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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).

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LEGAL SERVICES PROVIDED TO NON-RESIDENTS RELATING TO TRANSACTIONS INVOLVING LAND IN NEW ZEALAND

PUBLIC RULING – BR PUB 07/03

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

Taxation Law

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

This Ruling applies in respect of section 11A(1)(k).

The Arrangement to which this Ruling applies

The Arrangement is the supply by a registered person of legal services to a non-resident (who is outside New Zealand at the time the services are performed) relating to:

- transactions involving the sale or purchase of land in New Zealand or the lease, licence, or mortgage of land in New Zealand, or
- easements, management agreements, construction agreements, trust deeds, guarantees and other agreements concerning land in New Zealand, or
- disputes arising in relation to land in New Zealand.

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

Under section 11A(1)(k) the supply of the following types of legal services to a non-resident who is not in New Zealand at the time the legal services are performed is zero-rated:

- legal services relating to transactions involving the sale and purchase of land in New Zealand (including the drafting of agreements for the sale and purchase of land, the provision of legal advice in relation to the sale and purchase transaction and ancillary and related services leading up to the completion of the sale and purchase transaction);
- legal services relating to transactions involving the lease, licence, or mortgage of land in New Zealand;
- legal services relating to easements, management agreements, construction agreements, trust deeds, guarantees and other agreements relating to land in New Zealand; and
- legal services relating to disputes arising in relation to land in New Zealand (including drafting court documents, court appearances, representation in negotiations and settlements and general advice in relation to such disputes).

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 22 May 2007 and ending on 22 May 2010.

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

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULINGS BR PUB 07/03

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 07/03 ("the Ruling").

Background

Under section 11A(1)(k), GST is chargeable at the rate of 0% on services supplied to a non-resident who is outside New Zealand at the time the services are performed. However, section 11A(1)(k) does not apply to services that are supplied "directly in connection with" land situated in New Zealand: section 11A(1)(k)(i)(A).

New Zealand legal firms may provide legal services to clients who are non-residents and who are outside New Zealand at the time the services are performed. Such legal services could include:

- legal services relating to transactions involving the sale and purchase of land in New Zealand (including the drafting of agreements for sale and purchase of land, the provision of general legal advice in relation to the sale and purchase transaction and ancillary or related services leading up to the completion of the sale and purchase transaction);
- legal services relating to transactions involving the lease, licence, or mortgage of land in New Zealand;
- legal services relating to easements, management agreements, construction agreements, trust deeds, guarantees and other agreements in relation to land in New Zealand (including the drafting of documents and the provision of legal advice in relation to such transactions);
- legal services relating to disputes arising in relation to land in New Zealand (including drafting court documents, court appearances, representation in negotiations and settlements and the provision of general legal advice in relation to such disputes).

This ruling concerns the meaning of the phrase "directly in connection with" in section 11A(1)(k)(i) and the degree of connection between legal services and land in New Zealand necessary before such services would be regarded as services that are supplied "directly in connection with" land in New Zealand.

Legislation

Section 11A(1)(k)(i) provides:

A supply of services that is chargeable with tax under section 8 must be charged at the rate of 0% in the following situations:

….

(k) Subject to subsection (2), the services are supplied to a person who is a non-resident and who is outside New Zealand at the time the services are performed, not being services which are—

(i) Supplied directly in connection with—

(A) Land situated in New Zealand or any improvement to the land; or

(B) Moveable personal property, other than choses in action or goods to which paragraph (h) or (i) applies, situated in New Zealand at the time the services are performed;…

Application of the legislation

Meaning of "directly in connection with"

In *Case E84* (1982) 5 NZTC 59,441, Judge Bathgate discussed the meaning of the phrase "in connection with" in the context of the Income Tax Act 1976 in the following terms:

It is a matter of degree whether, on the interpretation of a particular statute, there is a sufficient relationship between subject and object to come within the words "in connection with" or not. **It is clear that no hard and fast rule can be or should be applied to the interpretation of the words "in connection with". Each case depends on its own facts** and the particular statute under consideration.

….

Its proper interpretation depends on the context in which the phrase is used. It may mean "substantial relation in a practical business sense", or it may have [a] far more restricted meaning, depending on its context, … (p 59,446) [emphasis added]

Judge Bathgate considered that it is a question of fact and degree and impression whether there is a sufficient relationship between two things so as to be "in connection with" each other and that the evaluation of whether two things are "in connection with" each other requires a common sense assessment of the factual situation.

However, in section 11A(1)(k)(i) the phrase "in connection with" is qualified by the word "directly".

The interpretation of the phrase "directly in connection with" in the GST context was considered in *Auckland Regional Authority v CIR* (1994) 16 NZTC 11,080; *Wilson & Horton Ltd v CIR* (1994) 16 NZTC 11,221 (HC); (1995) 17 NZTC 12,325 (CA); *Case S88* (1996) 17 NZTC 7,551 (appealed as *CIR v Suzuki New Zealand Ltd* (2000) 19 NZTC 15,819 (HC); (2001) 20 NZTC 17,096 (CA)); *Malololailai Interval Holidays New Zealand Ltd v CIR* (1997) 18 NZTC 13,137 and *Case T54* (1998) 18 NZTC 8,410. These cases illustrate how the phrase is to be interpreted in the context of section 11A(1)(k)(i)(A).

The issue considered in the *Auckland Regional Authority* case was whether landing dues, terminal services charges and international garbage disposal charges levied by the ARA (the operator of Auckland International Airport) were paid for services that were supplied "directly in connection with" the service of international transportation. Barker J held that landing dues (which were paid for the use of runways, turnoffs, taxiways and holding bays) were supplied "directly in connection with" international transportation, since the service of international transportation could not be supplied without the provision of runways etc. However, he considered that the terminal services charge (which related to the use of terminals and equipment used for embarkation or disembarkation from international aircraft, maintenance and cleaning of luggage carousels, gate lounges, baggage makeup, distribution and storage areas) were "ancillary" (in the sense of being secondary or subservient) to the supply of international transportation. Barker J also considered that the garbage disposal service was a separate service from the supply of international transportation and that, although an essential service, it was ancillary to the service of transportation.

The *Auckland Regional Authority* case is not directly on point as it addresses the issue of whether two services are supplied "directly in connection with" each other, rather than whether a service is supplied "directly in connection with" land or other goods in New Zealand. However, by analogy, the case suggests that a service would not necessarily be "in connection with" an item even if the service could not have been performed without the existence of the item.

In *Wilson & Horton*, the issue was whether the supply of advertising space in a newspaper was "directly in connection with" the goods advertised. In the High Court, Hillyer J considered that the goods that were the subject of the advertising were "at least one step removed from the services supplied by the newspaper proprietor" and that, therefore, the advertising services were not supplied "directly in connection with" land or any moveable personal property situated in New Zealand (p. 11,224). Hillyer J saw a distinction between the painting of a vessel (which would be directly connected with the vessel) and services supplied to the passengers or crew of the vessel (which would not be directly connected with the vessel).

On appeal, it was accepted by both parties that the High Court's conclusion was correct. Therefore, this aspect of the High Court's judgment was not addressed by the Court of Appeal.

The legislation was amended to overturn the result in *Wilson & Horton* (based on the Court of Appeal's interpretation of the phrase "for and to" which was previously contained in section 11(2)(e) (now section 11A(1)(k))). However, the phrase "directly in connection with" was retained in the provision. This suggests that the "one step removed" test applied by the High Court in *Wilson & Horton* reflects the intention of the legislation.

In *Case S88*, Judge Barber considered the phrase "directly in connection with" in relation to an arrangement involving warranties in respect of imported vehicles. The non-resident manufacturer (MC), from whom the importer (SNZ) purchased vehicles, provided a service warranty to SNZ under which it agreed to reimburse SNZ for certain repairs. SNZ on-sold the vehicles to a dealer, who in turn sold the vehicles to the public. The warranty given by SNZ was wider than the warranty which SNZ received from MC. If SNZ was required to reimburse the dealer for the cost of repairs covered by SNZ's warranty and if the particular repairs were also within MC's warranty, SNZ would claim reimbursement from MC. The issue was whether the payment received from MC was for services supplied "directly in connection with …moveable personal property" (the vehicles) in New Zealand.

Judge Barber considered that the service provided by SNZ was the repair of the vehicles (which was carried out by the dealer on behalf of SNZ) and that there was a direct relationship between the repair service and the vehicle. He noted that the repair service could not be performed but for the existence of the vehicle:

> In my view, t**he repair services effected by the dealer are directly in connection with the vehicles** originally manufactured by MC but which, at the time of repair, are owned by the customer as purchaser from the dealer. The latter has, shortly before, purchased the vehicle from the objector. The moveable personal property in question is the repaired vehicle. **There is a direct relationship or connection between the service of the repairs and the vehicle**. Accordingly, the said "proviso" to s 11(2)(e) must apply to the facts of this case and prevent the objectors from relying on the zero-rating provisions of the s 11(2)(e). **The repair service could not be performed but for the existence of the vehicle**. The repairs were carried out for the objector (and others) which was carrying them out for MC (and others). **The objector was not merely arranging for the repairs to be carried out, but was responsible under warranty to make the repairs**—as was MC. That activity, or supply, meets the statutory nexus between goods and the service. **The service is the actual repair of vehicles even though that work was performed by a contractor—usually the dealer**.
>
> I agree … that s 11(2)(e) requires the existence of a linkage between the non-resident for whom the services are supplied and the moveable personal property, situated in New Zealand, in relation to which the services are performed. However, there is no requirement in s 11(2)(e) or anywhere else, that at the time the services are performed, the moveable property must be owned by the non-resident person, or that the non-resident person must be entitled to use or possession of the property. (p 7,558) [emphasis added]

The High Court upheld Judge Barber's decision (*Suzuki New Zealand v CIR*). McGechan J considered that the repair services provided by the importer were analogous to the "painting the ship" example given in *Wilson & Horton*:

> I have no doubt that **repair services were carried out directly in connection with moveable personal property situated**

> **in New Zealand at the time the services were performed**. Quite simply, they were repairs carried out on cars within New Zealand. **The situation equates [to] "painting the ship". The nexus could not be closer**. … The duality involved is not prohibitive. … while there was one repair, it arose under and met two quite separate contracts with two different persons. So far as SMC is concerned, the repair was a service to SMC, quite irrespective of the other contract with an SNZ customer likewise discharged. I see no reason why a provision of services to SMC under one contract should be viewed differently because of provision of services to a customer under another. They are concurrent but different supplies. The facts that SMC is non-resident, and a non-owner, are of no present consequence given the way s 11(1)(e)(ii) is worded. (p 15,830)[emphasis added]

The Court of Appeal agreed that the repair services were supplied "directly in connection with" moveable personal property in New Zealand. Blanchard J, giving the judgment of the Court, said:

> **There is a nexus in both cases between the performance and the consideration given by the other party**. In the present case there is a more than sufficient financial and legal connection, as demonstrated by the evidence, between SMC's payments and the carrying out of the repairs on behalf of SNZ by its dealers. **The repairs may have been done for the customers**, in practical terms, under SNZ's standard warranty, **but they were also done for SMC under its warranty**.
>
> …
>
> It follows from what we have said that we also reject the argument, made in relation to s 11(2)(e), that the services were not supplied directly in connection with movable personal property situated in New Zealand. **The repair services were obviously supplied in relation to goods, namely motor vehicles, which were situated in New Zealand. The supply of repairs could hardly be more directly connected with the motor vehicles**. The fact that they may have no longer been owned by SMC or SNZ is irrelevant. Section 11(2)(e) therefore has no application. (pp 17,102, 17,103) [emphasis added]

In *Malololailai Interval Holidays*, a New Zealand company had supplied services relating to the marketing of timeshare interval holidays at a resort in Fiji to another New Zealand company. The issue was whether the marketing services were "supplied directly in connection with land, or any improvements thereto, situated outside New Zealand". If so, the services would be zero-rated under section 11(2)(b) (now section 11A(1)(e)). (As the phrase "directly in connection with" has the same meaning throughout section 11A (*Wilson & Horton Ltd v CIR* (1994) 16 NZTC 11,221, 11,224), the *Malololailai* case is relevant to the interpretation of the phrase in the context of section 11A(1)(k)(i).)

In *Malololailai* Neazor J referred to *Case E84* and said:

> A good deal of the debate in that case about whether a narrow or wide interpretation of the statutory phrase was appropriate might have been seen as unnecessary if the word "directly" had been used, as it is in s 11 of the Goods and Services Tax Act 1985. (p. 13,144)

These comments highlight the importance of the addition of the word "directly". The use of the word "directly" narrows the scope of what might be considered to be "in connection with" the land and confirms that there must be a direct relationship between the relevant services and land.

The *Malololailai* case also confirms that the recipient of a service need not acquire a legal interest in land before the service would be regarded as one that is "directly in connection with" the land. At page 13,143 Neazor J commented:

> It is not in my view necessary to consider the first point of Mr McLay's argument further than that, because the issue is not whether the purchaser acquires land or an interest in land, but whether the services provided by the marketer on behalf of the objector are "directly in connection with land", which may involve much less than acquiring an interest in the land. By way of example, the provision of gardening services would surely come within the statutory words.

Neazor J considered that a transaction between the New Zealand vendor and the purchaser of an interval holiday would be "directly in connection with" land outside New Zealand, but that the marketing services supplied by the marketing company (although essential to bring together the vendor and purchaser and although closely related to the sale and purchase transaction) were not "directly in connection with" the land. The marketing services merely facilitated a transaction that was directly connected to the land (the transaction between vendor and purchaser). Neazor J considered that (as with the advertising services in *Wilson & Horton)* the marketing services were one step removed from a transaction that directly related to the land:

> **I would regard the contractual transaction between [the New Zealand selling company] and the purchaser of an interval holiday as within the descriptive words "directly in connection with land or any improvement thereto**", although that determination is not essential to this decision, but when attention is paid to the services supplied by [the marketing company] to [the NZ selling company] consider that those services are not within the statutory description. What [the marketing company] does is to advertise and promote interval holidays for [the NZ selling company] and negotiate the contract for individual holidays (including the consideration for that contract between the purchaser and [the NZ selling company]) up to the point where the contract is effected between those two parties.
>
> The services provided by [the marketing company] are not directly in connection with the land or the improvements. The transaction of those considered which would be in that category is the transaction between [the NZ selling company] and the purchaser. **The transaction between [the marketing company] and [the NZ selling company] is one which brings about the transaction which has direct effect**, but in my view is of a kind to which Hillyer J's words may properly be applied—it is **one step removed from the direct transaction**.

If one of the analogies referred to needs to be chosen I would take that of the publication of advertisements in the *Wilson & Horton* case. The newspaper proprietor's services facilitated or opened the way to the transactions between vendor and purchaser, and that in my view is what [the marketing company] did, although it was more closely involved in the transaction to which the statutory words apply than the publisher of an advertisement would be. Nevertheless the transaction having direct effect was not that of the publisher, or in this case of the sales agent. (p 13,146) [emphasis added]

The *Malololailai* case was decided before the High Court and the Court of Appeal judgments in Suzuki. Although *Malololailai* was referred to in submissions to the High Court in the Suzuki case, it was not discussed in detail by the High Court and the case was not referred to by the Court of Appeal. The Commissioner considers that the approach in *Malololailai* is consistent with the approach taken in the *Wilson & Horton* case and is not inconsistent with the *Suzuki* decisions. These cases support a narrow interpretation of the phrase "directly in connection with".

Case T54 concerned the service of producing a video of Japanese honeymoon couples holidaying in New Zealand supplied by a Japanese company. Judge Barber considered that the services were not supplied "directly in connection with" the video camera or the blank tape used to create images (which were later edited to create the final video). Judge Barber considered that the video camera and blank tape were merely tools used to carry out the services and were not the object or objective of the services. He considered that the service provided was the creation of the final video. The judge concluded that the taxpayer had not provided services "directly in connection with" moveable personal property situated in New Zealand at the time services were performed. This was because the video did not come into existence until after the taxpayer's services had been performed and at that time the video was outside New Zealand:

The resultant video cassette did not come into existence until after the relevant services had been performed. It was not "situated inside New Zealand at the time the services are performed". Until then it was only a blank tape. There is no other relevant moveable personal property to which the objector's service could be regarded as supplied "directly in connection with". Insofar as there is a connection between the said videoing services and the said blank tape (which fills up during the day) and camera and equipment, that connection is not a "direct" connection. That particular tape is only part of the equipment involved in the process of creating another tape - the resultant videotape cassette. Tools and equipment are aids to the supply of such videoing services, and are not the objects of such services. Those services could be regarded as supplied directly in connection with the Japanese tourists who, of course, are not moveable personal property. (pp 8,414-8,415)

Case T54 is distinguishable on its facts from the types of situations addressed in this item, because it is not possible to argue that land did not exist before legal services are provided (an argument that was accepted in *Case T54*).

Test of whether services are "directly in connection with" land in New Zealand

The following principles on the interpretation of the phrase "directly in connection with" can be drawn from the above cases:

- Whether there is sufficient relationship between two things, so as to be "in connection with" each other, is a matter of fact and degree and impression and the evaluation of whether there is a sufficient relationship between two things requires a common sense assessment of the factual situation (*Case E84*).
- The inclusion of the word "directly" in section 11A(1)(k)(i) indicates that a close connection would be required between a service and land for the service to be regarded as a service that is supplied "directly in connection with" the land (*Malololailai*).
- Although there must be a direct relationship between the service and the property, for the service to be directly in connection with that property, the non-resident to whom the service is provided need not own or be entitled to the use or possession of the particular property (*Suzuki*).
- The recipient of the service need not acquire a legal interest in land before the service would be regarded as a service that is "directly in connection with" the land. Services that are "directly in connection with" land include services that have a physical effect on the land, such as gardening or repairs to improvements to land (*Malololailai*).
- Services that merely bring about or facilitate a transaction that has direct effect on land and which are one step removed from a transaction that has a direct effect on the land are not supplied "directly in connection with" the land (*Wilson & Horton*, *Malololailai*).
- If the service could not have been performed but for the existence of the land, this may suggest that the service is supplied "directly in connection with" the land, but this factor is not conclusive (*ARA*; *Suzuki*).

As a close relationship is required between the relevant services and land in New Zealand, the services must be supplied directly in connection with specific land in order to fall within section 11A(1)(k)(i)(A).

Legal services

Legal services that may be supplied to non-residents include:

- *Legal services relating to transactions involving the sale and purchase of land in New Zealand*

  An analogy can be drawn between the marketing services considered in the *Malololailai* case and legal services in respect of the sale and purchase of land in New Zealand. In *Malololailai*, it was held that the marketing services did not have a direct effect on the land and that they merely facilitated a transaction that had a direct effect on the land (that is, the sale and purchase between the vendor and purchaser). Legal services relating to the sale and purchase of land facilitate or give effect to a transaction between the vendor and purchaser which has a direct effect on the land but are one step removed from that transaction.

Accordingly, legal services relating to the sale and purchase of land in New Zealand (including the drafting of an agreement for the sale and purchase of land in New Zealand, legal advice in relation to a sale and purchase transaction and ancillary or related services leading up to the completion of a sale and purchase transaction) are not services that are supplied "directly in connection with" the land that is the subject of the transaction. Therefore, such services are zero-rated under section 11A(1)(k).

- *Legal services relating to transactions involving the lease, licence or mortgage of land in New Zealand or legal services relating to easements, management agreements, construction agreements, trust deeds, guarantees and other agreements concerning land in New Zealand*

The same reasoning applies to legal services relating to transactions involving the lease, licence, or mortgage of land in New Zealand or legal services relating to easements, management agreements, construction agreements, trust deeds, guarantees and other agreements concerning land in New Zealand. These services are provided to a person who enters into a transaction that would have direct effect on the land. However, such legal services are at least one step removed from the land that is the subject matter of the transactions. These services merely assist in bringing about or facilitating a transaction that has direct effect on the land.

Accordingly, legal services relating to transactions involving the lease, licence or mortgage of land in New Zealand or legal services relating to easements, management agreements, construction agreements, trust deeds, guarantees and other agreements concerning land in New Zealand (including the drafting of agreements relating to these transactions and the provision of legal advice in respect of such transactions) are not supplied "directly in connection with" the land that is the subject of these transactions. Such services are zero-rated under section 11A(1)(k).

- *Legal representation in disputes in relation to land in New Zealand*

Legal services involving representation in disputes relating to land in New Zealand (including drafting court documents, court appearances, representation in negotiations and settlements, and general advice) are also one step removed from the land to which the dispute relates. These services may be supplied as a consequence of a transaction that has direct effect on the land. However, consistent with the approach taken in *Malololailai*, the services are not supplied "directly in connection with" the land to which the dispute relates. Therefore, these services are also zero-rated under section 11A(1)(k).

Example

Steve, who is a US resident, comes to New Zealand with a view to purchasing land for investment purposes. He returns to the US and continues to carry on negotiations for the purchase of land from a distance. Tracey, a New Zealand solicitor, arranges for searches of the land in Land Information New Zealand's records to be carried out and obtains a LIM report from the local authority. She provides advice in relation to tax issues relating to the purchase, advice on whether Overseas Investment Commission consent to the purchase is required and general legal advice in relation to the transaction. Tracey then drafts an agreement for sale and purchase which is signed by both parties. She also advises Steve regarding a mortgage to be secured over the land, drafts a transfer to be signed by the vendor and attends to settlement of the transaction.

After settlement, Steve telephones a real estate agent and arranges for the property to be leased. Tracey drafts the lease and negotiates with the lessee's solicitor regarding the form of the lease. The lease is signed and the lessee takes occupation of the property. During a brief visit to New Zealand, Steve discovers that the lessee is using the property for a purpose that is not authorised by the lease. Tracey drafts a notice to the lessee terminating the lease and arranges for the notice to be served. The lessee then applies to the court for an injunction preventing Steve from terminating the lease. Steve instructs Tracey to draft documents opposing the injunction. Tracey provides advice in relation to the management of the dispute and represents Steve in settlement negotiations with the lessee. Ultimately, the dispute is settled out of court.

The legal services provided by Tracey either facilitate transactions between Steve and the vendor, the mortgagee or the lessee which have a direct effect on the land (by creating or changing legal interests in respect of the land) or arise as a consequence of these transactions. However, Tracey's legal services are one step removed from transactions which directly affect the land. The legal services are not supplied directly in connection with land in New Zealand. Therefore, provided Steve is outside New Zealand at all times when these services are performed, the services will be zero-rated under section 11A(1)(k).

INTEREST DEDUCTIBILITY—*ROBERTS AND SMITH*—BORROWING TO REPLACE AND REPAY AMOUNTS INVESTED IN AN INCOME EARNING ACTIVITY OR BUSINESS

Rulings BR Pub 07/04—BR Pub 07/09 originate from issues paper IRRUIP 5*: Interest deductibility in certain arrangements,* which was issued for public consultation in March 2001. (IRRUIP 5 had superseded an earlier issues paper, IRRUIP 3.) Consultation comments received on IRRUIP 5 have been taken into account in forming the Commissioner's opinion outlined in these rulings and commentary. There are no significant changes from the Commissioner's opinion expressed in IRRUIP 5 in respect of the matters covered in these rulings and commentary.

The Commissioner's opinion of the application of *Public Trustee v CIR* [1938] NZLR 436, discussed in IRRUIP 5, is outlined in Interpretation Statement IS0082—*Interest Deductibility—Public Trustee v CIR*. Other issues discussed in IRRUIP 5 may be covered in future statements.

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A PARTNERSHIP TO RETURN CAPITAL CONTRIBUTION

PUBLIC RULING – BR PUB 07/04

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a partnership to return capital to partners who previously invested that capital.

The Arrangement only includes:

- a partnership carrying on a business for the purpose of deriving assessable and excluded income both at the time the partnership borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where one or both of the following applies:

- subpart BG of the Act applies to void the arrangement [subpart BG relates to tax avoidance arrangements];
- interest is deductible under section DB 7 [section DB 7 applies to companies].

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer. The rules in Part FG are commonly referred to as the "thin capitalisation rules".]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Any partner's share of the interest will be deductible by that partner to the extent that the partner's capital contribution was used directly in the partnership's business, or used to repay borrowed funds on which the interest was deductible.
- Any partner's share of the interest will not be deductible by that partner to the extent that the borrowed funds are used by the partnership to pay current year income to the partner, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 22 May 2007 and ending on 22 May 2010.

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

Susan Price
Senior Tax Counsel

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A PARTNERSHIP TO RETURN PROFITS

PUBLIC RULING – BR PUB 07/05

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a partnership to pay profits to partners.

The Arrangement only includes:

- a partnership carrying on a business for the purpose of deriving assessable or excluded income both at the time the partnership borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where one or both of the following applies:

- subpart BG of the Act applies to void the arrangement [subpart BG relates to tax avoidance arrangements];
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This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer The rules in Part FG are commonly referred to as the "thin capitalisation rules".]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Any partner's share of the interest will be deductible by that partner to the extent that the profits are past years' profits that were used directly in the partnership's business or used to repay borrowed funds on which the interest was deductible.
- Any partner's share of the interest will not be deductible by that partner to the extent that the borrowed funds are used by the partnership to pay current year income to the partner, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

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Susan Price
Senior Tax Counsel

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A COMPANY TO REPURCHASE SHARES

PUBLIC RULING – BR PUB 07/06

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to repurchase shares from its shareholders as authorised by the Companies Act 1993.

The Arrangement only includes:

- a company carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the company borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where one or both of the following applies:

- subpart BG of the Act applies to void the arrangement [subpart BG relates to tax avoidance arrangements];

- interest is deductible under section DB 7 [section DB 7 applies to companies].

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer The rules in Part FG are commonly referred to as the "thin capitalisation rules".]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Interest will be deductible in the circumstances described in the Arrangement to the extent that the funds that were represented by the shares and returned to shareholders were funds contributed by the shareholders and used directly in the company's assessable or excluded income earning activity or business, or used to repay borrowed funds on which the interest was deductible.
- Interest will not be deductible to the extent that the borrowed funds are used by the company to pay current year income to a shareholder, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.
- Interest will be deductible in the circumstances described in the Arrangement if the shares are bonus issue shares, to the extent that the bonus issue shares:
    - were paid up out of funds used directly in the company's assessable or excluded income earning activity or business; and
    - were not paid up out of current year income, unrealised asset revaluations, or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 22 May 2007 and ending on 22 May 2010.

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

Susan Price
Senior Tax Counsel

INTEREST DEDUCTIBILITY—FUNDS BORROWED BY A COMPANY TO PAY DIVIDENDS

PUBLIC RULING – BR PUB 07/07

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to pay dividends to its shareholders.

The Arrangement only includes:

- a company carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the company borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where one or both of the following applies:

- subpart BG of the Act applies to void the arrangement [subpart BG relates to tax avoidance arrangements];
- interest is deductible under section DB 7 [section DB 7 applies to companies].

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer The rules in Part FG are commonly referred to as the "thin capitalisation rules".]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Interest will be deductible to the extent that the dividends are sourced from past years' profits or contributed capital, which was used directly in the company's assessable or excluded income earning activity or business, or used to repay borrowed funds on which the interest was deductible.

- Interest will not be deductible to the extent that the borrowed funds are used by the company to pay current year income to a shareholder, or are purported to be used to make a payment out of unrealised asset revaluations or internally generated goodwill.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 22 May 2007 and ending on 22 May 2010.

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

Susan Price
Senior Tax Counsel

INTEREST DEDUCTIBILITY—FUNDS BORROWED TO REPAY DEBT

PUBLIC RULING – BR PUB 07/08

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

Taxation Law

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

This Ruling applies in respect of section DB 6.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a taxpayer or a partnership to repay borrowed funds to the person who invested those funds in the taxpayer or partnership.

The Arrangement only includes:

- a taxpayer or a partnership carrying on an assessable or excluded income earning activity or a business for the purpose of deriving assessable or excluded income both at the time the taxpayer or partnership borrows the funds and at the time the interest on those funds is payable; and
- arrangements where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include arrangements where one or both of the following applies:

- subpart BG of the Act applies to void the arrangement [subpart BG relates to tax avoidance arrangements];
- interest incurred under the Arrangement is deductible under section DB 7 [section DB 7 applies to companies].

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure that worldwide interest expense is apportioned appropriately to a New Zealand taxpayer The rules in Part FG are commonly referred to as the "thin capitalisation rules".]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will be deductible in the circumstances described in the Arrangement to the extent that the funds which are repaid:
    - were used directly in the taxpayer's or partnership's assessable or excluded income earning activity or business; or
    - were used by a company and the interest was deductible under section DB 7; or
    - were used by a company to purchase shares and the interest was deductible under section DB 8; or
    - were used for one of the Arrangements in Public Rulings BR Pub 07/04–BR Pub 07/09, and met the requirements for interest deductibility in those rulings; or
    - were used to retain income earning assets from sale and satisfied the elements of the Public Trustee case set out in the Commissioner's Interpretation Statement IS0082; or
    - themselves repaid, either directly or through a series of borrowings used to repay borrowings, other borrowed funds in respect of which the interest was deductible.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 22 May 2007 and ending on 22 May 2010.

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

Susan Price
Senior Tax Counsel

INTEREST DEDUCTIBILITY—FUNDS BORROWED TO MAKE A PAYMENT TO A GROUP COMPANY

PUBLIC RULING – BR PUB 07/09

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

Taxation Law

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

This Ruling applies in respect of section DB 6 and section IG 2.

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of and the payment of interest on funds used by a company to make a payment under section IG 2(2) to another company that has a net loss.

The Arrangement does not include arrangements where one or both of the following applies:

- subpart BG of the Act applies to void the arrangement [subpart BG relates to tax avoidance arrangements];
- Interest is deductible under section DB 7 [section DB 7 applies to companies].

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will not be deductible in the circumstances described in the Arrangement.

The period for which this Ruling applies

This Ruling will apply for the period beginning on 22 May 2007 and ending on 22 May 2010.

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

Susan Price
Senior Tax Counsel

COMMENTARY ON PUBLIC RULINGS BR PUB 07/04–07/09

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Rulings BR Pub 07/04–07/09 ("the Rulings").

The Rulings and commentary express the Commissioner's view of the principles relating to interest deductibility in the Australian Full Federal Court decision in *FC of T v Roberts; FC of T v Smith* 92 ATC 4 ("*Roberts and Smith*").

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

Summary

1. The interest deductibility test is satisfied if there is a sufficient connection between interest incurred and assessable income. The sufficient connection is established if the borrowed funds on which interest is incurred are used in deriving assessable income or in a business carried on for the purpose of deriving assessable income.
2. In *Roberts and Smith* the borrowed funds were not used directly in deriving income, but the Court held that the interest is deductible.
3. *Roberts and Smith* is authority that there is a sufficient connection between interest and income when the interest is incurred on borrowed funds used to replace an amount previously invested in an income earning activity or business and to return the amount to the person who invested it. The link with income is through the new borrowings taking the place of funds that have a sufficient connection with assessable income or in respect of which interest was deductible through the operation of section DB 7 or DB 8 of the Income Tax Act 2004. Capital contributions, past years' profits and debt are all capable of being replaced.
4. The case only applies where the amount replaced and repaid is owed to a person separate to the income earning activity or business. It does not apply to sole traders.

Background

Legislation

Income Tax Act 2004

PART D — DEDUCTIONS

Subpart DA — General rules

DA 1 GENERAL PERMISSION

DA 1(1) Nexus with income

A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—
- (i) their assessable income; or
- (ii) their excluded income; or
- (iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—
- (i) their assessable income; or
- (ii) their excluded income; or
- (iii) a combination of their assessable income and excluded income.

DA 1(2) General Permission

Subsection (1) is called the general permission.

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

DA 2 GENERAL LIMITATIONS

DA 2(1) Capital limitation

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

DA 2(2) Private limitation

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

DA 2(3) Exempt income limitation

A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the **exempt income limitation**.

…

DA 2(7) Relationship of general limitations to general permission

Each of the general limitations in this section overrides the general permission.

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

DA 3 EFFECT OF SPECIFIC RULES ON GENERAL RULES

DA 3(1) Supplements to general permission

A provision in any of subparts DB to DZ may supplement the general permission. In that case, a person to whom the provision applies does not have to satisfy the general permission to be allowed a deduction.

DA 3(2) Express reference needed to supplement

A provision in any of subparts DB to DZ takes effect to supplement the general permission only if it expressly states that it supplements the general permission.

DA 3(3) Relationship of general limitations to supplements to general permission

Each of the general limitations overrides a supplement to the general permission in any of subparts DB to DZ, unless the provision creating the supplement expressly states otherwise.

DA 3(4) Relationship between other specific provisions and general permission or general limitations

A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.

DA 3(5) Express reference needed to override

A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—

(a) that it overrides the general permission or the relevant limitation; or

(b) that the general permission or the relevant limitation does not apply.

…

DB 1 TAXES, OTHER THAN GST, AND PENALTIES

DB 1(1) No deduction

A person is denied a deduction for the following:

(a) income tax:

(b) a civil penalty under Part 9 of the Tax Administration Act 1994:

(c) a tax, a penalty, or interest on unpaid tax that is—
- (i) payable under the laws of a country or territory outside New Zealand; and
- (ii) substantially the same as a civil penalty as defined in section 3(1) of the Tax Administration Act 1994, or a criminal penalty under Part 9 of the Act, or interest imposed under Part 7 of the Act.

…

DB 6 INTEREST: NOT CAPITAL EXPENDITURE

DB 6(1) Deduction
A person is allowed a deduction for interest incurred.
DB 6(2) Exclusion
Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.
DB 6(3) Link with subpart DA
This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.
Defined in this Act: capital limitation, deduction, general limitation, general permission, interest.

DB 7 INTEREST: MOST COMPANIES NEED NO NEXUS WITH INCOME

DB 7(1) Deduction
A company is allowed a deduction for interest incurred.
DB 7(2) Exclusion: qualifying company
Subsection (1) does not apply to a qualifying company.
DB 7(3) Exclusion: exempt income
If a company (**company A**) derives exempt income or another company (company B) in the same wholly-owned group of companies derives exempt income, subsection (1) applies to company A only if all the exempt income is 1 or more of the following:
(a) dividends; or
(b) income exempted under section CW 46 (Disposal of companies' own shares); or
(c) income exempted under section CW 48 (Stake money) and ancillary to the company's business of breeding.
DB 7(4) Exclusion: non-resident company
If a company is a non-resident company, subsection (1) applies only to the extent to which the company incurs interest in the course of carrying on a business through a fixed establishment in New Zealand.
DB 7(5) Exclusion: interest related to tax
Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.
DB 7(6) Link with subpart DA
This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.
Defined in this Act: business, capital limitation, company, deduction, dividend, exempt income, exempt income limitation, fixed establishment, general limitation, general permission, income, interest, New Zealand, non-resident company, qualifying company, supplement, wholly-owned group of companies, withholding tax limitation

DB 8 INTEREST: MONEY BORROWED TO ACQUIRE SHARES IN GROUP COMPANIES

DB 8(1) Deduction: borrowing to acquire group company shares
A company is allowed a deduction for interest incurred on money borrowed to acquire shares in another company in the same group of companies.
DB 8(2) Exclusion: group not in existence at tax year end
Subsection (1) does not apply if the 2 companies are not in the same group of companies at the end of the tax year for which the deduction is claimed.
DB 8(3) Deduction: interest after qualifying amalgamation
A company is allowed a deduction for interest incurred on money borrowed to acquire shares in another company that has ceased to exist on a qualifying amalgamation.
DB 8(4) Exclusion: group not in existence immediately before qualifying amalgamation
Subsection (3) does not apply if the 2 companies were not in the same group of companies immediately before the qualifying amalgamation.
DB 8(5) Application from tax year of qualifying amalgamation
Subsection (3) applies in the tax year in which the qualifying amalgamation occurs and in later tax years.
DB 8(6) Link with subpart DA
This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.
Defined in this Act: company, deduction, exempt income limitation, general limitation, general permission, group of companies, interest, qualifying amalgamation, share, supplement, tax year, withholding tax limitation.

Roberts and Smith principle not relevant to section DB 7 deductions

5. The interest deductibility legislation distinguishes between companies and other taxpayers. Interest incurred by companies is automatically deductible—that is, there is no requirement to satisfy a nexus test—except for certain exceptions. The effect of this is that most companies seeking interest deductions will obtain them under section DB 7, rather than by applying *Roberts and Smith. Roberts and Smith* may apply to companies who do not come within section DB 7.

6. Under section DB 7, interest incurred by a company is automatically deductible, provided the statutory exceptions in subsections DB 7(2) – (5) do not apply. The exceptions are:
   - qualifying companies;

- companies deriving exempt income except if that exempt income is dividends, exempt income arising from a disposal of a company's own shares or exempt income related to stake money and a breeding business;
- non-resident companies to the extent to which interest is not incurred in the course of carrying on a business through a fixed establishment in New Zealand; and
- interest on unpaid taxes payable to another country and substantially the same as civil or criminal penalties as defined under certain laws in New Zealand.

7. The effect of section DB 7 is discussed in *Tax Information Bulletin* Vol 13, No 11 (November 2001).

How the sections of the Act, other than section DB 7, apply in relation to interest deductibility

8. Section DB 6(1) provides that:

> A person is allowed a deduction for interest incurred.

9. Section DB 6(3) states that

> This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

10. Therefore, a person seeking to deduct interest is subject to the general permission, which states:

> **DA 1 GENERAL PERMISSION**
> **DA 1(1) Nexus with income**
> A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—
> (a) incurred by them in deriving—
> (i) their assessable income; or
> (ii) their excluded income; or
> (iii) a combination of their assessable income and excluded income; or
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
> (i) their assessable income; or
> (ii) their excluded income; or
> (iii) a combination of their assessable income and excluded income.
> **DA 1(2) General permission**
> Subsection (1) is called the **general permission**.

11. So in considering the application of the Act to interest expense, a person must satisfy the test under the general permission that the expenditure (interest in this case) is incurred in deriving assessable income (or excluded income) or incurred in carrying on a business for the purpose of deriving assessable (or excluded income). This test is the same in all relevant respects to the test under the 1994 Act.

12. The concept of "excluded income" requires some comment in relation to how it will be dealt with in this commentary. "Excluded income" is defined and specified to include, for example, GST, fringe benefits, certain life insurance premiums or claims derived by persons carrying on the business of life insurance, and other specific classes of income (see sections OB 1, BD 1(3) and subparts CX and CZ). The addition of the reference to "excluded income" in the general permission does not alter the principles applying to the deductibility of interest. The same principles apply to excluded income. However, because the concept of "excluded income" is a statutory mechanism used to deal with certain types of income, and does not affect the principles of interest deductibility, for ease of reference, "excluded income" is not referred to further in this commentary.

13. The general permission is subject to the general limitations, pursuant to section DA 2(7). The general limitations include the private limitation and the capital limitation:

> **DA 2 GENERAL LIMITATIONS**
> **DA 2(1) Capital limitation**
> A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.
> **DA 2(2) Private limitation**
> A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.
> …
> **DA 2(7) Relationship of general limitations to general permission**
> Each of the general limitations in this section overrides the general permission.

14. The private limitation applies to interest expense, pursuant to section DA 2(2). The capital limitation, on the other hand, does not apply to interest. This result is achieved in the Act by the capital limitation being expressly overridden. Sections DA 3(4) and DA 3(5) state the general rule that a limitation (such as that applying to capital expenditure) does not apply if it is expressly overridden:

> **DA 3(4) Relationship between other specific provisions and general permission or general limitations**
> A provision in any of subparts DB to DZ may override any 1 or more of the general permission and the general limitations.
> **DA 3(5) Express reference needed to override**
> A provision in any of subparts DB to DZ takes effect to override the general permission or a general limitation only if it expressly states—

(a) that it overrides the general permission or the relevant limitation; or

(b) that the general permission or the relevant limitation does not apply.

…

15. The capital limitation is expressly overridden in relation to interest by section DB 6(3) (subsection DB 6(1) is reproduced to give context):

DB 6 INTEREST: NOT CAPITAL EXPENDITURE
DB 6(1) Deduction
A person is allowed a deduction for interest incurred.
…
DB 6(3) Link with subpart DA
This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.
Defined in this Act: capital limitation, deduction, general limitation, general permission, interest.

Summary of the legislation relating to interest deductions

16. In summary, the legislation provides the following general rules relating to interest deductibility:

- Interest incurred by companies is usually automatically deductible;
- For other taxpayers, interest is deductible if it is incurred in deriving assessable income or incurred in carrying on a business for the purpose of deriving assessable income;
- Interest is not deductible if it is private or domestic in nature;
- Being capital in nature will not, on its own, mean that interest is non-deductible.

ANALYSIS OF THE COMMISSIONER'S OPINION

The *Roberts and Smith* case

Introduction

17. Courts have established that the general test for interest deductibility requires a sufficient connection between the interest on borrowed funds and the derivation of income. This sufficient connection depends on the use to which the assets provided with the borrowed funds are put (see Richardson J in *Eggers v Commissioner of Inland Revenue* (1988) 10 NZTC 5,153, and *Pacific Rendezvous Ltd v C of IR* (1986) 8 NZTC 5,146; Cooke P at p 573, Richardson J at pp 577-578 and Somers J at p 581). In most cases, the test is satisfied when the borrowed funds are used directly in an income earning activity or business in that they are used to acquire income earning assets.

18. In a limited number of cases, notably *Roberts and Smith and Public Trustee v CIR*, Courts have held that the borrowed funds were used in relation to the income earning assets, and that the connection was sufficient for deductibility, even though the funds were deployed outside the income earning activity or business. The application of *Roberts and Smith* is discussed in this commentary, and the application of Public Trustee is discussed in Interpretation Statement IS0082—Interest Deductibility—*Public Trustee v CIR*.

The facts of *Roberts and Smith*

19. The Australian decision in *Roberts and Smith* concerned the deductibility of interest incurred by a partnership which borrowed in order to repay partners part of their capital contributions. Judgment was given on two appeals heard together.

20. The facts were that new partners were to join the partnership, but the cost of contributing an amount equal to the capital of the existing partners was too high. To make it easier for the new partners to join the partnership, the partners decided to decrease the amount of the existing partners' capital by borrowing to repay partners their capital contributions. The Australian Full Federal Court held that the interest on this borrowing was deductible.

21. Hill J, who delivered the leading judgment, considered that the deduction was limited to the extent that the borrowed funds replaced the amount of partnership capital contributed by partners. His Honour explained (p 4,390):

> The provision of funds to the partners in circumstances where that **provision is not a replacement of funds invested in the business**, lacks the essential connection with the income producing activities of the partnership business. [emphasis added]

22. Hill J explained his reasoning in the following passage (p 4,390):

> Let it be assumed that the original partnership capital in the Lord Lindley sense [i.e. contributed capital] was $10 and that the balance in the account designated as "the capital account" of the partnership was $125,000, which included goodwill. That would mean that the equity of each partner in the partnership, assuming five partners, was $25,000. But it could not be said that each partner had invested funds totalling $25,000 as capital in the partnership. A cheque for $25,000 drawn on

> the partnership bank account would not operate to repay the partner any funds invested. The partnership capital would remain as $10, and all that would happen is that there would be a borrowing which was used to pay the partner $25,000. That borrowing would reduce the partner's equity in the partnership, but it could not represent a replacement of capital invested. The partnership assets would remain constant. The goodwill would still be worth $125,000; it would not have been distributed to the partners, nor could it be.
>
> On these facts, there could be no question of there being a refund of a pre-existing capital contribution. Rather, looking at the facts objectively, the only purpose of the borrowing would be the provision of funds to the partners to which they were not entitled during the currency of the partnership (save of course by agreement among themselves). The provision of funds to the partners in circumstances where that provision is not a replacement of funds invested in the business, lacks the essential connection with the income producing activities of the partnership, or, in other words, the partnership business.
>
> … If at least $125,000 of the amount in that account represents partnership capital in the Lord Lindley sense, undrawn profit distributions, advances by partners *or other funds which have actually been invested in the partnership* and which the partners were entitled to withdraw in June 1984, then in my view the taxpayer is entitled to succeed. [emphasis added]

23. His Honour considered that interest is only deductible in this type of situation if the borrowed funds replace amounts that have actually been invested in the partnership. The reason for this is that the borrowed funds will only take on the character of the funds they are replacing if in fact they have the effect of replacing funds used in the business. Capital contributions can be replaced by borrowings that are used to pay out these contributions to partners. Hill J explains that goodwill is not an amount invested in an income earning activity, and so it cannot be repaid to anyone, and therefore borrowed funds cannot take the place of that goodwill. Similarly, with asset revaluations, the revalued portion of the asset is not an amount that has been invested so it cannot be repaid to anyone.

24. Therefore, *Roberts and Smith* applies if an amount is able to be replaced by borrowed funds and if the amount replaced is then returned to the person who invested it. The link with income comes through the new borrowings taking the place of funds that have a sufficient connection with assessable income. Capital contributions, undrawn profits and advances are all capable of being replaced.

25. This principle from *Roberts and Smith* is referred to in this commentary as the "replacement and repayment principle".

Are the borrowed funds used in an income earning activity?

26. In Hill J's view, in the circumstances of *Roberts and Smith* the borrowings replaced the capital that had been paid in by the partners. A question might be raised as to how borrowings can be said to replace funds invested in an income earning activity or business, when the borrowings were actually paid direct to the partners and were never paid into the partnership. The "replacement" occurs in the books of the partnership in that equity is reduced and debt increased. There might seem to be some difficulty in understanding how one debt, with its own parties, conditions, and direct use can inherit the deductibility status of a completely different debt. A basic principle of deductibility would seem to be that deductibility of any item should depend on the circumstances in which it is incurred. A further issue is that if the direct use of the borrowed funds is a private use, for example the private use of partners in a partnership, then it might be argued that the prohibition against deductions of a private nature in section DA 2(2) might apply.

27. Hill J supports his reasoning by saying that interest on a debt that replaces a debt is deductible. But that statement is not an explanation, and it is not clear that a debt replacing a debt inherits its deductibility status. A contrary approach was taken in the Canadian decision in *Interior Breweries Ltd v Minister of National Revenue* [1955] C.T.C. 143, 55 D.T.C. 1090 (Exch.). In that case Cameron J of the Exchequer Court held that interest was not deductible where the borrowed funds were used to pay a bank loan. Cameron J considered that the borrowed money was not used to earn income, but was "used entirely to pay off the bank loan…" (p 148).

28. However, *Interior Breweries* does not appear to have been applied in any later cases. In Canada, the reason is that legislation was introduced to reverse its effect. It seems likely that the decision may not be accepted in New Zealand or Australia if it were argued, because although New Zealand and Australian courts have been cautious about allowing deductions relating to indirect uses of borrowed funds (particularly in the lower courts in regard to cases where there has been private use of funds), they have not taken such a strict approach as the Canadian courts. *Roberts and Smith* is an Australian example of acceptance by a Court that interest may, in some situations, be deductible when the borrowed funds are not used directly to derive income.

The approach to identifying the use of borrowed funds in New Zealand

29. In New Zealand, as in Australia and Canada, the interest deductibility test involves considering the use of the borrowed funds and the connection between the funds and the derivation of income. However, New Zealand Courts have held that the use of funds encompasses not only the direct use of the funds, but also the outcome of that use. In *Public Trustee* the borrowed funds were applied in payment of the death duties. It was argued that the funds were used to retain assets. The dissenting judge in *Public Trustee*, Northcroft J, had the following view about how the borrowed funds were used (p 459):

> … if money be borrowed to discharge a debt of the owner of the business which debt is otherwise unconnected with the business and if the alternative be a sale of business assets with a consequent diminution of profits, then, in my opinion, this would be capital employed in the payment of the debt and not in the production of income.

30. Northcroft J's view was not shared by the majority. The majority held that the capital was used in the payment of the debt and to retain assets. Callan J held that borrowed capital used in retaining assets is employed in the production of assessable income, just as capital used in acquiring assets is employed in the production of assessable income. Therefore, the case is authority that in identifying how borrowed funds are used as required by the statutory test, the use of funds will not only encompass the actual application of the funds, but will include the outcome of the application. This interpretation is consistent with the meaning of "use" in the *Concise Oxford Dictionary* (11^{th} ed, Oxford University Press, 2004):

> **use** take, hold, or deploy as a means of achieving something.

31. This definition involves two aspects: deployment (ie application) and outcome. A similar conclusion was reached in *Pacific Rendezvous*. The use of the funds was held to be in acquiring assets for the motel business and in augmenting the company's capital. *Pacific Rendezvous* therefore established that if borrowed funds are used in deriving assessable income, and the sufficient connection is established, it does not matter that the funds are also used to achieve a non-taxable outcome. In the Commissioner's opinion, this same reasoning applies to the *Roberts and Smith* situation. If the sufficient connection is established through the use of the borrowed funds, that connection is not lost if there is a second, non-income-related outcome. In *Roberts and Smith*, the two outcomes were the replacement of funds that had a sufficient connection with the derivation of assessable income, and the use of the funds by partners for non-partnership and possibly private uses.

32. The Commissioner's opinion is, following Hill J's judgment, and applying the understanding of "use" that New Zealand Courts have taken, that borrowings used to replace and repay amounts invested in an income earning activity or business will have a sufficient connection with income. In those circumstances, the new borrowings take on the character of the money they replace, and the interest will be deductible if the original funds were used directly in the income earning process. Deductibility will not be affected by a concurrent non-income earning use of the borrowed funds.

A requirement of the replacement and repayment principle—the funds must return to their owners

33. An element of the *Roberts and Smith* replacement and repayment principle is that the repaid funds are returned to the person who originally paid them. The principle stated by Hill J in *Roberts and Smith* is as follows (p 4,390):

> The provision of funds to the partners in circumstances where that provision is not a replacement of funds invested in the business, lacks the essential connection with the income producing activities of the partnership, or in other words, the partnership business.

34. *Roberts and Smith* does not apply when the borrowed funds are paid to someone else other than the person who originally paid them into the income earning activity. In that situation, even though the borrowed funds would be recorded as a liability against the assets, there is no particular connection between the new borrowing and those assets. That situation contrasts with the one where the borrowings are used to repay funds in the partnership that had a sufficient nexus for deductibility. When the new borrowing has the effect of repaying those other funds to the person who contributed them, the replacing funds have a special connection with the funds replaced that can be traced from one use of funds to the other, such that the replacing funds can take the place of the replaced funds and so take on the deductibility nexus of the replaced funds. Funds used to replace but not repay funds do not have that same connection with those amounts and do not inherit any deductibility status.

35. This distinction can be understood from a statutory interpretive point of view. If the *Roberts and Smith* principle extended to borrowings used to replace any amounts in an income earning activity or business, then interest on those funds would in most cases be deductible. That result would be inconsistent with

the presence of a statutory test for deductibility that requires a sufficient connection between interest and income. For example, a business might borrow and use the funds for a non-income use, such as to make a nil interest loan to a sister company, to invest in a company which was barred from making distributions, or to pay criminal fines. The argument might be made that as the borrowing would be reflected in the business' liabilities, it was used in the income earning activity. However, borrowed funds used in that way are not connected with the income earning activity or business. No amount is repaid, and therefore the borrowings cannot inherit any connection with income.

36. Professor Parsons discussed this issue in his paper *Roberts and Smith: Principles of Interest Deductibility*.[1] He argued that the *Roberts and Smith* principle should not be simply that a borrowing inherits the deductibility status of the original borrowing. If that were the rule, then there "would be opened a means of obtaining deductions for interest in respect of money borrowed that is used for private non-income producing purposes". In the Commissioner's opinion, an interpretation of the deductibility provision that would lead to all interest being deductible, in the context of a provision that the Courts have said requires a sufficient connection and apportionment where that connection is not established, cannot be correct.

37. Therefore, in the Commissioner's view, the *Roberts and Smith* principle requires that funds repaid are returned to the person who invested or advanced them.

New Zealand cases relevant to *Roberts and Smith*

Case P56

38. The approach of the TRA in *Case P56* (1992) 14 NZTC 4,386 is similar to the Commissioner's interpretation of *Roberts and Smith*. Partners borrowed to draw out more than they had invested in the partnership. The interest was held to be non-deductible. Willy DJ said that if the partners had replaced capital investments, they would have been entitled to interest deductions. (p 4,396).

Case M127

39. *Roberts and Smith* appears to be inconsistent with *Case M127* (1990) 12 NZTC 2,817. *Case M127* concerned a husband and wife operating a coffee lounge business. They had $76,000 of their own equity invested in the business. There was little available cash. They wished to buy a new dwelling house, and had some cash outside of the business, but were $70,000 short. The partnership paid $70,000 to the husband and wife as individuals. This put the partnership account into overdraft. The partnership then borrowed to repay the overdraft, leaving it with a credit balance of $2,304. In summary, the borrowed funds were used by the partnership to pay back a loan to the bank, which had been taken out to repay partners their capital so that they could buy a house. The effect on the partnership's balance sheet was that the capital contributed by the partners was replaced by the loan.

40. The objectors argued that the borrowed money was used in the production of income. It does not appear from the judgment that they specifically argued that the loans replaced their equity. The case was heard before *Roberts and Smith* was decided, so the taxpayers did not have that case available as a precedent.

41. It is helpful to consider the case in the context of the general principles of interest deductibility. The direct test for interest deductibility, followed in *Pacific Rendezvous v CIR* and *C of IR v Brierley* (1990) 12 NZTC 7,184, requires borrowed funds to be traced to a use that derives income. *Roberts and Smith* is authority that a strict tracing is not required, if the borrowing replaces funds, and the replacement involves a replacement of money actually invested. The direct use of the borrowed funds in *Roberts and Smith* was to pay capital out to partners, who may have used the funds for private use. Hill J said at p 4,388:

> A tracing approach, if carried beyond the payment to the partner, encourages the argument raised by the Commissioner in the present case that the funds were used for the private purpose of the partner who received them. But that fact will not preclude the deductibility of the outgoing. The funds to be withdrawn in such a case were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production of the partnership of assessable income.

42. In *Case M127*, if a strict tracing approach is applied, the loan was used to pay off a business overdraft. That overdraft loan can be traced to private use by the partners. If *Roberts and Smith* is applied to the facts, the second loan can be seen as replacing the overdraft, which in turn replaced the equity. The equity was used directly to fund the partnership's business, and therefore, there is a sufficient connection with income such that the interest is deductible. This reasoning was not argued, or applied by Bathgate DJ. Bathgate DJ held that the interest was not deductible. The case is, therefore, incompatible with *Roberts and Smith*. The objectors may have still failed on the facts, had they argued *Roberts and Smith*, because a large proportion of the $76,000 appears to have been made up of goodwill.

[1] Professor Ross Parsons, Taxation in Australia Red Edition. Vol.1 No.5 June 1993 p.261 at p.266

43. In the absence of *Roberts and Smith*, Bathgate DJ held in *Case M127* that the borrowed funds were used for private purposes. His Honour considered that the first loan by way of overdraft was used to buy the house, the second loan paid back the overdraft, and that neither loan was used in producing partnership income. Instead, the loans were used to purchase the house for the objectors. The interest incurred by the partners was private in nature.

44. The decision in *Case M127* is therefore inconsistent with the decision in *Roberts and Smith*. Although the TRA case is from the New Zealand jurisdiction, a decision of the Full Federal Court of Australia has precedential value, and in the circumstances of this issue the Commissioner considers that a higher New Zealand court would follow the decision in *Roberts and Smith* rather than the TRA decision.

The arrangements to which the replacement and repayment principle applies

Returns of capital to partners

45. The *Roberts and Smith* replacement and repayment principle applies to borrowed funds used to repay partners their capital contributions to the partnership. Interest is deductible on borrowings used to repay capital to partners, to the extent that the capital that was repaid was used in earning assessable income.

46. This view is based on the conclusion that a partnership can transfer property to a partner. However, a partnership is not a legal entity. A partnership consists of a collection of rights and obligations between the partners, and ownership of partnership assets is vested in the partners, not the partnership. It could be argued, therefore, that a partnership cannot repay partnership property to a partner, because the partner already owned that property.

47. A key concept of partnership law is that partners do not have individual rights to partnership property. In *Hadlee & Sydney Bridge Nominees Ltd v C of IR* (1993) 15 NZTC (PC), the Privy Council considered the rights of partners. Lord Jauncey, delivering the judgment, said at paragraph 5 that as a matter of general law a partner does not have title to specific partnership property but has a beneficial interest in the entirety of the partnership assets and in each and every particular asset of the partnership (his Lordship quoting Richardson J in the Court of Appeal *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1991)13 NZTC 8,116, 8,126 and referring to *Lindley on Partnership* 15th edition, page 516).[2] This beneficial interest, expressed in terms of its realisability, is in the nature of a future interest taking effect in possession on (and not before) the determination of the partnership.

48. Molloy says in *Principles of the Law of Partnership*[3] that a receipt received by a partnership remains a receipt of the partnership alone, which is to say by the partners jointly. He says that if an amount is partnership property, it is not an individual entitlement of any particular partner. The individual partner does not derive several income (ie each partner's individual allocation of income) until it has been ascertained whether the overall result for the relevant fiscal period has been that the firm has derived any net assessable income.

49. The point was made in *Crowe v Commissioner of Taxation* (1958) 100 CLR 532 that there is a distinction between partnership property and partner's individual property. The case was concerned with an expense, rather than income, but is relevant because it makes the point that partnership property is not the same as individual entitlements of the partners. In *Crowe* a partnership took out a policy on each of the lives of its four partners. Each policy was for the benefit of all four partners. The premiums were paid by the firm and the policy was in the name of the firm. A provision of the Australian Commonwealth income tax legislation permitted the deduction of "amounts paid by the taxpayer as premiums or sums for insurance on the life of the taxpayer." Fullagar J said that if any of the partners were to have:

> … effected an insurance on her own life, and the partnership had paid a premium on the policy at her request and debited the amount to an advance account in its books, I should have said that she ought to be held to have "paid" the premium, although no money or money's worth passed from her hand to the hand of the insurer.

50. The issue in the case was whether payment by the firm, of the premium on a policy which the firm itself had taken out, had been payment by the taxpayer. Fullagar J answered the question in the negative:

> [T]hat a partnership has, in English law, no legal personality distinct from those of the individual partners … does not mean that there is not a very real difference between a right or obligation of a partnership (or partners as such) and a right or obligation of an individual member of a partnership.

51. The insurance contracts were taken out in the name of the firm, and the firm (and not each individual partner) paid the premiums. The premiums were paid by the partners jointly. It was therefore not a payment made by any one of the individual partners. Similarly, in the Commissioner's view,

[2] Lindley & Banks on Partnership, 17th edition, para. 19-08.

[3] *Principles of the Law of Partnership* sixth edition Webb and Molloy Butterworths Wellington 1996 para. 11.235

income of a firm is derived by the partners jointly, and not individually by each partner.

52. This conclusion is consistent with section HD, which provides that:

> **HD 1 ASSESSMENT OF PARTNERS, CO-TRUSTEES, AND JOINT VENTURERS**
> **HD 1(1)** Where amounts are derived or incurred by 2 or more persons jointly, whether as partners, co-trustees, or otherwise,—
>
> (a) in the case of co-trustees, they include such amounts that would be income or deductions if the co-trustees were a single taxpayer resident in New Zealand in a joint calculation of taxable income and are jointly and severally liable for the resulting income tax liability:
>
> (b) in the case of partners there is no joint assessment, but each partner must, in calculating their taxable income, take into account their share of the income that they jointly derive from the firm:
>
> (c) in any case other than that of co-trustees or partners, each person jointly deriving or incurring such amounts must, in calculating their taxable income, take into account their share of the income that they jointly derive.

53. As partners own an undivided interest in partnership property, and do not have individual title to any particular items of partnership property, there can be a valid legal transfer of property from a partnership to a partner, because the nature of the legal ownership changes from joint ownership to ownership by a single person. Therefore, the *Roberts and Smith* principle can apply to partnerships. The *Roberts and Smith* case of course involved a partnership, and so is authority for this point.

54. Proposals released in an Inland Revenue discussion document in June 2006, *General and limited partnerships – proposed tax changes*[4] to change the law relating to the taxation of partnerships will not, in their current form, affect this conclusion.

55. It should be noted that a return of capital, whether by a partnership or a company, is not connected with income simply because it is an ordinary part of running a business. A return of capital is not part of the income earning activity, it is a transaction relating to the structure of the business. However, there is a sufficient connection with income in this arrangement because, following Roberts and Smith, borrowing to return capital has the effect of replacing and repaying the funding of the income earning activity. In these circumstances, the borrowed funds continue the connection the repaid funds had with income.

[4] A Government discussion document. June 2006

Share repurchases

56. A repurchase of shares by a company involves a payment by a company to its shareholders of amounts previously contributed by shareholders. The effect of the payment by the company is a diminishment of the shareholder's capital holding in the company. This arrangement is analogous to a return of capital to partners in a partnership.

57. Therefore, in the Commissioner's view, the replacement and repayment principle may apply to share repurchases. Interest is deductible on borrowings used to repay share capital to shareholders, to the extent that the capital was used in deriving the company's assessable income.

58. As discussed above, interest incurred by companies will usually be deductible under section DB 7, without the necessity to apply *Roberts and Smith*.

Payments of past years' profits to partners

59. Past years' profits in a partnership, which Hill J refers to as undrawn profit distributions, can be viewed as amounts contributed by partners. If a partner does not withdraw profits, they are allocated to partners equally, or in accordance with the divisions in the partnership agreement (*Principles of the Law of Partnership*).[5] The accounting treatment might be to carry profits to the credit of the partner's respective current accounts by book entry calculated at the end of the accounting period. Although there may not be any active reinvestment by the partners themselves, this process can reasonably be seen as an investment of capital.

60. Therefore, in the Commissioner's view, past years' profits can be seen as reinvestments by partners in the partnership and the replacement and repayment principle may apply. Interest is deductible on borrowings used to repay past years' profits to partners, to the extent that those profits were used in earning assessable income or in the partnership business.

Payments of current year income to partners

61. The Commissioner's opinion is that the principle from *Roberts and Smith* does not extend to borrowings purporting to return the current year income that has not yet been identified as profits. The reason is that current year income is not an amount that has been invested in the partnership by the partners, and so cannot be repaid to partners.

62. The principle from *Roberts and Smith* is that interest may be deductible if borrowed funds repay funds invested in an income-earning activity or business carried on to derive income. The issue with current year income is whether it is an amount that can be repaid. To be repayable, it must have been paid into the partnership by someone. The

[5] ibid para.s 2.48 and 4.109

amount can only have been paid in if someone other than the partnership has had an entitlement to it at some time. Therefore, the issue is to decide whether partners can be said to have become individually entitled to current year income at some time before any purported replacement.

63. To consider this question, the legal nature of current year income will be examined. If current year partnership income is owned by individual partners at any point during the year, it could in theory be invested by partners in the partnership business.

Is current year income partnership property or property of individual partners?

64. The conclusion has already been reached that there is a distinction between partnership property and property belonging to individual partners. In considering the application of *Roberts and Smith* to current year income, the next step is to ascertain whether it is partnership property, or property of individual partners.

65. The Partnership Act 1908 is silent on the treatment of current year income. It provides for the division of profits in section 27:

> 27. Rules as to interests and duties of partners—
>
> The interests of partners in the partnership property, and their rights and duties in relation to the partnership, shall be determined, subject to any agreement (express or implied) between the partners, by the following rules:
>
> (a) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm:
>
> …
>
> (d) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him:

66. Under section 27, partners are entitled to share in any profits, subject to any agreement to the contrary. The concept of "profits" is not defined. There is no particular guidance in the Partnership Act as to when the division and allocation of profits occurs.

67. It has been held in Australia that, for tax purposes, the amount that forms part of each partner's individual income is only ascertainable once partnership accounts have been prepared, and that this would normally be at year end. In *FC of T v Galland* 86 ATC 4885 the High Court held that in the absence of an agreement stating a different balance date, accounts of the partnership would be required to be taken each year as at 30 June and a partner's share of the partnership income would be distributed to the partner as at that date. The Court said that:

> …although a partner is not usually entitled to call for a distribution of profits or net income until accounts have been prepared, he has an individual interest in the net income of the partnership, notwithstanding that the precise amount of his interest cannot be determined until the accounts are prepared for the relevant period.

68. The Court's view is that partners are not [usually] entitled to current year income. The partners have an individual interest in the net income of the partnership, but not an immediate entitlement to the current year income. Galland was quoted by Hill J in *Roberts and Smith* as authority for the proposition that a partner's share of the partnership income is derived by the partner only once annual accounts of the partnership have been prepared. Hill J said:

> In the absence of agreement, accounts for the partnership would be required to be taken each year as at 30 June and a partner's share of the partnership income would be derived by him as at that date: FC of T v Galland.

69. Further, it is in the nature of profits that they have to be identified before anyone can become entitled to them. Fletcher Moulton LJ provided a definition of "profits" in *Re Spanish Prospecting Co. Ltd* [1911] 1 Ch 92 at 98-99 [6] (cited in *Galland*):

> The word "profits" has, in my opinion, a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general practice, although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respect from this fundamental signification. "Profits" implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at two dates … We start therefore with this fundamental definition of profits, namely, if the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question.

70. As Fletcher Moulton LJ points out, as a matter of logic, profits can only be known once they are calculated. They can only be calculated when the amounts of income and expenses for the relevant fiscal period are known. Although amounts will come in that will in due course form profits, until the fiscal period has ended, the amount of profits

[6] This definition was adopted by Williams J in *Dalgety v Commissioner of Taxes* [1912] NZLR 260 at 261-262, and discussed in *The Law of Partnership in Australia and New Zealand Higgins & Fletcher LBC Information Services 2001* eighth edition

cannot be known. It follows, in the Commissioner's opinion, that an entitlement cannot arise until the amount can be known, and it can only be known at the end of the fiscal period. This period, as Fletcher Moulton LJ says, is generally annual.

71. Therefore, the Commissioner's opinion is that a partner does not have an individual entitlement to current year income. Current year income is owned by all of the partners jointly. Individual partners have an ownership interest in it in common with the other partners, but not an entitlement to their potential individual share until profits have been calculated and allocated for a fiscal period.

Discussion of current year income in *Roberts and Smith*

72. In applying the law to the case he was considering, Hill J explained that it was necessary to identify whether the partners received a refund of capital, or whether they received amounts in excess of their capital. Hill J considered capital to be the aggregate amounts contributed by the partners for the purpose of commencing or carrying on the partnership business (p 4,389). The partnership accounts he was considering did not separate out the contributed capital from other items. He thought that it was possible that the amount of capital represented in the partnership accounts included (p 4,390):

- contributed capital;
- internally generated goodwill;
- undrawn distributions;
- profits of the year not yet distributed; and
- asset revaluations.

In Hill J's view, the items that could be replaced with a deductible result were (p 4,390):

- contributed capital;
- undrawn profit distributions;
- advances made by partners; and
- other funds which have actually been invested in the partnership and which the partners were entitled to withdraw.

73. Hill J did not include "profits of the year not yet distributed" (i.e. current year income) as amounts able to be replaced. Hill J's view was that the types of amounts that could be replaced with a deductible result were funds which had actually been invested in the partnership and which the partners were entitled to withdraw at the time of the borrowing.

74. In contrast, Hill J considered that undrawn distributions that have been allocated to partners, but not paid out (i.e. past years' profits), can be replaced with borrowings and the interest would be deductible.

Application of the *Roberts and Smith* principle and the law on partnerships to current year income

75. Partners do not have rights to current year income as it arises during the year, because it is partnership property. Profits are generally determined at year-end. Until the profits are determined at year-end, the partners are not entitled to current year income. Any drawings taken from the partnership's current year income can only be a partner's anticipated share of the profits. Current year income cannot, therefore, be an amount invested in the partnership by the partners. As it is, in the Commissioner's opinion, essential for the *Roberts and Smith* replacement and repayment principle that the funds must be repaid to someone, there must be someone who has had an entitlement to them. Therefore, to be repayable, someone must have invested the funds in the income earning activity or business. Current year income has not been invested so the Roberts and Smith principle does not apply to it.

The difference between current year income and past year's profits

76. Past years' profits can be distinguished from current year profits because partners have become entitled to them, either at a time specified under the partnership agreement or, in the absence of a partnership agreement, when the partnership accounts are required to be taken (*FC of T v Galland*) and they have been notionally allocated to partners. Their status is then as advances to the partnership or new investments of capital. Hill J considered that past years' profits could be viewed as amounts invested, and that they could be repaid with a deductible result.

Payments of dividends

77. The *Roberts and Smith* replacement and repayment principle applies to borrowings used to pay dividends sourced from past year profits, usually described as retained earnings, to shareholders. There is, however, some conceptual difficulty in bringing a company's retained earnings within this principle. The difficulty is in analysing retained earnings as amounts contributed by shareholders. Company profits are not allocated to shareholders at the end of each year. Retained earnings are added to the existing retained earnings. Directors may decide to distribute some of these as dividends, or they may decide not to. Shareholders are not immediately entitled to retained earnings in the way that partners are entitled to partnership profits.

78. There are, however, similarities between a partnership's past years' profits and a company's retained earnings. They share the characteristic that the amount has been finally settled for the year, and the theoretical amount each shareholder (or partner) is entitled to can be established. They

can, in a sense, be seen as the amount a shareholder or partner has invested into the business. The features of partnership profits that do not suggest they have been invested by partners, are also shared by retained earnings. Both retained earnings and partnership profits are at the disposal of the business until the decision is made to pay them out. Just as partners may not necessarily make any active decision to reinvest past profits, shareholders would not usually make any decision to reinvest profits in the business. For these reasons, the Commissioner's opinion is that payment of dividends from retained earnings can be viewed as sufficiently analogous to payments to partners of partnership past years' profits, such that both should be treated the same in determining interest deductibility.

79. Therefore, in the Commissioner's view, retained earnings can be treated as notional reinvestments by shareholders in the company and the replacement and repayment principle should apply. Interest is deductible on borrowings used to pay dividends to shareholders, to the extent that those profits were used in income earning.

80. If company profits are distributed as bonus issues, then similarly the amount represented by the shares can be seen as capital able to be replaced under the replacement and repayment principle.

81. It should be noted that interest incurred by companies will generally be deductible under section DB 7, the provision that gives companies in most situations an automatic deduction for interest, and that *Roberts and Smith* would be an alternative basis for deductibility for interest incurred on borrowed funds used to pay dividends.

Replacement of debt

82. Borrowings used to repay borrowings used in an income earning activity or business are within the *Roberts and Smith* principle. Hill J in *Roberts and Smith* said that where a loan is taken out and used to repay a debt that was used directly in an income earning process or business, the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense. In Hill J's mind, there is no difference in terms of interest deductibility between repaying one debt with another and borrowing to return capital, and both situations should be similarly treated.

83. If the first refinancing takes on the character of the debt it replaces, then logically, subsequent refinancings should also inherit that character. Therefore, the Commissioner's opinion is that interest is deductible on borrowings used to repay other borrowings, to the extent those other borrowings can be traced to a use that gave rise to deductible interest.

Continuation of a statutory nexus

84. The general rule from *Roberts and Smith* is that borrowings may inherit the deductibility status of funds they repay. In some situations, the repaid funds may be deductible by the operation of a specified statutory nexus, rather than the general rule which requires as a question of fact a sufficient connection with income. One relevant nexus is in section DB 7, which provides for automatic deductions for most companies, and the other is in section DB 8, which provides for deductions for companies investing in shares in a group company.

85. Although the nexus in each of these two sections is different in nature from the nexus in *Roberts and Smith*, where the replaced funds achieved the nexus by being used to derive income, nevertheless, the Commissioner considers that the deductibility status should also be inheritable when deductibility is established through a statutory nexus. If it were not, and refinancing meant interest that had been deductible as a matter of law rather than fact was no longer deductible, Parliament's intention for sections DB 7 and DB 8 would be defeated. Therefore, the Commissioner's opinion is that *Roberts and Smith* applies to replacement and repayment of borrowed funds in respect of which deductibility is established under sections DB 7 and DB 8.

What is the treatment if the lender's right is assigned?

86. The Commissioner's view is that the principle from *Roberts and Smith* is that funds may be replaced with borrowed funds and the interest will be deductible, if the repaid funds are returned to their owners. The exception is the replacement and repayment of a debt, where the right to receive the amount advanced has been assigned to someone else. Interest would still be deductible under the principle, because in those circumstances there is still a repayment of funds invested, as the amount can be traced back to the original investor through the assignee.

Is direct tracing required?

87. The replacement and repayment principle requires identifying how the original funds were used, and identifying the use of the new debt to repay those original funds. Therefore, under the principle, the use of funds needs to be identified or "traced".

88. Given the compliance costs that may arise in some circumstances, consideration has been given to whether tracing is essential to the replacement and repayment principle. It is recognised that for some taxpayers, who have daily changes to their borrowings, the requirement may be difficult to fulfill.

89. One approach would be to allow a deduction if the refinancing loan is taken out and the first loan paid back about the same time. However, it seems likely that this "around the same time" requirement would not in practice operate to limit deductibility to arrangements within the principle, and would result in interest on any borrowing qualifying for deductibility.

90. An alternative is that the Commissioner would accept that a loan is a replacement unless it is used solely for a private or exempt use. However, that approach would, in the Commissioner's view, be too wide to be consistent with the statutory requirements, as any use of borrowings would satisfy the test (apart from sole private and exempt uses). The test would not be limited to replacement of funds that are returned to their owners. Without the element of replacement, there would not be a sufficient nexus with income. Uses of funds that would qualify would be those uses that would not seem to be within the intent of the interest deductibility provision such as nil interest loans to sister companies, investments in companies prohibited from making distributions, and so on.

91. Therefore, the Commissioner takes the view that the replacement and repayment principle requires that borrowings should be traced to replacement of funds that satisfy the statutory nexus for deductibility. Taxpayers with few borrowings should usually be able to trace money. Taxpayers with more complicated borrowing practices will, in most case, be companies, for which interest will be deductible under section DB 7, without the need to satisfy the *Roberts and Smith* principle.

92. It should be remembered that all debt is subject to a tracing test. In a number of cases that considered the direct test of interest deductibility, the courts have held that the use of funds must be traced: for example, *Pacific Rendezvous Ltd* and *Brierley*.

When interest is not deductible

Subvention payments

93. Interest incurred by companies is generally deductible under section DB 7. Therefore, interest incurred by a company on borrowed funds used to make a subvention payment would generally be deductible under that section.

94. If section DB 7 does not apply, then the application or not of *Roberts and Smith* becomes relevant. The replacement and repayment principle is that interest is deductible on borrowings repaying funds paid into the business or income earning process. A subvention payment is a payment between companies in a group to reduce the overall tax burden of the group. It is not a replacement of an amount previously advanced by the recipient company, or an amount repaid to shareholders for amounts they invested in the paying company.

95. Therefore, in the Commissioner's view, the use of borrowed funds to pay a subvention payment does not satisfy the replacement and repayment principle from *Roberts and Smith,* and interest incurred on borrowed funds used to pay a subvention payment is not deductible under that principle.

Sole traders

96. The principle in *Roberts and Smith* is that interest is deductible on borrowed funds used to repay funds to investors in an income earning activity or business. This principle applies where an entity—whether a partnership or a company—borrows money and uses it to return amounts invested in the partnership or company. Individuals with an income earning activity or business but who do not operate through a company or any other structure (referred to as a "sole trader"), do not have a separate entity in which to invest their money. If an individual invests money used for private purposes into a business or activity they carry on as a sole trader, there has been no change in ownership of that money. It is artificial to describe a transaction with oneself as a replacement and repayment of funds. Therefore, in the Commissioner's opinion, the replacement and repayment principle cannot apply to sole traders arguing that borrowing funds have the effect of returning their capital or past years' profits.

97. Although a partnership is not a separate legal entity from its partners, as discussed above, there is a distinction between property owned by a partnership and property owned by individual partners. Therefore, in contrast to sole traders, there can be a valid legal transfer of property from a partnership to a partner, and the *Roberts and Smith* principle can apply to partnerships.

98. Professor Parsons raised some arguments that support applying the *Roberts and Smith* principle to individuals in *Roberts and Smith: Principles of Interest Deductibility*.[7] He said that separate accounting records may personify a separate entity. Secondly, he argued that the legislation recognises a sole trader in business as separate from the sole trader in a private capacity, because the deductibility provisions distinguish between individuals in business and individuals not in business. However, he considered that these arguments may be tenuous, and that it will be difficult for a sole trader to establish that interest on borrowings used to withdraw capital is not prohibited as private. Also, Professor Parsons considered these arguments in the context of an interpretation of *Roberts and Smith* that is much broader than the interpretation taken by the Commissioner.

[7] See n 1

99. Although an individual cannot replace capital, an individual can, however, deduct interest incurred in using borrowed funds to replace a debt owed to a third party, where the amount first borrowed was used directly in the individual's income earning activity or business. As the borrowed funds replaced are repaid to a separate entity, the third party lender, the funds are able to be repaid, and so the *Roberts and Smith* principle can apply.

Goodwill and asset revaluations

100. Hill J singled out internally generated goodwill as an amount in the partnership capital account that could not be replaced because it is not an amount that has been invested by someone in the business. At p 4,390, Hill J explained that a payment of goodwill is not a "refund of a pre-existing capital contribution."

101. Glazebrook and James[8] have explained that goodwill cannot be distributed because after a purported distribution, it would still remain. Therefore, internally generated goodwill is not an amount that can be replaced with borrowed funds with a deductible result.

102. However, the situation will be different if goodwill is purchased. In that situation, funds, either equity or debt, are used to purchase the goodwill. These funds can be replaced with borrowed funds and the interest would be deductible.

103. If purchased goodwill is revalued internally, the extent of the internal revaluation is not represented by an amount invested in the business that can be replaced. Therefore, interest on an amount borrowed purporting to replace goodwill to the extent that it is internally generated will not be deductible.

104. Similarly, amounts that are attributable to asset revaluations cannot be repaid and replaced and are not within the *Roberts and Smith* principle.

Private use

105. The Commissioner's view is that when borrowings are used to return partners' capital, the interest may be deductible despite the fact that the direct use of the borrowed funds may be for the private use of the taxpayer. The reason is that the borrowed funds are also used for a concurrent income-related use—the replacement of funds used in deriving income.

106. That situation compares with the one where the borrowed funds replace borrowed funds that are being used solely for private use. In that situation, the interest on the replacing funds will not be deductible.

Australian Tax Office's view on *Roberts and Smith*

107. The ATO has issued a ruling on its interpretation of *Roberts and Smith*. The ATO's view is similar to the Commissioner's view; see TR 95/25 *Income Tax: Deductions for Interest Under Subsection 51(1) of the Income Tax Assessment Act 1936 Following FC of T v Roberts; FC of T v Smith*, issued 29 June 1995. Two addenda have been added to TR 95/25, primarily to update the references in the ruling to the Australian Income Tax Assessment Act 1997. A consistent interpretation of *Roberts and Smith* was applied in TR 2005/12, which relates to borrowings used to repay amounts to beneficiaries.

The Commissioner's view of the deductibility of interest on funds invested in QCs, CFCs and FIFs

108. The second issues paper on interest deductibility, IRRUIP 5, which considered the application of *Roberts and Smith*, discussed the issues of compliance costs. In the context of that discussion, the paper considered the deductibility of interest in investments such as qualifying companies, controlled foreign companies and foreign investment funds that give rise to both assessable and exempt income to the investor. Because these investments give rise to both assessable and exempt income, the issue arises as to whether the interest should be deductible in full. It was concluded in the issues paper that interest incurred on funds invested in these types of companies is deductible in full. If the funds were repaid with new borrowings, applying *Roberts and Smith*, the interest on the replacing funds would take on the deductibility status of the repaid funds.

109. *Roberts and Smith* is concerned with refinancing of investments, and when it applies, the deductibility status of the initial investment is taken on by the replacing funds. It is not necessary to understand the reasons for the deductibility or otherwise of the initial investment to understand the *Roberts and Smith* principle. Because the deductibility of interest incurred in relation to qualifying companies, controlled foreign companies and foreign investment funds is not relevant to an understanding of how the *Roberts and Smith* case applies, the issue is not dealt with further in this commentary or in the rulings.

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[8] "*Taxation Implications of Company Law Reform*" by Susan Glazebrook and Jan James, New Zealand Journal of Taxation Law and Policy, Volume 1 132 at p 157

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.

NATIONAL AVERAGE MARKET VALUES OF SPECIFIED LIVESTOCK DETERMINATION 2007

This determination may be cited as "The National Average Market Values of Specified Livestock Determination, 2007".

This determination is made in terms of section EC 15 of the Income Tax Act 2004 and shall apply to specified livestock on hand at the end of the 2006-2007 income year.

For the purposes of section EC 15 of the Income Tax Act 2004 the national average market values of specified livestock, for the 2006-2007 income year, are as set out in the following table.

NATIONAL AVERAGE MARKET VALUES OF SPECIFIED LIVESTOCK

Type of Livestock	**Classes of Livestock**	**Average Market Value per Head $**
Sheep	Ewe hoggets	54.00
	Ram and wether hoggets	48.00
	Two-tooth ewes	75.00
	Mixed-age ewes (rising three-year and four-year old ewes)	65.00
	Rising five-year and older ewes	48.00
	Mixed-age wethers	37.00
	Breeding rams	215.00
Beef cattle	*Beef breeds and beef crosses:*	
	Rising one-year heifers	406.00
	Rising two-year heifers	620.00
	Mixed-age cows	752.00
	Rising one-year steers and bulls	502.00
	Rising two-year steers and bulls	720.00
	Rising three-year and older steers and bulls	882.00
	Breeding bulls	1546.00
Dairy cattle	*Friesian and related breeds:*	
	Rising one-year heifers	594.00
	Rising two-year heifers	1075.00
	Mixed-age cows	1245.00
	Rising one-year steers and bulls	379.00
	Rising two-year steers and bulls	618.00
	Rising three-year and older steers and bulls	797.00
	Breeding bulls	1067.00
	Jersey and other dairy cattle:	
	Rising one-year heifers	524.00
	Rising two-year heifers	986.00
	Mixed-age cows	1176.00
	Rising one-year steers and bulls	271.00
	Rising two-year and older steers and bulls	461.00
	Breeding bulls	785.00
Deer	*Red deer*	
	Rising one-year hinds	152.00
	Rising two-year hinds	270.00
	Mixed-age hinds	296.00
	Rising one-year stags	184.00
	Rising two-year and older stags (non-breeding)	301.00
	Breeding stags	1226.00

Type of Livestock	Classes of Livestock	Average Market Value per Head $
	Wapiti, elk, and related crossbreeds	
	Rising one-year hinds	172.00
	Rising two-year hinds	302.00
	Mixed-age hinds	359.00
	Rising one-year stags	206.00
	Rising two-year and older stags (non-breeding)	338.00
	Breeding stags	1240.00
	Other breeds	
	Rising one-year hinds	67.00
	Rising two-year hinds	115.00
	Mixed-age hinds	150.00
	Rising one-year stags	86.00
	Rising two-year and older stags (non-breeding)	136.00
	Breeding stags	407.00
Goats	*Angora and angora crosses (mohair producing)*:	
	Rising one-year does	27.00
	Mixed-age does	41.00
	Rising one-year bucks (non-breeding)/wethers	20.00
	Bucks (non-breeding)/wethers over one year	19.00
	Breeding bucks	77.00
	Other fibre and meat producing goats (Cashmere or Cashgora producing):	
	Rising one-year does	31.00
	Mixed-age does	43.00
	Rising one-year bucks (non-breeding)/wethers	30.00
	Bucks (non-breeding)/wethers over one year	29.00
	Breeding bucks	140.00
	Milking (dairy) goats:	
	Rising one-year does	170.00
	Does over one year	250.00
	Breeding bucks	300.00
	Other dairy goats	25.00
Pigs	Breeding sows less than one year of age	187.00
	Breeding sows over one year of age	231.00
	Breeding boars	324.00
	Weaners less than 10 weeks of age (excluding sucklings)	56.00
	Growing pigs 10 to 17 weeks of age (porkers and baconers)	107.00
	Growing pigs over 17 weeks of age (baconers)	176.00

This determination is signed by me on the 24th day of May 2007.

Susan Price
Senior Tax Counsel

CORRECTION

There is an error in the TIB Vol 18, No 7 (August 2006). At page 31, the item "Provisional Depreciation Determination PROV16" shows the estimated useful life of "Marble rock instruments", as appearing in both tables of the item, to be "2.5" years. This should read "25" (twenty five) years. The depreciation rates remain unchanged. We apologise for this error.

NEW LEGISLATION

TAXATION (KIWISAVER AND COMPANY TAX RATE AMENDMENTS) ACT 2007

The Taxation (KiwiSaver and Company Tax Rate Amendments) Bill was introduced into Parliament under urgency on 17 May 2007. The bill was tabled during the Budget debate and passed through its final stages in Parliament on 17 May. It gave effect to Budget announcements of a company tax rate reduction, an associated reduction for certain savings vehicles, and the new tax credit for members of KiwiSaver schemes. The bill also made technical changes to the portfolio entity tax rules and to the KiwiSaver Act 2006, to ensure the smooth introduction of KiwiSaver in July. The resulting Act received Royal assent on 21 May 2007.

The Act amends the Income Tax Act 2004, the Tax Administration Act 1994, the KiwiSaver Act 2006, the Companies Act 1993, the Superannuation Schemes Act 1989, the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 and the Goods and Services Tax (Grants and Subsidies) Order 1992.

KIWISAVER AMENDMENTS

Sections CX 1B, KJ 1 to KJ 5 and OB 1 of the Income Tax Act 2004; section 68C of the Tax Administration Act 1994; sections 4, 6, 14, 25, 46, 56, 93 to 94, 128A, 209, 233 and clauses 12, 14 and 17 of Schedule 1 of the KiwiSaver Act 2006; section 35 of the Superannuation Schemes Act 1989; and the schedule to the Goods and Services Tax (Grants and Subsidies) Order 1992.

The government announced a set of enhancements to KiwiSaver in Budget 2007. The enhancements include a tax credit for contributions paid by members of a KiwiSaver scheme or a complying superannuation fund. The Act also makes a number of technical amendments relating to KiwiSaver and the complying superannuation fund rules.

The Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill was also introduced into Parliament on 17 May 2007. The bill introduced further Budget announcements, including the KiwiSaver employer tax credit and compulsory employer contributions. The bill received its first reading on 17 May and was referred to the Finance and Expenditure Committee for consideration. It is expected to be enacted by the end of the year.

Key features

Member tax credit

From 1 July 2007, people who contribute to a KiwiSaver scheme (or a complying superannuation fund)[1] will be eligible for a member tax credit that matches the amount of their contribution to the scheme up to $1,042.86 a year ($20 a week). The member tax credit applies to contributions received by the scheme in the member credit year (1 July to 30 June).

[1] A complying superannuation fund is a section within a registered superannuation scheme that has been approved by the Government Actuary as having met certain criteria, such as those relating to KiwiSaver lock-in rules and portability.

The tax credit will be available to employees, the self-employed and other people who are not employees, such as beneficiaries. Employer contributions and contributions withdrawn under a mortgage diversion facility do not count for purposes of the member tax credit.

Eligibility for the member tax credit

The tax credit will be available to:

- members of a KiwiSaver scheme or a complying superannuation fund; and
- who are 18 years of age and over; and
- whose principal place of residence is in New Zealand; or
- who are government employees who are living outside New Zealand; or
- who are working overseas as a volunteer or for token payment for a charitable organisation named in the Student Loan Act regulations.

A person's principal place of residence is considered to be the main (principal) place where the person resides or their main abode. That is, one's home or dwelling place – the place where one lives. "Home" is defined in the Shorter Oxford Dictionary as "the fixed residence of a family or household, one's own house, the dwelling in which one habitually lives or which one regards as one's proper abode". In *Geothermal Energy Ltd v CIR* [1979] 2 NZLR 324, Justice Beattie stated that "home" "…is simply the location of what for the present constitutes the centre of gravity of the domestic life of the taxpayer – the axis around which his domestic life revolves". This suggests that it is where the member normally lives.

Example 1

On 2 July 2007, Kara begins working at the local bakery. Kara is a New Zealand citizen and is 17 years old. Because Kara is under 18 years of age, she is eligible to join KiwiSaver but is not entitled to the member tax credit. If Kara joins KiwiSaver she will receive the $1,000 kick-start contribution and the fee subsidy.

Example 2

Graham is a 44-year old KiwiSaver member, who is married with three children and lives in Christchurch. Graham gets seconded to Melbourne for three months and rents an apartment there for the duration of his secondment. Graham returns to Christchurch every second weekend and his family visits him in Melbourne for a week during his stay. As Graham's principal place of residence is in Christchurch with his wife and family, Graham is eligible for the member tax credit for any contributions he makes during this period.

In order for a member of a KiwiSaver scheme or a complying superannuation fund to receive the total member tax credit of $1,042.86 a year, they must satisfy the eligibility criteria each day of the member tax credit year.

Example 3

Elaine joins KiwiSaver on 1 April 2008, 91 days before the end of the member credit year (30 June 2008). Elaine makes contributions to her KiwiSaver scheme during this 91-day period totalling $2,000. To work out Elaine's member tax credit entitlement for the 2007–2008 member tax credit year the formula is:

Number of days Elaine has been a member of KiwiSaver during the member credit year ÷ by 365 × the lesser of either the:

- amount of contributions Elaine has made to her KiwiSaver scheme during the member tax credit year; or
- $1,042.86.

91 ÷ 365 × $1,042.86 = $260

Example 4

Ian joins KiwiSaver on 1 April 2008, 91 days before the end of the member tax credit year (30 June 2008). Ian makes contributions to his KiwiSaver scheme during this 91-day period totalling $900. Ian's member tax credit entitlement for the 2007–2008 member credit year is:

91 ÷ 365 × $900 = $224.38

Members of a KiwiSaver scheme or a complying superannuation fund will be ineligible for a member tax credit upon the date of eligibility for fund withdrawal from a KiwiSaver scheme. That is, the later of:

- reaching the New Zealand superannuation qualification age (currently 65); or
- the date on which they have been a member of a KiwiSaver scheme or complying superannuation fund for five years.

Example 5

Anna joins KiwiSaver on 6 January 2008, the day of her 61st birthday. Anna will be entitled to the member tax credit for the contributions she has made to her KiwiSaver account until 6 January 2013, the day on which she will have been a member for five years (that is, the date of eligibility to withdraw funds).

Payment of the member tax credit

The superannuation provider will claim tax credits annually (on 30 June) on behalf of individual members. However, it can also claim a part-year tax credit for those who stop being a member of KiwiSaver or a complying superannuation fund during the year. When it receives the tax credit, the provider will apportion it across the investments the member has subscribed to or been allocated. If the person involved is a member of both a KiwiSaver scheme and a complying superannuation fund (or a member of more than one complying superannuation fund), the amount of the credit will be apportioned between the schemes on the basis of the contributions made to each.

Withdrawal of the member tax credit

Withdrawal of the member tax credit will be permitted in the following circumstances:

- the later of the date of eligibility for New Zealand Superannuation (currently 65 years) or five years' membership in a KiwiSaver scheme;
- in cases of serious illness; and
- upon death, to the member's estate.

Withdrawal of the member tax credit will not be permitted in the following circumstances:

- to assist with the purchase of a member's first home;
- for purposes of significant financial hardship; or
- to help with mortgage repayments (mortgage diversion).

If members permanently emigrate and withdraw their interest, the nominal value of the tax credit, up to the value of their accumulation in their scheme, will be repaid to the government. There is no requirement to withdraw from a KiwiSaver scheme upon permanent emigration.

Treatment of tax credit for tax purposes

The member tax credit will be treated as excluded income for income tax purposes. For GST purposes, it will be treated as a non-taxable grant or subsidy.

Miscellaneous amendments regarding the member tax credit

The Act makes associated amendments to the definition of "complying fund rules" in the Income Tax Act 2004 and to section 56 of the KiwiSaver Act (notification of transfers and requirement to transfer funds and information). The purpose of the changes is to ensure that member tax information is transferred when a member transfers to another fund.

The Act incorporates the terms relating to the member tax credit into the KiwiSaver and complying superannuation fund trust deeds. The amendment also ensures that the law relating to this tax credit applies despite anything to the contrary in the trust deed.

The Act provides a transitional measure in relation to prospectuses and investment statements issued before 1 July 2007, to ensure that they remain valid as a result of the new member tax credit. The Act also amends the KiwiSaver Scheme rules in Schedule 1 of the KiwiSaver Act to reflect the member tax credit.

The Act amends the definition of "Crown contribution" to include the member tax credit.

Further KiwiSaver amendments

Employer contributions to KiwiSaver schemes

From 1 July 2007, it will be mandatory for all employer contributions to a KiwiSaver scheme to be paid through Inland Revenue using the employer monthly schedule process. This requirement is to allow Inland Revenue to police the payment by employers of the proposed compulsory employer contribution. The change is being made from 1 July 2007, to minimise compliance costs for employers in having to change systems from 1 April 2008, when the proposed compulsory employer contribution comes into force. Section 94 has been repealed as a result of this requirement.

Complying superannuation fund rules

The Act amends the definition of "complying fund rules" in the Income Tax Act 2004 and section 35 of the Superannuation Schemes Act, to ensure that the rules for complying superannuation funds apply to superannuation schemes (or sections within schemes) that are defined contribution schemes in nature, as intended.

Government employees

The Act clarifies how the KiwiSaver Act applies to government employees who are serving outside New Zealand. KiwiSaver will apply to them only if they are employed under New Zealand terms and conditions and if it is lawful to offer KiwiSaver membership in the jurisdiction they are serving in. Furthermore, the amendment to section 14 will exclude government employees working overseas from the automatic enrolment rules.

The Act amends the definition of "permanent employees" in section 25 and section 46, to exclude employees who are not subject to the automatic enrolment rules. As a result, employers will be:

- eligible to be an exempt employer even though some employees who work overseas are not able to join; and
- able to choose a KiwiSaver scheme to which all new permanent employees will be allocated, even though some new permanent employees who work overseas are not able to join.

A government department will not be excluded from being an exempt employer because they have some employees who are living overseas in a jurisdiction where offers of membership to KiwiSaver may be unlawful.

Application dates

The amendments relating to the member tax credit and employer contributions to KiwiSaver schemes come into force on 1 July 2007. The amendments relating to government employees and the complying superannuation rules came into force on the date of enactment, 21 May 2007.

CHANGES TO THE COMPANY TAX RATE

Section HL 20 and Schedule 1 of the Income Tax Act 2004

The tax rate for companies and certain savings vehicles has been reduced from 33% to 30%. The reduction is consistent with the government's economic transformation goals of increasing productivity and improving New Zealand's international competitiveness.

The top rate for portfolio investment entities has been capped at 30%, instead of the previous 33%, while the tax rate for certain widely held savings vehicles has also been lowered to 30%.

The new tax rates are intended to encourage savings and implement a more neutral tax treatment of different savings entities.

Background

The changes give effect to announcements made in Budget 2007, to lower the tax rate for companies and certain savings vehicles.

As a result of these changes, a number of transitional and consequential amendments are required to the Income Tax Act 2004 and the Tax Administration Act 1994 to reflect the reduced tax rates. These amendments (excluding provisional tax) are included in the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill, which was introduced into Parliament on 17 May 2007 and is expected to be enacted by the end of 2007.

Key features

Clause 5 of Schedule 1 has been amended to reduce the company tax rate from 33% to 30%. The definition of "company" includes a unit trust, so this new rate also applies to unit trusts (see Bonus Bonds Trust below).

Clause 1 has been amended to reduce the tax rate on life insurance policyholder income from 33% to 30%.

The definition of "portfolio investor rate" has been amended to reduce the maximum tax rate for portfolio investment entities that are portfolio tax rate entities from 33% to 30%. Consequential amendments have been made to the definition of "prescribed investor rate" and section HL 20(9).

Clause 7 has been amended to reduce the tax rate on group investment funds deriving category A income (which is taxed as if it were a company) from 33% to 30%.

A change has been made to clause 4 (trustee income) to exclude a number of widely held investment vehicles which are ordinarily subject to the 33% trustee tax rate. These vehicles are subject to a 30% tax rate under new clause 8B, which refers to:

- an approved unit trust to which the Income Tax (Exempt Unit Trusts) Order 1990 applies. The Bonus Bonds Trust is an approved unit trust. The 1990 Order considers the unit trust not to be a company. Income earned by the trust is taxed at the 30% rate under clause 8B;
- a widely held superannuation fund; and
- a widely held group investment fund (GIF). This applies to GIFs if they derive category B income or are designated GIFs.

To be a "widely held superannuation fund" or a "widely held GIF" a vehicle must satisfy either:

- the investor membership requirements that a portfolio investment entity must satisfy (which is generally that the vehicle must have more than 20 members when the vehicle is treated as having one portfolio investor class comprising all the investors); or
- certain criteria that a qualifying unit trust must satisfy. Generally, the vehicle must be a retail one with at least 100 members. However, the 100-member rule can be relaxed in certain circumstance if the vehicle is genuinely widely held.

Finally, as a result of the change to the company tax rate, the dividend withholding payment rate also reduces from 33% to 30% (section NH 2(1)).

Application dates

The new tax rates apply from the beginning of the 2008–09 income year, except for portfolio investment entities that do not pay provisional tax and that attribute income to members on a daily or quarterly basis. For these portfolio investment entities, the new maximum rate will apply from 1 April 2008.

PROVISIONAL TAX

Sections MB 4, MB 7, MB 9, MB 10, MZ 10 to MZ 12 and OB 1

Transitional uplift factors relating to the calculation of provisional tax instalments have been introduced. Specifically, where the base year is 2007–08 or earlier and provisional tax is being calculated for the 2008–09 or later income years then:

- when a 105% uplift is generally required, the transitional factor is 95%;
- when a 110% factor is generally required, the transitional factor is 100%; and
- when the GST ratio method is used that is based on residual income tax (RIT), the transitional factor is 90%.

The transitional uplift factors have been introduced so that provisional tax liabilities are not overstated as a result of basing provisional tax instalments on a previous year's RIT.

Background

A number of options for calculating provisional tax instalments rely on the taxpayer's RIT for a previous year. Basing provisional tax instalments on a previous year's RIT will have the effect of overstating provisional tax instalments if the taxpayer is a company or a savings vehicle.

Key features

The calculation factors are detailed in Table 1.

Table 1

Provisional tax year	Based on RIT for	Current uplift	Transitional uplift or discount
Standard method (including 6-monthly GST method)			
2008–09	2007–08	105%	95% (multiply 2007–08 RIT by 95%)
2008–09	2006–07	110%	100% (multiply 2006–07 RIT by 100%)
2009–10	2007–08	110%	100% (multiply 2007–08 RIT by 100%)
GST ratio for 1 and 2-monthly filers			
2008–09	2007–08 and earlier years	100%	90% (multiply 2007–08 RIT by 90%)
2009–10	2007–08 and earlier years	100%	90% (multiply 2007–08 RIT by 90%)

Sections MB 4 (methods for calculating provisional tax liability), MB 7 (GST ratio method), MB 9 (calculating amount of instalment under standard and estimation methods) and MB 10 (calculating amount of instalment using GST ratio) have been amended by providing sign posts to new sections MZ 10, MZ 11 and MZ 12. Each of these new sections applies when a person or a portfolio tax rate entity is a new tax rate person, and uses the 30% tax rate for the 2008–09 and later income years.

Section MZ 10 signals the transitional uplift factors for the standard method of calculating provisional tax instalments for the purposes of section MB 4.

Section MZ 11 reduces the uplift factor for the GST ratio for one and two-month filers to 90%.

Section MZ 12 reduces the uplift factors for the standard method of calculating provisional tax instalments (including 6-monthly GST filers) from 105% to 95%, and from 110% to 100%, respectively.

Application date

The new transitional rules apply from the start of the 2008–09 income year.

REMEDIAL AMENDMENTS TO THE PORTFOLIO INVESTMENT ENTITY TAX RULES

Sections CB 4B, CP 1, CX 44C to CX 44E, DB 17, DB 43B, DB 43C, EB 2, EX 1, HL 5 to 10, HL 11B, HL 12, HL 14, HL 15, HL 16, HL 19, HL 20, HL 21, HL 23, HL 23B, HL 24, HL 26, HL 27, HL 28, HL 30, HL 31, IG 1, KI 1, LD 10, LD 10B, LD 11, NG 1, and OB 1 of the Income Tax Act 2004; sections 31B, 33A, 36 and 57B of the Tax Administration Act 1994; section 53 of the Companies Act 1993; and section 97B of the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006

A number of technical amendments have been made to the portfolio investment entity tax rules to give effect to the policy intent of the rules. The changes provide collective investment entities that elect to be portfolio investment entities with the necessary flexibility to implement the rules and ensure that different commercial arrangements can be accommodated. The amendments also make a number of technical corrections to the rules. These changes will enable a smooth introduction of KiwiSaver and the portfolio investment entity rules on 1 October 2007.

Background

The new tax rules for portfolio investment entities were enacted at the end of 2006 and address a number of long-standing problems with the taxation of collective investment vehicles. The effect of the new rules is that, from 1 October 2007, people that invest in a collective investment vehicle that elects to be a portfolio investment entity will be taxed in a broadly similar manner to a person that made the same investment directly. This is achieved by providing portfolio investment entities with tax relief on certain Australasian share gains, applying the new fair dividend rate method for non-Australian share gains, and ensuring that the investment earnings that low-income people derive through portfolio investment entities are taxed at 19.5%.

Since the rules were enacted, a number of technical issues with the application of the rules have arisen. These changes address these issues and provide collective investment vehicles with the necessary flexibility to implement the new rules.

Key features

Section HL 20 has been amended to provide that the portfolio entity tax liability is calculated for a portfolio calculation period and a portfolio investor class and each investor in the portfolio investor class.

The new section HL 23B allows portfolio tax rate entities that pay tax under sections HL 21 or HL 23 to make voluntary payments of tax when an investor partially reduces their interest in a portfolio investor class. As the amount of tax that is paid under section HL 23B is voluntary it is left to the discretion of the entity to calculate the amount of tax payable. This will accommodate the different ways entities calculate tax when an investor partially exits a portfolio investor class.

A number of changes have been made to section HL 27 to deal with various issues that have arisen in relation to the way portfolio tax rate entities allocate and use tax credits. One of the main changes ensures that tax credits attributable to an investor in a portfolio tax rate entity that is itself a portfolio tax rate entity, can flow through to the portfolio tax rate entity investor without limitation.

Section HL 28 has been amended to set more appropriate rules on a portfolio investment entity's use of portfolio entity formation losses. Broadly, the new rules will require portfolio investment entities to spread the use of portfolio entity formation losses over three years. These losses cannot be used to offset net income when the portfolio investment entity has income covered by New Zealand tax credits.

The definition of "portfolio investor rate" in section OB 1 has been amended so that the top rate of tax in a portfolio tax rate entity is 30% (instead of 33%). This amendment applies from the 2008–09 and later income years.

Application dates

The application date for most of these changes is 1 October 2007, to coincide with the commencement of the portfolio investment entity rules. The amendment that reduces the top rate of tax in a portfolio tax rate entity from 33% to 30% applies from the 2008–09 and later income years. The amendment to the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 that ensures entities can elect on or after 1 April 2007 to be a portfolio investment entity applies from 1 April 2007.

Detailed analysis

Calculation of portfolio entity tax liability for an investor as a member of a portfolio investor class

Section HL 20 has been amended to ensure that the portfolio entity tax liability is calculated for a portfolio calculation period and a portfolio investor class and each investor in the portfolio investor class. Before the amendment, the portfolio entity tax liability was calculated for a portfolio calculation period and an investor (that is, as being the sum of the portfolio entity tax liability for each portfolio investor class that the investor is a member of). There was no ability for a portfolio tax rate entity to calculate the tax liability for the investor as a member of a portfolio investor class.

The new approach will allow portfolio tax rate entities to calculate a tax liability for an investor as a member of a portfolio investor class and apply the investor's share of the tax credits for the class (both foreign and New Zealand) accordingly. The provisions relating to foreign and New Zealand tax credits have also been amended so that credits can be allocated to an investor and used to reduce their liability as a member of a portfolio investor class. This is discussed in more detail below.

It is important to note that these changes would not generally prevent a portfolio tax rate entity from applying an investor's tax credits to reduce the investor's portfolio entity tax liability across all their classes. That is, in addition to allowing a portfolio investor class-based approach to calculation of tax liabilities and utilisation of credits, the amended rules will also support the former approach of allowing an investor's portfolio entity tax liability to be reduced by all of the investor's available foreign and New Zealand tax credits. The way tax credits can be utilised (especially foreign tax credits) is relevant where a tax liability is triggered when an investor reduces their interest in a portfolio tax rate entity.

The new approach is designed to accommodate the different commercial arrangements that a portfolio tax rate entity may have.

Payment of tax on switches between portfolio investor classes and partial exits

New section HL 23B allows portfolio tax rate entities that pay tax under section HL 21 or HL 23 to make voluntary payments of tax when an investor fully or partially exits a portfolio investor class.

This change allows portfolio tax rate entities to pay tax when an investor switches from one investor class to another within the same entity, and also to accommodate partial exits from a portfolio investor class (which may be a reduction in an investor's interest in the entity rather than a switch to another class). In both cases, without the amendment, the rules would not have triggered a tax liability.

Before this amendment, an investor that switched between portfolio investor classes would not have triggered a taxable event under the rules. This is because, for portfolio tax rate entities that pay tax under section HL 21 or HL 23, the previous rules provided that a taxable event would arise mid-period only if there was a so-called "portfolio investor exit period". A portfolio investor exit period arises when an investor's portfolio investor interest (defined in the context of their interest in the entity) is less than their portfolio entity tax liability. Therefore, a switch between portfolio investor classes would not have triggered a portfolio investor exit period as it would not have resulted in a reduction in an investor's interest in the entity (that is, a reduction of the interest relating to one class would be offset by an increase in the interest relating to another class).

Similarly, a withdrawal from a portfolio investor class would not have triggered a taxable event if the interest being withdrawn was not sufficiently significant to give rise to a portfolio investor exit period. That is, a taxable event would not have been triggered if the remaining interest in the entity exceeded the tax liability that would otherwise have arisen in respect of the amount withdrawn. This is what is referred to as a partial exit.

A portfolio tax rate entity that pays tax under section HL 21 or HL 23 now has the option of treating switches between investor classes as a taxable event under section HL 23B and, as a result, section HL 7. That is, if an investor withdraws from a portfolio investor class (either completely or partially) and reinvests the funds in another portfolio investor class of the same entity, then the entity can elect to pay the tax for the part of the year before the withdrawal.

Similarly, if there is a partial exit from a portfolio tax rate entity that pays tax under section HL 21 or HL 23, the entity can elect to pay tax for the portion of the interest that was withdrawn. This includes switches between portfolio investor classes that are not complete withdrawals.

As the application of section HL 23B is voluntary, a portfolio tax rate entity that pays tax under section HL 21 or HL 23 can choose not to pay tax for investors switching between classes, or when there are partial exits from a portfolio investor class or the entity as a whole.

Income allocated by portfolio tax rate entities to partial withdrawals

If an entity elects to make optional payments of tax on reductions of investor interests, the portfolio entity tax liability referred to in the new section HL 23B is up to the portfolio tax rate entity to determine. Because the payment of tax is voluntary it is left to the discretion of the entity to calculate the amount of tax payable. In any case, an accurate tax calculation for the investor as a member of a portfolio investor class is required at the end of a quarter or a tax year.

This effectively means that a portfolio tax rate entity has the option of calculating an investor's portfolio entity tax liability either on the actual interest that is redeemed, or it can choose to treat the interest being cancelled as a proportion of the investor's interest in the entity as a whole. In the latter case, under section HL 23B the entity is able to calculate the tax liability on the interest redeemed as a proportionate share of the investor's tax liability for all portfolio investor classes that the investor has an interest in. An example illustrates:

An investor has an interest in Class A and Class B of a portfolio tax rate entity that pays tax under section HL 23. On two days the classes derive portfolio investor allocated income and portfolio investor allocated loss as outlined in Example 1. At the end of day two the investor redeems 20 percent of their interest in Class A. The 20 percent redemption represents a 10 percent redemption of the investor's interest in the entity.

Example 1

	Class A	**Class B**
Day 1	Income = $100	Income = $20
Day 2	Loss = $80	Income = $10

Under the proportionate approach, total income for the investor is $50. Therefore, given the investor redeems 10 percent of their interest in the portfolio tax rate entity, the entity could pay tax under section HL 23B on $5. Alternatively, the entity could pay tax in relation to the amount actually redeemed. This means that tax could be paid on 20 percent of income attributable to class A (20% x $20 = $4).

Section HL 23B allows both approaches to calculating the tax liability when there is a partial exit from a portfolio investor class as outlined above.

Under the changes to the definition of "portfolio investor exit period" (in particular, paragraph (b) of the definition), a portfolio investor exit period arises where the portfolio entity tax liability for an investor for a portfolio investor class and any other class exceeds the investor's portfolio investor interest for the portfolio investor class and any other class. In other words, a portfolio investor exit period arises if the total accumulated tax liability for the investor exceeds the value of their interest in the entity as a whole.

If a portfolio investor exit period arises, section HL 23(2) requires a tax payment, the amount of which is the portfolio entity tax liability of the entity for the portfolio investor exit period – that is, the total accumulated tax liability across all classes.

Option for a section HL 21 portfolio tax rate entity to pay tax rather than zero-rate when an investor withdraws

Under new section HL 23B, if an investor in a portfolio investor class of a portfolio tax rate entity that pays tax under section HL 21 withdraws their interest in the class or the entity in a quarter, the entity has the option of paying the tax relating to the quarter in which the exit occurs, rather than zero-rating the withdrawal.

If this is the case, then a portfolio investor exit period does not arise and the investor does not need to include any income relating to the quarter in which the withdrawal was made in their tax return. This has the benefit of ensuring that the income relating to the period of the withdrawal remains excluded income of the investor.

Again, because the application of section HL 23B is voluntary, the entity would still have the option to zero-rate the investor. In this case it would be the responsibility of the investor to pay the resulting tax liability.

Timing of optional tax payment

An optional payment of tax under section HL 23B must be made to Inland Revenue by the end of the month following the month in which the investor switch or partial exit occurred, in the case of an investor in a portfolio tax rate entity that pays tax under section HL 23. Optional payments of tax relating to investors in portfolio tax rate entities that pay tax under section HL 21 are due at the same time as the normal quarterly tax payment.

Rebates under section KI 1 can also arise on investor switch or partial exit from a portfolio tax rate entity that pays tax under section HL 23. The timing for payment of these rebates is the same as would occur if tax was payable. An amendment to section HL 26(2) has been made to provide this rebate mechanism for partial exits.

Consequential amendments to the definition of portfolio investor exit period

The definition of "portfolio investor exit period" in section OB 1 has been consequentially amended to ensure that it applies generally on a portfolio investor class basis, and is therefore consistent with subpart HL.

However, a portfolio investor exit period continues to arise when there is a reduction in an investor's interest so that the investor's total remaining interest in the entity across all classes is less than the tax liability relating to the reduction.

For portfolio tax rate entities that pay tax under section HL 23, this means they are only required to pay tax for an investor on a part-year basis if there is a portfolio investor exit period. However, as discussed above, these entities can make voluntary payments of tax under section HL 23B when investors partially exit a class or the entity as a whole.

For investors in portfolio tax rate entities that pay tax under section HL 21, a portfolio investor exit period does not arise if the entity has made a payment of tax under section HL 23B sufficient to meet the relevant portfolio entity tax liability for the investor. This ensures that any income allocated in the quarter in which the investor withdrew their interest, and on which the entity has paid tax, is still considered as excluded income under section CX 44D.

A section HL 7 adjustment

As the section HL 23B payment gives rise to a portfolio entity tax liability of the entity, an adjustment under section HL 7 to reflect the liability is required. The maximum period for making this adjustment is discussed in more detail below.

Investor return adjustment in section HL 7 can apply for an investor's interest in a portfolio investor class or their interest in a different class

Section HL 7 has been amended to allow a portfolio tax rate entity to perform an investor return adjustment to reflect the effect of the investor's portfolio investor rate as a member of a portfolio investor class. Previously, the investor return adjustment had to be performed for the investor's interest in the entity as a whole.

It should be noted, however, that a portfolio tax rate entity still has the flexibility to perform the investor return adjustment to whatever portfolio investor interest of the investor that the entity considers is required. This is because, under the amended section HL 7(3), the entity can adjust the investor's portfolio investor interest in the relevant class, or their interest in another class. This means that a portfolio tax rate entity can adjust an investor's interest in any way it sees fit to reflect the tax paid. This change, like the changes to section HL 20 and the tax credits provisions (described below), provides greater flexibility for portfolio tax rate entities.

Remedial changes to section HL 7(3) provide that the investor return adjustment must be made within two months of the end of the tax year, if the entity has made an election to pay tax under section HL 23.

The legislation allows the investor return adjustment to be made more frequently than within two months of the end of a calculation period or a tax year (depending on the type of portfolio tax rate entity). Section HL 7(3) specifies the maximum timeframe for making the return adjustment. It is not intended to preclude an entity making adjustments to investor interests earlier, if this is desired from a commercial perspective.

Allocation of portfolio investor allocated income to zero-rated portfolio investors aligned with investor's income year

Previously, investors in portfolio tax rate entities that are zero-rated portfolio investors with non-standard balance dates were treated as deriving portfolio investor allocated income (or loss) in an income year, if the relevant income allocation period fell within their income year. Portfolio tax rate entities that pay tax under sections HL 21 and HL 23 must operate on a 31 March tax year basis. This could have resulted in zero-rated portfolio investors having to return income for two tax years of the entity, in their income year.

For example, an investor with a 30 June balance date would have needed to include all portfolio investor allocated income derived between 1 July 2008 and 30 June 2009 in their 2008–09 tax return. In contrast, the 2008–09 tax year for the portfolio tax rate entity would be from 1 April 2008 to 31 March 2009. The investor would therefore need to include their share of the income in the entity's 2009–10 tax year as well (the three months from 1 April 2009 to 30 June 2009). However, income information for the 2009–10 tax year would not be communicated to the investor until 30 June 2010 and would not separately identify the 1 April to 30 June income.

Sections CP 1 and HL 24 have been amended so that zero-rated portfolio investors with non-standard balance dates only derive in an income year an amount of portfolio investor allocated income from a portfolio tax rate entity that relates to the portfolio allocation periods in the entity's income year that end in the investor's income year.

Similarly, zero-rated portfolio investors with non-standard balance dates only have in an income year an amount of portfolio investor allocated loss, in relation to a portfolio tax rate entity that pays tax under section HL 21 or HL 23, that relates to the portfolio allocation periods in the entity's income year that end in the investor's income year. No portfolio investor allocated loss arises in relation to a portfolio tax rate entity that pays tax under section HL 22.

Amendments have also been made to section HL 27 to ensure that the allocation of foreign and New Zealand tax credits matches the allocation of the income for non-standard balance date zero-rated investors.

Under these changes, the investor in the example above would only be treated as deriving in their 2008–09 income year (the period 1 July 2008 to 30 June 2009) the portfolio investor allocated income or loss that relates to the portfolio tax rate entity's 2008–09 tax year (1 April 2008 to 30 March 2009). Any portfolio investor allocated income relating to the period 1 April 2009 to 30 June 2009 would not be included in the investor's return of income for 2008–09, as this relates to the portfolio tax rate entity's 2009–10 tax year. Similarly, only the investor's share of New Zealand and foreign tax credits that relate to the portfolio tax rate entity's 2008–09 tax year would be available as a credit in the investor's 2008–09 income year.

Foreign tax credits

Consistent with the changes to sections HL 20 and HL 7, section HL 27 has been amended so that tax credits (both foreign and New Zealand) are allocated to an investor as a member of a portfolio investor class, and are able to be used by a portfolio tax rate entity to reduce the investor's portfolio entity tax liability relating to the portfolio investor class. In the case of foreign tax credits, depending on whether application of foreign tax credits is restricted to the tax liability of an investor as a member of a specific portfolio investor class or all portfolio investor classes the investor has an interest in, a different tax result may arise.

A number of amendments have been made to add greater flexibility to the way a portfolio tax rate entity (particularly entities that pay tax under section HL 23) can use tax credits. The provisions do not remove other options available under the portfolio investment entity tax rules.

Foreign tax credits allocated to investors each day

Under section HL 27(3), foreign tax credits are allocated for each portfolio allocation period (for example, a day) to each investor as a member of a portfolio investor class. The amount of foreign tax credit allocated is based on the investor's share (that is, the investor fraction) of the class's share of the foreign income which gives rise to the credit.

Foreign tax credits can only be used by a portfolio tax rate entity to reduce the portfolio entity tax liability of the investor to which they have been allocated. Therefore, a portfolio tax rate entity must track foreign tax credits allocated to each investor in a tax year. This is also necessary because an investor who exits a portfolio investor class during the tax year, but re-enters the class in a future period within the same year, should be able to get the benefit of any foreign tax credit not previously used.

The allocation of foreign tax credits to investors (which will occur daily in most cases), and the ability of a portfolio tax rate entity to use the credits to pay the portfolio entity tax liability for an investor, should be distinguished. The ability for a portfolio tax rate entity to use foreign tax credits is given under section HL 27(10). Similarly, if the investor is a zero-rated portfolio investor, section HL 27(7) governs the ability of the investor to use foreign tax credits to reduce the tax liability on their portfolio investor allocated income. A number of changes have been made to these sections. These are discussed in greater detail below.

Foreign tax credits can be used to reduce a portfolio entity tax liability for any portfolio investor class of the investor

Foreign tax credits allocated to an investor as a member of a portfolio investor class can be used by a portfolio tax rate entity as a credit against income tax payable by the entity for the investor as a member of that class. Under the amendments to section HL 27(10), a portfolio tax rate entity can also use foreign tax credits that have been allocated to the investor as a member of one portfolio investor class, to reduce the portfolio entity tax liability of the investor for another portfolio investor class.

Therefore, amended section HL 27(10) gives flexibility to portfolio tax rate entities in the way that they make use of foreign tax credits allocated to investors. If foreign tax credits can be used across different portfolio investor classes of the same investor, rather than just to reduce the portfolio entity tax liability of the class that gives rise to the credit, a different tax result will arise. Example 2 illustrates.

If an entity chooses to use foreign tax credits allocated to an investor only against the portfolio entity tax liability of the portfolio investor class which gives rise to the credit, the total portfolio entity tax liability for Class A would be $0 (and no foreign tax credit would be able to be used). For Class B, a liability of $25 with an available credit of only $10 would arise. On the other hand, if the portfolio tax rate entity chooses to utilise the credits available to the investor as a member of both Class A and Class B to reduce the aggregate tax liability for the investor, the liability would be $25, with total available foreign tax credits of $15. In this case, the investor would benefit from having an extra $5 of tax credit.

Example 2

	Class A	Class B
Day 1	PETL = $10 (FTC = $5)	PETL = $15 (FTC = $10)
Day 2	PETL = –$10 (FTC = $0)	PETL = $10 (FTC = $0)

The above result would be an absolute tax difference, rather than a tax timing difference, as any excess foreign tax credits are forfeited at the end of a tax year. In other circumstances, a class approach to utilising foreign tax credits may be more beneficial – for example, where the overall entity result for the investor is a loss but they have foreign tax credits allocated to investment classes that are profitable.

The amended legislation allows both approaches outlined above, to provide greater flexibility to portfolio tax rate entities.

New section HL 27(10B) outlines the amount of foreign tax credit that is available to be used in a portfolio calculation period to reduce an investor's portfolio entity tax liability as a member of the portfolio investor class that gives rise to the credit, or as a member of another portfolio investor class.

The amount of the credit is the lesser of available allocated foreign tax credits (excluding credits used in previous calculation periods) and the amount of the investor's portfolio entity tax liability (again, excluding credits used to meet tax liabilities in previous periods).

Foreign tax credits allowed to be carried back to reduce a portfolio entity tax liability of an investor in previous portfolio calculation periods

The amendments to section HL 27 ensure that foreign tax credits can be used for the benefit of an individual investor in a portfolio tax rate entity that pays tax under section HL 23, in a tax year, irrespective of the portfolio calculation period in which they arise.

Under the changes, a portfolio tax rate entity that pays tax under section HL 22 or HL 23 can use foreign tax credits to reduce an investor's portfolio entity tax liability in the portfolio calculation period in which the credit is allocated and earlier portfolio calculation periods in the same tax year.

This effectively allows foreign tax credits allocated to an investor to be carried back (as well as forward) to previous allocation periods in the tax year. This provides a more consistent income year approach to the use of foreign tax credits by a portfolio tax rate entity, rather than use of the credits being limited to the day in which they arise and any future period. Any foreign tax credits unable to be used at the end of the tax year would, as previously, be forfeited.

A broadly similar approach applies to a portfolio tax rate entity that pays tax under section HL 21 – the main difference being that foreign tax credits can only be carried back within a portfolio calculation period.

Foreign tax credits allocated to zero-rated investors

Under the amended section HL 27(7), foreign tax credits that are allocated to investors in a portfolio tax rate entity that are themselves portfolio tax rate entities can be used by these investor entities without restriction.

This allows such investors to flow-through the allocated foreign tax credits to their investors each day. Previously, all zero-rated investors in portfolio tax rate entities were restricted to the lesser of the allocated foreign tax credit or the entity's share of the portfolio investor allocated income multiplied by the entity's basic tax rate for the relevant tax year. This is no longer the case for investors in portfolio tax rate entities that are themselves portfolio tax rate entities.

Section HL 27(8) has been amended to deal with foreign tax credits allocated to zero-rated investors that are not portfolio tax rate entities. For these investors the maximum the investor can use in their income year is the lesser of the amount of the credit that is allocated or:

- for an investor with a portfolio investor exit period in a portfolio tax rate entity that pays tax under section HL 21, the amount calculated by multiplying the investor's portfolio investor rate by their portfolio investor allocated income for the exit period;
- for a zero-rated portfolio investor in a portfolio tax rate entity that pays tax under section HL 21 or HL 23, the amount calculated by multiplying the basic statutory rate of tax for the investor by their portfolio investor allocated income for the tax year.

As noted earlier, amendments have also been made to align the foreign tax credits allocated in a tax year of the portfolio tax rate entity to the income year of zero-rated investors with non-standard balance dates.

New Zealand tax credits

Section HL 27(11), which deals with credits other than foreign tax credits under subpart LC, allows New Zealand tax credits to be used by a portfolio tax rate entity in a similar manner to foreign tax credits.

That is, the total amount of New Zealand tax credits available can be used for a portfolio entity tax liability for an investor's interest in a portfolio investor class. This is relevant for an investor who exits from a portfolio tax rate entity that pays tax under section HL 23 or when an entity elects to make optional payments of tax under proposed section HL 23B. Example 3 illustrates.

Example 3

	Class A	**Class B**
Day 1	PETL = $50 (NZTC = $33)	PETL = $20 (NZTC = $0)
Day 2	PETL = $50 (NZTC = $0)	PETL = $70 (NZTC = $15)

The investor withdraws 50 percent of his interest in Class A. The investor's share of the tax liability for the interest redeemed is $50. The entity can use the investor's total allocation of New Zealand tax credits over both classes – that is, $48 (not just the $33 credit relating to Class A) – to reduce this tax liability to $2.

As any excess New Zealand tax credits that are allocated to individuals can be rebated, this flexibility alters the timing of tax payments rather than the amount of tax paid. The rules do not require an entity to follow the above approach – that is, using New Zealand tax credits allocated to an investor as a member of one portfolio investor class to offset the investor's portfolio entity tax liability in relation to another portfolio investor class. This is simply another option available to portfolio tax rate entities.

As noted earlier, consequential amendments align New Zealand tax credits allocated in a tax year of the portfolio tax rate entity to the income year of zero-rated investors with non-standard balance dates.

New rules for use of portfolio entity formation loss

The new legislation:

- Removes the requirement to reduce the amount of any rebate under section KI 1 or a deduction under section DB 43 in relation to portfolio entity formation losses used in a tax calculation period. Portfolio investor allocated losses can be rebated without restriction and similarly there is no reduction in the amount of loss allowed as a deduction to zero-rated investors in portfolio tax rate entities. Sections KI 1(3) and DB 43(2) have been repealed to achieve this.
- Allows a portfolio tax rate entity to use portfolio entity formation loss without restriction to reduce class net income for a portfolio investor class in a portfolio allocation period, if the total portfolio entity formation loss of the entity is less than 5 percent of the total market value of the entity's portfolio entity investments. Section HL 28(3) has been replaced by new section HL 28(3)(a) to achieve this.
- Allows a portfolio tax rate entity, whose portfolio entity formation loss exceeds 5 percent of the entity's market value, to use on each day of the first three years of the entity's existence, up to 1/1095 of the total portfolio entity formation loss of the entity to reduce any class net income for a portfolio investor class of the entity on that day. Under this change:
  - when there is insufficient class net income for a portfolio investor class on a day, the day's allocation of portfolio entity formation loss can be carried forward and added to the next day's allocation of portfolio entity formation loss;
  - if there is an amount of portfolio entity formation loss that has not been used after the end of the three-year period, the total amount of unused portfolio entity formation loss can be used without restriction to reduce class net income for a portfolio investor class and a portfolio allocation period.

  New sections HL 28(4) and (5) contain the formula for calculating the amount of portfolio entity formation loss that may be allocated to a portfolio allocation period.

New Zealand tax credits must be used before portfolio entity formation losses

Portfolio entity formation losses allocated under new section HL 28(3) cannot be used to reduce the class net income of a portfolio investor class of an entity if sufficient New Zealand tax credits are available in a portfolio allocation period to offset the portfolio entity tax liability that would otherwise arise.

New Zealand tax credits are defined as imputation credits, credits for resident withholding tax, dividend withholding payment credits and Māori authority credits. There is no restriction in relation to the use of portfolio entity formation losses where a portfolio investor class has foreign tax credits (that is, credits for foreign NRWT deducted) in an allocation period.

Under new sections HL 28(6) and (7), the amount of portfolio entity formation loss allowed to be allocated to a portfolio allocation period is the lesser of:

- the maximum allowable portfolio entity formation loss for the allocation period (calculated under section HL 28(4)); or
- the amount by which the class net income of a portfolio investor class for the allocation period exceeds the total New Zealand tax credits allocated to the period, grossed up to an amount by dividing by the statutory rate of tax for a company.

Clarification that formation losses can be held at the entity or portfolio investor class level

While section HL 28 treats portfolio entity formation losses as arising at the entity level, a portfolio tax rate entity can choose for portfolio entity formation losses to be held at a portfolio investor class level. When calculating class taxable income under section HL 19, a class's shares of a portfolio entity formation loss should be determined. The methodology for determining each class's share is left to the entity. It therefore follows that the rules do not prevent an entity from dividing the entity's formation losses between classes on becoming a portfolio tax rate entity.

Investor fees to be allowed as a deduction against portfolio entity tax liability for an investor

The formula in section HL 20(4) which calculates the portfolio entity tax liability for an investor in a portfolio investor class has been amended to allow certain fees relating to an investor's portfolio investor interest to be taken into account. That is, a deduction for fees charged to an investor's account (calculated as the amount of fees multiplied by the portfolio investor rate of the investor) can be used to directly reduce the portfolio entity tax liability for the investor. The fees that would be deductible are those that are charged to the investor for ongoing management and administration services, including switching fees, in relation to their portfolio investor interest. These fees should be spread over each portfolio allocation period the investor is present in a portfolio investor class.

As the fees charged are specific to the investor, section HL 20(4) is the appropriate mechanism to ensure that each investor's individual fee circumstances are accurately reflected. The formula also takes into account any fee rebates credited to the investor's account (these rebates would increase the portfolio entity tax liability of the investor, as they would be taxable if paid directly to the investor).

This change to allow fees to reduce the income tax payable by the entity, on behalf of investors, is designed to prevent investors having to file a tax return to get a deduction separately. Consequently, new section DB 43C has been added to prevent fees charged by portfolio tax rate entities that are included in the portfolio entity tax liability calculation under section HL 20, being deductible separately to the investor. Similarly, new section CX 44E has been added to prevent any fee rebates being separately taxable to the investor. These amounts are treated as excluded income to the investor.

Consequential changes to reflect the deduction of fees and addition of fees rebates have also been made to section HL 24, which calculates the portfolio investor allocated income and portfolio investor allocated loss for an investor.

Unlisted companies allowed to temporarily qualify as a portfolio listed company

New section HL 11B allows certain unlisted companies to temporarily be treated as portfolio listed companies if they meet a number of criteria. These criteria include:

- the company would meet paragraph (a) of the definition of "qualifying unit trust" in section OB 1 (if it were a unit trust); and
- the company has resolved to become listed on a recognised New Zealand exchange if it were to obtain the required consents; and
- the company has applied to the Securities Commission for an exemption to disclose in its prospectus its intention to become a listed company; and
- the company satisfies the Commissioner that it would apply to become a listed company if it obtained the required consents.

The company must be listed on a recognised exchange within two years from when it first elected to be a portfolio investment entity in order to retain portfolio listed company status.

The definition of "portfolio listed company" has been consequentially amended so that a company that is eligible under section HL 11B temporarily qualifies as a portfolio listed company.

Foreign investment vehicles can invest through other foreign investment vehicles

Section HL 5 has been amended to allow a foreign investment vehicle to own more than 20 percent of another foreign investment vehicle. This allows a foreign investment vehicle to hold investments through other foreign investment vehicles.

Section HL 5 also allows foreign investment vehicles to hold their investments through trusts when the foreign investment vehicle is the sole beneficiary.

Other amendments – Income Tax Act 2004

- Amendments have been made to various sections of the Income Tax Act 2004 to ensure that the New Zealand Superannuation Fund receives the same treatment as a portfolio investment entity. These include amendments to sections CX 44C(1) and (2) to ensure that the New Zealand Superannuation Fund is not taxed on proceeds from the disposal of shares in New Zealand-resident companies and certain Australian-resident listed companies.
- Section CX 44D(3)(a)(i) has been amended to remove the reference to zero-rated portfolio investors as this term is not relevant in relation to portfolio listed companies. The amendment ensures that a natural person, other than a trustee, can elect to treat a distribution from a portfolio listed company as a taxable amount.

- Section CX 44D(3)(b) has been amended to provide that distributions from portfolio listed companies are not treated as excluded income if the distributions are fully dividend withholding payment credited. This ensures that non-resident investors in portfolio listed companies are still subject to non-resident withholding tax on dividends which carry full dividend withholding payment credits. Section NG 1(2)(a) has been consequentially amended to remove a redundant reference.
- Section HL 8 has been amended to ensure that only portfolio listed companies must attach full imputation credits (to the extent available) to distributions. The previous wording of section HL 8 could have been interpreted to include other portfolio investment entities, which were not intended to be covered by the provision.
- Section HL 10(2) has been amended to ensure that portfolio investment entities that derive portfolio investor allocated income from investments in other portfolio investment entities and/or distributions from superannuation funds meet the income type requirement under the eligibility rules.
- Sections HL 10(3) and (5) have been amended so that they refer to the market value of the underlying investment held, rather than voting interests, in the case of investments in unit trusts. Before this change, there was an argument that the entity and class shareholding investment requirements could be circumvented for an investment by a portfolio investment entity in a unit trust.
- Section HL 10(4) has been amended to remove investments in a life insurer from the exception to the entity shareholding investment requirement for a portfolio investment entity.
- Section HL 12 has been amended to ensure that failures to meet the eligibility requirements under section HL 4 are considered when an entity becomes a portfolio investment entity.
- Section HL 15 has been amended to allow portfolio tax rate entities that have a portfolio calculation period of a quarter to elect a portfolio allocation period of a month by giving notice to the Commissioner before the start of a tax year or when the entity chooses to become a portfolio tax rate entity.
- Section HL 16 has been amended to clarify that a portfolio tax rate entity can allocate a portfolio investor interest to an investor for a portfolio allocation period if the investor has an unconditional entitlement to the interest at the end of a vesting period. The maximum duration of a vesting period, under section HL 16(2)(e)(ii), has also been increased to five years (from three years previously) to align with vesting periods for certain KiwiSaver funds.
- Section HL 31 has been amended to require a portfolio investor proxy to provide information to a portfolio investment entity concerning whether the portfolio investor proxy would cause the portfolio investment entity to breach the eligibility criteria. As a consequence of this amendment, section HL 6(1)(a)(ii) has been removed.
- Section IG 1(2) has been amended to clarify that the rules for determining which companies are treated as a group of companies do not apply for portfolio tax rate entities, rather than portfolio investment entities generally. In particular, a portfolio listed company can be included in a group of companies.
- New section LD 10B is being added to allow a credit to a zero-rated portfolio investor for any income tax paid by a portfolio tax rate entity in relation to the investor's portfolio investor allocated income.
- Sections LD 10(2) and LD 11(2) have been amended to ensure that a taxpayer receives as a tax credit the amount of any income tax actually paid by the portfolio tax rate entity, in relation to an amount of portfolio investor allocated income that is not excluded income under section CX 44D(1)(b) or where the income relates to a portfolio investor exit period under section HL 21(5).
- Section NG 1(2)(f) has been amended to ensure that distributions from portfolio tax rate entities to non-residents are not subject to further tax through deduction of non-resident withholding tax.
- The definition of "income tax liability" has been amended to include income tax that is calculated under subpart HL for a portfolio tax rate entity.
- The definition of "portfolio investor rate" in section OB 1 has been amended to allow portfolio tax rate entities to apply an updated rate that the investor has provided before the end of the year and use that rate for amounts that the entity has not yet calculated a liability for the purposes of the rules. The definition has also been amended so the top rate of tax in a portfolio tax rate entity is 30% (instead of 33%). The latter amendment applies from the 2008–09 and later income years.
- The definition of "portfolio land company" has been amended to clarify that a company is considered a portfolio land company if the company owns land or shares in a portfolio land company that comprises 90 percent of the gross assets of the company on 80 percent or more of the days in the income year in which the company has gross assets of more than $100,000.
- The definition of "portfolio tax rate entity" has been amended so that it refers to a portfolio defined benefit fund and not a defined benefit fund.

- The definition of "prescribed investor rate" has been amended to clarify that the $60,000 threshold in paragraph (b)(ii) is calculated taking into account both an investor's portfolio investor allocated income and loss. A further clarification to the definition has been made to provide that the 0% rate applies if the investor is a portfolio investment entity, other than a portfolio investment entity or superannuation fund which has a trustee that has elected a 33% tax rate.

Amendments to the Tax Administration Act 1994

- Section 31B has been amended to ensure that investors in portfolio tax rate entities that pay tax under section HL 21 and have a portfolio investor exit period, are issued with information that the Commissioner considers relevant to the exit period, at the end of the month following the quarter in which the exit period ends. Section 31B has also been amended to provide that portfolio tax rate entities must give a statement to zero-rated portfolio investors on an annual basis only. References to "income year" have also been changed to "tax year" to better align with core provisions.
- Section 33A(1)(b) has been amended to ensure that zero-rated portfolio investors (or investors in portfolio tax rate entities that pay tax under section HL 21, and have a portfolio investor exit period) receiving small amounts of portfolio investor allocated income do not have to file a return where these amounts, combined with other types of income which have not been correctly taxed at source, is $200 or less.
- The return filing date for portfolio tax rate entities and portfolio investor proxies in section 57B has been amended to cater for non-standard balance dates.

Amendments to other statutes

- Section 53(2) of the Companies Act 1993 has been amended to correct a cross-referencing error.
- The Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 has been amended to ensure that entities can make an election to be a portfolio investment entity from 1 April 2007 (although the date that the election is effective will be on or after 1 October 2007).

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 07/04 DISCRETIONS TO BE EXERCISED BY THE COMMISSIONER OF INLAND REVENUE UNDER THE KIWISAVER ACT 2006

Introduction

1. This Standard Practice Statement ("SPS") sets out:

   (a) the Commissioner's practice when exercising some of the principal discretions conferred by the KiwiSaver Act 2006, and

   (b) the requirements for employees, members or employers who request the exercise of the Commissioner's discretions.

2. In particular, this SPS discusses the exercise of the Commissioner's discretions to:

   (a) accept or decline late opt-out requests, or

   (b) refund or not refund pre-opt-out contributions and excess contributions, or

   (c) refund or not refund initial contributions on the grounds of significant financial hardship and/or serious illness, or

   (d) accept or decline applications for contributions holidays on the ground of financial hardship, or

   (e) accept or decline requests for reconsideration of discretionary decisions (late or otherwise).

Contents

3. The headings of the key issues discussed in this SPS are set out below:

Application

4. Unless specified otherwise, all legislative references in this SPS refer to the KiwiSaver Act 2006 ("the Act").

5. This SPS applies to:

   (a) employees who are automatically enrolled as KiwiSaver members under section 15 or other natural persons who opt into membership under section 33 ("members"), and

   (b) employers subject to subpart 1, Part 3 of the Act ("employers").

6. Pursuant to section 4(1), members are natural persons who have been admitted to memberships of KiwiSaver schemes and who are, or may become, entitled to benefits under those schemes.

7. This SPS does not apply to:

   (a) natural persons who are not subject to the Act under section 6, or

   (b) exempt employers under section 30.

8. Please note that when this SPS is published, some remedial amendments to the Act have been introduced in the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill ("the Bill"). The proposed amendments to the Act appear in italics throughout the SPS but may not reflect the final wording of the Act. In particular, the standard practice relating to *PAYE intermediaries* or *compulsory employer contributions* will apply only if the Bill is enacted. It is expected that this SPS will be updated from time to time.

9. This SPS uses certain terms that are not defined in the Act. Set out below are some of these terms:

    (a) "*Opt-out requests*" are opt-out notices that members provide under section 17(1) within the period specified in section 16.

    (b) "*Opt-out period*" is the period specified in section 16 for making opt-out requests that starts on the 13th day and ends on the 55th day after the date on which the members commenced their employment (members are entitled to opt out of the KiwiSaver scheme during this period).

    (c) "*Late opt-out requests*" are opt-out requests that the Commissioner receives outside the opt-out period and within three months, that is, pursuant to section 4(3), within 92 days from the date that the Commissioner receives the first contributions in respect of the members and to which any of section 18(1)(b)(i) to (iv) applies.

    (d) "*Pre-opt-out contributions*" are contributions paid in respect of members that are in the Commissioner's possession after the member has opted out.

    (e) "*Excess contributions*" are amounts of contributions that exceed the amounts that must be deducted under the Act and are in the Commissioner's possession.

    (f) "*Significant financial hardship and/or serious illness refund requests*" are members' applications for refunds of initial contributions made under section 113(1) on the grounds of significant financial hardship and/or serious illness.

    (g) "*Contributions holidays requests*" are applications for contributions holidays made under section 102 (which are effectively applications for temporary breaks from making contributions).

    (h) "*Financial hardship contributions holidays requests*" are contributions holidays' requests made under section 102(a) on the ground of financial hardship.

    (i) "*Reconsideration requests*" are applications made by affected persons under section 212(2) for the reconsideration of any of the Commissioner's discretionary decisions made under Parts 2 and 3 of the Act, which are made within twenty working days from the date that the Commissioner gave the affected persons notice of the discretionary decision.

    (j) "*Late reconsideration requests*" are reconsideration requests made after twenty working days from the date that the Commissioner gave the affected persons notice of the discretionary decisions that the Commissioner may accept under section 212(2).

Background

10. The Act permits voluntary work-based savings schemes to be established to facilitate individual's savings habits, principally through the workplace.

11. The purpose of the Act is to:

    (a) encourage long-term savings habits and asset accumulation by individuals who may not otherwise enjoy standards of living in retirement similar to those enjoyed before retirement, and

    (b) increase individuals' well-being and financial independence particularly in retirement and provide retirement benefits.

12. The Commissioner will administer the KiwiSaver schemes, including allocating members' and their employers' contributions to the members' respective scheme providers for investment, through the pay-as-you-earn ("PAYE") system in accordance with the PAYE rules set out in subpart NC of the Income Tax Act 2004 ("ITA 2004").

Legislation

13. The relevant legislative provisions are:

    (a) paragraph (a)(iii) of the definition of "tax" and the definition of "disputable decision" in section 3(1), Part IVA and sections 6, 6A, 14, 14B, 138E and 173L of the Tax Administration Act 1994 ("TAA"), and

    (b) the definition of "PAYE intermediary" in section OB 1 and subparts NBA and NC of the ITA 2004, and

    (c) sections 29 and 35(6) of the Interpretation Act 1999, and

    (d) sections 4(3), 6, 16 to 18, 21, 22, 60, 69, 75, 80, 81, 100, 102 to 114, 212, 217, 218, 221, 222, 224, 226 and clauses 11 to 13 in Schedule 1 ("KiwiSaver scheme rules").

Standard Practice and Relevant Discussion

Making requests to the Commissioner

14. Section 217(2) provides that persons must give notices in writing ("make written requests") under section 14B(2) of the TAA if the Act requires them to give notices to the Commissioner (for example, opt-out notices under section 17(1)(a) and (2)(a)). However, the Commissioner's discretions to allow

requests under sections 17(2)(b), 103(1) and 113(3) are not limited by section 14B of the TAA. That is, section 217(2) does not apply if the Commissioner allows other forms of requests.

15. For the purposes of this SPS, persons who do not need to make written requests to the Commissioner by the operation of section 217(2) may give notices ("make requests") to the Commissioner:

    (a) in person at an Inland Revenue office during working hours, or

    (b) by telephone, or

    (c) in writing.

16. For the purposes of paragraphs 14 and 15(c), persons may make written requests to the Commissioner by:

    (a) personally delivering the requests to any Inland Revenue office during working hours, or

    (b) sending the requests:

        (i) by facsimile to Inland Revenue, or

        (ii) by e-mail on Inland Revenue's secure Online Correspondence Service, or

        (iii) to an Inland Revenue office by post.

Opt-out requests

Opting out

17. Members can make opt-out requests during the opt-out period (please see the discussion in paragraph 31). However, if that period has expired and:

    (a) the Commissioner, or

    (b) the members' employer, or

    (c) the employers' PAYE intermediary,

    receives the opt-out requests within three months of the Commissioner receiving the members' first contributions, the Commissioner may accept the late opt-out requests. In this circumstance, the Commissioner will usually accept the late opt-out requests if any of the following factors applies:

    (a) any of the omissions specified in section 18(1)(b)(i) to (iii) has occurred (as summarised at paragraph 39), or

    (b) an event outside the member's control caused the opt-out request to be late under section 18(1)(b)(iv) and the Commissioner considers it reasonable to accept the late opt-out request.

How to opt out

18. Section 17(2) allows members to opt out of their KiwiSaver scheme memberships by making opt-out requests to:

    (a) the Commissioner, or

    (b) their employers, or

    (c) *PAYE intermediaries*,

    if the opt-out requests are in:

    - the forms contained in the information packs, or
    - any other form and manner that the Commissioner allows (for example, by letter, telephone or in person).

19. For the purposes of this SPS and sections 17 to 20, a PAYE intermediary is:

    (a) defined in section OB 1, and acts under subpart NBA of the ITA 2004 (that is, a person accredited as a PAYE intermediary under section NBA 2 with employer arrangements approved by the Commissioner under section NBA 3), and

    (b) treated as an employer.

Making opt-out requests

20. Members must make written opt-out requests by using the forms included in the information packs unless the Commissioner allows them to make requests in another form and manner under section 17(2)(b).

21. Pursuant to section 17(1)(a), members must make written opt-out requests to the Commissioner by one of the methods set out in paragraph 16.

22. Pursuant to section 17(1)(b), members can also make written opt-out requests to:

    (a) employers, or

    (b) *PAYE intermediarie*s,

    by one of the methods set out in section 218. That is, by:

    (a) personal delivery to:

        (i) non-corporate employers or *PAYE intermediaries* at any time, or

        (ii) corporate employers' or *PAYE intermediaries*' offices during working hours, or

    (b) electronic means of communications if the members comply with the Electronic Transactions Act 2002, or

(c) sending the requests by post to the employers or *PAYE intermediaries* at:

(i) the street addresses of their usual, or last known places of:

(A) residence, or

(B) business, or

(ii) any other acceptable addresses that the employers or *PAYE intermediaries* have advised to the members.

23. Members may make opt-out requests under section 17(2)(b), that is, in a form and manner allowed by the Commissioner, by giving the requests to:

(a) the Commissioner by one of the methods set out in paragraphs 15 and 16, or

(b) their employers or *PAYE intermediaries* by:

(i) personal attendance, or

(ii) telephone, or

(iii) any one of the methods set out in paragraph 22.

Requisite information for opt-out requests

24. Members making opt-out requests must provide all requisite or essential information to enable the Commissioner to positively identify the members and their employers.

25. The information the Commissioner requires under section 17(3) for positive identification may vary from case to case. However, members should generally provide their:

(a) full name, and

(b) home address, and

(c) telephone number, and

(d) Inland Revenue Department number ("IRD number"), and

(e) bank account number (if available), and

(f) employment commencement date, and

(g) employers':

(i) business names (including the location if the employer has multiple business locations), and

(ii) IRD number (if known).

26. Furthermore, members must sign and date any written opt-out requests.

27. Section 17(3) gives the Commissioner the discretion not to accept opt-out requests that do not contain essential or correct information. In practice, the Commissioner will accept opt-out requests containing minor omissions or errors if the members and their employers can still be positively identified. However, in some cases (for example, if the requests are unsigned), the Commissioner will confirm the opt-out decisions with the members and may request further information after positively identifying the employees and their employers.

28. The following examples clarify the information requirements for effective opt-out requests.

29. **Insufficient information:** the Commissioner receives a written opt-out request made under section 17(2)(b). The opt-out request names ABC Limited (a fast-food chain's trade name) as the member's employer but does not specify the location of the particular restaurant franchise where the member is employed (that is, the street name and the city). In this circumstance, the Commissioner does not initially accept the opt-out request because there is insufficient information to positively identify the employer. However, the Commissioner will request further information from the member to positively identify their actual employer.

30. **Unsigned opt-out request:** the Commissioner receives an unsigned opt-out request from a member. The Commissioner cannot accept the opt-out request or refund the pre-opt-out contributions into the bank account stated in the opt-out request at this stage because the opt-out request is unsigned and therefore the Commissioner cannot verify the bank account number. However, the Commissioner will accept opt-out requests which contain minor omissions or errors in the information provided, but do not affect the Commissioner's positive identification of the members and their employers. The Commissioner will usually contact the member to verify their decision to opt out.

The opt-out period

31. Pursuant to section 16, members must make opt-out requests (that is, during the opt-out period) by one of the methods set out under the heading "How to opt out".

32. Pursuant to section 16, opt-out requests made in person or by telephone are treated as made within the opt-out period if made to:

(a) non-corporate employers or *PAYE intermediaries* by the end of the last day of the opt-out period ("last day"), or

(b) corporate employers or *PAYE intermediaries* during working hours on the last day, or

(c) the Commissioner by the end of Inland Revenue's usual business hours on the last day.

However, if the last day is not a working day, as defined in section 29 of the Interpretation Act 1999, and the member does not work on that day then, pursuant to section 35(6) of the Interpretation Act 1999, the last day will be the next working day. Under sections 217(2) (opt-out requests given to the Commissioner) and 218(8) (opt-out requests given to employers or *PAYE intermediaries*) opt-out requests sent by post are treated as having been made on the last day if they would have been delivered in the ordinary course of post.

33. Pursuant to section 17(4), opt-out requests given to employers including *PAYE intermediaries* that the Commissioner accepts take effect on the later of:

    (a) the 13th day after the date that the member commenced employment, and

    (b) the day that the employers received them.

34. Pursuant to section 17(4), opt-out requests given to, and accepted by the Commissioner take effect on the later of:

    (a) the 13th day after the date that the member commenced employment, and

    (b) the day that they are accepted (this applies in most cases).

35. If a member opts out, their contributions will usually be refunded. Please see paragraphs 56 to 62 regarding the Commissioner's practice to refund pre-opt-out contributions under section 80(1)(a) or (b).

36. The following examples clarify when the Commissioner would consider that the members have made opt-out requests.

37. On 1 October 2007, Tui commences work for a twenty-four hour service station called Gamma Limited and becomes a KiwiSaver member. Tui is rostered to work the night shift on 24 November 2007 (the 55th day after the date she commenced employment with Gamma Limited). Tui arrives at work at 11pm and gives a completed opt-out request to her employer. In this circumstance, the opt-out request is made in time because Tui has given it to her employer during working hours on the last day of the opt-out period.

38. Jake commences work for Beta Limited on 28 January 2008, a business that operates seven days a week. Jake becomes a KiwiSaver member. On 22 March 2008, (that is, the 54th day after he commenced his employment), Jake completes an opt-out request. However, 23 March 2008, (that is, the 55th day) is a Sunday. All Inland Revenue offices and the office of his employer's *PAYE intermediary* will be closed. In this circumstance, Jake must give the opt-out request to his employer during its normal Sunday working hours to ensure it is received within the opt-out period. Otherwise, Jake's opt-out request will be treated as a late opt-out request and can only be accepted if the Commissioner exercises the discretion under section 18(2).

Late opt-out requests

39. Pursuant to section 18(2), the Commissioner may accept opt-out requests that:

    (a) the Commissioner, or

    (b) the employer, or

    (c) a PAYE intermediary,

    receives, or is deemed to receive in the ordinary course of post:

    (a) after the opt-out period has expired, and

    (b) before the expiry of three months, that is, 92 days, after the date the Commissioner receives the member's first contribution if:

        (i) section 18(1)(b)(i) applies because the employer did not supply an information pack to the member within seven days of their commencement of employment with that employer, or

        (ii) section 18(1)(b)(ii) applies because the Commissioner did not send an investment statement to the member for their provisionally allocated default KiwiSaver scheme under section 50(3)(c), or

        (iii) section 18(1)(b)(iii) applies because the employer did not supply an investment statement for their chosen KiwiSaver scheme to the member under section 43 if that choice is effective, or

        (iv) section 18(1)(b)(iv) applies because events outside the member's control meant that they could not make an opt-out request and the Commissioner considers it to be reasonable to accept the request.

Essential information not supplied by the members' employers or the Commissioner

40. When members' opt-out requests are late, they can rely on any one of the omissions set out in section 18(1)(b)(i) to (iii). Members must specify the relevant omission(s) relied on. The Commissioner will consider, on a case-by-case basis, all the information provided and undertake any necessary investigations when determining whether to accept late opt-out requests made on these grounds.

41. The Commissioner considers that the following guidelines apply in determining whether omissions have occurred for the purposes of section 18(1)(b)(i) to (iii):

(a) If the members did not receive information packs from their employers and the employers contend that these were sent to the home addresses provided by the members under section 22(1)(a), the Commissioner will accept that the information packs may be lost in the post and section 18(1)(b)(i) applies, if the employers held the members' correct contact addresses when the information packs were allegedly sent to them.

(b) If the members did not receive investment statements from their employers and the employers contend that these were sent to the home addresses provided by the members under section 22(1)(a), the Commissioner will accept that the investment statements may be lost in the post and section 18(1)(b)(iii) applies if the employers held the members' correct contact addresses, when the investment statements were allegedly sent to them.

(c) However, if the employers or the Commissioner:

(i) did not send, or

(ii) held incorrect contact addresses for the members when they allegedly sent,

the information packs or investment statements to the members, and the Commissioner is satisfied that the members provided their correct addresses to their employers under section 22(1)(a), the Commissioner will accept that omissions have occurred for the purposes of section 18(1)(b)(i) to (iii).

42. For example, Andrew makes a late opt-out request on the grounds that the Commissioner did not send him an investment statement under section 50(3)(c). The Commissioner considers the matter further and discovers that an investment statement was sent to the postal address provided by Andrew. However, further investigation reveals that this postal address was incorrectly recorded in Inland Revenue's systems and therefore did not match the correct address provided by Andrew to his employer. In this circumstance, the Commissioner accepts the late opt-out request because he is satisfied that Andrew provided the correct address to his employer and that section 18(1)(b)(ii) applies.

Events outside the members' control

43. All late opt-out requests made under section 18(1)(b)(iv) must clearly state why they are late (that is, the events outside the members' control). Furthermore, the late opt-out requests should include the information set out in paragraphs 24 to 26. This will enable the Commissioner to positively identify the members and their employers. The Commissioner will consider these requests on a case-by-case basis.

44. For the purposes of section 18(1)(b)(iv), events outside the members' control may include, but are not limited to:

(a) accidents or disasters affecting the members or their immediate family, or

(b) illnesses, emotional or mental distress affecting the members or their immediate family, or

(c) the members' involuntary absences from their employment because of:

(i) unplanned events or occurrences reasonably requiring them to leave New Zealand (for example, an immediate family member's illness or death), or

(ii) obligations arising from their employment, occupation or volunteer services (for example, an unplanned overseas business trip).

45. In deciding whether it is reasonable to accept late opt-out requests made under section 18(1)(b)(iv), the Commissioner may consider the following:

(a) Why were the opt-out requests late? What was the principal reason?

(b) Whether the lateness was minimal (that is, were the opt-out requests made as soon as practicable after the expiry of the opt-out period?)

46. The following examples clarify what is meant by events outside the members' control.

47. On 1 August 2007, Sam commences new employment. On 10 September 2007, he travels to India for one week on a business trip. Two days before Sam is due to return to New Zealand, he becomes ill and is forced to stay in a hospital for another ten days. Sam is too ill to contact anyone in New Zealand during that time. Sam does not return to New Zealand until 27 September and makes a late opt-out request stating the reasons for his lateness to the Commissioner the next week under section 18(1)(b)(iv). In this circumstance, the Commissioner accepts the late opt-out request because Sam's extended absence from New Zealand was unplanned and he was unable to opt out in India. Furthermore, Sam has made the opt-out request as soon as practicable after returning to New Zealand.

48. On 3 September 2007, Jill commences new employment and becomes a member. On 25 October 2007, Jill is admitted to a private hospital for knee surgery which she had scheduled six months earlier. Jill does not submit an opt-out request before undergoing surgery and makes a late opt-out request under section 18(1)(b)(iv) on 9 November, two weeks after she has been discharged from the hospital. In this circumstance,

the Commissioner considers that the knee surgery is not an event outside Jill's control, because it has been scheduled for six months and the lateness was not minimal.

Declined late opt-out requests treated as contributions holiday requests

49. Pursuant to section 18(3), declined late opt-out requests will be treated as if they were contributions holiday requests, if section 102 applies to the members.

50. In these instances, the Commissioner will treat the declined late opt-out requests as financial hardship contributions holiday requests under section 102(a). However, the Commissioner cannot consider these requests unless the members provide the information specified in section 103(2) with their late opt-out requests or within a period allowed by the Commissioner. Therefore, members making late opt-out requests should consider including details of their financial hardship if applicable (please see paragraphs 108 to 109).

51. Generally, members who make late opt-out requests will not qualify for contributions holidays under section 102(b) because twelve months will not have elapsed since the Commissioner received their first contribution.

52. For example, the Commissioner declines a late opt-out request three months after receiving Brian's first contribution as a member. Brian does not yet qualify for a contributions holiday under section 102(b) and has not provided the information required under section 103(2) (including details of their financial hardship) with his late opt-out request. In this circumstance, the Commissioner will treat the declined late opt-out request as a contributions holiday request under section 102(a) but cannot further consider the request because no financial hardship details have been provided. The Commissioner's practice will be to request the necessary information when giving notification of the declined opt-out. If Brian then provides the requested information including details of his financial hardship, the Commissioner will consider the request under section 102(a).

Refunds

Refunds by the Commissioner

53. The Commissioner has the discretion to make refunds in certain circumstances. This section of the SPS sets out the Commissioner's standard practice when considering whether to make refunds. Generally, the Commissioner will not exercise the discretion to refund under sections 80, 81 and 100 only in unusual circumstances.

54. For the purposes of section 80(1)(a) and (b), contributions that may be refunded are amounts deducted from the members' salaries or wages that are in, or are deemed under section 69 to be in, the Commissioner's possession.

55. For the purposes of sections 81 and 113, "contributions" are contributions made by members and employers in respect of those members.

Refunds of pre-opt-out contributions

56. Pursuant to section 80(1)(a), the Commissioner will usually refund pre-opt-out contributions to the employees if they have opted out.

57. Pursuant to section 80(1)(c), the Commissioner will usually refund contributions to the employees, if:

    (a) they have opted out, and

    (b) the contributions were deducted from their salary or wages by the employers but not:

        (i) refunded to the employees by them, or

        (ii) paid to the Commissioner.

58. Furthermore, under section 100, if the employees have opted out, the Commissioner will usually refund pre-opt-out employer contributions that are still in the Commissioner's possession to the employers.

59. In most cases, if an opt-out is effective, the Commissioner will refund contributions to the employees to ensure their memberships can cease. However, in certain circumstances, the Commissioner may not exercise the discretions to refund contributions under sections 80(1) and 100.

60. The following example clarifies how the discretions under sections 80(1) and 100 will be exercised.

61. The Commissioner accepts an opt-out request after receiving two pre-opt-out contributions from the employee and considers refunding these under section 80(1)(a). However, the Commissioner discovers that the contributions were mistakenly paid under the member's name and actually belong to someone else. In this circumstance, the Commissioner decides not to refund the contributions to the employee because they belong to another person.

62. If, under section 80(1)(c), the Commissioner refunds to employees amounts for contributions that were not:

    (a) paid to the Commissioner, or

    (b) refunded to them by their employers,

    the Commissioner will then recover the amount from the employers or members if the refund was incorrectly made to them.

Excess contribution refunds

63. The Commissioner may refund excess contributions to members under section 80(1)(b).

64. The following examples clarify how the discretion to refund excess contributions will be exercised.

65. An employer deducts and remits to the Commissioner an amount comprising 10% of a member's gross salary when their chosen contribution rate is only 4% and the employer's contribution is also 4%. The member requests a refund. In this circumstance, the Commissioner determines that 2% of the member's salary received is an excess contribution and refunds the full excess amount to the member.

66. In August 2007, an employer inadvertently deducts and remits to the Commissioner an excess contribution for a member. In September, the employer discovers the excess contribution. They make a negative adjustment to the assessment of contribution in the September 2007 EMS and also remit a reduced amount of contribution to "cancel out" the excess contribution. In this circumstance, the Commissioner accepts the one-off adjustment to the September EMS and the reduced contribution. Although the excess contribution is in his possession, the Commissioner does not refund the excess amount because he has effectively received the correct contributions for August and September 2007 leaving no excess contribution to refund.

67. Pursuant to section 81(2), if providers refund excess contributions to the Commissioner, the Commissioner must refund or give credit for these amounts in the manner that the Commissioner thinks fit. Generally, the Commissioner would direct credit the refund into the members' nominated bank accounts unless they request that credits be transferred to other tax types under section 173L of the TAA (please see paragraphs 70 and 71 for further details).

68. However, under section 101(2), the Commissioner may not refund excess employer contributions if the contributions received would be less, after the refunds are deducted, than what is required under the Act according to the members' and the employers' agreed or compulsory contribution rates.

69. For example, a provider receives an excess employer contribution from the Commissioner (that is, an amount exceeding the compulsory employer contribution rate) and purchases some units in the member's superannuation fund. The Commissioner learns of the excess contribution and requests a refund from the provider on the member's behalf. However, after the refund has been requested, the value of the units purchased with the excess contribution decreased. Thus, the amount remaining in the superannuation fund is now less than that required under the member's and the employer's compulsory contribution rates. Accordingly, the provider cannot refund any of the excess contribution to the Commissioner because this would reduce the amount of contribution below the required amount.

Transfers instead of refunds

70. Section 81(3) allows members to request that the Commissioner transfers all or part of any excess or pre-opt-out contributions to their other tax types or periods under section 173L of the TAA instead of refunding these amounts.

71. The Commissioner may consider such transfer requests when exercising the discretion under sections 80(1) or 81(2). Generally, the Commissioner would give effect to any transfer requests received.

Refunds when members cannot prove to an employer that they are taking a contributions holiday

72. Pursuant to section 114(3), if members on contributions holidays:

    (a) start new employment, and

    (b) cannot comply with section 22(1)(c)(ii) by showing the employers written confirmation of their contributions holidays,

    the Commissioner may refund any contributions that have been received from the employers and are still held by the Commissioner (including contributions refunded to the Commissioner by the providers under section 81(1)).

Significant financial hardship and/or serious illness refund requests

73. Section 113(1) allows members may make requests for refunds of initial contributions if they are:

    (a) suffering, or likely to suffer, significant financial hardship, or

    (b) suffering serious illness.

74. For the purposes of section 113, "initial contributions" are contributions that are received and held by the Commissioner in the holding account under section 75(2). That is, contributions that have not been paid to the members' providers under section 75(3). Therefore, significant financial hardship and/or serious illness refund requests should be made within three months of the date the Commissioner receives, or is deemed to receive, the member's first contribution. Otherwise, the initial contributions may no longer be held by the Commissioner. (Please note that "initial contributions" do not include the Crown contribution paid under section 226).

75. Pursuant to section 113(5), the Commissioner must refund contributions on receiving the members' significant financial hardship and/or serious illness refund requests if satisfied that they suffer, or are likely to suffer:

   (a) significant financial hardship, or

   (b) serious illness.

76. Pursuant to section 113(3), the Commissioner may allow members to make significant financial hardship and/or serious illness refund requests by any means including those set out in paragraphs 15 and 16.

77. All significant financial hardship and serious illness refund requests must include:

   (a) the members':

      (i) name and address, and

      (ii) IRD number, and

      (iii) significant financial hardship or serious illness details (including medical certificates), and/or

   (b) any other information that the Commissioner requires. This may include:

      (i) evidence of the members' assets and liabilities for significant financial hardship refund requests, or

      (ii) verification of other documents or evidence provided in support of the refund request by oath, statutory declaration, or otherwise (for example, medical opinions).

78. The following example clarifies when the Commissioner may request further information from the members.

79. A member has suffered a stroke and is unable to work. The member makes a significant financial hardship refund request under section 113(1) and provides details of his medical condition including a letter from his neurologist documenting his condition. In this circumstance, the Commissioner also asks the member to provide details of any loss of income insurance policy held and insurance receipts to verify the member's financial position.

Significant financial hardship

80. Pursuant to clause 11(1) in Schedule 1, "significant financial hardship" includes significant financial difficulties that arise because of:

   (a) members' inabilities to meet:

      (i) minimum living expenses, or

      (ii) minimum mortgage repayments on their principal family residence, that result in the mortgagee seeking to enforce the mortgage on the residence, or

   (b) the costs in respect of:

      (i) modifying residences to meet special needs arising from members' or their dependants' disability, or

      (ii) medical treatment for members' or their dependants' illnesses or injuries, or

      (iii) palliative care for members or their dependants, or

      (iv) funerals for members' dependants, or

   (c) the members suffering from serious illnesses (please see paragraphs 89 and 90).

81. Generally, the Commissioner would not consider significant financial hardship to include financial difficulties that arise because the members are:

   (a) obliged to pay other taxes, or

   (b) engaging in excessive social or entertainment activities, or

   (c) making mortgage repayments in respect of investment properties, or

   (d) unable to make mortgage repayments on their principal family residence if those repayments, and the residence exceed the members' and their families' basic requirements or where refinancing the mortgage to reduce repayments is a reasonable alternative.

82. For the purposes of clause 11(1), "minimum living expenses" would usually include the actual and reasonable costs of:

   (a) basic food and grocery items, and

   (b) accommodation (including mortgage repayments, interest, rates and necessary maintenance for their principal family residence), and

   (c) basic clothing, and

   (d) utility services such as power, gas and telecommunications, and

   (e) transportation, and

   (f) fire and general insurances, and

   (g) medical and dental costs necessary for the maintenance of good health, and

   (h) school fees (excluding private school fees) and tertiary education costs, and

   (i) other normal (non-luxury) household items.

83. The Commissioner will normally consider minimum living expenses in the context of normal community standards across the whole of New Zealand taking into account regional differences (such as variations in rent or power usage). Whether members can meet minimum living expenses will be determined on a case-by-case basis and after taking into account all relevant factors.

84. The following examples clarify the meaning of minimum living expenses.

85. Jessica, as a member, makes a significant financial hardship refund request and provides evidence of her assets and liabilities. Jessica has recently financed some luxury goods including a large plasma television and state-of-the-art home theatre system which she cannot sell without breaching the hire purchase agreement. In this circumstance, the Commissioner considers that Jessica can meet minimum living expenses and therefore declines the significant financial hardship refund request.

86. Roger, a member, makes a significant financial hardship refund request and provides financial information that discloses he is paying a relatively high life insurance premium. The Commissioner requests further information and discovers that Roger is required to hold a life insurance policy as a condition of his mortgage on the principal family residence. Roger would be unable to obtain a lower interest rate from another lender without this same condition. In this circumstance, the Commissioner is satisfied that the life insurance premium is integral to Roger's minimum living expenses and accepts the significant financial hardship refund request.

87. Whether persons are dependants for the purposes of clause 11(1) of Schedule 1 will be determined on a case-by-case basis. In determining whether persons are dependants, the Commissioner will consider:

    (a) whether they are dependent on the member for financial support, and

    (b) the degree of relationship to the member, and

    (c) what degree of financial support the member habitually provides to them.

88. Please note that significant financial hardship requests are not:

    (a) financial hardship contributions holiday requests under section 102(a), or

    (b) serious hardship write-off requests under section 177(1)(a) of the TAA.

    Such requests must be made separately under those respective legislative provisions.

Serious illnesses

89. For the purposes of clauses 11(1)(g) and 12(3) in Schedule 1, serious illnesses are:

    (a) injuries, and/or

    (b) illnesses, and/or

    (c) disabilities that:

        (i) result in the members being totally and permanently unable to engage in work for which they are suited by reason of experience, education, or training (or any combination of these), or

        (ii) pose a serious and imminent risk of death.

90. The Commissioner will generally require the members to provide medical evidence of their serious illnesses to substantiate that the criteria have been satisfied.

91. The following example clarifies when the Commissioner would consider members to suffer a serious illness.

92. Jack is an aerobics instructor who has been a KiwiSaver member for three months. Jack is paralysed in a car accident and is now confined to a wheelchair. Jack makes a serious illness refund request. In this circumstance, the Commissioner is satisfied that Jack is totally and permanently unable to work as an aerobics instructor for which he is suited because of his experience and training. The Commissioner refunds the initial contributions to Jack under section 113(5). This is notwithstanding that Jack may be able to perform other roles with his employer.

Refund methods

93. Pursuant to section 221(1), the Commissioner must refund contributions by direct crediting them into the employee's nominated bank account. However, if the Commissioner is satisfied that direct crediting:

    (a) would result in undue hardship to persons, or

    (b) is not practicable,

    the Commissioner may refund contributions by any other acceptable means under section 221(3).

94. For example, the Commissioner decides to refund pre-opt-out contributions to the employee. The employee has nominated a bank account in their written opt-out request. The bank account is now closed. In this circumstance, the Commissioner cannot direct credit the contributions into the bank account. Therefore, the Commissioner considers it impracticable to direct credit the refund to the employee and, instead exercises the discretion under section 221(3) and sends a refund cheque by post to their residential address.

Financial hardship contributions holidays

Financial hardship contributions holidays

95. Members cannot apply for a contributions holiday within twelve months of the Commissioner receiving their first contribution unless they can show that they are suffering, or are likely to suffer financial hardship.

96. Section 102(a) allows members to make financial hardship contributions holidays requests if:

    (a) the Commissioner has received their first contribution (including contributions deemed to be received under section 69), and

    (b) they are suffering, or likely to suffer financial hardship.

97. Pursuant to section 103(1), the Commissioner may allow members to make contributions holiday requests by any means that is acceptable to the Commissioner. This will include by one of the means set out in paragraphs 15 to 16.

98. Pursuant to section 104(1), the Commissioner must:

    (a) accept financial hardship contributions holidays requests, and

    (b) grant contributions holidays if:

        (i) the Commissioner is satisfied that the members are suffering, or are likely to suffer, financial hardship, and

        (ii) the requests include the following information under section 103(2):

            (A) the members':

            - name and address, and
            - IRD number, and

            (B) the name and address of each of the members' employers nominated to be subject to the contributions holidays, and

            (C) the length of the contributions holidays required, and

            (D) details of the members' financial hardship, and

            (E) any other information that the Commissioner requires.

Financial hardship

99. The Commissioner will consider financial hardship contributions holidays requests on a case-by-case basis. However, the Commissioner considers that the following guidelines are relevant to determining whether members are suffering, or are likely to suffer financial hardship for the purposes of sections 102(a) and 103(2)(e).

100. The question of whether members are suffering, or are likely to suffer financial hardship is not a matter of moral or cultural judgment. However, members engaging in extravagant or lavish lifestyles, when viewed objectively, are unlikely to be regarded as suffering financial hardship. In this circumstance, they cannot make their KiwiSaver contributions simply because of their high living expenses.

Unchanged financial circumstances

101. If members' financial circumstances are unchanged, the Commissioner may accept that they are suffering, or are likely to suffer financial hardship if they show that they underestimated the financial effect that making contributions would have on their disposable income and cannot afford to pay their reasonable living expenses as a result.

Changed financial circumstances

102. The Commissioner is more likely to accept that members are suffering, or are likely to suffer financial hardship if their financial circumstances have changed since they have commenced their membership, than if their financial circumstances are unchanged.

103. For the purposes of this SPS, the members' financial circumstances will have changed if their personal disposable incomes have reduced because their:

    (a) personal income has reduced, and/or

    (b) living expenses have increased,

    to the extent that it is no longer financially feasible for them to continue making contributions as a result.

104. If members' financial circumstances have changed, the Commissioner may accept that they are suffering, or are likely to suffer financial hardship and grant contributions holidays if the Commissioner considers that the changes are because of unexpected events or events beyond the members' control.

105. The Commissioner would generally consider events beyond the members' control or unexpected events to include:

    (a) the need to repair, maintain, or replace essential items of the members' or their dependants' real or personal property, for example:

        (i) vehicles if no other reasonable transportation alternatives are available, or

(ii) major household appliances or items of a non-discretionary nature (for example, washing machines or fridges),

because of:

(i) accidents involving themselves or their partners or dependants, or

(ii) naturally-occurring events, or

(iii) normal wear and tear, or

(b) illnesses, injuries or conditions suffered by members or their partners or dependants that affect their income or cause material expenses including:

(i) medical treatment costs for the members' or their dependants' illnesses, injuries or conditions, or

(ii) special medical or rehabilitative equipment costs for the members or their dependants, or

(iii) costs for:

(A) modifying residences to meet the special needs of the members or their dependants, or

(B) palliative care for members or their dependants, or

(C) the members' or their spouses' or partners' pregnancies, or

(c) inflationary factors such as price increases in:

(i) basic commodities, or

(ii) interest rates on borrowings, or

(iii) residential rents, or

(d) changes in shared living arrangements that cause increases in the members' residential rents or reductions in board payments received by them, or

(e) members', or their dependants' education costs excluding private school fees and related costs if alternative funding is unavailable or not feasible, or

(f) involuntary changes in the members' or their partners' employment circumstances or investments that cause reductions in their household income (for example, a vacant investment property, a reduction in overtime work available), or

(g) a reduction in the members' household income because of voluntary changes in the members' or their partners' employment circumstances for work related or family reasons (for example, reducing work hours to contribute to child rearing or taking redundancy rather than moving to a workplace in a different city).

106. However, the Commissioner may consider that members are not suffering, or are not likely to suffer financial hardship if their financial circumstances have changed because of events or circumstances within their control or discretion, because they could have considered the financial implications of these events or circumstances.

107. Although the Commissioner will treat each request on a case-by-case basis, generally the Commissioner would consider planned events or events within the members' control or discretion to include, but not be limited to:

(a) the replacement of items of the members' real or personal property if the existing property is still in good working order, or

(b) the purchase of non-essential or luxury goods or services (for example, overseas holidays).

Financial hardship details

108. Generally, the Commissioner will decide whether to grant contributions holidays and their term on the basis of the financial hardship details provided with the members' financial hardship contributions holidays' requests (or late opt-out requests).

109. However, at times under section 103(2)(f), the Commissioner may ask the members to provide further relevant information to determine whether they are suffering, or are likely to suffer financial hardship. This information may include, but is not limited to:

(a) the costs of any repairs, maintenance, or the replacement of items of the members or their dependants' real or personal property, and

(b) details of any insurance policies held by the members or their partners and any proceeds received, and

(c) medical records or other evidence that substantiate:

(i) the members' or their dependants' illness, injury, medical condition, and/or

(ii) the members' or their spouses or partners' pregnancies.

Contributions holidays periods

110. The Commissioner will consider the appropriate term of the contributions holidays on a case-by-case basis after taking into account the members' individual circumstances.

111. Pursuant to section 104(2), if the Commissioner grants financial hardship contributions holidays, they must be for a period of three months although

a longer period can be allowed (for example, a longer term specified in the financial hardship contributions holiday request). Contributions holidays will usually start from the date that they are granted by the Commissioner.

112. Generally, contributions holidays will be granted for sufficient periods to allow the members' financial circumstances to improve to the extent that contributions are sustainable.

113. The following examples clarify the meaning of financial hardship.

114. Anna is a member who has made contributions for four months. Anna's fridge develops a fault beyond repair. She has to purchase a replacement fridge on hire purchase. Anna makes a financial hardship contributions holiday request for a ten-month term to allow her to pay for the new fridge. Anna will have completed payments under the current hire purchase agreement in ten months' time and can afford to recommence contributions then. In this instance, the Commissioner accepts her application and grants a contributions holiday for ten months because Anna's living expenditure has increased due to an event beyond her control.

115. Jane is a member who has made contributions for seven months. Jane lives in a shared accommodation with two other flatmates and does not own the house. One of Jane's flatmates moves out and Jane has to pay an increased share of the rent with the other remaining flatmate until a replacement flatmate is found. In the past, it had taken up to three months for another flatmate to be found. Jane makes a financial hardship contributions holiday request for a three-month contributions holiday. In this circumstance, the Commissioner accepts the financial hardship contributions holiday request and grants a contributions holiday for three months because Jane's increased living expenses is due to an event beyond her control.

116. Rick is a member who has made contributions for two months. Rick was recently made redundant and has taken a job with a different employer at a reduced salary. Rick's new employer has continued to deduct contributions from his salary at his chosen rate of 4% of his gross salary. Rick does not want to opt out. So, Rick makes a financial hardship contributions holiday request for eight months to allow him to repay existing debts and reduce his living expenses to a sustainable level. Rick also successfully requests a refund of initial contributions under section 113 because he suffers significant financial hardship. In this circumstance, the Commissioner accepts the request because the reduction in employment income is directly related to Rick's previous redundancy, which was an event beyond his control. The Commissioner also grants Rick a contributions holiday for a longer period of twelve months to allow sufficient time for his financial position to improve.

117. Terry is a member who has made contributions for two months. Terry installs a swimming pool for recreational reasons and secures finance to pay for it. Terry makes a financial hardship contributions holiday request for ten months because he can no longer meet his personal expenses from his disposable income. In this circumstance, the Commissioner declines Terry's application, as Terry's increase in living expenses relates to an unnecessary discretionary event, that is, the swimming pool purchase.

118. Please note that financial hardship contributions holidays requests are not:

(a) significant financial hardship or serious illness refund requests under section 113(1), or

(b) serious hardship write-off requests under section 177(1)(a) of the TAA.

Such requests must be made separately under those respective legislative provisions.

Decision review process

Decision review process

Discretions under Parts 2 and 3 of the Act

119. Pursuant to section 212, the Commissioner may reconsider certain earlier decisions. This is known as the decision review process.

120. These decisions are any matters that under Parts 2 and 3 of the Act are left to the Commissioner's:

(a) discretion, or

(b) judgment, or

(c) opinion, or

(d) approval, or

(e) consent, or

(f) determination.

Examples of these include declining late opt-out requests, declining to grant contributions holidays and declining significant financial hardship refund requests.

121. The decision review process operates separately and is outside the disputes resolution process set out in Part IVA of the TAA.

122. Pursuant to section 138E(1)(e)(ivb) of the TAA, taxpayers cannot challenge discretions exercised under Parts 1 to 3 of the Act by commencing proceedings in a hearing authority. Accordingly, such decisions are not “disputable decisions” for the purposes of the dispute rules in the TAA.

123. The decision review process cannot be used to review non-discretionary decisions or the same discretionary decision twice. However, persons may apply for judicial review of some decisions made under the Act.

Persons affected by the Commissioner's decisions

124. Applicants (including persons other than members) may make reconsideration requests under section 212(1). The Commissioner must be satisfied that decisions affect the applicants before considering their reconsideration requests.

125. For example, the Commissioner determines that an employer has not provided information about the member to the Commissioner under section 23(1). The employer is liable for a penalty under section 215 because a notice has previously been given to it for the same omission and section 215(2)(b) applies. The employer makes a reconsideration request in respect of the determination made under section 23 because they contend that they did, in fact, send this information to the Commissioner by post. In this circumstance, the Commissioner is satisfied that the determination affects the employer, who may make the reconsideration request.

Making reconsideration requests

126. Applicants may make reconsideration requests by one of the methods set out in paragraphs 15 and 16.

127. The Commissioner may also require applicants to make reconsideration requests or provide supporting information in writing under section 212(3). In such cases, members may make written reconsideration requests by one of the methods set out in paragraph 16.

Late reconsideration requests

128. Pursuant to section 212(2), applicants must make reconsideration requests and/or provide any supporting information within:

(a) twenty working days after the date that the Commissioner gave them notice of the discretionary decision, or

(b) any longer period allowed by the Commissioner.

129. Therefore, the Commissioner may accept reconsideration requests or supporting information made after the expiry of the time period as mentioned in paragraph 128(a).

130. The Commissioner will consider late reconsideration requests on a case-by-case basis. If the explanations for the delays in making the reconsideration requests are reasonable, the Commissioner will accept the reconsideration requests as valid requests.

131. Then, the Commissioner will consider all relevant matters when exercising the discretion to accept late reconsideration requests and ensure that the discretion is exercised fairly and lawfully.

Treatment of late reconsideration requests

132. The Commissioner may accept late reconsideration requests if the applicants cannot make the reconsideration requests within twenty working days after the date that the Commissioner gave them notice of the relevant decision because of:

(a) events or circumstances beyond their control including:

(i) accidents or disasters, and/or

(ii) illness or emotional or mental distress, or

(iii) delays in accessing information to support the reconsideration request, or

(b) unplanned personal absences from New Zealand, or

(c) genuine oversights or errors of a one-off nature.

133. Such events or circumstances should not include the applicants' tax agents' acts or omissions unless the Commissioner is satisfied that these were caused by events beyond the tax agents' control that could not have been:

(a) anticipated, and

(b) avoided by compliance with accepted standards of business organisation and professional conduct.

134. Therefore, applicants should state the facts clearly and provide sufficient relevant information when making reconsideration requests.

135. The following examples clarify the exercise of the Commissioner's practice to accept late reconsideration requests.

136. On 28 September 2007, the Commissioner advises John in writing that his financial hardship contributions holiday request is declined. John decides to make a reconsideration request and provide further supporting information regarding his financial circumstances, but in early October 2007, his son becomes ill and is hospitalised. The medical condition of John's son improves slowly and John spends a reasonable amount of time at the hospital over the next six weeks. John makes a late reconsideration request on 12 November 2007. The reconsideration request clearly explains the decision to be reconsidered, the reason for the lateness and includes further supporting financial information. In this circumstance, the

Commissioner would exercise his discretion to accept the late reconsideration request under section 212(2) because it is related to circumstances beyond John's control.

137. On 5 November 2007, the Commissioner advises Lucy in writing that her significant financial hardship request was declined because she did not satisfy the significant financial hardship requirements. Unfortunately, Lucy's husband misfiles the Commissioner's notice with his own business papers. Lucy does not discover the notice until mid-December. Lucy makes a late reconsideration request which includes further relevant supporting information about her financial situation and a clear explanation of why the reconsideration request was late. In this circumstance, the Commissioner would accept the late reconsideration request because this is a one-off situation resulting from a genuine oversight. The merits of the reconsideration request and supporting information also justify the exercise of the discretion under section 212(2). However, this does not necessarily mean that the Commissioner will reverse the original decision to not refund the initial contributions.

The discretion under section 212(4)

138. Pursuant to section 212(4), the Commissioner on receiving reconsideration requests (whether late or otherwise) may:

(a) fully accept the reconsideration requests, or

(b) seek further information from the applicants, or

(c) fully decline the reconsideration requests, or

(d) accept or decline the reconsideration requests in part and decline or accept the other part.

The Commissioner will generally make decisions regarding any reconsideration requests within twenty working days of receiving them.

139. If the Commissioner requests further information from the applicants under section 212(4)(b), this must be provided by the agreed date. This will generally be twenty working days after the date the information is requested.

140. If the Commissioner:

(a) declines:

(i) late reconsideration requests under section 212(2), or

(ii) reconsideration requests under section 212(4) (that is, does not exercise the underlying discretion in the applicants' favour), or

(b) accepts or declines reconsideration requests in part and declines or accepts the other part under section 212(4)(d),

the Commissioner will advise the applicants of the decision to decline and the reasons for that decision as soon as practicable.

141. If the Commissioner accepts reconsideration requests (late or otherwise) and decides to exercise the underlying discretion to which the reconsideration request relates in the applicants' favour, the Commissioner will also advise them in writing if appropriate.

142. For example, Tracy makes a reconsideration request in respect of a declined financial hardship contributions holiday request within twenty working days of receiving the Commissioner's notice. The Commissioner reconsiders the previous decision and accepts it was wrong. The Commissioner then sends written confirmation of the contributions holiday to Tracy under section 105(1)(a).

This Standard Practice Statement is signed on 18 June 2007.

Graham Tubb
Group Tax Counsel
Legal and Technical Services

REGULAR FEATURES

DUE DATES REMINDER

July 2007

9 Provisional tax instalment due for people and organisations with a March balance date

20 Employer deductions

Small employers (less than $100,000 PAYE and SSCWT deductions per annum)

- *Employer deductions (IR 345)* or *(IR 346)* form and payment due
- *Employer monthly schedule (IR 348)* due

30 GST return and payment due

August 2007

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

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.