TAX INFORMATION BULLETIN

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THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

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

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

The following draft item is available for review/comment this month, having a deadline of 11 May 2007.

Ref.	**Draft type**	**Description**
ED 0098	Standard practice statement	Discretions to be exercised by the Commissioner of Inland Revenue under the KiwiSaver Act 2006.

Please see page 93 for details on how to obtain a copy.

BINDING RULINGS

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

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

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

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

FORESTRY RIGHTS—SECONDHAND GOODS GST INPUT TAX DEDUCTION

PUBLIC RULING – BR PUB 07/01

Note (not part of ruling): This ruling is essentially the same as Public Ruling BR Pub 01/08, which was published in *Tax Information Bulletin* Vol 13, No 9 (September 2001). BR Pub 01/08 was a reissue of BR Pub 98/5, which was published in *Tax Information Bulletin* Vol 10, No 12 (December 1998). BR Pub 98/5 was a reissue of BR Pub 95/3, which was published in *Tax Information Bulletin* Vol 7, No 3 (September 1995). BR Pub 01/08 applied up until 30 September 2006. This ruling takes into account minor changes to the legislation since BR Pub 01/08 was issued. This ruling will apply for an indefinite period beginning on 1 October 2006.

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 the section 2(1) definition of "secondhand goods", section 3A(1)(c) definition of "input tax", and section 20(3).

The Arrangement to which this Ruling applies

The Arrangement is the supply to a GST-registered person of a "forestry right" (as defined in the Forestry Rights Registration Act 1983) by way of sale in the following circumstances:

- The sale is not a taxable supply; and
- The right is situated in New Zealand at the time of supply; and
- The right is acquired by the registered person for the principal purpose of making taxable supplies; and
- The right has been used by at least one prior owner for its intrinsic purpose.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- A forestry right is a secondhand good for which an input tax deduction is available within the section 2(1) definition of "secondhand goods", section 3A(1)(c) definition of "input tax", and section 20(3).

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 1 October 2006.

This Ruling is signed by me on the 22nd day of February 2007.

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 07/01

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusion reached in public ruling BR Pub 07/01 (the Ruling).

The subject matter covered in the Ruling was previously dealt with in public ruling BR Pub 01/08 (*Tax Information Bulletin* Vol 13, No 9 (September 2001)) under the heading "Forestry rights—secondhand goods GST input tax deduction: Public Ruling—BR Pub 01/08". BR Pub 01/08 was a reissue of BR Pub 98/5 (*Tax Information Bulletin* Vol 10, No 12 (December 1998)), which was a reissue of BR Pub 95/3 (*Tax Information Bulletin* Vol 7, No 3

(September 1995)). BR Pub 01/08 applied until 30 September 2006. This Ruling extends that coverage and applies for an indefinite period beginning on 1 October 2006.

Background

We have been asked to clarify whether a GST-registered person who buys a forestry right by way of a non-taxable supply may make a secondhand goods input tax deduction. It has been unclear whether a forestry right can be a secondhand good.

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

Legislation

Section 2 of the Forestry Rights Registration Act 1983(FRRA) defines "forestry right" (for the purposes of that Act):

Forestry right means a right created in accordance with this Act:

Section 2A of the FRRA deals with the creation of forestry rights. It states:

2A Creation of forestry rights

(1) A forestry right may be created by the proprietor of land—
  (a) By creating in accordance with subsection (3); or
  (b) By granting to any other person; or
  (c) By reserving to the proprietor on the sale of the land,—
  the right to—
  (d) Establish, maintain, and harvest; or
  (e) Maintain and harvest,—
 a crop of trees on that land.
(2) The forestry right may also—
  (a) Grant or reserve rights of access and rights of construction and use of tracks, culverts, bridges, buildings, and other works and facilities if those rights are ancillary to and necessary for the purposes of subsection (1):
  (b) Provide for charges, payments, royalties, or division of the crop or the proceeds of the crop,—
 whether or not such rights or provisions are coupled with an obligation.
(3) Despite any enactment or rule of law, the proprietor may, in accordance with this section, create a forestry right for the proprietor.
(4) No right created under this section is capable of conferring a right of exclusive possession of the land.

Section 3(1) of the FRRA states:

Notwithstanding any rule of law or equity to the contrary, every forestry right shall be deemed to be a *profit à prendre*.

Section 2(1) of the Goods and Services Tax Act 1985 defines "goods":

Goods means all kinds of personal or real property; but does not include choses in action, money or a product that is transmitted by a non-resident to a resident by means of a wire, cable, radio, optical or other electromagnetic system or by means of a similar technical system:

Section 3A(1)(c) defines "input tax" in relation to secondhand goods:

(1) Input tax, in relation to a registered person, means—
 …
  (c) an amount determined under subsection (3) after applying subsection (2).

Section 20(3) allows deductions from output tax, and states:

(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—
  …
   (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:
  …
  (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:

Application of the Legislation

Under sections 2(1), 3A, and 20(3), seven conditions must be met before the purchase of a forestry right by a GST-registered person will permit a secondhand goods input tax deduction.

- Forestry rights must be "goods" as defined in section 2(1).
- The supply of a forestry right must be by way of sale.
- The supply of the forestry right must be a non-taxable supply.
- The sale must involve payment in the taxable period for which an input tax deduction is sought.
- The forestry right must be secondhand.
- The forestry right must be acquired for the principal purpose of making taxable supplies.

- The forestry right must be situated in New Zealand at the time of sale.

The following paragraphs consider some of these requirements.

"Goods"

The Commissioner considers that a forestry right (as defined in section 2 of the FRRA) is a "good" for GST purposes. "Goods" means all real and personal property but does not include choses in action. Section 3(1) of the FRRA deems forestry rights to be *profits à prendre*. A *profit à prendre* is a right to take something off another person's land. A *profit à prendre* is an interest in land. It is not a chose in action because the rights under a *profit à prendre* are of a possessory nature, whereas a chose in action can be enforced only by action. An example of a "chose in action" is the granting of a licence at a boat marina. The benefits arising from the licence cannot be obtained by taking possession of the licence, but by action against a licensor who refuses to honour the licence. On the other hand, a forestry right, which can be enforced by taking possession, is real property and a "good" for GST purposes.

"Sale"

A secondhand goods input tax deduction is available only if there is a supply by way of sale. Forestry rights are a form of transferable property right, like other *profits à prendre*, and may be sold. It will be a question of fact whether there has been a sale rather than a lease or sub-grant of a forestry right. Because of the definition of "input tax" in section 3A, a secondhand goods input tax deduction is available only where there is a sale (section 3A(2)).

The sale must be by way of a non-taxable supply for an input tax deduction to be available.

"Payment"

An input tax deduction is available only to the extent that there has been payment for the goods in the relevant taxable period. Therefore, if there is a sale by instalments, input tax deductions are available only in the taxable period in which each instalment is paid.

"Secondhand"

The forestry right must be "secondhand" before an input tax deduction is available. The Commissioner considers that land is a secondhand good. This is supported by case law (e.g. *Case* N13 (1991) 13 NZTC 3105). The Court of Appeal decision in *Coveney v CIR* (1995) 17 NZTC 12,193 appears to have confirmed this view, notwithstanding earlier obiter dicta that land may not be a secondhand good in *L R McLean v CIR* (1994) 16 NZTC 11,211 (CA) and *King v Bennetts* (1994) 16 NZTC 11,370.

However, when a specific interest in land, like a forestry right, is newly created, it is a unique mix of rights distinct from the original land over which it was created. Accordingly, the original creation of a forestry right cannot be a sale of secondhand goods. The forestry right is a new item of property. Before a forestry right can be a secondhand good, at least one prior owner must have made use of the right for its intrinsic purpose (e.g. *L R McLean v CIR*) being some exercise of the rights conferred by the forestry right. A forestry right is a bundle of rights giving its owner the right to:

- establish, maintain, and harvest; or
- maintain and harvest,

a crop of trees on that land.

The forestry right will be considered a secondhand good so long as the prior owner has used the forestry right for its intrinsic purpose, namely has exercised some of the rights provided under that forestry right (e.g. the prior owner has established, maintained, and/or harvested a crop of trees).

Examples

Example 1

Purchaser is a GST-registered person who intends to enter the forestry industry in a small way. On 1 October 2006 she buys a forestry right from Supplier, who is not registered for GST. Supplier had bought the right 18 months earlier from a farmer who had decided not to diversify into forestry. Supplier had used the right on a small scale to remove a small amount of timber. The purchase price is $20,000 payable in four quarterly instalments. The first payment is made on 1 November 2006. Purchaser is entitled to a secondhand goods input tax deduction because the forestry right was disposed of by sale, the seller was unregistered (non-taxable supply), the forestry right was secondhand, and Purchaser acquired the right for the principal purpose of making taxable supplies. In Purchaser's next GST return (for the 2 months ending 30 November 2006) she should deduct as input tax the tax fraction of the amount of the first instalment ($5000). Accordingly, she may deduct $555.55.

Example 2

The same facts as example 1, but neither the Supplier nor any other previous owner has harvested any trees, but the Supplier has used the existing forestry right to plant a crop of trees on the land. Once again a secondhand goods credit would be available as the Supplier has used the forestry right for one of its intrinsic purposes, being the right to establish a crop of trees.

FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA) – FRINGE BENEFIT TAX (FBT) LIABILITY

PUBLIC RULING - BR PUB 07/02

Note (not part of ruling): This ruling replaces Public Ruling BR Pub 01/05 published in *Tax Information Bulletin* Vol 13, No 7 (July 2001)). This new ruling is essentially the same as the previous ruling. However, the new ruling has been updated and applies the Income Tax Act 2004 instead of the equivalent provisions in the Income Tax Act 1994. The changes between the provisions of the 1994 and 2004 Acts affecting this ruling do not affect the conclusions previously reached.

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

Taxation Laws

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

This Ruling applies in respect of sections CX 12, CX 13 and CX 31.

The Arrangement to which this Ruling applies

The Arrangement is the deduction of contributions from wages payable to employees and the payment of these contributions, together with employer contributions, to the United States Federal Government in accordance with the Federal Insurance Contributions Act ("FICA"), by an "American employer" (as defined in FICA) who is required to do so because the employer employs a citizen or citizens of the United States of America.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- Employer contributions paid under FICA do not give rise to a "fringe benefit" under section CX 12 as the contributions are not made for the benefit of employees.
- Employer contributions paid under FICA do not give rise to a "fringe benefit" under section CX 13. As trust funds established for the purpose of paying disability benefits or Medicare and funded by contributions under FICA were not established for the benefit of employees and have not been approved by the Commissioner, they are not "sick, accident or death benefit funds" as defined in section OB 1.
- Employer contributions paid under FICA do not give rise to an "unclassified benefit" in terms of section CX 31 as a benefit is not provided by employers in connection with the employment of employees through the payment of employer contributions under FICA.
- Employee contributions required to be deducted from wages and paid under FICA do not give rise to an "unclassified benefit" as such contributions represent part of the assessable income of employees and are expressly excluded from the definition of "fringe benefit" by section CX 4.

Therefore, payments required under FICA are not subject to fringe benefit tax ("FBT").

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 July 2004 and ending on 30 June 2009.

This Ruling is signed by me on the 12th day of March 2007.

Martin Smith
Chief Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 07/02

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 07/02 ("the Ruling").

Background

The Federal Insurance Contributions Act (FICA) is the part of the US Internal Revenue Code under which employers and employees are required to make payments for the funding of social security benefits. In some circumstances an employer who employs an employee to provide services in New Zealand is required to comply with obligations under the FICA legislation. FICA applies when an "American employer" pays wages for services performed as an employee by a US citizen outside the US: sections 3101 and 3111 and the definition of "employment" in section 3121 Internal Revenue Code. "American employer" means the US Government or its instruments, residents of the US or companies that are organised under the laws of the US.

If FICA applies, employers must make deductions from wages payable to an employee in respect of Old-Age Survivors and Disability Insurance ("OASDI") and Hospital Insurance (known as "Medicare"), and must pay the deductions to the Internal Revenue Service. In addition, employers are required to make payments for OASDI and Medicare (employer contributions) at the same rate. The current rate in respect of OASDI is 6.2 percent and in respect of Medicare the rate is 1.45 percent. An employer who fails to make the required payments or fails to make the payments on time is liable for a penalty.

Under FICA amounts deducted from wages payable to employees are deemed to have been paid to employees at the time of deduction (Internal Revenue Code 26 US Chapter 21 section 3123). FICA does not provide for recovery of OASDI or Medicare payments imposed on employees from an employee where the employer has failed to make deductions.

Payments collected under FICA are paid into the US Treasury's General Fund and are appropriated to three separate funds: the Federal Hospital Insurance Trust Fund; the Federal Old-Age and Survivors Insurance Trust Fund; and the Federal Disability Insurance Trust Fund. Amounts held in these funds are not held for any particular individual.

A person must be a US citizen or legally resident in the US to be entitled to social security benefits (Public Law 104-193; Personal Responsibility and Work Opportunity Act 1996).

Under the US social security legislation (Public Health and Welfare Code, 42 USC Chapter 7) a person must hold not less than 40 credits to be entitled to a retirement benefit. The amount needed to gain a credit changes from year to year. Currently a credit is gained for every quarter in which an employee earns more than $970 from employment. No more than four credits can be gained in respect of a year. The minimum age to qualify for a retirement benefit depends on when a person was born.

However, a person could qualify for a disability benefit with fewer credits, depending on their age. To be entitled to a disability benefit:

- A person must have a medical condition that meets the definition of "disability" in the social security legislation; and
- Twenty of the 40 credits required to qualify for a disability benefit must have been earned in the 10 years ending in the year in which the person became disabled.

If a person who is covered by social security dies, their surviving spouse or dependent children can receive a survivors benefit. The right to retirement, survivors and disability benefits cannot be assigned or transferred.

The amount of the monthly benefit paid depends on the person's earnings during the person's working life and the age at which the person retires. The amount of the benefit is calculated according to a formula in the legislation.

People aged 65 or older are entitled to receive Medicare benefits if they:

- Receive a social security benefit;
- Have worked long enough to be eligible for a social security benefit;
- Would be entitled to a social security benefit based on their spouse's work record and their spouse is aged at least 62; or
- Have worked long enough in a federal, state or local government job to be insured for Medicare.

People aged under 65 who receive disability benefits or who have permanent kidney failure may qualify for Medicare.

Legislation

"Fringe benefit" is defined in section CX 2(1) as follows:

A **fringe benefit** is a benefit that—

(a) is provided by an employer to an employee in connection with their employment; and

(b) either—

  (i) arises in a way described in any of sections CX 6, CX 8, CX 9, or CX 11 to CX 15; or

  (ii) is an unclassified benefit; and

(c) is not a benefit excluded from being a fringe benefit by any provision of this subpart.

Section CX 12 provides:

(1) A fringe benefit arises when an employer contributes to a superannuation scheme for the benefit of an employee.

(2) This section does not apply if the contribution is a specified superannuation contribution.

Section CX 13 provides:

A fringe benefit arises when an employer makes a contribution for the benefit of an employee to a sickness, accident, or death benefit fund.

"Unclassified benefit" is defined in section CX 31 as follows:

Unclassified benefit means a fringe benefit that arises if an employer provides an employee with a benefit in connection with their employment that is—

  (a) not a benefit referred to in any of sections CX 6 to CX 15; and

  (b) not a benefit excluded under this subpart.

Section CX 4 provides:

To the extent to which a benefit that an employer provides to an employee in connection with their employment is assessable income, the benefit is not a fringe benefit.

"Superannuation scheme" is defined in section OB 1 as follows:

superannuation scheme—

(a) means—

(i) a trust or unit trust established by its trust deed mainly for the purposes of providing retirement benefits to beneficiaries who are natural persons or paying benefits to superannuation funds; or

(ii) a company that is not a unit trust, is not resident in New Zealand, and is established mainly for the purpose of providing retirement benefits to members or relatives of members who are natural persons; or

(iii) an arrangement constituted under an Act of the Parliament of New Zealand, other than the Social Security Act 1964, mainly for the purpose of providing retirement benefits to natural persons; or

(iv) an arrangement constituted under the legislation of a country, territory, state, or local authority outside New Zealand mainly for the purpose of providing retirement benefits to natural persons; and

when referring to a superannuation scheme that is a trust, means the trustees of the scheme.

The definition of "arrangement" in section OB 1 reads as follows:

Arrangement means a agreement, contract, plan or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect.

The definition of "sickness, accident or death benefit fund" in section OB 1 reads as follows:

sickness, accident, or death benefit fund means a sickness, accident, or death benefit fund that is—

(a) established for the benefit of—

(i) employees; or

(ii) the members of an incorporated society; or

(iii) the surviving spouses and dependants of those employees or members; and

(b) approved by the Commissioner

Application of the legislation

Liability for FBT

Whether an employer is required to pay fringe benefit tax (FBT) in respect of either employer or employee contributions made under FICA depends on whether the employer has provided or granted a "fringe benefit" (section ND 1(1)). There will be a "fringe benefit" where:

- A benefit arises in a way described in any of section CX 6, section CX 8, section CX 9 or sections CX 11 to CX 15 or a benefit of any other type is provided by an employer to an employee in connection with their employment (an "unclassified benefit"); and
- The benefit is not excluded from being a fringe benefit by any provision of subpart CX.

In Australian cases, in the FBT context, the courts have considered that a fringe benefit will not be provided unless there is a link between the benefit and a particular employee: see *Essenbourne Pty Ltd v Commissioner of Taxation* (2002) ATC 5201; *Walstern v Commissioner of Taxation* 2003 ATC 5076; *Cameron Brae Pty Ltd v FCT* 2006 ATC 4433. The Commissioner considers that this principle also applies in the New Zealand context. As with the Australian legislation, the wording of the legislation suggests that it contemplates a benefit provided to a particular employee. The definition of "fringe benefit" in section CX 2(1) refers to "a benefit that is provided by an employer to an employee in connection with their employment". Sections CX 12 and CX 13 also refer to "a contribution for the benefit of an employee". As with the Australian legislation, under the valuation provisions any payment made by the employee is to be taken into account in determining the taxable value of the fringe benefit. The need for a link between the benefit and an employee is consistent with the purpose of the FBT provisions. FBT was intended to apply to non-cash remuneration provided to an employee and although liability for FBT is imposed on the employer, the theoretical basis for the imposition of FBT is that it is payable in respect of amounts that are essentially (or would be) income of an employee.

Contributions to superannuation scheme: section CX 12

Under section CX 12 a fringe benefit arises when an employer makes a contribution to a superannuation scheme (other than a specified superannuation contribution) for the benefit of an employee.

The definition of "superannuation scheme" in section OB 1 includes an arrangement constituted under the legislation of a country, territory, state or local authority outside New Zealand mainly for the purpose of providing retirement benefits to natural persons (paragraph (a)(iv) of the definition).

Superannuation scheme

The definition of "superannuation scheme" specifically includes an arrangement constituted under legislation.

FICA requires employer and employee contributions to fund social security benefits, including retirement benefits. The US social security legislation contains the provisions relating to eligibility for retirement benefits and the payment of retirement benefits. These two

pieces of legislation together establish a system for the funding and payment of social security benefits, including retirement benefits. Therefore, there is an arrangement that is constituted under US legislation (the US social security legislation and FICA).

The Federal Old-Age and Survivors Insurance Trust Fund was established under FICA (Internal Revenue Code Chapter 7 section 401). Under the US social security legislation an amount equal to 100 percent of the amount collected from employees and employers in respect of OASDI is appropriated to that trust fund (42 USC section 401). Monthly retirement benefits and survivors benefits are paid out of that trust fund. (A separate trust fund to be known as "the Federal Disability Insurance Trust Fund" is also established under the social security legislation.) The social security legislation sets out the conditions for entitlement to retirement benefits and provides for the payment of retirement benefits (42 US section 402).

For paragraph (a)(iv) of the definition of "superannuation scheme" to apply, the arrangement must be mainly for the purpose of providing retirement benefits.

Payments under FICA are appropriated to the Federal Old-Age Survivors Insurance Trust Fund and are to be used for the purpose of funding retirement benefits. Survivors' benefits are also paid out of the fund to the widows, widowers and children of people who would have been entitled to receive a retirement benefit (that is, benefits could be paid out of the trust fund to people who have not reached retirement age). However, such people would be entitled to receive a benefit only if a person who qualifies for a retirement benefit has died. The principal object of creating the trust fund is to provide for the payment of retirement benefits.

FICA is part of a legislative scheme for the provision of social security benefits by the US Federal Government, which is the equivalent of provision of benefits under the New Zealand Social Security Act 1964. In *Roe v Social Security Commission* (10 April 1987) unreported, High Court, Wellington, M 270/86, Davison CJ) the plaintiff was the recipient of a social security retirement benefit paid by the US Government. The issue was whether the benefit formed part of a programme providing benefits, pensions or periodical allowances for any of the contingencies for which benefits, pensions or allowances could be paid under the New Zealand Social Security Act. Davison CJ commented:

> The US retirement benefit is clearly on the evidence a benefit paid by the US Government of the same type as a NZ national superannuation benefit. Both are paid by the respective Governments and both are part and parcel of programmes for assistance to age-related beneficiaries. (p. 8)

The Commissioner considers that payments made under FICA and appropriated to the Federal Old-Age and Survivors Insurance Trust Fund are paid under an arrangement constituted under US legislation mainly for the purpose of providing retirement benefits to natural persons. Therefore, there is a superannuation scheme that is constituted under the social security legislation and FICA in terms of paragraph (a)(iv) of the definition of "superannuation scheme". This differs from the view expressed in the Commissioner's previous ruling on this issue (BR Pub 01/05). However, for section CX 12 to apply, payments made by employers under FICA must be contributions for the benefit of an employee.

Whether contributions are for the benefit of employees

Payments employers are required to make under section 3111(a) of FICA are tax. Section 3111(a) imposes on every employer "an excise tax, with respect to having individuals in his employ". An excise tax is "a tax upon an activity" (CCH *Federal Tax Guide Reports* paragraph 21,001), in this case a tax imposed in respect of employment (*Helvering v Davis* 57 SC 904).

However, a payment by an employer could be a contribution although the employer has a statutory obligation to make the payment. In *Case M9* (1990) 12 NZTC 2069 it was held that the predecessor of section CX 12 applied to contributions made by a local authority to the National Provident Fund, although the employer did not have a choice about making the contributions. Judge Bathgate considered that the focus of the FBT legislation was whether the contributions could be regarded as a benefit from the employees' point of view. Judge Bathgate said:

> The objector's claim that the superannuation payments by the objector on behalf of its employees compulsorily paid by it under the National Provident Fund Act, are not benefits because it had no choice as to whether to make the payments is to an extent understandable, from the employer's point of view. A benefit is often regarded as being given voluntarily, rather than compulsorily. A benefit may however be given under compulsion in some circumstances — *Yates v Starkey* [1951] 1 All ER 732. From the employees' point of view, and after all Pt XB of the Income Tax Act is only concerned with benefits received by employees, albeit from employers, the contributions to the superannuation fund can be considered as a benefit. (p. 2073)

In *Yates v Starkey*, referred to by Judge Bathgate, the Court of Appeal held that a person who had been ordered by the court to pay his wife an annual amount in trust for his children had provided funds for the purpose of the settlement of a trust. Jenkins LJ commented:

> I do not agree that the words "has provided" necessarily connote an exercise of free will. It seems to me that the taxpayer here if asked "Who is providing for the maintenance for your children?" could with perfect accuracy have replied "I am doing so under an order of the court". (p. 479)

However, for section CX 12 to apply the contribution must be for the benefit of an employee. In *Case M9*, although the employer was required by the National Provident Fund Act to make contributions, the objective of the contributions was to provide a benefit to employees under the National Provident Fund.

In *NZI Bank Ltd v Euro-National Corporation Ltd* [1992] NZLR 528 Richardson J made the following comments in respect of the interpretation of the phrase "for the benefit of employees":

> It is not sufficient to satisfy para (b) that the shares are to be held on trust for employees. The shares must be held "for the benefit" of employees. "For" in that context means with the object and purpose of benefiting employees and the "benefit" to employees must be discernible and real. As in the case of the exercise of trustees' powers to make advances for a person's benefit, it must confer an advantage which can be enjoyed by employees. It must be of value to employees. An arrangement does not qualify as being "for the benefit of employees" unless employees actually stand to benefit. (p. 544)

Hence, for a contribution to be "for the benefit of an employee" in terms of section CX 12, the contribution must be made for the purpose of benefiting the employee and the contribution must provide something of real value to the employee.

Employer contributions required under FICA are not hold in trust for any employee. The US Social Security system for the payment of retirement benefits is a pay-as-you-go scheme under which current employer and employee contributions are used to fund the payment of retirement benefits to current recipients of retirement benefits. Neither employer nor employee contributions are allocated to, or held for, individual employees.

Payments that an employer must make under FICA are not attributable to any particular employee. Excise tax is calculated on the total wages paid by the employer. Employees are not entitled to receive a refund of payments made either by employers or employees under FICA. The entitlement of employees to a retirement benefit does not depend on whether the employer has paid the excise tax imposed on the employer under FICA. To qualify for a retirement benefit, a person must be a "fully insured individual" (42 USC 402(a)(1)). To be a "fully insured individual" a person must hold sufficient credits (that is, a minimum of 40 credits). The number of credits earned is based on the amount of the employees' earnings over their working life and not on the payment of employer contributions. Payments made by employers under FICA also do not affect the amount of the benefit payable. The amount of the retirement benefit is based on average earnings over a person's working life, indexed to account for changes in average wages.

Employees cannot transfer or assign their right to any future benefit (42 USC 407). *Flemming v Nestor* 363 US 603 establishes that a person who makes payments under FICA does not as a consequence acquire a right to a benefit analogous to a property right.

The Commissioner considers that payments of excise tax under FICA are not made by employers for the benefit of any particular employee as:

- Employee contributions are not held in trust for any individual employee;
- Employees are not entitled to receive any part of the contributions made by employers;
- Employees do not obtain the right to a retirement benefit as a consequence of the payments made by employers; and
- The payment of employer contributions by employers does not affect the amount of the benefit payable to employees.

Therefore, such payments do not give rise to a fringe benefit in terms of section CX 12.

Contributions to sickness, accident or death benefit fund: section CX 13

Under section CX 13 a fringe benefit arises when an employer makes a contribution for the benefit of an employee to a sickness, an accident or a death benefit fund.

The definition of "sickness, accident, or death benefit fund" refers to a sickness, an accident, or a death fund that is:

- Established for the benefit of employees, the members of an incorporated society, or the surviving spouses and dependants of those employees; and
- Approved by the Commissioner.

Under the US social security legislation separate funds are established for the payment of disability benefits and Medicare (the Federal Disability Insurance Trust Fund and the Hospital Insurance Trust Fund). Self-employed people can also earn credits so that they are entitled to receive disability benefits or Medicare. The funds are not limited to the employees of a particular employer or to employees in general. They were established to fund the payment of government-provided disability benefits and hospital and medical benefits that are available to all people who earn sufficient credits to qualify for benefits and satisfy the other conditions set out in the US legislation. Payments by employers do not directly affect employees' entitlement to disability benefits or Medicare. Whether the employer pays employer contributions does not affect the employees' entitlement to disability benefits or Medicare or the amount of the benefit.

The Commissioner considers that neither the Disability Insurance Fund nor the Hospital Insurance Trust Fund was established for the benefit of employees. The funds were not established for the benefit of a particular employer's employees and were not established for the benefit of employees alone. Employees do not obtain a right to receive Medicare or disability benefits as a consequence of the payments made by their employer.

To be a sickness, an accident or a death fund within the statutory definition, a fund must also be approved by the Commissioner. As the Commissioner has not approved either the Federal Disability Insurance Fund or the Hospital Insurance Fund, the funds cannot be sickness, accident or death benefit funds for the purpose of section CX 13.

Therefore, the Commissioner considers that a benefit does not arise in terms of section CX 13 as a consequence of payments required to be made by employers in respect of the Federal Disability Insurance Trust Fund or the Hospital Insurance Trust Fund under FICA as these funds are not sickness, accident or death funds as defined in section OB 1.

Unclassified benefit: section CX 31

The definition of "unclassified benefit" in section CX 31 refers to a benefit an employer provides to an employee "in connection with their employment" other than the benefits referred to in any of sections CX 6 to CX 15.

"Benefit" is not defined for FBT purposes. Therefore, the ordinary meaning of "benefit" applies. In *CIR v Dick* (2001) 20 NZTC 17,396 Glazebrook J commented as follows on the meaning of "benefit":

> [48] The *New Shorter Oxford Dictionary* (1993 ed) defines benefit (in relevant part) as: a favour, gift, a benefaction, an advantage, a good, pecuniary profit. Likewise the definition of advantage is: a favouring circumstance, something which gives one a better position, benefit. Looking at the dictionary meaning of those words it would appear that something may not be a benefit or advantage if it has been acquired through the provision of services or goods at market value. This, therefore, is in contrast to the definition of income.

The Commissioner considers that in the FBT context a "benefit" is an advantage, a material acquisition that confers an economic benefit on an employee. As outlined in "QB0043 The meaning of 'benefit' for FBT purposes" (published in *Tax Information Bulletin* Vol 18, No 2 (March 2006)), in considering whether a benefit has been provided to an employee it is not relevant that the employee made a payment for what is provided.

For there to be a "fringe benefit", the benefit must be provided by an employer to an employee in connection with their employment. The meaning of the phrase "in connection with" was considered in *Claremont Petroleum NL v Cummings* (1992) 110 ALR 239. Wilcox J said:

> The phrase "in connection" is one of wide import, as I had occasion to observe in a different context in *Our Town FM Pty Ltd v Australian Broadcasting Tribunal* (1987) 16 FCR 465 at 479-80; 77 ALR 577 at 591-592:
>
>> The words "in connection with"…. do not necessarily require a causal relationship between two things: see *Commissioner for Superannuation v Miller* (1985) FCR 153 at 154, 160, 163; 63 ALR 237 at 238, 244, 247. They may be used to describe a relationship with a contemplated future event, see *Koppen v Commissioner for Community Relations* (1986) 11 FCR 360 at 364; 67 ALR 215; *Johnson v Johnson* [1952] P47 at 50 1. In the latter case the United Kingdom Court of Appeal applied a decision of the British Columbia Court of Appeal, *Re Nanaimo Community Hotel Ltd* [1945] 3 DLR 225, in which the question was whether a particular court, which was given "jurisdiction to hear and determine all questions that may arise in connection with any assessment made under this Act", had jurisdiction to deal with a matter which preceded the issue of an assessment. The trial judge held that it did, that the phrase "in connection with" covered matters leading up to, or which might lead up to an assessment. He said:
>>
>>> "One of the very generally accepted meanings of 'connection' is 'relation between things one of which is bound up with or involved in another', or again 'having to do with'. The words include matters occurring prior to as well as subsequent to or consequent upon so long as they are related to the principal thing. The phrase 'having to do with' perhaps gives as good a suggestion of the meaning as could be had."
>>
>> This statement was upheld on appeal. (p 280)

Hardie Boys J made the following comments on the meaning of "in connection with" in *Strachan v Marriott* [1995] 3 NZLR 272:

> "In connection with" may signify no more than a relationship between one thing and another. The expression does not necessarily require that it be a causal relationship: *Our Town FM Pty Ltd v Australian Broadcasting Tribunal* (1987) 16 FCR 465, 479 per Wilcox J. But, as Davies J warned in *Hatfield v Health Insurance Commission* (1987) 15 FCR 487, at p 491:
>
>> Expressions such as 'relating to', 'in relation to', 'in connection with' and 'in respect of' are commonly found in legislation but invariably raise problems of statutory interpretation. They are terms which fluctuate in operation from statute to statute . ... The terms may have a very wide operation but they do not usually carry the widest possible ambit, for they are subject to the context in which they are used, to the words with which they are associated, and to the object or purpose of the statutory provision in which they appear. (pp. 279-281)

In *The Queen v Savage* [1983] CTC 393 Dickson J in the Supreme Court of Canada commented:

> 23 ….Our Act contains the stipulation, not found in the English statutes referred to, "benefits of any kind whatever ... in respect of, in the course of, or by virtue of an office or employment". … Further, our Act speaks of a benefit "in respect of" an office or employment. In *Nowegijick v The Queen*, [1983] C.T.C. 20, 83 D.T.C. 5041 this Court said, at 25 [5045], that:
>
> **The words "in respect of" are, in my opinion, words of the widest possible scope. They import such meanings as "in relation to", "with reference to" or "in connection with"**. The phrase "in respect of" probably the widest of any expression intended to convey some connection between two related subject matters.
>
> See also *Paterson v. Chadwick,* [1974] 2 All ER 772 (QBD) at 775. [Emphasis added]

Therefore, the phrase "in connection with" is used to describe a relationship between two things, but not necessarily a causal relationship. The phrases "in connection with", "in relation to" and "in respect of"

have similar meanings. These expressions are capable of having a very wide meaning. The degree of the relationship required depends on the context in which the expression is used.

In the Australian FBT context, the courts have considered that it cannot be said that any causal relationship between the benefit and the employment is a sufficient relationship for FBT purposes and that a sufficient or material rather than a causal connection or relationship between the benefit and the employment must be established: see *J & G Knowles & Associates Pty Ltd v FCT 2000* ATC 4151. In that case, the court considered that it was helpful to consider whether the benefit is a product or incident of the employment. The Commissioner considers that this approach would also be appropriate in the New Zealand context, given that FBT was intended to apply to non-cash remuneration provided to employees.

The Commissioner considers that where the employment is a substantial reason for the provision of the benefit, there would be a sufficient relationship between the benefit and the employment (see "QB0043 The meaning of 'benefit' for FBT purposes" (published in *Tax Information Bulletin* Vol 18, No 2 (March 2006))).

Employer contributions

The Commissioner considers that employer contributions do not give rise to a benefit that is provided by the employer in connection with the employment of any employee. It is not possible to establish a link between a benefit arising from the payment of employer contributions and any particular employee. The reasons are as follows:

- Employees do not obtain a benefit in the form of an entitlement to receive payments made by employers under FICA. Employees have no beneficial entitlement to amounts paid by them or by their employer under FICA.
- An employee's right to receive a social security benefit is conditional on the employee satisfying the eligibility requirements in the social security legislation. When the right to receive payment from a fund is conditional, a benefit would not be provided when payment is made to the fund (*Constable v Commissioner of Taxation* 5 ATD 83). In *Constable* the taxpayer was the member of a provident fund established for the employees of the Shell group of companies. Both employer and employee contributions were paid to the fund. The fund's regulations permitted members to withdraw the amount held on their behalf if an amendment was made to the regulations that curtailed their rights. Such an amendment was made with effect from 30 September 1947. The taxpayer withdrew amounts held to his credit (including the employer's contributions and interest earned on the amount contributed). The High Court of Australia held that these amounts did not constitute an allowance, a gratuity, compensation, a benefit, a bonus or a premium in respect of or for or in relation to the taxpayer's employment or services rendered by him. Dixon CJ and McTiernan, Williams and Fullager JJ in their joint judgment commented:

  > It appears to us that the taxpayer becomes entitled to a payment out of the fund by reason of a contingency (viz an alteration of the regulations curtailing the rights of members) which occurred in the year enabling him to call for the amounts shown by his account. It was a contingent right which became absolute. The happening of the event which made it absolute did not, and could not amount to an allowing, giving or granting to him of any allowance, gratuity, compensation, benefit, bonus or premium. The fund existed as one to a share in which he had a contractual, if not a proprietary title. All that occurred in the year of income with respect to the sums in question was that the future and contingent or conditional right became [a] right to present payment and payment was made accordingly.
  >
  > ….
  >
  > It is not of course, a matter which arises for decision in the present case, but to avoid misunderstanding it is we think desirable to say that on the frame of the regulations we find it by no means easy to see how the sums so contributed can be regarded as allowed, granted or given to the employee when they are paid to the Administrators of the Fund. It is only after the Administrators have exercised their discretion that the moneys paid to the special account are reflected in the member's (employee's) account and even then that does not mean that the member becomes presently entitled to the moneys credited to that account. (pp. 95-96)

- A benefit (either in the form of a social security benefit or the right to receive a social security benefit) would not be provided when payments are made by the employer under FICA. Employees must satisfy the statutory criteria (including citizenship or residence requirements, reaching retirement age, disability, earning the minimum number of credits) before a benefit would be paid to the employees. *Fleming v Nestor* 363 US 603 confirms that a right to receive future benefits does not accrue as a consequence of payments made by the employer under FICA.
- The substantial reason for payment or the provision of retirement, disability or Medicare benefits to an employee is that the employee satisfies the statutory criteria for eligibility to receive the benefit. The amount of any benefit paid is not related to the payments made under FICA. The amount depends on a person's earnings history (whether as an employee or a self-employed person). Therefore, there is an insufficient relationship between the payment of a social security benefit and payments made by the employer under FICA.

Employee contributions

The Commissioner considers that the deduction of employee contributions from wages and the payment of such contributions under FICA also do not give rise to a benefit in connection with the employee's employment. As employee contributions form part of the salary or wages paid to employees, employee contributions are assessable income of employees in terms of section CE 1(1)(a). That being the case, such contributions are specifically excluded from the definition of "fringe benefit" by section CX 4. In *Case* 207 CTBR(NS) 91 it was accepted that deductions made under FICA from the salary paid to an Australian resident who was a visiting professor at a university in the US was assessable income of the taxpayer. The issue was whether the amount deducted under FICA was exempt income (on the basis that a liability for income tax in the US had been paid).

Summary

For there to be an FBT liability, the employer must have provided a "fringe benefit" to an employee.

- Employer contributions paid under FICA do not give rise to a "fringe benefit" under section CX 12 as the contributions are not made for the benefit of employees.
- Employer contributions paid under FICA do not give rise to a "fringe benefit" under section CX 13. As trust funds established for the purpose of paying disability benefits or Medicare and funded by payments under FICA were not established for the benefit of employees and have not been approved by the Commissioner, the funds are not "sick, accident or death benefit funds" as defined in section OB 1.
- Employer contributions under FICA do not give rise to an "unclassified benefit" in terms of section CX 31 as a benefit is not provided by employers in connection with the employment of employees through the payment of employer contributions under FICA.
- Employee contributions do not give rise to an "unclassified benefit". Employee contributions required to be deducted from wages and paid under FICA represent part of employees' assessable income and are expressly excluded from the definition of "fringe benefit" by section CX 4.

Therefore, payments required under FICA are not subject to FBT.

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.

2007 INTERNATIONAL DISCLOSURE EXEMPTION ITR18

Introduction

Section 61 of the Tax Administration Act 1994 (TAA) requires people to disclose interests they hold in foreign entities.

Under section 61(1) of the TAA, a person who has a control or income interest in a foreign company or an attributing interest in a foreign investment fund (FIF) at any time during an income year must disclose the interest held. However, section 61(2) allows the Commissioner of Inland Revenue to exempt any person or class of persons from this requirement if disclosure is not necessary for the administration of the international tax rules (as defined by section OB 1) contained in the Income Tax Act 2004 (ITA).

Under section 61(2), the Commissioner has issued an international tax disclosure exemption which applies for the income year ended 31 March 2007. This exemption may be cited as "International Tax Disclosure Exemption ITR18", and the full text appears at the end of this item.

Scope of exemption

The scope of the 2007 disclosure exemption is the same as the 2006 exemption.

Interests held by residents

Disclosure is required by residents for these interests:

- an attributing interest held in an FIF in respect of which FIF income or FIF loss arises
- an income interest of 10% or more held in a foreign company. The disclosure obligation applies in respect of all foreign companies regardless of the country of residence.

An "income interest of 10% or greater" is defined in section OB 1 of the ITA. For the purposes of determining exemption from disclosure it includes these interests:

1. an income interest held directly in a foreign company
2. an income interest held indirectly through any interposed foreign company
3. an income interest held by an associated person (which is not a controlled foreign company) as defined by section OD 8(3) of the ITA.

Example

If a husband and wife each hold an income interest of 5% in a Cayman Islands company, the interests would not be exempt from disclosure because the husband and wife are associated persons under section OD 8(3)(d). Under the associated persons test they are each deemed to hold the other's interests, so they each hold an "income interest of 10% or greater" which must be disclosed.

They are not required to account for attributed CFC income or loss under the controlled foreign company rules. However, they would have to account for FIF income or loss under the FIF rules.

In this example the husband and wife must disclose their interests as interests in a foreign company and as interests in an FIF. However, only the FIF interests should be disclosed on an IR 439, IR 440, IR 441, IR 442 or IR 443 form (see "Overlap of interests" on page 81).

Foreign company interests

A resident who holds a control or income interest in a foreign company must disclose that interest, regardless of the company's country of residence. The 2007 international tax disclosure exemption also makes no distinction about residence, and any interest in a foreign company which is an income interest of 10% or more must be disclosed. Disclosure is to be made on an *(IR 477)* or *(IR 479) Interest in a foreign company disclosure schedule* form.

The disclosure exemption makes no distinction on the residence of a foreign company for these reasons:

- attributed (non-dividend) repatriation rules apply to an income interest of 10% or more in a controlled foreign company (CFC) regardless of the CFC's country of residence
- identifying tax preferences applied by the taxpayer (whether or not specified in Schedule 3, Part B of the ITA) in respect of an interest held in a foreign company which is resident in a Schedule 3, Part A of the ITA jurisdiction (ie, Australia, Canada, Federal Republic of Germany, Japan, Norway, Spain, United Kingdom and the United States of America)

- the requirement for a CFC which is resident in a country not listed in Schedule 3, Part A of the ITA to attribute foreign income or loss from 1 April 1993.

Foreign investment fund interests

An interest in a foreign entity must be disclosed if it constitutes an "attributing interest" in a foreign investment fund in respect of which FIF income under section CQ 5 or FIF loss under section DN 6 arises.

The types of interest that must be disclosed are:

- rights in a foreign company or anything deemed to be a company for the purposes of the ITA (eg, a unit trust)
- an entitlement to benefit from a foreign superannuation scheme
- an entitlement to benefit from a foreign life insurance policy
- an interest in an entity specified in Schedule 4, Part A of the ITA (no entities were listed when this *TIB* went to press).

However, the following interests are exempt (under sections EX 32 to EX 37) from being an attributing interest in an FIF and therefore do not have to be disclosed:

- an income interest of 10% or more in a CFC (separate disclosure is required of this as an interest in a foreign company)
- an interest in a foreign company that is resident and liable to income tax in a country or territory specified in Schedule 3, Part A of the ITA (ie, Australia, Canada, Federal Republic of Germany, Japan, Norway, Spain, United Kingdom and the United States of America)
- an interest in an employment-related foreign superannuation scheme
- a qualifying foreign private annuity, unless an election has been made to remain within the FIF rules, by the due date for filing the person's 2004 tax return—see Inland Revenue's booklet *Overseas private pensions (IR 257)* for more information
- an interest held by a natural person in a foreign entity located in a country where exchange controls prevent the person deriving any profit or gain or disposing of the interest for New Zealand currency or consideration readily convertible to New Zealand currency
- an interest in a foreign life insurance policy or foreign superannuation scheme acquired by a natural person before they became a New Zealand resident for the first time, for a period of up to four years.

Interests in foreign entities held by a natural person not acting as a trustee also do not have to be disclosed if the total cost of the interests remains under $50,000 at all times during the income year. This disclosure exemption is made because no FIF income under section CQ 5 or FIF loss under section DN 6 arises in respect of these interests.

A resident who holds an attributing interest in an FIF in respect of which FIF income or loss arises at any time during the 2007 income year must disclose the interest and calculate FIF income or loss on the form *Interest in foreign investment fund disclosure schedule and worksheet (IR 439), (IR 440), (IR 441), (IR 442), (IR 443)*. The FIF rules allow a person four options to calculate FIF income or loss (accounting profits method, branch equivalent method, comparative value method and deemed rate of return method), so the Commissioner has prescribed four forms to disclose and calculate FIF income or loss from an attributing interest in an FIF, using one of the methods. The respective forms to use for whichever FIF income calculation method you choose to apply are:

- IR 439 form for the accounting profits method
- IR 440 form for the branch equivalent method
- IR 441 form for the comparative value method
- IR 442 form for the comparative value method and multiple interests
- IR 443 form for the deemed rate of return method.

Overlap of interests

A situation may arise where a person is required to furnish a disclosure for an interest in a foreign company which is also an attributing interest in an FIF. For example, a person with an "income interest of 10% or greater" in a foreign company which is not a CFC is strictly required to disclose both an interest held in a foreign company and an attributing interest held in an FIF.

However, to meet the disclosure obligations only one disclosure return (either the IR 477 or IR 479 form or the IR 439, IR 440, IR 441 or IR 443 form) is required for each interest a person holds in a foreign entity.

Here are the general rules for determining which disclosure return to file:

1. Use the appropriate IR 439, IR 440, IR 441, IR 442 or IR 443 form to disclose all attributing interests in FIFs and, in particular:
    - an interest in a foreign company which is not resident in a Schedule 3 Part A country and is not a CFC (regardless of the level of interest held)
    - an income interest of less than 10% in a CFC which is not resident in a Schedule 3, Part A country

- an interest in a foreign life insurance policy or foreign superannuation scheme, regardless of the country or territory in which the entity was resident.

2. Use the IR 477 or IR 479 forms to disclose:

   - an income interest of 10% or more in a foreign company (regardless of the country of residence) that is not being disclosed on the IR 439, IR 440, IR 441, IR 442 or IR 443 form.

Disclosure is not required on any of the forms for an income interest of less than 10% in a foreign company (whether a CFC or not) which is also not an attributing interest in an FIF in respect of which FIF income or loss arises. An example is an interest which is covered by the Schedule 3, Part A exclusion from the FIF rules.

Interests held by non-residents

The 2007 disclosure exemption removes the need for interests held by non-residents in foreign companies and FIFs to be disclosed.

This would apply, for example, to an overseas company operating in New Zealand (through a branch) in respect of its interests in foreign companies and FIFs.

The purpose of the international tax rules is to make sure that New Zealand residents are taxed on their share of the income of any overseas interests they hold. However, under the international tax rules, non-residents are not required to calculate or attribute income under the CFC rules (sections CQ 2(1)(d) and DN 2(d) of the ITA 2004). In addition, under sections CQ 5(1)(e) and DN 6(1)(e) of the ITA 2004, a non-resident is not to be treated as having any FIF income or loss. The disclosure of non-residents' holdings in foreign companies or FIFs is not necessary for the administration of the international tax rules.

Summary

The 2007 international tax disclosure exemption removes the requirement of a resident to disclose an interest held in a foreign company (if the interest is not also an attributing interest in an FIF in respect of which FIF income or loss arises) that does not constitute an income interest of 10% or more (ie, less than 10%). The disclosure exemption is not affected by the foreign company's country of residence. Further, an attributing interest in an FIF in respect of which FIF income or loss arises must be disclosed.

The 2007 disclosure exemption also removes the requirement for a non-resident to disclose interests held in foreign companies and FIFs.

Persons not required to comply with section 61 of the Tax Administration Act 1994

This exemption may be cited as "International Tax Disclosure Exemption ITR18"

1. Reference

This exemption is made under section 61(2) of the Tax Administration Act 1994. It details interests in foreign companies in relation to which any person is not required to comply with the requirement in section 61 of the Tax Administration Act 1994 to make disclosure of their interests, for the income year ending 31 March 2007. This exemption does not apply to interests in foreign companies which are attributing interests in foreign investment funds in respect of which FIF income or loss arises, unless that interest is held by a non-resident of New Zealand.

2. Interpretation

In this exemption, unless the context otherwise requires, expressions used have the same meaning as in section OB 1 of the Income Tax Act 2004.

3. Exemption

(i) Any person who has an income interest or a control interest in a foreign company (not being an attributing interest in a foreign investment fund in respect of which FIF income under section CQ 5 or FIF loss under section DN 6 arises), in the income year ending 31 March 2007, is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year, unless the interest held by that person during any accounting period of the foreign company (the last day of which falls within that income year of the person), would constitute an income interest of more than 10%, as defined under sections EX 14 to EX 17 of the Income Tax Act 2004, as if the foreign company was a controlled foreign company.

(ii) Any non-resident person who has an income interest or a control interest in a foreign company or an attributing interest in a foreign investment fund in the income year ending 31 March 2007, is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year if either or both of the following apply:

- No attributed CFC income or loss arises in respect of that interest in that foreign company by virtue of sections CQ 2(1)(d) and DN 2(d) of the Income Tax Act 2004.
- No foreign investment fund income or loss arises in respect of that interest in that foreign investment fund by virtue of sections CQ 5(1)(e) and DN 6(1)(e) of the Income Tax Act 2004.

This exemption is made by me acting under delegated authority from the Commissioner of Inland Revenue pursuant to section 7 of the Tax Administration Act 1994.

This exemption is signed on the 9th day of March 2007.

Tony Morris
Assurance Manager (Large Business)

DETERMINATION PROV17: TAX DEPRECIATION RATES PROVISIONAL DETERMINATION NUMBER 17

This determination may be cited as "Determination PROV17: Tax Depreciation Rates Provisional Determination Number 17".

1. Application

This determination applies to taxpayers who own assets in the "Hire Equipment (short-term hire of 1 month or less only)" asset category that are in the provisional asset class set out below.

This determination applies to "depreciable property" other than "excluded depreciable property" for the 2006 and subsequent income years.

2. Determination

Pursuant to section 91AAG(4) of the Tax Administration Act 1994 I hereby amend Determination DEP1: Tax Depreciation Rates General Determination Number 1 (as previously amended) by:

- Inserting into the "Hire Equipment (short-term hire of 1 month or less only)" asset category, the provisional asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed below:

Provisional asset class	Estimated useful life (years)	DV banded dep'n rate (%)	SL equiv banded dep'n rate (%)
Furniture (loose) with a general DV rate of 18% *	2	50	40

* Residual value has been estimated at 25%.

3. Interpretation

In this determination, unless the context otherwise requires, expressions have the same meaning as in the Income Tax Act 2004 and the Tax Administration Act 1994.

This determination is signed by me on the 16th day of February 2007.

Susan Price
Senior Tax Counsel

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 07/02 NOTIFICATION OF A PENDING AUDIT OR INVESTIGATION

Introduction

1. This Standard Practice Statement ("SPS") sets out the Commissioner's practice for notifying taxpayers of a pending audit or investigation. For many taxpayers, notification of a pending audit will be by letter without any prior contact by Inland Revenue on the matter.

2. For the purpose of this SPS, the words "audit" and "investigation" have the same effect, ie, Inland Revenue may undertake a variety of tasks to review a taxpayer's compliance with their tax obligations but these will all be referred to as "audits".

3. Not all contact by Inland Revenue officers with taxpayers about their tax affairs relates to an audit or will necessarily lead to one. Often, Inland Revenue will contact a taxpayer to gather information for tax administration purposes only.

4. Similarly, not all contact by Inland Revenue officers (investigators) is related to an audit already under way. An investigator may contact a taxpayer for information but no decision has been made to audit them. General enquiries by Inland Revenue investigators are not considered part of an audit unless the taxpayer has been clearly notified that one is pending or has begun. Taxpayers will be encouraged to voluntarily disclose any errors or omissions.

Application

5. This SPS applies from 20 March 2007. It replaces *SPS INV-260 Notification of a pending audit or investigation* which was published in *TIB* Vol 12, No 2 (February 2000) which expired on 1 March 2002 but was still being applied.

6. This SPS should be read with *SPS INV-251 Voluntary Disclosures* and any subsequent SPS issued in replacement.

Background

7. This SPS has been produced because of a number of situations where an audit notification was in dispute and as a consequence, whether a taxpayer was entitled to a reduction of the shortfall penalty for a pre-notification voluntary disclosure. These situations show a need for Inland Revenue to communicate clearly when giving notification of a pending audit or when one has begun.

8. Notwithstanding the above, there will be occasions when Inland Revenue will not give notice of a pending audit. For example, if it holds anonymous information, suspects tax avoidance/evasion, or it is appropriate to make an unannounced visit to verify a taxpayer's compliance with the law.

Legislation

9. Unless specified otherwise, all legislative references in this SPS refer to the Tax Administration Act 1994 ("TAA").

10. A shortfall penalty payable by a taxpayer, under any of sections 141A to 141EB, may be reduced in accordance with section 141G where the taxpayer makes a full voluntary disclosure to Inland Revenue about the details of the shortfall.

11. The time that a taxpayer receives notice of a pending audit is important when considering their ability to claim to a shortfall penalty reduction for making a full voluntary disclosure. Information about this is set out below.

141G. REDUCTION IN PENALTY FOR VOLUNTARY DISCLOSURE OF TAX SHORTFALL—

141G (1) 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"); or

(b) After the taxpayer is notified of a pending tax audit or investigation, but before the Commissioner starts the audit or investigation (referred to in this section as "post-notification disclosure").

141G (2) The Commissioner may from time to time—

(a) Specify the information required for a full voluntary disclosure; and

(b) The form in which it must be provided.

141G (3) The level by which the shortfall penalty is reduced—

(a) For pre-notification disclosure is 75%:

(b) For post-notification disclosure is 40%.

141G (4) A taxpayer is deemed to have been notified of a pending tax audit or investigation, or that the tax audit or investigation has started, if—
(a) The taxpayer; or
(b) An officer of the taxpayer; or
(c) A shareholder of the taxpayer, if the taxpayer is a close company; or
(d) A tax adviser acting for the taxpayer; or
(e) A partner in partnership with the taxpayer; or
(f) A person acting for or on behalf of or as a fiduciary of the taxpayer,—
is notified of the pending tax audit or investigation, or that the tax audit or investigation has started.

141G (5) An audit or investigation starts at the earlier of—
(a) The end of the first interview an officer of the Department has with the taxpayer or the taxpayer's representative after the taxpayer receives the notice referred to in subsection (4); and
(b) The time when—
(i) An officer of the Department inspects information (including books or records) of the taxpayer after the taxpayer receives the notice referred to in subsection (4); and
(ii) The taxpayer is notified of the inspection.

Discussion

What is an audit or investigation?

12. The terms "audit" and "investigation" are generally used by Inland Revenue to have a similar, if not same, meaning. Inland Revenue officers, usually referred to as investigators, carry out the audits.

13. An audit is any examination of a taxpayer's financial affairs to verify that they have paid the correct amount of tax and complied with their tax obligations as required by law. For example, an audit may simply be a review of a GST registration, or it may be a full examination of business records.

14. Inland Revenue undertakes various types of audit activities. These include income tax or GST audits, payroll audits, GST refund checks, payroll and GST registration checks and any other type of review.

15. For further information about audits please see *Inland Revenue's guide Inland Revenue audits – Information for taxpayers (IR 297)*. You can get this at www.ird.govt.nz/forms-guides or by calling INFOexpress on 0800 257 773 between 6am and 12 midnight, seven days a week.

Situations that are not audits

16. Inland Revenue investigators often call taxpayers for background information on GST returns without having decided whether to carry out an audit. These situations are not considered part of an audit unless the taxpayer has been clearly notified that an audit is pending or has begun.

17. Return processing and non-investigative service staff often contact taxpayers for information omitted or incorrectly entered on filed returns, to enable the self-assessment process to be completed. This SPS does not cover the activities of these Inland Revenue officers. Affected taxpayers can follow up these requests by making voluntary disclosures to correct earlier non-compliance.

18. When analysing risk generally, Inland Revenue officers routinely request information from various sources, including individual taxpayers, to research and prioritise tax compliance risk areas. In these circumstances, the purpose of the Inland Revenue officers' call is to collect information and their contact with taxpayers is not an audit nor is it notice of a pending audit.

Notice of a pending audit

19. Inland Revenue officers will clearly communicate the purpose of their contacts with taxpayers or their agents. When Inland Revenue investigators contact taxpayers or their agents to notify them of a pending audit, the communication will use the words "audit" or "investigation". Notification of a pending audit will only follow when a decision has been made to audit the taxpayer.

20. Requests for information to enable Inland Revenue to decide whether to carry out an audit are not part of an audit or notice of a pending audit.

21. When notice of a pending audit is mailed to the taxpayer without earlier verbal notification, Inland Revenue will consider the taxpayer to have been notified within a normal mail delivery period.

Standard Practice

Notification of an audit

22. Not all contacts by an Inland Revenue officer with a taxpayer will be about an audit. If the purpose of the contact is to notify the taxpayer of an audit, this will be brought clearly to their attention by using the words "audit" or "investigation". This is to ensure there is no misunderstanding about the purpose of the contact.

23. Notification of a pending audit will generally be made in writing.

24. If notification is given to the taxpayer by some other form – for example, by telephone – it will usually be confirmed by a letter advising details of the audit. The letter will also advise taxpayers they can make post-notification voluntary disclosures at any stage prior to the end of the first interview.

25. There will be few exceptions to the practice of notifying a taxpayer of a pending audit, or confirming a notification of an audit, by letter. Instances where this may happen are:

    - where Inland Revenue holds anonymous information;
    - there are strong indications the taxpayer is involved in an aggressive tax practice;
    - where the visit is intended to be unannounced (i.e. a "spot check");
    - where it is impractical to send a letter due to time constraints.

26. The time of notification of an audit will be at the earlier of:

    - when the taxpayer receives a letter;
    - when they receive a telephone call;
    - when an Inland Revenue officer makes an unannounced visit.

27. For many taxpayers, notification of a pending audit will be by letter without any earlier contact by Inland Revenue.

28. An audit is pending when Inland Revenue decides it will audit a taxpayer and has notified them. As well as confirming verbal notifications by letter, Inland Revenue officers are required to record details of any verbal notification given to a taxpayer in case a dispute arises.

Details of audit notification

29. Notification of an audit will inform the taxpayer, first, that they are being audited and, second, which areas of their tax affairs are to be audited. Taxpayers will also be informed of the direction and focus of an audit as it progresses. If the audit's scope widens during the audit and other tax types and/or periods are to be reviewed, the taxpayer will be promptly notified of this change.

30. Audits sometimes involve considering compliance by other parties that are connected. For example, a partnership and the individual partners, a company and its shareholders. Subject to paragraphs 8 and 25, notification of an audit will be made to each party subject to a pending audit.

This Standard Practice Statement is signed on 20 March 2007.

Graham Tubb
Group Tax Counsel, Assurance

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.

QB 07/01 ZERO-RATING OF SUPPLIES OF SAIL-AWAY BOATS – USE AS SECURITY OR OFFERED FOR SALE

We have been asked to clarify some issues relating to zero-rating of supplies of "sail-away boats" under section 11(1)(i) of the Goods and Services Tax Act 1985 ("the GST Act"). In particular, the issues relate to the exercise of the Commissioner's discretion under section 11(8) to extend the 60-day period within which a recipient of the supply of a boat ("the recipient") must export the boat under section 11(7)(a), where the boat is used as security or offered for sale while it is in New Zealand.

This article replaces the guidelines published on page 43 of the *Tax Information Bulletin*, Vol 6, No 6 (December 1994).

(Note: All legislative references in this item are to the GST Act.)

Background

Generally, goods are subject to GST if the supply of the goods is made in New Zealand. However, section 11(1)(i) and (7) allows for the zero-rating of a boat which is supplied in New Zealand but then exported, under its own power, by the recipient (commonly known as a "sail away boat") if:

(a) the boat is supplied by way of sale, and

(b) the recipient exports the boat under its own power to a place outside New Zealand (that is, when the boat departs its final New Zealand port there is an intention that the boat's next port of call will be outside New Zealand):
  - (i) within 60 days of the recipient or their agent taking physical possession of it (later referred to as "the 60-day period"), or
  - (ii) within a longer period allowed by the Commissioner under section 11(8), and

(c) the supplier (who is the vendor of the boat) or the recipient (who is the purchaser) keeps and makes available to the Commissioner the necessary documentation in relation to:
  - (i) records of the sale of the boat, and
  - (ii) limitations on dealings in and the uses that the boat will be put to before export, and
  - (iii) the proposed and actual date of export.

Inland Revenue published some guidelines on what would constitute limitations on dealings in and the uses of the sail-away boat. The guidelines can be found on page 43 of *Tax Information Bulletin*, Vol 6, No 6 (December 1994) and the relevant extract is cited as follows:

> "The supplier must keep the following documentation to support zero-rating:
>
> - …
> - a written statement from the purchaser that the boat will not be hired, given away, offered for sale, used as security or otherwise disposed of while it is in New Zealand
> - …
> - …"

Inland Revenue has reviewed the above guidelines and replaces them with the statements below.

Revised operational guidelines on the zero-rating of supplies of sail-away boats

The Commissioner may extend the 60-day period under section 11(8) if:

(a) the supplier of the boat applies in writing, and

(b) the Commissioner is satisfied that circumstances beyond the control of the supplier and recipient have prevented or would prevent the export of the boat within the 60-day period.

When seeking an extension of the 60-day period under section 11(8), the supplier must advise the Commissioner of the circumstances which have prevented, or would prevent, the boat from being exported within 60 days. The supplier must also advise when the recipient will be expected to export the boat under its own power to a place outside New Zealand.

For example, during sea trials a major mechanical problem is encountered which can only be repaired after ordering a spare part from overseas. This will mean a delay which will prevent the recipient from exporting their boat under its own power within the 60-day period. The supplier of the boat, when applying for an extension of the 60-day period in writing, should give details of the mechanical problem and explain how this has prevented the export of the boat within the initial 60-day period. The details may include the order of the spare part made, the date by which the boat is expected to be repaired and the date by which the recipient is expected to export the boat under its own power to a place outside New Zealand.

Furthermore, the supplier must keep and make available to the Commissioner the following documentation:

(a) a written statement from the recipient that the boat is not intended for use within New Zealand before it is exported and that the boat will be exported from New Zealand,

(b) a written statement from the recipient that the boat will not be hired or given away before it is exported,

(c) a written statement from the recipient that where the boat is offered for sale while it remains in New Zealand, the boat will be exported under its own power to a place outside New Zealand before the completion of the sale, and

(d) a record of the sale.

In order to support the zero-rating of the supply of the sail-away boat under section 11(1)(i), the supplier needs documentary evidence to show that the recipient exported the boat. In addition to the documentation set out in (a) to (d) above, the supplier must keep and make available to the Commissioner a copy of the clearance document issued to the recipient by the New Zealand Customs Service upon leaving New Zealand.

Where the supplier does not have a copy of the clearance document, the supplier will need to make available other documentation, which as a whole, proves that the boat has left New Zealand. Acceptable evidence includes, and is not limited to the entry for export, documents issued by the foreign customs authority evidencing arrival of the boat, evidence of foreign registration of the boat, etc.

Discussion

A sail-away boat can now be used as security for the recipient without affecting the zero-rating of the supply

The revised operational guidelines no longer prohibit the recipient of the supply from using a sail-away boat as security while the boat is within New Zealand. This is because such a prohibition does not accord with commercial practice nowadays. Recipients may use their sail-away boats as security for financing arrangements for the purpose of building the boats or/and for other commercial purposes. Using the boat as security does not of itself constitute physical "use" of the boat within New Zealand.

However, if the recipient defaults on loan repayments and the security is called upon within New Zealand before the boat is exported, the supply of the boat by the supplier to the recipient cannot be zero-rated under section 11(1)(i). This is because the recipient has not exported the boat under its own power to a place outside New Zealand. This means that GST is to be returned by the supplier on the supply of the boat.

A sail-away boat can be offered for sale by the recipient of the supply before exporting the boat under its own power to a place outside New Zealand

These revised operational guidelines have clarified the "offered for sale" restriction before the boat is exported. Inland Revenue considers that a mere offer for sale (for example, advertising to invite potential buyers) by the recipient of the supply before exporting would not constitute "use" of the boat in New Zealand. Therefore, merely offering the boat for sale while it is still in New Zealand will not affect the zero-rating of the supply.

However, if the recipient of the supply sells the boat to a person in New Zealand before they export it, the supply of the sail-away boat from the supplier to the recipient will not be zero-rated under section 11(1)(i).

On the other hand, if the recipient of the supply agrees to sell the boat to a person outside New Zealand and the person will complete the resulting sale by making full payment only after the recipient or their agent has sailed the boat under its own power to a place outside New Zealand, the supply of the sail-away boat from the supplier to the recipient will still be zero-rated under section 11(1)(i). This is because the boat will be exported under its own power before the completion of the subsequent sale.

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.

COMMISSIONER'S DECISION TO REFUSE A LATE NOPA REVIEW

Case:	Diana Balich v The Commissioner of Inland Revenue
Decision date:	21 February 2006
Act:	Sections 89K, 113 and 141G of the Tax Administration Act 1994.
Keywords:	Exceptional circumstances, voluntary disclosure.

Summary

The High Court found the Commissioner had made a reviewable error in the process by which he reached his decision not to accept a late notice of proposed adjustment under section 89K. However, the High Court declined to grant relief to the taxpayer due to the futility of her underlying arguments.

Facts

Ms Balich registered for GST on 27 September 2001 and subsequently claimed a refund for the period ending 31 January 2002. The Commissioner commenced an audit of the return and ascertained that Ms Balich had previously been declared bankrupt in 1991, and that she had been using her pre-bankruptcy IRD number since then. The audit also established that Ms Balich had been receiving payments on account of GST in the course of her business as a real estate agent, but not returning GST to the Commissioner. In some cases real estate agencies had made withholding tax payments for Ms Balich, but she had not filed any income tax returns.

Throughout the audit Ms Balich was advised by a chartered accountant. She signed agreed adjustments for the 1995–2001 income years and GST periods, and default assessments were issued by the Commissioner for the 1993 and 1994 years. The audit was finalised in September 2003 and the file transferred to Return and Debt Collection, who took steps to try and obtain information on Ms Balich's financial position. As this information was not forthcoming, the Commissioner issued a final demand letter. Default judgment was obtained in the District Court, and Ms Balich's subsequent application to have the default judgment set aside was unsuccessful.

Ms Balich attempted to provide the Commissioner with a "voluntary disclosure" showing that her tax position was not as assessed, and also provided amended returns and a Notice of Assessment. A Notice of Proposed Adjustment (NOPA) was also provided arguing that income tax was illegal as it is a form of slavery, or that she was entitled to deduct "reward" from her income of $200,000 per year. The Commissioner did not accept the NOPA as it was received outside the statutory response period and exceptional circumstances had not been established as no evidence had been provided to show Ms Balich was so depressed as to not be able to provide a NOPA within the response period.

Decision

Winkelmann J first considered whether the Commissioner had erred in failing to amend the assessments in light of the amended returns. Referring to *Duncan v The Commissioner of Inland Revenue* (2004) 21 NZTC 18,735 (HC) she considered that the issues raised by Ms Balich on review should have been raised in the disputes process and that they were therefore beyond the scope of judicial review. In any event, the view that the Commissioner formed in refusing to amend the assessments was entirely reasonable and the underlying arguments of the taxpayer had no merit whatsoever.

Winkelmann J then considered whether the Commissioner had made an error in declining to accept the late NOPA because of exceptional circumstances. Her Honour found that an error had been made by the Department as it knew Ms Balich was under a misapprehension that letters from her doctor and psychologist to show she was chronically depressed had been provided to the Commissioner. The Commissioner had not received the letters, and relied upon the absence of the letters as a reason for declining to accept the late NOPA. In the circumstances it was found that this amounted to procedural unfairness.

As to Ms Balich's voluntary disclosure and notices of assessment, it was held the provision for

voluntary disclosure in section 141G of the Tax Administration Act 1994 did not apply and no error was made. The Commissioner's audit was completed in September 2003, and the disclosure made in 2005. The argument that the disclosure was made prior to the audit, because an audit can begin at any time, was an implausible reading of the Act. In any event, voluntary disclosures only apply to shortfall penalties.

Ms Balich also argued that she had been unlawfully coerced into registering for GST, filing returns and signing the agreed adjustment while vulnerable due to her depression. Of particular concern to the taxpayer was that she had been told she may be prosecuted if she did not file the returns. In the circumstances, the Departmental officers adopted the appropriate course of action by advising prosecution was possible, as it was a likely consequence if she did not comply. It was found the other actions complained of consisted of no more than the Department lawfully utilising the processes set out in the Act.

As Winkelmann J found the Commissioner had made a reviewable error through procedural unfairness in respect of his decision under section 89K, she considered what relief was appropriate. Counsel for the Commissioner submitted that the Court should exercise its underlying discretion not to grant relief, and Her Honour agreed. The letters relied upon by Ms Balich did not establish that she was still unwell in September 2005 and it was also considered relevant that she was advised by a chartered accountant throughout the audit. As such, the circumstances pleaded did not provide a reasonable justification for her not issuing a NOPA within the response period.

Even if exceptional circumstances had been established the Commissioner still would have been able to exercise the residual discretion within section 89K not to accept the late NOPA. This was because none of the proposed challenges to the assessment had any real prospect of success.

Finally, as Ms Balich was also responsible for the delay in issuing the NOPA, it was inappropriate for the Court to direct the Commissioner to reconsider his decision under section 89K, as it would simply further delay Ms Balich fulfilling her obligation to meet her undoubted tax liability.

WAIVER IN TERMS OF SECTION 24(6)(B) OF THE GST ACT

Case: Decision Number 4/2007

Decision date: 28 February 2007

Act: Goods and Services Tax Act 1985

Keywords: associated parties, time of supply, price undetermined, waiver of tax invoice, time of test

Summary

When requested to waive the requirement for a tax invoice under section 24(6)(b) of the GST Act the Commissioner must apply the two limbs of the test at the time he makes his determination. A waiver under section 24(6) cannot operate retrospectively.

Facts

The Disputant, a partnership of two trusts purchased livestock from an associated entity, the W partnership. In terms of the deed of sale the settlement date was 31 March 2002 which was also the date possession passed. The sale price was to be determined by a valuation which was only obtained in November 2002. The time of supply was in the GST period ending 31 March 2002. Both parties were registered for GST.

Neither party accounted for the transaction until the W partnership issued a tax invoice on 31 March 2004. On 1 April 2004 the Commissioner allowed the transfer of the GST input credit from the Disputant to the W partnership.

The result was that the W partnership had incurred use of money interest from the time of supply period (31 March 2002) until it issued a tax invoice (31 March 2004).

On 31 March 2004 the Commissioner refused a request from the Disputant to make a determination in terms of section 24(6)(b) of the GST Act that a tax invoice was not required to be issued by the W partnership. If the Commissioner has allowed the request the Disputant would have been able to claim the input credit in the time of supply period and transfer it to the W partnership at that time, the result being that the W partnership would not have incurred use of money interest.

Judgment

For unassociated persons section 9(6) deals with the situation where the consideration of goods has not been determined at the time of supply. In terms thereof the supply is deemed to take place when payment is due or received or an invoice is issued, whichever is the earlier. However, that section does not apply to associated persons.

In terms of section 20(2) an input tax credit can only be claimed when a tax invoice is supplied unless one of the exceptions apply, such as, where the Commissioner is satisfied a tax invoice is not required to be issued under section 24(6).

The W partnership had a duty to account for the supply in the period ending 31 March 2002 but was unable to as the price of the livestock had yet to be determined by valuation. It should have delayed the time of supply until the valuation had been received. The fact that the time of supply was in its control is relevant to the exercise of the Commissioner's discretion under section 24(6).

It is also relevant that the when the vendor received the valuation in November 2002 it still did not issue a tax invoice, as is the fact that the Disputant never requested one.

On 9 October 2003 the W partnership asked the Commissioner to make a determination under section 24(6)(b) that a tax invoice was not required to be issued. The Commissioner had to apply a two step test. Firstly, he had to be satisfied that there were sufficient records to establish the particulars of the supply, or, that there would be at some future time be sufficient records thereof. Secondly, he had to be satisfied that it would be impractical to require a tax invoice be issued.

The Commissioner is required to determine the two limbs of the test at the time of his determination which was at 31 March 2004. The first limb of the test was satisfied as the valuation was completed in November 2002. In respect of the second limb no reason was given as to why it would be impractical to obtain a tax invoice as at March 2004 or October 2003, when the application was made. The details of the supply were known in November 2002. At the date of the request there was no practical reason why the Disputant could not obtain a tax invoice.

A waiver under section 24(6) cannot operate retrospectively.

Finally, the Commissioner did not breach section 6 or s 6A of the Tax Administration Act 1994 by failing to exercise his discretion in s 24(6) in favour of the Disputant.

APPLICATION FOR LEAVE TO COMMENCE PROCEEDINGS AFTER EXPIRY OF RESPONSE PERIOD DISMISSED

Case:	Decision Number 5/2007
Decision date	2 March 2007
Act:	Tax Administration Act 1994; section 138D.
Keywords:	Application for leave, commence proceedings, expiry of response period, exceptional circumstances

Summary

The applicant sought leave from the Authority to commence proceedings out of time, on the grounds exceptional circumstances applied. The Authority decided that no exceptional circumstances existed and dismissed the application.

Facts

In about 2000, a dispute developed between the parties over tax payable in the 1994 and 1995 years. There were dealings between the applicant's solicitors and the investigator based in Nelson, IRD Wellington and the Crown Law Office. The in-house accountant received copies of all communications between the parties but generally such communications took place between the applicant's solicitor and the Department.

The Department sent a letter to the applicant's solicitor on 20 April 2006 to advise notices of assessment would be issued shortly. The letter also noted that the assessments would be sent directly to the applicant. A copy of the letter was sent to the in-house accountant, and the external accountant. The assessments issued on 27 April 2006. The applicant failed to commence proceedings before the response period expired on 26 June 2006, but did so on 10 August 2006.

The in-house accountant received the assessments on either 28 April or 1 May 2006, but took no action until 8 May 2006. That appeared to be due to the investigator having telephoned the external accountant in relation to the assessments, and the external accountant telephoning the in-house accountant who said he had received them and would contact the external accountant to discuss them.

In mid June 2006, the external accountant reminded the in-house accountant he had not forwarded on the assessments. The in-house accountant undertook to do so, but did not attend to that until 26 June 2006, the last day of the response period.

Decision

1. The applicant relied on four factors which it said amounted to exceptional circumstances beyond its control and provided it with reasonable justification for its failure to commence proceedings in time:

    (1) That there were very long delays between a process being agreed to between the parties and the IRD issuing the assessments.

    (2) The communications from the IRD suggested it would take a next step without any next step then following.

    (3) That the IRD were in the practice of forwarding copies of documents to, and primarily dealing with the applicant's solicitors, but did not do so with regard to the assessments.

    (4) That printing on the back of the notices of assessment recorded that the applicant had a four month period in which to challenge the assessments.

The submission for the Department was that there was no causal link between any of these factors, and the applicant's default, which arose from repeated failures of its agents.

The Authority accepted the IRD submission that any delays by it prior to issuing the assessments cannot be

said to be the cause of the in-house accountants failure to properly consider correspondence copied to him, or to re-familiarise himself with the agreed process and to follow the matter up within two months.

The Authority noted the 20 April 2006 from IRD made it clear the Commissioner would shortly be issuing the assessments. Thus any delays by the IRD prior to 20 April 2006 were irrelevant to the present situation.

The Authority also accepted an IRD submission that the facts did not show that the investigator indicated he would do something and then fail to do it.

On the facts, the Authority placed no weight on the fact the notices of assessment were sent directly to the in-house accountant. There was no lack of control of the situation by the applicant. He also noted that this event or circumstance did not reasonably justify the default, as the letter of 20 April 2006 could not be clearer as to where the notices of assessment would be posted.

The Authority also found that the reference to a four month period on the back of the notices of assessment applied only to the issue of a NOPA and not to disputing the assessment by filing a challenge. He also noted those procedures do not apply where a tax audit has occurred, and the notices of assessment stated repeatedly "amended as per investigation."

NEW LEGISLATION

TAXATION (SAVINGS INVESTMENT AND MISCELLANEOUS PROVISIONS) ACT 2006

TAXATION (ANNUAL RATES OF INCOME TAX 2006–07) ACT 2006

The Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill was introduced in May 2006. The main focus of the bill was the reform of the tax rules on income from share investments made through managed funds and by individuals.

The bill received its first reading in Parliament on 25 May, and its second and third readings on 12 December 2006. The two resulting Acts received Royal assent on 18 December 2006, the date of enactment.

The resulting Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 amends the Income Tax Act 1976, Income Tax Act 1994, Income Tax Act 2004, the Goods and Services Act 1985, Tax Administration Act 1994, Companies Act 1993, Public Trust Act 2001, Securities Act 1978, Trustees Act 1956, Trustee Companies Act 1967, Unit Trust Act 1960 and the Tax Administration (Form of Warrant) Regulations 2003.

The Taxation (Annual Rates of Income Tax 2006–07) Act 2006 confirms the income tax rates for the 2006–07 income year.

NEW TAX RULES FOR OFFSHORE PORTFOLIO INVESTMENT IN SHARES

Sections CD 26, CQ5, DN 5, DN 6, EX 33, EX 33B, EX 33C, EX 33D, EX 33E, EX 38, EX 40, EX 40B, EX 41, EX 42, EX 44, EX 44B to EX 44E, EX 45, EX 45B, EX 46, EX 47, EX 50 to EX 53, EX 54B, EX 56, EX 59, GD 14, IE 4, IG 5, OB 1 and Schedule 4 of the Income Tax Act 2004; sections 81 and 91AAO of the Tax Administration Act 1994

The Income Tax Act 2004 has been amended to provide new rules for taxing offshore portfolio investment in shares. The new rules generally apply to an investment by a New Zealand resident in a foreign company when the investor owns less than 10 percent of the company.

The main changes are that the "grey list" exemption in the foreign investment fund rules has been removed and a new fair dividend rate method – which broadly taxes 5 percent of a portfolio's opening value each year – generally applies to interests of less than 10 percent in foreign companies. If the total return on the share portfolio is less than 5 percent then individuals and family trusts pay tax on the lower amount (they pay no tax if the shares make a loss).

Under the new rules, investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange, such as the All Ordinaries index (the 500 largest listed companies) are taxed the same as New Zealand investments: they are taxable on dividends if the investment is held on capital account or on dividends and realised gains if held on revenue account.

There is a NZ$50,000 cost threshold for investments in offshore companies outside Australia held by individuals, below which these investments continue to be taxable under general income tax rules (for example, on dividends only if held on capital account).

Under the new rules, offshore portfolio investment in shares is taxed consistently, regardless of the country where the investment is located and whether the investment is made by an individual directly or through a collective investment vehicle. The new rules manifest the government's policy that New Zealand residents should be taxed on their world-wide income.

Background

The previous tax rules for offshore portfolio investment in shares favoured investment in the eight "grey list" countries (Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States). Investments in companies resident in these countries were taxed only on dividends if they were held on capital account (which was the case for most individuals). Dividend-only taxation was, in many instances, an inappropriate tax base because many foreign companies have a policy of paying low or no dividends. The investor could still, however, derive an economic gain from the investment via an increase in the share price. It was therefore quite easy to achieve a low tax or no tax result for direct portfolio investment in shares outside New Zealand. This could give higher income or more sophisticated taxpayers significant scope to minimise their tax burden by investing offshore.

On the other hand, portfolio investment in some high growth and lower tax countries, including trading partners in Asia and Latin America, were over-taxed relative to investment in countries such as the United States and the United Kingdom. In particular, investors faced significant tax barriers to investment in these countries as a result of the application of the previous foreign investment fund rules, which generally taxed full accrued capital gains (and captured the full effect of currency fluctuation and share price volatility). This inhibited connections with these newer and increasingly important investment destinations. The tax rules for offshore portfolio investment in shares therefore operated very unevenly.

A further problem with the previous "grey list" exemption was the difference in tax treatment between investments in those jurisdictions made directly and those made through a collective investment vehicle. Under the "grey list" exemption, individuals were typically taxed only on dividends because they held their shares on capital account. On the other hand, collective investment vehicles were taxed on their "grey list" investments mostly on a revenue account basis (dividends and realised gains) because they were normally in the business of trading in shares. As was the case with investment in New Zealand companies, collective investment vehicles faced a tax disadvantage under the previous tax rules for offshore portfolio investment in shares.

The new rules are aimed at creating more consistent and coherent tax rules for offshore portfolio investment in shares by type of investment (direct versus investment through a collective investment vehicle) and jurisdiction (grey list versus non-grey list and New Zealand). In particular, the changes reflect the need to ensure that investments via portfolio investment entities and other managed funds are not tax disadvantaged relative to direct investment; this is important from the perspective of encouraging investment through KiwiSaver.

Overall, the new rules attempt to levy a reasonable level of tax on offshore share investments. The exemption for investments in Australian-resident listed companies reflects the fact that Australian dividend yields, like those in New Zealand, are relatively high. The exemption also takes into account the special relationship between New Zealand and Australia under Closer Economic Relations. Consequently, dividend-only taxation is a reasonable approach for Australian-resident listed companies because the Australian tax system encourages distributions, as the New Zealand tax system does. Dividend-only taxation is not feasible for taxing investments in companies resident in jurisdictions whose tax systems do not encourage the payment of dividends. For these investments a reasonable level of tax should be collected each year. The new fair dividend rate method, which broadly taxes 5 percent of a portfolio's opening value each year, seeks to do so.

Proposals to reform the tax rules for offshore portfolio investment in shares were outlined in the government discussion document, *Taxation of investment income*, released in June 2005. This discussion document built on the work carried out in earlier reviews, including the Tax Review in 2001. The new offshore tax rules have been the subject of extensive consultation and reflect a number of amendments in the course of policy development, to take into account various concerns raised during consultation.

Key features

The new tax rules for offshore portfolio investment in shares mainly involve changes to the foreign investment fund rules in the Income Tax Act 2004. The main features of the new rules are:

- The previous exemption in the foreign investment fund rules for investments of less than 10 percent in companies resident in "grey list" countries has been abolished. (The "grey list" countries are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.)
- Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange, such as the All Ordinaries index (the 500 largest listed companies), are exempt from the foreign investment fund rules. The general income tax rules will continue to apply to these Australian investments: that is, taxable only on dividends if the shares are held on capital account and on dividends and realised share gains if the shares are held on revenue account. However, investments in Australian-resident listed companies held by portfolio investment entities are generally taxable only on dividends.
- A NZ$50,000 minimum threshold applies to an individual's investments in foreign companies other than Australian-resident listed companies. If the original cost of these shares totals NZ$50,000 or less, the foreign investment fund rules do not apply to the individual. This threshold does not generally apply to trusts.
- Investments in certain Australian unit trusts that meet minimum investment turnover requirements and use the RWT proxy rules are exempt from the foreign investment fund rules.
- There are two temporary exemptions for investments in certain grey list companies for five years and two years respectively. Investments in Guinness Peat Group plc qualify for the five-year exemption (that is, for the 2007–08 to 2011–12 income years) and investments in the New Zealand Investment Trust plc qualify for the two-year exemption (that is, the 2007–08 and 2008–09 income years). Investors who hold shares in these companies on revenue account may elect for the exemption not to apply to them.
- There is an exemption for venture capital investments in grey list companies that were previously resident in New Zealand and maintain a significant New Zealand presence.
- There is a limited exemption for offshore shares acquired through employee share purchase schemes if there are restrictions on the disposal of the shares. The exemption applies only for the duration of the restrictions.
- The "grey list" exemption will continue to apply for non-portfolio investments of 10 percent or more in foreign companies. However, because of their widely held nature, the following entities do not qualify for this grey list exemption: portfolio investment entities, superannuation schemes, unit trusts, life insurers and group investment funds.

- Two new income calculation methods under the foreign investment fund rules – the fair dividend rate and cost methods – have been introduced to apply generally to less than 10 percent interests in foreign companies (including unit trusts).
- Under the fair dividend rate method:
  - Tax is paid on 5 percent of the share portfolio's opening market value each year.
  - If the investor is an individual or family trust and the total return (dividends and capital gains) on the portfolio is less than 5 percent then tax can be paid on the lower amount with no tax payable when the total return is nil or negative.
  - Paying tax on an amount lower than 5 percent is achieved by allowing individuals and family trusts to use the comparative value method. Individuals and family trusts have the ability to switch freely between the fair dividend rate and comparative value methods between income years.
  - Within the same income year an individual or family trust must apply either the fair dividend rate method or the comparative value method. It is therefore not possible to use the fair dividend rate method for shares which produce a total return of over 5 percent (thereby getting the benefit of the 5 percent cap under that method) and use the comparative value method for shares which produce a total return of less than 5 percent in the same year.
  - Generally, only shares held at the start of an income year are taken into account and therefore purchases and sales of shares during a year are ignored.
  - However, shares that are both purchased after the start of an income year and sold before the end of the same income year are taxed on the lower of 5 percent of their cost or the actual gains made on these "quick sales".
  - Dividends are not taxed separately; however, foreign withholding tax deducted from dividends is still available as a foreign tax credit.
  - There are no foreign investment fund losses.
- The fair dividend rate method cannot be used for "guaranteed return"-type investments. The comparative value method must be used for these investments.
- The cost method taxes 5 percent of the cost of a person's investments, with the cost base increased by 5 percent each year to proxy for an increase in the value of the investment. This method is available for investments for which it is not possible to obtain market values (except by independent valuation) and therefore it is not practical to apply the fair dividend rate method. The cost base can be reset by independent valuation every five years.
- Investors can use the other methods for calculating foreign investment fund income or loss – branch equivalent, accounting profits, comparative value and deemed rate of return – if they satisfy the conditions for using these methods.
- The previous ring-fencing rules for foreign investment fund losses (other than those calculated under the branch equivalent method) have been repealed.
- The rules for converting amounts from foreign currency into New Zealand currency have been made consistent. In particular, the changes require taxpayers to be consistent in their use of currency conversion methods.
- The rules dealing with when a person enters into or exits from the foreign investment fund rules, such as when a person becomes a resident of New Zealand or the $50,000 minimum threshold is exceeded so a person enters into the rules, have been amended to cater for the new fair dividend rate and cost methods.
- Offshore investments which become subject for the first time to the new foreign investment fund rules enter the new rules at their market value on the start date of the new rules (which for most individuals will be 1 April 2007).

Application dates

The new tax rules for offshore portfolio investment in shares apply for income years beginning on or after 1 April 2007. For the large majority of individuals who have a standard balance date of 31 March, this means that the new rules apply from the start of their 2007–08 income year on 1 April 2007. For early balance date taxpayers, the new tax rules apply from the start of their 2008–09 income year; for example, for a person with a 31 December balance date, the new rules apply from the start of their 2008–09 income year on 1 January 2008. For late balance date taxpayers, the new tax rules apply from the start of their 2007–08 income year; for example, for a person with a 30 June balance date, the new rules apply from the start of their 2007–08 income year on 1 July 2007.

A special application date rule applies for companies, group investment funds, or superannuation funds that intend to be portfolio investment entities. These entities may choose to delay the application of the new offshore tax rules until 1 October 2007 when the new tax rules for portfolio investment entities come into force. This

deferral is effected by the entity giving a notice to the Commissioner before 1 April 2007 (if the entity exists before that date) or within one month of the day on which the entity comes into existence (if the entity comes into existence between 1 April 2007 and 1 October 2007). This special application date rule for prospective portfolio investment entities is intended to align the start dates of the new offshore tax rules and the new tax rules for portfolio investment entities.

It is intended that the special application date rule of 1 October 2007 for entities intending to become portfolio investment entities also applies to early balance date taxpayers that choose to become portfolio tax rate entities (other than those choosing to pay provisional tax under section HL 22) because of the operation of section HL 12(2) and section 38(1B) of the Tax Administration Act 1994. Such early balance taxpayers are treated as having a late balance date of 30 September 2007; this means that the new offshore tax rules can also apply to such entities from 1 October 2007.

Detailed analysis

Interests subject to the new foreign investment fund rules (sections EX 29 to EX 31)

The foreign investment fund rules apply to a wide range of interests in foreign entities. The rules broadly seek to tax the income earned by foreign entities on interests held by New Zealand residents. The rules provide a mechanism for attributing the income of a foreign entity to a New Zealand resident who has an interest in that entity.

In particular, the following interests, subject to certain exemptions discussed below, are subject to the foreign investment fund rules:

- Interests in a foreign company (including a foreign unit trust). These interests are measured by reference to direct income interests as defined in section EX 31.
- Rights to benefit from a foreign superannuation scheme.
- Rights to benefit from a foreign life insurance policy.

The main change to the scope of the previous foreign investment fund rules is that the general exemption for interests in grey list companies no longer applies to less than 10 percent (that is, portfolio) interests.

$50,000 minimum threshold for application of foreign investment fund rules (sections CQ 5 and DN 6)

A minimum threshold applies to an individual's investments in foreign companies below which the foreign investment fund rules do not apply. The term "individual" is used here to refer to a natural person. If the original cost of these shares totals NZ$50,000 or less at all times in an income year, the foreign investment fund rules do not apply for that year. The individual investor will continue to pay tax only on dividends if they hold the shares on capital account. This minimum threshold also encompasses interests in foreign superannuation schemes and life insurance policies.

It should be noted that this rule is a threshold rather than an exemption. Therefore, if the cost of a person's offshore shares exceed $50,000 all their shares are subject to the foreign investment fund rules and not just the excess costing more than $50,000.

The $50,000 minimum threshold takes into account brokerage fees if these form part of the cost of acquiring any shares.

The exchange rate on the date of purchase of any shares in foreign currency should be applied for the purposes of the NZ$50,000 minimum threshold. This information can be obtained from websites which contain on-line currency conversion calculators – for example, www.oanda.com/convert/classic, which goes back to January 1990. The New Zealand Reserve Bank's monthly exchange rate data is also acceptable to Inland Revenue for this purpose: www.rbnz.govt.nz/statistics. Exchange rate information is also available from all major trading banks.

A married couple or a couple in a de facto relationship or civil union can qualify for a total NZ$100,000 threshold. This can be achieved by half of the shares costing $100,000 being held in each spouse's name, the shares being wholly jointly owned, or a combination of individual and joint ownership. Each spouse would have to add half the cost of the jointly owned shares to their individual shares to ascertain if they come under or over the threshold. For example, if each spouse holds shares in their own name costing $20,000 and jointly own shares costing $60,000, then both spouses would qualify for the threshold. Each spouse's $50,000 total is calculated by adding the shares they individually own ($20,000) and half ($30,000) of the shares they jointly own. However, if one spouse in this example instead individually owned shares costing $40,000 then that spouse would not qualify for the threshold: the spouse's total would be $70,000 ($40,000 plus $30,000 share of jointly owned shares). The other spouse would still qualify for the threshold.

A special rule is available for establishing whether investments that were acquired before 1 January 2000 fall within the minimum threshold. For these shares, the market value at 1 April 2007 may be halved and used to calculate the amount to be added to the cost of investments acquired on or after 1 January 2000 to determine whether the minimum threshold is exceeded. The rule is designed to assist investors who have no record of the cost of investments they have held for many years. Treating the cost of pre-2000 interests as half of the market value is optional but, once elected,

the treatment cannot be changed in subsequent income years. Also, if this option is chosen it must be used for all investments acquired before 1 January 2000.

The NZ$50,000 minimum threshold for the application of the new offshore tax rules also applies to the following small range of trusts:

- The settlor of the trust is a relative or legal guardian of the beneficiary, or a person associated with a relative or legal guardian of the beneficiary, and is required by a court order to pay damages or compensation to the beneficiary.
- The settlor is the ACC.
- The trust is of the estate of a deceased person and the current income year begins before the date that is five years after the person's death.
- The settlor of the trust is the estate of a deceased person and a court order requires the proceeds of damages or compensation to be settled on the trust for the beneficiaries of the trust.

Family trusts that are not within the limited range outlined above, such as discretionary trusts, do not get the benefit of the $50,000 minimum threshold because of the risk of multiple trusts being used for the benefit of the same individuals.

If an investor holds offshore shares in a year costing more than the NZ$50,000 threshold and disposes of a sufficient quantity of them during the same year to bring the cost of shares held under the threshold, they will still be subject to the new offshore tax rules in that year (as they have held shares costing greater than NZ$50,000 for part of the year). They will, however, qualify for the threshold in the following year, assuming they do not purchase any additional shares in that year.

If an investor holds offshore shares at the start of a year costing less than the NZ $50,000 threshold, and buys more shares during the year that takes them over the threshold, they will be subject to the foreign investment funds rules for the whole of that year. If the investor uses the fair dividend rate or comparative value method for that year, they will not be taxed on any dividends on those shares that year. (This is the effect of section EX 47.)

Shares in foreign companies, that are covered by the various exemptions from the foreign investment fund rules, such as those for investments in Australian-resident listed companies and certain grey list companies, do not count towards the NZ$50,000 minimum threshold.

The NZ$50,000 minimum threshold is based on the cost of offshore shares held rather than their market value. This is so taxpayers can refer to actual cost when determining whether the threshold applies to them, rather than having to track changing market values over time.

The NZ$50,000 minimum threshold is designed to reduce compliance costs. The threshold attempts to strike a balance between accuracy and simplicity for individual investors with relatively small amounts invested offshore and recognises that any additional accuracy gained from applying the more complex foreign investment fund rules (compared with dividend-only taxation) may be outweighed by the compliance costs.

Exemption for investments in Australian-resident listed companies (section EX 33C)

Investments in Australian-resident listed companies are generally exempt from the foreign investment fund rules. This means that investors, other than portfolio investment entities, who invest directly in Australian-resident companies listed on the Australian Stock Exchange will continue to be taxed under general income tax rules – they will be taxed on dividends only if the share is held on capital account, and on dividends and realised share gains if held on revenue account.

Investments in Australian-resident listed companies by portfolio investment entities will be taxable only on dividends, subject to the portfolio investment entity having full equity risk in the Australian share. This is because any realised share gains are treated as excluded income under section CX 44C.

The exemption for Australian-resident companies is restricted to companies listed on an approved index of the Australian Stock Exchange (ASX). The approved ASX indices include the ASX All Ordinaries (the 500 largest listed companies), ASX 50 Leaders and ASX 200. The exemption should cater for most New Zealanders' portfolio share investments in Australia.

The following website contains a list of companies on the ASX All Ordinaries index:

http://www2.standardandpoors.com/portal/site/sp/en/au/page.topic/indices_asxallo/2,3,2,8,0,0,0,0,0,0,3,0,0,0,0,0.html

The exemption applies only to interests in Australian-resident companies that are required to have a franking account in accordance with Australian tax law.

Generally, a New Zealand investor that receives a "franked" dividend from a company that is listed on the ASX All Ordinaries index will be entitled to this exemption from the foreign investment fund rules. The exemption should therefore be relatively easy to self-assess.

Interests in Australian unit trusts do not generally qualify for the Australian exemption because they are not required to have a franking account and will therefore be subject to the new foreign investment fund rules (an exception for interests in certain Australian unit trusts is discussed below).

The exemption does not apply to an investment in an Australian-resident company whose residence tie-breaks to a country other than Australia or New Zealand under an Australian tax treaty. This is because such a company may not be subject to full Australian or New Zealand tax.

New Zealand's Inland Revenue has a close working relationship with the Australian Tax Office, which will allow the use of this exemption to be monitored.

Australian unit trusts (section EX 33D)

Investments in certain Australian unit trusts that turn over a sufficient proportion of their investments each year and use the RWT proxy rules for meeting the tax obligations of its New Zealand investors are exempt from the new foreign investment fund rules.

For the exemption to apply the Australian unit trust is required to turn over a minimum of 25 percent of its profit-making assets each year. This requirement would encourage distributions to be made to New Zealand-resident unit holders. The minimum turnover requirement does not take into account investments in loss because otherwise there could be an incentive to dispose only loss-making investments to meet the minimum turnover requirement. Only profit-making assets are taken into account for the purpose of the formula in section EX 33D(2); this is an effect of the opening wording in section EX 33D(l)(e).

Inland Revenue has no problem with shares being sold and immediately repurchased for the purpose of satisfying the turnover requirement (aka "bed and breakfast" arrangements).

The exemption is only available to those investors in the qualifying Australian unit trust who elect to use the RWT proxy mechanism. This is because this mechanism gives assurance that New Zealand tax liabilities will be satisfied. It is also expected that the RWT proxy, who will generally be a New Zealand-based agent, will be able to advise investors on whether an Australian unit trust meets the turnover requirements.

The exemption for investments in Australian unit trusts that meet minimum turnover requirements and where the investor elects to use the RWT proxy mechanism is meant to accommodate current arrangements, where investors in certain Australian unit trusts have their tax liabilities satisfied under the RWT proxy rules, thereby reducing compliance obligations.

Australian unit trusts were not generally included in the exemption from the foreign investment fund rules in section EX 33C for Australian investments because they could be used as roll-up vehicles to invest outside Australia in companies that pay little or no dividends (and therefore avoid the new offshore tax rules). New Zealand investors could invest in these vehicles and derive income in the form of capital gain, without a tax liability arising on this income in either Australia or New Zealand. The minimum turnover requirement in the limited exemption in section EX 33D addresses this concern.

Temporary exemptions for investments in certain grey list companies (section EX 33B)

There are two temporary exemptions from the foreign investment fund rules for five years and two years respectively for investments in certain grey list companies (that is, companies resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States).

Five-year exemption for investments in New Zealand-owned grey list companies

Under this temporary exemption, investments in companies that meet certain criteria would continue to be taxable under the general income tax rules for a period of five years, that is, for the 2007–08 to 2011–12 income years.

The main criteria for this temporary exemption are that the investment is in a grey list company that on 17 May 2006 (the date of introduction of this legislation):

- is listed on a recognised exchange in both New Zealand and a grey list country;
- is liable to income tax in a grey list country;
- has more than 20,000 shareholders who have addresses in New Zealand on the company's New Zealand share register and these shareholders hold shares in the company carrying voting interest of more than 50 percent; and
- has assets of which more than 50 percent in total value are shares in other companies carrying voting interest of more than 50 percent.

For this exemption to apply the grey list company must within 30 days after the date of enactment (18 December 2006) of this legislation, give to the Commissioner of Inland Revenue notice that on 17 May 2006 the company satisfied the above criteria.

The rationale for this temporary exemption is to allow time for completion of the government's review of the controlled foreign company tax rules. Pending the outcome of this review, which includes consideration of whether the controlled foreign company rules should exempt income from active investment while continuing to tax income from passive investment, some grey list companies may consider relocating to New Zealand. If this were the case, the offshore tax rules for portfolio investments would not apply to investments in such companies. The outcome of this review would be important for a company like Guinness Peat Group plc in its consideration of whether to relocate, as its primary

investment would likely be an active investment in a controlled foreign company.

Two-year exemption for investments in grey list companies investing in Australasian shares

There is also a temporary exemption of two years (that is, the 2007–08 and 2008–09 income years) from the new foreign investment fund rules for interests in grey list companies that invest primarily in Australasian equities.

For investors to qualify for this two-year holiday, the grey list company would need to have at least 90 percent of its assets (by value) invested in New Zealand-resident listed companies and Australian-resident listed companies; also at least 50 percent of the grey list company's assets (by value) must be invested in New Zealand-resident companies. This Australasian investment requirement would have to be maintained throughout the two-year exemption period.

Further criteria for this exemption are that the grey list company must, on 17 May 2006 (the date of introduction of this legislation):

- be listed on a recognised exchange in both New Zealand and in a grey list country;
- have shareholders of which more than 40 percent have addresses in New Zealand on the company's New Zealand share register;
- be liable to income tax in a grey list country;
- have assets of which at least 50 percent in total value are shares in New Zealand-resident companies; and
- have assets of which at least 90 percent in total value are shares in New Zealand-resident listed companies and Australian-resident listed companies.

It is also necessary for the grey list company in the 30-day period after the date of enactment (18 December 2006) of this legislation to give the Commissioner of Inland Revenue notice that on 17 May 2006 it satisfied the above criteria.

The purpose of this temporary exemption is to allow the relevant grey list companies time to relocate to New Zealand and become portfolio investment entities. This is because New Zealand investors in grey list entities that have a predominantly Australasian investment policy would benefit if this happened. Such entities would benefit under the portfolio investment entity tax rules from not having their capital gains from trading Australasian shares taxed.

Revenue account investor election (section EX 33B(3))

Investors who hold shares on revenue account that qualify for the temporary exemptions from the new foreign investment fund rules can elect that the exemption not apply, which means that such shares will be taxed under the foreign investment fund rules. The election is made in a return of income for an income year; the election is irrevocable and applies for that income year and the remaining years of the exemption period.

Institutional investors (that is, portfolio investment entities and other managed funds) would generally hold their investments on revenue account, and would be taxable on any gains that are realised. In many cases, the fair dividend rate method would result in a lower tax liability for such investors. A fair dividend rate method would also be easier for managed funds to apply under the portfolio investment entity tax rules.

This election is likely to be particularly beneficial for portfolio investment entities as attribution of income to investors would be simple under the fair dividend rate method. In contrast, if the general tax rules were to apply, investors would be subject to tax on realised gains on these investments. This would require deferred gains and losses to be allocated across tax years and current and future investors, which would be difficult for portfolio investment entities to manage.

Publication of list of qualifying companies

An amendment has been made to the secrecy provisions to allow Inland Revenue to publish the names of companies that it has received notification from that they meet the criteria for the temporary exemptions from the foreign investment fund rules (section 81(4)(mc) of the Tax Administration Act 1994).

Guinness Peat Group plc has given notice to the Commissioner under section EX 33B(1)(b) that it meets the criteria for the five-year exemption. New Zealand Investment Trust plc has given notice to the Commissioner under section EX 33B(2)(b) that it meets the criteria for the two-year exemption.

Venture capital exemption (section EX 33(3) and (4))

There is an exemption from the new offshore tax rules that is designed for venture capital investments in New Zealand-resident start-up companies that migrate offshore to gain access to additional equity financing. Without this exemption the New Zealand investors could end up holding portfolio interests subject to the foreign investment fund rules. The policy basis for this exemption is that venture capital investments do not compete with investment via New Zealand managed funds and therefore are not the target of the new rules.

The criteria for the venture capital exemption are:

- The investment is shares in a grey list company that was previously a New Zealand-resident company.
- The investor acquired the shares before the company migrated from New Zealand and before the shares were listed on a recognised exchange. It is intended that these investors will be able to continue to invest in the company after it has listed without losing the exemption.

- The grey list company has a fixed establishment in New Zealand, which has at least $1 million of expenditure (not including interest) each year or 10 full-time employees or contractors providing services.
- Before migrating, the company had been tax-resident in New Zealand for a minimum of 12 months and had the majority of its assets and employees in New Zealand for at least a year.
- The exemption lasts for 10 income years from the income year in which the company migrates.
- The shares would enter the foreign investment fund rules at market value at the end of the 10-year exemption period.

The exemption also applies to shares purchased in a grey list company that owns a New Zealand company that meets the above criteria. This variation to the exemption caters for situations where shares in a grey-list company are received in exchange for shares in a New Zealand-resident company. The 10-year exemption period starts from the income year in which the grey list company acquires a majority of the shares of the New Zealand-resident company.

Employee share purchase scheme exemption (section EX 33(5))

There is a limited exemption from the new foreign investment fund rules for individuals who hold shares in a foreign company acquired through an employee share purchase scheme that satisfies the following criteria:

- The foreign company is resident in a grey list country and is the employer of the employee or owns, directly or indirectly, the New Zealand-resident employer of the employee.
- The shares are acquired through employment under a share purchase agreement (as defined in section CE 7).
- There are restrictions in the share purchase agreement applying to the disposal of the shares for a period that satisfies the requirements in section CE 3.

Employees have up to six months from the date the restrictions on disposal no longer apply to dispose of their shares before the foreign investment fund rules apply to the shares. After this period, the shares would enter the foreign investment fund rules at their market value.

Non-portfolio grey list exemption (section EX 33(1) and (2))

Interests of 10 percent or more, (non-portfolio interests) in grey list companies (those resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States) are exempt from the new foreign investment fund rules. The company must be liable for income tax in the grey list country it is resident in for this exemption to apply.

The investor's interest in the grey list company must be 10 percent or more at all times in the relevant income year for the exemption to apply. If the interest falls below 10 percent after the start of the income year and the fair dividend rate method can be applied to the interest there will be no foreign investment fund income in that year.

The grey list exemption for interests of 10 percent or more in grey list companies does not apply if the interest is held by a portfolio investment entity, superannuation scheme, unit trust, life insurer or a group investment fund. This exception is because of the widely held nature of such investors.

Other exemptions from the new rules

Other exemptions from the foreign investment fund rules which existed before these changes, such as those for interests covered by the controlled foreign company rules and employment-related pensions continue to apply, other than the previous general grey list exemption.

Methods for calculating foreign investment fund income or loss

The amendment Act introduces two new methods for calculating foreign investment fund income – the fair dividend rate method and the cost method.

It is expected that the fair dividend rate method will be the primary method for calculating foreign investment fund income for less than 10 percent interests in foreign companies (including unit trusts). The only significant exceptions to this would be when individuals and family trusts choose to use the comparative value method when the total annual return from an investment is less than 5 percent and when the comparative value method (or deemed rate of return method) is required to be used for portfolio investments which have a guaranteed return nature. These exceptions are discussed further below.

The comparative value method takes into account the full economic returns (capital gains and dividends) from an investment. The deemed rate of return method is the back-up method to the comparative value method and can be applied when current market value information about an investment is not available and is based on the original cost of the investment.

The branch equivalent and accounting profits methods remain available for use by taxpayers who satisfy the conditions for their use. Significant information is required to use these methods, which are designed to tax investors on their share of a foreign company's underlying earnings.

Fair dividend rate method (sections EX 44B to EX 44E)

Under the new fair dividend rate method tax is paid on 5 percent of the opening market value of an investor's

offshore portfolio share investments held at the start of an income year. However, if the investor is an individual or family trust and the total return (dividends and capital gains) is less than 5 percent, tax can be paid on this lower amount with no tax payable when the total return is negative.

On-line calculators will be available on the Inland Revenue website to assist people to calculate their foreign investment fund income using the fair dividend rate method.

Non-natural person investors (other than family trusts) are taxed on 5 percent of the value of shares held each year. There is no variation to this rate in years where the investor earns less than 5 percent.

General features of fair dividend rate method

The fair dividend rate method:

- taxes 5 percent of the market value of offshore shares held at the start of an income year (the close of trading price on the last day of the preceding income year is acceptable to Inland Revenue);
- applies only to portfolio investments in offshore shares – that is, interests of less than 10 percent in a foreign company – that have verifiable market values;
- works on a pooled approach, rather than on an investment-by-investment approach, for shares that qualify;
- ignores purchases and sales of shares during a year, except when the shares are bought and sold in the same year – separate "quick sale" rules, described below, apply for these. Therefore, there is no foreign investment fund income in the year of purchase in relation to shares that are acquired after the start of an income year. Conversely, there is no reduction in foreign investment fund income in relation to shares held at the start of an income year that are sold during the year;
- does not tax dividends separately (this is achieved through section EX 47). However, foreign withholding tax deducted from dividends is still available as a foreign tax credit under section LC 1(1) and (4) (note that section LC 1(4) provides that the amount of foreign tax credit calculated under section LC 14 is based on the taxpayer's FIF income); and
- does not result in foreign investment fund losses.

The primary formula for the fair dividend rate method is:

5% x opening market value (total for all shares for which method is used) plus quick sale adjustment (for shares bought and sold in same year, discussed below).

Market value information is not restricted to listed share prices. Other information that is verifiable and therefore should be used includes published unit prices for redemptions and the net asset values at which units can be redeemed. However, exit values that incorporate a penalty for early withdrawal or redemption would not be acceptable.

Application of method to individuals and family trust investors

For individual investors and family trusts, a variation to the fair dividend rate approach outlined above is allowed. Under this variation if investors can show that their total return on all their offshore shares, for which the fair dividend rate method is allowed to be used, is less than 5 percent of the opening market value they are taxable on the lower amount. If the total return for the year is nil or negative, no tax would be payable (and no loss recognised). The total return is calculated using the comparative value formula in section EX 44:

(closing market value of shares held + total sales proceeds + dividends received) – (opening market value of shares held + total value of purchases)

Example 1

When an individual makes a total return of more than 5 percent

John holds offshore shares that have a market value of $100,000 at the start of the year. These shares are worth $115,000 at the end of the year. John also derives a $10,000 dividend.

Under the fair dividend rate method, John pays tax on 5 percent of $100,000 or a lower amount if his return for the year is less than 5 percent. No tax is payable if he makes a negative return.

John's total return for the year is the $15,000 capital gain on his shares and the dividend of $10,000. His total return is therefore $25,000. However, his taxable income for the year is limited to 5 percent of the opening value of his shares. This would result in taxable income of $5,000. (Under the fair dividend rate method the $10,000 dividend is not separately taxed.)

Example 2

When an individual makes a total return of less than 5 percent

Mary also holds offshore shares that have a market value of $100,000 at the start of the year. These shares increase in value to $102,000 at the end of the year. Mary also receives a $1,000 dividend.

As in the previous example, Mary would pay tax on 5 percent of $100,000 (her opening value) unless she can show that she made a return of less than this.

Mary's total return for the year is $3,000 (comprising a capital gain of $2,000 and a dividend of $1,000), which is less than 5 percent of her opening value of $100,000. Therefore, Mary is only taxed on $3,000.

Example 3

When an individual makes a loss

Judy holds offshore shares that have a market value of $100,000 at the start of the year, which decrease in value to $75,000 at the end of the year. She also receives a $10,000 dividend.

As in the previous examples, Judy would be taxable on 5 percent of the opening value of her shares unless she can show that her total return for the year is less than 5 percent.

Judy's total return for the year comprises a capital loss of $25,000 and the dividend of $10,000. Her net return is therefore a loss of $15,000. Because Judy has made a negative return on her offshore shares, no tax is payable under the fair dividend rate method.

Application of method to managed funds and other non-natural person investors

For New Zealand managed funds, including portfolio investment entities, and other non-natural persons (except family trusts) the variation outlined above does not apply. This means that tax payable is on a fixed 5 percent return irrespective of how investments perform.

A fixed fair dividend rate is more consistent with the portfolio investment entity rules than a variable rate. For most managed funds – referred to in the legislation as "unit valuers" – the 5 percent fair dividend rate applies to the average value of the entity's offshore portfolio share investments for the year. That is, for investment vehicles, such as unit trusts and superannuation funds, that calculate the value of their investments and their investors' units on a regular basis, the taxable income for each valuation period (which could range from a day to a quarter) would be calculated using the following formula:

$$5\% \times \text{market value of investments at start of period} \times \frac{\text{the number of days in the period}}{\text{number of days in the income year}}$$

The values that are used by unit valuers for unit pricing purposes are acceptable to Inland Revenue for purposes of applying the fair dividend rate method provided a consistent approach is taken. This policy should cater for daily unit valuers in relation to the treatment of weekends and public holidays.

Rules for shares that are bought and sold in the same income year ("quick sales")

Shares that are purchased after the start of the income year and then sold before the end of the same income year are taxed on the lower of 5 percent of the cost of the purchase or the actual gains made on these "quick sales".

The so-called "quick sale" rules are designed to tax shares that are bought and sold within the same income year – that is, for a taxpayer with a standard income year, shares that are purchased after 1 April and sold before the following 31 March. Without these rules, no tax would be payable on these shares as they would not be reflected in the value of shares held at the start of the year or in the value of shares held at the start of the following year.

The quick sale rules for investors (other than daily valuers) allow them to pay tax based on the lower of 5 percent of the average cost or the actual gains made on any "quick sales".

In the legislation the amount which is added to the standard fair dividend rate formula (5% x opening market value) to take account of shares bought and sold in the same income year is referred to as the "quick sale adjustment".

The quick sale adjustment is calculated as the lower of 5 percent of the cost of shares that are bought and sold in the same year – referred to the legislation as the "peak holding adjustment" – and the actual gains made on any such shares – referred to in the legislation as "quick sale gains".

The peak holding adjustment is the total of the amounts (a pooled approach) calculated for each foreign company using the formula: 5% x quick sales x average cost.

The "quick sales" amount in the peak holding adjustment formula is the lower of:

- the difference between the greatest number of shares held in the foreign company during the income year and the number of shares held in the foreign company at the start of the income year; and
- the difference between the greatest number of shares held in the foreign company during the income year and the number of shares held in the foreign company at the end of the income year.

The "average cost" component in the peak holding adjustment formula is the amount of expenditure that the shareholder incurs during the income year in acquiring or increasing their shareholding in a foreign company divided by the total number of shares acquired in the foreign company during the income year. Using the average cost approach takes account of the situation when different parcels of shares in the same company are purchased during the year at different prices. Taking the average cost of all such share parcels purchased in the year is easier than requiring investors to track the cost of each share that is subsequently sold.

The "quick sale gains" component of the quick sale adjustment is the greater of zero and the total amount for all shares bought and sold in foreign companies during the year (a pooled approach) calculated by taking the total amount derived from holding (including any dividends) or disposing of the shares in a foreign company and subtracting the total expenditure incurred in acquiring the interest (this would not include holding costs such as interest).

In ascertaining whether shares are bought and sold in the same year for the purposes of the "quick sale gains" part

of the quick sale adjustment, a last-in-first-out (LIFO) method applies to determine whether shares in a foreign company sold in a year were purchased in the same year.

Capping the quick sale adjustment to the actual gains made on shares that are bought and sold in the same income year, militates against over-taxation of quick sales that could occur if there was a high turnover of shares.

Example 4

Jane holds 10,000 shares worth $30,000 in Co.A and 10,000 shares worth $50,000 in Co.B on 1 April 2007. On 30 May, she buys another 1,000 shares in Co.A for $4,000 and on 15 October she buys another 4,000 shares in Co.A for $20,000. On 30 November she receives dividends of $1,000 from Co.A. and $2,000 from Co.B. On 2 February 2008, Jane sells 3,000 of her Co.A shares for $15,000. At the end of the year, Jane's remaining 12,000 Co.A shares are worth $48,000 and her 10,000 Co.B shares are worth $55,000.

Jane would be taxable on $4,000 (that is, 5% of $80,000) under the standard fair dividend rate method. However, Jane also bought 3,000 shares in Co.A during the year that she sold before the end of the year. The average cost of these 3,000 shares is $4.80 ($24,000 cost of acquiring new shares in the year divided by 5,000, the number of new shares). Her quick sale adjustment for these shares is the lesser of her peak holding adjustment and her quick sale gains. Her peak holding adjustment is:

5% x 3,000 (quick sales) x $4.80 (average cost) = $720

Jane's quick sale gains takes into account the total proceeds from holding or disposing of shares she bought and sold in Co.A during the year. These proceeds include a $200 dividend, which is the pro rata share of the $1,000 dividend paid on the Co.A shares that is attributable to the 3,000 shares bought and sold in the year (the 3,000 shares sold divided by the total 15,000 shares multiplied by the $1,000 dividend). Jane's remaining proceeds are the $15,000 sale proceeds from the 3,000 quick sale shares. From the total proceeds she subtracts the expenditure on the quick sale shares, which is the number of quick sale shares (3,000) multiplied by their average cost ($4.80) as calculated above. Therefore Jane's quick sale gains are:

($15,000 + $200) – $14,400 = $800

Jane's quick sale adjustment is therefore $720 (being the lesser of the peak holding adjustment of $720 and the quick sale gains of $800).

Jane's income under the fair dividend rate method is the sum of the opening value result ($4,000) and the quick sale adjustment ($720). This is $4,720.

Jane could be taxable on a lesser amount if she is able to show that her total return under the comparative value method in section EX 44 is less than $4,720. This option is only available for natural persons and family trusts.

Jane calculates that her actual return is:

($103,000 + $15,000 + $3,000) – ($80,000 +$24,000) = $17,000

As Jane's total return is more than $4,720, she is taxed at her personal tax rate on $4,720.

Example 5

NZ Co. holds 20,000 shares worth $120,000 in Foreign Co.A and 10,000 shares worth $80,000 in Foreign Co.B on 1 April 2007. On 15 May, NZ Co. buys a further 5,000 shares in Foreign Co.A for $30,000 and a further 5,000 shares in Foreign Co.B for $40,000. On 1 October NZ Co. receives a $2,000 dividend from Foreign Co.A. On 1 February 2008, NZ Co. sells 2,000 shares in Foreign Co.A for $14,000 and 3,000 shares in Foreign Co.B for $18,000.

NZ Co. would be taxable on $10,000 (that is, 5% of $200,000) under the standard fair dividend rate method. However, because NZ Co. also bought 2,000 shares in Foreign Co.A and 3,000 shares in Foreign Co.B during the year that it sold before the end of the year it would also have to calculate a quick sale adjustment.

NZ Co's quick sale adjustment for the shares it has bought and sold during the year is the lesser of its peak holding adjustment and its quick sale gains. NZ Co's peak holding adjustment is the total of the amounts from applying the peak holding adjustment formula for each of Foreign Co.A and Foreign Co.B.

For Foreign Co.A the calculation is:

5% x 2,000 (quick sales) x $6.00 (average cost) = $600

For Foreign Co.B the calculation is:

5% x 3,000 (quick sales) x $8.00 (average cost) = $1,200

NZ Co's peak holding adjustment is therefore $1,800 ($600 + $1,200).

NZ Co's quick sale gains is the total of the amounts from applying the quick sale gains formula for each of Foreign Co.A and Foreign Co.B.

NZ Co's quick sale gains for Foreign Co.A takes into account NZ Co's total proceeds from holding or disposing of the 2,000 shares in Foreign Co.A that it bought and sold during the year. These proceeds include a $160 dividend which is the proportion of the $2,000 dividend paid on the Foreign Co.A shares that is attributable to the 2,000 shares sold during the year (the 2,000 shares sold divided by the total of 25,000 shares multiplied by the $2,000 dividend). NZ Co's other proceeds from Foreign Co.A are the $14,000 sale proceeds from the 2,000 quick sale shares. From the total proceeds ($14,160) NZ Co. subtracts the

expenditure on the quick sale shares which is $12,000 (the 2,000 quick sale shares multiplied by their average cost of $6.00). Therefore, NZ Co's quick sale gains calculation for Foreign Co.A is:

($14,000 + $160) – $12,000 = $2,160

NZ Co's quick sale gains calculation for Foreign Co.B takes into account the total proceeds from holding or disposing of the 3,000 shares in Foreign Co.A that it bought and sold during the year, that is the $18,000 sale proceeds. From this amount NZ Co. subtracts the expenditure on the quick sale shares, which is the number of quick sale shares (3,000) multiplied by their average cost ($8.00). Therefore, NZ Co's quick sale gains calculation for Foreign Co.B is:

$18,000 – $24,000 = $6,000 loss

Combining the quick sale gains results for Foreign Co.A ($2,160) and Foreign Co.B ($6,000 loss) produces a $3,840 loss. Because the final result cannot be less than zero, NZ Co's quick sale gains amount is zero.

NZ Co's quick sale adjustment is therefore zero, being the lesser of its peak holding adjustment ($1,800) and its quick sale gains (zero). NZ Co's foreign investment fund income under the fair dividend rate method is therefore $10,000 (based on the $200,000 opening market value of its interests).

The quick sale rules do not apply to entities that value their investments daily. Where the valuation period is more than a day (for example, a month or a quarter) the entity needs to apply the quick sale rules to shares bought and sold during the respective valuation period. For example, a unit trust that values its investments quarterly would apply the quick sale rules to any shares that are bought after the start of the quarter and sold before the end of the quarter.

Shares that are bought and sold over different income years

The systematic buying and selling of offshore shares over different income years by taxpayers (other than daily unit valuers) for the purpose of reducing tax under the fair dividend rate method may result in the application of the general anti-avoidance provisions (sections BG 1 and GB 1).

Share reorganisations

There are also rules to deal with situations where an investor buys and sells shares during an income year (or valuation period for managed funds) and there is a share split between when the shares were purchased and when they were sold. This is described as a "share reorganisation" in the legislation. The rules establish the average cost of the "equivalent interest" that is sold for the purposes of applying the fair dividend rate method.

Foreign investment fund losses

No foreign investment fund losses can be produced under the fair dividend rate method (section EX 44B(4)).

A matching restriction on foreign investment fund losses has been included in the comparative value method which applies when individuals and family trusts choose to use that method instead of the fair dividend rate method for their less than 10 percent interests in foreign companies in an income year because the total return from all such investments in the year is less than 5 percent of opening market value. If a person has a total foreign investment fund loss under the comparative value method from all their less than 10 percent interests in the year the loss is reduced to zero (section EX 44(6B) and (6C)).

Example 6

Joe has portfolio interests (less than 10 percent interests) in Foreign Co A and Foreign Co B. Joe elects to use the comparative value method (instead of the fair dividend rate method) in a year. His investment in Foreign Co A produces a foreign investment fund loss of $1,000 and his investment in Foreign Co B produces foreign investment fund income of $400. Joe's total foreign investment fund loss for the income year is $600. Section EX 44(6C) reduces this total foreign investment fund loss to zero. This rule ensures a similar treatment of foreign investment fund losses for less than 10 percent interests in foreign companies under both the fair dividend rate and comparative value methods.

The above restriction on foreign investment fund losses does not apply if the less than 10 percent interest in a foreign company is a "guaranteed return" investment of a type listed in section EX 40(8)(a) (discussed below). The foreign investment fund loss restriction does not apply to these interests because they are subject to comprehensive taxation under the comparative value method (which means they are not allowed the benefit of the 5 percent cap under the fair dividend rate method).

Cost method (section EX 45B)

A cost-based method is available for offshore portfolio investments for which it is not possible to obtain market values (except by independent valuation) and therefore it is not practical to apply the fair dividend rate method. This back-up method taxes 5 percent of the cost of a person's investments, with the cost base increased by 5 percent each year to proxy for an increase in the value of the investment.

The main features of the cost method are:

- It taxes 5 percent of the cost of the portfolio investment each year plus an uplift of 5 percent to account for investment growth.
- No tax is payable in the year in which the investment is acquired, as there would be no cost base at the start of the year.
- The cost base for each subsequent year (referred to as the "opening value" in the legislation) is adjusted by any sales and purchases in the previous year and increased by the foreign investment fund income

for the previous year (5 percent of the "opening value" in the previous year), to account for investment growth. In the first year after the year the investment is acquired the original cost would constitute the opening value.

- Any dividends derived are not taxed separately (this is achieved through section EX 47). However, foreign withholding tax deducted from dividends is still available as a foreign tax credit under section LC 1(1) and (4). Any dividends are not subtracted from the opening value in the next year (this is because 5 percent deemed growth is likely, on average, to underestimate the actual increase in the value of the investment).
- The rules for shares bought and sold within the same income year ("quick sales") apply to portfolio investments for which the cost method is used.
- The method applies on an interest-by-interest basis rather than on a pooled basis.
- No foreign investment fund losses can be produced under the cost method.

Investors are required to use an independent valuation as the initial cost base if the interest was not an attributing interest in the previous income year. This requirement is mainly designed for former grey list investments that were not attributing interests before the 2007–08 income year. It is a one-off valuation requirement that allows investors to apply the cost method.

Investors have the ability to revalue their interests in companies subject to the cost method through an independent valuation and adjust their opening value accordingly. This allows investors to lower their cost base if the capital value of their investment has decreased. This resetting of the cost base through an independent valuation can be done once every five income years.

The main example of an interest for which the cost method is allowed to be used would be shares in a foreign company that are not listed on a recognised exchange and for which it is not practical to apply the fair dividend rate method because opening market value cannot be determined except by an independent valuation.

Example 7

On 1 April 2007, Peter holds an interest in a family company that is resident in the United Kingdom. He put in capital of $20,000 for which he received an 8 percent shareholding. The market value of his holding cannot be obtained without an independent valuation. Therefore, Peter is allowed to use the cost method. Under this method, his taxable income for the 2007–08 year would be calculated as 5 percent of $20,000 = $1,000. In the 2008–09 year, assuming Peter has not acquired or disposed of any interests in the company, his cost base is deemed to have increased by 5 percent (that is, by $1,000). His taxable income in the 2008–09 tax year would therefore be 5 percent of $21,000 = $1,050. His taxable income in the 2009–10 year would be 5 percent of $22,050 = $1,102 (again assuming he has not acquired or disposed of any interests in the company).

Rules for shares that are bought and sold in the same income year ("quick sales")

Shares that are purchased after the start of the income year and then sold before the end of the same income year are taxed at 5 percent of their average cost. As with the fair dividend rate method, these rules are necessary because without them no tax would be payable on such shares as they would not be included in the opening value.

The quick sale rules in the cost method are similar to those in the fair dividend rate method except that the actual gains on quick sales are not taken into account. Therefore, the rules are simpler to apply as they are based only on 5 percent of the average cost of quick sale shares.

The term "quick sales" in the legislation refers to shares that are bought and sold during the income year. The "average cost" of these quick sale shares is calculated by dividing the total expenditure incurred on acquiring new shares in the year by the total number of shares acquired in the year. Using the average cost approach takes account of the situation when different parcels of shares in the same company are purchased during the year at different prices.

Other foreign investment fund calculation methods

Although the new fair dividend rate and cost methods will be the primary methods for calculating foreign investment fund income for less than 10 percent interests in foreign companies, investors have the option of using the other methods for calculating foreign investment fund income or loss – branch equivalent, accounting profits, comparative value and deemed rate of return – if they satisfy the conditions for using these methods.

Removal of foreign investment fund loss ring-fencing rules (sections DN 5, DN 8, IE 4 and IG 5)

The previous ring-fencing rules in section DN 8 for foreign investment fund losses (other than foreign investment fund losses calculated under the branch equivalent method) have been repealed.

If a taxpayer has a ring-fenced foreign investment fund loss from the 2006–07 or an earlier income year that has previously not been used, it will become deductible in 2007–08 as foreign investment fund losses are no longer ring-fenced (other than those arising under the branch equivalent method).

Currency conversion rules

The rules for converting amounts from foreign currency into New Zealand currency have been standardised for all foreign investment fund calculation methods (other than the branch equivalent method which has separate currency conversion rules).

For the fair dividend rate, cost, comparative value and deemed rate of return methods, investors have two options for performing exchange rate conversions:

- conversion using the exchange rate on the day for which market value is determined or on which each amount is derived or incurred; or
- conversion at the average of the close of trading spot exchange rates for the fifteenth day of each month that falls in the year.

For a person using the accounting profits method, the person must choose for all the calculations of the net after-tax accounting profits to be in:

- the currency of the foreign investment fund's accounts, with the result then converted at the average of the close of trading spot exchange rates for the fifteenth day of each complete month that falls in the accounting period; or
- New Zealand currency.

Having chosen a currency conversion method for an attributing interest in a foreign investment fund, a person must use the same method for that interest in subsequent income years. Therefore, it will no longer be possible to change currency conversion methods from year to year for the same attributing interests.

A person is also required to use the same currency conversion method for all attributing interests for which they use the same foreign investment fund calculation method. For example, if a person chooses to use only the fair dividend rate method for their offshore portfolio share investments they must use the same currency conversion method – the actual (spot) exchange rates or an annual average rate – for all those investments.

These changes, which require consistency in the use of currency conversion methods, are intended to prevent taxpayers changing their currency conversion method in order to reduce their income tax liabilities.

Restrictions on choice of calculation methods

Subject to certain restrictions, anyone with attributing interests in foreign investment funds may choose to use any of the six methods of calculating foreign investment fund income or loss – fair dividend rate, cost, accounting profits, branch equivalent, comparative value and deemed rate of return – by completing their return of income accordingly (section EX 38).

The rules dealing with the restrictions on choosing the particular calculation methods have been amended to incorporate the new fair dividend rate and cost methods. These new restrictions apply to attributing interests that are shares in foreign companies and do not apply to attributing interests in foreign superannuation schemes and foreign life insurance policies.

Restrictions on using the fair dividend rate method (sections EX 40(7), (8) and (9), and EX 40B and section 91AAO of the Tax Administration Act 1994)

The fair dividend rate method may generally only be used for interests of less than 10 percent in foreign companies (section EX 40(7)(b)).

In determining whether a person's shareholding in a foreign company is less than 10 percent they are treated as holding any interests held by associated persons. This rule prevents persons holding 10 percent or more interests in foreign companies disaggregating their interests amongst associated persons to inappropriately access the fair dividend rate method.

The requirement that a person's interest in a foreign company must be less than 10 percent must be met at all times during the income year if the foreign company is not a grey list company. However, if the foreign company is a grey list company (that is, a company resident in Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States) the requirement has only to be met at one point in time in the income year. The reason for this lesser restriction for investments in grey list companies is to allow a person to continue to use the fair dividend rate method for the year they are increasing their interest in a grey list company from less than 10 percent to 10 percent or more instead of requiring them to use the comparative value method for that transitional year before they become entitled to the exemption from the foreign investment fund rules for 10 percent or more interests in grey list companies.

An exception to this less than 10 percent rule is that a portfolio investment entity, an entity eligible to be a portfolio investment entity (such as a superannuation fund that does not elect) or a life insurance company can use the fair dividend rate method for any level of interest they hold in a foreign investment vehicle. This is generally defined as a non-resident collective investment vehicle that meets the requirements in section HL 5. Because of the widely held nature of these investing entities, investments by these entities can be regarded as being in-substance portfolio investments and therefore should be entitled to have the fair dividend rate method apply to them (section EX 40(7)(a)).

A person is allowed to use the fair dividend rate method for an attributing interest for an income year only if the person does not use the comparative value method for any other attributing interest that is a share in a foreign company and for which the person would be allowed to use the fair dividend rate method – for example, it is a less than 10 percent interest (section EX 40(8)(b)). This requirement provides the mechanism which prevents

persons (including individuals and family trusts) from selectively using the fair dividend rate method for their shares to produce a total return (dividends and capital gains) of over 5 percent (thereby gaining advantage of the 5 percent cap under that method) and using the comparative value method for their shares to produce a total return of less than 5 percent (which would tax that lesser amount). Therefore, individuals and family trusts must choose between using either the fair dividend rate method or the comparative value method for all their less than 10 percent shareholdings in foreign companies and cannot "cherry pick" between these methods. In other words, investors must take a portfolio approach to applying the fair dividend rate or comparative value methods.

The fair dividend rate method does not apply to certain offshore portfolio share investments which effectively offer New Zealand investors "guaranteed returns". These investments are more akin to debt investments than equity investments and it is New Zealand's policy to tax debt investments in full. For example, a portfolio investment in a company resident in a low-tax jurisdiction that invests in high-yield debt or other guaranteed return instruments would be taxable on a maximum return of 5 percent under the fair dividend rate whereas if they had invested directly in these instruments they would be taxable on the full return.

There are five types of investments of a "guaranteed return" nature that do not qualify for the fair dividend rate method (sections EX 40(8)(a)(i) to (v)) and EX 40(9)):

1. Fixed rate share investments in foreign companies (a "fixed-rate share" is defined in section LF 2(3) of the Income Tax Act 2004).
2. Non-participating redeemable share investments in foreign companies (a "non-participating redeemable share" is defined in section CD 14(9) of the Income Tax Act 2004).
3. Investments which involve an effectively non-contingent obligation, directly or through an arrangement, to return an amount to the investor that exceeds the issue price of the investment. The Commissioner has a discretion under section 91AAO of the Tax Administration Act 1994 to make a determination that an investment that is caught by this non-contingent obligation restriction but is not substantially debt in nature, still qualifies for the fair dividend rate method.
4. The Commissioner has the discretion to make a determination under section 91AAO of the Tax Administration Act 1994 that an investment that is not excluded from the fair dividend rate method by the above restrictions, but is still substantially debt in nature, does not qualify for the fair dividend rate method.
5. Investments in non-resident entities whose assets comprise 80% or more New Zealand dollar denominated financial arrangements (debt instruments) also do not qualify for the fair dividend rate method. This is necessary, as the rule in category 3 above may not be effective in instances when the investment is in a foreign bond fund that invests back into New Zealand government debt. This is because the obligation to provide a return in excess of the issue price would apply to the foreign fund holding the New Zealand debt, not between the New Zealand investor and the fund.

The principle underlying the Commissioner's making of a determination precluding use of the fair dividend rate method is that the method should not apply to investments in foreign entities that provide investors with a return similar to a New Zealand dollar denominated debt instrument. The determination process is intended to prevent investments that may otherwise be marketed as a New Zealand dollar denominated debt investment being held through an offshore entity to take advantage of the fair dividend rate method. For the purposes of making a determination described under category 4 the criteria that the Commissioner will consider will include:

- The proportion of the foreign entity's assets that comprise debt or other fixed return instruments (such as fixed rate shares).
- The extent to which the entity's investments comprising debt or other fixed rate instruments are denominated in New Zealand currency.
- In relation to investments of the entity that are not denominated in New Zealand currency, the extent to which the exchange rate risk has been removed by swaps, forward currency contracts or other derivatives.

The Commissioner will take into account the whole arrangement, including any interposed entities or financial arrangements, in ascertaining whether the investment in a foreign entity provides investors with a return similar to a New Zealand dollar denominated debt instrument.

The degree of credit risk of the entity's debt investments is not a relevant factor in the determination process.

In making any determination under section 91AAO of the Tax Administration Act 1994, the Commissioner will take into account the economic relationships created by the whole arrangement and the principle that the fair dividend rate method should only be used for an in-substance equity investment where the investor has an interest in the business profits and losses of a foreign entity. This determination process is intended to provide sufficient flexibility to deal with cases close to the boundary.

Determinations apply on a prospective basis only, unless the taxpayer would, in the absence of the determination, be subject to a shortfall penalty in respect of the investment that is affected by the determination.

For investments in place before 18 December 2006 (date of enactment of the new offshore tax rules), the Commissioner will apply any determination from the start of the tax year beginning after the making of the determination. This will also be the general rule for other investments except for those investments designed to circumvent the restrictions on the use of the fair dividend rate method; determinations for these investments may apply from the date they are made.

The Australian "economic substance" test for determining whether an instrument is debt or equity provides guidance for determining whether an investment involves an effectively non-contingent obligation to return an amount to the investor that exceeds the issue price of the investment (as in category 3 above) and therefore should not have the fair dividend rate method applied to it, because the investment is essentially debt. Contingencies that are immaterially remote are ignored for the purposes of this rule. Guidelines issued by the Australian Tax Office provide guidance on understanding what an "effectively non-contingent obligation" is. In particular, the guidelines note that regard should be had to the terms, conditions and pricing of the instrument.

A person who is not allowed to use the fair dividend rate method for an attributing interest because it comes within one of the five categories of "guaranteed return" investments must use the comparative value method for that interest, or the deemed rate of return method if the comparative value method is not practical because the person cannot obtain the opening market value for the interest (section EX 40B).

Deemed rate of return method (section EX 40(5))

A person may not use the deemed rate of return method for an attributing interest if the interest is a less than 10 percent shareholding in a foreign company and the person is not required to use the deemed rate of return method for the interest under section EX 40B (because it is a "guaranteed return" form of investment).

Comparative value method (section EX 40(6))

A person may use the comparative value method for an attributing interest that is a share in a foreign company only if:

- the interest is 10 percent or more at any time in the income year (for this purpose, a person's interests are increased by any interest held by associated persons); or
- the interest is a "guaranteed return" form of investment referred to in section EX 40(8)(a) for which the comparative value method or deemed rate of return method must be used under section EX 40B; or
- the person is a natural person or a family trust (defined as a qualifying trust established mainly for the benefit of natural persons related to the settlor or charities and which has no settlor who is not a natural person; the trust must also not be a superannuation scheme).

The main purpose of these restrictions is to prevent persons other than individuals or family trusts from using the comparative value method for less than 10 percent shareholdings in foreign companies and thereby potentially "cherry picking" between the fair dividend rate and comparative value methods by changing their investments between years. The restriction is also consistent with the fair dividend rate method being the primary calculation method for less than 10% interests in foreign companies.

Cost method (section EX 40(10))

The cost method is the back-up method to the fair dividend rate method and is designed to cater for less than 10 percent interests in foreign companies for which use of the fair dividend rate method is allowed. For example, the investment does not have a "guaranteed return" but it is not practical to use the fair dividend rate method because the investor cannot determine the opening market value of the interest except by an independent valuation. An example of where the cost method may be used may be investments in unlisted foreign companies.

Default calculation method (section EX 41)

The rules which allocate a default calculation method in situations when a person does not choose a particular calculation method for an attributing interest (as required under section EX 38(2)) and the foreign investment fund rules do not have the effect of requiring a particular method to be used, have been amended to cater for the new fair dividend rate and cost methods.

The default calculation method for less than 10 percent interests in foreign companies for which use of the fair dividend rate method is allowed (for example, the interest is not a "guaranteed return" form of investment) is the fair dividend rate method if it is practical to use that method. If it is not practical to use that method for such interests the default calculation method is the cost method.

In practice, the default calculation method rules give the Commissioner a basis for assessing an investor's income if no tax return is filed.

Restrictions on change of calculation method (section EX 50)

The general rule in EX 50(1) is that once a person uses a particular calculation method for an attributing interest in a foreign investment fund they must continue to use the same method for the interest in subsequent periods unless they are allowed a change of method under the other provisions of section EX 50.

The rules in section EX 50 allowing calculation methods to be changed have been amended to allow natural persons and family trusts to change as many times as they

choose between the fair dividend rate and comparative value methods (section EX 50(8)). A family trust (including a testamentary trust) is defined as a qualifying trust established mainly for the benefit of natural persons related to the settlor or charities and which has no settlor who is not a natural person. The trust must also not be a superannuation scheme.

This ability to switch freely between the fair dividend rate and comparative value methods provides the mechanism for individuals and family trusts to pay tax on an amount lower than 5 percent of opening value under the fair dividend rate method if the total return on the investment, as calculated under the comparative value method, produces a lower amount.

A person may change from the fair dividend rate method if it is not practical to continue with that method because it is impossible to determine the start-of-year market value of the interest except by an independent valuation (section EX 50(2)(f)).

It is also possible to change from the cost method if that method was the default method under section EX 41 (which is the method a person must use for an attributing interest if they failed to choose a calculation method for the interest) and it ceases to be the default method under that provision (for example, if start-of-year market values become available so the fair dividend rate method becomes the default method).

Consequences of change of calculation methods (section EX 51)

The rules dealing with the consequences of changing calculation methods (if the change is allowed under the other foreign investment fund provisions) have been amended to cater for the new fair dividend rate and cost methods.

When changing from the fair dividend rate or cost methods to the branch equivalent or accounting profits methods, or vice versa, there is a deemed disposal and reacquisition of the interest at market value at the start of the foreign investment fund accounting period to which the new method applies (section EX 51(1) and (2)).

When changing from the fair dividend rate method to the cost method there is a deemed disposal and reacquisition of the interest at market value at the start of the income year to which the new method applies. The opening value for the purposes of the cost method will be this market value (section EX 51(3)).

When changing from the cost method to the fair dividend rate or comparative value methods there is a deemed disposal and reacquisition of the interest at the start of the income year to which the new method applies at what would have been the opening value for the year under the cost method. This value will also be the opening value for the purposes of the fair dividend rate and comparative value methods (section EX 51(4)).

Entry into and exit from foreign investment fund rules (sections EX 52, EX 53 and GD 14)

The rules dealing with circumstances in which a person enters into or exits from the foreign investment fund rules have been amended to cater for the new fair dividend rate and cost methods.

When a person using the fair dividend rate or cost methods for an attributing interest in a foreign investment fund ceases to be resident in New Zealand they are deemed to have disposed of the interest at its market value at the time immediately before they cease to be a New Zealand resident (section EX 52(1) and (2)).

When a person becomes a resident of New Zealand and uses the fair dividend rate or cost methods for an attributing interest in a foreign investment fund for the period after the change of residence, they are deemed to have acquired the interest at its market value at the time of the change of residence (section EX 52(3) and (4)).

When a person holds property which becomes an attributing interest in a foreign investment fund because an exemption in sections EX 32 to EX 37 ceases to apply (or the NZ$50,000 minimum threshold is exceeded) there is a deemed disposition and reacquisition at market value of the property at the time of its change in status if the person uses the fair dividend rate or cost methods for the interest (section EX 53(1) and (2)).

When a person holds property which ceases to be an attributing interest in a foreign investment fund because an exemption in sections EX 32 to EX 37 starts to apply (or the person falls below the NZ$50,000 minimum threshold), there is a deemed disposition and reacquisition of the interest at market value at the time of its change in status if the person used the fair dividend rate or cost methods for the interest before the change (section EX 53(5) and (6)). This deemed disposition and reacquisition does not set a new cost basis for the purposes of the $50,000 minimun threshold in sections CQ5 and DN6; the original cost basis applies for the purposes of the $50,000 threshold in the following income year.

When a person using the fair dividend rate or cost methods for an attributing interest disposes of the interest for nil or inadequate consideration they are deemed to have disposed of the interest at its market value at the time (section GD 14(1) and (2)).

When a person acquires an attributing interest in a foreign investment fund for consideration that is not equal to the interest's market value, and they use the fair dividend rate or cost methods for the interest, they are deemed to have acquired the interest at its market value at the time (section GD 14(3) and (4)).

Transitional rules: values at which offshore interests enter the new rules (section EX 54B)

All investments which become subject for the first time to the new foreign investment fund rules enter the new rules

at their market value on the start date of the new tax rules. For most individuals this will be 1 April 2007.

This entry into the new rules at market value is achieved under section EX 54B(2) by a deemed disposition and reacquisition of the interests at their market value on the start date of the new foreign investment fund rules for the investor. This deemed disposition and reacquisition applies only for transitional purposes and, in particular, it does not set a new cost basis for the purposes of the $50,000 minimum threshold for application of the foreign investment fund rules in sections CQ 5 and DN 6. The original cost basis applies for the purposes of the $50,000 threshold.

A person who holds their investments on revenue account, such as a managed fund, and which becomes subject to the new foreign investment fund rules may have a resultant tax liability because of the deemed disposition and reacquisition under section EX 54B(2). This liability can spread over three years beginning with the first year of application of the new foreign investment fund rules. At least one-third of this tax liability must be paid in the first year, half of the balance paid in the second year and the remaining balance paid in the third year (section EX 54B(3)(a)).

A person who has a tax liability because of the deemed disposition and reacquisition under section EX 54B is not liable to pay any penalty or interest for an inaccuracy in an estimate, or shortfall in the payment, of provisional tax if the inaccuracy or shortfall arises because of the deemed disposal (section EX 54B(3)(b)).

TAX RULES FOR PORTFOLIO INVESTMENT ENTITIES

Sections CB 4B, CP 1, CX 44C, CX 44D, DB 17(1) and (2), DB 43B, subpart HL, IE 1(2BB), KD 1(1)(e)(viii), KI 1, LB 2(2C), LC 1(1B) and (1C), LD 3(1B) and (1C), LD 8(1B) and (1C), LD 10, LD 11, ME 1(2)(k), MG 2(1), MJ 1(1), OB 1 and Schedule 1 of the Income Tax Act 2004; sections 28B, 31B, 33(1), 36AB, 38(1B), 57B and 139AA(1)(ab) of the Tax Administration Act 1994; section 53(2) of the Companies Act 1993; sections 4 and 72B of the Public Trust Act 2001; sections 2, 5(4A) and 5(4B) of the Securities Act 1978; sections 2 and 42E of the Trustees Act 1956; sections 2 and 33B of the Trustee Companies Act 1967; and sections 2 and 12A of the Unit Trust Act 1960

From 1 October 2007, entities that meet the definition of a "portfolio investment entity" will be able to elect into new tax rules under which they will not be taxable on gains on shares in New Zealand and certain Australian companies. Portfolio investment entities will also generally pay tax on investment income based on the tax rates of their investors (capped at 33%), rather than at a flat rate. Income earned via a portfolio investment entity will not affect investors' entitlements to family assistance (under Working for Families) or their student loan repayment and child support obligations.

Background

The new tax rules for portfolio investment entities have arisen from proposals in the *Taxation of investment income* discussion document (released in 2005) to alleviate a number of long-standing problems with the taxation of collective investment vehicles (CIVs).

The first problem the new rules address is the difference in tax treatment when people invest directly in New Zealand shares and when they invest in such shares via a New Zealand CIV. Someone who invests in New Zealand shares directly is taxed on dividends only because the investment is likely to be held on capital account. Gains of a capital nature are typically not taxable as New Zealand does not have a general capital gains tax. However under the old rules, an equivalent investment via a CIV would typically have been taxed on dividends as well as any realised New Zealand share gains. This occurred because CIVs are generally in the business of trading in shares making any income from this business taxable. The new tax rules put investment in New Zealand (and certain Australian) shares through CIVs that elect to become portfolio investment entities on a similar tax footing to individuals investing directly in Australasian shares. Similarly, the new offshore tax rules for portfolio investment (with less than 10 percent interests) in offshore companies will result in greater consistency of treatment between investments in such companies through CIVs and directly. The new rules for offshore portfolio investment in shares are discussed separately in this *Tax Information Bulletin.*

The new rules also address the problem of investors in collective investment vehicles having their investment income taxed at a higher rate than their marginal tax rate. For example, superannuation funds are taxed at 33% on their income, although a substantial number of investors in such funds may have a lower marginal tax rate (say, 19.5%). This has created a significant tax disincentive for lower income savers to use managed funds. Under the new rules, lower income savers investing in entities that elect to become portfolio investment entities will be taxed at their correct tax rate – 19.5%. The investment income of higher income savers will continue to be taxed at 33% to ensure that these investors continue to have an incentive to save via portfolio investment entities.

The new tax rules for portfolio investment entities are integral to the government's KiwiSaver initiative as they remove a number of tax disincentives to saving via managed funds.

The government has announced that certain remedial amendments will be included in a tax bill to be introduced in May this year. The commentary below relates to the portfolio investment entity tax rules enacted in December 2006.

Key features

The new portfolio investment entity tax rules are contained principally in new subpart HL of the Income Tax Act 2004 but should be read in conjunction with the relevant definitions in section OB 1. Sections HL 1 and HL 2 outline the scheme and purpose of the subpart. There are three main types of portfolio investment entity:

- portfolio tax rate entities;
- portfolio listed companies; and
- portfolio defined benefit funds.

The portfolio tax rate entity is the main type of portfolio investment entity.

To become a portfolio investment entity, an entity must meet a number of eligibility criteria (contained in section HL 3). These include the requirements that:

- the entity must be a company, superannuation fund or group investment fund (and not a life insurer) (section HL 3(7)));
- the entity must be resident for tax purposes in New Zealand (section HL 3(8));
- investors' interests in the entity must give investors the same rights to all types of investment proceeds (with the exception of Category B income) (section HL 3(9)); and
- the entity must not have ceased to be a portfolio investment entity for a period of less than five years (section HL 3(10)).

An entity must also meet a number of other eligibility requirements (contained in sections HL 6, HL 9 and HL 10). The main requirements are:

- the investor membership requirement, which generally requires a portfolio investor class of a portfolio investment entity to have at least 20 non-associated persons as investors (section HL 6);
- the investor interest size requirement, which generally requires an investor in a portfolio investor class to hold no more than a 20 percent interest in the class (section HL 9);
- the investment type and income type requirements, which generally require a portfolio investment entity to have 90 percent or more of its investments by value in the form of land, financial arrangements and excepted financial arrangements, and derive 90 percent or more of its income from such investments with that income being in the form of dividends, financial arrangement income, rent from land, proceeds from disposing of property and FIF income (sections HL 10(1) and (2)); and
- the entity shareholding investment requirement, which requires a portfolio investment entity (and a portfolio investor class) to hold voting interests of less than 20 percent in any underlying companies invested into (section HL 10(3)).

(Note: There are a number of exemptions from the requirements contained in sections HL 6, HL 9 and HL 10.)

Portfolio tax rate entities must also make adjustments to investors' interests in the entity to reflect the effect of tax paid at investors' elected tax rates. This is called the "investor return adjustment requirement" and is contained in section HL 7.

There are rules that deal with breaches of the portfolio investment entity eligibility criteria. These criteria are contained in section HL 4.

The rules for electing and ceasing to be a portfolio investment entity and the consequences of each are contained in sections HL 11 to HL 14. An entity can elect to become a portfolio investment entity from 1 April 2007 by giving notice to the Commissioner of Inland Revenue. An election is effective from 1 October 2007 at the earliest. On becoming a portfolio investment entity, section HL 12(3) deems a disposal and re-acquisition at market value of New Zealand and certain Australian shares held by the entity. Any tax liability relating to this event is payable equally over three years. An entity can cease to be a portfolio investment entity by giving notice to the Commissioner.

Sections HL 15 to 23 and HL 27 to 30 deal with the obligations and requirements (including calculation mechanisms) for entities that elect to become portfolio tax rate entities. Portfolio tax rate entities must allocate income to investors and calculate and pay tax on this income based on the tax rates elected by their investors.

The entity must elect a portfolio allocation period (the period over which income, expenses, losses and credits are allocated) and a portfolio calculation period (the period over which tax is calculated, generally involving one or more allocation periods) under section HL 15.

The tax liability for a portfolio tax rate entity for a portfolio calculation period is calculated under section HL 20. It is the sum of the liabilities calculated for each investor in the entity and for each class the investor has an interest in, for each allocation period.

Portfolio tax rate entities that choose a portfolio calculation period of a quarter must pay the amount of any portfolio entity tax liability within one month of the end of the portfolio calculation period, under section HL 21. These entities are not subject to the provisional tax rules. A portfolio tax rate entity that pays tax under section HL 21 does not need to pay tax based on the tax rate of an exiting investor if, broadly, the tax liability of the entity associated with that investor in the period is equal to or greater than the value of the investor's interest remaining in the entity (defined as a "portfolio investor exit period"). The exiting investor must instead pay tax on that income at the end of the year.

Alternatively, portfolio tax rate entities can elect to pay provisional tax under section HL 22. These entities have a portfolio calculation period of a year. Any provisional tax paid is available as a credit against the entity's portfolio entity tax liability calculated at the end of the year under the mechanism in section HL 20.

Portfolio tax rate entities that choose a portfolio calculation period of a day must pay tax when investors exit the entity, under section HL 23. These entities are required to pay tax relating to exiting investors within one month of the end of the exit period. For investors who remain in the entity, the portfolio entity tax liability is payable within one month of the end of the tax year.

Investors in portfolio tax rate entities must elect a tax rate (called a portfolio investor rate) based on their prescribed investor rate. The prescribed investor rate for natural persons is either 19.5% or 33%. Investors in portfolio investment entities may elect a 19.5% rate only if their total income (other than portfolio investment entity investment income) in either of the previous two years is $38,000 or less. An investor must elect the 33% tax rate if their combined portfolio investment entity and non-portfolio investment entity income in both of the previous years is greater than $60,000. The prescribed investor rate for all other resident investors is 0%, unless a person is a resident trustee who elects a prescribed investor rate of 33%.

Investors in portfolio tax rate entities have portfolio investor allocated income or losses under section HL 24. Section CX 44D provides that the amount of any portfolio investor allocated income is treated as excluded income to natural person investors who elect a portfolio investor rate that is no lower than their prescribed investor rate. This means that investors do not need to include portfolio investor allocated income in their tax return, so that income allocated by portfolio tax rate entities does not affect entitlements to family assistance (under Working for Families) or student loan and child support repayment obligations.

Portfolio investor allocated income is not considered excluded income for zero-rated portfolio investors (and certain exiting investors in entities paying tax under section HL 21). This income must be included in the investor's tax return. Under section HL 25, these investors are allowed a deduction for the amount of any portfolio investor allocated losses under section DB 43B.

Portfolio investor allocated losses relating to non-zero rated investors under sections HL 21 and HL 23 are available as a rebate to the entity under section HL 26. The rebate is allowed under section KI 1.

Any tax credits received by a portfolio tax rate entity must first be used against the portfolio entity tax liability of the entity, under section HL 27. Any excess tax credits, other than foreign tax credits, are allowed as either a rebate to the entity under section KI 1 or to the investor, in the case of zero-rated portfolio investors. Foreign tax credits are not rebated and must be used in the income year in which they are derived.

Portfolio tax rate entities electing under section HL 22 to pay provisional tax must carry forward any losses that are not able to be utilised (such losses are not available as a rebate).

Sections HL 28 and HL 30 outline the rules for portfolio entity formation losses (which are losses generated in a period before an entity becomes a portfolio investment entity) and portfolio class land losses (which arise where a portfolio investor class of an entity owns predominantly land).

Section HL 31 outlines the rules and obligations for becoming a portfolio investor proxy. These entities, typically custodians and nominees, must perform the responsibilities under subpart HL (for example, the allocation of income, payment of tax, and filing of returns) as if they were a portfolio investment entity.

Under section CX 44C, gains on the disposal of shares in New Zealand-resident companies and Australian-resident companies listed on an approved index of the Australian Stock Exchange by portfolio investment entities are not taxed.

Returns-filing requirements for portfolio investment entities and other information requirements are provided in sections 28B, 31B, 36AB and 57B of the Tax Administration Act 1994.

Application date

An entity can apply to the Commissioner of Inland Revenue to become a portfolio investment entity from 1 April 2007. The earliest date a portfolio investment entity can apply the new tax rules is 1 October 2007.

Detailed analysis

Subpart HL

The new portfolio investment entity tax rules are contained principally in new subpart HL of the Income Tax Act 2004. A number of changes to the bill as introduced were made at the Finance and Expenditure Committee stage of the bill. This included the re-ordering and re-structuring of a number of provisions in new subpart HL.

New section HL 1 – intended effect

New section HL 1 sets out the intended effects of the new rules for portfolio tax rate entities which are portfolio investment entities, and investors in portfolio tax rate entities. The intended effect of the rules is that a portfolio tax rate entity uses funds supplied by investors to make investments of a specified nature. The entity has a tax liability relating to the income from these investments that is calculated using the tax rate elected by each investor (their "portfolio investor rate"). This resembles the liability that would arise if the investors had made the investments separately. The entity must distribute

the income to investors, after deducting the appropriate tax liability. Investors in a portfolio tax rate entity that have elected a correct portfolio investor rate greater than zero have no tax liability on the income allocated to them by the entity. Importantly, the economic return that the investor receives, allowing for tax, would resemble the return from investing directly. The intention is that the income derived by the entity, and the tax thereon are, in economic substance, to be considered as income and tax of the investor.

New section HL 2 – scheme and purpose

New section HL 2 sets out the scheme and purpose of the portfolio investment entity tax rules. It provides a roadmap to navigate through subpart HL.

New section HL 3 – eligibility requirements

New section HL 3 sets out the eligibility requirements to be a portfolio investment entity. It is important to note that a portfolio investment entity is defined in section OB 1 to mean: a portfolio tax rate entity, a portfolio listed company or a portfolio defined benefit fund. A portfolio listed company is defined in section OB 1 as a company that is listed on a recognised exchange in New Zealand and which has become and is a portfolio investment entity. A portfolio defined benefit fund is also defined in section OB 1 as a defined benefit fund that has become, and is, a portfolio investment entity that does not allocate income to investors. A defined benefit fund is defined as a superannuation scheme, registered under the Superannuation Schemes Act 1989, that must comply with section 15(1)(a) of that Act.

A portfolio tax rate entity is a company, superannuation fund or group investment fund which has become, and is, a portfolio investment entity and is not a company listed on a recognised exchange in New Zealand or a portfolio defined benefit fund. Such entities must allocate income to investors and calculate and pay tax on this income based on the tax rates elected by their investors. Portfolio listed companies and portfolio defined benefit funds, in contrast, do not allocate income to their investors. These entities pay tax at a flat 33% tax rate.

To be a portfolio investment entity generally, the entity must meet the form and business requirement, residence requirement and entity history requirement under sections HL 3(7), 3(8) and 3(10), respectively. The form and business requirement is that the entity must be a company, superannuation fund or group investment fund and not be a life insurer. The residence requirement is that the entity must be a resident for tax purposes in New Zealand (including under a double tax agreement). The entity history requirement is that the entity must not have ceased to be a portfolio investment entity for a period of less than five years, before the relevant election. This requirement is designed to prevent the portfolio investment entity rules from being used to gain unintended tax benefits.

An entity that elects to be a portfolio tax rate entity or a portfolio listed company must meet the income interest requirement under section HL 3(9). The income interest requirement is that each investor's interest ("portfolio investor interest") in the entity must give the same rights in relation to the proceeds from the investments of the entity as those of other investors. This is to prevent a portfolio tax rate entity streaming different types of income to investors in the entity depending on the individual tax status of the investor. An example of this would be providing tax-free Australasian capital gains to investors that have elected a portfolio investor rate of 33% while providing imputed dividends to investors with a 19.5% elected rate. There is an exception to the income interest requirement when income is Category B income (income derived by certain group investment funds).

In addition to the general eligibility criteria, portfolio investment entities must also meet the further eligibility requirements contained in sections HL 6, HL 9 and HL 10 which are discussed below.

New section HL 4 – failure to meet eligibility requirements

Under section HL 4, an entity would generally cease to be eligible as a portfolio investment entity if it fails to meet one or more of the eligibility requirements contained in section HL 3, at any time. A portfolio investment entity must comply with the general eligibility criteria in sections HL 3(7), 3(8) and 3(10) at all times during the year. In addition, portfolio tax rate entities and portfolio listed companies must comply with sections HL 7 and HL 8 respectively.

However, in the case of the further eligibility requirements contained in sections HL 6, HL 9 and HL 10, an entity can temporarily breach these requirements, if the breach is fixed within a specified timeframe and the breach is significant and is the result of an event or circumstance outside the control of the entity. The rules governing "temporary" breaches of the further eligibility criteria are found in section HL 4(2).

Under section HL 4(2)(b), a breach of the further eligibility requirements imposed by sections HL 6, HL 9 or HL 10 must be corrected by the end of the quarter following the end of the quarter in which the entity first failed to meet one of these requirements. This would allow an entity a maximum of six months to correct a failure to meet one of the relevant further eligibility criteria.

Section HL 4(2) also contains rules to accommodate breaches of sections HL 6, HL 9 and HL 10 when an entity is starting up as a portfolio tax rate entity and winding down. In both cases, an entity has a maximum period of 12 months before failure to meet one or more of the further eligibility criteria triggers cessation of portfolio investment entity status.

The requirement for the breach to be as a result of a circumstance or event outside the control of the entity is to ensure that these rules are not triggered as a result of a deliberate failure to meet the eligibility criteria

under sections HL 6, HL 9 and HL 10. Examples of circumstances beyond the control of the entity are:

- when an investor in an entity that is subject to the investor interest size requirement in section HL 9 temporarily holds a portfolio investor interest of more than 20 percent because of other investors exiting the entity;
- when a "portfolio investor class" of an entity does not meet the investor membership requirement under section HL 6 because a number of investors have exited it; or
- when an entity holds less than 90 percent of its assets in the types of financial asset investments outlined under section HL 10 as a result of a reduction in the value of the entity's financial asset investments compared with the other assets it holds.

The requirement for the breach to be "significant" is mainly to ensure that minor breaches resulting from human or other error do not trigger the breach rules (a breach resulting from human error is arguably within the control of the entity).

Portfolio investment entities should monitor compliance with the further eligibility criteria outlined in sections HL 6, HL 9 and HL 10 on a quarterly basis.

New section HL 5 – definition of a foreign investment vehicle

New section HL 5 outlines the definition of a foreign investment vehicle. This section outlines the types of foreign-resident entities that can invest in portfolio investment entities. In turn, the section outlines which foreign-resident entities a portfolio investment entity may invest in, without causing the portfolio investment entity to breach the various eligibility requirements under sections HL 6, HL 9 and HL 10.

A foreign investment vehicle is defined under section HL 5 as an entity that is not resident in New Zealand, is a company or superannuation scheme, and would meet a number of the further eligibility criteria to be a portfolio investment entity under sections HL 6, HL 9 and HL 10. In effect, a foreign investment vehicle is an entity that, if it were New Zealand tax-resident, would be eligible to be a portfolio investment entity. That is, it is a widely-held vehicle that holds portfolio investments in underlying companies.

Consequently, under section HL 6, a portfolio investment entity would meet the investor membership requirement if it has a foreign investment vehicle as an investor. Similarly, a foreign investment vehicle can hold up to 100 percent of a portfolio investment entity without breaching the investor interest size requirement in section HL 9. Under section HL 10, a portfolio investment entity can hold up to 100 percent of a foreign investment vehicle without breaching the entity shareholding investment requirement.

New section HL 6 – investor membership requirements

New section HL 6 contains the investor membership requirements for a portfolio investment entity and each portfolio investor class of the entity. Subsection (1) of this section contains the requirements for an entity that is not a company listed on a recognised exchange in New Zealand.

Portfolio investor class

The further eligibility requirements in sections HL 6, HL 9 and HL 10 apply in the context of a portfolio investor class of a portfolio investment entity. A portfolio investment entity, other than a portfolio-listed company, can have multiple portfolio investor classes, such as a separate class for different investment options. However, for the entity to qualify as a portfolio investment entity, each portfolio investor class of the entity must meet the relevant further eligibility criteria in sections HL 6, HL 9 and HL 10. A portfolio investor class is defined in section OB 1 as one or more investors in an entity, where each investor has an entitlement to the proceeds from the investments of the entity, the investments are the same for all investors, and each investor's interest in the investments are in similar proportion (that is, they differ by less than 2.5 percent of the average value) to other investors.

Under section HL 6(1), an entity – or, if the entity has more than one portfolio investor class, each portfolio investor class of the entity – must have at least 20 persons as investors, treating all interests held by persons that are associated (as defined under section OD 8(3)) as one person. Under section HL 6(4) only persons holding an interest of 5 percent or more are counted as associates. This is to prevent portfolio investment entities from having to keep track of associated parties that hold small interests. An interest held by a portfolio investor proxy (as defined in section HL 31) is treated as an investment by one person.

Exceptions to the investor membership requirement (sections HL 6(1)(b) to (j), 6(3) and 6(4))

A portfolio investor class does not need to meet the investor membership requirement if the class has at least one investor that is a portfolio investment entity or is a foreign investment vehicle, an entity that is eligible to become a portfolio investment entity but does not elect to do so, or if it is a life insurance company. There are also exceptions to the investor membership requirement if the class has, as an investor, either the New Zealand Superannuation Fund, the Accident Compensation Corporation (or Crown entity or subsidiary) or the Earthquake Commission.

Boutique portfolio investor classes can have fewer than 20 persons as investors in certain circumstances. To qualify, the entity holding the portfolio investor class must have at least one other portfolio investor class which

meets the investor membership requirement No investor in the boutique class (other than the manager or trustee of the entity) can control the investment decisions of that class and the interests of investors in all boutique classes of the entity must total less than 10 percent of the total value of interests in the entity. This exception to the investor membership requirement is designed to ensure that umbrella funds offering investors boutique investment options alongside more mainstream products are not denied access to the new rules.

An entity electing to be a portfolio investment entity also does not need to meet the investor membership requirement if the entity, if treated as a unit trust, would meet one or more of paragraphs (a) and (c) to (e) of the qualifying unit trust definition in section OB 1. The investor membership requirement would also not need to be met if the entity is a superannuation fund that is established under the proposal for restructuring of the National Provident Fund required by the National Provident Fund Restructuring Act 1990 or a fund established by the Government Superannuation Fund Act 1956.

Investor membership requirement for a listed company (section HL 6(2))

The investor membership requirement for an entity that is a company listed on a recognised exchange in New Zealand is that the entity must not have more than one portfolio investor class. Such companies are, by definition, widely held as a result of the listing requirements in New Zealand. Therefore, no further investor membership requirements are required.

New section HL 7 – investor return adjustment requirements

When an entity elects to be a portfolio tax rate entity, the entity is required to make adjustments to reflect the effect of tax paid by the portfolio tax rate entity or any rebate that is available to the entity. The investor return adjustment requirement is designed to provide investors on marginal tax rates lower than 33% the benefit of these rates on their allocated income (portfolio investor allocated income) or loss (portfolio investor allocated loss).

An entity can choose between two methods for making the adjustment. The first is to adjust members' interests in the entity. These adjustments must be made within two months of the end of a quarter or the tax year, depending on the tax calculation period elected by the entity under section HL 15. In the case of portfolio tax rate entities that elect to pay provisional tax under section HL 22, the adjustment must be made within three months of the end of the tax year. Alternatively, the investor return adjustment could be made to the amount of any distribution paid to an investor. Portfolio tax rate entities have a choice of the method of the adjustment under sub-section (4).

The investor return adjustment requirement does not apply if an entity elects to become a portfolio listed company or a portfolio defined benefit fund. This is because, unlike portfolio tax rate entities, portfolio listed companies and portfolio defined benefit funds would not calculate their tax liability based on the tax rates elected by investors.

Changes to other Acts to give effect to the investor return adjustment requirement

As a consequence of the investor return adjustment requirement, amendments have been made to the following Acts to enable adjustments to be made without significant compliance and operational complications:

- Companies Act 1993
- Public Trust Act 2001
- Securities Act 1978
- Trustee Act 1956
- Trustee Companies Act 1967
- Unit Trusts Act 1960.

New section HL 8 – imputation credit distribution requirement

The imputation credit distribution requirement only applies to entities that elect to become portfolio listed companies. Portfolio listed companies will continue to pay tax as a company. As a result, under section HL 8, portfolio listed companies must maintain an imputation credit account. Any distributions made by these entities must carry imputation credits to the extent permitted by imputation credits available as determined by the directors of the entity.

Distributions from portfolio listed companies to shareholders (section CX 44D(3))

Fully imputed distributions to shareholders from a portfolio listed company are considered excluded income unless an investor specifically includes the distribution as income in their tax return (section CX 44D(3)(a)). If the investor elects to do so, the imputation credits would be able to be used to offset any tax liability on the distribution. Investors on a marginal tax rate lower than 33% may chose to treat the distribution as taxable income and use any excess imputation credits against other taxable income. Under section CX 44D(3)(b), the amount of any distributions that are not fully imputed are also considered excluded income to the shareholder. This is to ensure that income that has not been taxed at the portfolio listed company level (for example, capital gains from the sale of shares in a New Zealand company) can be distributed to investors without the investor paying tax on that income.

New section HL 9 – investor interest size requirement

New section HL 9 contains the investor interest size requirement for a portfolio investment entity. Under the

investor interest size requirement, no single investor (or group of associated investors) in a portfolio investment entity or, where applicable, a portfolio investor class, can hold more than 20 percent of the underlying investments of the entity or class. As with the investor membership requirement, section HL 9(6) specifies that only persons holding portfolio investor interests of 5 percent or more are counted as associates for the purposes of determining whether the investor interest size requirement has been breached.

Exceptions to the investor interest size requirement (sections HL 9(2), 9(3), 9(4) and 9(6))

An investor in a portfolio investment entity can hold more than 20 percent of the entity or, if applicable, the portfolio investor class if the investor is a portfolio investment entity, a foreign investment vehicle or an entity that is eligible to become a portfolio investment entity but does not elect to be. There is no investor interest size requirement for an entity that is a life insurer, the New Zealand Superannuation Fund, the Accident Compensation Corporation (or Crown entity subsidiary) or the Earthquake Commission.

An entity electing to be a portfolio investment entity does not need to meet the investor interest size requirement provided the entity, if treated as a unit trust, would meet one or more of paragraphs (a) and (c) to (e) of the qualifying unit trust definition. This safe harbour also applies to a superannuation fund that is established under the proposal for restructuring the National Provident Fund required by the National Provident Fund Restructuring Act 1990 or a fund established by the Government Superannuation Fund Act 1956. The reason for this safe harbour is that these entities are themselves widely held.

Investor interest size requirement for portfolio listed companies (sections HL 9(3) and 9(5))

An investor in a portfolio listed company is generally not allowed to hold a portfolio investor interest of more than 20 percent. However, under section HL 9(5), an investor in a portfolio listed company is allowed to hold an interest of more than 20 percent, but no more than 40 percent, in the company if the investor held the interest in the entity beginning on 17 May 2006 and continued to hold the interest after 30 September 2007. This exception to the general investor interest size requirement deals with the problem of investors with large "legacy" investments in listed investment companies that elect to become portfolio listed companies.

New section HL 10 – investment type, income type and entity shareholding investment requirements

Under the investment type requirement in section HL 10(1), a portfolio investment entity must have 90 percent or more of its assets by value invested in deriving income from land, financial arrangements, excepted financial arrangements or a right or option relating to such property.

Similarly, under the income type requirement in section HL 10(2), 90 percent or more of the income derived by a portfolio investment entity must be income derived from an interest in land, financial arrangements, excepted financial arrangements or a right or option relating to such property. A further requirement is that the income must be passive in nature and consist of dividends, income taxed under the financial arrangement rules, rent from an interest in land, proceeds from the disposal of property listed in section HL 10(1), or foreign investment fund income.

Under the entity shareholding investment requirement in section HL 10(3), a portfolio investment entity must hold less than 20 percent ownership interests (denoted by voting interests) in companies (including unit trusts) that it invests into. The entity shareholding requirement applies on a portfolio investor class basis – the class shareholding investment requirement under section HL 10(5) – if a portfolio investment entity has more than one portfolio investor class. Taken together these rules are designed to ensure that the main purpose of a portfolio investment entity is portfolio investment.

Exceptions to the entity shareholding investment requirement (sections HL 10(3)(b), 10(4) and 10(5)(b))

An entity can hold more than a 20 percent interest in a company if the market value of all voting interests in companies of more than 20 percent comprise less than 10 percent of the total market value of the entity's investments. There is a similar exception to the class shareholding investment requirement under section HL 10(5). These exceptions are designed to provide portfolio investment entities with some investment flexibility and recognise that an entity can have as its main function portfolio investment even though it has a limited number of non-portfolio investments.

There are further exceptions to the entity shareholding requirement if the interest is in:

- another portfolio investment entity;
- an entity that could be a portfolio investment entity but does not elect in;
- a foreign investment vehicle;
- a life insurance company; or
- a company that predominantly owns land (defined as a portfolio land company).

A portfolio investment entity can invest up to 100 percent in these entities.

New section HL 11 – becoming and ceasing to be a portfolio investment entity

An entity can elect to be a portfolio investment entity under section HL 11 by giving a notice in the prescribed

form to the Commissioner of Inland Revenue at any time after 1 April 2007. A notice of election is effective from the later of either:

- 1 October 2007 (the application date of the portfolio investment entity tax rules);
- the date the entity is formed (in the case of a new entity);
- the date nominated in the notice to the Commissioner; or
- a date 30 days before the notice is received.

Similarly, an entity can cease to be a portfolio investment entity under section HL 11 by providing a notice in the prescribed form to the Commissioner. A cancellation is effective from the later of the date on which the entity became a portfolio investment entity, the date nominated in the notice, or the date the notice is received.

New section HL 12 – requirements on becoming a portfolio investment entity

An entity that makes an election under section HL 11 becomes a portfolio investment entity unless it cancels the election within 12 months of the date of election or fails to meet one or more of the general eligibility criteria in section HL 3 (other than breaches that can be fixed and are fixed within the conditions specified in section HL 4(2)).

If an entity with a non-standard income year chooses to become a portfolio tax rate entity and elects to pay tax under sections HL 21 or HL 23, then the entity has a transitional income year (under section 39 of the Tax Administration Act 1994). The income year starts on the date that the election to become a portfolio tax rate entity became effective and ends on the following 31 March.

All portfolio tax rate entities that pay tax under sections HL 21 and HL 23 must have standard balance dates. That is, they must operate on a tax year basis. This is reiterated under section 38(1B) of the Tax Administration Act 1994, which prevents section HL 21 and HL 23 entities from electing a non-standard balance date. The standard balance date requirement does not apply to portfolio tax rate entities that elect to pay tax as provisional taxpayers under section HL 22, or to portfolio listed companies or portfolio defined benefit funds.

On becoming a portfolio investment entity, section HL 12(3) deems the entity to dispose and re-acquire any shares held in New Zealand and certain Australian-resident listed companies (as defined under section CX 44C(1)(a) and (b)) at their market value on the day before the election is effective. The deemed disposition and re-acquisition does not apply in the case of an investment in a company that is a portfolio investment entity or an entity that will become a portfolio investment entity within six months. This is designed to prevent double taxation. The investee company would also be subject to a deemed disposal and re-acquisition of shares subject to the section CX 44C exclusion.

New section HL 13 – transitional tax rules

Any tax liability arising from the effect of the election on the length of the entity's income year under section HL 12 or the deemed disposal and re-acquisition under section HL 12 can be spread evenly between the year in which the entity became a portfolio investment entity and the following two years under section HL 13(2). For the purposes of any transitional tax liability, the provisional tax rules, tax penalties rules and use-of-money interest rules do not apply (section HL 13(1)).

New section HL 14 – requirements on ceasing to be a portfolio investment entity

An entity ceases to be a portfolio investment entity if it cancels the election to be a portfolio investment entity under section HL 11 or becomes ineligible to be a portfolio investment entity under section HL 4. The cessation of portfolio investment entity status is effective from the date on which the cancellation of portfolio investment entity status is effective or the first day after the end of the quarter in which the entity ceased to be a portfolio investment entity under section HL 4. For example, an entity that is no longer eligible to be a portfolio investment entity, through the operation of section HL 4, on 27 May 2007, would cease to be a portfolio investment entity on 1 July 2007 in accordance with section HL 14(2)(b).

Once an entity has ceased to be a portfolio investment entity the entity is treated as having disposed and reacquired of any shares in New Zealand and Australian-resident listed companies, as defined under section CX 44C(1)(a) and (b), at their market value. These shares would no longer be subject to the protection of section CX 44C(1) on gains from sale. Instead, the normal capital/revenue boundary would apply to any future sales.

The disposal and re-acquisition of shares is treated as being to and from another person at the market value of the shares on the date the entity ceased to be a portfolio investment entity (section HL 14(3)). This provision ensures that shares previously subject to the Australasian share exemption re-enter the tax base at their market value on the date the entity ceases to be a portfolio investment entity in accordance with section HL 14(2).

Calculation and payment of tax for portfolio investment entities

The requirements to calculate and pay tax vary depending on the type of portfolio investment entity.

Portfolio tax rate entities would generally pay tax four times a year, under section HL 21. There are exceptions to this general rule in the case of portfolio tax rate entities that elect to pay tax when investors exit (under section HL 23) and in the case of portfolio tax rate entities that elect to remain provisional taxpayers (under section HL 22). Sections HL 15 to 23 and HL 27 to 30 deal with the calculation and payment of tax for portfolio

tax rate entities. Portfolio listed companies and portfolio defined benefit funds continue to pay tax, broadly, under current rules.

New section HL 15 – the periods relevant to the calculation of tax for portfolio tax rate entities

A portfolio tax rate entity must first elect a portfolio calculation period and portfolio allocation period under section HL 15. This determines the periods over which income (and expenses, losses and tax credits) are allocated and tax is calculated.

The portfolio allocation period is the period over which a portfolio tax rate entity allocates its taxable income or loss, under section HL 19. The portfolio calculation period consists of one or more portfolio allocation periods and represents the period over which the entity must calculate its portfolio entity tax liability or rebate, under section HL 20, on taxable income or loss allocated to each portfolio allocation period under section HL 19. A portfolio tax rate entity therefore cannot elect a portfolio allocation period that is greater than the entity's portfolio calculation period.

An entity can choose different portfolio allocation periods and portfolio calculation periods, depending on the type of portfolio tax rate entity they elect to become.

The default portfolio allocation period for a portfolio tax rate entity is a day. Alternatively, a portfolio tax rate entity may choose a portfolio allocation period of a month, quarter, or income year by giving notice to the Commissioner before the start of the relevant tax year or when the entity first chooses to become a portfolio tax rate entity.

The default portfolio calculation period for a portfolio tax rate entity is a quarter. A portfolio tax rate entity can choose a portfolio calculation period of a day or income year (for entities electing under section HL 22 to pay provisional tax) by giving notice to the Commissioner – again, before the start of a tax year or when the entity first chooses to become a portfolio tax rate entity.

Special rules for portfolio tax rate entities that elect to pay provisional tax (sections HL 15(2)(c) and 15(3)(c))

A portfolio tax rate entity that elects to pay provisional tax under section HL 22 has a portfolio calculation period of an income year. Such an entity can, however, choose a portfolio allocation period of a day, a month a quarter or income year. A portfolio tax rate entity that elects to pay provisional tax under section HL 22 must notify the Commissioner of their portfolio calculation period and portfolio allocation period when they make the election under section HL 22.

New section HL 16 – income not allocated, or allocated but not vested

New section HL 16 deals with income that is not able to be allocated to an investor by a portfolio tax rate entity and income that is able to be allocated to an investor but has not vested in the investor. Note: This section applies to portfolio tax rate entities only.

In the case of income that is not able to be allocated to an investor, the portfolio tax rate entity is treated as the investor for the purposes of calculating the entity's tax liability. This means that income relating to amounts such as reserve accounts or managers' holdings in portfolio tax rate entities would be taxed at 33%.

Some superannuation funds – for example, employer-based schemes that become portfolio tax rate entities may have members who have amounts contributed on their behalf that do not vest unless certain criteria are met. The intended effect of section HL 16(2) is that the tax rates of superannuation fund members should be used to tax income arising on unvested employer contributions, subject to the following conditions:

- For the superannuation funds established before the bill was introduced on 17 May 2006, the vesting period has not been extended beyond the period in existence at that date.
- Superannuation funds established after this bill's introduction must have vesting periods equal to or less than three years. For superannuation funds meeting this condition, the contributions made within the three-year period must vest in the employee within that period.

These conditions have been legislated to recognise the existence of established superannuation funds and vesting periods, and provide for new superannuation funds. The conditions associated with vesting periods have been designed to align with the intention of the portfolio investment entity rules that income will be taxed at the appropriate rate.

New section HL 17 – new investors treated as part of existing investor class

This section allows new members of a portfolio investor class of a portfolio tax rate entity to be treated as an existing member of that class. In the absence of this section the new investor may not be treated as being an investor in a portfolio investor class as they may temporarily hold interests in the underlying investments of the class that are different in proportion to those of other investors in the class. This difference may arise because the entity needs time to buy more of the underlying investments to make the investor's portfolio investor interests in the underlying investments similar in proportion to those of other investors in the class.

New section HL 18 – calculation of class net income or class net loss for portfolio tax rate entities

Section HL 18 outlines the formula for calculating the net income or loss for a portfolio investor class for each

portfolio allocation period in a portfolio calculation period. It applies to a portfolio tax rate entity. A portfolio investor class has net income in a portfolio allocation period if the total amount of the entity's assessable income that is allocated to the class for the allocation period exceeds the total amount of the deductible expenditure that the entity allocates to the portfolio allocation period. A portfolio investor class has a net loss in an allocation period if total deductions for the class exceed assessable income for the class. It should be noted that under section EG 3, income and deductions of portfolio tax rate entities are allocated to the same periods as the entity allocates these amounts for the purpose of setting a unit price or, if the entity does not set a unit price, the amounts are allocated according to the entity's financial statements.

This calculation, along with the calculation under section HL 19, would be done at the end of a portfolio calculation period for each portfolio allocation period in the calculation period.

Example 1

PIE A has assessable income of $20,000 and expenses of $3,000 on day 1. On day 2, PIE A has a loss of $6,000 and expenses of $1,000. PIE A has class net income of $17,000 on day 1 and class net loss of $7,000 on day 2 (assuming PIE A elects an allocation period of a day and has a single portfolio investor class).

New section HL 19 – calculation of class taxable income or class taxable loss for portfolio tax rate entities

Section HL 19 outlines the formula for calculating the class taxable income or loss for a portfolio investor class for each portfolio allocation period in a portfolio calculation period. A portfolio investor class has taxable income in a portfolio allocation period if the amount of any net income (calculated under section HL 18) exceeds the amount of any "other loss used". "Other loss used" is defined as the total of portfolio entity formation losses and any portfolio class land loss that has not been used in any previous portfolio allocation period to reduce net income.

Portfolio entity formation losses are essentially losses that have been generated prior to the entity becoming a portfolio tax rate entity that have been carried into the new rules. They are defined more fully in section HL 28.

A portfolio class land loss arises when a portfolio investor class has investments that are predominantly in the form of land or in companies that hold land (defined as portfolio land companies). Where this class has a net loss for a portfolio allocation period under section HL 18, this loss can be carried forward as a portfolio class land loss for offset against net income of the class in future portfolio allocation periods. Portfolio class land losses are defined under section HL 30.

The amount of portfolio entity formation loss and portfolio class land loss which can be used in a portfolio allocation period is limited to the amount of net income calculated under section HL 18 for the class and the period.

A portfolio investor class of a portfolio tax rate entity has a taxable loss if the class has a net loss (under section HL 18).

New section HL 20 – calculation of portfolio entity tax liability or amount of rebate

Section HL 20 outlines the formula for calculating the tax liability for a portfolio tax rate entity for a calculation period or, when there is a loss, for the calculation period, the amount of the loss that can be rebated under section KI 1.

The tax liability or amount of the rebate for a portfolio tax rate entity is the total calculated under section HL 20 for all investors that have been in the entity during the period and have elected a tax rate (defined as a "portfolio investor rate") of greater than zero percent. Therefore, any "zero-rated portfolio investors" (as defined in section OB 1) and certain investors with a portfolio exit period (also defined in section OB 1) are not included in the tax calculation under section HL 20. Income or loss allocated by a portfolio tax rate entity to zero-rated portfolio investors and investors with a portfolio exit period (in the case of portfolio tax rate entities that elect to pay tax under section HL 21) is taxable or deductible respectively, directly for these investors. This is discussed in further detail below.

The "portfolio entity tax liability", or the amount of the rebate, is the total of the amounts calculated under section HL 20(4):

- for each investor with a portfolio investor rate of greater than zero;
- for each portfolio investor class the investor has an interest in;
- for each day in a portfolio allocation period; and
- each portfolio allocation period in a portfolio calculation period.

Therefore, the portfolio entity tax liability or the amount that is to be rebated is the sum of the separate tax calculations relating to each investor for each day of the calculation period.

When a portfolio tax rate entity chooses a portfolio allocation period greater than a day – for example, a quarter – the portfolio entity tax liability (or rebate) for the allocation period is spread evenly across each day in the allocation period, for each investor.

Example 2 illustrates how a portfolio investment entity uses section HL 20 to calculate tax.

To avoid complexity, the following examples describe portfolio investment entities that would not meet either or both of the investor membership requirement in section HL 6 and the investor interest size requirement in section HL 9.

Example 2 – portfolio entity tax liability

PIE A (from Example 1) has five investors, each holding 20 percent of the entity. Investors A, C and D elect a tax rate of 19.5%. Investors B and E have a tax rate of 33%.

The portfolio entity tax liability is the sum of the tax liabilities for each individual investor for each portfolio allocation period in the relevant calculation period (assume PIE A's calculation period only encompasses day 1 and day 2).

	Investors on 19.5% (3)	33% (2)
Day 1	$\frac{0.2*(\$17{,}000)*0.195 = \$663}{1}$	$\frac{0.2*(\$17{,}000)*0.33 = \$1{,}122}{1}$
Day 2	$\frac{0.2*(-\$7{,}000)*0.195 = -\$273}{1}$	$\frac{0.2*(-\$7{,}000)*0.33 = -\$462}{1}$

Portfolio entity tax liability (or amount of rebate (if negative)):

[($663*3 + $1,122*2) + (–$273*3 + –$462*2)] = $2,490 (portfolio entity tax liability)

Example 3 – rebate

PIE B has five investors, each holding 20 percent of the entity. Investors A, D, and E have a 33% tax rate and investors B and C elect a 19.5% tax rate (assume PIE B's calculation period only encompasses day 1 and day 2).

PIE B has net income of $15,000 on day 1 and a net loss of $20,000 on day 2. Under section HL 19, PIE B has portfolio class taxable income of $15,000 on day 1 and a portfolio class taxable loss of $20,000 on day 2. Under section HL 20:

	Investors on 19.5% (2)	33% (3)
Day 1	$\frac{0.2*(\$15{,}000)*0.195 = \$585}{1}$	$\frac{0.2*(\$15{,}000)*0.33=\$990}{1}$
Day 2	$\frac{0.2*(-\$20{,}000)*0.195 = -\$780}{1}$	$\frac{0.2*(-\$20{,}000)*0.33 = -\$1{,}320}{1}$

Portfolio entity tax liability (or amount of rebate (if negative)): [($585*2 + $990*3) + –$780*2 + –$1,320*3)] = $4,140 – $5,520 = –$1,380). This is the amount that may be rebated under section KI 1.

Payment of tax by portfolio tax rate entities

Different types of portfolio tax rate entities have different rules for the payment of tax calculated under section HL 20 or the receipt of rebates.

New section HL 21 – portfolio tax rate entities that have a portfolio calculation period of a quarter

Section HL 21 outlines the rules for payment of tax by portfolio tax rate entities that have a portfolio calculation period of a quarter. These portfolio tax rate entities fall into the default category as a result of the portfolio calculation period of a quarter being the default option under section HL 15. It is anticipated that most entities in this category will have a portfolio allocation period of a day.

These entities would not be required to pay provisional tax under subpart MB of the Income Tax Act. Instead, they are required, after each portfolio calculation period, to pay an amount of tax equal to the portfolio entity tax liability calculated under section HL 20 for the portfolio

calculation period. The payment must be made within one month of the end of the portfolio calculation period. Similarly, when the entity has an amount calculated under section HL 20, for a portfolio calculation period that is able to be rebated under section KI 1, this amount would be rebated after the entity has filed their return for the period. This means any losses or excess tax credits relating to the portfolio calculation period that are able to be refunded would be dealt with quarterly.

On payment of tax or on receipt of a rebate, the portfolio tax rate entity would need to adjust each investor's portfolio investor interest or make a distribution under section HL 7, to reflect the investor's share of the entity's portfolio entity tax liability (or rebate). For a section HL 21 portfolio tax rate entity, this would be within two months of the end of the relevant calculation period.

Example 4

If PIE A (from Example 1) has a quarterly portfolio calculation period (and days 1 and 2 are the only allocation periods in the quarter), the portfolio entity tax liability of $2,490 (calculated in Example 2) would be payable within one month of the end of the quarter. Similarly, if PIE B (from Example 3) has a quarterly portfolio calculation period, it would be entitled to a rebate under section KI 1 after the end of the quarter.

Under the investor return adjustment requirement in section HL 7, each investor in PIE A (and PIE B) would need to have their portfolio investor interest or any distribution adjusted for the tax paid (or rebate received). This would have to occur within two months of the end of the relevant quarter. Assuming PIE A elects to adjust each investor's interest, investors A, C and D in PIE A would have their portfolio investor interest reduced by $390 and investors B and E would have their interest reduced by $660.

Exiting investors "zero-rated"

Investors who exit a portfolio tax rate entity that pays tax under section HL 21 part-way through a portfolio calculation period would be "zero-rated" by the entity. That is, the portfolio investment entity would pay tax on the exiting investor's share of the income earned during the period at zero percent.

A portfolio investor exit period is defined in section OB 1, in the context of section HL 21, as a period that starts at the beginning of a portfolio calculation period and ends five days after the end of the portfolio calculation period. The five-day grace period after the end of a portfolio calculation period is to accommodate investors who leave a section HL 21 portfolio tax rate entity just after the end of a calculation period, but before the entity has calculated the portfolio entity tax liability for the calculation period.

An investor has a portfolio investor exit period if the amount of the portfolio entity tax liability for the investor (calculated under section HL 20 as if the investor did not have an exit period) would equal or exceed the value of the investor's interest at the end of the exit period. This means that for an investor to be zero-rated, the investor's share of the tax liability for a portfolio calculation period must exceed any residual interest in the entity (in all classes of the entity) after they have made a withdrawal. If no portfolio investor exit period arises, the normal section HL 20 tax liability calculation would apply to the investor at the end of the quarter.

Example 5

PIE C has a portfolio calculation period of a quarter. Investor A reduces his interest in PIE C by $10,000 part-way through a portfolio calculation period. His residual interest in PIE C is $1,000. At the end of the portfolio calculation period, investor A's share of the portfolio entity tax liability for the portfolio calculation period is $1,250. Because investor A's share of the portfolio entity tax liability for the period is greater than his residual interest, there is a portfolio investor exit period. Consequently, PIE C can apply a zero percent tax rate for investor A for the purposes of section HL 20.

Cancellation of any residual portfolio investor interests (section HL 21(5))

Where an investor partially exits, a portfolio tax rate entity that makes payments of tax under section HL 21, and the level of the withdrawal is sufficient to trigger a portfolio investor exit period (and hence zero-rating), any residual portfolio investor interest in the entity must be cancelled and paid to Inland Revenue under subsection (5). This payment satisfies some of the investor's tax liability on income from the portfolio tax rate entity. While the investor will be required to include the amount of portfolio investor allocated income from the entity in relation to the portfolio investor exit period in their tax return, the amount of the investor's portfolio investor interest paid to the Commissioner under subsection (5) will be treated as a credit under section LD 11 against this tax liability.

A payment by the portfolio tax rate entity to the Commissioner under subsection (5) would also need to be made within one month of the end of the portfolio calculation period in which the portfolio investor exit period falls.

Example 6

As investor A in PIE C in Example 5 has a residual interest, under section HL 21(5), PIE C would be required to cancel this residual interest and pay this amount within one month of the end of the portfolio calculation period in satisfaction of investor A's share of the portfolio entity tax liability. The $1,000 paid by PIE C would be available as a credit in the investor's tax return.

New section HL 22 – portfolio tax rate entities that elect to pay provisional tax

Section HL 22 enables portfolio tax rate entities that choose a portfolio calculation period of a year to continue to be subject to the provisional tax rules under subpart MB.

The actual income tax liability for these entities would still be calculated under section HL 20 at the end of the year, which allows investors' tax rates to be taken into account when calculating the entity's portfolio entity tax liability. This effectively results in the entity applying a blended average tax rate for the year. The investor return adjustment requirement under section HL 7 applies and would need to occur within three months of the end of the year.

The provisional tax paid by the entity during the year would be allowed as a credit against the entity's portfolio entity tax liability. As the provisional tax rules would operate, the entity may be subject to the use-of-money interest rules if the amount of provisional tax paid is less than (or exceeds) the portfolio entity tax liability calculated at the end of the year.

No rebate for losses and excess tax credits arising during a portfolio calculation period (sections IE 1(2BB), HL 26 and HL 27)

Unlike section HL 21 portfolio tax rate entities, entities that elect to pay provisional tax under HL 22 would not receive rebates for losses and excess credits arising in the portfolio calculation period. Instead, under section IE 1(2BB), any amounts calculated under section HL 20 that would otherwise be rebated under section KI 1, are carried forward.

No "zero-rating" of exiting investors

Portfolio tax rate entities that elect to pay tax under section HL 22, would not be able to apply a zero-percent tax rate to the income earned by investors that exit the fund during the year. These entities would pay tax on all the income the entities earned during the year. Therefore, to cover the tax liability relating to exiting investors, these entities are likely to ensure that an appropriate amount is withheld from investors when they exit.

Example 7

PIE D elects to pay provisional tax under section HL 22. PIE D has a portfolio calculation period of an income year and elects a portfolio allocation period of a month. It makes provisional tax estimations of $333 for each of the provisional tax payment dates 1 to 3.

PIE D has two investors, investor A and investor B each holding 50 percent of PIE D. Investor A elects a tax rate of 19.5% and investor B elects a tax rate of 33%. Investor B exits PIE D completely, six months after the start of the tax year. On exit of investor B, the PIE pays investor B an amount, which includes assessable income of $1,500 (this is based on the PIE earning assessable income of $500 in each of the first six months). PIE D withholds tax of $495 on this amount. Investor C (with a tax rate of 33%) enters PIE D after investor B has exited. At the end of the year PIE D has taxable income of $6,000. Each investor's share of the portfolio entity tax liability is:

Investor A: 0.5*$6,000*0.195 = $585

Investor B: 0.5*$6,000*(6/12)*0.33 = $495

Investor C: 0.5*$6,000*(6/12)*0.33 = $495

(note: section HL 20 calculations have been simplified)

The portfolio entity tax liability for PIE D for the year is $1,575. This amount is the entity's final tax liability. The provisional tax payments totalling $1,000 are available as a credit against this liability. PIE D would therefore have a residual income tax liability of $575. This residual liability would be payable at the entity's terminal tax date.

PIE D must also carry out the investor return adjustment under section HL 7 within three months of the end of the income year for each investor still in the entity.

New section HL 23 – portfolio tax rate entities that pay tax when investors leave

Section HL 23 applies to portfolio tax rate entities that elect a portfolio allocation period and portfolio calculation period of a day under section HL 15. To be a section HL 23 portfolio tax rate entity, an entity must give notice in a prescribed form to the Commissioner of Inland Revenue at the time at which the entity selects its portfolio allocation and portfolio calculation periods under section HL 15.

Like entities that elect to pay tax under section HL 21, portfolio tax rate entities subject to section HL 23 would not be provisional taxpayers. However, unlike section HL 21 portfolio tax rate entities, these entities would pay tax (calculated under section HL 20) relating to all calculation periods in the tax year and for all investors remaining in the entity, within one month of the end of the tax year. Similarly, when the entity has an amount for a tax year under section HL 20 that is able to be rebated under section KI 1, this amount would be only rebated after the entity has filed its return for the year. The investor return adjustment under section HL 7 would also apply at the end of the tax year.

Tax payable on behalf of exiting investors (section HL 23(2))

Unlike a section HL 21 portfolio tax rate entity, investors who exit a portfolio tax rate entity that elects to pay tax under section HL 23 will not be zero-rated. Instead, the entity would need to pay the investor's share of the portfolio entity tax liability relating to a portfolio investor

exit period to the Commissioner within one month from the end of the month in which the portfolio investor exit period ends. Therefore, investors who exit a section HL 23 portfolio tax rate entity during a tax year would not need to file a return for their portfolio investor allocated income for a portfolio investor exit period.

Example 8

PIE E elects to pay tax under section HL 23 by choosing a portfolio allocation period and portfolio calculation period of a day. PIE E has two investors: investor A (who holds 40 percent of PIE E) and investor B (who holds 60 percent of PIE E). Both investors elect a 33% tax rate. For simplicity, this example assumes only four portfolio allocation and portfolio calculation periods for the year. In portfolio allocation period 1, the entity has taxable income of $1,000, in period 2 a taxable loss of $500, in period 3, taxable income of $2,500 and in period 4, taxable income of $3,000.

Investor A exits PIE E completely at the end of period 3 and is replaced by investor C (who elects a tax rate of 19.5%). PIE E would need to calculate investor A's share of the portfolio entity tax liability for portfolio calculation periods 1 to 3 (the investor's portfolio investor exit period) and deduct this amount from the payment that is made to investor A:

Period 1:	0.4*($1,000)*0.33	=	$132
Period 2:	0.4*(-$500)*0.33	=	-$66
Period 3:	0.4*($2,500)*0.33	=	$330

The amount that is deducted – $396, would need to be paid to the Commissioner within one month of the month in which investor A's portfolio investor exit period ends.

For investors B and C, their share of the portfolio entity tax liability for the tax year, calculated below, would be payable within one month of the end of the tax year.

	Investor B	Investor C
Period 1:	0.6*($1,000)*0.33 = $198	-
Period 2:	0.6*(-$500)*0.33 = -$99	-
Period 3:	0.6*($2,500)*0.33 = $495	-
Period 4:	0.6*($3,000)*0.33 = $594	0.4*($3,000)*0.195 = $234
Total:	$1,188	$234

Section HL 24 – portfolio investor allocated income and loss

Sections HL 24 and HL 25 deal with the treatment of income or loss allocated to investors by portfolio tax rate entities. This is defined as portfolio investor allocated income or loss.

Election of a tax rate

Investors in portfolio tax rate entities can elect a tax rate in accordance with the definition of the prescribed investor rate in section OB 1. The prescribed investor rate for an investor in a portfolio tax rate entity is:

- 0% in the case of an entity that is a charity (that is, an organisation or trust that derives exempt income under sections CW 34 and CW 35), a company, a superannuation fund, a trustee (other than a trustee that elects 33%), a portfolio investment entity, or a portfolio investor proxy (as defined in section OB 1). These investors are defined as "zero-rated portfolio investors";
- 19.5% in the case of a natural person who, in either of the previous two income years, had taxable income of $38,000 or less (not including portfolio investor allocated income) and a total amount of $60,000 or less in taxable income plus portfolio investor allocated income; and
- 33% in all other cases and for a trustee that elects this rate.

The rate elected by an investor is called the portfolio investor rate and is used by the portfolio tax rate entity to calculate the entity's tax relating to the investor and the period under section HL 20. A portfolio investor rate must be provided to a portfolio tax rate entity before the end of a portfolio calculation period. Under section 28B of the Tax Administration Act a person cannot provide a portfolio investor tax rate of 19.5% unless they provide their tax file number to the portfolio tax rate entity. If no portfolio investor rate is elected, the default rate of 33% applies.

An investor who exits a portfolio tax rate entity that makes payments of tax under section HL 21 has a portfolio investor rate of 0% if the investor has a portfolio investor exit period in the relevant calculation period.

Calculation of portfolio investor allocated income or loss (section HL 24(5))

Under section HL 24, the portfolio investor allocated income or loss for an investor is the total income or loss calculated under subsection (5) for that investor for each portfolio allocation period in a tax year the investor was present in the entity and each day of the portfolio allocation period, and each portfolio investor class to which the investor belongs. An investor's portfolio investor allocated income or loss mirrors the investor's share of the income on which the portfolio entity tax liability is calculated under section HL 20.

Excluded income in certain circumstances and not others (sections CP and, CX 44D)

Under section CP 1, the amount of any portfolio investor allocated income is treated as income of the investor in the year containing the relevant income-allocation periods. Section CX 44D provides that portfolio

investor allocated income derived by an investor under section CP 1 is excluded income of the investor if:

- the prescribed investor rate for the investor is more than 0%;
- the investor has not chosen a portfolio investor rate that is less than the prescribed investor rate; and
- the income is not allocated to a portfolio investor exit period, in the case of an exiting investor from a section HL 21 portfolio tax rate entity.

Under section CX 44D(2), any distribution from a portfolio tax rate entity to an investor is also treated as excluded income of the investor. In this context, a distribution would include an investor redeeming their units with the PIE. Excluded income does not need to be separately identified and returned.

As portfolio investor allocated income is excluded income for tax purposes, provided investors elect a portfolio investor rate that is no lower than their prescribed investor rate, the income does not affect entitlements to Working for Families' tax credits, or student loan repayment obligations or child support payment obligations.

Consequences if portfolio investor rate is lower than prescribed investor rate

If an investor elects a portfolio investor rate that is lower than the prescribed investor rate, then the portfolio investor allocated income is not considered as excluded income under section CX 44D(1)(b). Instead, the full amount of income becomes the investor's taxable income in the tax year in which it is allocated to the investor by the portfolio tax rate entity.

The taxpayer is allowed a credit under section LD 10 for any tax paid by the portfolio tax rate entity in relation to any portfolio investor allocated income that is no longer considered excluded income under section CX 44D.

However, even if portfolio investor allocated income is not considered excluded income as a result of section CX 44D(1)(b), the receipt of this income would not affect entitlements to family assistance (under Working for Families). This is because section KD 1 has been amended to exclude any amount of portfolio investor allocated income that is not considered excluded income as a result of section CX 44D(1)(b) from the calculation of net income for family assistance (under Working for Families) purposes.

Section HL 25 – portfolio investor allocated loss for zero-rated portfolio investors and certain investors with portfolio investor exit periods

Section HL 25 outlines the treatment of portfolio investor allocated losses for investors that are zero-rated portfolio investors or those investors in section HL 21 portfolio tax rate entities that have a portfolio investor exit period. As a portfolio tax rate entity does not have a portfolio entity tax liability in relation to these investors, any portfolio investor allocated income is not considered excluded income under CX 44D. Therefore the investor must include this income in their tax return. Similarly, any portfolio investor allocated loss is allowed as a deduction to zero-rated portfolio investors and investors in section HL 21 portfolio tax rate entities with a portfolio investor exit period, under section DB 43B(1).

Reduction in amount of loss allowed as a deduction (section DB 43(2))

Section DB 43B(2) is designed to ensure that zero-rated portfolio investors in portfolio investment entities cannot claim tax deductions for losses that flow through to them from the portfolio investment entity if the investor has benefited from the portfolio investment entity using a formation loss against income earlier in the year.

Section HL 26 – rebates to portfolio tax rate entities that pay tax under sections HL 21 and HL 23

Section HL 26 provides that section HL 21 and section HL 23 portfolio tax rate entities can get rebates under section KI 1 in certain circumstances. The rebates are allowed for investors with portfolio investor rates above zero percent and investors in section HL 21 portfolio tax rate entities that do not have a portfolio investor exit period. Instead of these investors receiving a benefit for any losses or excess credits directly, it is the portfolio tax rate entity that would receive a rebate, of an amount that is calculated under section HL 20 (although this is subject to section KI 1). The entity would then be responsible for allocating each investor's share of the rebate by adjusting each investor's portfolio investor interest (or alternatively making a distribution) under section HL 7.

Reduction in amount of rebate allowed (section KI 1(2))

Section KI 1, which allows the rebate, is designed to reduce any amount calculated under section HL 20 by any portfolio entity formation losses used in the portfolio calculation period to which the rebate relates. This provision is intended to ensure that rebates can only arise if the entity has incurred a net loss for the calculation period.

Section HL 27 – credits received by portfolio tax rate entities

Section HL 27 outlines the ability of portfolio tax rate entities (and certain investors in portfolio tax rate entities) to use tax credits to reduce their portfolio entity tax liability, obtain a refund of income tax or attach the credit to distributions. Section HL 27 does not apply in the case of portfolio tax rate entities that have elected to pay tax under section HL 22. As in the case of losses, section HL 22 portfolio tax rate entities would be subject to normal income tax rules in relation to the use of any tax credits.

Foreign tax credits (sections HL 27(7)(a) and HL 27(10)(a))

Under section HL 27, foreign tax credits (known as subpart LC credits) can only be used to reduce a portfolio tax rate entity's portfolio entity tax liability under section HL 20. Any excess credits cannot be rebated under section KI 1. These provisions are intended to ensure a tax treatment for a portfolio investment entity's foreign tax credits that is broadly similar to the tax treatment of foreign tax credits of direct investors – taking into account that many portfolio investment entities will be doing tax calculations daily.

Other tax credits (sections HL 27(7)(b), HL 27(8), HL 27(9) and HL 27(11))

Other tax credits (not under subpart LC – such as imputation credits) must first be used to reduce a portfolio tax rate entity's portfolio entity tax liability. However, any excess credits are available to be rebated under section KI 1 in the case of investors other than zero-rated portfolio investors and investors with exit periods in section HL 21 entities (see section HL 27(11)(b)).

New section HL 28 – portfolio entity formation losses

Section HL 28 outlines what a portfolio entity formation loss is and how these losses can be used. A portfolio entity formation loss is defined as any net loss arising from a period ending on or before an entity becomes a portfolio investment entity that can be carried forward and used to reduce a portfolio investment entity's taxable income. A portfolio entity formation loss may therefore comprise investment losses incurred by the entity before it became a portfolio investment entity, that could not be used, or losses arising under the transitional rules in section HL 12(3).

Unlike losses that arise during a portfolio calculation period, portfolio entity formation losses cannot be rebated under section KI 1. They must be used up over time against the taxable income of the entity. Portfolio entity formation losses can be carried forward to subsequent income years.

The intent of section HL 28(3) is to provide new formation losses to an entity when rebates, credits, or deductions have been claimed under sections DB 43B, HL 27 and KI 1.

New sections HL 29 and HL 30 – portfolio class land losses

Certain restrictions on the use of losses apply in the case of portfolio investor classes whose investments are predominantly in the form of land. This class is effectively defined as one where, at the end of a calculation period, the interests of the class that are held in land or portfolio land companies (defined as companies whose assets comprise more than 90 percent in land or other land companies) comprise more than 50 percent of the value of the investments of the class.

Under sections HL 29 and HL 30, any tax losses relating to investment classes of a portfolio tax rate entity that predominantly invest in land or land companies would not be rebated. Instead, these losses would form a portfolio class land loss, which could be carried forward and offset against taxable income from the relevant class in future portfolio calculation periods. Portfolio class land losses cannot be offset against taxable income from other non-"land" classes.

New section HL 31 – portfolio investor proxies

On the basis of investor information held (or other circumstances), certain entities (such as custodians and nominees) may be in a better position to apply the responsibilities outlined under subpart HL than the portfolio investment entities themselves. In such scenarios, an entity that is eligible to perform responsibilities under the portfolio entity tax rules that would ordinarily be performed by the portfolio investment entity, may do so by becoming a portfolio investor proxy and applying section HL 31.

Under section HL 31(1), an entity is eligible to be a portfolio investor proxy for an investor in a portfolio investment entity in relation to a portfolio allocation period if the following conditions are met:

- The portfolio investment entity is not a portfolio listed company (section HL 31(1)(a)).
- The entity holds a portfolio investor interest for an investor in the portfolio investment entity (section HL 31(1)(b)).
- The entity gives the portfolio investment entity a notice that the entity is holding the portfolio investor interest as a portfolio investor proxy (section HL 31(1)(c)(i)), together with any other information the Commissioner may require the entity to provide to the portfolio investment entity (section HL 31(1)(c)(ii)).

Section HL 31(2) clarifies the role of the entity once it becomes a portfolio investor proxy. The role is to carry out the responsibilities (detailed in section HL 31(3)) of the portfolio investor proxy in relation to amounts allocated to it as holder of the portfolio investor interest on behalf of the investor for the portfolio allocation period. The responsibilities detailed in section HL 31(3) must be carried out as if:

- the entity which becomes a portfolio investor proxy were a portfolio investment entity (section HL 31(2)(a));
- the portfolio investor interest held by the entity were an interest of the investor in the income of the entity (section HL 31(2)(b)); and

- the portfolio investor allocated income, portfolio investor allocated loss, and distributions received by the entity for the investor (from the portfolio investment entity) were income or loss of the entity and the investor is entitled to these through their portfolio investor interest (section HL 31(2)(c)(i) and (ii)).

The responsibilities of a portfolio investor proxy in relation to amounts allocated to it from the portfolio investment entity are contained in section HL 31(3). These responsibilities are to:

- allocate, to the investor, portfolio investor allocated income and portfolio investor allocated losses for the portfolio allocation period (section HL 31(3)(a));
- distribute, to the investor, distributions and credits for the portfolio allocation period (section HL 31(3)(b));
- pay income tax on portfolio investor allocated income for the portfolio allocation period (section HL 31(3)(c));
- adjust the portfolio investor interest of the investor, or distributions to the investor, to reflect the effect of the investor's portfolio investor rate on the amount of distributions and payments above (section HL 31(3)(d));
- provide the Commissioner with returns relating to the allocation, distributions, credits, and payments referred to above (section HL 31(3)(e)(i)); and
- provide the Commissioner with any other information required (section HL 31(3)(e)(ii)).

Other provisions in the Income Tax Act 2004

New section CX 44C – exclusion for trading gains on Australasian equities by portfolio investment entities

New section CX 44C provides the exclusion for portfolio investment entities on certain Australasian share-trading income.

Under section CX 44C, income derived by a portfolio investment entity from disposal of a share, where the share is in a New Zealand tax-resident company or by a company resident in Australia for tax purposes and listed on an approved index under the Australian Stock Exchange rules (explained more fully earlier in this bulletin), is excluded income of the portfolio investment entity.

As a consequential amendment, sections DB 17(1) and (2) have been amended to prevent portfolio investment entities from receiving a deduction for the cost of shares subject to section CX 44C, on disposal.

Dividends (section CB 4B)

Under section CB 4B, where a dividend is declared in respect of a share to which section CX 44C applies before the share is disposed of, but the dividend is paid after the disposal, the portfolio investment entity is considered to have derived the dividend as gross income. The amount of gross income is limited to the amount of any dividend that is not fully imputed for New Zealand tax purposes.

Tax Administration Act 1994 provisions

New section 31B – information to be provided by portfolio tax rate entities to investors

Section 31B(1) and (2) outlines the requirement for a portfolio tax rate entity to provide information which the Commissioner considers relevant to zero-rated portfolio investors and investors with portfolio investor exit periods. This information will be needed by these investors to comply with their tax obligations for any income or loss allocated to them by a portfolio tax rate entity.

Section 31B(3) requires a portfolio tax rate entity to provide all other investors with information the Commissioner considers relevant for each income year by 30 June after the end of the income year.

Section 31B(4) requires a portfolio tax rate entity to give a notice to each investor in the entity, at least once each income year, requesting that the investor provide the entity with the investor's prescribed investor rate.

New section 36AB – portfolio investment entities to file returns electronically

Section 36AB requires the Commissioner to prescribe the electronic format in which a tax return must be provided by a portfolio tax rate entity or a portfolio investor proxy.

New section 57B – returns to be filed and annual reconciliation statements to be provided by portfolio tax rate entities and portfolio investor proxies

Section 57B outlines the return filing requirements and payment obligations for portfolio tax rate entities and portfolio investor proxies.

Portfolio tax rate entities or portfolio investor proxies that pay tax under section HL 21 must file a return in a prescribed form at the end of each calculation period.

The entity must also pay an amount equal to the portfolio entity tax liability to the Commissioner along with each return of income.

Portfolio tax rate entities or portfolio investor proxies that pay tax under section HL 23 must file a return in a prescribed form:

- for investors with a portfolio investor exit period by the end of the month following the month in which the portfolio investor exit period ended;
- for investors who hold portfolio investor interests at the end of the tax year by the end of the month following the end of the tax year.

Portfolio tax rate entities that pay tax under section HL 22 must perform the responsibilities of a provisional taxpayer under the provisional tax rules.

All portfolio tax rate entities and portfolio investor proxies must file an annual return in a prescribed form showing the income tax paid for the tax year and any other information the Commissioner considers necessary. The return must be filed by 30 June.

Consequential amendments

Consequential amendments have been made to:

- section 139A(2)(a)(iii) to extend the late-filing penalties rules to returns filed under section 57B by portfolio tax rate entities and portfolio investor proxies; and
- section 139AA(2) to apply the non-electronic filing penalty to portfolio tax rate entities and portfolio investor proxies that do not furnish returns in a prescribed electronic format.

NEW RULES FOR THE TAX TREATMENT OF EXPENDITURE ON GEOTHERMAL WELLS

Sections CZ 20, DZ 15, EE 6, EE 32, EE 37, EE 38, EE 40, EE 44B, EE 51 and OB 1 of the Income Tax Act 2004 and sections CZ 7, DZ 7 and OB 1 of the Income Tax Act 1994

The rules covering tax deductions now allow an immediate deduction where expenditure has been incurred on drilling or acquiring geothermal wells and the wells are failures. The changes allow:

- Capital expenditure on geothermal wells drilled in New Zealand to be treated as in use, or available for use, for business purposes from the time that the well is completed.
- If the well is a failure (that is, there is no reasonable prospect of it being used in an income-earning process), its cost or remaining tax book value will be deductible. In all other cases the cost of a well will be depreciated over the estimated useful life of the well.
- If a previously failed well is subsequently used or sold and the taxpayer has previously claimed a deduction for the cost of the well the taxpayer must write-back the lower of its cost or its previous tax book value, and this will be assessable for income tax.

These changes will allow a deduction for the capital cost of failed geothermal wells. It was previously arguable that such expenditure was not deductible.

Background

Power generators had previously raised concerns with the potential non-deductibility of the cost of unsuccessful geothermal wells. The problem was complicated by a number of factors. For example, it is sometimes difficult to determine whether a geothermal well is a success or failure at the time that the well is completed. Sometimes a geothermal well's output takes time to stabilise or "warm up". It is also sometimes difficult to determine whether a productive geothermal well will be used in an income-earning process. For new geothermal power generation projects, investment decisions are based more on expectations of the future price of electricity and the nature of the geothermal field rather than the output potential of a single well.

Under the previous rules capital expenditure on failed geothermal wells may have not be deductible, as it was arguable that failed geothermal wells have neither been in use or available for use. The amendments ensure that developers of New Zealand's geothermal assets are entitled to deductions when capital expenditure results in no enduring benefit.

Key features

Central to the new rules is the term "geothermal energy-proving period". The geothermal energy-proving period brings completed geothermal wells into the tax depreciation rules. The geothermal energy-proving period starts with the completion or acquisition of the well and ends when the taxpayer determines that the well will not be used, or there is no reasonable prospect that the well can be used, in deriving assessable income.

If the geothermal well is a failure, meaning there is no reasonable prospect that the well will be used in an income-earning process, the taxpayer can treat the cost of the well as a depreciation loss.

If there is a reasonable prospect that the well could be used in an income-earning process, the taxpayer can begin depreciating the well from the date of its completion. Allowing depreciation deductions for the well to start from the date of completion reduces incentives for taxpayers to expense the costs of geothermal wells when they are uncertain if the well will be used in an income-earning process.

In the case where a new geothermal well or newly acquired geothermal well is immediately placed into use, or is available for use, the well would not be subject to the geothermal energy-proving period. The tax depreciation

rules would apply as usual, with the cost of the well depreciated over 20 years from the date that the well is in use or available for use.

Loss recovery rules apply when a previously failed geothermal well is either sold, or brought into use or made available for use.

Application dates

The rules apply from the 2003–04 income year or a later income year for deductions for failed wells where drilling began, or the well was purchased, in or after that year. The new rules allowing depreciation deductions for wells that are in the geothermal energy-proving period applies from the 2006–07 income year.

Detailed analysis

Section CZ 20 is a loss recovery rule. It applies to wells started and completed between 31 March 2003 and 17 May 2006 or acquired during this period. If the well is written off and is subsequently used or sold when a deduction has been previously taken, then the lesser of the amount received or the amount of the earlier deduction under section DZ 15 is treated as income. This applies for the 2005–06 and later income years. Section CZ 7 is the equivalent section in the Income Tax Act 1994 and applies for the 2003–04 and later income years.

Section DZ 15 applies to wells drilled or acquired between 31 March 2003 and 17 May 2006. It allows a deduction for expenditure incurred on a geothermal well, if one has not been taken under another provision, when the geothermal energy-proving period has ended. This section applies for the 2005–06 and later income years. Section DZ 7 is the equivalent section in the Income Tax Act 1994 and applies for the 2003–04 and later income years.

Subsection EE 6(4) applies to geothermal wells completed or acquired on or after 1 April 2003. This rule allows a person who owns a geothermal well for the geothermal energy-proving period to depreciate the value of the well. This subsection treats the well as property that declines in value and is available for use in carrying on a business for the purpose of deriving assessable income. The subsection applies for the 2006–07 and later income years.

Subsection EE 32(1)(a) allows a deduction for a geothermal well that is no longer used, because the geothermal energy proving period ends. The amount of loss is the well's adjusted tax book value at the start of the income year. It applies to a geothermal well that is completed or acquired on or after 1 April 2003 and applies for the 2006–07 and later income years.

Subsection EE 37(2) specifies that sections EE 41 to 44 do not apply when a well's geothermal energy-proving period ends. The effect is that the general depreciation square-up rules (of loss and recovery) do not apply to these wells. This subsection applies to geothermal wells acquired or completed on or after 1 April 2003 for the 2006–07 and later income years.

Sections EE 38(6B) and EE 40(5B) are loss recovery rules. Section EE 40(5B) makes the bringing into use of an unused geothermal well an event for the purposes of section EE 37. Section EE 38(6B) sets the consideration derived from that event as the amount of the deduction previously taken under section EE 32(4). These subsections apply when a geothermal well's geothermal energy-proving period ended and the well is subsequently brought into use. These subsections apply to a geothermal well for the 2006–07 and later income years if the well is completed or acquired on or after 1 April 2003.

Subsection EE 44B specifies that a person is treated as acquiring a previously unused well on the day that it is brought into use and is subsequently disposed of, for its original cost. Subsection EE 51(3)(a) ensures that all earlier deductions taken during a well's geothermal energy-proving period are subtracted from the historical cost for a geothermal well that has been brought into use after it has been previously considered a failure. This ensures that for depreciation purposes the correct adjusted tax value is used to calculate depreciation deductions for the well and that the depreciation recovery values are correct.

Two definitions have been added to section OB1 and one existing definition has been amended in the Income Tax Act 2004. The definition of "geothermal energy-proving period" – which starts when a well is completed or acquired and ends when the well for the foreseeable future is not intended and cannot reasonably be expected to be used – is a key definition. A geothermal well is considered completed at the end of completion testing in line with normal industry practice.

The second definition – "geothermal well" – means a bore or well solely for the purposes of investigating or exploiting geothermal energy.

The definition of "dispose" excludes a geothermal well that ceases to be available for use under section EE 6(4).

These definitions are replicated in section OB 1 of the Income Tax Act 1994.

AUSTRALIAN SUPERANNUATION FUND EXEMPTION

Sections CW 23B and EX 33E of the Income Tax Act 2004, section CG 15 2(cb) of the Income Tax Act 1994, section 245RA (2)(cb) of the Income Tax Act 1976

A new exemption has been added to the foreign investment fund (FIF) rules. The exemption applies to interests in specified Australian superannuation schemes held by an individual.

The exemption applies from the 1993–94 income year.

Background

Individuals working in Australia generally have compulsory contributions into a superannuation scheme made on their behalf by their employers. This scheme is treated as an employment-related foreign superannuation scheme for New Zealand tax purposes.

In general, Australian and New Zealand citizens cannot access these superannuation interests until they reach retirement age. If these individuals migrate or return to New Zealand they could be subject to tax on these interests under the FIF rules if they make contributions to the scheme after being resident in New Zealand for five years.

Consultation with the private sector has suggested that individuals with Australian superannuation interests may not be complying correctly with their tax obligations under the FIF rules or may not be aware that they have to account for tax. For those people who are aware of their tax responsibilities, determining whether they have a FIF obligation can involve high compliance costs. Although the current exemptions provide some relief from these rules, there may be difficulty in determining which exemption applies and the need to meet the ongoing requirements of the exemption.

In addition, the potential tax consequences under the FIF rules could be a disincentive for individuals with interests in particular superannuation schemes to take up long-term or permanent employment in New Zealand. For example, members of defined benefit schemes[1] must continue to contribute to such schemes to preserve the expected value of their future entitlements. If they cease making contributions, the ultimate benefit payout could be significantly reduced from the level expected had contributions continued. While it is in their interests to continue to contribute they would eventually face tax consequences under the FIF rules. If a member transferred his or her entitlements in a defined benefit scheme to another scheme such as a defined contribution scheme this transfer could also give rise to a FIF liability.

The scope of the new exemption will have wide coverage because most superannuation schemes in Australia (including schemes that receive compulsory employment superannuation contributions under Australia's guarantee scheme) will fall within one of the listed schemes. These schemes are all subject to strict prudential standards and rules relating to the preservation and early release of superannuation benefits. Therefore, the exemption should achieve the desired policy outcome of addressing the trans-Tasman migration and compliance issues arising under the FIF rules.

Key features

New section EX 33E of the Income Tax Act 2004 exempts from the FIF rules interests in the following Australian superannuation schemes:

- approved deposit funds;
- exempt public sector superannuation schemes;
- regulated superannuation funds; and
- retirement savings accounts.

These schemes are subject to strict preservation rules whereby benefits are generally locked-in until a person reaches retirement age. Individual schemes may have some capacity to pay benefits to people experiencing severe financial hardship and on compassionate grounds, but these payments are strictly limited. For example, payments may be made to treat life-threatening illnesses, to prevent foreclosure by a mortgagee or the exercise of an express or statutory power of sale over the family home. When a person dies the scheme will pay benefits in cash to the person's dependents or the person's estate. It is also possible to transfer benefits between superannuation schemes, but only to Australian schemes that meet certain regulatory standards, including the preservation of benefits.

Consequential amendments have also been made to the corresponding provisions in the Income Tax Act 1994 and the Income Tax Act 1976.

New section CW 23B provides roll-over relief in situations when an individual has withdrawn an amount from one of the listed schemes and invests the entire amount in another listed scheme. The amount withdrawn and reinvested will be exempt from income tax. This roll-over relief applies on a prospective basis from the 2006–07 income year.

Application date

The new exemption applies from the 1993–94 income year for taxpayers whose corresponding non-standard accounting year ends after 30 November 1993, or the 1994–95 income year for all other taxpayers.

Detailed analysis

Description of Australian superannuation schemes

The superannuation schemes subject to the new exemption are all constituted under Australian law and are described below. The principal legislation governing the regulation of superannuation in Australia is the Superannuation Industry (Supervision) Act 1993 (SISA) and the Superannuation Industry (Supervision) Regulations 1994 (SISR).

Approved deposit funds

An "approved deposit fund" is defined in section 10 of SISA. Approved deposit funds receive, hold and invest certain types of roll-over funds until the funds are withdrawn in accordance with the preservation rules in SISA. They were created as roll-over vehicles into which a member could transfer superannuation benefits so as to retain them in the superannuation system.

[1] Defined benefit schemes provide superannuation benefits that are based on the member's salary at a particular time (or averaged over a particular period) or some other amount specified in the trust deed of the scheme.

Exempt public sector superannuation schemes

An "exempt public sector superannuation scheme" is defined in section 10 of SISA. Exempt public sector superannuation schemes provide for payments of superannuation, retirement or death benefits, and are established under:

- a Commonwealth, state or territory law; or
- the authority of the Commonwealth, state or territory government, or a municipal corporation, another local governing body or a public authority that is constituted by or under a Commonwealth, state or territory law.

These schemes are specifically listed in Schedule 1AA of SISR. Although these schemes are not regulated under SISA they conform to the principles of that Act.

Regulated superannuation funds

A "regulated superannuation fund" is defined in section 19 of SISA. These funds have made an irrevocable election for the regulatory provisions of SISA to apply to them. Most entities involved in the provision of superannuation in Australia will be regulated superannuation funds. They include:

- corporate/employer funds, which are established and run by an employer (usually large) for its own employees;
- industry funds, which are for employees of different employers in the same industry, for example – hospitality industry or building industry;
- retail or public offer funds, which are open to anyone to join, and are usually run by large banks or life insurance companies; and
- small funds approved by the Australian Prudential Regulation Authority[2] and self-managed superannuation funds[3]. These funds have five or fewer members and are predominantly used by the self-employed.

Retirement savings accounts

A "retirement savings account" is defined in section 8 of the Retirement Savings Account Act 1991. These accounts are typically offered by banks or similar financial institutions and operate in a similar way to a bank account – accumulating small amounts deposited regularly by their members and by the member's employer and paying interest on those deposits. The money is invested in assets that are low risk. The Retirement Savings Accounts Regulations 1997 contain preservation rules including restrictions on the early release of benefits from retirement savings accounts, which are identical to the preservation rules in the SISR.

Preservation rules and restrictions on early release

In general, superannuation benefits may be paid out only on the occurrence of one of the following events:

- retirement on or after reaching preservation age. A person's preservation age depends on his or her date of birth – if a person's date of birth is before 1 July 1960, his or her preservation age would be 55[4] years. In addition, if a member is under 60 years of age the scheme must be satisfied that the member never intends to work again;
- reaching age 65 years;
- permanent incapacity;
- termination, at any age, of gainful employment with an employer who had contributed to the scheme, as long as the benefits are paid in the form of a non-commutable lifetime pension.

The early release of superannuation benefits is not permitted on any grounds other than those specified by the relevant legislation. The final decision on whether a release is permitted on any grounds rests with the trustees of the applicant's superannuation schemes, subject to the governing rules of the scheme.

There are two principal ways by which an individual can access his or her superannuation benefits before reaching retirement age. An individual can apply to his or her superannuation scheme's trustee on the grounds of severe financial hardship; or alternatively, apply to the Australian Prudential Regulation Authority for release on compassionate grounds.

Benefits may be released on compassionate grounds in very limited circumstances. These circumstances are defined in relevant legislation or in the trust deed of the scheme and cover expenses for medical treatment, medical transport, modifications to the family home or motor vehicle because of severe disability, palliative care, and funeral expenses. Funds may also be released on compassionate grounds to prevent foreclosure of a mortgage or exercise of a power of sale over the member's principal place of residence. Benefits can also be released to meet expenses in other cases where the release is consistent with one of these grounds.

The regulatory arrangements attempt to balance the need for superannuation benefits to be protected for retirement purposes against the need for access when superannuation fund members experience a personal emergency.

Non-preserved or unrestricted interests

The exemption applies to interests in superannuation schemes that are subject to preservation arrangements. However, some interests that were acquired before

[2] The Australian Prudential Regulation Authority is responsible for prudential regulation of all superannuation funds, except self-managed funds, and for ensuring that those funds comply with the relevant regulatory standards.

[3] Self-managed superannuation funds are administered by the Australian Tax Office.

[4] The preservation age is increasing from 55 to 60 on a phased basis between the years 2015 and 2025. This will mean that for an individual born before 1 July 1960, the preservation age will remain at 55 years, whereas an individual born after 30 June 1964, the preservation age will rise to 60.

certain dates might not be preserved or restricted. This is because over the years the rules relating to accessing Australian superannuation benefits have been gradually tightened to encourage or enforce the preservation of member interests, but the general practice has been to "grandparent" any interests that members have had at the time of each change.

Even so, these unpreserved or unrestricted interests should still qualify for exemption from the FIF rules as long as the scheme is listed in the new exemption provision. Excluding these interests from the exemption relief would have led to both compliance costs for taxpayers and administrative costs for Inland Revenue, thereby negating any benefit from the exemption.

NEW RULES FOR SELECTING SSCWT RATES

Sections NE 2AA, NE 2AB, NE 2B and OB1 and Schedule 1 of the Income Tax Act 2004, section 32B of the Tax Administration Act 1994

The rules for selecting Specified Superannuation Contribution Withholding Tax (SSCWT) rates under the progressive scale have been changed so that the rate selected is based on an employee's salary or wages and employer superannuation contributions, instead of being based on an employee's salary or wages alone.

The change is intended to ensure that employee superannuation contributions are taxed at more or less the correct marginal rate for each employee.

Background

In 2004 the SSCWT rules were changed so that employers could elect to use one of four possible methods for taxing employee superannuation contributions:

- Deduct SSCWT, using a flat rate of either 15%, 21% or 33%, based on each employee's annual salary or wages, with thresholds at $9,500 and $38,000.
- Deduct SSCWT, using a flat rate of 33%, regardless of the employee's salary or wages.
- Deduct SSCWT, using a flat rate of 39%, regardless of the employee's salary or wages.
- Treat employer superannuation contributions as salary or wages, and subject them to income tax, through PAYE.

Some taxpayers began to use the first method to achieve tax advantages, by sacrificing a significant portion of their salary to achieve a lower tax rate. An employee would agree to take a much lower salary, in return for increased employer superannuation contributions. If an employee could reduce their salary to below $9,500, then both the salary and the employer superannuation contributions would be taxed at 15%. In extreme cases, tax rates on employment income could be reduced from 39% to 15%.

No employers and employees were found to be using the 39% flat rate.

Key features

The basis for selecting SSCWT rates under the first method has been changed. New section NE 2B of the Income Tax Act 2004 allows employers to elect to use the rates specified in Schedule 1, part A, clause 10(a) for the SSCWT rate threshold amount for the employee. The SSCWT rate threshold amount is defined in OB 1 as the total of an employee's salary or wages and employer superannuation contributions in the previous year. The effect of this is to base SSCWT rates on the total of salary or wages and employer superannuation contributions, instead of on salary or wages alone.

To ensure that individual employees whose salary or wages is close to a threshold are not disadvantaged, the thresholds for the SSCWT rate threshold amount are set at about 120% of the equivalent income tax thresholds. This means that an employer superannuation contribution would need to exceed 20% of salary or wages before the employee was taxed at a higher rate on employee superannuation contributions than the marginal rate he or she was taxed at on salary or wages.

The new rates and thresholds are in Schedule 1 and shown below.

SSCWT rate threshold amount	SSCWT rate
Up to $11,400	15%
Between $11,401 and $45,600	21%
Greater than $45,600	33%

Employers can still elect to use the 33% flat rate (33% SSCWT on all employer superannuation contributions regardless of salary or wages), and employees can still elect to use the PAYE method, with the agreement of their employer. However the 39% flat rate has been removed because it was not being used (repealed section NE 2AA).

Tax Administration Act section 32B(1)(b)has been amended so that for the purposes of calculating Fund Withdrawal Tax, the rules that were in force up to 1 April 2007 are applied to contributions made up until 1 April 2007, and the rules that will apply from 1 April 2007 are applied to employer contributions made from 1 April 2007 onwards.

Application date

The new rules apply from 1 April 2007.

ALLOWING DOCUMENTS TO BE REMOVED FOR INSPECTION

Sections 3, 16C, 20D and 20F of the Tax Administration Act 1994, Regulation 4B and Schedule 2 of the Tax Administration (Form of Warrant) Regulations 2003

Changes have been made to the Tax Administration Act 1994 and the Tax Administration (Form of Warrant) Regulations 2003 to give the Commissioner the power to remove and retain documents for full and complete inspection. This power may be exercised only if the Commissioner has the consent of the dwelling occupier or a warrant from a judicial officer.

Background

Previously, the Commissioner did not have the power to remove and retain documents for inspection without a taxpayer's express permission. However, this was not always feasible as a person could refuse to provide the requested document or could even destroy it. Although it is an offence to fail to provide information to the Commissioner when required to do so, some individuals have preferred to face a monetary penalty for not providing the information rather than be prosecuted for a more serious offence such as fraud or tax evasion based on the documents requested.

There are several reasons for giving the Commissioner the power to remove, retain and inspect documents. Having original documents satisfies the "best evidence" rule by which Courts may view an original document more favourably than a copy. It may also be necessary to forensically examine an original document. This may happen, for example, when there is a dispute about who created the document or whether the information contained in the document has been altered.

Key features

New section 16C of the Tax Administration Act 1994 authorises the Commissioner of Inland Revenue or an authorised officer to remove books and documents from a place accessed under section 16 and retain them for so long as is necessary for a full and complete inspection. This power may be exercised only if the Commissioner has the consent of an occupier of the place or a warrant.

A warrant is issued by a judicial officer on written application by the Commissioner. To issue a warrant, a judicial officer must be satisfied that for the Commissioner to carry out functions such as collecting tax or duty under any of the Inland Revenue Acts, removing books or documents from a place and retaining them for a full and complete inspection may be required.

Every warrant issued must meet the requirements in section 16(5) which apply to the issue of a warrant to access a private dwelling.

The Commissioner is required to produce the warrant on first entering a place and whenever subsequently reasonably required to do so.

The owner of removed books or documents may obtain a copy of the removed books or documents either at the time of their removal or at any reasonable times subsequently.

While in possession of the books or documents, the Commissioner may make copies of them. Those copies, once certified by the Commissioner, are admissible as evidence in Court as if they were the originals.

Section 16C allows the Commissioner to remove documents from any place accessed under section 16 of the Tax Administration Act, which contains the Commissioner's general power to access any premises. It is therefore necessary for the requirements of section 16 as well as those in section 16C to be satisfied. In particular, this means it may be necessary to obtain two warrants in relation to a private dwelling: a warrant to obtain access to the private dwelling under section 16 and another warrant to remove documents from the dwelling and retain them for inspection under section 16C. No warrants are necessary if the occupier of the dwelling gives their consent.

Section 3(1) of the Tax Administration Act 1994, which is the definition section of the Act, has been amended to define "full and complete inspection" and "judicial officer".

"Full and complete inspection" includes use as evidence in court proceedings. It is implicit that a right to "full and complete inspection" also includes the right to perform forensic tests and other actions within the ordinary meaning of the word "inspection".

"Full and complete inspection" has also been defined to exclude removal of documents to make copies under section 16B. This ensures that the power under new section 16C is separate from, and does not affect, the section 16B power.

The definition of "judicial officer" has been amended to apply to new section 16C of the Tax Administration Act. A "judicial officer" is a person who is a district court judge, justice, community magistrate, or registrar of a district court.

Consequential amendments have also been made to sections 20D(4)(a) and 20F(2)(a), which relate to the disclosure of tax advice documents.

Tax Administration (Form of Warrant) Regulations 2003

New regulation 4B provides that a warrant issued under the new power in section 16C must be in the form set out in Schedule 2.

New Schedule 2 of the Regulations sets out the form of a warrant which is issued by a judicial officer to enable the Commissioner to exercise the new power to remove, retain and inspect documents.

Application date

The amendments apply from 18 December 2006.

OTHER POLICY MATTERS

EXEMPTION FOR ALLOWANCES PAID TO MILITARY AND POLICE PERSONNEL SERVING IN OPERATIONAL AREAS

Section CW 19 of the Income Tax Act 2004

Amendments have been made to section CW 19 of the Income Tax Act 2004 to exempt from income tax allowances paid to members of the New Zealand Defence Force or the Police, which are directly and solely paid for serving in operational areas.

A Ministerial Committee will have the ability to exempt from income tax the pay and other allowances paid to members of the New Zealand Defence Force or the Police who serve in operational areas.

Background

Previously, section CW 19 of the Income Tax Act 2004 provided that *all* pay and allowances received by members of the New Zealand navy, military or air force while serving in an operational area were exempt from income tax. A Ministerial Committee comprising the Prime Minister, the Minister of Finance and the Minister of Defence was responsible for determining if a specified area was an operational area. As the previous exemption applied on an "all or nothing" basis, the Ministerial Committee declined to declare areas to be operational areas. This was because the Committee had considered that allowances paid as a result of a deployment to an operational area should be exempt, but not the full pay and other allowances paid to Defence Force members. Consequently, section CW 19 was never used.

Instead, operational allowances were paid to New Zealand Defence Force members as special assistance under the Social Security Act 1964 in a programme referred to as the Defence Force Allowance Programme. This payment system was adopted to ensure that New Zealand Defence Force members could receive additional allowances associated with operational deployments without any flow-on reduction in entitlements to benefits that they, or their dependents, were receiving. This payment system was intended as a temporary measure only until a long-term payment arrangement for New Zealand Defence Force service allowances could be developed.

The amendments streamline and clarify the operation of section CW 19 and remove the administrative difficulties associated with the previous payment system.

Key features

The amendments to section CW 19 will mean that:

- operational allowances, paid to members of the New Zealand Defence Force or the Police as a direct result of their deployment to an operational area, are automatically exempt from income tax; and
- the Ministerial Committee, which includes the Prime Minister, the Minister of Defence, the Minister of Police, the Minister of Finance and the Minister of Foreign Affairs, can determine that any amounts of pay and/or allowances (other than allowances paid as a direct result of the deployment to an operational area), are exempt from income tax.

An "operational area" is an area that satisfies a two-part test. First, the Minister of Defence must order the deployment of New Zealand Defence Force members for a specific mission authorised by the government. Second, the Chief of Defence Force must further define the area in which the mission is to be carried out.

Operational allowances that were paid under the special assistance programme will be exempt under the new section CW 19.

Application date

The new exemption takes effect three months after the date of enactment, 18 December 2006.

NEW RULES FOR SPREADING INCOME ON THE SALE OF PATENTS

Section EI 3B of the Income Tax Act 2004

This amendment allows taxable income from the sale of patent rights to be spread evenly over three income years, at the vendor's election.

Background

Patent rights are often sold for non-cash items, such as shares or share options. Section CB 26 of the Income

Tax Act 2004 makes gains on sale of patent rights taxable income, but if patent rights are sold for non-cash items, a vendor can have a tax liability without having the cash to pay it. This can create cashflow problems for vendors of patent rights, thus creating a potential barrier to investment in research and technology.

Key features

Vendors of patent rights will be able to spread income on sale of patent rights over three years, including the year of sale. Allowing the income spread may help to alleviate the potential cashflow problem, thus helping to reduce the potential barrier to investment in research and technology.

The three-year spread is at the taxpayer's election, giving taxpayers greater capacity to plan for the required cashflows.

Application date

The amendment applies from the 2007–08 income year.

ORGANISATIONS APPROVED FOR CHARITABLE DONEE STATUS

Section KC 5(1) of the Income Tax Act 2004

The following organisations have been granted charitable donee status from the 2006–07 tax year.

- Children on the Edge (NZ) Trust
- DIPS'N Charitable Trust (International)
- The New Zealand Council of the Ramabai Mukti Mission Trust Board
- Waterharvest Trust
- Zonta International District 16 (New Zealand) Charitable Trust

Donations made to these organisations will entitle individual taxpayers to a rebate of 33⅓ percent 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 percent of that income.

A Māori authority may also claim a deduction from its net income. The maximum deduction for a Māori authority is 5 percent of its net income donated to charitable organisations and/or a body that has been defined as a Māori association under the Māori Community Development Act 1962

CONSOLIDATED GROUPS AND FOREIGN LOSSES

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

The law has been amended to make the loss rules for consolidated groups consistent with the rules for non-consolidated groups. This will prevent losses from being used in two different jurisdictions by a consolidated group.

Background

Under the group loss rules, a loss-making company can offset its losses against the income of another company in the same group. Companies can group their losses if they are at least 66 percent commonly owned.

Under the consolidation rules, companies can elect to be treated as a single entity (the "consolidated group") if they are 100 percent commonly owned and subject to certain other requirements contained in the definition of "eligible company". Effectively, this means that a loss-making company can offset its income against another company in the same consolidated group.

There are two restrictions that prevent companies in a non-consolidated group from grouping the same loss in more than one jurisdiction. First, dual-resident companies may not offset losses against the income of other companies in a group. A "dual-resident company" is a New Zealand-resident company which is either treated as non-resident under a double tax agreement or is liable for tax in another jurisdiction by reason of domicile, residence or place of incorporation. Second, in order to offset losses, the loss-making company must either be incorporated in New Zealand or carry on business in New Zealand through a fixed establishment. This requirement helps ensure that companies cannot change their place of residence to circumvent the restriction against grouping the same loss in more than one jurisdiction.

Under previous law, these rules did not apply in the same way to consolidated groups. While the rules for consolidated groups required that the company be a New Zealand resident, they did not include the requirements relating to incorporation or fixed establishment in New Zealand that are in the loss rules for non-consolidated groups.

Further, although the rules for consolidated groups required that a company must not be treated as a non-resident for the purposes of a double tax agreement, there was no restriction on grouping losses if a company in a consolidated group was also liable for income tax in another country because of their domicile, residence or place of incorporation.

Key features

Every member of a consolidated group must be an "eligible company" as defined in section OB 1. The amendment modifies the definition of "eligible company" to require that the company in question be incorporated in New Zealand or carry on business in New Zealand through a fixed establishment. The amended definition further requires that an eligible company must not be liable for tax in another jurisdiction by reason of domicile, residence or place of incorporation.

To ensure that taxpayers cannot retrospectively take advantage of the discrepancy in the previous law, the equivalent definition in the Income Tax Act 1994 has also been amended. This amendment applies from the 1997–1998 income year. The application date coincides with the date that the income tax core provisions took effect, which included the enactment of current loss grouping rules.

However, a savings provision ensures that the amended definition does not apply to taxpayers who were members of a consolidated group (under previous law) at the time. The position of existing dual-resident members of a consolidated group is protected for their 2005–2006 and 2006–2007 years if they elected to join the consolidated group before 17 May 2006.

Certain dual-resident members that are genuine trading companies are also grandparented for 2005–2006 and later income years. These companies must be in business and have elected to join the consolidated group before 17 May 2006. In addition, the company's interest deductions (or deductions under the financial arrangement rules) for the previous income year, ignoring foreign exchange fluctuations in the debt, must be less than 50 percent of the company's total allowable deductions for that year.

Application date

The amendment applies from the 1997–1998 income year. Table 1 illustrates when the grandparenting provisions will apply.

Table 1

Taxpayer's situation	**Savings or grandparenting provision applies for**
Taxpayer was a member of a consolidated group at the time	1997–98 to 2004–05 income years
Taxpayer elected to be part of consolidated group before 17 May 2006	2005–06 and 2006–07 income years
The taxpayer: - elected to be part of consolidated group before 17 May 2006; and - is in business; and - less than 50 percent of the company's total allowable deductions for the previous income year were interest deductions (or deductions under the financial arrangement rules).	2005–06 and later income years

ASSESSMENTS BY THE COMMISSIONER

Section 89C of the Tax Administration Act 1994

Circumstances in which the Commissioner may make an assessment without having first issued a Notice of Proposed Adjustment (NOPA) have been extended to cover the situation when the Commissioner has reasonable grounds to believe that a taxpayer has been involved in fraudulent activity, irrespective of whether the taxpayer remains in New Zealand.

Application date

The amendment applies from 18 December 2006.

GST AND FINANCIAL SERVICES

Sections 3 and 20F of the Goods and Services Tax Act 1985

Changes have been made to section 3(1) of the Goods and Services Tax Act 1985 to treat certain activities involving investments in equity securities and participatory securities as supplies of financial services. The financial services may be zero-rated if supplied to businesses.

Background

Supplies of financial services in New Zealand are generally exempt from GST. Since 1 January 2005, however, supplies of financial services to GST-registered persons whose taxable supplies equal or exceed 75% of their total supplies may be zero-rated, when the financial services provider elects to do so.

The amendment recognises that, in its absence, certain activities involved with investments in the form of shares may not be treated as supplies of goods and services for the purpose of the GST Act. For example, entities, such

CONFIRMATION OF ANNUAL INCOME TAX RATES FOR 2006–07

Schedule 1, Income Tax Act 2004

The income tax rates that will apply for the 2006–07 tax year are:

Policyholder income	33 cents for every $1 of schedular taxable income
Māori authorities	19.5 cents for every $1 of taxable income
Companies, public authorities and local authorities	33 cents for every $1 of taxable income
Trustee income (including that of trustees of superannuation funds)	33 cents for every $1 of taxable income
Trustees of group investment funds in respect of category A	33 cents for every $1 of schedular taxable income
Taxable distributions from non-qualifying trusts	45 cents for every $1 of taxable income
Other taxpayers (including individuals)	
– Income not exceeding $38,000	19.5 cents for every $1 of taxable income
– Income exceeding $38,000 but not exceeding $60,000	33 cents for every $1 of taxable income
– Income exceeding $60,000	39 cents for every $1 of taxable income
Specified superannuation contribution	
Where the employee has made an election under section NE 2AA	39 cents for every $1 of the withholding tax contribution
Where the employer has made an election under section NE 2AB and the amount of salary or wages given by section NE 2AB is:	
– not more than $9,500	15 cents for every dollar of contribution
– more than $9,500 and not more than $38,000	21 cents for every dollar of contribution
– more than $38,000	33 cents for every dollar of contribution
Where no such election is made	33 cents for every $1 of contribution

The income tax rates confirmed are the same as those that applied for the 2005–06 tax year.

as investment companies and equity funds, whose sole activity is to hold shares are generally unable to register for GST. Any GST incurred by these entities (investors) is therefore irrecoverable.

If the investor seeks to pass on the cost of the irrecoverable GST– for example, in the form of requiring higher returns from investments in other GST-registered persons (investees) – tax cascades may arise. The greater the activity associated with the management of the investment, the more likely it will be that the investor will seek to recover those costs from the investee.

The amendment seeks to resolve this problem by treating certain equity security or participatory security investments (such as the acquisition of shares) that allow the investor to influence the management of the investee as a supply of "financial services". If the investor acquires shares in an investee that is GST-registered and 75% of the investee's total supplies are taxable supplies, the investor may elect to zero-rate the investment (including such activities associated with maintaining the investment) and register for GST. Information on when the supply of financial services may be zero-rated can be found in Inland Revenue's *GST guidelines for working with the new zero-rating rules of financial services*.[5]

A consequential amendment has also been made to section 20F(1) so that it refers to a "person" rather than a "registered person". The change means that a person making GST-exempt supplies, and who is therefore unable to register for GST, can elect to zero-rate supplies of financial services under section 20F and register for GST.

Key features

Section 3(1) has been amended by inserting new paragraphs (m) and (n).

[5] See www.taxpolicy.ird.govt.nz or *Tax Information Bulletin*, Vol 16, No 10 (November 2004).

New paragraph (m)

An investment in an entity will be treated as a supply of financial services if:

- the investment is in an equity security or participatory security that is equal to or greater than 10 percent of all the equity securities and participatory securities issued by the entity; and
- the investment allows the investor, or a person acting on behalf of the investor, to influence the management of the business of the entity.

The reference to influence over an entity that is exercised by a person other than the investor was changed from an "associated person" to "a person acting on behalf of the investor" at the recommendation of the Finance and Expenditure Committee. The change reflects that the investment sector commonly uses independent managers to influence the business of the investee.

New paragraph (n)

The bill initially included a definition of "actively managed investment". This definition was removed as part of the Finance and Expenditure Committee deliberation on the bill and the clause was re-written as new paragraph (n).

Activities, including on-going activities, that an investor undertakes to evaluate an investment meeting the requirements of section 3(1)(m), such as monitoring or holding the investment, will be treated as a supply of financial services under section 3(1)(n). Activities connected with influencing the management of the investee are also treated as a supply of financial services. The paragraph extends to pre-acquisition activities that are carried out for the principal purpose of acquiring an investment described in section 3(1)(m).

Application date

The changes apply from the date of enactment, 18 December 2006.

Detailed analysis

Active investment

The changes to the definition of "financial services" are directed at active investment in the share capital of another entity. The active nature of the investment is measured using two conjunctive tests.

The first test requires that the investment is equal to or greater than 10 percent of all the equity securities and participatory securities issued by the entity.

The second test requires that the investment allows the investor, or a person acting on behalf of the investor, to influence the management of the business of the entity. This test considers whether the investment allows the investor an active role in the management of the investee entity.

Consideration for the supply of goods and services

"Consideration" for the purposes of the GST Act is typically thought of in terms of discrete amounts or obligations, such as explicit fees. "Consideration" can also take the form of margins in certain circumstances – for example, the interest rate differential between borrowing and lending rates. In the case of equity investment, the consideration received by an investment company for its intermediation services would be the net difference between the dividends it receives and the dividends it pays to its own shareholders. Additional commentary on valuing supplies of financial services is set out in Inland Revenue's guidelines on the application of the zero-rating rules for business-to-business supplies of financial services.[6]

GST ON FRINGE BENEFITS

Section 10 of the Goods and Services Tax Act 1985

A change to section 10(7) of the Goods and Services Tax Act 1985 extends the circumstances in which fringe benefits are not subject to GST. The change means that GST will not apply to fringe benefits if the GST-registered person providing the benefit is unable to deduct GST when the benefit is acquired. The purpose of the change is to remove the possibility of GST being imposed twice on the supply of certain fringe benefits.

Background

Fringe benefits are generally subject to GST because the employer is considered to be making a supply of goods and services to the employee. GST, being a tax on final consumption in New Zealand, must be charged on fringe benefits unless the benefit is an exempt or zero-rated supply, or the employer's activity is that of making exempt supplies. The GST treatment of fringe benefits assumes that the GST-registered person can deduct any GST paid.

An example is when gift vouchers are given to employees as a fringe benefit.

The rules relating to vouchers may prevent GST-registered employers from deducting input tax if the initial supply by the issuer of the gift vouchers to the employer is disregarded. Instead, GST may be accounted

[6] See page 64, ibid.

for when the vouchers are redeemed for goods and services. Because GST is not charged by the issuer of the vouchers, the GST-registered employer cannot deduct GST when the vouchers are purchased. Section 21I(1) requires tax to be charged when the employer provides the vouchers to an employee. Before the rule change, GST could arguably be charged twice – once when the GST-registered employer provides the vouchers as a fringe benefit and again when the voucher is redeemed.

The rule change now treats the fringe benefit as having a nil value to address the fact that the GST-registered employer is unable to deduct input tax in connection with purchasing the vouchers. GST will still be imposed when the vouchers are redeemed for goods and services.

Key features

Section 10(7) has been amended to treat the supply of fringe benefits as having a nil value when a GST-registered employer is unable to deduct input tax in connection with purchasing the fringe benefit.

Application date

The change applies to fringe benefits provided on and after 18 Dember 2006.

GST GROUPING RULES

Section 55 of the Goods and Services Tax Act 1985

Section 55, which governs the treatment of GST groups, has been amended to allow companies to form a GST group even if all of the members are not GST-registered. The change does not affect companies that are already grouped for GST purposes.

Key features

Section 55(1) now allows a group of companies meeting the requirements of section IG 1 of the Income Tax Act 2004 to be treated as a group for GST purposes if the total value of taxable supplies made by the companies is equal to or greater than 75 percent of the total supplies made by the group. The change allows companies that were previously unable to form a GST group to now do so and removes the GST risk associated with intra-group supplies.

A consequential change has also been made to section 55(3) to ensure that the representative member of the GST group is a GST-registered person.

Application date

The amendment applies from 1 October 2001.

REMEDIAL ISSUES

TAXATION OF BUSINESS ENVIRONMENTAL EXPENDITURE

Sections 14, 54, 55, 56, 57, 163 and 203 of the Income Tax Act 2004

New rules for business environmental expenditure were enacted on 21 June 2005 to ensure that all business operating costs, including those for dealing with environmental concerns, are taken into consideration in calculating taxable income, and that the timing of such deductions is appropriate.

A number of remedial changes have been made to clarify the new business environmental tax rules and ensure that the original legislation has its intended effect.

Treatment of by-products

The definition of “deductible environmental expenditure” allows a tax deduction for dealing with by-products on cessation of business. However, taxpayers may deal with by-products before cessation. The words “incurred in the cessation of a business” have been removed from item 7, Part B of Schedule 6B, to ensure that expenditure incurred before the cessation of business on the treatment of by-products is deductible and that there is no distortion between the treatment of by-products before and after cessation of business.

ERA transfers

The business environmental rules contain an Environmental Restoration Account (ERA) mechanism that allows business taxpayers, through making a deposit, to set aside a portion of their tax payments to pay for future site restoration and monitoring expenditure.

To ensure that ERA deposits follow the associated restoration liability, taxpayers are allowed to make transfers from their ERAs in a number of circumstances – for example, on the sale of a site. However, a number of the new ERA provisions were unclear on the treatment of transfers.

Section EK 20, which allows the nominated company for a consolidated group to make ERA payments and applications for refunds on behalf of the consolidated group now also makes specific reference to ERA transfers.

Section EK 6 (interest on payments to ERA) has been amended so that interest is payable on an amount that is treated as a payment under sections EK 15, EK 16 and EK 19. Amendments have also been made to treat an

amount as a payment under section EK 16 (transfer on death, bankruptcy or liquidation).

The section EK 16 reference to funds being transferred to the Ministry for the Environment has also been removed as subsequent work indicates that it is now unlikely that a restoration liability would be transferred to the New Zealand government (for example, where there is an orphan site).

ERA refunds

It was initially proposed that taxpayers would be able to make only one ERA deposit or refund per year. However, in order to increase flexibility, this was subsequently altered. A change has therefore been made to remove the words "or after earlier payment or request for refund" from section CX 43B as this was a reference to the limitation on multiple payments and refunds.

A change has also been made to clarify that there are two types of refunds permitted under section EK 12 – those requested by the taxpayer and those made by Inland Revenue when a taxpayer's ERA exceeds the maximum balance. In calculating the latter, the amount of the refund will be the difference between the actual and permitted balance. The amendments also remove the reference to any amount of refund requested by the taxpayer in subsection EK 12(8).

Removal of the distinction between industrial and non-industrial waste

The previous environmental tax rules applied solely to dealing with "industrial" waste. There was no definition of this term, resulting in uncertainty about when tax deductions were available for environmental expenditure. The new rules no longer make this distinction and also retrospectively remove the word "industrial" for any income year for which a taxpayer took a position on the definition of industrial waste before the introduction of the new rules. An amendment has been made to section DJ 10 in the Income Tax Act 1994 to allow a taxpayer who initially qualifies to have the word "industrial" removed to apply this same treatment for subsequent income years up until the time that the new environmental tax rules apply.

Application dates

These amendments apply to expenditure incurred in an income year beginning on or after 10 June 2005. The change to section DJ 10 of the Income Tax Act 1994 applies for income years subsequent to 1994–95 if a taxpayer has taken a tax position on the meaning of "industrial waste" before 16 November 2004.

FAMILY ASSISTANCE PROVISIONS

Sections 103 to 111

Several remedial amendments have been made to the family assistance provisions in the Income Tax Act 2004. Some were required to fine-tune the provisions to ensure that they give full effect to the policy intent of the Working for Families package, while others correct minor drafting errors.

In-work payment and weekly compensation

The changes are intended to remove any doubt that concurrent entitlement to the in-work payment and weekly compensation under the Injury Prevention, Rehabilitation, and Compensation Act 2001 is limited to incapacity suffered on or after 1 January 2006.

Key features

The reference in section KD 2AAA(1)(d) to subsection (7) has been replaced by a reference to subsection (8). The change clarifies that when subsection (8), relating to eligibility for the in-work payment when weekly compensation payments are received as a result of incapacity arising on or after 1 January 2006, applies, the requirements for income from an activity and full-time earner do not apply.

To further remove doubt, paragraph (xvi) of the definition of "salary or wages" has been omitted from the list in section KD 2AAA(5)(a)(i) of source deductions that are not eligible income from an activity. Paragraph (xvi) of the definition of "salary or wages" relates to payments of weekly compensation made under the Injury Prevention, Rehabilitation, and Compensation Act 2001. Instead, new subparagraph KD 2AAA(5)(a)(iii) was inserted to clarify that only weekly compensation payments under the 2001 Act in respect of incapacity before 1 January 2006 are not eligible income from an activity.

Application date

The amendments apply from the tax year beginning 1 April 2006, the application date for the in-work payment.

IN-WORK PAYMENT AND PAID PARENTAL LEAVE

The change clarifies that recipients of parental leave payments are not precluded from entitlement to the in-work payment if they met the necessary full-time work test before receiving paid parental leave.

Key features

Paragraph (x) of the definition of "salary or wages" has been omitted from the list in section KD 2AAA(5)(a)(i) of source deductions that are not eligible income from an activity. Paragraph (x) of the definition of "salary or wages" related to parental leave payments made under Part 7A of the Parental Leave and Employment Protection Act 1987.

The inclusion of parental leave payments in the list created an inconsistency between the requirement to have income from an activity and the requirement to normally be a full-time earner, both of which must be met, with the result that recipients of paid parental leave would have been precluded from entitlement.

Application date

The amendment applies from the tax year beginning 1 April 2006, the application date for the in-work payment.

FAMILY ASSISTANCE FOR SHARED CARE ARRANGEMENTS

The changes provide flexibility by allowing entitlement to the relevant elements of family assistance when a shared care arrangement is intended to continue for at least four months (one-third of a year), and the proportion of care is such that each parent has exclusive care for at least one-third of the shared care period. This could mean, in some instances, that parts of a shared care period fall in two tax years, something that was previously prevented if the shared care arrangement began within four months of the end of a tax year.

Key features

The rule in section KD 2AA(2) that defines who is a principal caregiver has been replaced with a more flexible rule that maintains the idea of one-third of a year as being an indication of some permanence to the shared care arrangement. The new rule allows any four-month period to apply so that the period does not have to fall entirely within a tax year.

Example

A shared care arrangement that began on 1 February 2007 and was expected to continue at least until June 2007 would meet the new test. Previously, as there were less than four months to the end of the tax year, the sharing of the family assistance entitlement could not have begun until the first day of the following tax year, 1 April 2007.

The provision relating to the parental tax credit is unchanged – the requirement is one-third of the entitlement period.

The rule in section KD 2AA(2B) that defines who is a principal caregiver for the purposes of the in-work payment was slightly different in that the period of care does not have to coincide with the period of eligibility for the in-work payment. That rule has also been replaced to allow the greater flexibility in application.

Application date

The amendments apply from the tax year beginning 1 April 2006, the application date for the in-work payment.

IN-WORK PAYMENT FOR CONTINUOUS ELIGIBLE PERIODS

The concept of an "eligible period" is a critical component of the family assistance system. Under the changes, when there are eligible periods of part-weeks that together form one continuous period, families will not lose entitlement to the in-work payment in any weeks in which the eligibility criteria are otherwise met.

Key features

The in-work payment is available only when the employment criteria are met for a full week. If an eligible period was less than a week, the law previously would not allow in-work payment to be made for that week even if the eligible period was consecutive with another eligible period. This was contrary to the policy intent.

The replacement definition of "weeks" in section KD 2AAA(2) allows the recognition of contiguous eligible periods as if they were one so that entitlement to the in-work payment is available for all full weeks in which the relevant employment criteria are met. It also maintains the correct treatment when only one unbroken eligible period is involved.

Application date

The amendment applies from the tax year beginning 1 April 2006, the application date for the in-work payment.

RING-FENCING OF FAMILY SUPPORT

The change ensures that the ring-fencing provisions reflect the policy intent that maximum family support entitlement would be guaranteed for periods spent on a benefit if a family's annualised monthly income

(calculated on a month-by-month basis while on a benefit) is below the abatement threshold.

Key features

Ring-fencing in the family assistance provisions is intended to protect families who move from benefit to work, or vice versa, during the year. Without ring-fencing, they would incur an end-of-year overpayment of family support if their full-year income was at a higher level than their on-benefit income.

However, ring-fenced periods did not previously create new "eligible periods". This meant that when the abatement formula was applied to an eligible period that contained a ring-fenced period, it was possible for the income to eliminate entitlement, even for the periods that had been ring-fenced, and the benefits of ring-fencing were lost.

The additional paragraph inserted in the definition of "eligible period" in section OB 1 provides for a ring-fenced period also to be an eligible period so that it can be excluded from the abatement formula.

Application date

The amendment applies from the tax year beginning 1 April 2005, the commencement date for the ring-fencing provisions.

MINOR TECHNICAL AND DRAFTING AMENDMENTS

A number of amendments correct errors of a minor technical or drafting nature. Some of these are the result of inadvertent wording and printing changes in the drafting of the Taxation (Working for Families) Act. Other amendments clarify the effect of links to definitions that also apply elsewhere in the Income Tax Act 2004.

Formula for calculating "net specified income"

The formula in section KD 1(1)(g)(ii) for calculating "net specified income" when the person is a major shareholder in a close company (generally, a company with five or fewer shareholders) has been amended to replace the item "(c – d)" with "c". The change was needed to reflect the current tax position of a close company. Changes to close company and imputation rules created a need to amend the formula, but the need was overlooked when the relevant imputation credit provisions were introduced.

Formula for calculating family assistance tax credits

The definition of item "IWP or CTC" in the formula for calculating the subpart KD credits (family assistance) in section KD 2(2) has been amended to make it clear that a person may get the in-work payment (IWP) or the child tax credit (CTC) but not both concurrently.

Application of definitions

Section KD 3(1) has been amended to clarify that the definitions of "qualifying person" and "employment" specific to the purposes of the family tax credit apply to both the calculation of the family tax credit and the rules for the family tax credit.

Drafting oversight

Section KD 5(6A) (b)(ii) was amended by the Taxation (Working for Families) Act 2004 by replacing the former reference to section KD 5B with the words "sections KD 2 and KD 3", section KD 5B having been repealed in that Act. However, the need for in-work payment in the list of rates to be included in the calculation of interim instalments in the section was overlooked. That oversight has been rectified.

Adjustment of amounts

The method by which the Governor-General, by Order in Council, is to adjust the threshold of the family tax credit is prescribed in section KD 5C.

Section KD 5C has been amended to correct an inadvertent wording change that would have required the Order in Council to change the whole of the family tax credit, rather than just the item amount in the formula, as was intended. This would have had the effect of prescribing a fixed amount of family tax credit, rather than an amount that has regard to after-tax income of an eligible family.

Payment of arrears by the Commissioner

Under the general rules for payment by instalment, instalment payments can be made only for a period going forward from the date of application.

However, the Commissioner is able to pay the arrears of tax credits for the period since a benefit ceased when a person goes off a benefit but delays application for family assistance to be paid by the Commissioner.

The opportunity was taken to remove duplication in the relevant provisions by amending section KD 7(3A) to make it clear in what circumstances the provision can be used, and by repealing section KD 7(3C).

Application date

The minor amendments apply from the tax year beginning 1 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 remedial amendments arose from this review and were added to the bill at the select committee stage.

Key features

The provisions affected are:

- section DB 9B *(Base price adjustment under old financial arrangement rules)*;
- section DB 36 *(Bribes paid to public officials)*;
- section EE 33 *(Transfers of depreciable property between associated persons in a non-qualifying amalgamation)*;
- section EX 36(1) *(Immigrant's accrued superannuation entitlement exemption)*;
- section EY 8(3)(b) *(Meaning of "life insurance")*;
- section FC 21 *(Amounts derived by non-residents from renting films)*;
- section NG 1(2) *(Application of NRWT rules)*;
- section OB 1 *(Definition of fixed rate share)*; and
- Schedule 22*A (Identified policy changes).*

In addition, some corrections to cross-references and terms used are made within sections EX 52, EX 53, OD 5(6F), and OD 8(3).

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 DB 9B (Base price adjustment under old financial arrangement rules)

Section DB 9B was inserted in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006 to provide for a deduction on certain amounts calculated under the base price adjustment within the old financial arrangement rules. The relationship between this section and section DA 3 was inadvertently overlooked in its enactment.

This amendment completes the amendment recommended by the Rewrite Advisory Panel by setting out the relationship between section DB 9B and section DA 3. The new subsection states that the section supplements the general permission and overrides the general limitation. This is consistent with the application of section DB 9, which relates to a deduction for certain amounts calculated under the base price adjustment with the financial arrangement rules.

Section DB 36 (Bribes paid to public officials)

Section DB 36 permits a deduction for a corrupt payment made to a foreign official in New Zealand. This is an unintended change in the policy underlying the rule, although the corresponding rule in the 1994 Act (section DJ 22) was ambiguous.

The policy of this rule is that a corrupt payment (a bribe) made to a public official is not deductible. This policy complements the policy in sections 105 to 105E of the Crimes Act 1961 and clarifies the extent to which this type of payment is not a deduction for income tax purposes. This policy applies in determining a person's taxable income for a year, and includes payments made both in and out of New Zealand whether paid to a New Zealand or foreign public official.

There are two exceptions to this general policy, but they relate only to payments made to foreign public officials.

- The first exception is if the payment is made to a foreign public official related to routine government activity and is a very minor amount.
- The second exception is when the payment is made outside New Zealand and the payment is not illegal in the country which the foreign public official represents.

Section DB 36 is amended to more clearly reflect the underlying policy than the present rule.

Section EE 33 (Transfers of depreciable property in a non-qualifying amalgamation)

Section EE 33 of the 2004 Act is the rewrite of the combined effect of section EG 17 and FE 5(2) of the 1994 Act. The purpose of the rule is to ensure that associated companies cannot have uplift in the depreciable value of the asset base for depreciable property transferred in a non-qualifying amalgamation. However, section EE 33 inadvertently omitted a reference to the test of association.

This amendment restores the test of association, and also reverses the order of sections EE 33 and EE 34. The reversal of the section order places the more generally applicable rule before the more specific rule, and also provides that in a non-qualifying amalgamation, the rule in the new section EE 34 will override the general rule in the new section EE 33.

This amendment restores the effect of the law to that existing in the 1994 Act. Section FE 5(2) is also amended to indicate its relationship with the new section EE 34.

Section EX 36(1) (Immigrant's accrued superannuation entitlement exemption)

Section EX 36(1) of the 2004 Act contained an unintended change in law in that the words "to the extent that" qualify subsections (2) to (9) of section EX 36. This indicates that apportionment should be applied to all of these subsections.

However, in the corresponding provisions in the 1994 Act (the definition of "interest in an employment-related foreign superannuation scheme" in section OB 1 of the 1994 Act), apportionment is required for the provisions that correspond to subsections (2) to (4).

The amendment corrects section EX 36(1) to apply the apportionment rule just to subsections (2) to (4). This restores the requirement that subsections (5) to (9) are to be satisfied without any apportionment.

Section EY 8(3)(b) (Meaning of "life insurance")

In section EY 8(3)(b)(i), subparagraph (b)(i) did not contain a reference to a specified cause named in a policy of accident or medical insurance. This was considered to narrow the meaning of "life insurance" from that set out in section OB 1 of the 1994 Act. The policy intent of the 1994 Act wording was to ensure that minor non-life benefits set out in a medical or accident insurance policy would not come within the life insurance taxation rules. An example of the type of benefit contemplated in this policy is funeral expenses.

This amendment restores the wording of the law to that set out in the definition of "life insurance" in the 1994 Act.

Section FC 21 (Amounts derived by non-residents from renting films)

Section FC 21 rewrites section CN 2 of the 1994 Act. Sections CN 2(1)(b) and CN 2(4) were omitted in rewriting the section. In the 1994 Act, CN 2(1)(b) extended the application of the film renter rule in section CN 2 of the 1994 Act to New Zealand-resident companies that were controlled by non-residents. Section CN 2(4) of the 1994 Act prevented tax being imposed twice on rentals. This could otherwise have occurred if rentals derived by a person subject to this rule were on-paid to another person under an agreement relating to those rentals.

The reason for removing the application of the film renter rules to New Zealand-resident companies was set out in the exposure draft of the Rewrite Bill (published in 2001). This drafting change was intended to facilitate the rationalisation of the provision with the transfer pricing rules, as sections CN 2(1)(b), CN 2(4) and section GD 13 were considered to be addressing the same policy question.

This amendment to Schedule 22A clarifies that this rationalisation relating to the film renter rules is an intended change in law.

In addition, the effect of section CN 2(4) of the 2004 Act is reinstated. The omission of this rule from section FC 21 in the 2004 Act potentially led to tax being imposed on a film rental derived by a non-resident operating through a fixed establishment in New Zealand, and again on certain on-payments related to that film rental to another non-resident if the source of the payment is in New Zealand. The amendment restores the law as it was under the 1994 Act to prevent this potential dual imposition of taxation.

Section NG 1(2) (Application of NRWT rules)

The Taxation (Core Provisions) Act 1996 removed the exclusion for exempt income from section NG 1. In making this change, it was intended that readers would rely on the core provisions exempt income rule to ensure that income of this nature would not be liable for non-resident withholding tax.

In the 2004 Act, the change in terminology from "gross income" to "income" in NG 1, coupled with the Core Provisions Act change has led to uncertainty about whether non-resident withholding tax can be imposed on non-resident withholding income that is exempt income.

The policy is that non-resident withholding tax should not be imposed on exempt income. This amendment clarifies the section to ensure that the policy is expressed clearly.

Section OB 1 (Definition of fixed rate share)

In the definition of a fixed rate share in the 2004 Act, it is unclear whether the term "dividend" in that definition includes an amount of any imputation credit or dividend withholding payment credit attached to the dividend. This is because the term "dividend," as defined in sections CD 3 to CD 13, includes the amount of an imputation credit and dividend withholding payment credit attached to the dividend (section CD 9 is the relevant provision).

The policy intent is an imputation credit or a dividend withholding payment credit that is attached to a dividend is not taken into account in determining whether the share on which the dividend is paid is a "fixed rate share".

The definition of "fixed rate share" has been amended to remove that uncertainty and reflect the policy more clearly.

TAX DEPRECIATION TREATMENT OF PATENTS

Sections DB 31(4)(a) and (b), DZ 14, EE 16(4)(b) and (5)(b), EE 16(6), EE 24B, EE 27(1)(b) and (c), EE 27B, EE 37(2), EE 51(1)(b) and (c), EE 51(3)(a), EE 51(5)(a) to (d), EE 58, and definitions of "acquire" and "dispose" in section OB 1 of the Income Tax Act 2004

A number of remedial changes have been made to new tax depreciation rules for patents and plant variety rights, which were enacted as part of the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005. The changes deal with several unintended consequences of the rules and further simplify the tax depreciation rules for patents (and patent applications) and plant variety rights.

Background

As enacted by the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005:

- For patent applications lodged with a complete specification before 1 April 2005 and granted to a taxpayer in their 2005–06 or a later income year, a "catch up" depreciation deduction for the period the patent application was pending is allowed in the year the patent is granted.
- For patent applications lodged with a complete specification on or after 1 April 2005, a deduction for depreciation is allowed in the income year the application is filed and in subsequent years (including years when the patent is granted).
- Plant variety rights acquired or granted in a taxpayer's 2005–06 or later income year are depreciable property.
- For plant variety rights applications that are granted in a taxpayer's 2005–06 or a later income year, a "catch up" depreciation deduction for the period the application was pending is allowed in the income year the rights are granted.

These rules were enacted mainly by the addition of new sections EE 27B, EE 27C, EE 27D and EE 27E to the Income Tax Act 2004.

However, the rules as enacted contained the following unintended consequences:

- They double counted the period a patent (and patent application) or plant variety rights were held when calculating the amount of depreciation loss allowed – first under sections EE 27B to EE 27E and then under section EE 16. This double counting has the effect of reducing the amount of depreciation allowed.
- They did not take into account the "remaining legal life" of a patent (and patent application) or plant variety rights when additional costs in relation to these rights were incurred. This also had the consequence of lowering the amount of depreciation allowed.

Key features

New section DZ 14 provides a one-off "catch up" deduction for the period a patent application was pending for patent applications with complete specifications lodged before 1 April 2005 that are granted in the 2005–06 or a later income year. New section EE 24B provides a one-off "catch up" depreciation deduction for plant variety rights applications that are granted in the 2005–06 or a later income year.

Sections EE 27B to EE 27E have been replaced by new section EE 27B, which provides the correct annual rate for patents granted in a person's 2005–06 and subsequent years. This new provision provides the correct depreciation rate for a patent that has been granted (taking into account factors such as depreciation previously allowed for the patent application and any additional costs incurred).

Existing section EE 27 applies to patent applications with complete specifications that are lodged on or after 1 April 2005 and plant variety rights that are acquired or granted in the 2005–06 or a later income year.

A number of other consequential amendments have been made to sections DB 31(4), EE 16, EE 27(1), EE 37(2), EE 51 and to the definitions of "legal life" in section EE 58 and "acquire" and "dispose" in section OB 1 of the Income Tax Act 2004. The definition of "patent application date" in section OB 1 has been repealed.

Application date

These changes apply from 1 October 2005 to:

- patent applications lodged with a complete specification before 1 April 2005 that are granted in the 2005–06 or later income years;
- patent applications lodged with a complete specification on or after 1 April 2005; and
- plant variety rights acquired or granted in the 2005–06 or a later year.

Correction: The Commentary on the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill incorrectly referred to patent applications with complete specifications lodged before 1 April 2007. The correct date is 1 April 2005.

FRINGE BENEFIT TAX

Sections DB 45, ND 1A, ND 1C, ND 1G, ND 1U, ND 1V and Schedule 2 of the Income Tax Act 2004

The amendments make some remedial changes to the fringe benefit tax (FBT) rules.

Background

Significant changes were made to the FBT rules in early 2006, including the methods that an employer can use to value the fringe benefit arising from an employee's private use of an employer-provided motor vehicle. Some aspects of those changes have since required further clarification by way of remedial amendments to assist in the interpretation and application of the changes.

Key features

The main features of the remedial amendments are:

- Clarification that, in general, motor vehicles leased before 1 April 2006 should be subsequently valued at cost.
- Clarification as to how the tax value of a vehicle is calculated when it is acquired from an associated person.
- Confirmation that a party to a 9-to-5 or flip-flop lease may be able to deduct any depreciation loss they incur in relation to the leased vehicle even when the vehicle is being used privately.
- Clarification that the market value that can be used as the cost price for a re-leased vehicle is the market value at the time the vehicle is first leased or rented to the employer.
- A change to the valuation provisions for subsidised transport to ensure that the extension of the scope of those provisions made in early 2006 works correctly.
- The reference to "the date on which the vehicle ceases to be leased" has been revised to make it clear that it relates to all leases of the vehicle by the employer.
- Out-of-date cross-referencing has been rectified.

Application date

The amendments apply to a person's liability for FBT for a period beginning on or after 1 April 2006, apart from the revised Schedule 2, Part A, clause 3 which applies from the date of assent, and the change to ND 1G which applies from the 2005–06 income year.

Detailed analysis

Motor vehicles

Vehicles leased before 1 April 2006

Before 1 April 2006, leased vehicles were valued for FBT purposes at their market value at the beginning of the lease. This method is no longer available. Instead, the intent was that, from 1 April 2006 (or from the income year beginning on or after 1 April 2006 if the employer returns FBT on an income year basis) these vehicles should be valued at cost. However, the legislation was not clear on this point. Similarly, it was also the intention that vehicles that had been subject to 9-to-5 and flip-flop leases before 1 April 2006 should also be valued at cost. Accordingly, amendments to section ND 1A now clarify that, as intended, one FBT treatment applies to vehicles on hand at 1 April 2006, irrespective of whether they are leased or owned by the employer, that treatment being that they must be valued at their cost price.

There are two exceptions from this requirement to use cost:

- When the initial return period for the vehicle begins on or after 1 April 2006 and the vehicle is not subject to a 9-to-5 or flip-flop lease. This exception enables, for example, an employer who has acquired a vehicle that was previously subject to a 9-to-5 or flip-flop lease to value it at its tax value.
- When the vehicle is owned by the employer or associated person and a period of five years has elapsed since the beginning of the period of the employer's initial return for the vehicle.

New subsections ND 1A(1E) and ND 1A(1F) apply retrospectively for a person's liability for fringe benefit tax for a period beginning on or after 1 April 2006. Taxpayers who have taken a reasonable interpretation of the law as it stood at the time should not in this instance incur penalties should these new provisions result in a revision in their FBT liability for returns made before the law change was made. This does not, however, extend to use-of-money interest, which reflects the time value of the underpaid tax rather than being a penalty. Also, the Commissioner of Inland Revenue has very limited ability to waive interest.

The Commissioner can remit interest when it is consistent with the collection of the highest net revenue over time. In this regard, the Commissioner will need to consider each case on its own merits but, as a general rule, interest will be remitted when an Inland Revenue officer has given incorrect advice (for example, if the taxpayer has directly been given an incorrect date or amount for tax payment) or when the taxpayer has relied on incorrect information contained in an Inland Revenue publication. Retrospective legislative change would not, however, qualify as general grounds for a waiver.

Switching valuation methods when there is a series of leases

A further change to section ND 1A(1C) replaces the words "ceases to be leased" with "ceases to be leased by the employer or an associated person without a consecutive or successive lease of the vehicle by the employer or an associated person". This change has been made to verify that when a series of leases has been entered into, switching between valuation methods can be done only when the last lease has expired.

Deductibility of depreciation when FBT applies

Nine-to-five and flip-flop leases were brought within the ambit of the FBT rules as a result of the changes in early 2006 (see section CX 6B). As a result, a new section DB 45 was added to ensure that the owner of a vehicle that was subject to a 9-to-5 or flip-flop lease could claim a deduction for the full amount, not just the business portion, of any expenses they incurred in relation to that vehicle. There was some question as to whether this deduction extended to depreciation. The amended section DB 45 now clarifies this position by referring to both expenditure and depreciation loss.

Tax value calculation when associated parties involved

Amendments to clause 3 in Part A of Schedule 2 clarify how the tax value of a vehicle is to be calculated when it is acquired either directly or indirectly from an associated person.

Like section GC 16, which outlines what cost price to use for the cost price method when a vehicle is acquired from an associated person, the new provisions in respect of the tax value cover not only direct transactions between associated parties but also situations when there are a series of transactions and parties involved. This includes the interspersing of an unassociated person between two associated persons. However, the underlying approach is that:

- When the associated person has either used the cost price method or has not used any method at all, the new owner will need to use the higher of their cost price for the vehicle and the cost price to the associated person as the basis for their tax value.
- When the associated person has used the tax value method, then the new owner will need to use the higher of their cost price and the tax value of the associated person as the basis for calculating their tax value.

Market value to be calculated at time vehicle first leased

Clause 7 of Schedule 2 enables an employer who leases a vehicle that has been previously leased to another party to use its market value as its cost price provided the employer and any previous lessee are not associated. An amendment to clause 7 confirms that the market value referred to in that item is the market value at the time the vehicle is first leased or rented to the employer.

Transport benefits

Transport benefits provided by transport operators to their staff are valued at specified rates. One of the changes included in last year's package of FBT changes was to allow any similar benefits provided by transport operators to employees of the same group of companies as the transport operator to be valued on the same basis. While a change was made to the definition of "subsidised transport" at that time, a change to the associated valuation provisions in section ND 1C(3) was overlooked. This has now been rectified.

Remedial cross-reference changes

Remedial changes to sections ND 1U and ND 1V have been made to ensure that these sections correctly cross-reference to the relevant parts of Schedule 2. A change to section ND 1G also ensures that this section is correctly cross-referenced.

DEPRECIATION FORMULA – APPORTIONMENT OF BUSINESS AND PRIVATE USE

Sections DE 2, EE 11, EE 33, EE 34, EE 49 and FB 7 of the Income Tax Act 2004

Two new formulas to allocate losses on disposal for depreciable property, when the property is used for both business and private purposes and is purchased and disposed of in the same income year, have been added to the Income Tax Act 2004. The new formulas correct an anomaly in the current formulas as they incorrectly apportion losses in these circumstances.

The current formulas will continue to apply in situations where the property has been held for longer than a year.

Background

Deductions for depreciation losses are only allowed when an asset is in use or available for use for business purposes. For assets that are used for both business and private purposes, deductions for depreciation losses must be apportioned on the basis of business use. In the same way, any final depreciation loss (the difference between the asset's depreciated value and the amount received on disposal) must also be apportioned.

The rules that govern the treatment of gains and losses from the disposal of depreciable property and motor vehicles include formulas that are used to apportion the proceeds from the disposal between the business and private use.

The formula in section FB 7(6) apportions gains and losses from the disposal of depreciable property and section DE 2(7) does the same for motor vehicles. A problem has been identified with the operation of these formulas.

A variable in both formulas is all depreciation deductions that have been allowed on that asset. The problem is that this variable is always zero for assets disposed of the same year they were purchased. This is because the tax rules don't allow a deduction for an amount of depreciation loss in the year in which the asset is disposed, except if the consideration received is less than the assets-adjusted tax book value. The result is that the formulas always produce a result of zero, even though the taxpayer may have suffered a loss on disposal.

This anomaly has been rectified by the introduction of two additional formulas.

Key features

Apportioning depreciation loss on disposal of motor vehicles

Section DE 2 of the Income Tax Act 2004 governs calculations of deductions for business use in relation to motor vehicles. Among other things, this section provides a formula to apportion an amount of depreciable loss on a disposed motor vehicle between its business and private use.

The new formula in subsection DE 2(8C) is to be used when calculating the portion of the depreciation loss that is allowed as a deduction when a motor vehicle is acquired and disposed in the same income year. This formula avoids any reference to depreciation deductions and instead simply multiplies the depreciation loss on disposal by the proportion the asset was used for business purposes.

The amendment also clarifies that the formula in subsection DE 2(7) should continue to be used to apportion between business and private use when there is a depreciation loss on disposal of a motor vehicle when that has already been subject to depreciation deductions.

It should be noted that a person will be deemed to acquire a motor vehicle when the person starts to use the motor vehicle for business purposes or it is available for business use. For example, a car that has been bought in 2003 for personal use and which started being partly used for business purposes in 2007 is deemed to be acquired in 2007 for the purposes of this section.

Apportioning depreciation loss on disposal of depreciable property

Generally, a person is not allowed any depreciation loss for an item of depreciable property for the income year in which the person disposes of it.

A new exception to this rule has been added to new section EE 11(6) of the Income Tax Act 2004 for situations when depreciable property has been partly used for business and partly for personal purposes. The new section specifies that in these circumstances, depreciation loss should be calculated under section FB 7(9).

Section FB 7 is used to apportion a depreciation loss on disposed items (other than motor vehicles) that have been used for both business and private purposes. The new formula in section FB 7(9) apportions the amount of any depreciation loss allowed as a deduction when an item of depreciable property is acquired and disposed in the same income year by multiplying the depreciation loss resulting from the disposal by the proportion that the property was used for business purposes. The proportion of business use is expressed in the formula as the number of days in the income year on which the person owns the item and uses it, or has it available for use for business purposes, divided by the total number of days in the income year on which the person owns the item and uses it, or has it available for use for any purposes. The section also stipulates that a unit of measurements other than days can be used in the formula if it achieves a more appropriate result.

It should be noted that a person will be deemed to acquire a depreciable item when the person starts to use the item, or to have it available for use for the purpose of deriving assessable income or carrying on a business for the purpose of deriving assessable income.

Consequential amendments have been made to sections EE 49(2) (definition of "base value"), EE 33(3)(a)(ii) and EE 34(2)(a)(ii) (cost of item to person) of the Income Tax Act 2004 to allow the calculation of an asset's value at its market value at the time it is first used or becomes available for use in business.

Application date

These provisions apply for the 2006–07 and later income years.

ECONOMIC RATE OF DEPRECIATION FOR CERTAIN AIRCRAFT AND MOTOR VEHICLES

Sections EE 25D(2)(cb) and EE 25D (3) of the Income Tax Act 2004

The rule covering the setting of depreciation rates for certain aircraft and motor vehicles has been clarified.

The changes were necessary because they arguably applied to a broader class of motor vehicles and aircraft than was intended. These amendments ensure that only motor vehicles and aircraft that previously had residual values above 13.5 percent of cost can set their depreciation rates under section EE 25D.

Section EE 25D(2)(cb) excludes aircraft used for top-dressing or spraying. It is now clear that depreciation

rates for aircraft used for these purposes is set under section EE 25B.

Section EE 25D(3) clarifies that the type of motor vehicle that this section applies to are vehicles designed exclusively or mainly to carry people, with seats for no more than 12 people.

The rules apply from the 2005–06 and later income years.

As a point of clarification, the Commissioner remains of the view that the estimated useful life of motor vehicles where the depreciation rate is set under section EE 25D remains five years. For aircraft where the depreciation rate is set under section EE 25D the estimated useful life remains 15 years. The clarification is necessary because estimated useful life is important when taxpayers are having to determine whether a lease is a finance or operating lease.

CALCULATING DEPRECIATION RATES FOR ASSETS WITH HIGH RESIDUAL VALUES

Section EE 25E of the Income Tax Act 2004

The rules covering the method for calculating depreciation rates on assets that have a residual value of more that 13.5 percent of cost have been corrected.

The word "before" had been inserted in the legislation rather than the term "on or after". The correction means that section EE 25E applies to plant and equipment acquired on or after 1 April 2005 and buildings acquired on or after 19 May 2005. The rules apply for the 2005–06 and later income years.

ELECTION TO DEPRECIATE PLANT AND EQUIPMENT AT OLD RATES

Section EE 26B of the Income Tax Act 2004

The rules covering the election to continue to depreciate plant and equipment at the old depreciation rates have been clarified for plant and equipment that has its depreciation rate set under a method other than section EE 25B.

Section EE 26B allows taxpayers to elect not to apply the new depreciation rates to plant and equipment acquired on or after 1 April 2005 and before the beginning of the 2006–07 income year. There was some uncertainty about whether section EE 26B applies to types of plant and equipment when the depreciation rate is not calculated under the new double declining balance method. The legislation has been amended to remove any uncertainty. This change applies for the 2005–06 and later income years.

TEMPORARY EXEMPTION FOR TRANSITIONAL RESIDENTS

Sections FC 23, FC 24, KD 3, KD4, NF 1, NF 2, OB 1 and OE 1 of the Income Tax Act 2004 and section 87(2) and (3) of the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006

The rules for the temporary exemption for transitional residents have been amended to correct certain technical difficulties identified after the original legislation introducing the exemption had been enacted.

Background

The Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006 introduced a tax exemption for transitional residents (see *Tax Information Bulletin* Vol. 18 No. 5 June 2006). The exemption is available to people coming to live in New Zealand on or after 1 April 2006 for the first time or after an extended absence. It lasts for four years after migration and covers most types of foreign income.

The legislation has been amended to deal with various technical issues that came to light after enactment. The timing and eligibility rules for the exemption have been changed to avoid a potential mismatch with the tax residence rules for individuals. Facility for a person to elect not to be a transitional resident has been introduced and changes have been made to clarify that resident withholding tax does not have to be deducted from interest and dividends --covered by the exemption.

Key features

Changes to the timing and eligibility rules for the exemption

There are two ways a person can become tax-resident in New Zealand under section OE 1 of the Income Tax Act 2004: by acquiring a permanent place of abode here or by being present in the country for more than 183 days in a 12-month period. Where the 183-day rule applies, a person becomes tax-resident from the first of those 183 days.

Under the previous legislation, a person qualified for the exemption only after they acquired a permanent place of abode in New Zealand. Focusing on permanent place of abode was intended to avoid situations where people qualified for the exemption "too soon" – for example, where a temporary visit to New Zealand before actual migration triggered tax residence under the 183-day rule. However, this approach allowed for a potential mismatch between the rules for the exemption and the general tax residence rules: in certain circumstances, a person could become tax-resident in New Zealand without qualifying for the exemption. The timing and eligibility rules for the exemption contained in sections FC 23 and FC 24 of

the Income Tax Act 2004 have therefore been amended as follows:

- To avoid the possibility that a person may become resident for tax purposes without qualifying for the exemption, the eligibility and timing rules for the exemption have been aligned with the general tax-residence rules.
- To resolve issues associated with people qualifying for the exemption too soon, any backdating under the 183-day residence rule is ignored for the purposes of the eligibility rules and time-limit for the exemption.

Opting out of the exemption

In certain circumstances, a person may be better off not receiving the exemption – for example, if they have foreign losses, wish to claim family assistance, or have little or no foreign income and prefer to defer their claim. It was therefore always intended that people should be able to choose whether or not to receive the exemption. The original legislation did not allow people to make this choice. A mechanism has been introduced in section FC 24 to allow taxpayers to opt out of the exemption if they wish.

Resident withholding tax

Resident withholding tax is required to be deducted from interest and dividends paid to New Zealand residents. Resident withholding tax applies to "resident withholding income", as defined by sections NF 1 and OB 1 of the Income Tax Act 2004. Under the original legislation, there was nothing that removed foreign-sourced interest and dividends accruing to a transitional resident from this definition. In certain circumstances – such as when an agent received such income on behalf of a transitional resident – this could mean that withholding tax had to be deducted, notwithstanding that there was no underlying liability. To avoid this, the definition of resident withholding income has been amended to exclude income covered by the exemption. In addition, section NF 2 now makes it clear that an agent is normally able to rely on a statement by a client that income is covered by the exemption for the purposes of deciding whether or not to deduct resident withholding tax.

Application date

The changes apply retrospectively, for the 2005–06 and later income years. Transitional provision has been made to ensure that people are not disadvantaged as a result.

Detailed analysis

Section FC 23 of the Income Tax Act 2004

Section FC 23 sets out the general requirements for being a transitional resident. A number of changes have been made to this section.

The requirement, in paragraph (a), that a person must have a permanent place of abode in New Zealand has been replaced. The requirement now is to be tax-resident in New Zealand.

Paragraph (b) limits the exemption to people who have not lived in New Zealand for at least 10 years (the non-residence period). This provision has been amended so that the test is now applied by reference to the date a person satisfies the requirements in section OE 1(1) or (2) – that is, the date on which the person obtains a permanent place of abode or their 184th day of presence within a 12-month period, whichever is the earlier. Applying this test by reference to the date on which section OE 1(1) or (2) is satisfied rather than the date from which tax residence begins, ensures that people are not disqualified under the 10-year rule merely because of backdated residence under section OE 1(2). This could happen, for example, if a person returned to live in New Zealand after the required non-residence period, but had visited New Zealand for a holiday a few months before doing so.

There are two limbs to paragraph (b). Sub-paragraphs (i) and (ii) are independent tests and a person can satisfy the required non-residence period provided they meet one, both, or a combination of the tests for at least 10 years.

Sub-paragraph (i) focuses on whether a person satisfied the requirements of section OE 1(1) or (2). This avoids the problems associated with backdated residency.

Sub-paragraph (ii) focuses on whether a person was resident in New Zealand. It is possible for a person to be non-resident by virtue of section OE 1(3) even while they satisfy section OE 1(2) (see *Public Information Bulletin* 180, June 1989). Sub-paragraph (ii) ensures that deemed non-residence under section OE 1(3) can be counted towards the required non-residence period.

Paragraphs (c) and (d) together ensure that a person may only qualify once as a transitional resident. Paragraph (c) requires that a person must not have been a transitional resident before the non-residence period. New paragraph (d) focuses on the period after the non-residence period. It ensures that a person who ceases to be a transitional resident for any reason cannot subsequently satisfy section FC 23, even if they meet the other criteria. The usual application of paragraph (d) will be when a person elects to stop being a transitional resident under section FC 24 (3).

Sections FC 24 and KD 4 of the Income Tax Act 2004

Section FC 24 has been entirely rewritten. It deals, in particular, with the period of exemption and elections not to receive the exemption.

Subsection (2) provides that the period for which a person is a transitional resident begins on the first day of tax-residence in New Zealand and lasts for up to 48 months from the end of the month in which the person satisfies the requirements in section OE 1(1) or (2). The effect is that

the starting point for the exemption is aligned with the start of a person's tax-residence in New Zealand – including when the period of tax residence has been backdated by virtue of section OE 1(2) – but any backdating is ignored for the purposes of the time limit for the exemption.

Subsections (3) to (7) provide a mechanism whereby a person can elect not to be a transitional resident. The deadline for making an election is set out in subsections (6) and (7). This has been aligned with the deadline for making a return for the relevant tax year (a later deadline applies for 2005–06). Transitional residents and their partners are not eligible to receive family assistance. Accordingly, an application by a transitional resident for a tax credit under subpart KD is deemed by subsections (4) and (5) to be an election not to be a transitional resident by that person and any partner. This deeming provision has retrospective effect. However, subsection (5)(b) allows a person who applies for a subpart KD credit before 1 April 2007 to notify the Commissioner before 1 June 2007 that they do not want that application to be treated as an election not to be a transitional resident. Section KD 4(4B) ensures that a person exercising this right is not liable for a shortfall penalty.

Section 87(2) and (3) of the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 and section OE 1(2B) of the Income Tax Act 2004

As noted earlier, section FC 23(b) has been amended so that the requirement for a 10-year non-residence period is applied by reference to the date a person satisfies the requirements in section OE 1(1) or (2). An equivalent change has been made to the rule that limits the availability of the exemption to people who come to live in New Zealand on or after 1 April 2006.

Section 87(2)(a) of the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 specifies that to qualify for the exemption a person must begin to satisfy the requirements for tax-residence on or after 1 April 2006. Backdated residence under section OE 1(2) would not prevent a person from qualifying for the exemption, provided they had not established a permanent place of abode or been present for more than 183 days in a 12-month period before that date.

Under the previous rules, a person who became tax-resident before 1 April 2006 may still have qualified for the exemption, provided they had not acquired a permanent place of abode in New Zealand before that date. Section 87(2)(b) allows these individuals to continue to qualify, while section 87(3) allows their exemption to be backdated to their first date of tax residence, as for other transitional residents. Section OE 1(2B) of the Income Tax Act 2004 is no longer required and has therefore been repealed, with retrospective effect.

The following examples illustrate how the new timing and eligibility rules for transitional residents are intended to operate in practice.

Example 1

Robert visits New Zealand for an interview on 1 February 2006. He relocates here permanently and acquires a permanent place of abode on 1 May 2006. He is subsequently deemed to be tax-resident from 1 February under the 183-day rule. He has never been tax-resident in New Zealand before.

Robert would qualify for the exemption. Although he is treated as tax-resident from 1 February 2006, he does not begin to satisfy the requirements of section OE 1 for being a resident until 1 May. His exemption would run from 1 February 2006 to 31 May 2010.

Example 2

Roger first arrives in New Zealand on 1 June 2005. He stays for three months (92 days). He comes back to New Zealand on 1 March 2006 and stays for another three months (92 days). By the time he leaves, on 31 May 2006, he has been in New Zealand for more than 183 days in a 12-month period and is deemed to be tax-resident from 1 June 2005. Roger relocates to New Zealand and establishes a permanent place of abode here on 1 January 2007. He has never been tax-resident in New Zealand before.

Roger would qualify for the exemption. Although he is deemed to be tax-resident from before 1 April 2006, he does not begin to satisfy the requirements of section OE 1 for being a resident until after that date. His exemption would run from 1 June 2005 to 31 May 2010.

Example 3

Rachael leaves New Zealand and ceases to have a permanent place of abode here on 30 September 2006. She returns on holiday from time to time to visit friends. Each time, she is only present in New Zealand for a couple of weeks a year. Her last holiday here is from 1 to 14 August 2016. On 1 December 2016, Rachael decides to move back to New Zealand to live. She acquires a permanent place of abode on that date. She was last resident on 30 September 2006, just over 10 years ago. On 19 May 2017, when she has been present for 184 days, she is deemed to be tax-resident from 1 August 2016.

Rachael would qualify for the exemption. She began to satisfy the requirements of section OE 1 for being a resident on 1 December 2016 when she reacquired a permanent place of abode in New Zealand. At that time, she had not been resident in the preceding 10 years. Her exemption would run from 1 August 2016 to 31 December 2020.

Sections NF 1 and NF 2 of the Income Tax Act 2004

Section NF 1(2) has been amended, taking interest and dividends covered by the exemption outside the definition of resident withholding income. This clarifies, in particular, that agents receiving such exempt income on behalf of transitional residents are not required by section NF 3 to deduct resident withholding tax. Section NF 2(7B) ensures that agents will normally be able to rely on a notice given by a client that income is exempt

DEATH AND ASSET TRANSFERS

Sections FI 4, FI 6 and FI 7 of the Income Tax Act 2004 and 120C of the Tax Administration Act 1994

Remedial changes have been made to ensure that provisions relating to death and asset transfers in the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 reflect their policy intention.

Distributions to spouse or de facto partner

Section FI 4 of the Income Tax Act 2004

The policy intention of section FI 4 was that roll-over relief should apply for distributions to a deceased's spouse or de facto partner, as long as no person outside the second degree of relationship to the deceased is entitled to property which is taxable. A remedial amendment has been made to ensure that section FI 4 reflects this.

The amendment is effective from 1 October 2005, the date subpart FI came into force.

Forestry

Section FI 6 of the Income Tax Act 2004

The amendment ensures that roll-over relief applies for forestry assets held at the date of a taxpayer's death, irrespective of whether a life tenant is entitled to part of the trust property and irrespective of who the trustees of the estate are. The roll-over applies as long as a relative to the second degree of the deceased is beneficially entitled to the forest.

The amendment is effective from 1 October 2005.

10-year rule for land held on capital account

Section FI 7 of the Income Tax Act 2004

This section has been amended to correct a drafting error. A reference to section CB 10 has been changed to section CB 12.

Section CB 10 deals with situations where a development or subdivision of land began within 10 years of its acquisition. These sales are taxable, irrespective of when the sale occurred. Because a tax liability should always arise from a sale of land in these circumstances, there is no need to provide roll-over relief when an owner dies.

The reference to section CB 10 has been removed effective from 16 May 2006, the date of introduction of the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill.

On the other hand, section CB 12 provides that if land is sold within 10 years of acquisition and the land has been enhanced by zoning or similar factors, the profit on sale is taxable. However, if the owner had held the land for 10 years, no tax liability would have arisen on the sale of the land. Therefore the taxpayer's death, in itself, should not trigger a tax liability.

The reference to section CB 12 has been included retrospectively from 1 October 2005.

Concessionary use-of-money interest

Section 120C of the Tax Administration Act 1994

The intention of changes to the definition of "date interest starts" in section 120C was that concessionary use-of-money interest rules should apply to any income tax liability arising in a period that ends with the taxpayer's death (subject to the condition that the relevant liabilities are paid on time). An amendment has been made, effective from 1 October 2005, to ensure the definition reflects this policy.

NEW GST DUE DATE FOR MARCH TAXABLE PERIODS

Sections MB 13, MB 14, MB 24, MB 27, and Schedule 13 of the Income Tax Act 2004, and sections 120KC, 120KD of the Tax Administration Act 1994, and section 16 of the Goods and Services Tax Act 1985

To provide more time for businesses and tax agents to comply with their GST obligations and, from next year, to comply with their provisional tax obligations, the due date for the March GST returns has been extended to 7 May.

Background

For taxable periods ending on or after March this year the due date for GST returns will change from the last working day of the month to the 28th of the month. Where the 28th falls on a weekend or public holiday, the due date will be the next working day. However, where GST returns are due over the Christmas period (November returns) the due date is extended to 15 January.

Consultations with tax agents has identified that the combination of the changes to the GST due date, bringing it forward by up to three days, and the introduction next year of provisional tax payments aligned to GST due dates could increase businesses' and tax agents' workloads over the Easter period. Also this increased workload occurs during a period where the number of working days available to do the work is reduced as a result of the Easter period.

Application date

The new due date for March GST returns applies to taxable periods ending on or after 31 March 2007.

Key features

Sections 16(2) and (5) have been amended to change the March taxable period due date from 28 April to 7 May.

Also a number of consequential amendments have been made to the examples that appear at the end of sections MB13, MB14, MB 24, and MB 27 of the Income Tax Act 2004 and sections 120KC and 120KD of the Tax Administration Act to reflect the new due date for the March GST taxable period.

Also Schedule 13, Part A of the Income Tax Act 2004 has been updated to reflect the new due date.

LIMIT ON REFUNDS AND ALLOCATIONS OF TAX

Sections MD 2(4) of the Income Tax Act 1994 and the Income Tax Act 2004

The imputation rules have been amended to extend the circumstances when tax overpaid before a breach in shareholder continuity can be refunded. The amendment corrects an anomaly in the previous rules.

Background

Generally, overpaid company tax cannot be refunded if a refund would result in a debit balance to the company's imputation credit account (ICA).

Under section ME 5(1)(i), a breach of shareholder continuity in a company results in a debit arising to the ICA at the time of the breach. Although a "discontinuity" debit can effectively be ignored for the purposes of effecting the refund, there is a condition that the debit must arise after "the date of payment of the first instalment of provisional tax" for the year to which the overpayment applied.

Where a company does not pay provisional tax – for example, because its income tax liability is satisfied instead by resident withholding tax deducted from interest – there is no "date of payment of the first instalment of provisional tax". Therefore no adjustment can be made to the ICA balance under current law in relation to the overpayment that arose before a breach in continuity.

The anomaly has only recently been identified, although it has existed since the imputation rules were introduced. Inland Revenue is aware of only one case affected by it.

Key features

Section MD 2(4) of the 1994 and 2004 Income Tax Acts, which effectively allows an imputation account debit that arises on a breach of shareholder continuity to be ignored for the purpose of calculating a tax refund, has been amended to ensure that it operates correctly, whether the overpayment of tax was made before or after the first instalment of provisional tax.

Application date

The amendment applies from the 2000–2001 year. This date is arbitrary. It was chosen because it will ensure that the correct tax treatment is applied to the only case identified so far as affected by the anomaly.

THE IMPUTATION SYSTEM AND COMPANIES TREATED AS NOT BEING RESIDENT UNDER A DOUBLE TAX AGREEMENT

Section ME 1 of the Income Tax Act 2004

Section ME 1(2)(b) has been amended to clarify that companies (other than Australian imputation credit account companies) cannot maintain an imputation credit account if they are treated as not being resident in New Zealand under a double tax agreement.

Background

Previously, section ME 1(2)(b) provided that a company must not establish and maintain an imputation credit account if it was resident in New Zealand but not subject to tax on all or part of its income under a double tax agreement when it was, for the purposes of that agreement, treated as not being a resident of New Zealand.

There was a risk that the reference to the company being "not subject to tax in respect of all or part of its income under a double tax agreement" could have been interpreted as narrowing the circumstances in which a company was prevented from maintaining an imputation credit account. A company that was treated as being not resident in New Zealand under a double tax agreement, but that did not actually have any income that was exempted from tax as a result, may have considered itself outside the scope of section ME 1(2)(b).

Key features

The amended version of section ME 1(2)(b) puts beyond doubt that this provision applies to all resident companies treated as not being resident under a double tax agreement, irrespective of whether they have income that is exempted from tax as a result. The drafting of this provision is now more closely aligned with that of equivalent provisions elsewhere in the Act.

REVERSE TAKEOVERS

Section OD 5AA of the Income Tax Act 1994 and the Income Tax Act 2004

Concessionary continuity rules, which apply to carrying forward losses and imputation credits when there is a change in a company's shareholding, were extended to recognise that continuity can be maintained through reverse takeovers or mergers by the introduction of section OD 5AA by the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006. That section has been amended because it did not produce the correct result where:

- treasury stock or cross-shareholdings are cancelled without consideration upon the takeover; or
- the subsidiary of the initial parent is also a limited attribution company.

Paragraphs (e) and (f) of section OD 5AA(2) have been amended to correct the position, effective from the original application date of the 1998–99 income year.

CHANGES IN GST TAXABLE PERIODS

Sections 15C and 15D of the Goods and Services Tax Act 1985

Two amendments have been made to correct legislation already enacted to align provisional tax payments with GST payment dates.

These changes enable taxpayers to change from accounting for GST on a six-monthly or two-monthly basis to a monthly basis or from accounting for GST on a monthly basis to a two-monthly basis. The amending legislation also provides for when changes in taxable periods take effect from.

Background

The recently enacted changes in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act to align provisional tax payments with GST due dates did not replicate the current policy of allowing GST-registered taxpayers to change their taxable periods.

Application date

These amendments apply from the 2008–09 income year, if the taxpayer derives assessable income in that year, or in all other situations the changes apply to taxable periods beginning on or after 1 April 2008.

Key features

Two amendments have been made to the GST Act 1985. The first amends section 15C to enable taxpayers who account for GST on a six-monthly or two-monthly basis to change to accounting for GST on a monthly basis. The amendment also enables taxpayers who account for GST on a monthly basis to change to a two-monthly basis.

The second amends section 15D(1)(a) to ensure that the provisions determining when a change in GST taxable period takes effect from (section 15C) apply when a taxpayer changes from a six-monthly to two-monthly basis or where a taxpayer is required to change to a monthly basis because their taxable supplies exceeded the $24 million threshold.

MISCELLANEOUS TECHNICAL AMENDMENTS

Allocation of research and development tax deductions

Section EJ 21 of the Income Tax Act 2004

A remedial amendment has been made to the changes enacted in 2006 to the research and development (R&D) tax rules. An amendment to section EJ 21 of the Income Tax Act 2004 clarifies that when a company has had a breach of shareholder continuity the amount of R&D tax deductions allocated to an income year is the lesser of the R&D income in that year and the R&D deductions that have not been allocated to earlier income years. This amendment accords with the previously announced policy objectives of this reform.

Corporate migration terminology

Sections NF 4 and NG 11 of the Income Tax Act 2004 and sections 29, 49 and 51 of the Tax Administration Act 1994

To provide consistency of terminology in the recently enacted corporate migration amendments, the reference to "emigration date" in several provisions has been replaced by the correct defined term "emigration time".

Cross-referencing in Section NBB

Section NBB 5 of the Income Tax Act 2004

Changes have been made to section NBB 5 of the Income Tax Act 2004 to clarify the rules relating to the treatment of PAYE subsidy overpayments.

Subsection NBB 5(5) of the Income Tax Act 2004 has been redrafted to include correct cross-references.

The amendments apply for pay periods beginning on or after 1 October 2006.

Minor beneficiary rule clarification

Section HH 3C of the Income Tax Act 2004

Section HH 3C of the Income Tax Act 2004, which provides an exclusion from the minor beneficiary rule, has been clarified to ensure that the test is satisfied when one or more of the conditions are met.

Share-lending rules

Sections 2(17), 117, 132, 151, 155(24) of the Income Tax Act 2004 and 178 of the Tax Administration Act 1994

Remedial amendments have been made to the recently enacted share-lending rules. The amendments clarify that when resident withholding tax (RWT) has been paid by the share user as part of a share-lending arrangement, the share supplier does not get an imputation credit for that RWT as well as an imputation credit under section NF 8B. The amendments also remove requirements that are not relevant to share-lending arrangements from the share-lending statement and dividend withholding payment credit refund sections. These amendments accord with previously announced policy objectives of this reform.

The reference to an "associated person" in section ME 5(1)(ac) has also been removed as the definition of "returning share transfer" in section OB 1 already includes an associated person test.

The amendments are effective from 1 July 2006.

Date on which notices are delivered

Sections 14(9), 14B(8) and 14C(8) of the Tax Administration Act 1994

Rebuttable presumptions, that notices are posted on the day on which they are postmarked, have been removed from sections 14(9), 14B(8) and 14C(8) of the Tax Administration Act 1994. As Inland Revenue does not copy or store envelopes, the presumption is of little value.

The effect of the removal is that notices will be treated as having been given on the day on which they would have been delivered in the ordinary course of the post. That date will be determined after considering all the relevant evidence. If a postmarked envelope is held, Inland Revenue will accept it as evidence that the notice was posted, at the latest, on the day of the postmark.

The amendment applies from 1 April 2005, the date the presumptions applied from.

GST associated persons definition

Section 2A of the Goods and Services Tax Act 1985

The Goods and Services Tax Amendment Act 2005 amended the test for associating relatives in the associated persons definition in section 2A of the GST Act. The purpose of the amendment was to associate individuals who are in a civil union or de facto relationship. This amendment was part of a number of amendments intended to remove unjustified discrimination in the application of laws on the grounds of marital status or sexual orientation so laws are neutral on their application to different relationships and consistent with human rights obligations.

Former section 2A(5) of the GST Act provided that the test associating relatives extended to trustees for relatives. The amendment in 2005 did not maintain the effect of this provision. It was not intended that this aspect of the relatives associated persons test be changed. An amendment correcting this drafting error has been made to the test associating relatives in section 2A of the GST

Act to reinstate the trustee aspect of this tes

Extension of time bars

Section 108B of the Tax Administration Act 1994

Section 108B of the Tax Administration Act 1994 sets out the rules for extending the time bars for amending tax assessments. Subsection (1)(a) provides that the time bar can be extended by a period of up to 12 months, where the Commissioner and the taxpayer agree in writing. Subsection (1)(b) allows the taxpayer to extend the time bar for a further six months from the end of the 12-month extension period. This further six-month extension period was enacted in 2004.

Former section 108B(2) required any time bar waiver under subsection (1) to be in the prescribed form and to be signed and delivered to the Commissioner before the end of the original four-year time bar period. It was

intended that the further six-month extension of the time bar in section 108B(1)(b) could be effected by the taxpayer giving notice to the Commissioner before the end of the 12-month extension period allowed in section 108B(1)(a). However, the necessary consequential amendment was not made to section 108B(2) when the further six-month extension period was enacted in 2004. A remedial amendment has been made to section 108B to allow a taxpayer to extend a time bar by a further six-month period by giving notice to the Commissioner before the end of the initial 12-month extension period. This amendment ensures that the time bar extension provisions operate as intended.

ORDERS IN COUNCIL

STUDENT LOAN SCHEME – INTEREST RATES FOR 2007–08

The student loan scheme interest rates for the 2007–08 tax year have been set as follows:

Base interest rate	4.1 percent
Interest adjustment rate	2.7 percent
Total interest rate	6.8 percent

These rates were set by the formula adopted last year. Details of the formula can be found in *Tax Information Bulletin:* Vol 18, No 3 (April 2006)

Student Loan Scheme (Interest Rates) Regulations 2007

STUDENT LOAN SCHEME – VOLUNTEER EXEMPTION

The following organisations have been added to the list of organisations that are "named" for the purposes of section 38AE(1)(b) of the Student Loan Scheme Act 1992:

- Bright Hope International Trust
- Interserve (NZ)
- Mission Aviation Fellowship of New Zealand Incorporated
- National Spiritual Assembly of the Bahá'ís of New Zealand
- NET Ministries (National Evangelization Teams)
- OMF New Zealand

The effect of being "named" is that student loan borrowers working overseas as a volunteer, or for a token payment, for such an organisation may be granted an exemption, for a period of up to two years, from the requirement that they be present in New Zealand for 183 or more days to qualify for an interest-free loan.

Student loan borrowers seeking the exemption should contact their local Inland Revenue office.

Student Loan Scheme (Charitable Organisations) Amendment Regulations 2007

MATTERS OF INTEREST

GST AND BLOODSTOCK DESTINED FOR EXPORT

Introduction

This statement amends Inland Revenue's previous policy on zero-rating of Goods and Services Tax (GST) and export of bloodstock contained in *Tax Information Bulletin* Vol.11 No.7 (August 1999). This statement sets out the policy in relation to bloodstock destined for export that will not be exported within 28 days of the time of supply.

Background

Under section 11(5)(b) of the Goods and Service Tax Act 1985 the Commissioner may extend the period of time that goods sold for export may remain in New Zealand. This may be when, due to the nature of the supply, it is not practicable for the supplier to export the goods, or a class of goods, within 28 days beginning on the day of the time of supply.

The previous policy set out the maximum extension period of 12 months available for all age bloodstock to all destinations.

Policy

The Commissioner has a discretion to extend the 28-day period before the supply of goods is charged with GST where, due to the nature of the supply, it is not practicable for the supplier to export the goods within 28 days of the time of supply.

Pursuant to this statement, on written request the Commissioner may grant an extension of time to a maximum of 24 months from the time of supply. The extension is available for bloodstock of all ages to all destinations.

The bloodstock cannot be used for commercial activities while in New Zealand prior to export. This includes a thoroughbred yearling as defined in TIB Vol.4 No.6 (January 1993) contesting a race for prize money under the New Zealand Rules of Racing or being used for breeding.

If the animal is still in New Zealand at the expiration of the 24 month period, GST becomes payable regardless of whether the animal is subsequently exported.

An application for an extension must be made in writing accompanied by a copy of the contract of supply directed to your local Inland Revenue office.

This policy does not extend to zero-rate goods and services supplied in respect of bloodstock during the period of extension – eg. agistment or veterinarian services. GST is payable on those goods and services consumed in New Zealand.

Bloodstock exported by the supplier

For goods to be zero-rated when supplied the -

- supplier will enter the goods for export, pursuant to the Customs and Excise Act 1996, in the course of, or as a condition of making the supply and will export the goods;
- goods will be deemed to be entered for export, pursuant to the Customs and Excise Act 1996, and exported by the supplier in the course of, or as a condition of, making the supply.

By contrast, if a horse is sold in New Zealand and exported by the purchaser, it is the purchaser and not the supplier who is the exporter. As a result this supply could not be zero-rated.

Liability where zero-rated bloodstock is on-sold or not exported

If the bloodstock for export is on-sold by the purchaser to another party (regardless of whether the other party is in New Zealand or overseas) or not exported then the original supply could not be zero-rated. The original supplier would be liable for the GST that would have been chargeable if GST had been levied at the applicable rate (currently 12.5%).

If an animal dies within the period of extension, from circumstances beyond the control of both the supplier and the recipient, then the supply will be zero-rated.

Application date of policy

The policy contained in this statement will be effective from the 1st of April 2007.

REGULAR FEATURES

DUE DATES REMINDER

April 2007

10 End-of-year income tax

7 April 2007

- 2006 end-of-year income tax due for clients of agents with a March balance date

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

May 2007

7 GST return and payment due

21 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

28 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2007–2008*. This calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum.

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Standard practice statement	***Comment deadline***
☐ ED 0098: Discretions to be exercised by the Commissioner of Inland Revenue under the KiwiSaver Act 2006	11 May 2007

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