A discounted gym membership is offered to the 200 employees of ABC bank through an arrangement between the bank and the gym. The discounted membership will not be liable for FBT as long as it is the gym's practice to offer the same discount to other unrelated groups of around 200 persons.

A similar amendment has been made in relation to the valuation of services because of uncertainty about what constitutes an arm's-length price offered to the public in the open market in New Zealand on ordinary trade or professional terms. The price to the public is used as the benchmark so that if the price charged to the employee is the same as that charged to the public then no FBT arises.

Under revised section ND 1K, a person providing services to a group of employees is treated as providing the same or similar services to the public if the person provides the same or similar services to a group that has negotiated the transaction on an arm's-length basis and is comparable in number to the group of employees. Any price charged to the employees below that charged to the other group would be subject to FBT.[3]

Changes to charities exemption

Cash remuneration to employees of charitable organisations is taxed through the PAYE system, as for other employees. Non-cash benefits provided to employees of charitable organisations are, however, generally exempt from FBT, other than when the employees are employed in a charity's business.

New subsection CX 21(2) further restricts the exemption by specifically excluding from the exemption benefits arising in relation to short-term charge facilities when the aggregate value of the benefits to an employee in a tax year from the facilities exceeds 5% of the employee's salary or wages in that year. This change is designed to reduce the potential for charitable organisations to provide

[3] This approach is also used in valuing low-interest loans (see ealier discussion).

a significant proportion of their employees' remuneration in the form of fringe benefits. This is more likely to occur if a benefit can readily be substituted for cash and a wide range of goods and services can be purchased as is the case with credit and debit cards.

Subsection CX 21(3) provides a definition of what constitutes a short-term charge facility. Basically, the focus is on arrangements that enable an employee to charge non-business related purchases or hire costs to an account that the employer is liable to pay. It does not include employment-related loans under section CX 9.

New section ND 1IB indicates that the value of the benefit in these cases would be the cost to the employer of the non-business purchases of goods and services plus any interest incurred in relation to those purchases and, if a credit card is provided solely for non-business use, any account and service fees associated with the card.

For employers who file quarterly FBT returns, new section ND 8B indicates how the employer is to calculate whether there is an FBT liability in relation to the 5% threshold in any particular quarter.

Employer-paid family travel

In certain circumstances an employer can now pay the travel costs of an employee's spouse, civil union or de facto partner and/or family to enable them to visit an employee who is required to temporarily work out of town or offshore and no FBT will apply. To qualify for the exemption in new section CX 17(2), the value of the travel must not exceed the amount that would have been provided as a tax-free allowance to the employee had the employee travelled home instead. This exemption is therefore provided on the basis that the outcome is the same as if the employee had been provided with a reimbursement allowance for their additional travel costs.

Section OB 1 has been amended so that paragraph (a) of the definition of "relative" applies to section CX 17. That definition covers blood relatives within the second degree of relationship and those married to them, and adopted children, including those of persons within the first degree of relationship.

Example

Company X sends its senior marketing representative (Wayne) to Wellington to train four new marketing officers for three weeks. Wayne travels home the first weekend at a cost of $610 for return flights but decides his wife should visit him the second weekend. The cost for return flights in her case is also $610 in which case there is no FBT liability.

Share options cancelled in exchange for cash

Share options provided to an employee by an employer are treated as employment income, with the value of the benefit being the difference between the value of shares on the date of acquisition – that is, on the exercise of the options – and the amount paid by the employee for them. To avoid double taxation, the FBT rules specifically exclude such benefits (see section CX 4).

A question arose over whether the treatment of options that are cancelled in exchange for cash rather than exercised and converted into shares would be treated as either employment income or a fringe benefit. This was because of an argument that a cancellation did not constitute a disposal.

The policy intent is to treat the cancellation of a share option the same as if the share had been disposed of. The reality is that the employee is receiving a payment for some form of benefit in this situation.

To rectify this position, an amendment has been made to section CE 2 to clarify that the cancellation of share options in exchange for cash is a disposal of rights in terms of section CE 2(3), and is employment income of the employee.

Administrative simplifications to choosing when to pay FBT

These remedial changes are aimed at providing greater administrative flexibility and lower compliance costs. An amendment to section ND 2(3) enables an employer to choose to pay FBT on a quarterly basis at the time of filing irrespective of whether or not FBT has to be paid. Also, through amendments to sections ND 13 and 14, an election to pay FBT annually or on an income-year basis rather than quarterly will be able to be made by telephone rather than having to be in writing.

Non-standard balance date taxpayers and income-year FBT elections

Small close companies are allowed to file and pay FBT on an income-year basis. Clarification was required on an issue concerning such companies with non-standard balance dates who elected to switch from paying FBT on a quarterly to an income-year basis. An election should apply from the beginning of the next income year so that all the necessary steps relating to the last year of quarterly payment, including the end-of-year multi-rate square-up, take place before the election applies.

New subsection ND 14(2B) provides the necessary clarification by requiring that in the case of a small close company, the employer must undertake the section ND 10 final quarterly payment calculation in relation to any incomplete year that arises by virtue of the election.

Employers ceasing to employ staff

Employers ceasing to employ staff during the year with no intention of replacing them now have the option of applying the flat rate of 64% in their final return rather than having to undertake the multi-rate calculation. New section ND 8(3) gives effect to this change.

Employers choosing this option are still required to undertake a square-up in that the 64% rate is applied to fringe benefits provided from the beginning of the year

up to the time staff ceased to be employed (with a credit for FBT already paid during the year). In other words, the 64% rate does not apply to just the last quarter. The difference from the previous approach is that the employer no longer has to calculate the appropriate multi-rates in relation to the employees.

TAXATION OF SHARE-LENDING TRANSACTIONS

Sections CD 9, CD 10B, CD 10C, CD 43, CH 1, CX 44B, DB 12B, DB 12C, DB 40, EA 1, ED 1, ED 2, EW 5, EW 52B, GC 14F, GC 14S, GD 1, LB 2, LD 3, LD 8, LD 9, ME 4, ME 5, ME 6B, ME 11, ME 12, MG 4, MG 5, MG 14, MG 15, NF 1, NF 2, NF 2A, NF 2B, NF 2D, NF 3, NF 4, NF 8B, OD 8, Schedule 14 and a number of definitions in section OB 1 of the Income Tax Act 2004 and sections 30B and 30C of the Tax Administration Act 1994

The tax treatment of share-lending transactions has been clarified and reformed by:

- introducing specific share-lending rules to allow the taxation of "qualifying" share-lending transactions on the basis of economic substance; and
- strengthening the tax rules to ensure that non-qualifying share-lending transactions do not give rise to an unintended fiscal cost.

These changes give greater consistency to the tax treatment of share-lending transactions with the treatment of other commercial transactions such as finance leases and hire-purchase agreements. The amendments also give taxpayers more certainty about how these transactions are taxed. Finally, the changes protect the tax base by preventing taxpayers from using share-lending transactions to effectively transfer the receipt of imputation credits to gain a tax advantage.

Background

Share-lending involves the lending of shares to another party for a fee and allows brokers to transact in securities in which they have a shortfall. Share-lending also provides a relatively risk-free way for larger holders of shares, such as banks, insurance companies and funds managers, to increase their overall portfolio returns. Internationally, share-lending represents a substantial part of the daily settlement value in many transaction systems and can play an important role in facilitating market liquidity.

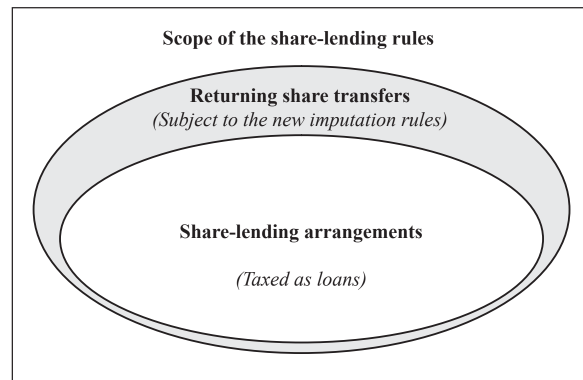
Historically, New Zealand has not had an onshore share-lending market, at least in part because of the tax treatment of these transactions. New Zealand, unlike many other jurisdictions, did not have special tax rules for share-lending. For New Zealand tax purposes, these transactions were taxed on the basis of legal form (a sale of shares) rather than economic substance (a loan), meaning that entering into a share-lending transaction was a taxable event.

The previous New Zealand tax treatment of share-lending transactions was out of line with international trends. It was inconsistent with the treatment of other commercial transactions and the economic and accounting treatment of share-lending transactions. There were also base maintenance concerns, with evidence that share-lending transactions were being used to effectively transfer the receipt of imputation credits and take advantage of the absence of specific tax rules in this area in New Zealand.

The changes to the tax treatment of share-lending were set out in the government discussion document, *Taxing securities lending transactions*: substance over form, released in November 2004.

Key features

The amendments to the Income Tax Act 2004 introduce share-lending rules to tax "qualifying" share-lending transactions on the basis of economic substance rather than legal form. They also strengthen the imputation rules to ensure that non-qualifying share-lending transactions do not give rise to a fiscal cost.



The new rules revolve around the definition of a returning share transfer.

A returning share transfer is an arrangement:

- when a share (the original share) is transferred from a share supplier to a share user;
- when the original share is listed on an official list of a recognised exchange;
- where it is conditionally or unconditionally agreed that the share user (or associate) will pay a replacement payment to the share supplier (or associate) if a dividend is payable on the original share; and
- where it is conditionally or unconditionally agreed that the original share or an identical share may be transferred from the share user to the share supplier (or associate); and

- that is not a warrant or instalment receipt.

Returning share transfers which meet a number of criteria (known as share-lending arrangements) will be taxed on the basis of their economic substance rather than legal form. This means that they will not be treated as a taxable disposal.

A "share-lending arrangement" is defined as a returning share transfer entered into on or after 1 July 2006 where:

- the agreed term of the transaction is one year or less;
- the terms are ordinary commercial conditions which are consistent with those that would apply between parties negotiating at arm's-length;
- the amount of resident withholding tax required under section NF 2(1)(g), if any, is paid;
- the share user disposes of an original share or an identical share to the share supplier during the agreed term of the arrangement, or within a further period allowed by the Commissioner; and
- the share user issues a credit transfer notice in relation to the dividend paid on the original share or establishes and maintains an imputation credit account (ICA) if a dividend is payable on the original share.

An identical share is a share that confers the same rights and imposes the same obligations on the holder as the original share.

A share supplier is a person described as such in the definition of a returning share transfer, from whom the share user acquires an original share under a returning share transfer.

A share user is a person described as such in the definition of a returning share transfer, who acquires an original share under a returning share transfer.

For the purposes of the share-lending rules, the definition of "associated person" is contained in section OD 8(3).

Treatment of returning share transfers which are not share-lending arrangements

The second key part of the share-lending rules is the introduction of new imputation rules. The share-lending rules are designed to ensure that imputation credits remain with the economic owner of the shares. However, because the rules only apply to qualifying transactions, taxpayers could structure transactions outside the qualification criteria in order to gain a tax advantage. Therefore amendments to the imputation rules have been made to bolster the share-lending rules.

The rules governing the treatment of returning share transfers are designed to complement existing anti-avoidance provisions. They apply when a share user (or associate) receives imputation credits attached to a dividend as part of a returning share transfer that is not a share-lending arrangement. Where the new rules apply, the tax benefit obtained will be cancelled by a debit to the ICA account of the share user. The share user is not allowed a credit of tax for the imputation credit. In addition, a transfer of shares under a returning share transfer which is not a share-lending arrangement will still be treated as a disposal for tax purposes.

Application date

The share-lending amendments apply from 1 July 2006.

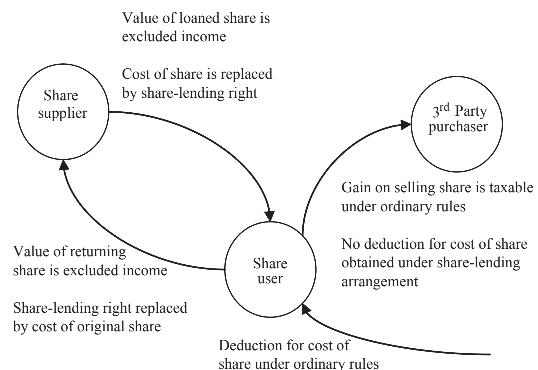
Detailed analysis

A number of changes have been made to the Income Tax Act 2004.

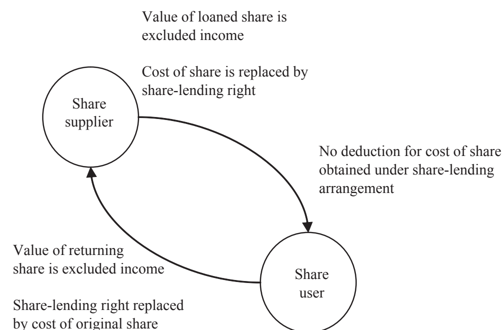
Structure of the new rules

One of the aims of the share-lending rules is to tax these transactions like loans. To achieve this, a number of existing provisions have been "switched off" as illustrated in the following diagrams.

Structure: borrowed shares are on-sold to a third party



Structure: borrowed shares are returned to supplier



Under new section CX 44B, any share-lending collateral derived by a person under a share-lending arrangement

will be excluded income. This covers any consideration received by the share supplier on lending the shares or by the share user on returning the original or an identical share.

Share-lending collateral is defined as an amount (or an adjustment to an amount) that is related to the market value of the original share under a share-lending arrangement and is paid to a person by a share user (or associate) to secure the transfer of the original share or by a share supplier (or associate) for the re-transfer of the original or an identical share. It does not include any amount of replacement payment. What is market value should be determined using normal commercial practice.

Example 1

The Kiwi Unit Trust (KiwiTrust) holds a number of Greenstone Limited shares in its portfolio. These were purchased at a cost of $2 per share and are listed on the New Zealand stock exchange. On 1 July 2006, KiwiTrust lends 1,000 Greenstone Limited shares to NZ Broker Limited on normal commercial terms.

NZ Broker Limited agrees to pay a cash lending fee and a compensation payment (or replacement payment) to KiwiTrust if any dividend is payable on Greenstone Limited shares over the term of the lending arrangement. As part of agreeing to make the compensation payment, NZ Broker Limited agrees to either transfer imputation credits or pay any resident withholding tax required. Legal title in the Greenstone Limited shares is transferred to NZ Broker Limited and it is agreed that identical Greenstone Limited shares will be transferred back to KiwiTrust in 30 days' time. KiwiTrust maintains an imputation credit account.

The above transaction meets the definition of a returning share transfer and a share-lending arrangement.

At the time of entering into the lending agreement, the market price for Greenstone Limited shares was $5 and NZ Broker Limited transferred $5,000 to KiwiTrust as collateral for borrowing the shares.

The $5,000 payment meets the definition of share-lending collateral as it is based on the market value of the shares lent and was paid by NZ Broker Limited to secure the transfer of the Greenstone Limited shares under the lending arrangement. Under section CX 44B, the $5,000 received from NZ Broker Limited will be excluded income for KiwiTrust.

Example 2

KiwiTrust lends a further 1,000 Greenstone Limited shares to NZ Broker Limited. At the time of entering into the lending agreement, the market price for Greenstone Limited shares was $5 and the broker transfers Weka Company Limited shares with an equivalent value to KiwiTrust as collateral for borrowing the Greenstone Limited shares.

(cont)

The Weka Company Limited shares meet the definition of share-lending collateral. Under section CX 44B, the value of the Weka Company Limited shares received from NZ Broker Limited will be excluded income for KiwiTrust.

If no collateral is paid for borrowing a share, then there will be no amount treated as income on the lending or returning of shares under a share-lending arrangement. This is because a share-lending arrangement is an excepted financial arrangement (refer to section EW 5(11B)). The lowest price clause which would otherwise apply to tax the market value of the borrowed share does not apply to shares under a share-lending arrangement. The same is true for sections GD 1 (Sale or other disposition of trading stock for inadequate consideration) and ED 2 (Transfers of certain excepted financial arrangements within wholly-owned groups), which can operate to tax a deemed market value and which do not apply to share-lending arrangements.

A question arises as to the impact of share-lending on the general tax status of an investor's shareholding. Under the disposal and dealing in property sections (sections CB 3 and 4), an amount is income if the property was acquired for the purpose of disposal. If property is acquired for more than one purpose, income will only be taxable if the purpose of resale was the dominant purpose, as determined at the time of acquisition. For these sections, each item of personal property must be looked at separately (each individual share transaction) and not on a global basis. Therefore, the fact that certain shares have been lent should not impact on the taxable status of other shares in the same portfolio. Determining whether a person is carrying on a business of share-trading is a more difficult analysis and will depend on the facts of the particular situation. This could include other transactions within the person's share portfolio.

Treatment of borrowed shares

As a share-lending transaction is legally a disposal of shares, tax adjustments would normally result through the operation of the revenue account property rules. A number of adjustments have therefore been made to these rules to treat a share-lending transaction as a loan.

Lending the shares

Section CH 1 has been amended to ensure that entering into a share-lending arrangement does not result in a tax adjustment from a change in the value of excepted financial arrangements "on hand". When a share supplier enters into a share-lending arrangement the lending of the shares (a disposal) would normally result in a reduction in the closing value of excepted financial arrangements and a net tax deduction for the cost of the shares.

This has been countered by allowing the share supplier to include in the closing value of excepted financial arrangements the value of a share-lending right.

A share-lending right is defined to mean a conditional or unconditional right to acquire an original share or an identical share under a share-lending arrangement. Section ED 1 provides that a share-lending right is valued at the cost of the original share. This ensures that there is no movement in the value of revenue account property.

Section DB 40 has been similarly amended to include the value of a share-lending right in the opening value of excepted financial arrangements and section EA 1 has been amended to include a share-lending right in the transactions covered by the revenue account property matching rules.

Example 3

KiwiTrust enters into a share-lending arrangement on 15 March 2007 to lend 5,000 NZ Fern Limited shares to NZ Broker Limited for one month. The shares cost $2.00 each and have a current market price of $4.00 per share. KiwiTrust has a 31 March balance date.

Because the lending transaction is a legal disposal, the value of the NZ Fern Limited shares ($10,000) will no longer be included in the closing value of excepted financial arrangements at 31 March 2007. However, as KiwiTrust has a right to acquire NZ Fern Limited shares, KiwiTrust will include the closing value of a share-lending right in income. Section ED 1 provides that the share-lending right is valued at the cost of the original shares ($10,000). This ensures that there is no movement in the closing value of excepted financial arrangements which would otherwise result in a tax adjustment.

The share-lending right is also included in the opening value of excepted financial arrangements for the 2007–08 income year, with KiwiTrust able to take a deduction for the value of the share-lending right at 31 March 2007, being $10,000.

Borrowing the shares

The share user is not allowed a tax deduction for the cost of acquiring the borrowed share as new section DB 12B prohibits a tax deduction for any amount of collateral paid in exchange for the share. This is consistent with the fact that the share user will not be taxed when they return the shares.

New section DB 12B overrides the general permission for a tax deduction and sections DB 17 to DB 19.

Example 4

As part of entering the share-lending arrangement with KiwiTrust, NZ Broker Limited transfers $20,000 cash to KiwiTrust as collateral for borrowing the shares. No tax deduction is permitted for this amount as section DB 12B prohibits a tax deduction for any amount of collateral paid in exchange for the borrowed shares. This overrides any tax deduction that would generally be permitted.

(cont)

This would also be the position if no collateral was provided. The borrowed shares have no cost so no tax deduction would be available. This is because the transaction is an excepted financial arrangement. The lowest price clause which would otherwise apply a market value to the shares does not apply. Similarly, no deemed purchase price arises under sections GD 1 or ED 2, as these do not apply to share-lending arrangements.

Example 5

Instead of transferring cash to KiwiTrust, NZ Broker Limited transfers $20,000 of Weka Company Limited shares to KiwiTrust as collateral for borrowing the shares. No tax deduction is permitted for this amount as section DB 12B prohibits a tax deduction for any amount of collateral paid in exchange for the borrowed shares.

Returning the shares

If the share user purchases an identical share to return to the share supplier, a tax deduction will be available under the ordinary provisions.

Example 6

On 15 April 2007, NZ Broker Limited purchases NZ Fern Limited shares on the share market at $3.80 per share to return to KiwiTrust.

As the shares will produce excluded income when they are returned, they will qualify as revenue account property. Therefore, a tax deduction should be available under section DB 17 for the cost of the shares ($19,000 in total).

Reacquiring the shares

The share-lending right disappears once a share supplier has received either the original share or an identical share. No tax deduction is allowed for any amount of collateral paid in exchange for the returning share (new section DB 12B). However, as excepted financial arrangements, the original share or identical share will be automatically included in the opening and closing value of revenue account property. Under section ED 1 they will be valued at the cost of the original share immediately before the share supplier entered the share-lending arrangement. This ensures that there is no movement in the value of revenue account property.

Example 7

On 15 April 2007, KiwiTrust receives 5,000 NZ Fern Limited shares back from NZ Broker Limited. The current market price for the shares is $3.80. KiwiTrust returns the collateral of $20,000 less the agreed lending fee.

(cont from p 89)

As KiwiTrust no longer has a right to receive NZ Fern Limited shares, the share-lending right ceases to exist. KiwiTrust is not allowed a tax deduction for the net amount of collateral returned to NZ Broker Limited (section DB 12B).

The NZ Fern Limited shares will be included in the closing value of excepted financial arrangements. Under section ED 1 they will be valued at the cost of the original share immediately before the share supplier entered the share-lending arrangement ($10,000). This ensures that there is no movement in the value of revenue account property.

The lending fee will be income under ordinary rules for KiwiTrust.

New section EW 52B has been inserted to ensure that any movement in the value of shares over the term of a share-lending arrangement is not "picked up" under the financial arrangement rules.

It should also be noted that the values used for revenue account property for tax purposes may differ from those adopted for accounting purposes.

Treatment of distributions

Income and deductions

If a distribution is paid on the original share during the term of the share-lending arrangement, the share supplier must receive a "replacement payment" from the share user. The aim of the replacement payment is to place the share supplier in the same position (as far as possible) as if they had received the actual distribution. The entity which issued the shares and any third-party purchaser of the shares should not be affected by the tax treatment of the share-lending arrangement.

A replacement payment is a payment economically equivalent to a dividend or part of a dividend for an original share. It is increased by the value of any imputation credits attached to the dividend. The new share-lending rules do not specify the level of cash payment to be made as a replacement payment. However, if a share user chooses to make a $100 cash replacement payment in respect of a $100 underlying dividend (rather than $67 plus the $33 of imputation credits) the level of resident withholding tax that may be payable will reflect the higher cash payment.

Under new section CD 43 the amount of any replacement payment derived is income of the recipient. A person who pays a replacement payment is allowed a tax deduction under new section DB 12C for the amount of expenditure incurred as a replacement payment under a share-lending arrangement. The deduction includes the amount of any imputation credits attached to the replacement payment under new sections ME 6B or NF 8B.

Share users who pay a replacement payment are required to provide a statement to share suppliers similar to a dividend statement. The requirements for the statement are set out in new section 30B of the Tax Administration Act 1994.

Example 8

During the term of the share-lending agreement entered into by KiwiTrust, a dividend of 10 cents per share is paid on the NZ Fern Limited shares. The dividend is fully imputed. NZ Broker Limited makes a compensation payment of $500 to KiwiTrust. Imputation credits of $246.27 are deemed to be attached as a result of resident withholding tax paid by NZ Broker Limited (as they do not attach the underlying imputation credits). The total value of the replacement payment is $746.27. Under section CD 43, this is income to KiwiTrust who is able to use the imputation credits in the normal way.

NZ Broker Limited is allowed a tax deduction for the total cost of the replacement payment ($746.27). NZ Broker Limited must also provide KiwiTrust with a statement setting out details of the replacement payment including imputation credits under section NF 8B.

The definition of "pay" for a replacement payment (and share-lending collateral) has been amended to include distribution, crediting or dealing with on the recipient's behalf. The definition of payment has been similarly amended. Therefore, when payments are netted together – for example, through being credited against another amount – the share-lending rules will apply to the gross payments.

Imputation credits

The share-lending rules aim to keep any imputation credits with the economic owner of the share, being the share supplier. This is achieved by transferring imputation credits to the share supplier and denying the share user a credit of tax under section LB 2.

A share user is required to maintain an ICA in order to attach imputation credits to replacement payments where a dividend is paid on the original share over the term of the lending transaction. This is unless they issue a credit transfer notice.

The share user can fund replacement payment imputation credits either out of imputation credits received on the underlying dividend (new section ME 6B), or when they have not received sufficient imputation credits, by paying resident withholding tax (new section NF 8B).

Imputation credits can also be transferred using the voluntary tax credit transfer system (without the need to maintain an ICA). This is based on the Australian system whereby relevant imputation credits are derived by the share supplier if the share user and share supplier notify Inland Revenue of the share-lending arrangement.

A credit transfer notice is a notice issued under section 30C of the Tax Administration Act 1994. New section 30C allows a share user to issue a credit transfer notice under a share-lending arrangement when a dividend is paid on an original share. Such a notice can be issued by the share user only when they have received the underlying dividend.

A credit transfer notice must:

- be in a form approved by the Commissioner;
- show the amount of imputation credits attached to the dividend;
- state that the imputation credit is to be transferred to the share supplier;
- attach a copy of the shareholder dividend statement for the dividend; and
- be given to the share supplier and the Commissioner when the dividend is paid or as soon as possible thereafter.

Any imputation credit transferred under a credit transfer notice is excluded from the taxable income of a share user (new section CD 10B). Instead, the amount of the imputation credit is income of the share supplier. This overrides the general rule in section CD 9 (Tax credits linked to dividends). A taxpayer who is issued with a credit transfer notice is also entitled to a credit of tax equal to the amount of the imputation credit shown in the notice.

Example 9

KiwiTrust lends Koru Corporation shares to a resident share user (borrower). During the period of the lending arrangement, a $100 fully imputed dividend is paid on the shares. At the time of payment, the shares are still held by the share user. The share user makes a cash replacement payment of $100 to KiwiTrust and elects to transfer the $49.25 of imputation credits using a credit transfer notice.

The imputation credits are excluded from the share user's taxable income (section CD 10B). Instead, the $49.25 of imputation credits is income of KiwiTrust. KiwiTrust is also entitled to a credit of tax equal to the amount of the imputation credit shown in the notice.

Example 10

KiwiTrust lends Koru Corporation shares to a non-resident share user (borrower). During the period of the lending arrangement, a $100 fully imputed dividend is paid on the shares. At the time of payment, the shares are still held by the share user. The share user receives an ordinary dividend of $100, supplementary dividend of $17.64 and imputation credits of $31.61. The share user makes a cash replacement payment of $117.64 to KiwiTrust and elects to transfer the $31.61 of imputation credits using a credit transfer notice.

The $31.61 of imputation credits is income of the KiwiTrust. KiwiTrust is also entitled to a credit of tax equal to the amount of the imputation credit shown in the notice.

Imputation credit account

A number of amendments have been made to the imputation rules to reflect the fact that the share-lending rules keep any tax credits with the economic owner of the share, being the share supplier.

Imputation credits received by a share supplier on a replacement payment are subject to the same treatment as normal imputation credits. An amendment has therefore been made to section ME 4 to allow imputation credits attached to a replacement payment (either from being passed on under new section ME 6B or from the share user paying resident withholding tax under new section NF 8B) to be entered into a share supplier's ICA. A credit will also arise if a person has been issued with a credit transfer notice transferring imputation credits.

For imputation credits arising under new sections ME 6B or NF 8B, the credit arises on the date that the replacement payment is paid. For credits transferred using a credit transfer notice, the credit arises on the date that the credit transfer notice is issued.

There are also new debit imputation entries. Under section ME 5, a debit must now be recorded in a share user's ICA if they have attached imputation credits to a replacement payment under new section ME 6B, transferred imputation credits using a credit transfer notice or received imputation credits on shares borrowed under a returning share transfer that is not a share-lending arrangement.

Debits arising from to a credit transfer notice or as a result of the returning share transfer anti-avoidance rules (discussed below), arise on the date that the relevant dividend is paid. Debits arising under new section ME 6B, arise on the date that the replacement payment is paid.

The changes for individual ICAs are replicated in the consolidated ICA rules.

Example 11

KiwiTrust lends 1,000 Black Limited shares to NZ Broker Limited. A $100 fully imputed dividend is paid on the shares, held at that time by NZ Broker Limited.

NZ Broker Limited makes a cash contribution payment of $100 to KiwiTrust and attaches $49.25 of imputation credits to the replacement payment under section ME 6B. It records a credit in its ICA for $49.25, being the imputation credits attached to the dividend received. A corresponding debit for $49.25 will be recorded, on the date that the replacement payment is paid, for the imputation credits attached to the replacement payment. NZ Broker Limited does not receive a credit of tax for the imputation credits as they are a share user under a returning share transfer (section LB 2(1B)). Instead, NZ Broker Limited claims a tax deduction for the replacement payment, including the imputation credits (section DB 12C).

KiwiTrust will record a credit in its ICA on the day that the replacement payment is paid for $49.25, being the imputation credits attached to the replacement payment. The replacement payment, including the imputation

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credits, is income to KiwiTrust under section CD 43. Under section LB 2, as the imputation credit is included in KiwiTrust's assessable income, a credit of tax is allowed for imputation credits attached to the replacement payment.

Example 12

KiwiTrust also lends 1,000 Rimu Corporation shares to NZ Broker Limited. During the period of the lending arrangement, a $100 fully imputed dividend is paid on the shares. At the time of payment, the shares are no longer held by NZ Broker Limited as they have been sold to a third party. NZ Broker Limited makes a cash contribution payment of $100 to KiwiTrust. As NZ Broker Limited did not receive the underlying dividend, it cannot transfer imputation credits under section ME 6B or use a credit transfer notice. Instead, NZ Broker Limited is required to pay resident withholding tax of $49.25 as calculated under section NF 2(1). This resident withholding tax converts to imputation credits of $49.25 under section NF 8B.

NZ Broker Limited claims a tax deduction for the replacement payment, including the imputation credits (section DB 12C).

KiwiTrust will record a credit in its ICA for $49.25 on the day that the replacement payment is paid, being the imputation credits attached to the replacement payment under section NF 8B. The replacement payment, including the imputation credits, is income to KiwiTrust under section CD 43. Under section LB 2(1), as the imputation credit is included in KiwiTrust's assessable income, a credit of tax is allowed for the $49.25 of imputation credits attached to the replacement payment. No credit of tax is available for the resident withholding tax as section LD 3 does not apply to replacement payments.

Dividend withholding payment credits

To a lesser extent, the share-lending rules also provide for the transfer of dividend withholding payment (DWP) credits to a share supplier under a share-lending arrangement.

Under the share-lending rules, DWP credits are only able to be transferred using a credit transfer notice. This operates in the same way as for imputation credits, with the requirements set out in new section 30C of the Tax Administration Act 1994. For the purposes of the credit transfer notice, a DWP credit is an imputation credit.

The amount of any DWP credit shown in a credit transfer notice issued to a share supplier is a credit under section MG 4 to the share supplier's DWP account. The credit arises on the date that the credit transfer notice is issued.

Under section MG 5, the amount of any DWP credit shown in a credit transfer notice issued by a share user is a debit to the share user's DWP account. The debit arises on the date that the related dividend is paid.

Any DWP credit transferred under a credit transfer notice is excluded from the taxable income of a share user (new section CD 10B). Instead, the amount of the DWP credit is income of the share supplier. Section LD 8 has been amended so that a taxpayer who receives a DWP credit transfer notice is entitled to a credit of tax rather than the taxpayer who issues the notice. Section LD 9 has also been amended to allow the Commissioner to refund DWP credits to the share supplier.

If a share user does not use a credit transfer notice, any DWP credits will convert to imputation credits in the hands of the share supplier. This occurs because a share user is required to pay resident withholding tax under new section NF 2(1)(g). The resident withholding tax liability is 33% of the replacement payment less any imputation credits attached to the payment or DWP credits transferred using a credit transfer notice. This means that for a dividend with DWP credits attached (which have not been transferred using a credit transfer notice), a share user will be required to pay resident withholding tax. Under new section NF 8B, this resident withholding tax is treated as an imputation credit attached to the replacement payment.

The above entries are replicated for DWP accounts of consolidated groups in section MG 14 for credits and section MG 15 for debits.

Example 13

KiwiTrust lends 1,000 Tui Limited shares to NZ Broker Limited. During the period of the lending arrangement, a $100 dividend with $49.25 of DWP credits attached is paid to NZ Broker Limited. NZ Broker Limited makes a cash contribution payment of $100 to KiwiTrust and elects to transfer the $49.25 of DWP credits using a credit transfer notice.

The DWP credits are excluded from NZ Broker Limited's taxable income (section CD 10B). Instead, the DWP credits are income of KiwiTrust.

NZ Broker Limited records a credit in its DWP account for $49.25, being the DWP credits attached to the dividend received. A corresponding debit for $49.25 is also recorded, on the date that the dividend is paid, for the DWP credits transferred in the credit transfer notice. NZ Broker Limited does not receive a credit of tax for the $49.25 of DWP credits (section LD 8(1B)).

NZ Broker Limited records dividend income of $100 and a deduction for the replacement payment of $100.

KiwiTrust records a credit in its DWP account for $49.25, being the credits transferred in the credit transfer notice. This is recorded on the day that the credit transfer notice is issued. KiwiTrust is also entitled to a credit of tax equal to the amount of the DWP credits shown in the credit transfer notice (section LD 8(1C)). KiwiTrust records taxable income of $149.25 and a tax credit of $49.25.

Example 14

KiwiTrust also lends 1,000 Matai Limited shares to NZ Broker Limited. During the period of the lending arrangement, a $100 dividend with $49.25 of DWP credits attached is paid on the shares. At the time of payment, the shares are no longer held by NZ Broker Limited as they have been sold to a third party.

NZ Broker Limited makes a cash contribution payment of $100 to KiwiTrust. As NZ Broker Limited did not receive the underlying dividend, it cannot transfer DWP credits using a credit transfer notice. Instead, NZ Broker Limited is required to pay resident withholding tax of $49.25 as calculated under section NF 2. This resident withholding tax converts to imputation credits of $49.25 under section NF 8B.

NZ Broker Limited claims a tax deduction for the replacement payment of $149.25 (section DB 12C).

KiwiTrust records a credit in its ICA for $49.25, being the imputation credits attached to the replacement payment under section NF 8B. This is recorded on the day that the replacement payment is paid. The replacement payment, including the imputation credits, is income of $149.25 to KiwiTrust under section CD 43. Under section LB 2, as the imputation credits are included in KiwiTrust's assessable income, a credit of tax is allowed for the imputation credits attached to the replacement payment. No credit of tax is available for the resident withholding tax as section LD 3 does not apply to replacement payments.

Share-lending withholding tax

The share-lending rules allow imputation and DWP credits to be transferred from a share user to a share supplier to put the share supplier in the same situation as if they had continued to hold the original share. However, a direct transfer is only possible where the share user receives the underlying dividend with the imputation or DWP credits attached. Where the shares have been on-sold to a third party it is not possible to transfer imputation or DWP credits. Therefore, the share-lending rules include a withholding tax obligation to fund imputation or DWP credits. This is set out in the definition of a share-lending arrangement, which requires a share user to pay the amount of tax required by new section NF 2(1)(g).

To reduce compliance and administration costs, the withholding tax obligation operates as part of the resident withholding tax (RWT) rules. The RWT rules have been amended to apply to replacement payments made under share-lending arrangements. Section NF 1 has been amended so that resident withholding income now includes a replacement payment. Section NF 4(4) has been amended so that people required to make RWT deductions in respect of replacement payments must pay all such deductions to the Commissioner on a monthly basis, no later than the 20th of the following month.

A new formula has been inserted into section NF 2 to calculate the amount of RWT payable on share-lending arrangements. The formula effectively requires RWT to be paid for any amount of replacement payment not fully imputed by credits from the underlying dividend (either through attachment to the replacement payment or credit transfer notice).

The amount of RWT payable is calculated as follows:

$a \times b/(1 - a) - c - d - e$

a = the rate of RWT specified in schedule 14, clause 2.

b = the amount of the replacement payment (net of imputation credits).

c = the amount of imputation credits attached to the replacement payment under section ME 6B.

d = the amount of imputation credits shown in any related credit transfer notice.

e = the amount of dividend withholding payment credits shown in any related credit transfer notice.

The rate of RWT is 33%. This is set out in Schedule 14, clause 2 which now applies to replacement payments. Amendments have been made to sections NF 2A, NF 2B and NF 2D so that a person cannot use another rate of RWT.

Share-lending RWT is a final tax. It does not give rise to a credit of tax for the share supplier (amendment to section LD 3). Instead, it will give rise to an imputation credit attached to the replacement payment (new section NF 8B).

Finally, as a share user is required to pay any RWT in order for a share-lending transaction to be a qualifying arrangement, section NF 3(2) has been amended so that agents and trustees are not required to make RWT deductions on receipt of payments which are replacement payments under a share-lending arrangement.

Example 15

KiwiTrust lends 1,000 Pipi Corporation shares to NZ Broker Limited. During the period of the lending arrangement, a $100 dividend with no imputation credits attached is paid to NZ Broker Limited. NZ Broker Limited makes a cash replacement payment of $67 to KiwiTrust. As NZ Broker Limited did not receive any imputation credits it is required to pay RWT of $33 as calculated under section NF 2:

$0.33 \times 67/(1 - 0.33) - 0 - 0 - 0 = \$33$

The RWT converts to imputation credits of $33 under section NF 8B.

NZ Broker Limited returns the dividend received and claims a tax deduction for the replacement payment, including the $33 of imputation credits (section DB 12C).

KiwiTrust records a credit in its ICA for $33, being the imputation credits attached to the replacement payment

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under section NF 8B. This is recorded on the day that the replacement payment is paid. The replacement payment, including the imputation credits, is income to KiwiTrust under section CD 43. Under section LB 2, a credit of tax is allowed for the imputation credit included in KiwiTrust's assessable income. No credit of tax is available for the RWT as section LD 3 does not apply to replacement payments.

If a cash replacement payment of $100 was made, NZ Broker Limited would be required to pay RWT of $49.25.

$0.33 \times 100/(1 - 0.33) - 0 - 0 - 0 = \$49.25$

The RWT converts to imputation credits of $49.25 under section NF 8B.

NZ Broker Limited would return the dividend received and claim a tax deduction for the replacement payment, including the $49.25 of imputation credits (section DB 12C).

KiwiTrust records a credit in its ICA for $49.25, being the credits attached to the replacement payment under section NF 8B. This is recorded on the day that the replacement payment is paid. The replacement payment, including the imputation credits, would be income to KiwiTrust under section CD 43. Under section LB 2, a credit of tax would be allowed for the imputation credits included in KiwiTrust's assessable income. No credit of tax would be available for the RWT as section LD 3 does not apply to replacement payments.

Impact of not qualifying

Ceasing to qualify

Taxpayers are required to determine whether a transaction qualifies as a share-lending arrangement at the start of the transaction.

If an arrangement fails to qualify at some point during its term (for example, because an identical share is no longer available) then it fails to qualify from the start of the transaction and the normal tax rules must be applied.

Taxpayers entering share-lending transactions are subject to the normal self-assessment rules. Therefore, if a taxpayer mistakenly treats a transaction as qualifying for the share-lending rules when they should not have done so, then they will need to restate the tax treatment of the transaction. Use-of-money interest and penalties could apply depending on the particular circumstances that gave rise to an incorrect treatment being adopted.

Example 16

A share supplier enters into a lending agreement to lend Paua Limited ordinary shares. Over the period of the lending arrangement, Paua Limited merges with

(cont)

Kea Corporation. The share user (borrower) returns shares in the merged entity at the end of the lending arrangement.

This would not qualify as a share-lending arrangement as the original or identical shares are not returned to the share supplier.

Similarly, if Paua Limited preference shares or bonds were returned, the arrangement would not qualify as a share-lending arrangement.

Returning securities transfers which are not share-lending arrangements

The share-lending rules are designed to ensure that imputation credits remain with the economic owner of the shares. For returning share transfers which are not share-lending arrangements, this is achieved through an additional imputation debit. Under section ME 5(1)(ac), a debit will arise for the amount of any imputation credit attached to a dividend that is paid to the person as a share user or associate in a returning share transfer that is not a share-lending arrangement.

Example 17

Overseas Pension Fund lends some of its listed New Zealand shares to NZ Investment Limited in exchange for a cash payment. The term of the agreement is three years. NZ Investment Limited agrees to make compensation payments equivalent to 85% of any dividends paid on the underlying shares. Over the term of the arrangement fully imputed dividends are paid on the underlying shares.

The arrangement is a returning share transfer but is not a share-lending arrangement as it has a term longer than one year. As NZ Investment Limited is the legal owner of the shares, it receives the dividends including the imputation credits. However, under section ME 5(1), a debit arises in NZ Investment Limited's ICA for the value of these imputation credits on the day that the dividend is paid. This is because NZ Investment Limited is a share user who has received imputation credits paid to NZ Investment as a share user in a returning share transfer that is not a share-lending arrangement.

Because the above imputation debit only applies to transactions which meet the definition of a returning share transfer, taxpayers could structure transactions outside the qualification criteria. Therefore, a new specific anti-avoidance provision has been included as part of the rules. New section GC 14G applies where a person enters into an arrangement that has an effect of avoiding a requirement of the returning share transfer definition so as to defeat the intention and application of the Income Tax Act. Where this is the case, the Commissioner may treat the arrangement as a returning share transfer and a person affected by the arrangement as a share user or share supplier.

ALLOCATION OF RESEARCH AND DEVELOPMENT TAX DEDUCTIONS

Sections DB 26, DB 27, EE 1, EJ 20 and EJ 21 of the Income Tax Act 2004

The Income Tax Act 2004 has been amended to allow companies that bring in new equity investors better access to tax deductions for research and development (R&D) expenditure.

The amendments allow taxpayers to allocate certain R&D tax deductions to income years after the year in which the related expenditure is incurred. This means that deductions will not be lost if there is a shareholding change between when the expenditure is incurred and when the deduction is recognised by the taxpayer. This tax treatment is optional. However, those who choose this approach must allocate R&D deductions against income resulting from R&D expenditure.

Technology companies, in particular, often have a long lead-in period in which they incur major expenditure before realising income from it. Under the previous law they could lose R&D tax deductions if they brought in new investors after their initial development stage. The changes better suit the growth cycle of technology companies and remove a barrier to R&D investment by allowing R&D tax deductions to be matched with related income.

Background

This reform is part of the government's economic transformation agenda.

Four private-sector taskforces were established to develop growth strategies for sectors of the economy seen as key to New Zealand's future economic performance. They were: the Biotechnology Taskforce, the Information and Communications Technology (ICT) Taskforce, the Design Industry Taskforce and the Screen Production Industry Taskforce.

As part of their 2003 report, the taskforces made various recommendations, including several on tax-related issues. One tax issue raised by both the Biotechnology and ICT taskforces was the relaxation of the loss carry-forward rules. Under those rules, the entry of new equity investors into technology companies could result in any accumulated tax deductions (generally tax losses) being lost because of a breach of the shareholder continuity requirements for carrying forward tax losses.

The tax rules broadly provide that a company can carry forward and offset its tax losses only when the tax benefit arising from the offset is obtained by at least 49% of the individual shareholders who originally bore the loss.

The Biotechnology and ICT taskforces recommended that the government consider changing the tax rules to preserve tax losses if business continuity was maintained even though shareholder continuity was lost.

The government did not favour a general business continuity test to supplement the shareholder continuity test for the following reasons:

- it is contrary to the main policy underlying the loss carry forward rules, which is to prevent the trading of losses between unrelated parties;
- it is the experience of other countries that the test is difficult to apply in practice, creating both complexity and uncertainty;
- a general business continuity test could potentially lock companies into businesses that are only marginally profitable and do not represent the best use of capital; and
- a general business continuity test could have significant revenue implications.

The government continued to explore further options to remove tax barriers to the growth of the technology sector in New Zealand.

The current changes to the tax treatment of R&D expenditure are the outcome of this work.

R&D tax rules

The tax treatment of most R&D expenditure is covered by section DB 26 of the Income Tax Act 2004. That section allows taxpayers a deduction for R&D expenditure if the expenditure does not satisfy all the asset recognition criteria contained in Financial Reporting Standard FRS-13: *Accounting for research and development activities*. These criteria are designed to approximate the point at which the R&D expenditure gives rise to a valuable asset.

Although most R&D expenditure is deductible, under the previous rules shareholding changes arising during the normal growth cycle of a technology company could result in the deductions being unable to be used.

Policy issues

The amendments are based on achieving a better match between the timing of tax deductions for R&D expenditure and income resulting from that expenditure. This treatment recognises that taxpayers in the development period of an R&D project are developing assets for the purpose of earning income in future periods instead of incurring economic losses in the initial development stage.

The previous tax treatment could recognise R&D expenditure too early in relation to the income resulting from it. However, these expenses are better viewed as developmental rather than operational expenses.

The previous mismatch in the early recognition of expenditure and the later recognition of income means that a company's deductions for R&D expenditure could be inappropriately lost when there was a shareholding change in the company.

This situation was particularly problematic for the growth cycle of technology companies because these companies typically have a long lead-in period when significant expenditure is incurred before any income is realised. It is part of the normal financing process for such companies to bring in additional equity investors after the initial development work has been successful. If tax deductions for that development work cannot be used because of shareholding changes it can effectively result in technology companies being taxed on their gross income. This is not an appropriate result given that the purpose of the Income Tax Act 2004 is to tax mainly net income.

The new treatment will better suit the growth cycle of technology companies as deductions for R&D expenditure will not be affected by changes in shareholding resulting from technology companies bringing in new investors.

Key features

The amendments better match the timing of deductions for R&D expenditure (including depreciation losses) with income resulting from R&D expenditure. The new treatment means that deductions for R&D expenditure will not be lost when companies bring in new equity investors.

Amounts qualifying for new allocation treatment

Three types of R&D tax deductions qualify for the new treatment and therefore can be allocated to income years after the year in which the related expenditure or depreciation loss is incurred:

- deductions for expenditure covered by the main R&D deduction provision in section DB 26 of the Income Tax Act 2004 (section DB 26(6B) of the Income Tax Act 2004);
- deductions for depreciation losses under subpart EE of the Income Tax Act 2004 for property used in carrying out R&D or for market development for an R&D product (section EE 1(4B) of the Income Tax Act 2004);
- deductions for expenditure incurred on the market development for a product resulting from R&D expenditure. This covers expenditure on investigating or developing a market for the product, which may be a good or a service. This market development expenditure must be incurred before the taxpayer starts commercial production or use of the product – for example, general advertising expenditure incurred after the start of commercial production will not be covered by this rule. The deductions for market development expenditure must already be allowed under the Act – for example, under the general permission in section DA 1 of the Income Tax Act 2004 (section EJ 20 of the Income Tax Act 2004).

The new allocation treatment for R&D expenditure is optional. Taxpayers who wish to continue to deduct their R&D expenditure or depreciation loss or their market development expenditure in the year it is incurred under section BD 4(2) of the Income Tax Act 2004 can do so.

Taxpayers can choose how much of a qualifying deduction will be allocated to a future income year. The amount not allocated under the new treatment will be deducted in the year the relevant expenditure or depreciation loss is incurred.

The new treatment is available to all taxpayers with R&D expenditure and not just those whose main activity is R&D. This is because the principle of achieving a better matching of the timing of deductions for R&D expenditure with income resulting from the expenditure is of general application.

R&D expenditure covered by section DB 26 of the Income Tax Act 2004, and therefore by the new allocation treatment, includes overhead costs (other than interest) such as rent and power. A company whose business is not exclusively R&D must conduct an apportionment on a reasonable basis of overhead expenses between its R&D function and other functions.

Interest expenditure is excluded from this treatment as a tax base-protection measure.

The new provisions use the definitions of "research" and "development" contained in Financial Reporting Standard FRS-13: *Accounting for research and development activities*. These definitions are already used in section DB 26.

In the case of a start-up technology company, which typically incurs significant expenditure for a long period before any income is realised, most of its pre-commercial production expenditure would qualify for this new deduction allocation treatment.

Allocation of deductions under new treatment

Taxpayers may choose to allocate deductions that qualify for the new treatment to an income year after the income year in which they incur the relevant expenditure or depreciation loss.

If they choose to use the new allocation treatment they must allocate the deductions in accordance with new section EJ 21. This provision generally requires taxpayers to allocate a deduction to an income year in which they derive assessable income they would not have derived but for R&D expenditure or the use or disposal of property used in carrying out R&D.

The assessable income referred to in proposed section EJ 21 includes any amount treated as assessable income under the Income Tax Act 2004 – for example, depreciation recovery income.

The new rules do not differentiate between successful and unsuccessful R&D projects. In particular, deductions

from unsuccessful R&D projects can be allocated against income resulting from successful R&D projects.

The amount of qualifying tax deductions (that is, deductions for R&D expenditure and depreciation losses and market development expenditure) allocated to a particular income year under this new treatment is the lesser of:

- the amount of the assessable income that would not have been derived but for R&D expenditure (including depreciation loss); and
- the amount of the qualifying deductions that has not been allocated to earlier income years.

Therefore, taxpayers who choose to use this treatment will be required to allocate the qualifying tax deductions to an income year to the extent of any income derived in that year resulting from R&D expenditure or depreciation loss.

This requirement is necessary as a tax-base protection measure to ensure that taxpayers do not use their R&D tax deductions to shelter their non-R&D income. Accordingly, the relevant R&D tax deductions cannot be deducted against unrelated income. The requirement is also consistent with the underlying policy intent of achieving a better match between the timing of deductions for R&D expenditure and the income resulting from that expenditure.

Example 1: New deduction allocation treatment

A start-up technology company incurs $5 million of expenditure on developing biotechnology products in the first five years of its existence. This amount includes deductions for depreciation losses on equipment used in carrying out the R&D and expenditure on surveys to gauge market interest in these products. The company uses the new deduction allocation treatment for R&D (including market development) expenditure. At the end of this period the company has developed several innovative products which have significant commercial potential. The company brings on board new investors to fund the next stage of development leading to the start of commercial production of the products. The company also discontinues its biotechnology projects which do not show promise. Under previous tax rules, introducing new investors in a company could result in deductions for previous R&D expenditure being forfeited. However, under the new deduction allocation treatment for R&D expenditure the company's tax deductions (including those relating to the company's unsuccessful biotechnology projects) are preserved until they can be offset against income resulting from the company's R&D products.

Taxpayers are also able to allocate any deduction to which section EJ 21 applies to the current year if they would have been entitled under Part I of the Income Tax Act 2004 to carry forward to that year a net loss from the year in which they incurred the expenditure (or the depreciation loss arose) to which the deduction relates.

In particular, this means that a company must have satisfied for the relevant period the shareholder continuity requirements in section IF 1 of the Income Tax Act 2004. This rule ensures that taxpayers have the same flexibility in using their tax deductions for R&D expenditure as if they had not chosen to use the new allocation treatment.

Taxpayers' decisions on the amount of R&D tax deductions allocated under the new treatment will be reflected in the tax positions they take in their returns of income for each tax year. In line with normal tax rules, these tax positions are binding on the taxpayer unless disputes procedures are initiated within the applicable response periods. The Commissioner will not consider it appropriate, outside a dispute, to exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment to adjust the amounts allocated under the new treatment.

Application date

The amendments apply from the 2005–06 income year.

CORPORATE MIGRATION

Sections CD 18, CD 32, FCB 1 to FCB 3, ME 6, MG 2, MI 2, MI 10, NF 4, NG 11 and OB 1 of the Income Tax Act 2004; sections 49 and 51 of the Tax Administration Act 1994

The Income Tax Act 2004 has been amended to ensure that companies that migrate from New Zealand pay tax on the worldwide income they earned while resident in New Zealand. The changes are intended to remove incentives for companies to migrate for tax reasons.

A company resident in New Zealand is liable for New Zealand tax on its worldwide income. However, a company was previously able to migrate without having necessarily paid tax on all the income that was earned while it was a New Zealand resident.

Under the amendments, a migrating company will be treated as if it had realised all its assets, liquidated, and fully distributed the proceeds to shareholders before migration. The distribution will be subject to tax as a dividend under the usual rules.

Clarifying technical amendments have also been made to the dividend withholding payment and conduit rules. For consistency with current imputation rules, a company that ceases to be resident in New Zealand will also cease to be a dividend-withholding payment account company and a conduit tax relief company.

Background

Applying the liquidation rules

A company has migrated from New Zealand if it is no longer a New Zealand-resident company under the

Income Tax Act 2004. This generally happens when companies transfer their place of incorporation overseas.

Under the Income Tax Act 2004, a company is a non-resident company if:

- it is not incorporated in New Zealand;
- it does not have its head office in New Zealand;
- it does not have its centre of management in New Zealand; and
- control of the company by its directors is not exercised in New Zealand.[4]

A company resident in New Zealand is liable for New Zealand tax on its worldwide income. However, before the new amendments, a company was able to migrate without necessarily paying tax on all the income that was earned while it was resident in New Zealand.

For example, any increase in the value of property situated outside New Zealand that accrued when a company was resident in New Zealand was previously not subject to New Zealand income tax if the company migrated and the property was then sold.[5] Income tax deductions may have been previously allowed in relation to the property on the assumption that there would be a resulting income stream that would be taxable in New Zealand.

Similarly, other income generated when a company was resident in New Zealand may not have been subject to New Zealand income tax until a distribution was made to the company's shareholders. However, when a company had migrated, distributions made to non-resident shareholders were not taxed in New Zealand at all as the company was no longer a New Zealand-resident company. Distributions to resident shareholders were still subject to New Zealand tax, although offset to some extent by credits for tax paid on the distribution in the company's new country of residence.

Company law

The Companies Act 1955 required the liquidation and discontinuation of the legal personality of a company before it could be removed from the New Zealand register of companies. Distributions made to shareholders on the liquidation of a New Zealand company are treated as a dividend.

In contrast, the Companies Act 1993 allows a company to transfer its place of incorporation offshore and become a non-resident company without the need to liquidate, make a distribution and pay New Zealand income tax. This created a tax incentive for companies to migrate rather than liquidate.

Applying the same tax treatment to both liquidating and migrating companies removes the existing tax incentive to migrate rather than liquidate, and increases the neutrality of the tax system.

Dividend withholding payment and conduit tax relief accounts

In most cases, a New Zealand-resident company must have an imputation credit account. When a company ceases to be a New Zealand resident, its imputation credit account must close and a debit adjustment made to bring any credit balance to nil.

A New Zealand-resident company may elect to maintain a dividend withholding payment (DWP) account to record credits for the amount of DWP paid by the company on foreign dividends it receives. These DWP credits are available for allocation to its shareholders. The company may also elect to be a conduit tax relief (CTR) company to obtain New Zealand tax relief on its foreign-sourced income based on its foreign shareholding.

The company may subsequently elect to cease to be a DWP account company (and a CTR company). An election may not necessarily be made when a company migrates from New Zealand. If an election is made, the company's DWP accounts will close and a debit adjustment made to bring any credit balance to nil. To recover the amount of CTR provided while the company was resident, a CTR company is also required to pay additional DWP of the amount of any credit balance in its CTR account.

Key features

Under the new rules, when a company ceases to be a New Zealand tax resident, the company will be treated as if it had been liquidated and paid a distribution to its shareholders.

This means that the existing tax rules that apply on the liquidation of a New Zealand company will also apply in the event of a company ceasing to be a New Zealand resident for income tax purposes.

The company will first be treated as disposing of its property at market value immediately before it ceases to be a New Zealand resident. Under the current tax rules, certain amounts (such as gains in the value of revenue account property and excess depreciation deductions) will be subject to tax. This is consistent with the current treatment of financial arrangements and interests in foreign investment funds when a company ceases to be a New Zealand resident.

The company will then be treated as having distributed all shareholder funds (which will include the proceeds of the deemed disposal) to its shareholders.

While realised capital reserves will generally be excluded from the distribution, a consequence of alignment with the liquidation rules is that they will be included for non-resident related company shareholders.

The amount of the deemed dividend will therefore vary between certain shareholders as shown in Table 1.

[4] Section OE 2 of the Income Tax Act 2004.

[5] Unless the property is a financial arrangement or a foreign investment fund interest.

Table 1: Treatment of shareholder dividends

Resident shareholder	Non-related non-resident shareholder	Related non-resident company shareholder
Dividend subject to RWT = shareholder funds, less available subscribed capital and realised capital reserves.	Dividend subject to NRWT = shareholder funds, less available subscribed capital and realised capital reserves.	Dividend subject to NRWT = shareholder funds, less available subscribed capital.

In accordance with the usual tax rules applicable to dividends, a migrating company will be required to withhold tax from a deemed dividend distribution immediately before it ceased to be a New Zealand-resident company, under the resident withholding tax (RWT) or non-resident withholding tax (NRWT) rules, as appropriate. The company is allowed to attach imputation credits to the deemed dividends arising on migration.

Under existing rules, RWT on dividends applies at the rate of 33%. A dividend distribution to a resident shareholder will be taxed at the shareholder's marginal tax rate, less imputation credits attached by the company.

A dividend distribution to a non-resident shareholder will be taxed at 30% if the shareholder is a resident of a non-treaty country and the dividend is not fully imputed or credited with dividend withholding payments. If the treaty allows, NRWT of 15% will apply to a dividend distribution to a shareholder from a treaty country or a shareholder from a non-treaty country if the dividend is fully imputed or credited.

Property will be treated as being re-acquired by the company at the same market value it was treated as being disposed of at the time of migration. For property that continues to be subject to tax in New Zealand after a company's migration (for example, standing timber situated in New Zealand), this will establish a new cost base to apply in the event of a subsequent disposal.

To remove the potential for double taxation in the event that, after its migration, a non-resident company pays a dividend to its shareholders, the amount of the distribution deemed to have been paid immediately before the company migrated is added to the company's available subscribed capital (which can be distributed tax-free to shareholders in certain circumstances).

A company that remains incorporated in New Zealand but moves its place of management to another country could also be treated as resident in the other country. In this type of situation, the company will not be considered to have migrated (because it remains a New Zealand-resident company for New Zealand income tax purposes) and the new tax rules will not apply to it. It follows that if a dual resident company is treated under a double tax treaty as being resident in another country for the purposes of the treaty the new rules will similarly not apply. The corporate migration rules therefore apply only to companies that cease to be resident under domestic income tax rules. The new rules are consistent with New Zealand's double tax treaties.

Consequential technical amendments

If a New Zealand-resident company migrates, it will cease to be a dividend withholding payment (DWP) company and a conduit tax relief (CTR) company. Its accounts will close and a debit adjustment made to bring any credit balance to nil. To recover the amount of conduit tax relief provided while the company was resident, a conduit tax relief company is also required to make an additional dividend withholding payment of the amount of any credit balance in its conduit tax relief account.

Previously, if a company ceased to be a New Zealand-resident company it was required to file a DWP account return but it was not clear whether it automatically ceased to be a DWP account company and a CTR company. The DWP and conduit rules have been clarified to ensure that the same treatment that applies to an imputation credit account company ceasing to be a New Zealand resident also applies to DWP and CTR companies. Therefore, if a company ceases to be a New Zealand-resident company, it will automatically cease to be a DWP account company and a CTR company and may be required to pay additional DWP. These amendments are in line with the policy intent of the DWP and conduit rules, and can be regarded as a clarification.

Application date

The amendments concerning corporate migration apply to companies migrating on or after 21 March 2005, the date of announcement of these amendments by the government.

A grandparenting provision applies to companies that had done everything within their control to migrate by 21 March 2005, but had not yet become non-resident. In particular, the new corporate migration rules do not apply to companies that, before 21 March 2005, completed the requirements in the Companies Act 1993 for migrating companies relating to public notification, shareholder approval, Inland Revenue clearance and solvency, and that applied for incorporation under the laws of another country or territory.

The amendments to the dividend withholding payment and conduit rules apply from 1 April 1997.

Detailed analysis

Deemed liquidation rules

New subpart FCB contains the tax rules for migrating companies. Section FCB 1 is the purpose provision for the subpart. It refers to a company resident in New Zealand that ceases to be a New Zealand resident for the purposes of New Zealand income tax. The company will be subject to the tax rules that apply when it:

- disposes of its property at market value;
- is liquidated; and
- distributes shareholder funds (including the deemed disposal proceeds) to its shareholders.

Under new section FCB 2, a migrating company is treated as if, immediately before it became a non-resident company, it had paid as a cash dividend to its shareholders, the amount that would be available for distribution if the company had disposed of its property at market value and gone into liquidation.

Section CD 18, which defines dividends on liquidation, has been amended to also apply if an amount is treated as being paid under section FCB 2 to shareholders of a migrating company. Therefore, the amount in excess of the available subscribed capital per share and the available capital distribution amount will be a dividend. In relation to amounts treated as being paid to shareholders that are non-resident related companies, paragraph (c)(ii) of the definition of "dividend" in section OB 1 provides that the amount in excess of available subscribed capital per share will be a dividend.

Under the existing section ME 6(1), a migrating company is entitled at the time of emigration to attach existing imputation credits to distributions made under subpart FCB. Amendments have been made to section ME 6 to allow a migrating company to retrospectively attach imputation credits to a dividend arising under subpart FCB. Tax paid that is attributable to income derived before the migration or to the migration itself (from the deemed disposition of property) will be treated for imputation purposes as being paid immediately before the company ceases to be a New Zealand resident. A migrating company will therefore be able to attach the amount of the imputation credits treated as being available immediately before the company ceased to be New Zealand-resident to a deemed dividend arising under subpart FCB.

The amount that is treated as being paid to a resident shareholder will be resident withholding income to which the RWT rules in subpart NF apply. New section NF 4(6B) provides that a migrating company must pay the RWT deductions to the Commissioner by the date that is three months after its migration. Section 51 of the Tax Administration Act 1994 has been amended to give the company the same three-month period for providing related information to the Commissioner.

The amount treated as being paid to a non-resident shareholder will be non-resident withholding income to which the non-resident withholding tax rules in subpart NG apply. New section NG 11(4B) provides that a migrating company must pay the NRWT deductions to the Commissioner by the date that is three months after its emigration. Section 49 of the Tax Administration Act 1994 has been amended to give the company the same three-month period for providing related information to the Commissioner.

New section CD 32(15B) removes the potential for double taxation in the event that a migrating company subsequently pays a dividend to its shareholders. The amount of the dividend a migrating company is treated as having paid to shareholders immediately before the company migrated from New Zealand is added to the company's available subscribed capital that may be returned to shareholders tax-free in certain circumstances.

New section FCB 3(a) provides that a migrating company is treated as disposing of all its property at market value immediately before it ceases to be a New Zealand resident. Accordingly, gains in value of revenue account property will be subject to tax under existing legislation (for example, section CB 3 or CB 4) and excess depreciation deductions will be recovered under existing section EE 41.

New section FCB 3(b) treats the company as re-acquiring the property for the same market value for which it was treated as having been disposed of at the time of migration. This will establish a new cost base for property that will continue to be subject to tax in New Zealand.

Section EE 26, which allows for a 20% depreciation loading on New Zealand-new assets, has been amended to disregard the deemed disposition and reacquisition under section FCB 3. This amendment ensures that a migrating company is still eligible for this 20% loading on its assets, which is the appropriate treatment as actual ownership of the relevant property does not change at the time of migration.

Equivalent amendments have been made to the Income Tax Act 1994.

Amendments to the dividing withholding payment and conduit rules

New section MG 2(6) provides that a migrating company ceases to be a dividend withholding payment (DWP) account company. New section MG 2(7) provides that the company must furnish a DWP return and pay any further DWP payable under section MG 9.

New section MI 2(8) provides that a migrating company also ceases to be a conduit tax relief company and must furnish an imputation return and, under section MI 10(3), pay DWP of the amount of any credit balance in its conduit tax relief account.

Equivalent amendments have also been made to the Income Tax Act 1994.

Example: Migration of a New Zealand company

S Ltd was incorporated in New Zealand in 1995 and issued 140,000 ordinary shares at $2 each to resident shareholders and 60,000 ordinary shares at $2 each to non-resident shareholders (40,000 of those shares are held by related non-resident companies).

The shareholders resolve to transfer S Ltd's place of incorporation and its directorial and managerial functions offshore. S Ltd has a realised capital profit of $150,000 and revenue reserves of $300,000. S Ltd also owns shares held on revenue account in a company that owns commercial rental property in Wellington. The market value of these shares is $500,000. They were purchased for $450,000. S Ltd also owns a New Zealand-registered patent worth $250,000. The cost of the patent was $200,000, and depreciation deductions of $50,000 have been claimed.

S Ltd's imputation credit account has a credit balance of $100,000.[6]

Disposal rules

Under section FCB 3, S Ltd is treated as disposing of all its property at market value immediately before ceasing to be a New Zealand resident.

The taxable amount from the disposal of the patent is $100,000 (market value less cost (reduced by the amount of depreciation already claimed)).[7] The taxable amount from the disposal of the shares is $50,000 (market value less cost).[8] Under the proposed amendments, S Ltd's tax liability on the deemed disposal of its revenue account property is $49,500, and the tax paid is credited to S Ltd's imputation credit account.

The company that owns the commercial property will remain in New Zealand, and the patent is registered in New Zealand. Therefore, future income derived from the shares and the patent will continue to be subject to New Zealand tax.[9] Under section FCB 3, S Ltd will be treated as re-acquiring the shares at $500,000 and the patent at $250,000, which will establish new cost bases for those assets.

Liquidation rules

Under section FCB 2, S Ltd is treated as if it had been liquidated and distributed all available amounts (being shareholder funds and the disposal proceeds) to its shareholders immediately before it became a non-resident company.

The total amount deemed to have been distributed by S Ltd to its shareholders is $4.75 per share.[10]

In calculating the amount of the dividend paid by S Ltd it is first necessary to exclude capital amounts from total funds. For these purposes, capital amounts comprise the amount of available subscribed capital (ASC) per share and, for shareholders that are not related non-resident companies, the available capital distribution amount.

Applying the formulae in the legislation, ASC per share is calculated as $2, and the available capital distribution amount is 75 cents. Therefore, the tax-free capital component of the amount distributed by S Ltd for each share held by a shareholder that is not a related non-resident company is $2.75, and the remaining $2 per share (representing revenue reserves) is taxable to each shareholder as a dividend.

S Ltd may attach imputation credits of 70 cents per share[11] to dividends paid to its shareholders.

Resident shareholders

The total amount received per share by resident shareholders on S Ltd's migration is $4.75, of which $2.75 (being $2 + $0.75) is tax-free. The remaining $2 per share is taxable to each shareholder as a dividend. The attached imputation credits of 70 cents per share can be used to satisfy the shareholder's income tax liability.

S Ltd is required to withhold resident withholding tax (RWT) from the dividends paid to resident shareholders. S Ltd's RWT amount per share is 19 cents.[12] S Ltd's total RWT amount is $26,600.[13]

Under section CD 32(15B), the amount of the distribution treated as a dividend is included in the subscriptions amount that S Ltd could return to shareholders tax-free.

(Cont)

6 A company could make use of the foreign investor tax credit rules by paying a fully imputed dividend and a supplementary dividend to its non-resident shareholders before it ceases to be a New Zealand-resident company.

7 See sections CB 26, DB 29 and DB 31.

8 See section CB 1.

9 Assuming that there are no tax treaty implications.

10 (400,000 + 150,000 + 300,000 + 150,000 – 49,500)/200,000. Note that all figures in this example have been rounded to two decimal places.

11 Existing imputation credit rules require the same imputation credit ratio to apply to all distributions within an income year. Applying this rule to the total imputation credit account balance of 149,500 allows dividends to resident shareholders to have 70 cents per share of imputation credits attached.

12 ((2+.70) x .33) – .70

13 .19 x 140,000

Non-related non-resident shareholders

The total amount received per share by non-related non-resident shareholders on S Ltd's migration is $4.75, of which $2.75 (being $2 + $0.75) is tax-free. The remaining $2 per share is taxable to each shareholder as a dividend.

S Ltd is required to withhold NRWT from dividends paid to non-related non-resident shareholders. S Ltd's NRWT amount per share held by these shareholders is 30 cents.[14] S Ltd's total NRWT amount in relation to these shareholders is $6,000.[15]

Related company non-resident shareholders

The amount of the dividend to the related non-resident company shareholders subject to NRWT is the amount paid in excess of ASC per share.

The total amount paid to related non-resident company shareholders on S Ltd's migration is $4.75, of which $2 is tax-free. The remaining $2.75 (representing revenue reserves and capital profits) is taxable to the company shareholder as a dividend subject to NRWT. S Ltd's NRWT amount per share held by these shareholders is 41 cents.[16] S Ltd's total NRWT amount in relation to these shareholders is $16,400.[17]

These calculations are summarised in Table 2.

Table 2: Summary of tax calculations

	Total (200,000 shares)	Resident shareholders (140,000 shares)	Non-related non-resident shareholders (20,000 shares)	Related non-resident company shareholders (40,000 shares)
Distribution	$950,500	$4.75	$4.75	$4.75
ASC	$400,000	$2.00	$2.00	$2.00
Available capital distribution amount	$150,000	$0.75	$0.75	$0.00
Taxable amount	$430,000	$2.00	$2.00	$2.75
Imputation credits	$149,500	$0.70	$0.70	$0.70
RWT	$26,600	$0.19	–	–
NRWT	$22,400	–	$0.30	$0.41

Operational implications of new legislation

For a company to migrate, an application by the company for removal from the New Zealand register of companies must be accompanied by written notice from the Commissioner of Inland Revenue that the Commissioner has no objection to the company being removed from the New Zealand register. This is as per section 351(c) of the Companies Act 1993.

Inland Revenue's current practice is that a company wanting to migrate will not receive such a notice if the Commissioner cannot be sure that tax debts, that may arise or need to be collected once the company has migrated, will be met.

To mitigate this concern, taxpayers have in the past offered Inland Revenue a letter of guarantee from, for example, a related New Zealand company that has the means to satisfy the migrated company's tax liability, or a bank in other circumstances. With the letter of guarantee in place, Inland Revenue is then able to provide written notice to the Registrar of Companies that the Commissioner has no objection to the migration.

While Inland Revenue's practice will not change with the new legislation there is now a greater likelihood of a tax debt, due to the additional income tax and withholding liabilities arising from this legislation, than was previously the case. Thus, companies should be aware that, on a case by case basis, some form of guarantee may need to be offered to ensure that the Commissioner has no objection to the migration.

[14] 15 x 2 (assuming that the standard NRWT treaty rate of 15% applies).
[15] .3 x 20,000
[16] .15 x 2.75
[17] .41 x 40,000

Previously, when a notice was given that the Commissioner had no objection to the migration of a company, it had been implicit that such a notice applied only to the company at the date of the notice. The notice did not apply should any other company or companies be subsequently amalgamated into the company.

For clarity in future, Inland Revenue practice will be that, when written notice is given that the Commissioner has no objection to a company being removed from the New Zealand register, the notice will explicitly state that it applies only to the company on the date of the notice and not in the event other companies are amalgamated into it.

TEMPORARY EXEMPTION FROM TAX ON FOREIGN INCOME FOR NEW MIGRANTS AND CERTAIN RETURNING NEW ZEALANDERS

Sections CD 34, CE 2, CQ 2, CQ 5, CW 22B, DN 2, DN 6, EW 5, EW 37, EW 42, EX 16, EX 35, EX 52, FC 22, FC 23, FC 24, HH 2, HH 4, KD 3, NG 2, OB 1 and OE 1 of the Income Tax Act 2004

New rules have been introduced to help remove the tax barriers inhibiting international recruitment to New Zealand.

People arriving to live in New Zealand on or after 1 April 2006 may qualify for a temporary tax exemption on their foreign income. All foreign-sourced income will be exempt, except for employment income connected with employment performed while in New Zealand and income from services. The exemption starts on the first day of the month that the person arrives in New Zealand to take up the exemption and lasts a further 48 months (four years). To qualify, an individual cannot have been tax-resident in New Zealand during the previous 10 years.

Background

The rules were introduced to help New Zealand businesses recruit highly skilled individuals from overseas, resulting in positive effects for the New Zealand economy.

Under New Zealand's residence rules, an individual who has been in New Zealand for an aggregate of 183 days in any 12-month period is considered to be a New Zealand resident and is liable to pay New Zealand tax on their worldwide income. Consequently, people coming to New Zealand from overseas may have faced extra tax costs compared with what they would have at home or in other countries. This is partly because some of New Zealand's tax rules relating to foreign-sourced income – such as the foreign investment fund rules and the controlled foreign companies rules – are more comprehensive than those of other countries. Often these extra tax costs were passed on to New Zealand businesses who recruited these people or who used their services. This occurred because the individual often negotiated higher remuneration to compensate for the additional tax liability.

Concerns with the previous law were highlighted by the Tax Review in 2001 in its *Final Report* and also in the government discussion document, *Reducing tax barriers to international recruitment to New Zealand*, released in November 2003.

Key features

The amendments introducing the new international recruitment rules are in the Income Tax Act 2004.

Eligibility for the exemption

The new rules for eligibility are contained in sections FC 23 and FC 24. The exemption applies to an individual who is a "transitional resident". An individual is a "transitional resident" provided that she or he has not been tax-resident in New Zealand during the last 10 years, and provided that she or he has never been a transitional resident before. The period that the person becomes a "transitional resident" (the period of exemption) starts on the first day of the month that the individual arrives in New Zealand to take up the exemption and continues for a further 48 months.

Types of income that are exempt

Foreign-sourced income

Section CW 22B provides that all foreign-sourced income derived by a transitional resident is exempt, except for employment income connected with employment performed while a transitional resident and income from the supply of services.

CFC rules

Sections CQ 2 and DN 2 exempt transitional residents from the controlled foreign company (CFC) rules. Attributed CFC income and attributed CFC losses do not arise if an individual holding an interest in a foreign company is a transitional resident.

FIF rules

Sections CQ 5 and DN 6 exempt transitional residents from the foreign investment fund (FIF) rules. FIF income and FIF losses do not arise if an individual holding an interest in a foreign investment fund is a transitional resident.

Financial arrangements rules

Section EW 5(15B) ensures that the financial arrangements rules do not apply to foreign financial arrangements of transitional residents.

Share options

Section CD 2(9) provides that a transitional resident who is granted an employee share option while non-resident,

and who exercises the option while a transitional resident, is not liable for tax on the proportion of the gain derived which relates to overseas employment.

Trusts

Section HH 2 provides that a trust is considered as a foreign trust for the duration of the exemption if the settlor is a transitional resident. This means that the 12-month period to elect for a foreign trust to become a qualifying trust begins on the date that the settlor ceases to be a transitional resident.

Section HH 4 provides that if the settlor of a trust is a transitional resident, the trustee is not subject to tax on income derived from outside New Zealand.

NRWT

Section NG 2(1)(b) provides that transitional residents do not have to withhold non-resident withholding tax (NRWT) – for example, on foreign mortgages.

Other changes

The definition of "qualifying person" in sections KD 3 and OB 1 has been amended to exclude transitional residents and their spouses. The effect is that transitional residents and their spouses are not eligible for any form of family assistance. Similarly, the definition of "principal caregiver" in section OB 1 has been amended, so that transitional residents and their spouses are not eligible for an in-work payment.

Application date

The amendments apply from 1 April 2006 for people arriving in New Zealand on or after this date, with application from the 2005–06 income year and subsequent income years.

Detailed analysis

Eligibility and length of the exemption

The exemption applies to new migrants and returning New Zealanders, who arrive in New Zealand on or after 1 April 2006, and satisfy the definition of "transitional resident". To satisfy the definition of "transitional resident", an individual cannot have been tax-resident in New Zealand during the previous 10 years (section FC 23(b)). Furthermore, the individual cannot previously have been a transitional resident (section FC 23(c)).

The period that the person becomes a "transitional resident" (the period of exemption) starts on the first day of the month the individual arrives in New Zealand to take up the exemption, and continues for a further 48 months (four years) (section FC 24).

An individual can only claim the exemption once in their lifetime (section FC 23(c)). Theoretically, an individual could defer claiming the exemption until a later time, when they will become eligible again.

Example 1: Eligibility for exemption

Sally is a New Zealander who has been living in Australia for the past 12 years. Sally decides to return to New Zealand to take up an executive position in an exciting new company, and arrives in New Zealand to live on 24 April 2006.

Sally will be a transitional resident and eligible for the temporary exemption on foreign-sourced income. The exemption will apply from the beginning of the month that she arrived to live in New Zealand – April 2006. The exemption will end on 30 April 2010, which is 48 months and 1 week after her arrival to live in New Zealand.

Determining residence for the purposes of the exemption

The definition of "residence" under New Zealand law (section OE 1(2)) is based on physical presence in New Zealand. If a person is present in New Zealand for more than 183 days in any 12-month period, they are considered to be New Zealand-resident from the first date they were present in New Zealand.

This would mean that for some new migrants or returning New Zealanders, their first date of residence would be backdated to a previous visit. Therefore, they would be ineligible for the exemption, if the date of the visit was before 1 April 2006. Or, the period of exemption would begin before the new migrant or returning New Zealander actually moved permanently to New Zealand.

To overcome this problem, sections OE 1(2B) and FC 23 include a rule which effectively ensures that the exemption period begins on the first day the individual arrives in New Zealand to take up the exemption. This is achieved by disabling the 183-day test for the 12 months before arrival, and relying on the "permanent place of abode" test in section OE 1(1).

The purpose of these changes is to exclude any "scoping visits" to New Zealand an individual may have made, when deciding whether or not an individual is eligible for the exemption and when the exemption begins.

Note: Whether a person has a permanent place of abode in New Zealand is a question of fact. More information and a discussion of the relevant case law, is set out in *Tax Information Bulletin* Vol. 7, No. 1, July 1995, pages 10-12.

Exclusion from family assistance

Transitional residents and their spouses are not eligible to receive family assistance payments.

Family assistance entitlements are determined by a modified form of net income. If individuals derive offshore income that is exempt under the amendments their net income is reduced. Without any change to the

law, individuals deriving exempt offshore income could receive family assistance payments that they would not otherwise be entitled to, or receive higher payments than they would otherwise be entitled to, if this income was not exempt.

For this reason, the definition of "qualifying person" in sections OB 1 and KD 3 and the definition of "principal caregiver" in section OB 1 have been amended.

If an individual is eligible for family assistance, when their foreign-sourced income is taken into account, they can choose not to be a transitional resident and pay tax on their foreign-sourced income. Furthermore, if a transitional resident finds that his or her circumstances change and they require family assistance, he or she could "give up" the exemption by paying tax on their foreign-sourced income. That way they can be assessed for family assistance entitlements in the normal way.

Scope of the exemption

The types of income/taxes that are exempt under the new rules are, for example:

- controlled foreign company income that is attributed under New Zealand's CFC rules;
- foreign investment fund income that is attributed under New Zealand's FIF rules (including foreign superannuation);
- non-resident withholding tax (for example, on foreign mortgages);
- approved issuer levy (for example, on foreign mortgages);
- income arising from the exercise of foreign employee share options;
- accrual income (from foreign financial arrangements);
- income from foreign trusts;
- rental income derived offshore;
- foreign dividends;
- foreign interest;
- royalties derived offshore;
- income from employment performed overseas before coming to New Zealand, such as bonus payments;
- gains on the sale of property derived offshore (held on revenue account); and
- offshore business income (that is not related to the performance of services).

The new rules eliminate those taxes that are generally passed on to New Zealand employers and provides migrants with temporary relief from the most compliance-cost intensive aspects of returning foreign income in New Zealand. Those eligible continue to be taxed on New Zealand-sourced income.

Example 2: Scope of exemption

Rebecca is from France. She decides to move to New Zealand, and realises that she is eligible for the exemption. She currently owns several residential buildings in France, from which she receives rent and has a mortgage. She also has some shares in various French companies.

She has a bank account with a French bank into which she receives rent from her tenants, and receives interest from the bank.

Under previous New Zealand law, if she were to migrate to New Zealand, she would be liable to pay New Zealand tax on her rental income and interest from her bank accounts. She would also have to withhold non-resident withholding tax (NRWT) on her mortgage interest payments made to the French bank. Furthermore, the shares she owns in French companies would constitute FIF interests. She would therefore be liable to pay New Zealand tax on the value of the shares as it accrued, regardless of how much had been distributed.

The new exemption rules mean that she does not have to pay New Zealand tax on her rental and interest income for the period of the exemption. Nor does she have to withhold NRWT on her mortgage interest payments. Furthermore, for the period of exemption, she does not have to pay any New Zealand tax in relation to the shares held in various French companies (either on the value of the shares as it accrues or on distributions from the shares).

Employee share options

New section CE 2(9) effectively provides that if a share option is granted in relation to overseas employment (at a time when the employee was not a New Zealand resident), but exercised while the employee is a transitional resident, then the transitional resident will not be taxable on the exercise spread.

However, when the employment services to which a share option relates have been provided both overseas and in New Zealand, the individual is required to pay tax on the New Zealand proportion of the exercise spread. This is done by calculating the value of the benefit (as if the person was not a transitional resident) and deducting the value of the benefit attributable to the period employed as a non-resident, in accordance with the formula provided in section CE 2(9)(b):

$$\text{Value before reduction} \times \frac{\text{period employed as non-resident}}{\text{Period employed}}$$

Example 3: Treatment of share options

David is a New Zealander who has worked abroad for 15 years, mostly in Asia. David started working for a multinational company on 2 May 2001. The multinational company transfers him to the New Zealand head office on 2 May 2006. On 1 May 2007, the multinational company issues him with some share options, which relate to his employment both in Asia and in New Zealand.

He decides to exercise the share options in December 2007. The gain he receives is $200,000. When filing his tax return he realises that he has to pay tax on the New Zealand portion of the gain. He calculates it as follows:

$$\$200{,}000 \times \frac{1{,}826 \text{ days}}{2{,}191 \text{ days}}$$

= $166,681.88

Portion of New Zealand-sourced income

= $200 000 – $166,681.88
= $33,318.12

David is therefore liable for New Zealand tax on $33,318.12.

Trusts

Previously, under section HH 2(1), if a settlor of a trust (that would have been a foreign trust had a distribution been made on the day immediately preceding the day that the settlor became a New Zealand resident) became resident in New Zealand, any settlor, trustee or beneficiary of the trust had 12 months to elect to make the trust a qualifying trust for New Zealand tax purposes. The amendment to section HH 2 defers the election until 12 months following the end of the exemption.

Furthermore, previously under section HH 2(1), a New Zealander who settled a foreign trust while non-resident could not elect into the qualifying trust rules upon his or her return to New Zealand. The changes to section HH 2 extend the election period to returning New Zealanders who are transitional residents. When a New Zealander who subsequently becomes a transitional resident settles a trust before their return, any settlor, trustee or beneficiary of the trust has 12 months, following the end of their exemption, to elect into the qualifying trust rules. The trust is deemed to be a foreign trust up until the date that they elect into the qualifying trust rules.

Foreign financial arrangements

New section EW 5(15B) states that an arrangement to which a transitional resident is a party to is an excepted financial arrangement if:

- no other party to the arrangement is a New Zealand resident; and
- the arrangement is not for the purpose of a business carried on in New Zealand by a party to the arrangement.

As an excepted financial arrangement, such an arrangement is excluded from the financial arrangements rules. This relieves the transitional resident from the compliance-cost intensive task of allocating income from the arrangement over the term of the arrangement and returning the income in New Zealand as allocated.

Furthermore, sections EW 37(1) and EW 42(1) have been amended to cover the situation where a transitional resident enters into the financial arrangement rules once the exemption is ended, or when the arrangement ceases to be an excepted financial arrangement.

Employment and services income

The reason for continuing to tax employment income and business income relating to services performed offshore is to prevent New Zealand-sourced income from being re-characterised as foreign-sourced income.

However, it is not uncommon for individuals who arrive in New Zealand to receive income from their previous overseas employment, such as bonus payments. This is because this income is often determined at a later date – for example, during a business's normal performance/pay review period. It would be inappropriate to tax this income simply because the individual is already in New Zealand.

Therefore, section CW 22B(c) excludes such income from being taxable. It provides that income from employment performed overseas before coming to New Zealand is exempt from New Zealand tax.

Example 4: Treatment of previous employment income

Craig is a sales professional who arrived in New Zealand from the United States on 10 April 2006. He was offered and accepted a sales job in New Zealand. Before he left the US, he was responsible for securing a big client for his US firm.

His former US employer, during its six-monthly pay and performance review, decides to pay him a bonus for securing the client.

This bonus was paid in relation to employment performed overseas before his arrival in New Zealand. Therefore, the bonus is exempt from New Zealand tax.

No deductions/losses can be taken against exempt income

As the exemption exempts foreign-sourced income, section DA 1 disallows deductions for any amount of expenditure or loss incurred in deriving this income. Similarly, any deduction that arises from investing into CFCs or FIFs will be disallowed, as transitional residents are exempt from the CFC and FIF rules.

Example 5: Deductions against exempt income

Jordan, who has been living in the United Kingdom (UK) for 15 years, decides to move back home for his children's education. He owns a house in the UK, which he decides to rent out.

However, before he leaves, he decides to modernise the house by painting it inside and out. The radiator is repaired and some electrical work is done on the house.

While in New Zealand, Jordan receives rental income each month from his tenants. However, this income is exempt under the new rules. Therefore, he cannot claim a deduction/loss against his New Zealand sourced income for the repair work he had done on his house in the UK.

No CFC/FIF disclosure requirement

The changes to section EX 16 (income interest in a CFC) and EX 35 (attributing interest in a FIF) effectively mean that a transitional resident does not have an interest in a CFC or FIF. Therefore, the transitional resident does not have any disclosure requirement under section 61 of the Tax Administration Act 1994.

NEW DISCLOSURE AND RECORD-KEEPING RULES FOR FOREIGN TRUSTS

Sections HH 4(3BB) and HH 4(3BC) of the Income Tax Act 2004, sections 3(1), 22(2)(fb) and (m), 22(2C), 22(7)(d), 59B, 61(1B), 81(4)(mb), 143(1B), 143(IC), 147(2B) and 147B of the Tax Administration Act 1994

New disclosure and record-keeping rules have been introduced for foreign trusts. A New Zealand-resident trustee of a foreign trust (referred to as a "resident foreign trustee") is required to disclose certain information to Inland Revenue and keep financial and other records relating to each foreign trust for New Zealand tax purposes. They are also obliged to provide these records to Inland Revenue, if requested.

Failure to comply with these requirements may result in a resident foreign trustee being subject to sanctions, such as prosecution for knowingly failing to disclose or keep the required information. In certain circumstances, the resident foreign trustee may be taxed in New Zealand on the foreign trust's worldwide income.

All section references in this item are to the Tax Administration Act 1994, unless otherwise stated.

Background

The new rules will enable New Zealand to meet its exchange of information obligations with its double tax agreement (DTA) partners, especially Australia. These rules will also ensure that New Zealand is better placed to meet its informational obligations as a member of the international community and organisations such as the Organisation for Economic Co-operation and Development (OECD).

Previously, a foreign trust that received a foreign-sourced amount of income was not required to provide information to Inland Revenue or keep records for New Zealand tax purposes about that income. A foreign trust is a trust that is not a unit trust and on each date on which a distribution is made from it, no settlor of it has been resident in New Zealand since the later of 17 December 1987 or the date that the first settlement was made under the terms of the trust.

Information relating to the foreign income of foreign trusts could be requested by foreign tax authorities under the exchange of information provisions in New Zealand's DTAs. As these trusts were not required to provide information to Inland Revenue, there was a risk that New Zealand was unable to provide foreign tax authorities with the information requested.

While the size of the problem is not readily definable, failure to provide information would have affected New Zealand's relationship with its DTA partners. Australian authorities, in particular, were concerned that foreign trusts were being established in New Zealand to avoid Australian tax.

The OECD has recently developed minimum standards to improve greater transparency and exchange of information between foreign tax authorities and to encourage international cooperation on tax matters. To comply with these standards, New Zealand must be in a position to exchange information on the foreign income of foreign trusts that are administered by New Zealand resident trustees.

Key features

The new rules for resident foreign trustees are contained in the Tax Administration Act 1994 and in new sections HH 4(3BB) and HH 4(3BC) of the Income Tax Act 2004.

- New section 59B requires that resident foreign trustees must disclose specified information relating to the foreign trust to Inland Revenue, including the name or other identifying particulars of the foreign trust; the name and contact details of the resident foreign trustees and whether a settlor is resident in Australia. If a resident foreign trustee claims to be a "qualifying resident foreign trustee", the name of the "approved organisation" and the name and contact details of the individuals who belong to the approved organisation must be disclosed. If a resident foreign trustee has been appointed to make the required disclosure and keep records, the name of that trustee and the names of the appointing trustees; any changes in this information.

- New sections 22(2)(fb) and (m), 22(2C) and 22(7)(d) require resident foreign trustees to maintain certain financial and other records in New Zealand for at least seven years after the end of the income year to which they relate. These records should enable the financial position of the foreign trust to be determined.
- The records required to be maintained must be provided to Inland Revenue, if requested. Such requests may be made periodically in respect of foreign trusts that have an Australian-resident settlor, and on a case-by-case basis if a valid request for information is received from another country with which New Zealand has a DTA.
- New sections 143(1B), 143 (1C) and current section 143A enable sanctions to apply to resident foreign trustees that knowingly fail to comply with the disclosure and record-keeping requirements.
- New sections 147(2B) and 147B enable sanctions to apply to the directors or other individuals holding positions of influence over the affairs of a corporate trustee if the trustee has knowingly failed to comply with the new rules.
- New sections HH 4(3BB) and HH 4(3BC) of the Income Tax Act 2004 provide that in certain circumstances, resident foreign trustees (other than “qualifying resident foreign trustees”) may be taxed in New Zealand on the worldwide income of the foreign trust, until such time as the requested information is provided. If a foreign trust has at least one qualifying resident foreign trustee, the income of that trust will never be subject to tax in New Zealand. These trusts will effectively enjoy a safe-harbour treatment.
- New section 59B(3) provides that in certain cases, there will be a two-year moratorium in applying the new rules.

Application date

The new rules relating to resident foreign trustees apply from 1 October 2006.

Detailed analysis

New definitions relating to foreign trusts (section 3(1))

Resident foreign trustees

The new rules apply to resident foreign trustees only. A “resident foreign trustee” is a person who:

- either alone or jointly with another person, acts as trustee of a foreign trust; and
- is resident in New Zealand within the meaning of section OE 1 or section OE 2 of the Income Tax Act 2004.

A resident foreign trustee can be an individual or a corporate body. A trustee of a foreign trust that is registered as a charitable entity under the Charities Act 2005 is specifically excluded from the definition of “resident foreign trustee”.

Qualifying resident foreign trustees

A “qualifying resident foreign trustee” is a resident foreign trustee which:

- if an individual is a member of an approved organisation; or
- has a director or other individual in a position allowing significant influence over the management or administration of the trustee, who is resident in New Zealand within the meaning of section OE 1 of the Income Tax Act 2004 and is a member of an approved organisation.

Approved organisation

An “approved organisation” is an organisation whose members include individuals who are subject to a professional code of conduct and who are subject to a disciplinary process intended to enforce compliance with that code. Members of an approved organisation will typically provide trustee services in the course of their business activities.

In addition, the Commissioner has the discretion to consider other suitable criteria in approving an “approved organisation”. Examples of other criteria the Commissioner may consider include:

- whether the organisation’s activities require its members to have certain qualifications; and
- whether the organisation has a minimum number of members.

To ensure that resident foreign trustees know which organisations have been approved by the Commissioner, the names of these organisations will be published by Inland Revenue on its website and or in appropriate publications (new section 81(4)(mb).

Disclosure of information to Inland Revenue

New section 59B requires all resident foreign trustees to provide specific information to Inland Revenue. However, if there is more than one resident foreign trustee, the resident foreign trustees may appoint one of themselves as an agent for the purpose of making the required disclosure.

Information to be disclosed

The specific information includes:

- the name or other identifying particulars (such as the date of settlement) about the foreign trust;
- the name and contact particulars of the resident foreign trustees;

- whether a settlor is resident in Australia;
- if a resident foreign trustee claims to be a qualifying resident foreign trustee, the name of the approved organisation and the name and contact particulars of the individuals who belong to the approved organisation;
- if a resident foreign trustee has been appointed by another resident foreign trustee as an agent to make disclosure and keep records required by the new rules, the name of that trustee and the names of the appointing trustees; and
- any changes in the particulars referred to above.

The collection of this information will assist Inland Revenue to identify the appropriate trustee(s) when information about a foreign trust is requested by one of New Zealand's DTA partners.

Inland Revenue will provide the Australian Taxation Office with information relating to foreign trusts that have a resident foreign trustee and an Australian-resident settlor on a regular basis. The requirement to inform Inland Revenue if a settlor of a foreign trust is an Australian resident is intended to ensure that Inland Revenue is in a position to request and provide this information. Australia is the only country to which New Zealand is proposing to provide information on that basis.

Timing of disclosure

The specific information must be provided as follows:

- Resident foreign trustees appointed on or after 1 October 2006 will be required to provide the specific information to Inland Revenue 30 days after the later of the date of the person's appointment as a trustee or the date of the person's arrival in New Zealand.
- Resident foreign trustees appointed before 1 October 2006 will be required to provide the specified information to Inland Revenue 60 days after the later of 1 October 2006 or the date of the person's arrival in New Zealand.

Therefore, in each case a disclosure will not be required until after the resident foreign trustee has arrived in New Zealand.

Keeping of financial and other records

New sections 22(2)(fb) and (m) impose an obligation on resident foreign trustees to maintain certain financial and other records in New Zealand for at least seven years after the end of the income year to which they relate.

If there is more than one resident foreign trustee the resident foreign trustees may appoint one of themselves as an agent for the purpose of keeping the records required by the new rules.

Meaning of "records"

The definition of "records" in section 22(7) has been amended to require resident foreign trustees of foreign trusts to keep and retain the following records:

- documents that provide evidence of the creation and constitution of the foreign trust (trust deed or similar);
- particulars of settlements made on, and distributions made by, the foreign trust, including the date of settlement or distribution, the name and address (if known) of settlors and recipients of distributions;
- a record of the assets and liabilities of the foreign trust, and details of all sums of money received and expended by the trustee in relation to the foreign trust, including evidence of when and where the receipt and expenditure takes place; and
- if the foreign trust carries on a business, the charts and codes of accounts, the accounting instruction manuals and the system and programme documentation which describes the accounting system used in each income year in the administration of the trust.

Differential record-keeping requirements

The records outlined above are required to be kept by all resident foreign trustees of foreign trusts that are in business.

Foreign trusts that are not in business are excluded from the requirement to keep information relating to their accounting information system. However, the records relating to the assets and liabilities of the foreign trust and the details of all sums of money received and expended by the trustee relating to the trust are required to be kept and retained. This more limited record-keeping is intended to reduce compliance costs for these trusts while ensuring that they maintain sufficient records to enable the financial position of the trust to be determined with reasonable accuracy.

Keeping of records offshore

Section 22(2) provides that a person who is required to keep records may apply to Inland Revenue for permission to keep records offshore, or in a language other than English. If a resident foreign trustee does not personally hold information relating to a foreign trust's offshore interests, the trustee may apply to Inland Revenue under this provision and the department may exercise its discretion to allow records to be kept offshore. If records are kept offshore, a trustee will be expected to provide records to Inland Revenue within a reasonable timeframe, if requested.

Keeping of records when no resident foreign trustee

If a resident foreign trustee leaves New Zealand and no resident foreign trustees remain in New Zealand, the departing trustee can either seek Inland Revenue's approval to keep and retain the records of the foreign

trust outside New Zealand, or maintain the records of the foreign trust in New Zealand. It is the responsibility of the departing trustee to ensure that the records are readily available and can be provided at minimal cost to Inland Revenue, if requested.

Sanctions for non-compliance

Knowledge offence in section 143A

The main sanction for non-compliance with the new rules is the knowledge offence in section 143A. It applies if a resident foreign trustee "knowingly" fails to disclose information or keep or provide records, as required by law.

If a resident foreign trustee has failed to comply with the new rules but was not aware of these rules, sanctions will not apply. As a matter of practice, if Inland Revenue is aware of the name and contact particulars of a resident foreign trustee, it will notify the trustee of his or her tax responsibilities as a trustee of a foreign trust, seek the required information disclosure and outline the record-keeping requirements. Whether the trustee is aware of his or her tax responsibilities will be a question of fact to be determined on a case-by-case basis, although it can be reasonably assumed that "professional trustees" and those trustees in the business of providing trustee services will be aware of the new requirements.

If a resident foreign trustee has failed to comply with the new rules and the trustee knew or ought to have known about his or her tax responsibilities as a trustee of a foreign trust, the trustee will be in breach of section 143A and, if convicted, will be subject to a monetary fine and/or imprisonment.

Sanctions for directors and managers of corporate trustees (new sections 147(2B) and 147B)

If a corporate trustee has committed an offence under section 143A, a director or other individual who is in a position allowing significant influence over the management or administration of the corporate trustee may also commit an offence under new section 147B. This will occur if the section 143A offence was caused by an act done, or carried out by, or by an omission of, or through knowledge attributable to the director or other person.

New section 147(2B) clarifies that the section 147B offence is not intended to apply to non-managerial employees of corporate trustees such as clerical staff.

Application of new sections HH 4(3BB) and HH 4(3BC) of the Income Tax Act 2004

If a non-compliant resident foreign trustee is not a "qualifying resident foreign trustee" and the trustee has been convicted of an offence under section 143A and has not provided the requested information, the world-wide income of the foreign trust will be subject to tax in New Zealand.

This tax liability ceases when the resident foreign trustee provides the required information to Inland Revenue.

If a non-compliant resident foreign trustee is a "qualifying resident foreign trustee", the sanctions for non-compliance will be limited to the penalty in section 143A. Therefore, foreign trusts that have at least one qualifying resident foreign trustee will never be subject to tax on their world-wide income – they will effectively enjoy a safe-harbour treatment. A resident foreign trustee can become a qualifying resident foreign trustee, or appoint a co-trustee who meets the qualifying resident foreign trustee criteria, at any time to qualify for the safe-harbour treatment.

The possibility of conviction under section 143A should provide sufficient deterrent for qualifying resident foreign trustees to meet their obligations under the new rules. A successful conviction may lead to disciplinary action being taken by the professional body of which the trustee is a member.

Non-application of section 143

The criminal penalty for failure to disclose information or keep records as required by law in section 143 will not apply to resident foreign trustees if they did not know of the new requirements described above, and/or another resident foreign trustee had been appointed to meet those requirements. It is recognised that had this penalty applied it would have created unfair results, especially for non-professional trustees of family trusts or estates and those trustees who are not in the business of providing trustee services.

New section 143(1B) clarifies that a resident foreign trustee cannot commit an offence under section 143(1)(a) for not keeping books and documents required to be kept under section 22. This will occur if the trustee proves that he or she did not know of the requirements of section 22 and/or that another resident foreign trustee had been appointed as agent of the resident foreign trustees for the purposes of section 22 and Inland Revenue had been notified of the appointment.

New section 143(1C) clarifies that a resident foreign trustee cannot commit an offence under section 143(1)(b) for not disclosing information required to be disclosed under section 59B. This will occur if the trustee proves that he or she did not know of the requirements under section 59B and/or that another resident foreign trustee had been appointed as agent of the resident foreign trustees for the purposes of section 59B and Inland Revenue had been notified of the appointment.

Two-year moratorium in applying the new rules in certain cases

New section 59B(3) provides that the disclosure required under new section 59B(1) and (2) and the application of section 22(2)(fb) and (m) is delayed for a period of two years (calculated from the date on which the trustee becomes a New Zealand resident). This delay applies to individuals who have been appointed a trustee of a foreign trust before becoming a New Zealand resident and the trustee:

- becomes a New Zealand resident on or after 1 October 2006; and
- is not in the business of providing trustee services; and
- has not been resident in New Zealand on any day in the period five years that ends immediately before the trustee becomes a New Zealand resident.

A trustee who is still resident in New Zealand at the end of the two-year period will be required to disclose the required information to Inland Revenue and start keeping records for New Zealand tax purposes. There is no ability to extend the two-year moratorium.

Requests for information about trusts from other countries

When a resident foreign trustee indicates that a settlor of a foreign trust is an Australian resident, Inland Revenue will periodically request additional information about the trust (such as financial records, details of distributions to beneficiaries and the identity of the settlor) and provide this information to the Australian Taxation Office.

Information will be provided to other DTA signatory countries on a case-by-case request basis, when Inland Revenue considers that there are valid grounds for requesting the information. Inland Revenue will not entertain general "fishing expeditions" from tax treaty partners for information on foreign trusts, or satisfy requests for information from countries that do not have a DTA or a tax information exchange agreement with New Zealand.

When a valid request for information is received, Inland Revenue will request additional information from the appropriate resident foreign trustee.

Inland Revenue is permitted to require information to be provided under section 17. That section imposes an obligation on persons to provide information that Inland Revenue considers necessary for any purpose relating to the administration or enforcement of the Inland Revenue Acts, or any other lawful function of the Commissioner.

Any information provided by a trustee will be subject to the existing tax confidentiality laws. Section 81 prevents Inland Revenue from providing information to a foreign jurisdiction except as permitted by section 88 such as under a DTA.

Related amendment

New section 61(1B) provides an exemption from the disclosure requirement in section 61 if the resident foreign trustee has complied with the disclosure requirement in new section 59B.

TREATMENT OF DISTRIBUTIONS FROM COOPERATIVES

Sections CD 1B, CD 24B and DV 10B of the Income Tax Act 2004 and section 74D of the Estate and Gift Duties Act 1968

To remove uncertainty in the treatment of payouts made by cooperatives to their members, an amendment to the dividend rules ensures that certain payouts are not treated as dividends but remain deductible to the cooperative and taxable in the hands of members at their marginal tax rate.

Background

Cooperatives can deduct distributions of profits arising from transactions with their members under the mutuality provisions contained in section HF 1 of the Income Tax Act 2004. Under the general deductibility provisions, however, it was not clear whether cooperatives could treat profits from activities not associated with members in the same manner – for example, investment activities that do not relate to the purchase or supply of product to or from the member.

The amendment clarifies the legislation and ensures that payouts from cooperatives, including value-added components from non-member transactions, will not be treated as dividends and will continue to be deductible subject to certain criteria.

The deductible treatment of payouts applies to most types of cooperatives, including those that receive payments from member shareholders and purchase product on their behalf (such as trading cooperatives).

Payouts from cooperatives to charities and exempt taxpayers will receive the same treatment as taxpaying shareholders. This means that payouts to exempt taxpayers will not be taxed. This treatment is in line with the policy objective of not taxing such organisations.

Key features

Section CD 24B ensures that New Zealand cooperative companies (or wholly owned subsidiaries of cooperative companies) may elect to exclude certain distributions made by or to members from being a dividend.

For the payout to be excluded from being a dividend and therefore deductible, it must be connected to the supply of trading stock traded between the cooperative and the member. This ties any payout from the cooperative to the member to the sale or receipt of goods. The principal purpose of holding any shares in a cooperative must be for the trade in a product with the cooperative. If a member holds shares in the cooperative and those shares are not required in order to trade with the cooperative, any distribution relating to those shares will be treated as a dividend.

The following further criteria must be met for a distribution to be excluded from being treated as a dividend:

- The cooperative company has reasonable grounds to believe that the member receiving the distribution is resident in New Zealand or has a fixed establishment in New Zealand at the time the distribution is made.
- The distribution must relate to the sale and purchase of tangible property. Payouts relating to the sale of intangibles, such as services and financing, will not be allowed to be deducted as trading stock by the cooperative.
- The distribution must relate to current trading stock that is not sold as part of the disposal of a business.

Section DV 10B ensures that a payout from a cooperative will be treated as deductible expenditure to the cooperative if it meets the criteria outlined in section CD 24B.

Section 74D in the Estate and Gift Duties Act 1968 ensures that this type of payout made by a cooperative company to a member of that company is not treated as a dutiable gift.

Application date

The exclusion of payouts from the definition of a dividend will apply from the 2005–06 and subsequent income years.

ACC ATTENDANT CARE PAYMENTS

Sections CE 12, CF 1(2)(g), CW 28B, DF 4, LD 1B, OB 2 of the Income Tax Act 2004, 33A(1)(a)(iiic) and 33C of the Tax Administration Act 1994

Changes have been made to the Income Tax Act 2004 and the Tax Administration Act 1994 to withhold tax on ACC attendant care payments made by the Accident Compensation Corporation (ACC).

Withholding tax at source will replace the current practice of injured claimants or their caregivers deducting and paying tax on the payments by ACC.

Withholding payments regulations will be amended later this year to include the ACC attendant care payments into the withholding payment rules and to require the ACC to withhold 15% of any ACC attendant care payments.

Background

Attendant care payments are made by ACC to injured claimants for the provision of personal care to those claimants. Claimants may use ACC-contracted caregivers or independent caregivers.

Uncertainty about the correct tax treatment of ACC attendant care payments led to some inconsistent practices. When independent caregivers were used, the accepted practice was that all independent caregivers were considered to be employed by the claimants they cared for. As a result, claimants had to meet all employer PAYE obligations. However, if caregivers worked less than 20 hours per week, they had to meet their own tax obligations as if they were self-employed.

Key features

New section CF 1(2)(g) of the Income Tax Act treats all ACC attendant care payments as income.

New section CW 28B of the Income Tax Act states that when a claimant uses all the money he or she receives as an ACC attendant care payment to pay for his or her attendant care, the ACC payment is exempt income of that claimant. The provision ensures that a claimant is not required to pay tax on the ACC payments that are applied fully for attendant care purposes.

Under new section DF 4 of the Income Tax Act, a claimant who does not pay the full amount of the money received from ACC to a caregiver will have to pay tax on the portion of the ACC payment not paid to the caregiver.

Amendments to the definition of "source deduction payment" in section OB 2 ensure that the claimant is not required to withhold any tax from an ACC payment that he or she makes to a caregiver.

New section 33A(1)(a)(iiic) of the Tax Administration Act states that claimants are not required to file returns of income if their only income for that tax year has come from ACC attendant care payments from which tax has been withheld.

New section 33C of the Tax Administration Act specifies that a caregiver whose annual income does not exceed $9,500 is not required to furnish a return of income for that income year.

New sections CE 12 and LD 1B of the Income Tax Act provide the mechanism for a caregiver to recognise and take into account tax that has been withheld by ACC. Section CE 12 will require that the amount the caregiver received from the claimant should be grossed up by the amount of tax already withheld. Section LD 1B provides a tax credit for the tax amount already withheld.

Application date

The provisions apply from 1 April 2007.

VENTURE CAPITAL INVESTMENT ALONGSIDE THE VENTURE INVESTMENT FUND

Section CW 11C of the Income Tax Act 2004

The amendments introduce a tax exemption on realised gains for investments made by non-residents alongside the New Zealand Venture Investment Fund Ltd (VIF).

Background

The VIF is a Crown-owned company which promotes the development of the New Zealand venture capital industry and invests alongside private-sector co-investors in early stage New Zealand companies. The exemption removes an impediment to New Zealand companies gaining access to offshore venture capital and is consistent with the government's growth and innovation framework.

The amendments complement reforms included in the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 aimed at removing tax barriers to international venture capital investment in New Zealand.

Key features

Section CW 11C has been added to the Income Tax Act 2004 so that income derived by a non-resident from the sale or other disposal of a share, or an option to buy a share, is exempt income if the following conditions are met.

Conditions relating to investment agreement

The VIF (or a company owned by the VIF) must have an agreement with a venture capital manager. This agreement must specify that the venture capital manager will make and manage investments on behalf of the VIF. The non-resident may also be a party to this agreement, although this is not a requirement.

The agreement must require the venture capital manager to purchase a share or option on behalf of the VIF (or a company owned by the VIF) and an identical share or option on behalf of the non-resident.

The agreement must specify that when investments are first made they must be in companies that have more than 50% of the value of their assets and 50% in number of their employees in New Zealand.

Conditions relating to the acquisition of share or option

As required by the investment agreement, the venture capital manager must purchase a share or option on behalf of the VIF (or a company owned by the VIF) and an identical share or option on behalf of the non-resident.

Conditions relating to investment

When the non-resident acquires the share or option, the company must have more than 50% of the value of its assets and 50% in number of their employees in New Zealand.

The company invested into must not have one or more of the following activities as a main activity:

- land development;
- land ownership;
- mining;
- provision of financial services;
- insurance;
- construction of public infrastructure assets;
- acquisition of public infrastructure assets; or
- investing with the main aim of deriving income from the investment in the form of interest, dividends, rent, or personal property lease payments that are not royalties.

Conditions relating to the situation at the time of disposal of the share or option

When the non-resident disposes of the share or option the following requirements must be met:

- the venture capital manager must have complied with their obligations under the investment agreement; and
- the non-resident must have complied with their obligations under any agreement between the non-resident and the VIF (or a company owned by the VIF); and
- there must be no investors who are New Zealand-resident who, with their associates, have an interest (direct or indirect) of more than 10% in the share or option.

The current dividend rules will continue to apply to dividends that non-residents derive from the investee companies.

Application date

The amendment applies from the date of enactment, 3 April 2006.

The exemption is intended to have a temporary effect because the VIF has a limited amount of funds to commit to investments. The exemption applies for investments in which the VIF has invested in, or committed to invest in, on or before 31 March 2010.

INCOME TAX EXEMPTION FOR GAMING MACHINE INCOME OF GAMING TRUSTS

Section CW 40B of the Income Tax Act 2004

The Income Tax 2004 has been amended to provide an exemption from income tax for the gaming machine income of gaming trusts. Under the previous rules, gaming trusts were able to apply for an exemption from RWT.

Background

During the select committee stage of the Charities Bill (now the Charities Act 2005) an issue was raised concerning the impact of the new legislation on gaming trusts. Specifically, the concern related to the fact that gaming trusts which are already subject to a regulatory regime imposed by the Department of Internal Affairs (under the Gaming Act 2003) would be subject to a second tier of supervision by the Charities Commission. This could result in conflicting objectives and influence their decisions on how they split their funding between sporting and recreational bodies on one hand and charities on the other.

Under the previous rules, a gaming trust could qualify for an income tax exemption under section CW 34 or CW 35 of the Income Tax Act in respect of its charitable purposes, and under section CW 39 for the promotion of amateur games or sports. As a result of the Charities Act 2005, from 1 October 2007 entities that wish to obtain a tax exemption for "charitable income" under sections CW 34 or CW 35 will be required to register with the Charities Commission.

However, to become a licensed gaming machine operator, gaming trusts are required to apply or distribute net proceeds only to or for an authorised purpose. An "authorised purpose" can include a charitable purpose and a non-commercial purpose that is beneficial to the whole or a section of the community. A non-commercial purpose can include the promotion of amateur sport. Although both purposes are authorised purposes and would qualify for a tax exemption, the promotion of amateur sport does not require the additional compliance costs of registration under the Charities Act. Consequently, under the previous trust it is more likely that gaming trusts would have opted to support amateur sport and rely on the section CW 39 tax exemption. This would have resulted in a reallocation of funds away from charities in favour of supporting amateur sport.

Key features

The new exemption removes these concerns. New section CW 40B of the Income Tax Act provides an exemption for gaming machine income of gaming trusts, in the hands of licensed operators, provided that they apply or distribute it as required by the Gambling Act 2003. This exemption means that gaming trusts would not have to rely on any of sections CW 34, CW 35 or CW 39 of the Income Tax Act for an income tax exemption.

Application date

The new section will apply from the date of enactment, 3 April 2006.

TAX CONSEQUENCES OF NATURAL DISASTERS

Sections CX 41, DF 1, DO 5B, DO 7, DP 3B, EC 5B, EH 36, EH 63, GD 1, MB 3B and OB 1 of the Income Tax Act 2004 and section DC 1 of the Income Tax Act 1994

Several amendments address problems which arose from the floods in February and July 2004. The amendments provide that:

- Deductions for expenditure for which a restorative grant is made under the Agriculture Recovery Programme do not have to be reduced in the income year in which the expenditure was incurred; instead the grant is considered to be income in the year in which it is received.
- Livestock donated because of a self-assessed adverse event is treated as leaving the donor's business at zero-value and entering the recipient's business at zero-value.
- Taxpayers affected by a self-assessed adverse event can make late estimates of provisional tax.
- Deductions for losses on farm, horticultural, forestry and aquacultural improvements are allowed when the improvement is destroyed or irreparably damaged.

Background

Previous amendments to the Taxation (Disaster Relief) Act 2004 and the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 provided short-term solutions to problems arising from the floods in the Lower North Island and the Bay of Plenty in February and July 2004. However, the need for longer term solutions was recognised by government. Several solutions were consequently developed in consultation with Federated Farmers and the New Zealand Institute of Chartered Accountants.

The Finance and Expenditure Committee subsequently recommended that deductions for losses on farm, horticultural, forestry and aquacultural improvements be allowed when the improvement is destroyed or irreparably damaged, and where the damage is not caused by the owner or an associated person (or their failure to act).

Key features

Restorative grants

The government made restorative grants as part of the Agriculture Recovery Programme for those affected by the floods in 2004. Sections CX 41(3) and DF 1(1) have been amended to ensure that deductions for expenditure for which a restorative grant is made will not have to be reduced in the income year in which the expenditure was incurred; instead the grant will be considered to be income in the year in which it is received. This ensures that unexpected use-of-money interest consequences do not arise.

The amendments in relation to restorative grants apply retrospectively from the 2003–04 income year, so that they apply to grants made to taxpayers affected by the floods in February 2004 and in the Bay of Plenty in July 2004. Section DC 1(1)(a) of the Income Tax Act 1994 has therefore been amended.

Donated trading stock

Amendments were made to deal with stock that is donated for use in farming, agricultural, or fishing businesses that are affected by a self-assessed adverse event.

Section EC 5B treats livestock as leaving the donor's business at zero-value and entering the recipient's business at zero-value, where that livestock is donated or supplied for consideration worth less than market value because of a self-assessed adverse event.

Section GD 1(4)(b) ensures that the anti-avoidance provision does not apply to such stock.

The separate definitions of "self-assessed adverse event" in sections EH 36 and EH 63 have been replaced with a definition in section OB 1.

Late election of provisional tax

Section MB 3B of the Income Tax Act 2004 was amended so that taxpayers with a farming, agricultural or fishing business affected by a self-assessed adverse event can request the Commissioner to accept a late estimate of provisional tax. The provision previously applied only to those affected by a qualifying event (that is, an event in which a civil defence emergency is declared).

Improvements destroyed by natural causes

Sections DO 5B, DO 7 and DP 3B allow deductions for losses on farming, horticultural, forestry and aquacultural improvements where the improvement is destroyed or irreparably damaged and rendered useless for the purposes of deriving income by an unexpected event, such as an earthquake or flooding. The damage must not be caused by the owner, an agent of the owner, or an associated person (or their failure to act). What is meant by "irreparably damaged" is that the improvement has no continuing economic value for the taxpayer.

Application dates

The amendments to the trading stock rules, provisional tax provisions, and deductions for losses on land and aquacultural improvements apply from the 2005–06 income year.

The amendments in relation to restorative grants apply retrospectively from the 2003–04 income year.

TAXATION OF FOREIGN HYBRIDS AND FOREIGN TAX CREDIT RULES

Sections CD 10C, EX 24, EX 33, EX 42, EX 44, EX 45, LC 4, LF 1, LF 5, LF 6 and OB 1 of the Income Tax Act 2004

The law has been clarified to allow people who invest in "foreign hybrids" to receive "grey list" treatment and foreign tax credits for tax they pay overseas on income earned by a foreign hybrid. The changes apply to foreign hybrids that are either a controlled foreign company (CFC) or a branch-equivalent foreign investment fund (FIF).

A foreign hybrid is an entity that has the characteristics of both a company and a partnership. It is treated as a company for New Zealand tax purposes, but is treated like a partnership (with "flow-through" tax treatment) or a branch of the parent company under another country's tax system.

Background

The rules have been introduced to ensure that the tax treatment is consistent when investing into different types of entities.

Under New Zealand domestic tax legislation, an interest in a foreign hybrid entity which has a separate legal personality is treated as an interest in a "company" and taxed as such. An investment by a New Zealand-resident in a foreign company will usually be treated as an investment in a CFC or a FIF. An investor in a CFC (or FIF) can usually claim a foreign tax credit for tax paid on its foreign income.

However, there was uncertainty in the rules about whether New Zealand members of a foreign hybrid entity could claim a foreign tax credit against their New Zealand income tax liabilities under the previous tax credit provisions in the Income Tax Act 2004. That uncertainty arose because, under the CFC credit provision in section LB 4, a credit was given only for foreign tax paid by the CFC. Yet a foreign hybrid, that is a CFC, does not actually pay the foreign tax because the tax is imposed on its members.

A further technical problem arose concerning whether a foreign hybrid could qualify for the grey list exemption from the CFC or FIF rules.

Application date

The amendments apply from 1 April 2006 for the 2006–07 tax year and subsequent tax years.

Key features

The Income Tax Act 2004 has been amended as follows:

- Sections EX 24 and EX 33 enables taxpayers to receive a grey list exemption from the CFC and FIF rules for investments in foreign hybrids.
- Section LC 4 enables shareholders with investments in foreign hybrids that are CFCs or branch-equivalent FIFs to receive tax credits for the foreign tax paid by the shareholder.
- Subpart LF allows corporate shareholders to receive underlying foreign tax credits and deemed underlying foreign tax credits to offset their foreign dividend withholding payment for tax paid in respect of the foreign hybrid.
- Section CD 10C allows the amount of a dividend received from a foreign hybrid to be reduced by the amount of foreign tax paid by the New Zealand shareholder on income earned by the hybrid.
- When attributing income under the accounting profits method in relation to a FIF, section EX 42 allows foreign tax paid by the New Zealand shareholder on income earned by the foreign hybrid to be taken into account. This effectively reduces the amount of attributed income.
- When attributing income under the comparative value method in relation to a FIF, section EX 44 allows foreign tax paid by the New Zealand shareholder on income earned by the foreign hybrid to be included in the definition of costs. This effectively reduces the amount of attributed income.
- When attributing income under the deemed rate of return method in relation to a FIF, section EX 45 allows foreign tax paid by the New Zealand shareholder on income earned by the foreign hybrid to be included in the definition of costs. This effectively reduces the amount of attributed income.

Detailed analysis

Why is section CD 10C required?

Section CD 10C is required to reflect the fact that the shareholder has directly paid the foreign tax of the hybrid that, in the normal course, would have been paid by the company itself, reducing the amount available for distribution as a dividend.

Without this provision, there would be over-taxation of foreign-sourced income. The following examples illustrate the reason for section CD 10C.

Meaning of the term "organised" in sections EX 24 (1)(b), EX 33(1C)(a), and LF 5(1)(b)(ii)

Sections EX 24(1)(b), EX 33(1C)(a) and LF 5(1)(b) refer to the term "organised". The term "organised" is used because in some countries foreign hybrids are not incorporated nor are they a resident for tax purposes – for example, certain limited partnerships. Therefore, the scope of the term "organised" is wider that scope of the terms "incorporated" and "resident".

80% threshold

One of the conditions for a CFC or FIF, that is a foreign hybrid to receive grey list treatment, is that the CFC or FIF must source at least 80% of its income from the grey list country (sections EX 24(1)(b)(ii) and EX 33(1C)(c)).

The 80% rule is necessary to ensure that grey list treatment is given to a hybrid entity only if the grey list country taxes most of the income earned by (or through) the hybrid entity. The threshold of 80%, as opposed to 100%, is intended to provide some flexibility when an insignificant amount of income is earned outside the jurisdiction.

Similarly, for a corporate investor to receive deemed underlying foreign tax credits, the foreign hybrid must source at lease 80% of its income from the grey list country (section LF 5(1)(b)(ii)). A grey list country would generally not impose tax on income sourced from another country which is attributable to an investor resident in another country. So, without this restriction, a deemed underlying foreign tax credit could be granted for income on which no grey list country taxation is payable by either the foreign hybrid or its investors.

EXEMPTION FOR RIGHTS TO BENEFIT FROM EMPLOYMENT-RELATED FOREIGN SUPERANNUATION SCHEMES

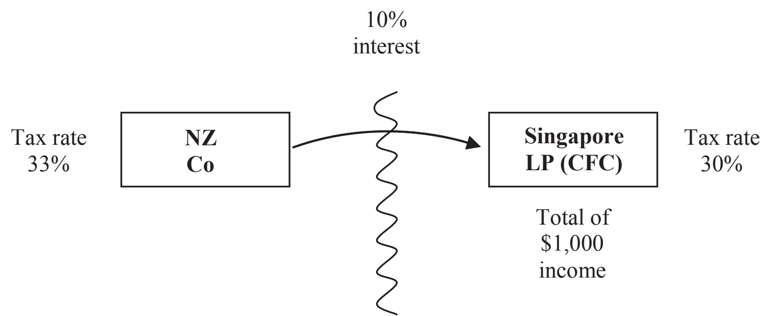
Section EX 36 of the Income Tax Act 2004, sections CG 14(3) and OB 1 of the Income Tax Act 1994 and sections 245R(1) of the Income Tax Act 1976

Amendments have been made to the foreign investment fund (FIF) exemption for rights to benefit from employment-related foreign superannuation schemes. The amendments extend the exemption to apply to returning residents and also give permanent exemption relief for all rights that were acquired in the first five years of each new period of New Zealand residence. These amendments apply retrospectively from the commencement of the FIF rules.

Background

Individuals working in Australia generally have compulsory contributions made on their behalf by their

Example 1: Foreign hybrid in non-grey list country (NZ company)



Singapore tax paid by NZ Co

Profit	$100
Tax @ 20%	$20 **(paid directly by NZ Co not entity)**

⇒ Singapore LP profit available for distribution = $100
(because the tax is paid by NZ Co.)

NZ attributed foreign income (AFI)

AFI	$100
NZ tax @ 33%	$33
LC 4 Credit	($20)
NZ tax to pay	$ 3

Distribution (without section CD 10C) (dividend of $100: Singapore LP profit)

$$\text{UFTC} \Rightarrow 100 \times \frac{200}{1000} = 20$$

FDWP = $100 + 20	=	$120.00
FDWP @ 33%	=	$39.60
UFTC credit	=	(20)
Beta credit	=	(13)
Net FDWP	=	$6.60

⇒ **Total tax paid by NZ Co** = $39.60

Total effective tax rate is 39.6%

With section CD 10C – dividend reduced

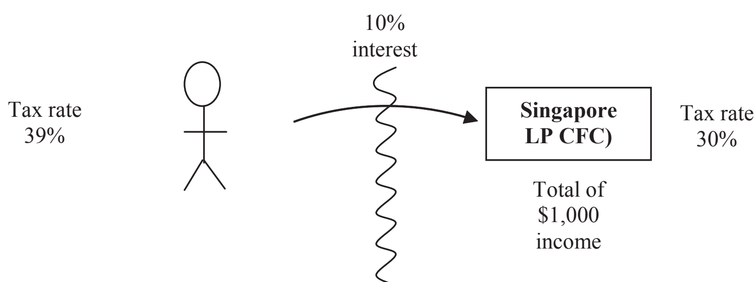
Tax paid in Singapore $ 20

Dividend received	$100
Dividend reduced	(20)
Net dividend	$ 80

FDWP = 80 + 20	=	$100
FDWP @ 33%	=	$ 33
UFTC	=	(20)
Beta	=	(13)
Net FDWP	=	0

⇒ **Total tax paid by NZ Co** = $33
Total effective tax rate is 33%

Example 2: Foreign hybrid in non-grey list country (NZ individual)



Singapore tax paid by NZ individual

Profit	$100	
Tax @ 20%	$20	**(paid directly by NZ individual)**

⇒ Singapore LP profit available for distribution = $100
(because the tax is paid by NZ individual)

NZ attributed foreign income (AFI)

AFI $100

NZ tax @ 39%	$ 39
LC 4 Credit	($ 20)
NZ tax to pay	$ 19

Distribution (without section CD 10C)

Dividend received	$100
NZ tax @ 39%	$ 39
Beta credit	$ (19)
Tax	$ 20

		NZ		**Singapore**		**Total**
⇒ **Total tax paid by NZ individual**	=	$39	+	$20	=	$59

Total effective NZ tax rate on the post-foreign tax dividend of $80 is 48.75%

With section CD 10C – dividend reduced

Tax paid in Singapore **$ 20**

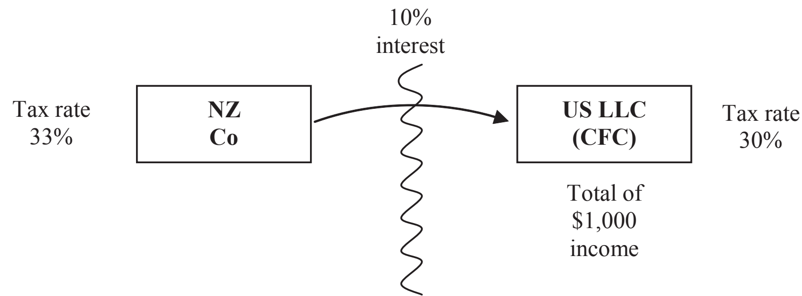
Dividend received	$100
Dividend reduced	$ (20)
Net dividend	$ 80

Dividend received	$ 80
NZ tax @ 39%	$ 31.20
Beta credit	$ (19)
Tax	$ 12.20

		NZ		**Singapore**		**Total**
⇒ **Total tax paid by NZ individual**	=	$31.20	+	$20	=	$51.20

Total effective NZ tax rate on the post-foreign tax dividend of $80 is 39%

Example 3: Foreign hybrid in grey list country (NZ company)



US tax paid by NZ Co

Profit	$100
Tax @ 35%	$35

⇒ US LLC profit available for distribution = $100
(because the tax is paid by NZ Co)

Distribution

$$UFTC = 100 \times \frac{0.33}{0.67}$$

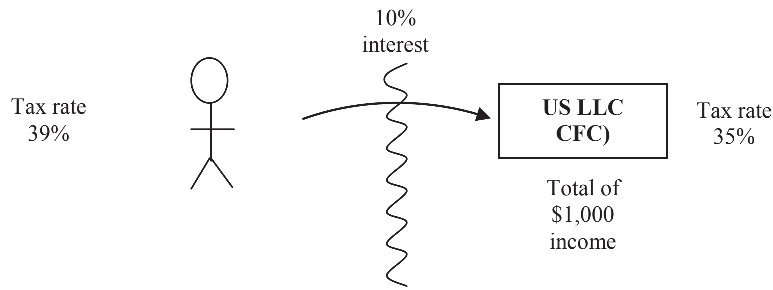
$$= 49.25$$

FDWP = 100 + 49.25	=	$ 149.25
FDWP @ 33%	=	49.25
UFTC =		(49.25)
Net FDWP	=	$ 0
Total tax paid by NZ Co	=	$ 35

⇒ Therefore no need for section CD 10C

However no issues with double taxation arise if section CD 10C is applied.

Example 4: Foreign hybrid in grey list country (NZ individual)



US tax paid by NZ individual

Profit	$100	
Tax @ 35%	$ 35	(paid directly by NZ individual)

⇒ US LLC profit available for distribution = $100
(because the tax is paid by NZ individual)

Distribution (without section CD 10C)

Dividend received	$100
NZ tax @ 39 %	$ 39

	NZ		USA		Total
Total tax paid by NZ individual =	$39	+	$35	=	$74

Total effective NZ tax rate on the post-foreign tax dividend of $65 is 60%

Distribution (with section CD 10C)

Tax paid in US $35

Dividend received	$100
Dividend reduced	$ (35)
Net dividend	$ 75

Dividend received	$ 65
NZ tax @ 39%	$ 25.35

	NZ		USA		Total
Total tax paid by NZ individual =	$25.35	+	$35	=	$60.35

Total effective NZ tax rate on the post-foreign tax dividend of $65 is 39%

employers into a superannuation scheme (the Australian Superannuation Guarantee Scheme). This scheme is an employment-related foreign superannuation scheme for New Zealand tax purposes. In general, Australian and New Zealand citizens cannot access their superannuation entitlements until they reach retirement age. If they migrate or return to New Zealand they could be subject to tax on those entitlements, under New Zealand's FIF rules.

The FIF rules currently tax the income earned by a foreign entity (such as a foreign superannuation scheme) according to the rights held by New Zealand residents in that entity. They ensure that foreign income earned by a foreign superannuation scheme on behalf of New Zealand residents is subject to New Zealand tax.

Consultation with the private sector indicated that people who held rights to benefit from an Australian superannuation scheme are not complying correctly with their tax obligations under the FIF rules and, indeed, may not even be aware that they have to account for tax. It is likely that this non-compliance is not unique to people with Australian superannuation interests. For those people who are aware of their tax responsibilities, determining whether they are required to pay tax under the FIF rules can involve high compliance costs such as specialist tax advice. Although the current FIF exemptions provide some relief from the rules, the difficulty is determining which exemption applies and how to meet the continuing requirements of the exemption if a person wants to continue to contribute to a foreign superannuation scheme after moving to New Zealand.

In the course of reviewing the effects of the impact of the FIF rules on individuals with rights to benefit from a foreign superannuation scheme, an inconsistency was also identified in the way first-time residents and returning residents to New Zealand were treated under the rules. There were more exemptions available to first-time residents than for returning residents, which raised concerns about equity and consistency.

For example, the previous exemption for rights to benefit from an employment-related foreign superannuation scheme applied to those rights that were held by first-time residents only and that were acquired by the person before he or she became a New Zealand resident for tax purposes.

The amendments specifically address the inconsistency in the FIF treatment of first time residents and returning residents. They also increase the level of exemption for rights to benefit from an employment-related foreign superannuation scheme, thereby improving the overall equity of the FIF rules and decreasing the tax burden and the associated compliance costs for those people affected.

Key features

The exemption in section EX 36 of the Income Tax Act 2004 applies to the rights of an individual to benefit, as a beneficiary or a member, from an employment-related foreign superannuation scheme. These rights must have accrued during the period:

- for which the person is not a New Zealand resident; and/or
- for which the person is a New Zealand resident and that
  - begins when the person becomes a New Zealand resident; and
  - ends before the first day of the fifth income year following the income year in which the person becomes a New Zealand resident.

The extent to which these rights have accrued during the period as described above is calculated using the following formula:

Closing value – opening value

Where:

Closing value is the market value of the rights on the day that ends the period

Opening value is the market value of the rights on the day that begins the period

The result of this formula is the value of the rights that are permanently exempt from the FIF rules. If there is more than one period that meets the description above, the rights accruing to each of these periods will be permanently exempt from the FIF rules.

Consequential amendments have also been made to the corresponding provisions in the Income Tax Act 1994 and the Income Tax Act 1976.

Application date

The amendments to the exemption for rights to benefit from employment-related foreign superannuation schemes apply from the commencement of the foreign investment fund rules, being the 1991–92 income year for taxpayers with a corresponding non-standard accounting year ending after 2 July 1992, or the 1992–93 and subsequent income years for other taxpayers.

INCREASE IN THE CHILD TAX REBATE

Section KC 2 of the Income Tax Act 2004

The maximum child rebate payable has increased from $156 to $351 a year.

Background

The child rebate was introduced so children are not required to pay tax on small amounts of income. As the child rebate has not been increased since 1983, its real value has eroded over time.

Consequently, an increasing number of children are earning income which exceeds the current rebate threshold. This is problematic as some child taxpayers incur compliance costs in relation to small amounts of income earned, while others fail to meet their tax obligations. When children do comply, administrative costs associated with collecting and processing small amounts of tax can exceed the revenue collected.

Key features

Section KC 2 of the Income Tax Act 2004 increases the child rebate to $351 a year and allows an eligible child to earn income (less interest and dividends) up to $2,340 per annum, tax-free.

Some eligible children will no longer be required to deduct tax or meet other tax obligations for the income they earn. All eligible children whose annual income exceeds $1,040 (less interest and dividends) will benefit from the increase.

Children who are under the age of 15, or under the age of 18 and attending primary or secondary school, or who turned 18 in the preceding income year and are still at school, are eligible to receive the rebate.

Application date

The amendment applies for income years corresponding to the 2006–07 and subsequent tax years.

REVERSE TAKEOVERS AND CONTINUITY RULES

Sections OB 1 and OD 5AA, 1994 and 2004 Income Tax Acts

The concessionary continuity rules, which apply to carrying forward losses and imputation credits when there is a change in a company's shareholding, have been extended to recognise that continuity can be maintained through reverse takeovers or mergers. The new rules apply when both companies involved in the takeover or merger are widely held or listed companies.

Background

Normally a company must have a continuity of shareholding of 49% to enable it to carry forward its tax losses for New Zealand income tax purposes. In relation to imputation credits, the required continuity percentage is 66%. These continuity rules are premised on tracing shareholding through groups of companies back to non-corporate shareholders. Concessionary rules allow for the fact that this is not practical in a number of circumstances.

Under the previous concessionary continuity rules, there was no provision to carry forward tax losses when a smaller, widely held listed company took over or merged with a larger one. However, conceptually, the takeover or merger itself should not have caused a breach of the continuity rules resulting in the forfeiture of tax losses or imputation credits when the continuity of shareholding thresholds of at least 49% or 66% was satisfied.

Key features

A new section OD 5AA has been inserted into the 1994 and 2004 Income Tax Acts to provide a new ownership tracing rule for reverse takeovers. The new rule will apply to a "changeover" in a limited attribution company (the initial parent) which is treated as holding ownership interests in another company (the subsidiary). A "changeover" can be a change in ownership, or a situation where the initial parent ceases to exist because of an amalgamation.

Continuity will not be lost if:

- immediately before the changeover the initial parent is treated as holding all the ownership interests in the subsidiary; and
- immediately after the changeover another limited attribution company (the new parent) is treated as holding all the ownership interests in the subsidiary; and
- before and after the changeover, each shareholder in the initial parent owns shares in the new parent in the same proportion to other shareholders in the initial parent (ignoring other interests in the new parent the shareholder might have); and
- there is commonality (49% of the carry forward of losses, or 66% for the carry forward of imputation and dividend withholding payment credits) in:
  - the ownership interests in the initial company that are treated as being held by the initial shareholders immediately before the changeover; and
  - the ownership interests in the new parent that are treated as being held by the initial shareholders immediately after the changeover.

"Limited attribution company" is defined in section OB 1 and is a:

(a) building society

(b) cooperative company

(c) listed company

(d) widely held company

(e) foreign company that is not a closely held company.

Application date

The new rule applies for changes in ownership occurring in the 1998–99 or a subsequent income year,

if the company files a tax return on the basis that the requirements of a continuity provision are satisfied in relation to the change of ownership. More generally it applies from 3 April 2006, the date of assent of the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006.

THE ADDITION OF SPAIN TO THE GREY LIST

Schedule 3 of the Income Tax Act 2004

The grey list is a list of countries whose tax systems are broadly similar to that of New Zealand's. Investments made in grey list countries are generally not subject to the controlled foreign company (CFC) and foreign investment fund (FIF) rules.

Key features

Spain has been added to the grey list via an amendment to Schedule 3 of the Income Tax Act 2004.

Investments in Spain are not eligible for the grey list exemption if any CFC or FIF takes advantage of concessionary tax regimes in the following regions:

- Canary Islands;
- Ceuta;
- Melilla;
- Alava;
- Guipúzcoa;
- Vizcaya; or
- Navarra.

Application date

The amendment applies for income years corresponding to the 2006–07 and subsequent tax years.

REGRASSING AND FERTILISING EXPENDITURE

Sections DO 1, DO 4, OB 1 and Schedule 7 of the Income Tax Act 2004

Sections DO 3, OB 1 and Schedule 7 of the Income Tax Act 1994

The treatment of regrassing and fertilising expenditure has been realigned to clarify when it is fully deductible and when it is to be treated on capital account. The changes are designed to provide more certainty when accounting for such expenditure and to bring the tax treatment into line with modern short-rotation pasture-management practices.

Under the new rules, regrassing and fertilising expenditure is fully deductible in the year incurred unless is associated with a significant capital activity, such as a farm conversion. When incurred as part of a significant capital activity it is amortised at 45% per year, instead of 6% as previously.

Amortisation rates for farming and agricultural expenditure will in future be updated by Order in Council.

Background

Inland Revenue published guidelines (Operational Statement 007) in July 2004 on the treatment of expenditure in converting farms from one agricultural purpose to another. These guidelines set out Inland Revenue's position on the treatment of regrassing and fertiliser expenditure – that it should be treated on capital account and amortised over time.

Concerns were raised by accountants and farmers over the result of this position, given the realities of modern farming practices and, in particular, because any regrassing and fertilising expenditure not considered to be fully and immediately deductible were required to be amortised at a rate of 6% a year – a rate not updated since 1986. The updated rules were developed in consultation with accounting and farming representatives, and take into account the significant shift in farming practices towards short rotation grassing practices.

Key features

The main changes introduced are:

- *Capital account treatment:* Regrassing and fertilising expenditure incurred in connection with a significant capital activity, such as a farm conversion, will be amortised at 45% of the diminished value of that expenditure each year. Schedule 7 to both the Income Tax Acts 1994 and 2004 has been amended to achieve this while retaining the 6% amortisation rate for expenditure incurred when preparing land for farming or agriculture.
- *Revenue account treatment*: Regrassing and fertilising expenditure will be fully deductible in the year it is incurred unless it is required to be treated on capital account and amortised. Section DO 3 of the 1994 Act and section DO 1 of the 2004 Act have been amended to provide for this.
- *Specific limitations:* Two limitations further clarify the boundary between capital and revenue account and exclude from capital account treatment expenditure that is associated with:
  - pasture that has an estimated useful life of one year or less because it would ordinarily be deductible under ordinary principles (see the amendments to section DO 3 of the 1994 Act

and section DO 1 of the 2004 Act); and

- Changes in the intensity of farming activities. This could include, for example, moving from 8 (low intensity) to 12 (high intensity) sheep or other stock units per hectare. The change is to provide consistency regardless of whether the change occurs in one year, more gradually over a number of years, or as a result of changes in the general technology of farming practices (see the amendments to section OB 1 that define "significant capital activity").

Application date

The amendments apply to expenditure incurred on or after 1 July 2004.

TRANS-TASMAN IMPUTATION CREDIT-STREAMING

Sections ME 6(1B), (1C) and (1D) and ME 8(6) of the Income Tax Act 2004

The amendments close a loophole by preventing Australasian groups of companies from allocating imputation credits to dividends paid to a New Zealand investor if the payment of the dividends results in a tax deduction in Australia.

Background

The intention of the trans-Tasman imputation rules is that New Zealand and Australian shareholders of trans-Tasman companies can be allocated imputation credits representing New Zealand tax paid and franking credits paid, in proportion to their ownership of the company. However, each country's credits can be utilised only by its residents.

The amendments address the problem of imputation "credit-streaming", where imputation credits were deliberately directed to New Zealand owners of Australian-issued redeemable preference shares, although the proceeds of the share issue did not directly cause further New Zealand tax to be paid by the Australasian group. A particular feature of these arrangements was that under Australian law, the share coupons were deductible as interest.

Key features

New section ME 6(1B) provides that imputation credits may not be attached to a dividend that is:

- paid in relation to a share that is a debt interest under the Australian Income Tax Assessment Act 1997; and
- included in the Australian tax return of the paying company.

This includes dividends paid on redeemable preference shares, as discussed above.

Section ME 8(6) provides that the "benchmark" dividend rules do not apply to any dividend to which imputation credits cannot be attached under section ME 6(1B).

Application dates

The general rule is that imputation credits may not be allocated to dividends paid on or after 21 July 2005. There are, however, several grandparenting rules.

Section ME 6(1C) provides that the new rule does not apply to a dividend if the shares were issued before 21 July 2005 and:

- the shareholder is not a member of the same group of companies that the dividend-paying company belongs to; and
- they are members of the same wholly owned group of companies, but both are non-resident.

Section ME 6(1D) provides an exception to the general "same group of companies" test where the shareholder acquired the shares:

- before 21 July 2005;
- for business reasons; and
- for reasons independent of the relationship between the shareholder and the paying company:
  - as part of a share broking business; or
  - as an investment held by the shareholder as part of an insurance business; or
  - as security for a loan given as part of a money lending business; or
  - as a trustee for a beneficiary who is not a company in the same group of companies as the shareholder.

UNACCEPTABLE TAX POSITION

Sections 141A(5), 141KB and 142B of the Tax Administration Act 1994

The amendments give the Commissioner a discretion to either cancel or not assess the unacceptable tax position shortfall penalty in certain circumstances.

The amendments are a short-term measure while further work is being undertaken to develop a long-term solution to certain problems with the unacceptable tax position shortfall penalty. The Minister of Revenue has announced that a discussion document will be released later this year and any necessary amendments included in a subsequent tax bill.

Background

An unacceptable tax position shortfall penalty of 20% of the tax shortfall is assessed if, viewed objectively, the tax position fails to meet the standard of being "about as likely as not to be correct". The penalty is only assessed in cases where the tax shortfall is significant; that is, a shortfall in excess of $20,000 and the lesser of either 1% of the total tax figure or $250,000. The penalty does not apply to tax shortfalls that arise from mistakes in the calculation or recording of numbers in a return.

The shortfall penalty for an unacceptable tax position is therefore intended as a signal to taxpayers who take tax positions where there is a significant amount of tax at stake. The unacceptable tax position standard does not require that the treatment a taxpayer gives to a particular matter must be the better view, or must be more likely than not the correct treatment. Rather, it must be a position to which a court would give serious consideration, but not necessarily agree with. This means that the taxpayer's argument should be sufficient to support a reasonable expectation that the taxpayer could succeed in court.

The current term "unacceptable tax position" results from an amendment to the penalties legislation in 2003. The unacceptable tax position shortfall penalty was previously the "unacceptable interpretation" shortfall penalty. The amendment was necessary because a taxpayer could argue that they had not made an interpretation and therefore the unacceptable interpretation shortfall penalty could not be assessed even when justified in terms of the penalty's objective.

Although this issue was not covered by the bill when it was introduced, the Finance and Expenditure Committee received submissions on this issue. Submitters considered that the unacceptable tax position shortfall penalty could penalise most, if not all, errors in excess of the minimum thresholds. If a taxpayer had made and acknowledged an error, by definition the tax position could not be "about as likely as not to be correct". Submitters argued that this was having an adverse effect on taxpayer behaviour in that it was making them less inclined to disclose errors for correction to Inland Revenue.

Key features

New section 141KB gives the Commissioner a discretion allowing him to either cancel or not assess the unacceptable tax position shortfall penalty. The discretion applies in cases where the Commissioner is satisfied that:

- the tax position is taken as the result of a clear mistake or simple oversight;
- the tax shortfall arising from the tax position is or would be subject to a reduced penalty because the shortfall was voluntarily disclosed before notification of a tax audit or investigation or is a temporary shortfall; and
- it is appropriate that the taxpayer not be liable to pay an unacceptable tax position shortfall penalty in relation to the tax position.

The new section applies retrospectively, back to 1 April 2003, the date on which the unacceptable interpretation shortfall penalty was changed to the unacceptable tax position shortfall penalty. This allows the Commissioner to cancel penalties that have been assessed. The cancellation will be effective from the date on which the penalty was assessed. For penalties assessed before 1 April 2006, taxpayers must make a written request to the Commissioner for the discretion to be exercised. If a penalty which has been paid is cancelled Inland Revenue will pay use-of-money interest on the amount paid.

If the Commissioner determines that a penalty that has been assessed should be cancelled, the Commissioner may consider whether in taking the tax position the taxpayer has failed to take reasonable care. If this is the case the shortfall penalty for not taking reasonable care could be assessed. Under the new section 141A(5) the penalty would be assessed at the time the Commissioner makes the decision that the discretion applies (and not at the time that the unacceptable tax position shortfall penalty was assessed). New section 142B(2) ensures that in such cases the due date for payment of the not taking reasonable care shortfall penalty is not when the tax shortfall was payable, but rather once the Commissioner has notified the taxpayer that the not taking reasonable care shortfall penalty is payable.

The decision on whether the Commissioner exercises his discretion in section 141KB(1) or not is a "disputable decision" for the purposes of the disputes resolution process.

Application date

The amendment applies retrospectively, back to 1 April 2003, the date on which the unacceptable interpretation shortfall penalty was changed to the unacceptable tax position shortfall penalty. If an unacceptable tax position shortfall penalty has been assessed before this amendment was made, and the tax shortfall meets the criteria set out above, Inland Revenue must receive a written request from the taxpayer before 1 October 2006 asking for their penalty to be cancelled.

Inland Revenue has published *SPS 06/01 Discretion to cancel or not assess shortfall penalties for taking an unacceptable tax position* which sets out the practice for exercising the discretion under section 141KB.

BLOODSTOCK WRITE-DOWN RATES

Sections EC 39, EC 40, EC 41, EC 42, EZ 4B and EC 4C of the Income Tax Act 2004

Write-down rates have been increased for stallions not previously used for breeding in New Zealand and for

broodmares. Stallions not previously used for breeding in New Zealand will be written down over two years under the straight-line method, and the diminishing value rate will be 75%. Broodmares will be written down over varying periods depending on the age of the mare when first bought or brought into breeding, with older brood mares (aged eight or over when first used for breeding) written off in full in one year. These write-down rates will apply to bloodstock bought or brought into breeding on or after 1 August 2006.

Background

Stallions not previously used for breeding in New Zealand were previously written down over four years under the straight-line method, or at a diminishing value rate of 37.5%. Broodmares were previously written down over varying periods depending on the age of the broodmare when first brought into breeding. The effect was to write down broodmares not previously used for breeding in New Zealand over a maximum of eight years and a minimum of three years, and for broodmares previously used for breeding in New Zealand, a maximum of nine years and a minimum of three years.

Key features

The new write-down rates for bloodstock are in sections EC 41 and EC 42. Write-down rules for bloodstock that was bought or brought into breeding before 1 August 2006 are contained in new sections EZ 4B and EZ 4C. The effect is to transfer the old rules for bloodstock write-downs to a Terminating Provisions subpart of the Income Tax Act 2004, and to allow the new write-down rules to be used only for bloodstock brought into breeding on or after 1 August 2006.

Section EC 41 applies to bloodstock not previously used for breeding in New Zealand. Section EC 41(2) sets the annual reduction for stallions at 50% of the cost price of the stallion, unless the stallion is valued by the reducing value method. Section EC 41(3) sets the reducing value rate at 75%. The annual reduction for stallions previously used for breeding in New Zealand is set in section EC 41(1) at 20% of cost price.

The formula for broodmares not previously used for breeding in New Zealand is in section EC 41(6). The formula generates the annual amount to be used for writing down the broodmares to which it applies:

$$\frac{1.25 \text{ x cost price of broodmare}}{9 - \text{age of broodmare}}$$

The age to be used in the formula is set in section EC 41(7). It is the age of the broodmare when first used for breeding, or if the broodmare is eight years of age or older, then the “age of broodmare” is set at eight.

The effect of this formula is to write down broodmares over a maximum of six years (for broodmares who begin breeding at age two), with broodmares aged eight and older written down in full in the year they are first used for breeding.

The formula for broodmares which have previously been used for breeding in New Zealand is in section EC 42(4). The formula generates the annual amount to be used for writing down the broodmares to which it applies:

$$\frac{\text{cost price of broodmare}}{9 - \text{age of broodmare}}$$

The age to be used in the formula is set in section EC 42(5). It is the age of the broodmare when it is first used for breeding, or if the broodmare is eight years of age or older, then the “age of broodmare” is set at eight.

The effect of this formula is to write down broodmares which have previously been used for breeding in New Zealand over a maximum of seven years (for broodmares who begin breeding at age two), with broodmares aged eight and older written down in full in the year they are first used for breeding.

Sections EZ 4B and EZ 4C contain the rules for writing down bloodstock that was brought into breeding before 1 August 2006. These rules have not changed. T*ax Information Bulletin*, Vol. 14, No. 11 (November 2002) contains an explanation of these rules.

Application date

The new rules apply to bloodstock brought into breeding on or after 1 August 2006.

DUTY ON RACING

Sections 3 and 4 of the Gambling Duties Act 1971

The rate of duty and the formula for calculating duty on racing have been aligned with the rate and formula for casino gambling duty. Racing duty is set at 4% of gambling profits.

Background

The New Zealand Racing Board made a submission to government arguing that racing duty should be aligned with casino duty. Racing duty was previously set at 20% of betting profits, although because there were various concessions in the formula for calculating duty, the effective rate of duty was about 18%.

Key features

Racing betting duty is set at 4% of gambling duty. Section 4(1) sets the rate of duty at 4% of betting profits. Section 4(2) sets the formula for calculating betting profits as:

amounts – refunds – winning dividends

Amounts, refunds and winning dividends are defined in section 4(2). "Amounts" is the total of all amounts received by the New Zealand Racing Board or its agents for totalisator racing betting, sports betting and fixed-odds racing betting. "Refunds" is the amount of refunds paid, and "winning dividends" is the amount of winning dividends paid out in respect of "amounts". Winning dividends are further defined in section 3 as the amount paid to a person for placing a winning bet, including amounts paid out of accumulated prize pools.

The effect of this formula is to align the calculation of racing betting duty with the calculation of casino gambling duty.

Application date

The new rate and formula for calculating racing betting duty will apply to all racing and sports betting on events for which results will be declared on or after 1 August 2006. Where an event is held over two or more days, it will be treated as having been held in the month in which the last day of the event occurs.

GST ON GOODS AND SERVICES SUPPLIED TO SECURITY HOLDERS

Sections 2, 3, 5, 9, 10 and 14 of the Goods and Services Tax Act

Changes have been made to the Goods and Services Tax Act to clarify the application of GST to supplies of financial services following the Court of Appeal decision *Commissioner of Inland Revenue v Gulf Harbour Developments Ltd*.[18]

Background

Since its enactment in 1985, the Goods and Services Tax Act has contained a number of measures that address the substitution of otherwise taxable goods and services for GST-exempt financial services. Examples of these measures include the exclusions that remove from the definition of "financial services" transactions involving real property and shares in the capital of flat- or office-owning companies. These measures are designed to prevent consumer preferences from being distorted as a result of otherwise taxable goods and services being repackaged as exempt financial services.

Concerns that similar repackaging could occur for non-land transactions were raised by the government in the discussion document, *GST and financial services*, in the context of participatory securities. However, as the recent Court of Appeal decision, *Commissioner of Inland Revenue v Gulf Harbour Development Limited* has highlighted, the problem of substitution using the definition of "financial services" also applies to equity securities.

[18] (2004) 21 NZTC 18,915

For the most part, determining the GST treatment of a transaction according to its form produces the most efficient tax outcome. This outcome, however, needs to be balanced against the effect that substitution, which gives rise to tax advantages, can have on consumer behaviour. If, in the absence of suitable anti-avoidance measures, a product can be offered without GST, consumers will have an obvious preference for this product over an identical product that is subject to GST. An example of a substitution arrangement is illustrated in figure 1.

The recent changes to the GST rules are therefore anti-avoidance measures. The amendments are directed at arrangements involving supplies of goods and services to final consumers with either or both the following features:

- The supplies would be taxable supplies but for the terms of an equity security or participatory security under which the supplies are made.
- The supplies are for a consideration other than market value, as a consequence of the terms of the equity security or participatory security.

The relevant clauses in the bill initially applied to debt securities as well as equity securities and participatory securities. The inclusion of debt securities in the amendments was in response to concerns regarding the general substitutability between equity and debt.[19] References to debt securities were subsequently removed at the recommendation of the Finance and Expenditure Committee in response to concerns that their inclusion could require GST to be paid on refundable deposits paid to secure licences to occupy at retirement complexes.

Key features

The key changes to the GST Act are:

- A new term, "associated supply", is inserted into section 2. An "associated supply" includes:
  - (a) supplies of goods and services for which the supplier and the recipient are associated persons; and/or
  - (b) the supply of a right, under an equity security or participatory security, to a supply of goods and services, other than exempt goods and services, which may be for a consideration that is other than at open market value.
- The meaning of the term "supply" has been amended by inserting new section 5(14B). Section 5(14B) will apply if part of a supply of an equity or participatory security involves an "associated supply". The section treats the "associated supply" as separate from the equity security or participatory security. Section 5(14B) applies to securities that are supplied on and after the date of enactment.

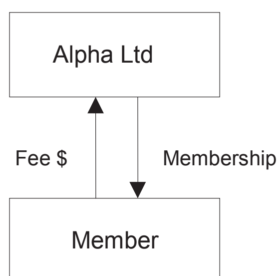
[19] See *Riverside Country Club v The Queen* 2001 CanLII 778 TCC.

Figure 1: Substitution arrangement

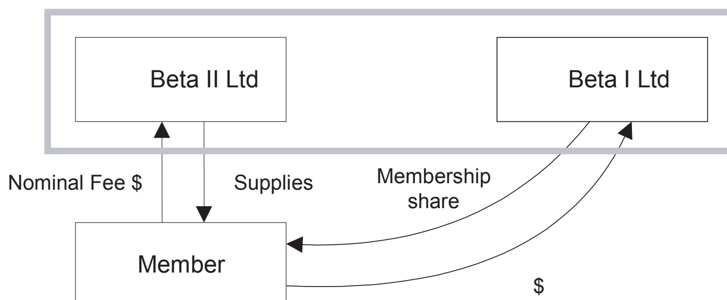
Alpha Club provides health-club facilities, including gymnasium and aerobic facilities. Membership to Alpha Club costs $1,350 each year including GST. Alpha Club requires $1,200 (net of GST) from each member each year to operate.

Beta Club, Alpha Club's competitor, offers comparable facilities and also requires $1,200 (net of GST) each year from each member to operate.

Alpha Club



Beta Club



Instead of annual membership subscriptions, Beta Club's members are offered shares in Beta Club's holding company Beta I Ltd for $11,600.[see note] The shares are redeemable for $1 in 10 years and permit access to the Beta Club's facilities which are held by Beta II Ltd. Beta I Ltd treats the supply of the membership share as a GST-exempt supply of financial services. Beta II Ltd charges shareholder members an annual fee of $45 (including GST) to cover maintenance costs. The GST consequences arising from the different pricing structures between the competing facilities are as follows:

Alpha Club		*Beta Club*		
Taxable supplies	$1,350	Exempt supplies	$1,160	(allocated each year)
GST collected	($150)	Taxable supplies	$45	
Net amount	$1,200	GST collected	($5)	
		Net amount	$1,200	
		GST savings	$145 each year	

Note: The value of the share is determined by subtracting the nominal annual charge ($40 excluding GST) from the amount required each year from the members ($1,200). Therefore $1,200 - $40 = $1,160. $1,160 x 10 years = $11,600.

- The application of section 14(1)(a), which exempts the supply of financial services, has been modified. Former sections 14(1)(a)(i) and (ii) have been moved to section 14(1B)(a) and (c) respectively. Section 14(1B) also includes a new paragraph (b) (which will apply to financial services supplied on and after the date of enactment) that excludes from the financial services exemption supplies that come within paragraph (b) of the definition of "associated supply" – that is, the supply of rights to goods and services under an equity or participatory security.

Other changes include:

- Consequential amendments have been made to sections 9(2)(a) and 10(3) to incorporate the new definition of "associated supply". Section 10(3) requires associated supplies to be made at "open market value". Section 9(2)(a) determines the time of supply for "associated supply" transactions as being the earlier of when:
  - an invoice is issued;
  - payment is made in respect of the supply;
  - the goods are removed by the recipient or made available to the recipient;
  - the services are performed.
- Section 3(3)(b) has been repealed. The section previously removed from the definition of "financial services" debt, equity and participatory securities to the extent that they include an interest in land. The section has been removed as the exclusion for these securities will be covered by the definition of "associated supply", section 5(14B) and section 14(1B)(b). The repeal of this section applies to securities that are supplied on and after the date of enactment.

Application date

The changes will apply from the date of enactment, 3 April 2006.

Detailed analysis

General application

Paragraph (b) of the definition of "associated supply" and section 10(3) will require the supply of a right under an equity or participatory security to be valued at market if it allows the security holder or another person to receive, for no consideration or a consideration less than the open market value, a supply of goods and services.

These provisions, in combination with sections 5(14B) and 14(1B), attempt to remove any GST advantages that may arise as a result of:

- substituting the supply of otherwise taxable goods and services for a supply of GST-exempt financial services; or
- substituting the consideration that would otherwise be payable for a supply of taxable goods and services for the consideration payable for the supply of GST-exempt financial services.

The GST advantages are removed as the supplier of the equity or participatory security will be required to attribute the consideration received for a GST-exempt security to the supply of the goods and services to the extent of the open market value of those goods and services.

Example 1: Marina berth

Travis pays $59,000 for a GST-exempt participatory security offered by a company, Construction Ltd, which is constructing a new marina. Once the marina is completed, the security entitles Travis to berth a yacht at the facility. Travis is not required to make any further payments for using the marina facilities. Under the new rules the supplier of the marina will have to attribute to the marina berth, to the extent of its open market value, some or all of the $59,000 received for the GST-exempt security.

Limits to the term "associated supply"

There are two exclusions from paragraph (b) of the definition of "associated supply". The exclusions apply if the equity security or participatory security:

- gives a right to exempt supplies of goods and services, such as dividends, bonus share issues or residential accommodation; or
- provides rights in relation to the control of the issuer, such as voting rights.

These exclusions attempt to remove rights that would be exempt from GST or that are inherently associated with equity investment from the definition of "associated supply". The limitations also ensure that the definition of "associated supply" is solely directed at situations where the ownership of an otherwise taxable supply of goods and services is, in substance, transferred without participation in the investment vehicle's capital or assets (or where such participation is merely ancillary).

Example 2: Company shareholder

Maude purchases shares in a company for $20,000. The shares entitle Maude to dividends and supplies of goods and services. Under the new rules the company will have to recognise a liability for GST on the market value of the goods and services supplied to Maude if those goods and services are supplied under the rights given by the shares. Any dividends that are paid to Maude from holding the shares will continue to be treated as GST-exempt.

Example 3: Unit trust

Regan purchases units in a unit trust. The purpose of the units is to participate in a number of property development projects. The units entitle Regan to a share of income produced by the development projects. The units also give a beneficial interest in the underlying assets and, if the unit trust is liquidated or wound up, Regan is entitled to receive a share of the physical assets.

Although the units give Regan beneficial rights to receive a share of the physical assets, the purpose of the units is to allow participation in any earnings produced by the property development projects. An "associated supply" is not considered to be created at the time the units are supplied because the intent of the units is not directed at transferring any project assets for Regan's use. An "associated supply" may be created at a later date if any assets belonging to the property development projects are subsequently transferred to Regan.

Market value

The objective of the amendments is to ensure that GST applies to supplies of taxable goods and services that arise as a result of a final consumer holding an equity or participatory security. Although the amendments apply to "associated supplies" to both consumer and business security holders, the valuation rules in sections 10(3) and 10(3A) mean that the requirement to value at open market value any goods and services treated as separately supplied under section 5(14B) generally arises only in respect of final consumers.

The open market value rules also do not apply if the consideration for the "associated supply" equals or is greater than the open market value of the supply.

Section 4, which defines "open market value", uses a "willing buyer/willing seller" test to determine the open market value of a supply. Inland Revenue has made a number of observations about the terms used in the definition of "open market value".[20] The terms "similar circumstances" and "freely offered" in section 4 are particularly relevant for the treatment of goods and services that are supplied to the security holder for a discount.

If an "associated supply" arises as a result of a discount because a security holder holds a security in the GST-registered person supplying the relevant goods and services, whether the discounted price may be treated as the open market value will depend on the circumstances under which the discount is offered. The discounted price could equate to open market value if, for example, it was comparable to a discount offered to the general public.

Example 4: Company shareholder

Cally pays $11,000 for a parcel (5,000) of shares in Global Retail Ltd. The shares allow shareholders to vote at shareholder meetings and receive dividends. Shareholders of Global Retail Ltd are also entitled to acquire goods and services from Global Retail's subsidiary company Local Retail Ltd for a discounted amount. The discount is 5% and is equivalent to discounts offered under Local Retail's frequent shopper programme once the shopper has spent more than $500 in three months.

The membership security is GST-exempt when supplied. However, if Cally purchases goods from Local Retail Ltd for a discount, consideration should be given at the time of supply as to whether GST should be returned on the full purchase price of the goods rather that the discounted price. As the discount offered by Local Retail Ltd is comparable to the discount it offers its customers under its frequent shopper programme, Local Retail is not required to return GST on the full price.

GST AND CREDIT CONTRACTS LEGISLATION

Sections 3 and 10 of the Goods and Services Tax Act

Changes have been made to sections 3 and 10 of the Goods and Services Tax Act to clarify the definition of "credit contracts" in relation to the Credit Contracts and Consumer Finance Act 2003 (CCCFA).

Background

The GST Act makes two cross-references to the credit contracts legislation:

- in connection with the definition of "financial services" under which services are exempt from GST; and
- a special valuation rule that separates the interest component under a credit contract from the principal value of the goods and services supplied under the contract. Under special valuation rules GST applies to the principal value but not the interest.

A problem was identified with a consequential change made to the GST Act, with effect from 1 April 2005, to reflect the new definition of "credit contract" in the CCCFA. Some lease arrangements, which were previously treated as "credit contracts" under the Credit Contracts Act 1981, no longer qualified as "credit contracts" under the CCCFA. This is because the term "credit" applies to a narrower set of contracts under the CCCFA.

For a contract to be considered a "credit contract" it must meet one of three limbs of the definition of "credit".[21] The most significant of these is that the contract must defer a payment of a debt. There are two elements to this requirement:

- there must be a debt; and
- the payment of that debt must be deferred.

Many finance leases do not defer the payment of debt. Each payment is due and payable as and when required under the lease. The total amount of the lease payments are not due on day one of the lease with the payments deferred over the term of that lease. Because of this, there is no deferral of a debt.

By contrast, before the CCCFA came into effect on 1 April 2005, a lease was treated as a "credit contract" under the Credit Contracts Act 1981 if a contract involved advancing money in return for a promise, the consideration of which exceeded the amount initially advanced.[22]

The result of this change in the meaning of "credit" is that lessors who entered into certain lease arrangements after 1 April 2005 on the expectation that GST would not apply to the interest component must now return GST.

To help overcome this problem, the new changes to the GST Act allow taxpayers a choice as to which definition of "credit contract" should be used. The measures are intended to be a temporary solution until a single definition of "credit contract" for the purposes of the GST Act is developed.

The changes to sections 3 and 10 of the GST Act were included in the bill after it was introduced.

Key features

Sections 3(2) and 10(5A) have been amended to reinsert the old 1981 definition of "credit contract" for leases entered into after 1 April 2005.

[20] See *Tax Information Bulletin* Vol. 6, No. 14 (June 1995), pages 6 to 8.

[21] See section 6 of the CCCFA.

[22] See section 3(1) of the Credit Contracts Act 1981.

New sections 3(3B) and 10(5B) allow taxpayers the choice to exclude as "credit contracts" contracts that would not be credit contracts under the CCCFA.

New sections 3(3C) and 10(5C) also allow credit contracts under the CCCFA, but not under the Credit Contracts Act 1981, to continue to be treated as "credit contracts".

Application date

The changes apply from 1 April 2005.

GST AND INTERNATIONAL POSTAGE STAMPS

Section 5 of the Goods and Services Tax Act

Section 5(11I) of the Goods and Services Tax Act has been amended by inserting a definition of "postage stamp".

Background

Previously, the GST Act defined "postage stamps" according to the Postal Services Act 1998. The Postal Services Act governs the supply of domestic postal services. Postal services involved solely in delivering mail overseas are not covered by the Postal Services Act, whereas operators involved in both domestic and international mail are. Persons that are not regulated by the Postal Services Act may issue stamps, but these are not "postage stamps" as defined in the Postal Services Act (and arguably not subject to the rule in section 5(11I) that would treat the supply as occurring when the stamp was sold).

The GST Act therefore had the potential to treat stamps differently depending on whether or not the stamp was sold by a postal services operator that was regulated by the Postal Services Act. Stamps sold by persons that were not covered by the Postal Services Act and relating to the transport of goods from New Zealand could arguably be zero-rated because the supply of stamps was connected with international mail. This situation arose because the GST Act gives taxpayers the option to treat the redemption of a stamp provided by a person who is not a registered postal operator as the supply instead of the issue or sale, if it is not practical to treat the issue or sale as the supply.

Similar services supplied by a person who was regulated by the Postal Services Act could not be zero-rated because of section 5(11I) and the reference to "postage stamp".

The new amendment ensures that GST applies to the supply in New Zealand of all stamps connected with mail and is consistent with the general policy of taxing services that are consumed in New Zealand at the single rate of 12.5%. The New Zealand-based sender of the mail is considered to receive the benefit of having it sent to another person and therefore as having consumed the postal services in New Zealand.

Key features

The amendment removes from the GST Act the reference to the definition of "postage stamp" contained in the Postal Services Act and replaces it with a broader definition of "postage stamp" in section 5(11I)(a) of the GST Act.

The new definition refers to an adhesive label, or mark or design, that is:

- issued or sold by a person to another person; and
- affixed to, impressed on, or printed on stationery; and
- indicates pre-payment of the fee chargeable for the carriage of a letter or parcel, or other article; and
- not intended to distinguish the article to which it relates from similar articles carried by the same person.

The new definition focuses on products that indicate pre-payment for carriage but are not specific to the parcel or article on which they are attached. Examples of adhesive labels that are not intended to be covered by the amendment include adhesive receipts that are particular to the parcel in terms of the amount charged (for example, PAT labels) or that uniquely identify the parcel in some manner (for example, a barcode).

Application date

The amendment applies from the date of enactment, 3 April 2006.

GST AND DISTRIBUTIONS FROM A TRUST MADE FOR NO CONSIDERATION BETWEEN ASSOCIATED REGISTERED PERSONS

Section 10 of the Goods and Services Tax Act

Section 10 of the Goods and Services Tax Act has been clarified for valuing distributions from a trust and for valuing a gift between associated registered persons.

The amendment ensures that the market valuation rule does not apply if the supply is made for no consideration and the registered recipient applies the goods and services in a taxable activity from the time of supply.

Background

The distribution of property to a beneficiary under a trust on the death of a registered person, or as a gift, is treated as a supply for GST purposes. Such supplies will often be between associated persons.

Supplies for no consideration between associated persons are valued for GST purposes at the open market value of the supply under section 10(3) of the GST Act.

Under section 10(3A) of the GST Act this valuation rule does not apply if the supply was acquired for the principal purpose of making taxable supplies and the associated supplier and recipient are both registered for GST purposes. This is intended to recognise that when one party charges GST and the other party is able to deduct that GST, the result is GST-neutral. In this situation the value of the supply is treated as the amount actually paid which, in the case of a distribution under a trust, is nil.

In the case of a supply made under a trust or as a gift from one GST-registered person to another, the recipient will receive the goods as a beneficiary. The recipient has no purpose of acquisition. Therefore GST that could arguably be charged on the basis of open market value in section 10(3A) would not apply. The beneficiary would also be potentially denied a deduction because the goods were not acquired for the principal purpose of making taxable supplies. The transaction would no longer be tax-neutral as intended by section 10(3A). The amendment removes this anomaly.

Key feature

Section 10 of the GST Act 1985 has been amended to preserve the intended revenue-neutral effect of a supply of goods and services between two registered associated persons when the goods or services are applied in the recipient's taxable activity from the time of supply.

Application date

The amendment applies from 1 October 1986. The bill earlier provided that the change would apply from the date of enactment. The application date was changed at the recommendation of the Finance and Expenditure Committee following submissions.

GST ON GOODS OUTSIDE NEW ZEALAND AT THE TIME OF SUPPLY

Section 11 of the Goods and Services Tax Act

Section 11(1)(j) of the Goods and Services Tax Act has been amended and confirms that goods, such as motor vehicles, that are contracted for and used in New Zealand but located outside New Zealand at the time of supply are charged at the standard rate of GST. It is a base-maintenance measure designed to prevent GST avoidance by using third parties to import goods that are offshore at the time of supply.

Background

Section 11(1)(j) previously zero-rated a supply of goods if the goods were outside New Zealand at the time of supply and were not entered for home consumption. The latter requirement was being used in certain circumstances to zero-rate the supply of goods in New Zealand by using an interposed third party. This practice was inconsistent with both the policy intent of the zero-rating rules and the wider objective of GST being a tax on goods and services supplied in New Zealand.

Key features

Section 11(1)(j) has been amended to allow zero-rating of goods outside New Zealand only if the goods are not in New Zealand at the time of delivery to the recipient. This confirms that the standard rate of GST should apply to goods consumed in New Zealand.

Section 11(1)(j) now requires that a supply of goods is zero-rated if the goods are not situated in New Zealand at the time of supply and:

(a) the goods are not situated in New Zealand at the time of delivery;

and/or

(b) the recipient pays GST under section 12 of the GST Act. (This ensures that if the recipient obtains the goods directly under a contract with a New Zealand GST-registered supplier, GST is not charged twice – once at the border under section 12 and again by the New Zealand supplier under section 8.)

Application date

The amendment applies to supplies made on and after 19 May 2005.

REMEDIAL MATTERS

CLARIFICATION OF TREATY OVERRIDE POWER

Section BH 1 Income Tax Act 2004

The amendment clarifies the override to section BH 1 of the Income Tax Act 2004 to provide double tax agreements (DTAs) enacted by Order in Council to override the Inland Revenue Acts, the Privacy Act 1993 and the Official Information Act 1982. The purpose of the amendment is to clarify which enactments are overridden by Orders in Council made pursuant to section BH 1.

Background

Overriding provisions allow regulations to be made which override all domestic legislation. In March 2002, the Regulations Review Committee recommended that, among other sections, section BH 1 of the Income Tax

Act 1994 (the predecessor to the Income Tax Act 2004) be reviewed. The government agreed to review the section in its response to the report.

The amendment specifically identifies enactments that DTAs override, namely: the Inland Revenue Acts, the Privacy Act 1993 and the Official Information Act 1982.

Key features

The key amendment replaces the reference to "any enactment" in section BH 1(4) with a reference to "any other Inland Revenue Act, the Official Information Act 1982 or the Privacy Act 1993".

Application date

The amendment applies from the date of enactment, 3 April 2006.

REWRITE AMENDMENTS

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.

The following 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 CB 9(1)(b) (sales of land by builders and associated persons of builders);
- section CD 32(15) (exclusions from dividends for available subscribed capital);
- section CD 33(2) (exclusions from dividends for capital gains);
- section CD 33(7)(b) (exclusion from dividends for capital gains);
- section EC 48 (replacement of bloodstock);
- section EI 6 (allocation across income years of income derived in anticipation);
- section EZ 35(3) (base price adjustment results under old financial arrangement rules);
- section OB 1 (definition of "shares of the same class"), section 394L(4A) of the 1976 Act (export market development credits and the imputation credit account); 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 CB 9(1)(b) and Schedule 22A

Section CB 9(1)(b) contains a policy change that, inadvertently, was not included in Schedule 22A at the time of enactment of the 2004 Act.

Section CB 9(1)(b) of the 2004 Act applies the test of whether or not a person is in business as a builder at the time at which the improvements began. Under the corresponding provision in the 1994 Act (CD 1(2)(d)), this test was applied at the time the land was acquired.

The time at which this test applies is relevant to both a builder and an associated person of the builder. The change in the time at which the test is applied to the associated person is a notified policy change identified in Schedule 22A, and officials considered that the same change should be applied to the builder in drafting section CB 9(1)(b).

This policy change is now correctly identified in Schedule 22A.

Section CD 32(15)

Section 32(15) has been amended to ensure that the outcome under the 2004 Act is the same as that under the 1994 Act.

Under the 1994 Act, the definition of "available subscribed capital" limited the subscriptions amount of available subscribed capital (ASC) of an amalgamated company resulting from a long-form amalgamation to the aggregate ASC of the amalgamating companies. This limitation was unintentionally not included

in the corresponding provision in the 2004 Act, section CD 32(15), and this has now been corrected.

Section CD 33(2)

In section CD 33(2), it is unclear whether the term "capital gains" is linked to the term "capital gain amount" that is used throughout section CD 33. This leads to a potential ambiguity that has been corrected by using the term "capital gain amount" consistently through the section.

Section CD 33(7)(b)

Section CD 33(7)(b) has been amended to correct an unintended change in relation to the treatment of certain capital gains. Under this provision, a capital gain is limited to a capital gain that is a gift.

Under the 1994 Act, section CF 3(7)(b)(which is the corresponding provision in the 1994 Act to section CD 33(7)(b)) included a range of amounts within the concept of "capital gain", but it did not restrict the concept of a capital gain to only a gift. In particular, the courts have indicated that the concept of capital gain in this context could include receipts from insurance claims and also capital compensation.

This amendment restores the position existing under the 1994 Act in relation to capital gains that are not gifts.

Section DB 9B

Section DB 9B is a new provision inserted to ensure that a deduction is allowed for an amount that is treated as a deduction under section EZ 34(6) or EZ 35(3) or (4) of the old financial arrangement rules.

Under the 1994 Act, an allowable deduction under section BD 2 included any amount allowed as a deduction in any of Parts C to I and Parts L and M.

Under the 2004 Act, Part D is an exhaustive list of deductions, and until Parts F to O are rewritten, any amount allowed as a deduction under a provision in Parts F to I continues to be a deduction under section DY 1. In addition, section DA 3 states that no provision in Part E supplements or overrides the general permission or overrides a general limitation.

As a result, in the 2004 Act the wording in sections EZ 34(6)(b) and EZ 35(3)(a)(ii) and EZ 35(4)(v) that purports to provide a deduction for the amount calculated under the base price adjustment under the old financial arrangement rules has no effect. This is an unintended change in outcome, and the new section DB 9B restores the deductibility of these amounts.

In addition, section DB 9B is intended to have the same relationship with section DA 3 as is set out in section DB 9 (which relates to the financial arrangement rules). However, this linkage was overlooked in drafting this new section and this will require an amendment in future legislation. This future amendment will provide that section DB 9B will supplement the general permission and override the general limitations.

Section EC 48

Section EM 3 of the 1994 Act permitted a gain on the sale of bloodstock to be offset against the purchase price of a replacement animal without requiring tracing of the actual sale proceeds.

The corresponding section in the 2004 Act (section EC 48) arguably indicates that the sale proceeds need to be separated from the general working capital of the taxpayer's business and specifically applied to the purchase of the replacement bloodstock. This would be a different outcome to that under section EM 3 of the 1994 Act.

Section EC 48 has been amended to ensure that the section cannot be read as requiring the sales proceeds on disposal of bloodstock to be tracked to specific replacement bloodstock.

Section EI 6

In section EI 6 of the 2004 Act, a person who derives income in anticipation (for example, key money on a lease) may allocate that income over the period of the contract. A requirement of this future spread of income is that the person must give a notice to the Commissioner setting out the income years to which the income is to be allocated.

In section EI 6 this notice is to be given in the tax year in which the income is derived. Under section EB 2 of the 1994 Act, this notice was to be given in the tax year following the tax year in which the income was derived.

Section EI 6 in the 2004 Act has been amended to restore the position existing under the 1994 Act.

Section OB 1 – Definition of "shares of the same class"

In section OB 1 of the 2004 Act, the drafting of the definition of "shares of the same class" provides for the three paragraphs (a), (b), and (c) to be alternative conditions to satisfy in order for shares to fall within this definition.

Under the 1994 Act definition of "shares of the same class", paragraphs (a) and (b) had to be satisfied cumulatively, and paragraph (c) was an alternative condition.

However, the 1994 Act also contained an unintended change in law in the definition of "shares of the same class", arising from an amendment in the Income Tax Amendment Act 1994 (applying from 1 July 1994). The 1994 amendment repealed and replaced paragraph (b) and, in doing so, inadvertently omitted the conjunction "and" between paragraphs (b) and (c). This left some ambiguity as to how the definition applied, and the 2004 Act was drafted as if each of the paragraphs was an alternative test.

Before this amendment in 1994, the rule in paragraph (c) was intended to permit a company (in particular, a unit trust) to elect to "subdivide" a class of shares (units) that meet the conditions in the original paragraphs (a) and (b) into a new class of shares. This new "sub-class" of shares would be formed on the basis of price or ownership despite it being a subset of the wider class. This subset of shares could have as few as one share.

Before the 1994 amendment, if the company chose to make this subdivision a class of shares on the basis of price and ownership, then that "sub-class" would be a separate class of shares. The original law was intended to ensure that shares treated as a share of the same class by virtue of paragraph (c) would not also be treated as a share of the same class under paragraphs (a) and (b).

The amendment restores the correct policy intent.

Section YA 5B

Section YB 4(1) of the 1994 Act provided for the continuing effect of section 394L(4A) of the 1976 Act. This provision ensures that a company is not required to pay further income tax if their imputation credit account has a debit balance at the end of an imputation year that can be attributed to an export market development expenditure tax credit (EMDE) arising before the end of the 1990 tax year.

Currently, there are still taxpayers with debit ICA balances that arose on receipt of EMDE refunds. These taxpayers rely on section YB 4(1) each year to grant relief from liability for further income tax.

Section YA 5B has been inserted to reinstate the effect of section YB 4(1) of the 1994 Act, but only so far as this rule relates to section 394L(4A) of the 1976 Act.

REIMBURSEMENT FOR THE USE OF A PRIVATE MOTOR VEHICLE

Section CW 13 of the Income Tax Act 2004

Employers may use published mileage rates to reimburse employees who use their own vehicles for work purposes.

In accordance with section CW 13 of the Income Tax Act 2004, employers may determine the amount of employee reimbursement exempt for tax purposes when employees use their own vehicles for work purposes.

Employers can reimburse an employee based on actual expenditure incurred by the employee – or by making a reasonable estimate of the expenditure incurred. A "reasonable estimate" recognises that employers have differing business needs and that a "one size fits all" rate may not necessarily be accurate.

Employers may use rates published by a reputable independent New Zealand source, representing a reasonable estimate (for example, New Zealand Automobile Association Inc mileage rates) to reimburse staff using their private motor vehicle for work purposes.

The mileage rate used must be a reasonable estimate. In establishing a reasonable estimate regard should be given to the nature of the business and the type of employee vehicles.

Employers may also continue to use the rates published by Inland Revenue in the T*ax Information Bulletin* Vol. 7, No. 8 (February 1996).

This gives employers four options when reimbursing staff for the business use of a private vehicle:

- actual expenditure incurred by the employee;
- an employer's own reasonable estimate of expenditure incurred by an employee;
- published mileage rates, as long as they represent a reasonable estimate; and
- the rates published by Inland Revenue in the February 1996 *Tax Information Bulletin*.

Employers may apply published mileage or other rates effective immediately. The other options have been available to employers for a number of years.

Reimbursement of shareholder-employees

The above conditions apply to shareholder-employees of a close company as for ordinary employees for reimbursement of motor vehicle expenditure if either of these conditions is met:

- the shareholder-employee receives regular amounts of salary or wages at least monthly throughout the year; or
- the shareholder-employee receives regular salary or wages that are at least $^{2}/_{3}$ of their annual gross income as an employee of the company.

For example, a shareholder-employee who meets either of these two conditions can use the rates published by Inland Revenue in the February 1996 *Tax Information Bulletin* for work-related travel in excess of 5,000 km a year as well as for work-related travel up to 5,000 km a year.

ORGANISATION APPROVED FOR CHARITABLE DONEE STATUS

Section KC 5(1) of the Income Tax Act 2004

Habitat for Humanity New Zealand Limited has been granted charitable donee status from the 2005–06 tax year.

Donations made to this organisation will entitle individual taxpayers to a rebate of 33 1/3% of the amount donated. The maximum rebate for all donations is $630 per annum.

A non-closely held company, or a closely held company which is listed on a recognised stock exchange, will be entitled to a deduction from its net income to a maximum of 5% of that income.

A Maori authority may also claim a deduction from its net income. The maximum deduction for a Maori authority is 5% of its net income donated to charitable organisations and/or a body that has been defined as a Maori association under the Maori Community Development Act 1962.

RESIDENT WITHHOLDING TAX ON DIVIDENDS PAID BY NON-RESIDENT COMPANIES

Section NF 2(1) of the Income Tax Act 1994 and section NF 2(1) and NF 2(4) and (4B) of the Income Tax Act 2004

An amendment ensures that trans-Tasman imputation credits are taken into account in calculating resident withholding tax (RWT) deductions from dividends paid by non-resident companies.

A second amendment relaxes a requirement for RWT to be deducted from dividends paid by non-resident companies to New Zealand shareholders, if the dividend-paying company has a fixed establishment in New Zealand and is not required by generally accepted accounting practice to present financial statements in New Zealand dollars.

Background

Non-resident companies with a fixed establishment in New Zealand are required to deduct and account for RWT from dividends paid to New Zealand shareholders. However, an exemption applied if, among other things, the dividend was paid in a currency other than New Zealand dollars.

Two issues were subsequently identified:

- RWT deductions should be able to be reduced by the amount of any trans-Tasman imputation credits; and
- the exemption where dividends were not paid in New Zealand dollars no longer targeted the dividends it was designed to exempt, because non-resident companies could pay dividends to New Zealand shareholders in New Zealand dollars, because that is more convenient for those shareholders.

The rationale for the requirement to deduct RWT was to address tax avoidance concerns that can arise if a non-resident company has no business operations in its home country, but has a branch operation in New Zealand. It should be unnecessary for a non-resident company which has significant business interests in its home country as well as in New Zealand to deduct RWT from dividends paid to New Zealand shareholders, because there is a low risk of tax avoidance in these circumstances.

If the non-resident company's financial statements are not required by generally accepted accounting practice to be presented in New Zealand dollars, this is an indication that there are significant home-country interests.

Key features

Paragraphs (b), (c) and (d) of section NF 2(1) have been amended to ensure that trans-Tasman imputation credits are taken into account when calculating RWT on dividends paid by non-resident companies.

Section NF 2(4)(a) has been amended to provide that a non-resident company is not required to deduct RWT from dividends paid to New Zealand shareholders if it is carrying on a taxable activity through a fixed establishment in New Zealand, and the Commissioner is satisfied that:

- the dividends are not attributable to, or effectively connected with, a fixed establishment outside New Zealand; and
- the dividends are payable in a currency other than New Zealand dollars, or the non-resident company is not required by generally accepted accounting practice to express its financial statements in New Zealand currency.

Application date

The amendments to section NF 2(1) apply from 1 April 2003, the date of introduction of the trans-Tasman imputation rules.

The amendment to section NF 2(4) applies from 1 April 2007. This will allow sufficient time for relevant shareholders to be informed about the change.

AMENDMENTS TO DISPUTES RULES

Sections 3, 89C, 89D, 89K, 89N and 89O of the Tax Administration Act 1994

A number of minor remedial amendments have been made to the Tax Administration Act 1994 (TAA). The amendments clarify and correct changes to the disputes resolution rule amendments in the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 (the amending Act).

Two-month response period to a notice of disputable decision

Section 3 contains a definition of "response period" within which parties to a dispute must produce the relevant document. The two-month response period for taxpayers to issue a notice of proposed adjustment (NOPA) to their self-assessment or the Commissioner's assessment was changed in the amending Act to four months. However, the response period for a taxpayer to issue a NOPA to a disputable decision that is not a notice of assessment remained at two months.

For consistency, the two-month period for a taxpayer to issue a NOPA to a notice of disputable decision has been changed to four months. A change was recommended by the Finance and Expenditure Select Committee to ensure that the move to a four-month response period is limited to situations when a NOPA is issued under the disputes resolution process. The two-month response period to initiate challenge proceedings remains.

The amendment applies from 1 April 2005, the date the new disputes rules took effect.

Commissioner may issue an assessment without first issuing a NOPA

Section 89C allows the Commissioner to issue an assessment without first issuing a NOPA in certain circumstances. Section 89C(db), introduced in the amending Act, provides for one such circumstance as being where the assessment is made in respect of facts and law which are identical to a previous assessment of the taxpayer "…for another income year…".

The amendment ensures that this exclusion applies to previous GST return periods as well as income years.

The amendment applies from the date of enactment, 3 April 2006.

Suspension of the dispute in a test case

The amending Act introduced a new section 89O to allow for the suspension of a dispute following the outcome of a test case. The suspension may be agreed in relation to a dispute between the Commissioner and a taxpayer if the Commissioner has designated a case involving another taxpayer as a test case. Any applicable time bars are put on hold until the outcome of the test case.

The period of the suspension starts from the date of the agreement and ends on the earliest of:

- the date of the court's decision in the test case; or
- the date on which the test case or the dispute is otherwise resolved.

A further provision describes the period of time within which the Commissioner must make the assessment. The period could require the Commissioner to issue the assessment on the date of the relevant decision. Practically, it will not be possible to issue the assessment if the period from the application to the time bar is not included in the time allowed for the suspension.

The change to section 89O clarifies that the period starting on the date of the agreement (made within the time bar) is in addition to the period within which the Commissioner must make the assessment (the four-year time bar). If the agreement to suspend the dispute is reached shortly before the application of the time bar, the amendment allows a further 60 days to issue the assessment.

The amendment applies from the date of enactment, 3 April 2006.

Application to High Court to issue an assessment without completing the disputes process

Section 89N applies in situations where the Commissioner applies to the High Court for an order to allow more time to complete the disputes process, or issue an assessment without completion of the disputes process.

The period of time is the total of the four-year time bar, and the period of time that starts on the date of the application (made within the time bar) and ends on the earliest of the date of the court's decision, the date on which the application or dispute is otherwise resolved. The period could require that the Commissioner issue the assessment on the date the relevant decision is made, rather than also allowing the time from the date of the application to the time bar to be included in the total time of the suspension.

The amendment clarifies that the period starting on the date of the application is in addition to the period within which the Commissioner must make the assessment (the four-year time bar).

The amendment applies from the date of enactment, 3 April 2006.

Request for information under a statute

Section 89N(1)(c)(vi) enables the Commissioner to issue an assessment without completing the disputes process when the disputant has failed to comply with an information request.

The provision of information is generally required by the Commissioner under the TAA. The amendment replaces all references to the word "request" with the word "require" in the provision, allowing the Commissioner

to issue an assessment without completing the disputes process.

The amendment applies from the date of enactment, 3 April 2006.

Cross-reference correction

Under the previous rules, section 89D(2C) provides that if the Commissioner has made a GST assessment for a taxpayer, the taxpayer can dispute the assessment only if they provide a return for the relevant GST-return period. The new amendment now provides that the general requirement in section 16(3) of the GST Act for a return to contain a notice of assessment does not apply in this case.

The amendment applies from the date of enactment, 3 April 2006.

Drafting

Section 89K(1)(a) has been re-drafted to correct duplicating amendments made by the earlier Taxation (Venture Capital and Miscellaneous Provisions) Act 2004. The amendment applies to disputes commenced on and after 1 April 2005.

MISCELLANEOUS TECHNICAL AMENDMENTS

Rollover of exemption for investments in listed controlled foreign companies

Section EZ 29 of the Income Tax Act 2004

Section EZ 29 has been replaced to extend the exemption for investments in listed controlled foreign companies (CFCs) up to and including the 2010–11 tax year.

As with the previous section EZ 29, new section EZ 29 provides an exemption from the CFC rules in certain circumstances if the CFC is resident in a so-called grey list country and the company is listed on a recognised exchange in that grey list country. (The grey list comprises Australia, Canada, Germany, Japan, Norway, Spain, United Kingdom and United States.) The exemption applies if, by virtue of the grey list country's stock exchange listing rules, the New Zealand resident holding the CFC interest cannot obtain sufficient information to calculate income under the CFC rules. The exemption will apply if the stock exchange listing rules of the grey list country:

- prevent the CFC from providing sufficient information for the person to calculate CFC income; or
- provide that, if the CFC provides sufficient information for the person to calculate CFC income, the CFC is required to make a further disclosure of information that would be harmful to the CFC's commercial interests.

The previous section EZ 29 applied for the 2001–02 to 2005–06 tax years. New section EZ 29 applies for the 2006–07 to 2010–11 tax years.

Remedial amendments to PAYE

Section LD 1 of the Income Tax Act 2004

Three amendments have been made to section LD 1 of the Income Tax Act 2004 to amend drafting errors. The first amends section LD 1(2) to ensure that an employee receives credit for the amount of PAYE deducted by the employer rather than just the amount of PAYE paid to the Commissioner.

The second amends section LD 1(2A) to remove the reference to family assistance credits paid by the employer to their employee as the employer no longer pays family assistance.

The final amendment is to section LD 1(6)(b) to ensure that if too much PAYE is refunded to a shareholder employee the shareholder employee and the employer are jointly and severally liable for the difference between the amount refunded and the amount actually paid to the Commissioner by the employer. The current wording only recoups the difference between the amount refunded and the amount shown on the employer monthly schedule and therefore potentially benefits employers who underpay their PAYE to Inland Revenue.

These amendments apply from 3 April 2006, being the date of assent of the Act.

Companies required to maintain imputation credit accounts

Section ME 1 of the Income Tax Act 2004

A New Zealand-resident company must establish and maintain an imputation credit account (ICA) under section ME 1(1) of the Income Tax Act 2004 unless it is prohibited from doing so under any of the circumstances listed in section ME 1(2). Before an amendment made by the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004, section ME 1(2)(a) prohibited a company from having an ICA if it was "not resident in New Zealand". This provision was redundant and should have been repealed because only a New Zealand-resident company can have an ICA. However, the 2004 amendment replaced section ME 1(2)(a) with a provision that prohibited a company from having an ICA if it was "resident in a country other than New Zealand".

The 2004 amendment had the unintended effect of prohibiting all dual-resident companies from having an ICA. This should not be the case. Only a dual-resident company of the type listed in section ME 1(2)(b) – that is, a company treated as not being a New Zealand resident for the purposes of a double tax agreement – should be prohibited. Section ME 1(2)(a) has therefore been repealed with application from the 2005–06 income year (the same application date as the 2004 amendment).

Definition of "beneficiary income"

Section OB 1 of the Income Tax Act 1994

The definition of "beneficiary income" in section OB 1 of the Income Tax Act 2004 uses the term "income year". The term "income year" is defined as the tax year (ending 31 March) or the non-standard accounting year approved by Inland Revenue. The definition of "beneficiary income" provides for distributions to be made to beneficiaries during the income year or within six months after the end of the income year. The effect of the reference to "income year" is that the six-month period expires on a date that is six months after the (approved) balance date of the trust. This is different from the Income Tax Act 1994 where the period ended six months after 31 March (30 September). The Rewrite Advisory Panel considered a submission that the 2004 Act contains an unintended change from the 1994 Act. The Panel agreed that such a change had occurred, but decided that the 2004 Act should remain unchanged and that a retrospective change to the 1994 Act should be made to bring it into line with the 2004 Act.

The definition of "beneficiary income" in section OB 1 of the Income Tax Act 1994 has therefore been amended so that it applies to non-standard accounting years as well as years ending on 31 March. The amendment applies from the 1995–96 income year. The amendment to the 1994 Act protects the position of all options used by taxpayers by giving them the later of six months post-balance date (for those who followed the 2004 Act position) or 30 September (for those early balance date taxpayers who followed the previous 1994 Act position).

Removal of "in writing" requirement for requests for penalty remissions

Sections 183ABA and 183H of the Tax Administration Act 1994

Section 183H of the Tax Administration Act no longer requires requests for remission of late filing penalties, non-electronic filing penalties, or late payment penalties to be in writing. Changes made to section 183ABA are consequential amendments.

The removal of the "in writing" requirement for requests applies from 4 April 2006.

TAX ADMINISTRATION AMENDMENT ACT 2006

Exchange of information with the Ministry of Justice

The Tax Administration Amendment Act 2006 is one of nine Acts to result from the passage of the Courts and Criminal Matters Bill, introduced in May 2003. The new Act received the Royal assent on 9 April 2006.

The Act extends the categories of information that can be included in information matching programmes to enable the Ministry of Justice to locate individuals who default on payment of their fines. The new information that can be provided is the name, address and phone number of the fines defaulter's employer.

This is in addition to the fines defaulter's last known address, the date when that address was last changed, if known, and the fines defaulter's telephone number. That information was already available under existing law (section 85A(4) of the Tax Administration Act 1994).

The definition of "fines defaulter" is also extended so that the information can also be used to trace persons who default in payment of reparation.

ORDERS IN COUNCIL

STUDENT LOAN SCHEME CHARITABLE ORGANISATIONS

Section 87 of the Student Loan Scheme Act 1992

Under section 38AE 1(b) of the Act, a student loan borrower who has been personally absent from New Zealand because he or she was working as a volunteer or for token payment for a charitable organisation named in the regulations may be granted an exemption. An exemption entitles that borrower to a full interest write-off, which gives effect to the government's interest-free student loan policy.

Borrowers living overseas for more than six months will generally not qualify for the interest-free student loans policy which came into effect from 1 April 2006. However, the law gives the Commissioner of Inland Revenue to grant an exemption for certain borrowers who are overseas.

The charitable organisations covered by the exemption are:

- Adventist Development and Relief Agency International (ADRA);

- Alay Buhay Foundation Trust;
- Amnesty International;
- ANCOP Foundation International Inc;
- Anglican Social Services (Hutt Valley) Trust Board;
- Caritas Internationalis;
- ChildFund International;
- Christian Blind Mission International (CBMI);
- Christian World Service (CWS);
- CORSO Incorporated;
- Doctors Without Borders/Médecins Sans Frontières;
- ECPAT International;
- Habitat for Humanity International;
- Hibiscus Coast East Timor Appeal Trust (HETA Trust);
- IHC New Zealand Incorporated;
- International Federation of Red Cross and Red Crescent Societies;
- IN Network;
- International Save the Children Alliance;
- Mahitahi Catholic Overseas Volunteer Trust;
- Mobility Equipment for the Needs of Disabled Trust (MEND);
- New Zealand Family Planning Association Incorporated;
- New Zealand Vietnam Health Trust;
- Oxfam International;
- Pax Christi International;
- RedR International;
- Richmond Fellowship International (RFI);
- Rotary International;
- Soroptimist International;
- SurfAid International;
- Te Ora Hou Aotearoa Incorporated;
- TEAR Fund;
- The Cambodia Trust;
- The Foundation for Peace Studies Aotearoa/New Zealand Incorporated (The Peace Foundation);
- The Fred Hollows Foundation;
- The Leprosy Mission International (TLM);
- The Salvation Army International;
- The UMMA Trust;
- The Volunteer Ophthalmic Services Overseas Charitable Trust (VOSO);
- Trade Aid New Zealand Inc;
- United Nations Children's Fund (UNICEF);
- United Nations Development Fund for Women (UNIFEM);
- Vietnam Cambodia and Laos Support Network (VICALSN);
- Vision Pacific Charitable Trust;
- Volunteer Service Abroad Inc;
- World Vision International;
- WWF; and
- World Young Women's Christian Association (World YWCA).

The amendments were made by Order in Council on 27 March 2006 and came into force on 1 April 2006.

(Student Loan Scheme (Charitable Organisations) Regulations 2006, 2006–68)

NEW DETERMINATION

DETERMINATION G30: DEBT SECURITIES, FINANCE LEASES AND HIRE PURCHASE AGREEMENTS DENOMINATED IN NEW ZEALAND DOLLARS

Determination G30 allows financial institutions that adopt International Financial Reporting Standards (IFRS) to continue to use the same methods of calculating income and expenditure for most financial arrangements as under the previous rules – in particular, where income and expenditure from those financial arrangements were returned under the alternative method to yield to maturity.

The new Determination can apply where IFRS is used for financial reporting by persons in the business of lending money and to the holders of finance leases and hire purchase agreements. However, it does not apply to debt securities that are held or issued for dealing or liquidity purposes.

Where the new Determination applies, the pre-IFRS tax treatment of interest and principle payments can continue. Generally, that treatment was an alternative to the yield to maturity method under section EW 16 of the Income Tax Act 2004. However, a condition of adopting an alternative method was that the same method be used for both tax and financial accounting purposes. Following the adoption of IFRS, section EW 16 no longer sanctions use of the alternative method because the tax method would not be used by the taxpayer for financial accounting purposes. Determination G30 reinstates the status quo for interest and principle payments.

However, fee income and fee expenditure are recognised under the determination for tax purposes in the same manner as they are recognised under IFRS. Tax adjustments for impairment are not allowed.

The determination is intended to be a temporary measure to provide certainty of tax treatment while a legislative response to the introduction of IFRS is being developed.

The new Determination was published in the *New Zealand Gazette* on Thursday 30 March 2006 and may be applied to existing financial arrangements at that date and to new financial arrangements subsequently acquired.

REGULAR FEATURES

DUE DATES REMINDER

June 2006

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

July 2006

7 Provisional tax instalments due for people and organisations with a March balance date

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

31 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2006–2007*. This calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum.

INLAND REVENUE NATIONAL OFFICE PO BOX 2198 WELLINGTON TELEPHONE (04) 498 5800