TAX INFORMATION BULLETIN

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THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

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

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

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

Ref.	**Draft type**	**Description**
DDG0133	General depreciation determination	Hired out baby gear
DDG0136	General depreciation determination	Flight simulators

Please see page 133 for details on how to obtain a copy.

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.

FAIR DIVIDEND RATE METHOD DETERMINATIONS

The following determinations, concerning New Zealand resident investors' ability to use the fair dividend rate method to calculate foreign investment fund (FIF) income from a type of attributing interest in a FIF, have been made under section 91AAO of the Tax Administration Act 1994.

DETERMINATION FDR 2008/03 – USE OF FAIR DIVIDEND RATE METHOD FOR A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND (MACQUARIE ESCALATOR)

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Policy Manager under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Shares in a non-resident company to which this determination applies are an attributing interest in a FIF for New Zealand resident investors.

New Zealand resident investors are required to apply the foreign investment fund rules to determine their tax liability in respect of their shares in the non-resident company each year.

Due to the presence of hedging arrangements involving instruments that may be highly effective in terms of hedging the underlying foreign currency financial arrangement, section EX 40(9)(d) of the Act could apply for the 2008–09 and subsequent income years to shares in the non-resident company and prevent the use of the fair dividend rate method in the absence of a determination under section 91AAO of the Tax Administration Act 1994.

Despite the presence of a financial arrangement which is potentially effectively hedged, I consider that it is appropriate for New Zealand resident investors in this arrangement to use the fair dividend rate method.

The overall arrangement (as described to me by the applicant) is in substance an equity investment that contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument that effectively provides guaranteed returns.

Scope of determination

The investments to which this determination applies are interests in an Australian Limited Partnership (either the Macquarie Escalator NZ 2007 (Nikkei 225 Index) Limited Partnership or the Macquarie Escalator NZ 2007 (DJ EuroStoxx 50 Index) Limited Partnership) which holds shares in a non-resident company. The General Partner of the Partnership is Escalator NZ GP Co Pty Limited. The Australian Limited Partnership is treated as a partnership for New Zealand tax purposes such that the shares in the non-resident company are treated as held directly by the New Zealand investors. The non-resident company:

(a) is an Australian incorporated company;

(b) issues Australian dollar denominated ordinary shares (not being fixed rate shares, non-participating redeemable shares or guaranteed return shares) to the New Zealand investors through the Australian Limited Partnership;

(c) invests proceeds from the issue of shares in a foreign currency denominated note, which is a financial arrangement that is linked to an underlying index such as:

  (i) an equity index;

  (ii) a commodities index;

  (iii) a property index;

  (iv) and provides returns calculated by reference to a percentage participation in the performance of the underlying index over each investment term (of approximately three years);

(d) provides a return to investors at the end of the investment term based on the returns received from the investment in the index linked note, which is not a fixed return;

(e) enters into foreign currency forward contract hedging arrangements for the purpose of providing New Zealand investors with the economic equivalent of an overall New Zealand dollar exposure in respect of their investment.

Interpretation

In this determination, unless the context otherwise requires:

"Australian Limited Partnership" means a partnership registered under the Partnership Act 1892 (NSW);

"Financial arrangement" means financial arrangement under section EW 3 of the Act;

"Fixed rate share" means a fixed rate share under section LF 2(3) of the Act;

"Non-participating redeemable share" means a non-participating redeemable share under section CD 14(9) of the Act;

"Guaranteed return share" means a share involving an obligation under section EX 40(9)(e) of the Act;

"Non-resident" means a person that is not resident in New Zealand for the purposes of the Act;

"The Act" means the Income Tax Act 2004, or any equivalent provision in the Income Tax Act 2007, as applicable.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2008–09 and subsequent income years.

Dated at Wellington this 6th day of March 2008.

David Carrigan
Policy Manager
Inland Revenue

DETERMINATION FDR 2008/04 – USE OF FAIR DIVIDEND RATE METHOD FOR A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND (MACQUARIE reFleXion TRUST)

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Policy Manager under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Shares in a non-resident company to which this determination applies are an attributing interest in a FIF for the New Zealand resident investor, which is a unit trust that has elected to be a portfolio investment entity ("PIE").

The New Zealand resident PIE investor is required to apply the foreign investment fund rules to determine its tax liability in respect of its shares in the non-resident company each year.

Due to the presence of hedging arrangements involving instruments that may be highly effective in terms of hedging the underlying foreign currency financial arrangements invested in by the non-resident company, section EX 40(9)(d) of the Act could apply for the 2008–09 and subsequent income years to shares in the non-resident company and prevent the use of the fair dividend rate method in the absence of a determination under section 91AAO of the Tax Administration Act 1994.

Despite the presence of financial arrangements which are potentially effectively hedged, I consider that it is appropriate for the New Zealand resident investor in this arrangement to use the fair dividend rate method.

The overall arrangement (as described to me by the applicant) is in substance an investment that contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt investment that effectively provides fixed returns.

Scope of determination

The investments to which this determination applies are shares held by one or more New Zealand resident unit trusts, each a Macquarie reFleXion Trust that has elected to be a portfolio investment entity ("the Trust"), in a non-resident company that:

a) is incorporated in the Cayman Islands;

b) issues classes of ordinary shares (not being fixed rate shares or non-participating redeemable shares) which are denominated in New Zealand dollars directly to the New Zealand investor (the Trust);

c) converts the New Zealand dollar proceeds from the issue of shares for foreign currency;

d) invests the foreign currency in a series of foreign currency denominated total return swaps, which are financial arrangements, each of which is linked to or designed to replicate the returns on an underlying fund or index, such as:

    1. an equity fund or index;

    2. an index of hedge funds;

    3. a commodities fund or index;

and each of which provides returns calculated by reference to the performance of those underlying funds or indices over a 6 year 10 month investment term and each of which is not akin to a debt investment in that returns will vary dependent upon the performance of the fund or index over time;

e) provides a return to the Trust at the end of the investment term based on the returns received from the investments in the index or fund-linked total return swaps, which is not a fixed return;

f) enters into various foreign currency hedging arrangements for the purpose of providing the ultimate New Zealand investors (investors in the Trust) with the economic equivalent of an overall New Zealand dollar exposure in respect of the principal of their investment (any gains are subject to foreign currency fluctuation).

Interpretation

In this determination, unless the context otherwise requires:

"Financial arrangement" means financial arrangement under section EW 3 of the Act;

"Fixed rate share" means a fixed rate share under section LF 2(3) of the Act;

"Non-participating redeemable share" means a non-participating redeemable share under section CD 14(9) of the Act;

"Non-resident" means a person that is not resident in New Zealand for the purposes of the Act;

"The Act" means the Income Tax Act 2004, or any equivalent provision in the Income Tax Act 2007, as applicable.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2008–09 and subsequent income years.

Dated at Wellington this 6th day of March 2008.

David Carrigan
Policy Manager
Inland Revenue

DETERMINATION FDR 2008/05 – A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND FOR WHICH A PERSON MAY NOT USE THE FAIR DIVIDEND RATE METHOD (ING DIVERSIFIED YIELD FUND)

Reference

This determination is made under section 91AAO(1)(b) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the Deputy Commissioner, Policy Advice Division, under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Units in the non-resident issuer to which this determination applies (the ING Diversified Yield Fund ("DYF")) are an attributing interest in a foreign investment fund ("FIF") for primarily New Zealand resident investors. New Zealand resident investors are required to apply the FIF rules to determine their tax liability in respect of their units in the non-resident issuer each year.

The non-resident issuer invests predominantly in financial arrangements (at least 80% of the investment mix) which, while not directly denominated in New Zealand dollars, provide a New Zealand Dollar equivalent return through the use of hedging arrangements. For the 2007–08 income year, section EX 40(9)(d) of the Income Tax Act 2004 ("the Act") does not exclude New Zealand resident investors from using the fair dividend rate ("FDR") method to determine their tax liability under the FIF rules, since the financial arrangements are not denominated in New Zealand dollars (although there are hedging arrangements in place). However, for the 2008–09 and subsequent income years the broadening of section EX 40(9)(d) under the Taxation (Business Taxation and Remedial Matters) Act 2007, means the New Zealand resident investors will be excluded from using the FDR method due to the hedging arrangements.

The policy intention is that investments in the DYF should not qualify for the FDR method as the DYF's investments are akin to New Zealand dollar denominated debt investments. However, in the absence of this determination, most New Zealand resident investors will be required to use the FDR method for the 2007–08 income year. This result is inconsistent with the policy intention of the FIF rules.

In addition, New Zealand resident investors would have to apply three tax methods in three income years, as follows:

- Before the 2007–08 income year, investments in the DYF were excluded from the FIF rules due to its residence status in a "grey list" country;
- For the 2007–08 income year the FIF rules apply and New Zealand resident investors would use the FDR method; and
- For the 2008–09 and later income years the FIF rules apply and New Zealand resident investors would use the comparative value calculation method.

It is clear that New Zealand resident investors will incur greater compliance costs than if only one of the FIF calculation methods was used uniformly over the term of their investment.

Despite investors in the non-resident issuer prima facie being able to use the FDR method to their investment for the 2007–08 income year, I consider that it is appropriate for New Zealand resident investors in this arrangement to be excluded from using the FDR method for the 2007–08 and subsequent income years. The overall arrangement (as described to me by the applicant) contains predominantly investment in debt securities and is sufficiently hedged so that it is akin to a New Zealand dollar denominated debt investment. Accordingly, it is appropriate that the FDR method not be used by New Zealand resident investors in the non-resident issuer.

Scope of determination

The investments to which this determination applies are units in a non-resident issuer which:

(a) is an Australian unitised trust established on 1 July 2003 (known as the ING Diversified Yield Fund);

(b) is managed by ING (NZ) Administration Pty Limited ("ING Administration"), a company incorporated and tax resident in Australia, or an entity which is associated with ING Administration;

(c) invests through a Cook Islands company in a portfolio of Collateralised Debt Obligations ("CDOs"), Credit Opportunity Funds ("COFs") and New Zealand Dollar denominated cash holdings;

(d) has a target rate of return (after fees) of 2% above the New Zealand 90-day bank bill rate;

(e) hedges 100% of its investments on a total portfolio market value basis to the New Zealand dollar.

Interpretation

In this determination, unless the context otherwise requires:

"CDOs" means Collateralised Debt Obligations which are high-yielding international interest bearing securities issued by offshore special purpose vehicles. The special purpose vehicles use the proceeds from the securitisation to invest in corporate debt and mortgage-backed securities and other credit products. Collateralised Debt Obligation securities are typically rated by external credit rating agencies;

"COFs" means Credit Opportunity Funds which are structured credit funds that invest in a diverse range of corporate debt securities including senior secured bank loans, unsecured investment grade bonds, non investment grade bonds, second-ranking corporate bonds, mezzanine loans and distressed corporate bonds. Credit Opportunity Funds invested into by the non-resident issuer include both rated and non rated credit funds;

"Financial arrangement" means financial arrangement under section EW 3 of the Act;

"Non-resident" means a person that is not resident in New Zealand for the purposes of the Act;

"The Act" means the Income Tax Act 2004, or any equivalent provision in the Income Tax Act 2007, as applicable.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may not use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2007–08 and subsequent income years.

However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination does not apply for the 2007–08 income year for an investor in the DYF unless that investor chooses for this determination to apply for that year.

Dated this 10th day of March 2008.

Robin Oliver
Deputy Commissioner, Policy
Inland Revenue

DETERMINATION FDR 2008/06 – A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND FOR WHICH A PERSON MAY NOT USE THE FAIR DIVIDEND RATE METHOD (ING REGULAR INCOME FUND)

Reference

This determination is made under section 91AAO(1)(b) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the Deputy Commissioner, Policy Advice Division, under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Units in the non-resident issuer to which this determination applies (the ING Regular Income Fund ("RIF")) are an attributing interest in a foreign investment fund ("FIF") for New Zealand resident investors. New Zealand resident investors are required to apply the FIF rules to determine their tax liability in respect of their units in the non-resident issuer each year.

The non-resident issuer invests predominantly in financial arrangements (at least 80% of the investment mix) which, while not directly denominated in New Zealand dollars, provide a New Zealand dollar equivalent return through the use of hedging arrangements. For the 2007–08 income year, section EX 40(9)(d) of the Income Tax Act 2004 ("the Act") does not exclude New Zealand resident investors from using the fair dividend rate ("FDR") method to determine their tax liability under the FIF rules, since the financial arrangements are not denominated in New Zealand dollars (although there are hedging arrangements in place). However, for the 2008–09 and subsequent income years the broadening of section EX 40(9)(d) under the Taxation (Business Taxation and Remedial Matters) Act 2007, means the New Zealand resident investors will be excluded from using the FDR method due to the hedging arrangements.

The policy intention is that investments in the RIF should not qualify for the FDR method as the RIF's investments are akin to New Zealand dollar denominated debt investments. However, in the absence of this determination, most New Zealand resident investors will be required to use the FDR method for the 2007–08 income year. This result is inconsistent with the policy intention of the FIF rules.

In addition, New Zealand resident investors would have to apply three tax methods in three income years, as follows:

- Before the 2007–08 income year, investments in the RIF were excluded from the FIF rules due to its residence status in a "grey list" country;
- For the 2007–08 income year the FIF rules apply and New Zealand resident investors would apply the FDR method; and
- For the 2008–09 and later income years the FIF rules apply and New Zealand resident investors would use the comparative value calculation method.

It is clear that New Zealand resident investors will incur greater compliance costs than if only one of the FIF calculation methods was used uniformly over the term of their investment.

Despite investors in the non-resident issuer prima facie being able to apply the FDR method to their investment for the 2007–08 income year, I consider that it is appropriate for New Zealand resident investors in this arrangement to be excluded from using the FDR method for the 2007–08 and subsequent income years. The overall arrangement (as described to me by the applicant) contains predominantly investment in debt securities and is sufficiently hedged so that it is akin to a New Zealand dollar denominated debt investment. Accordingly, it is appropriate that the FDR method not be used by New Zealand resident investors in the non-resident issuer.

Scope of determination

The investments to which this determination applies are units in a non-resident issuer which:

(a) is an Australian unitised trust established on 20 September 2005 (known as the ING Regular Income Fund);

(b) is managed by ING (NZ) Administration Pty Limited ("ING Administration"), a company incorporated and tax resident in Australia, or an entity which is associated with ING Administration;

(c) invests directly into a portfolio of Collateralised Debt Obligations ("CDOs"), and New Zealand Dollar denominated cash holdings;

(d) has a target rate of return (after fees) of 1% above the New Zealand 90-day bank bill rate over a rolling 12-month period;

(e) hedges 100% of its investments on a total portfolio market value basis to the New Zealand dollar.

Interpretation

In this determination, unless the context otherwise requires:

"CDOs" means Collateralised Debt Obligations which are high-yielding international interest bearing securities

issued by offshore special purpose vehicles. The special purpose vehicles use the proceeds from the securitisation to invest in corporate debt and mortgage-backed securities and other credit products. Collateralised Debt Obligation securities are typically rated by external credit rating agencies;

"Financial arrangement" means financial arrangement under section EW 3 of the Act;

"Non-resident" means a person that is not resident in New Zealand for the purposes of the Act;

"The Act" means the Income Tax Act 2004, or any equivalent provision in the Income Tax Act 2007, as applicable.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may not use the fair dividend rate method to calculate FIF income from the interest.

Application date

This determination applies for the 2007–08 and subsequent income years. However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination does not apply for the 2007–08 income year for an investor in the RIF unless that investor chooses for this determination to apply for that year.

Dated this 10th day of March 2008.

Robin Oliver
Deputy Commissioner, Policy
Inland Revenue

DETERMINATION DEP66: TAX DEPRECIATION RATES GENERAL DETERMINATION NUMBER 66

1. Application

This determination applies to taxpayers who own items of depreciable property of the kinds listed in the tables below that have been acquired on or after 1 April 2005.

This determination applies for the 2005–2006 and subsequent income years.

2. Determination

Pursuant to section 91AAF of the Tax Administration Act 1994 I set in this determination the economic rates to apply to the kinds of items of depreciable property listed in the tables below by:

- Adding into the "Hotels, Motels, Restaurants, Cafés, Taverns and Takeaway Bars", "Residential Rental Property Chattels", and "Telecommunications" industry categories the general asset class, estimated useful life, and diminishing value and straight-line depreciation rates listed in the table below.

General asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Set-top boxes without hard drive and personal video recorders (PVRs) without hard drive	5	40	30

- Adding into the "Hotels, Motels, Restaurants, Cafés, Taverns and Takeaway Bars", and "Residential Rental Property Chattels" industry categories the general asset classes, estimated useful lives, and diminishing value and straight-line depreciation rates listed in the table below.

General asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Digital versatile disc (DVD) recorders with hard drive	4	50	40
Digital versatile disc (DVD) recorders without hard drive	5	40	30

3. Interpretation

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

This determination is signed by me on the 4th day of March 2008.

Susan Price
Senior Tax Counsel

NEW LEGISLATION

Taxation (Annual Rates of Income Tax 2007–08) Act 2007

Taxation (Business Taxation and Remedial Matters) Act 2007

Taxation (KiwiSaver) Act 2007

The Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill was introduced into Parliament on 17 May 2007. It received its first reading on 17 May 2007 and its second reading on 4 December 2007. A number of substantial amendments were made to the bill by Supplementary Order Paper after the bill's introduction. The most significant of these changes were contained in SOPs 167 and 168, which introduced certain refinements to the KiwiSaver legislation, the redundancy payment rebate, changes to the finance lease tax rules, and inserted legislation relating to the 15 percent R&D tax credit into the Income Tax Act 2007.

The bill was split into three parts at the Committee stage of proceedings and the resulting bills passed their final stages on 12 December 2007, receiving Royal assent on 19 December 2007.

The three new Acts amend the Income Tax Act 2004, Tax Administration Act 1994, Income Tax Act 2007, Estate and Gift Duties Act 1968, Goods and Services Act 1985, Taxation Review Authorities Act 1994, Customs and Excise Act 1996, Privacy Act 1993, Income Tax (Withholding Payments) Regulations 1979, KiwiSaver Act 2006, Superannuation Schemes Act 1989, KiwiSaver Regulations 2006 and Holidays Act 2003.

KIWISAVER

THE NEW KIWISAVER LEGISLATION

Sections CS 10B, DC 6(1B), KJ 2(a), KJ 3, KJ 4(1), KJ 4(2) and (3), KJ 5(3), KJ 5(6)(a)(i), KJ 6 to KJ 12, NE 3(6) and OB 1 of the Income Tax Act 2004; sections 3(1), 4A(3)(bc), 22(2)(1), 68C(3)(a), 68C(4), 120B(b), 138L(2)(ab), 143A(5)(h), 157(10), 183A(1)(h), 183ABA(3A), 183D(1)(bc) of the Tax Administration Act 1994; sections 4(1), 4(2), 5(1), 6(1)(a), 6(2)(b) and (c), 8(6), 10, 11, 12(1)(c) and (2)(b), 17, 18(1)(b)(v), 18(2), 23A, 28(c), 34(5), 36(1) and (1B), 40(1), 40(2), 46(2), 46(3)(b), 48(1), 48(2), 50(1), 50(3), 51(4)(a), 51(5), 56(3)(c)(iv), 57(3), new subpart 4 of Part 2: sections 59A to D, sections 62(c), 63A, 66, 66A, 73(3), 75(1), 75(3), 77(3), 80(1), 81(1), 84(2), 84(3), 85, 85(3), 86(2), 92A, 93, 98(3)(e), 98A, 99(2) and (4), new subpart 3A of Part 3: sections 101A to K, sections 102(b)(iii), 113(5) and (6), 117A, 121(3)(a), 123(4), 123(5) and (6), 125A, 128A to D, 129, 153(d), 158(a), 161(1B), 161(2B), 162(2), 163(a), 164(2), 169(3), 186(5), 189B, 189C, 205A, 206, 210(2)(b)(ii), 211(1)(b) and (2), 214, 215, 216, 219, 221, 225(2), 226, 229, 230A and 234 of the KiwiSaver Act 2006; Schedule 1 clauses 2(2), 4(3), 8(8), 12(2), 12(3), 13, 14(2) and Schedule 4 of the KiwiSaver scheme rules; sections 2(1), 9BAA, 9D, 34, 35, 37 to 41 and Schedule 2 clauses 1(o) and 1(o)(iii) of the Superannuation Schemes Act 1989; regulations 6, 7, 20(4), 21, 27(b) and 30 to 32 of the KiwiSaver Regulations 2006; sections 8(1)(c)(v), 9(1)(c) and 14(c)(iii) of the Holidays Act 2003; sections CS 10B, DC 7(1), MK 1 to 4, MK 6, MK 8(2)(a), MK 9 to 16, RD 5(1)(d), RD 66, YA 1 and schedules 28 and 49 of the Income Tax Act 2007

The legislation giving effect to compulsory employer contributions and the employer tax credit is contained in the Taxation (KiwiSaver) Act 2007, which received Royal assent on 19 December 2007, and applies from 1 April 2008. The new Act also includes a number of other amendments. The most significant are changes to the member tax credit rules, the establishment of a process to deal with invalid KiwiSaver enrolments, changes to the definition of "salary and wages", changes to the complying fund rules, and regulatory regime changes.

Background

The government announced in Budget 2007 a number of changes to KiwiSaver that significantly increase the incentives to join the work-based savings scheme and to continue making regular contributions. The key changes included:

- A tax credit to members that matches their contributions to a KiwiSaver scheme or a complying superannuation fund (CSF),[1] up to a maximum of $20 per week. The legislation giving effect to the member tax credit was enacted in May 2007, in the Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007, and applies to contributions made from 1 July 2007.
- A compulsory employer contribution when an employee contributes to a KiwiSaver scheme or a CSF that will be phased in over four years, starting at 1 percent from 1 April 2008 and reaching 4 percent of gross salary or wages from 1 April 2011. This was legislated for in the Taxation (KiwiSaver) Act 2007.

[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 KiwiSaver lock-in rules and portability.

- An employer tax credit to reimburse employers for contributions they will be required to make into their employees' KiwiSaver scheme or CSF up to a maximum of $20 a week for each employee. This was also legislated for in the Taxation (KiwiSaver) Act 2007.

Key features

The new rules for KiwiSaver and complying funds involve changes to the KiwiSaver Act 2006, Income Tax Act 2004, Income Tax Act 2007, Tax Administration Act 1994, Superannuation Schemes Act 1989 and the KiwiSaver Regulations 2006. The main changes are:

- New rules for the member tax credit, the main changes being:
  - the period of membership for the purposes of calculating the member tax credit has been amended to include the period from the date that a contribution is first made or deducted from a person's salary or wages, and a definition of "creditable membership" has been introduced;
  - contributions received by the Commissioner but not transferred to a provider in the member credit year will count towards the calculation of the credit, and a definition for "member credit contributions" has been introduced; and
  - the formula for calculating the amount of credit has been clarified.
- Rules to establish compulsory employer contributions.
- Rules to establish the employer tax credit.
- Rules for dealing with "invalid KiwiSaver enrolments".
- Amendments to the definition of "salary or wages".
- New rules for minimum employee contributions.
- A number of changes have been made to the regulatory regime:
  - the definition of "independent trustee" has been amended to remove the requirement that the trustee be independent from the administration and investment managers of the scheme;
  - an amendment has been made to section 206 of the KiwiSaver Act to provide that persons are not investment brokers if they merely exercise a function, duty or power under the KiwiSaver Act;
  - a new section has been introduced to require all KiwiSaver schemes and CSFs to disclose their approach to responsible investment;
  - section 158 of the KiwiSaver Act has been expanded to enable the KiwiSaver register to include a sub-register of CSFs; and
  - a new section provides transitional relief for KiwiSaver and CSF providers for any non-compliance with any Act until 31 January 2007.
- A number of changes have been made with respect to CSFs:
  - the definition of "complying fund rules" has been amended;
  - compulsory employer contributions to CSFs must be allocated to the investment profile chosen by members and be fully vested;
  - the Superannuation Schemes Act 1989 has been amended to enable schemes that provide insurance benefits that are linked to superannuation accumulation to reduce those insurance benefits by the amount transferred if members elect to transfer their CSF accumulation to a KiwiSaver scheme; and
  - to obtain CSF status, a registered superannuation scheme will have to satisfy the requirements for the scheme to be registered before 1 July 2007.

A number of other changes have also been made and are included in this article.

Detailed analysis

Member tax credit (sections KJ to KJ 5 of the Income Tax Act 2004 and sections MK1(1) and (3) and MK 2 to MK8 of the Income Tax Act 2007)

A number of changes have been made to the member tax credit rules as enacted by the Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007. Section references are to the Income Tax Act 2004 unless otherwise specified.

Creditable membership

The requirements that a person must meet to be eligible for the member tax credit are set out in section KJ 2. New section KJ 2(a) introduces the requirement of having a "creditable membership" of KiwiSaver or a complying fund. Accordingly, a new definition of "creditable membership" has been included in section OB 1. The definition provides that when a person joins KiwiSaver or a complying fund, the period of eligibility for the member tax credit begins from the earlier of:

- the first of the month in which contributions are deducted from an employee's salary or wages; or
- the first of the month in which a contribution is received by Inland Revenue (a voluntary contribution paid directly to Inland Revenue); or

- the first of the month in which securities are allotted by a KiwiSaver scheme or a CSF.

Contributions paid to Inland Revenue – transitional rule

A transitional rule applied as a result of the legislative requirement that all contributions must be paid to Inland Revenue during the period 1 July to 30 September 2007. This transitional rule treated membership as beginning on the first of the month in which a provider received a valid application for membership from a person if contributions had been received by either Inland Revenue or the provider during the period 1 July to 31 October 2007.

Amount of member tax credit

The amount of the member tax credit payable is calculated under the formula in section KJ 3. It has been amended to correct a drafting error and to clarify the calculation of the credit. If a person meets the requirement set out in section KJ 2 for the full member credit year (1 July to 30 June), the amount of the credit is the total amount of contributions received during the year up to a maximum of $1,042.86. If the person does not meet the requirements in section KJ 2, the credit is apportioned on the basis of the number of days the person meets the requirements. Two possible formulas for calculating the credit are provided, with the relevant formula depending on whether the amount contributed by the member is more or less than $1,042.86 ÷ 365 ($2.857 per day).

First formula:

$$\frac{\text{member credit contributions}^{2}}{\text{included days}^{3}}$$

Second formula:

$$\frac{\$1{,}042.86 \text{ x included days}}{365}$$

If the amount calculated by the first formula is less than $1,042.86 ÷ 365 ($2.857 per day), the amount of the member tax credit is equal to the total amount of that person's contributions for the member credit year (1 July to 30 June). If the amount calculated under the first formula is equal to or greater than $1,042.86 ÷ 365 ($2.857 per day), the amount is calculated by the second formula.

[2] "Member credit contributions" are the total amount of a person's member credit contributions for all of the person's complying superannuation funds and KiwiSaver schemes for the member credit year.

[3] Included days are the number of days in the member credit year on which the person meets the requirements in section KJ 2.

Example 1

Tracey is automatically enrolled in KiwiSaver on 15 April 2008 through her employer. Her eligibility for the member tax credit begins on 1 April (deductions made from salary or wages in April), 91 days before the end of the member credit year (30 June 2008). Tracey makes contributions to her KiwiSaver scheme during this 91-day period totalling $500 (approximately $38 a week). As the amount that she has contributed is greater than $1,042.86 ÷ 365 ($2.857), the amount of her member tax credit is calculated using the formula:

$$\frac{\$1{,}042.86 \text{ x } 91 \text{ (included days)}}{365}$$

Tracey's tax credit entitlement for the 2007–08 member credit year is $260 (13 weeks at $20).

Example 2

Mike opts into KiwiSaver through his employer on 26 April 2008. The first contributions from his pay will not be deducted until May, so he makes a voluntary contribution to Inland Revenue that is received on 28 April 2008. Mike's eligibility for the member tax credit begins on 1 April 2008, 91 days before the end of the member credit year (30 June 2008). Mike makes contributions to his KiwiSaver scheme during this 91-day period totalling $200 (approximately $15.38 a week). As the amount he has contributed is less than $1,042.86 ÷ 365 ($2.857), the amount of his member tax credit for the 2007–2008 member credit year is equal to the total amount of his member credit contributions for the member credit year – $200 (approximately $15.38 x 13 weeks).

Member credit contributions

A new definition of "member credit contributions" has been introduced and includes amounts received and held by the Commissioner. These are contributions received and held by Inland Revenue but not on-paid to the provider until after the member credit year. These will count as contributions for calculating the member tax credit for that year. Employer contributions, amounts diverted under a mortgage diversion and amounts refunded are excluded for the purposes of calculating the credit.

Processing claim for credit

Section KJ 4(2) has been amended to provide that upon receipt of a claim, Inland Revenue has 30 working days to process and pay the claim to the provider. Member tax credits are paid to providers on a first-come basis. There is no longer a pro-rating of the payment between providers if the member has more than one provider.

Payment of credit

New subsection KJ 4(3) provides the circumstances in which the Commissioner may make a payment to individual members or to another provider. A final payment may be made to the member or the member's estate for reasons of serious illness, death or when the member's account is closed. Inland Revenue will pay the credit to the member's provider at the time the claim is made. If there is, or will be, a change in provider (a request for transfer), the credit will be paid to the new provider if requested by the first provider.

Allocating the credit

Section KJ 5 (3) has been amended to clarify the rules in relation to allocating the member tax credit. The provider must allocate the member tax credit according to the current investment allocation instructions the member has elected or the investment allocation to which the member has been assigned.

Claiming the credit

The provider must claim the tax credit in the "form prescribed by the Commissioner". Providers will make a claim after 30 June each member credit year on the basis of the contribution information they hold (and Inland Revenue does not hold) at that date. That will include information such as the amount of contributions received directly by the provider and the amount of contributions subject to a mortgage diversion. Inland Revenue will calculate and pay the credit based on the information received and the contribution information it holds. All contributions for complying funds will, however, need to be received by 30 June to count towards the calculation of the credit in that year as all complying fund contributions are made directly from the employer to the provider. (Inland Revenue does not hold contribution information for complying funds.)

The member tax credit process will require providers to furnish necessary information to Inland Revenue to enable it to calculate the member tax credit. Inland Revenue will calculate the member tax credit on the basis of this information and make supplementary member tax credit payments, where appropriate, when additional information is available in relation to money in the holding account.

Providers retain the ability to make supplementary claims for periods for which they have obtained the information needed to make a claim – either when no claim was previously lodged, or when less than the maximum eligible claim has previously been paid. However, because Inland Revenue will be calculating the entitlement to the member tax credit based on information provided to it and also on the qualifying contributions it holds, KiwiSaver providers may not need to make supplementary claims after the end of the member credit year.

As CSF providers may not always hold the relevant IRD numbers for their members, an amendment enables CSFs that do not have a member's IRD number to supply other information to Inland Revenue to assist it in making the payment. If it is unable to make the payment on the basis of the information provided, Inland Revenue will inform the provider so that the provider can write to the member requesting the necessary information. Section 68C (3)(a) of the Tax Administration Act 1994 has been amended to clarify that the IRD number need be provided only if known.

Transfers – information to be provided

Section 56 of the KiwiSaver Act has been amended so that KiwiSaver providers are no longer required to provide information about the amount of the member tax credit received or information about previous claims made by them to a new KiwiSaver provider on transfer. This is because Inland Revenue will hold this information. However, the following details will still need to be provided to another scheme on transfer:

- the value of qualifying contributions received directly;
- mortgage diversion arrangements;
- any periods of ineligibility because of residence outside New Zealand; and
- the date on which a person first became a member of a KiwiSaver scheme.

Permanent emigration

Clause 14(2) of Schedule 1 of the KiwiSaver Act has been amended to provide that when KiwiSaver members permanently emigrate and transfer all of their funds in their KiwiSaver scheme to a foreign superannuation scheme the nominal value of the credit up to the value of their accumulation in the scheme will be repaid to the Crown.

Compulsory employer contributions

New Subpart 3A of Part 3 of the KiwiSaver Act (sections 101A to 101K) requires an employer to make an employer contribution for each employee who has deductions for KiwiSaver or CSF contributions from his or her gross salary or wages. This requirement will be phased in as follows:

From	Employer compulsory contribution rate as a percentage of gross salary or wages
1 April 2008	1%
1 April 2009	2%
1 April 2010	3%
1 April 2011	4%

Existing contributions will count towards the compulsory amount in certain circumstances to prevent employers already making employer contributions to existing registered superannuation schemes from having to make additional compulsory employer contributions.

New section 101B provides rules relating to who should bear the cost of the compulsory employer contributions. In the first instance, compulsory employer contributions will be paid in addition to the employee's gross salary or wages as an additional payment (benefit) on top of existing remuneration. However, from 13 December 2007, employers and employees (or unions) may negotiate as to how compulsory employer contributions will be funded, provided any final agreement is an outcome of good faith bargaining.

General rules for compulsory employer contributions

New section 101A requires employers to pay a compulsory employer contribution for employees if they meet the requirements set out in section 101C (employee requirements).[4] The requirements are that employees are:

- paid salary or wages from which the employer deducts, or is required to deduct, contributions for their KiwiSaver scheme or CSF;
- aged 18 and over;
- not entitled to withdraw an amount from their KiwiSaver scheme or complying fund under the scheme rules that require lock-in (that is, the age of eligibility for New Zealand superannuation or five years of membership, whichever occurs later); and
- not a defined benefit scheme member.

If an employee does not meet any of these requirements, the employer is not required to make a compulsory employer contribution for that employee. This does not prevent an employer making voluntary contributions to an employee's KiwiSaver scheme or CSF if the employee does not meet these requirements.

Employers are required to make compulsory contributions if they are required to make KiwiSaver deductions from an employee's salary or wages. For example, if an employee is subject to the automatic enrolment rules but the employer does not make a deduction of KiwiSaver contributions, the employer is still required to pay a compulsory employer contribution for that employee.

A defined benefit scheme member (defined in section 4 of the KiwiSaver Act) is an employee whose employer makes contributions to an existing registered superannuation scheme that is a defined benefit scheme (the retirement benefits for employees are calculated by reference to their salary or wages). Compulsory employer contributions are not payable for members of defined benefit schemes if:

- the scheme was registered before 17 May 2007;
- the employer provided access to eligible employees before 17 May 2007; and
- the employee was employed by the employer before 1 April 2008 and the employer makes or has agreed to make contributions before that date.

In addition, an employee will be treated as a defined benefit scheme member in the following circumstances (provided that the foregoing requirements are met):

- The scheme is one that succeeds the scheme that has to be registered by 17 May 2007, provided that all relevant members transferred to that scheme by virtue of section 9BAA of the Superannuation Schemes Act.
- If an employee is covered by a collective agreement in force before 17 May 2007 and expiring after 1 April 2008 that requires the employer to make contributions to that scheme.
- If the employee has changed employment and the new employer is required to make contributions to that scheme on the same basis as the previous employer. This would cover the situation where an employee is treated as a defined benefit scheme member but changes employment and the new employer is required to continue to contribute to that scheme for that employee.

Calculation of compulsory employer contribution

New section 101D sets out the rules for determining the amount of the employer contribution. The amount of the contribution payable by an employer is calculated using the following formula:

Payment of salary or wages x CEC rate – other contributions – hybrid scheme contributions

The "payment of salary or wages" is the amount of gross salary or wages from which the employer deducts or is required to deduct an employee's contribution to a KiwiSaver scheme or a CSF.

The "CEC rate" is:

- 1 percent if the payment of gross salary or wages is made for a pay period in the year starting on 1 April 2008;
- 2 percent if the payment of gross salary or wages is made for a pay period in the year starting on 1 April 2009;
- 3 percent if the payment of gross salary or wages is made for a pay period in the year starting on 1 April 2010;

[4] An employer contribution is an employer superannuation contribution (specified superannuation contribution) made by an employer to a KiwiSaver scheme or a complying superannuation fund and includes compulsory contributions. It does not include amounts, such as group life insurance, that do not count as a contribution under section 68(2) of the KiwiSaver Act. See the definition of "employer contribution" in section 4 of the KiwiSaver Act. (Note that for the purposes of the Income Tax Act 2007, the term "employer's superannuation contribution" replaces the term "specified superannuation contribution".)

- 4 percent if the payment of gross salary or wages is made for a pay period in the year starting on or after 1 April 2011.

The CEC rate for a year applies only if the whole pay period is in the year specified. For example, if a pay period for an employee spans 1 April 2009, then the 1 percent rate will apply for the employer contributions in respect of the payment of salary or wages for that pay period. The 2 percent rate will apply to the next pay period.

"Other contributions" is the total amount that an employer pays (or credits) an employee in relation to payment of gross salary or wages if the amount is:

(a) an employer contribution made in absence of this section (that is, voluntary contributions to a KiwiSaver scheme or a CSF):

(b) an employer superannuation contribution made to a registered superannuation scheme if:

- the scheme (or the prior scheme if the scheme is a successor scheme) was registered before 17 May 2007;[5]
- the scheme provides access to eligible employees before 17 May 2007;
- the employee is employed by the employer before 1 April 2008 and the employer makes or has agreed to make employer contributions before that date, or the employee is covered by a collective agreement that is in force before 17 May 2007 and expires after 1 April 2008 requiring employer contributions to the registered superannuation scheme; and
- the registered superannuation scheme provides that the contributions vest completely in the employee within five years of becoming a member.[6]

(c) an employer contribution in relation to an employee who is a member of Parliament, a judicial officer, or a sworn member of the police or a class of employee prescribed in regulations made under section 230A of the KiwiSaver Act.

"Hybrid scheme contributions" cover those contributions an employer makes (or credits) to a scheme where the retirement benefits are calculated by adding to an employee's total contributions a percentage of those contributions. Such schemes are not included in the "defined benefit scheme member" exclusion or in "other contribution". The amount of the contribution is given by the following formula:

member's contributions[7] x vesting percentage[8]

Employer contributions that are paid from reserves will be treated as employer contributions for the purposes of "other contributions". Also, the amount of the employer contribution will be the amount payable before the deduction of employer's superannuation contribution tax (specified superannuation withholding tax).[9]

This only applies when the conditions in paragraph (b) "other contributions" above are met.

Example 3

Joe is a member of his employer's existing superannuation scheme and joins KiwiSaver. Joe, the scheme and his employer meet the rules of "other contributions" in section 101D of the KiwiSaver Act. Joe's employer makes a matching 2 percent employer contribution to the existing scheme every pay period. His employer will not be required to make compulsory employer contributions in the 2008–09 tax year or 2009–10 tax year as the amount of "other contribution" equals or is greater than the amount of the compulsory employer contribution payable. However, from 1 April 2010 Joe's employer will be required to make a 1 percent compulsory employer contribution to his KiwiSaver scheme and a 2 percent contribution from 1 April 2011 as the contributions to the existing scheme are less than the compulsory amount.

Section 101E allows an employee and employer to agree the allocation of compulsory employer contributions between an employee's KiwiSaver Scheme and CSF. If no agreement is reached, the compulsory employer contributions are first allocated to the employee's KiwiSaver scheme and then to the CSF (if any).

Application of section 101B

Section 101B(1) provides that compulsory contributions[10] are to be paid in addition to an employee's gross salary or

5 In relation to a successor scheme, all the relevant members must be transferred under section 9BAA of the Superannuation Schemes Act.

6 To determine the amount of the contribution that vests within the five-year period when a contribution is paid, the employer is required to calculate, on the basis of the vesting scale in the trust deed, the amount that will vest if the employee is still a member after five years. This does not exclude schemes where the vesting scale is more than five years – contributions are counted to the extent that they vest within the requisite 5-year period.

7 Member's contributions is the amount of the employee's contributions for the period to which the payment of gross salary or wages relates.

8 Vesting percentage is the percentage of the employee's total contributions that is added to those contributions five years after the employee first became a member of the scheme, grossed up for specified superannuation contribution withholding tax (SSCWT). SSCWT is a tax on any monetary contribution to a superannuation fund that is paid by an employer for an employee's benefit. Employer contributions to KiwiSaver schemes and complying superannuation funds are exempt from SSCWT up to a cap of whichever is less – your contribution or 4 percent of your salary and wages. However, any contributions over the cap are subject to SSCWT.

9 Employer's superannuation contribution tax from 1 April 2007.

10 A compulsory contribution is an amount of compulsory employer contribution calculated by section 101D, ignoring the application of section 101D(5)(d).

wages used in section 101D(3) (on top of remuneration). Subsections (2) and (3) provide that a contractual arrangement of parties to an employment relationship cannot override the intention of subsection (1). That is, if the contractual arrangements specify that the employee must pay the cost of compulsory employer contributions from the employee's existing salary or wages, the arrangement has no effect.

However, from 13 December 2007, parties to an employment relationship are free to agree contractual terms and conditions that ignore the "on top of" remuneration requirement and the provisions of this section do not apply. Subsection (4) inserts an "avoidance of doubt" provision so that the duty of good faith as described in the Employment Relations Act 2000 always applies when parties to an employment relationship bargain for terms and conditions relating to compulsory contributions and associated matters, such as the employer tax credit.

Enforcement of the payment of compulsory employer contributions to a KiwiSaver scheme

Sections 93 and 101F(1) require employer contributions to a KiwiSaver scheme to be paid to Inland Revenue at the same time as employee contributions via the PAYE system. Other amounts that do not count as contributions under section 68(2) of the KiwiSaver Act (such as group life insurance) must be paid direct to the provider.

The payment of compulsory employer contributions via Inland Revenue provides a mechanism to allow Inland Revenue to police the payment by employers. Non-payment of compulsory employer contributions will be subject to current collection and enforcement practices. Section 216 of the KiwiSaver Act has been amended to provide a specific penalty for employers that do not comply with the requirement to pay compulsory employer contributions. From 1 April 2009,[11] section 216 will be repealed and employers will be subject to the penalties that apply for the non-compliance of other PAYE-type tax obligations. Furthermore, the definition of "tax" in section 3 of the Tax Administration Act 1994 has been amended from 1 April 2008 to include compulsory employer contributions. This will allow the Commissioner to use existing collection powers.

Enforcement of the payment of compulsory employer contributions to CSFs

Section 101F(2) requires compulsory employer contributions to a CSF to be paid directly to the provider. The payment must be made no later than one month after the payment of the salary or wages to which the contribution relates.

In keeping with current practice, it will be the responsibility of the provider to ensure compulsory employer contributions from an employer are made. It is expected that the current practice of employers certifying that all employer contributions have been made will continue. New section 101H requires a provider to give notice to an employer requesting payment if the provider is aware that the employer has failed to pay compulsory employer contributions. A copy of that notice must be provided to the Government Actuary. If payment does not occur within one month of the notice being given and the amount of the unpaid contributions is more than $500, the provider must give notice to the Government Actuary of the default.

New section 101I specifies that once notification has been received, the Government Actuary must determine the amount of any short payment. The Government Actuary can use existing powers under the KiwiSaver Act to investigate the matter and determine the amount outstanding. Once the Government Actuary has determined the amount of any short payment, the employer will be notified of the amount and will have 28 days to pay or dispute the amount. If the amount remains unpaid and no objection has been received, the amount will be referred to Inland Revenue for collection. The amount will be due and payable to Inland Revenue 20 working days after the notice is received.

The definition of "tax" in section 3 of the Tax Administration Act 1994 has been amended to include compulsory employer contributions to a CSF. This will allow the Commissioner to impose penalties and use existing collection powers from 1 April 2009 when these debts are referred to the Commissioner for collection.

Rules for providers

Section 101G requires the provider to allocate the compulsory employer contributions across the investment products that the member has subscribed to or been allocated. The contributions are to vest immediately.

In addition, section 101G(3) requires the provider to notify Inland Revenue of the date that a member will be entitled to withdraw his or her accumulated interest in the scheme. This must be done within two months of the person becoming entitled to withdraw the accumulated interest. Inland Revenue must notify the member's employer of that date so that the employer can cease making compulsory employer contributions.

Withdrawal of compulsory employer contributions

The KiwiSaver Act allows a member to withdraw employer contributions that have vested in an employee in the following circumstances:

- to assist with the purchase of the member's first home (which includes second-chance buyers);[12]
- for significant financial hardship;
- for serious illness;
- on permanent emigration from New Zealand;

[11] Officials have identified a drafting error relating to a double-up in the application date of the amendments to section 216. The correct application date for the repeal of this section is 1 April 2009. This error will be remedied in the next available tax bill.

[12] A second-chance buyer is a previous home owner who is in the same financial situation as first-home buyers in terms of income and assets. Second-chance home buyers must apply to Housing New Zealand for a determination of whether they are in the same financial situation as a first-home buyer.

- on the death of the member;
- as required by any statute such as an order made under section 31 of the Property (Relationships) Act 1976; and
- upon the age of eligibility for New Zealand superannuation or five years of membership, whichever occurs later.

As section 101G(2) provides that compulsory employer contributions will vest immediately with the member, these contributions can also be withdrawn in the foregoing circumstances. However, the KiwiSaver Act does not allow employer contributions to be diverted under a mortgage diversion facility.

Shareholder-employees of a close company

Employers of shareholder-employees of a close company will be required to make compulsory employer contributions for employees if their remuneration from the company is subject to PAYE and they are having KiwiSaver contributions deducted from that remuneration. Salary or wages for the purposes of the KiwiSaver Act excludes salary or wages or other income to which section OB 2(2) (meaning of source deduction payment: shareholder-employees of close companies) applies. As a result, only salary or wages subject to PAYE are subject to a compulsory employer contribution.

Private domestic workers

The KiwiSaver Act has been amended to clarify how KiwiSaver applies to private domestic workers, who are required to pay their own PAYE. As a result, private domestic workers can be both an employee and employer under the KiwiSaver Act, and the Act has been clarified to reflect this. Private domestic workers can deduct KiwiSaver contributions from their salary or wages and can choose to be an employer for the purposes of compulsory employer contributions. If they pay compulsory employer contributions, they will be entitled to the employer tax credit.

Employer contributions counting towards the employee contribution rate

Previously, the KiwiSaver Act allowed employer contributions to count towards the employee contribution rate if the parties agreed. With the advent of compulsory employer contributions, this provision was to be amended from 1 April 2008 to require a minimum employee contribution of 4 percent unless the transitional rates in proposed section 66A applied (limited to employees who had already entered into such an agreement). The Finance and Expenditure Committee recommended that the transitional rule be extended to all employees if their employer agreed to contribute at the 4 percent contribution rate.

New section 66A allows employees to enter into an agreement with their employers that the employer will contribute at least 2 percent towards the employee's 4 percent minimum contribution rate, from 1 April 2008 until 31 March 2011, if:

- the employer and employee agree that they will use the transitional rates of contribution;
- the employer contribution for the payment of salary or wages is equal to or greater than the relevant transitional rate for the employee; and
- the employer contribution vests in the employee immediately after it is made.

The minimum contribution rate for employees whose employer agrees to contribute towards their contribution rate will be:

Pay period	Minimum employee contribution	Minimum employer contribution	Total contribution
From 1 April 2008	2%	2%	4%
From 1 April 2009	2%	2%	4%
From 1 April 2010	3%	3%	6%
From 1 April 2011 onwards	4%	4%	8%

Employer tax credit (sections KJ6 to KJ10 of the Income Tax Act 2004 and sections MK 1(2) and (4) and MK 9 to MK 16 of the Income Tax Act 2007)

New section MK 1(2) of the Income Tax Act 2007 (section KJ 6 of the Income Tax Act 2004) provides a tax credit to employers to help offset the costs of making matching compulsory employer contributions to an employee's KiwiSaver scheme or CSF. The tax credit will be equal to the lesser of the employer's contribution or $20 a week for each employee. Sections MK 9 to MK 16 of the 2007 Act (sections KJ 7 to KJ 12 of the 2004 Act) set out the eligibility rules and how the credit is to be applied. To minimise the compliance costs and cash-flow implications of compulsory employer contributions, the payment of the tax credit is integrated into the PAYE remittance process. It is expected that employers will pay Inland Revenue a net amount after deducting the tax credit from their PAYE liability for the payment period.

This tax credit can be claimed by any employer (including tax-exempt entities such as charities) provided the employer is making an employer contribution to a KiwiSaver scheme or a CSF for an employee who meets the requirements in section MK 9 of the Income Tax Act 2007.

The employer tax credit applies to employer contributions made to a KiwiSaver scheme or CSF from 1 April 2008.

The following section references are to the 2007 Act unless otherwise specified.

Entitlement

New section MK 1(2) allows an employer who makes a contribution on behalf of an employee a tax credit for the payment period equal to the amount calculated under section MK 10. To be eligible for the credit the employer must meet the requirements in section MK 9.

Eligibility requirements

To be eligible for the employer tax credit, the employer must:

(a) pay an employer contribution for an employee who is aged 18 or over and is not entitled to withdraw an amount from a KiwiSaver scheme or CSF under the scheme rules that require lock-in (that is, the age eligibility for New Zealand superannuation or five years of membership, whichever occurs later);

(b) provide details of the amount of the credit in an employer monthly schedule or remittance certificate (although that is not required if subsection (2) applies); and

(c) be an employer to which KiwiSaver applies (that is, be an employer who is tax-resident in New Zealand or, if not tax-resident, be an employer who carries on a business from a fixed establishment in New Zealand or chooses to apply the KiwiSaver Act on behalf of its employees).

Subsection (2) applies when the employer has unpaid compulsory employer contributions.

Amount of credit

The amount of the tax credit allowable to an employer is equal to the lesser of:

- the amount of the employer contributions for the employee for the payment period; and
- the amount calculated using the formula: $20 x weeks in payment period.

"Weeks in payment period" means the number of weeks for the payment of the employee's salary or wages for which the employee meets the eligibility requirements in paragraph (a) above, including weeks in that period in which no employer contribution is made. Parts of a week are expressed as a decimal. A "payment period" means the period in which PAYE is withheld in relation to an employee, and includes a period of a month or a period of the 1st to the 15th of a month and a period from the 16th to the end of a month.

For example, if during a payment period for the month of April an employer makes employer contributions of $50, the amount of the tax credit will be $50 because the actual employer contributions are less than the amount calculated by the formula ($85.71). If the actual employer contributions were more than $85.71, the amount of the tax credit for that month would be limited to $85.71.[13]

The tax credit is available for both voluntary and compulsory employer contributions to a KiwiSaver scheme or CSF.

Application of tax credit

New sections MK 11 to MK 13 set out the rules relating to how the tax credit will be applied. The tax credit is integrated into the PAYE remittance process so that the value of the credit is given to employers at the same time the employer is required to remit the contributions to providers or Inland Revenue.

Section MK 11 provides that the tax credit arises when the PAYE is due for the month or the date of payment of PAYE for a private domestic worker in which the employer contributions were made. For example, tax credits for contributions made during April 2008 for a monthly payment period would arise on 20 May 2008, being the payment date for that period.

Subsection (2) deals with the situation when subsection MK 9(2) applies, which covers short payment of compulsory employer contributions to a CSF or KiwiSaver scheme.

Sections MK 12 and MK 13 deal with the use of the tax credits to offset employer contributions and other PAYE liabilities.

The tax credit calculated for a payment period is used as follows:

- first, to pay KiwiSaver compulsory employer contributions due for that period or the amount owing to a CSF referred to in a notice received by the Commissioner under section 101I(5) of the KiwiSaver Act;
- second, to pay voluntary KiwiSaver employer contributions for that payment period;
- third, to pay any other amounts payable for that payment period by the employer;
- fourth, to pay any other amount payable by the employer to the Commissioner (arrears of an amount due under an Inland Revenue Act); and
- fifth, to be refunded to the employer.

From 1 April 2009, new section 101I of the KiwiSaver Act requires the Government Actuary to send a notice to Inland Revenue detailing the amount of compulsory employer contributions to a CSF that is owed by an employer. When the notice is received by Inland Revenue or there is a short payment of compulsory employer contributions to a KiwiSaver scheme, new section MK 13 allows the employer tax credits used under sections MK 12(1)(b) or (c) to be used to meet that amount owing. When this occurs, a tax liability of the amount of the credits used

[13] The formula provided in the Taxation (KiwiSaver) Act 2007 for the calculation of the employer tax credit currently results in a shortfall of the tax credit, depending on how many weeks pay an employee has received in a PAYE period. Officials are working on remedying this legislative error to ensure that the policy intent is implemented.

becomes payable by the employer to the Commissioner. This is to ensure that the employee receives a contribution equal to the amount of the employer tax credits claimed.

Miscellaneous provisions

New section MK 14 provides that if employer contributions are refunded as a result of an employee opting out of KiwiSaver, the amount of any tax credits claimed for the contributions is refundable to the Commissioner.

New section MK 15 provides that if someone is employed by a number of employers who are associated for tax purposes, the associated employers will be considered as one employer for the purposes of claiming the tax credit. This is to prevent associated employers claiming more than one credit for the same employee.

Private domestic workers who are employers for the purposes of the KiwiSaver Act are treated as paying salary or wages to themselves in the capacity of an employee for the purposes of the employer tax credit rules. This means that they are able to claim the credit if employer contributions are made.

Section DC 7 of the Income Tax Act 2007 (Contributions to employees' superannuation schemes), which allows an employer a deduction for contributions to an employee's superannuation scheme, has been amended to limit the amount of the deduction for contributions to a KiwiSaver scheme or CSF to the amount for which no credit was claimed.

Section CX 50 of the Income Tax Act 2007 ensures that the employer tax credit is treated as excluded income. For GST purposes, the employer tax credit will be treated as a non-taxable grant or subsidy.

Definition of "salary and wages" (section 4 of the KiwiSaver Act)

The definition of "salary and wages" in section 4 of the KiwiSaver Act has been amended in the following ways:

- From 1 July 2007, all weekly compensation and paid parental leave payable under Part 7A of the Parental Leave and Employment Protection Act 1987 are treated as salary or wages for the purposes of KiwiSaver.
- Redundancy payments as defined in the Income Tax Act 2004 are excluded from the definition of "salary and wages".
- Expenditure on account of an employee and allowances if they are overseas, accommodation and other costs of living are also excluded from the definition of "salary and wages".

The government's intention was that from 1 April 2008, the value of benefits such as board or lodging or the use of a house or quarters, or the payment of allowances instead of such benefits [14] would be excluded from the definition of "salary and wages" in section 4 of the KiwiSaver Act. However, this provision was inadvertently omitted from the amending Act. The omission is expected to be corrected in future legislation.

For the purposes of compulsory employer contributions, the following are not considered salary or wages:

- all weekly compensation and paid parental leave; and
- weekly compensation paid by an employer, unless the employer chooses to treat such payments as salary or wages.

This means that these payments are not subject to compulsory employer contributions.

For contributions to complying funds, bonuses, commissions and other amounts that are not included in gross base salary or wages are excluded. This enables employers that contribute to complying funds to apply current practice (gross base salary, or a variant of this) as a contributions multiplier. This change means non-regular payments are excluded and contributions, including compulsory employer contributions, are calculated on the same gross base salary basis as an employee's contribution. However, employers will have to use gross salary and wages as a basis for contributions for those employees that choose to opt into KiwiSaver.

Initial and confirmed back-dated validation of invalid membership (section 18 and new section 59 of the KiwiSaver Act 2006)

Invalid KiwiSaver enrolments occur in a range of circumstances. This can happen, for example, when people join KiwiSaver who are not entitled to because they do not meet the residency requirements. Alternatively, they could be incorrectly automatically enrolled, perhaps because they are under 18 years of age or over the New Zealand superannuation qualification age. A new subpart 4 (sections 59A to 59D) has been added to Part 2 of the KiwiSaver Act (allocation of people to KiwiSaver Schemes) to provide rules for invalid KiwiSaver enrolments. The relevant sections are treated as coming into force on 1 July 2007.

Section 59A of the KiwiSaver Act describes the circumstances in which an enrolment is treated as invalid and to which the invalid enrolment rules apply. They are when:

- a person does not meet the requirements of section 6 of the KiwiSaver Act – that is, at the time the person was automatically enrolled or opted in, he or she was not living or normally living in New Zealand [15] and was not a New Zealand citizen or entitled in terms of the Immigration Act 1987 to be in New Zealand indefinitely; or

[14] Para (b)(i) of the definition of "salary or wages" in the Income Tax Act 2004.

[15] Excluding state services personnel serving outside New Zealand, employed on New Zealand terms and conditions and serving in a jurisdiction where offers of KiwiSaver scheme membership are lawful. Before the date of enactment, the requirement was that the member be personally present in New Zealand at the time of enrolment.

- a person who does not meet the requirements of the automatic enrolment rules has been automatically enrolled – for example, when the person is less than 18 years of age or is a casual employee; or
- a person who is not entitled to opt in to KiwiSaver does so – for example, because the person is over the New Zealand superannuation qualification age or is already a member of a KiwiSaver scheme.

New section 59B specifies that the Commissioner or the relevant provider must be notified of an invalid enrolment as soon as practicable after it is discovered. The section also provides that, for a period of time, providers are able to treat as valid enrolments that have been identified as invalid as far as the administration of the fund is concerned. The time period for initial back-dated validation begins on the earliest of:

- the day the Act applied; or
- the automatic enrolment rules applied; or
- the opt-in rules applied to the person.

The time period ends on the earliest of:

- three months after the mistake was discovered by the KiwiSaver provider; or
- three months after the provider was notified by the Commissioner or other person; or
- the day that the provider pays the member's accumulation to the Commissioner.

New section 59C allows validation of a member's enrolment by the end of the time period of initial back-dated validation provided in section 59B if the person meets the rules for membership. This means that individuals who subsequently meet the membership criteria will have their membership validated. For individuals who should not be subject to the automatic enrolment rules, enrolment will be validated if they do not opt out and they are eligible to be a member.

This section will apply if at the time during the period specified in new section 59B, persons are eligible to be a member because they meet the requirements of section 6 and are:

- less than the New Zealand Superannuation qualification age (65 years of age); and
- have not opted out under the opt-out provisions in section 18, which have been extended to include persons invalidly automatically enrolled – the invalid enrolment will be validated by the Commissioner and the Commissioner must notify the provider of this.

Example 4

Sam finished school when he was 17 and started working for a builder. His employer automatically enrolled him into KiwiSaver. Six months later Sam's KiwiSaver provider became aware of the fact that although he was now 18, at the time he was automatically enrolled, he was only 17 years old (and the automatic enrolment rules should not have applied to him), so he had been invalidly enrolled. Sam will be validated as a member and remain enrolled as the opt-out period has expired.

New section 59D contains the refund process that will apply if the time period of initial validation ends and confirmation of backdated validation under section 59C has not occurred. The section sets out what the provider and Commissioner must do.

The provider must pay the member's accumulation to the Commissioner and immediately provide the Commissioner with:

- notice of the amount of the contributions received by the provider directly and when they were received;
- the amount paid out under mortgage diversion and when paid; and
- the amounts of any permitted withdrawals, when they were paid, their type and the amount of any Crown contribution in the permitted withdrawal.

The Commissioner must refund:

- the person's contributions received by the provider, minus any Crown contribution (such as the member tax credit) and amounts diverted under mortgage diversion or paid out by the provider as a permitted withdrawal; plus
- any amount held by the Commissioner (but not yet passed to the provider) net of interest.

The total amount of contributions refunded will include interest. Interest is calculated using the formula in section 87. For the purposes of the calculation of interest on refunds arising from invalid KiwiSaver enrolments, "interest period" is defined as beginning on the day the Commissioner or the provider received the contribution and ending on the day the Commissioner pays the refund.

Section 59(D)(4) provides that the refund is to be made to the person, the person's employer, the Crown or any other person that made the contribution. The Commissioner can make the refund in proportion to the best estimate of what they contributed, less amounts diverted under mortgage diversion or paid as a permitted withdrawal.

Section 59(D)(5) provides for the treatment of members' accumulated interest paid to the Commissioner by the provider and any contributions in the holding account. The money is treated as public money, and the Commissioner is required to pay it into the Crown Bank Account.

Example 5

After Kate completed her final year of school she started working at her local bakery over the summer before starting university. Kate's employer automatically

enrolled her into KiwiSaver. Two months later, Kate became aware that she had been automatically enrolled. As she was only 17 years old (under the age of eligibility for KiwiSaver membership) the enrolment was invalid.

Kate had already turned 18 by the time she became aware that she had been invalidly enrolled. This meant her enrolment could be validated or Kate could choose to apply for opt-out under section 18 (the extension period). An opt-out has to be made in the period that ends three months after the date on which the Commissioner receives the first contribution for Kate.

Regulatory regime for KiwiSaver and CSFs

A number of changes have been made to the regulatory regime for KiwiSaver and CSFs.

A CSF is a registered superannuation scheme that has incorporated certain KiwiSaver rules – in particular, lock-in and portability. Employer contributions to CSFs are eligible for the exemption from SSCWT that is provided for KiwiSaver schemes. The rules applicable to KiwiSaver schemes apply in most part to CSFs. The Taxation (KiwiSaver) Act 2007 introduces further obligations for CSFs in this regard. The Act also introduces new obligations for CSF providers. These obligations address the unique position of CSF in the KiwiSaver environment.

KiwiSaver rules

The KiwiSaver rules found in Schedule 1 of the KiwiSaver Act establish the conditions of membership for any KiwiSaver Scheme. For example, it includes rules relating to the lock-in of funds, circumstances of early withdrawal and rules preventing unreasonable fees from being charged. These rules apply to CSFs through the definition of complying fund rules in section OB 1 of the Income Tax Act 2004. The Taxation Act further aligned the complying fund rules with the KiwiSaver rules. Specifically, the Taxation Act includes an amendment to the definition of complying fund rules that ensures that any CSF must allow the withdrawal of funds as a lump sum. The complying fund rules also ensure that no person may join a CSF if the person is over the age of eligibility for New Zealand superannuation. Regulation 21 of the KiwiSaver Regulations 2006 has also been amended to enable CSFs to establish a mortgage diversion facility.

Sections 196 and 101G of the KiwiSaver Act have also been included in the complying fund rules. Section 101G of the KiwiSaver Act 2006 (as implied into the definition of the complying fund rules) ensures that compulsory employer contributions to CSFs must be allocated to the investment profile chosen by members and be fully vested. It further requires notice to be sent by providers to the Commissioner two months before the member becomes eligible to withdraw his or her funds by reaching the age of eligibility.

Unreasonable fees

The definition of "complying fund" rules in section OB 1 of the Income Tax Act 2004 has been amended to include a reference to rule 2 in Schedule 1 of the KiwiSaver Act. This requires all CSF providers to ensure that the fees they charge for membership are not unreasonable. Breaching this rule will amount to a breach of section 35 of the Superannuation Schemes Act 1989 and may be enforced through the provisions in the Superannuation Schemes Act that allow the Government Actuary to direct, de-register or order the wind-up of a scheme. The generic appeals processes in the Superannuation Schemes Act will also apply. An amendment has been made to section 40 of the Superannuation Schemes Act that enables a court to enforce the requirement that fees not be unreasonable.

Contribution rates

The definition of CSF rules in section OB 1 of the Income Tax Act requires CSFs to make deductions from salary or wages that are equivalent to the minimum contribution rate specified in section 25(1)(d) of the KiwiSaver Act. This requires contributions to be made at 4 percent of an employee's gross base salary. The compulsory employer contribution must be made at the relevant rate, as prescribed in section 101D of the KiwiSaver Act. The compulsory employer contribution has been phased in over four years, increasing from 1 percent of an employee's gross salary or wage to 4 percent of gross salary in 2011. The complying fund rules have been amended so that the transitional rules that allow employer contributions to count towards the minimum contribution requirement also apply to complying fund members.

Transfers and insurance

Section 9D of the Superannuation Schemes Act 1989 has been amended to enable schemes that provide insurance benefits linked to superannuation accumulation to reduce those insurance benefits if a member elects to transfer their CSF accumulation to a KiwiSaver scheme. The insurance benefit may be reduced by an amount proportionate to the amount that is transferred out of the CSF to a KiwiSaver scheme. For example, if a CSF member has an accumulation of $100,000 and elects to transfer $50,000 of that accumulation to a KiwiSaver scheme, the CSF may reduce the life insurance benefit attached to that member's account by $50,000.

Successor agreements

To obtain CSF status, a registered superannuation scheme must satisfy the requirements for the scheme to be registered before 1 July 2007. Similarly, there are requirements that any employer participating in the scheme, must have entered into a participation agreement before 1 July 2007. To ensure that employers are not locked into agreements with a specific provider, the law enables successor participation agreements to replace any

participation agreement entered into before 1 July 2007. Successor agreement will need to be established under the provisions in section 9BAA of the Superannuation Schemes Act.

Register of CSFs

Section 158 of the KiwiSaver Act has been expanded to enable the KiwiSaver register to include a sub-register of CSFs. The information recorded on the sub-register will be largely similar to the information recorded for KiwiSaver schemes, and will include contact details for trustees, the date of approval for complying fund status and annual financial balance dates. The details to be included in the register of complying funds are specified in section 161 of the KiwiSaver Act. The register applies from 1 April 2008.

Participation agreements

The new section 41 of the Superannuation Schemes Act requires all existing participation agreements relating to CSFs to be lodged with the Government Actuary within 28 days. This provision only applies to employers that have already chosen to provide access to the CSF under a participation agreement. Further, section 34 of the Superannuation Schemes Act has been amended to include a requirement that, on application for approval as a CSF any relevant participation agreement providing access to the CSF section of the scheme must also be provided to the Government Actuary.

Implied offer relating to transfers without consent

Section 9BAA of the Superannuation Schemes Act enabled a trustee or an employer to transfer members in a scheme or a specific class of members within a scheme to a new scheme when the terms of membership are no less favourable. An amendment has been made to this provision that deems an offer of securities to have been made by the relevant member and acceptance to have been tendered by the new provider if the application is successful. This does not nullify the requirements of the Securities Act to provide an investment statement, but simply recognises that a contract has been made between the parties. All providers will still be required to provide potential members being transferred with an investment statement for the new scheme.

Notification of fee changes

Amendments have been made to the KiwiSaver Act and the Superannuation Schemes Act to require trustees of a scheme to notify the Government Actuary of any changes to the fees being charged to members in that scheme. Section 189B of the KiwiSaver Act and section 39 of the Superannuation Schemes Act require a trustee of a scheme to notify the Government Actuary of any changes to the fees charged for membership in a CSF or a KiwiSaver scheme. A corresponding amendment to section 40 of the Superannuation Schemes Act and section 189C of the KiwiSaver Act has also been made that enables a court to enforce the "unreasonable fees" requirements. This amendment has replaced the provisions in clause 2 of Schedule 1 of the KiwiSaver Act that allowed enforcement by the courts. The prohibition against unreasonable fees, however, is still contained in clause 2 of Schedule 1 of the KiwiSaver Act.

Responsible investment

New section 205A has been introduced to require all KiwiSaver schemes and CSFs to disclose their approach to responsible investment. The disclosure of this approach must be in the form required by the KiwiSaver Act. The Act specifics that the disclosure must be in the investment statements of the scheme and must be included at the end of the "who is providing it for me?" section of the investment statement. The disclosure statement must be in the form prescribed by the section. Failure to comply with this requirement is treated as a failure to comply with the Securities Regulations 1983. This allows the Securities Commission to monitor and enforce compliance with this provision.

Definitions of "independent trustee"

The definition of "independent trustee" in clause 4 of the KiwiSaver Act has been amended to remove the requirement that the trustee be independent from the administration and investment managers of the scheme. The amendment allows trustees that are performing these back-office functions themselves to continue operating as trustees of the scheme. The amendment applies to both trustees and related companies of trustees. Further, requirements for independence from employer contributors have been removed. Technical amendments have also been made to the definition of "independent trustees" to clarify that only one director of a trustee corporation will need to satisfy the requirements for independence.

Investment advisers

An amendment has been made to section 206 of the KiwiSaver Act to provide that a person is not an investment broker if they merely exercise a function, duty or power under the KiwiSaver Act.

Further amendments

A number of other amendments have also been made to the KiwiSaver Act.

The following amendments are treated as coming into force on 1 July 2007

Use of PAYE intermediaries

Amendments have been made so that PAYE intermediaries can:

- accept KiwiSaver opt-out notices (section 17);

- be treated as an employer for the purpose of the notice requirement provisions for people who start new employment (section 23A); and
- be treated as an employer for the purpose of the opt-in rules (section 34).

Late opt-out notices

An amendment to section 18 ensures that the Commissioner can accept a late opt-out notice if it is received by the employer or the Commissioner in the period ending three months after the date on which the Commissioner received the first contribution for the person. Previously the opt-out could only be received by the Commissioner.

Eligibility of employers who have schemes established under master trusts

Section 28 has been amended so that an employer using a Master Trust scheme as a vehicle for an exemption can use any other evidence to demonstrate compliance with the exempt employer criteria.

Information packs

Section 40 has been amended to ensure that there is no inference that the Commissioner of Inland Revenue would, on an ongoing basis, forecast the number of information packs employers would need and issue them automatically. The Commissioner will regularly remind employers of the need to ensure they have adequate information packs.

Final allocation of members to a scheme

Sections 48 and 51 have been amended so that final allocation to a KiwiSaver scheme does not occur when a dispute is underway and ensures that final allocation to a KiwiSaver scheme occurs "as soon as practicable" three months after the Commissioner received the first contribution for the person.

Commissioner provisionally allocates certain people to default KiwiSaver schemes and sends investment statement

Section 50 has been amended to clarify that the exemption for the Commissioner from sending an investment statement for a default scheme because an employer has a chosen scheme will apply only to employment that triggered the automatic enrolment rules.

Involuntary transfers

Section 57 has been amended so that an employer-chosen scheme does not apply in the case of involuntary transfers.

Private domestic workers

New sections 63A and 92A provide that private domestic workers, who choose to deduct their own PAYE and contribute to KiwiSaver from their salary or wages, can be both an employer and employee for the purposes of KiwiSaver.[16]

Permanent legislative authority for on-paying contributions received through section 73

Section 73 has been amended so that a permanent legislative authority is established to allow Inland Revenue to on-pay deductions from salary or wages entered in the holding account. Because the relevant part of section 73 is also subject to the on-payment requirements of sections 75 (initial contributions) and 77 (small contributions), consistent amendments have been made to those sections as well.

Crown contribution

Section 75 has been amended so that the Commissioner holds contributions for a person in the Inland Revenue holding account for three months only after receiving the first contribution for the member or receiving notice that the person is a member of a KiwiSaver scheme.

Refund by Commissioner of amounts paid in excess of required amount of deduction or if employee opts out

Section 80 has been amended so that refunds of ad hoc contributions (contributions not deducted from salary or wages) are allowed.

Pro rating of employer contributions when contributions short paid

An amendment is being made to section 99 to allow the formula providing for the pro rating of employer contributions where the contribution is short paid to consider part payments. The amendment also clarifies that if an employer contribution is short paid, no more than 100 percent of the contribution recorded for an employee will be attributed to that person.

Duty of Commissioner under section 50 modified in certain cases in which section 210 applies

Section 211 has been amended to remedy drafting issues.

KiwiSaver penalties

An amendment has been made to section 215 to ensure that a KiwiSaver penalty will not be imposed if the Commissioner has not given the employer notice within the preceding 12 months that a penalty may be, or has been, imposed.

Consent to electronic transactions

Section 219 has been amended to exclude the Commissioner or any employee or officer of Inland Revenue from the deemed consent provided for in that section.

[16] A definition of "private domestic worker" is included in section 4 of the KiwiSaver Act.

Refunds made by employer by direct credit

Section 221 has been amended to clarify that the requirement to give a refund by direct credit to a bank account applies only to the Commissioner.

The following amendments to the KiwiSaver Act come into force on 1 April 2008

Application

Section 6 has been amended so that:

- the Act applies to people who, at the time they become subject to the automatic enrolment rules or opt in are, or normally are, living in New Zealand; and
- non-resident employers with no fixed establishment in New Zealand are included within the scope of KiwiSaver if they so elect, either by deducting KiwiSaver contributions from an employee's salary or wages and/or making employer contributions. These employers are entitled to the employer tax credit in respect of employer contributions.

Excluding casual employees from the automatic enrolment rules

Section 12 has been amended to exclude casual employees from the automatic enrolment rules. "Casual employment" is defined by reference to the Holidays Act 2003 as employment that is "intermittent or irregular". The effect is that if employees are paid holiday pay regularly with their salary or wages they will be excluded from automatic enrolment. Those employees can continue to opt in to KiwiSaver, either by providing a deduction notice to their employer or by contracting directly with a scheme provider.

This section has also been amended so that the current rules will continue to apply to temporary fixed-term employment. Employers are excluded from the automatic enrolment rules if their employment contract is for a period of 28 continuous days or less. If employment is extended beyond 28 days, on day 29 the employee becomes subject to the automatic enrolment rules.

Interest

Section 85 has been amended so that the start date for the calculation of interest on employer contributions held in the Inland Revenue holding account is the first day of the month in which contributions were received by Inland Revenue. This also applies to contributions received to which the employer tax credit applies.

Restrictions on transactions

New section 117A imposes investment restrictions on KiwiSaver schemes with fewer than 20 members. For the purposes of determining the number of members, a person associated with a member under section OD 8(3) of the Income Tax Act will be treated as one person. This provision will:

- require a transaction between the scheme provider and a person associated with either the provider or a member to be at market value;
- limit to 5 percent of the scheme's assets, investments related to or managed by the provider (other than in their capacity as a provider), a member or a person associated with a provider or member; and
- prevent a provider from lending money or providing financial assistance to a member or a person associated with the provider or member.

Effect of registration of KiwiSaver scheme under section 150

Section 153 has been amended so that KiwiSaver schemes registered under an umbrella superannuation scheme trust can be treated as separate for the purposes of the portfolio investment entity rules.

Objections and appeals against decisions of Government Actuary

Section 186(5) has been amended, as part of introducing compulsory employer contributions. The amendment does not allow a person to appeal against an election made by the Government Actuary relating to short payment of compulsory employer contributions to a CSF.

Amendments treated as coming into force on the date of assent

Secondments

Sections 10 and 11 have been amended so that employees who enter into a secondment arrangement whereby they are transferred from one employer to another but remain "employed" by the original employer are not subject to the automatic enrolment rules.

Employees under secondment arrangements will be subject to the automatic enrolment rules if, after entering into the arrangement, they terminate employment with the original employer and begin working for the employer they were seconded to.

Effect of opting in by employees

Section 36 has been amended to clarify that a person opting in via a provider must specify the name of their employer if that person is an employee (clarifying that deductions are required from salary and wages).

Employer may choose scheme for employees

Section 46 has been amended so that an employer can have a chosen KiwiSaver scheme for its employees only if the scheme is open to all permanent employees (new or existing).

Notification of transfers and requirement to transfer funds and information

Section 56 provides that when a member of a KiwiSaver scheme transfers to a new scheme, the provider of the old scheme must advise the new provider whether the Crown contribution (the $1,000 kick-start contribution) is part of the member's accumulated interest that is to be transferred.

Refund by provider of amounts paid in excess of required amount of contribution

Section 81 has been amended so that providers are required to refund to the Commissioner the amount of contribution that the Commissioner requests, up to the amount in excess of what was required to be paid under the Act.

Interest

Section 84 has been amended so that:

- section 68(2) of the Public Finance Act 1989 does not apply to returns on the investment of holding account money and interest earned from 1 July 2007 is public money; and
- a person can notify the Commissioner if they do not wish to be paid interest on contributions held by Inland Revenue or on a refund.

Section 86 has been amended so that interest calculations for money held in Inland Revenue's holding account and payable is limited to two decimal places.

Refunds of employer contribution by provider

Section 101 has been amended so that a provider of a KiwiSaver scheme must refund to the Commissioner any amount of employer contribution that the Commissioner requests when that amount has been paid in excess of the employer contribution required under the KiwiSaver Act.

Who may apply for a contributions holiday

Section 102 has been amended so that if a member transfers from a CSF to a KiwiSaver scheme, the time during which they have contributed to the complying fund counts towards the time for eligibility for a contributions holiday.

Refund of initial contributions

Section 113 has been amended so that for applications for a refund of initial contributions held in the Inland Revenue holding account on the grounds of significant financial hardship, the Commissioner will have authority to consider whether alternative sources of funding have been explored and to limit the amount withdrawn.

Further modifications to application of section 8 to 11 of the Superannuation Schemes Act 1989

The reference to a "superannuation scheme" in section 121(3)(a) of the KiwiSaver Act 2006 has been replaced with the term "KiwiSaver scheme".

Requirement for annual report and annual personalised statement of contributions and accumulations for members

New section 125A requires all KiwiSaver and complying superannuation scheme providers to supply members with a personalised statement of their investment holding, on at least an annual basis. At a minimum, all member statements should provide information on:

- the level of contributions made by the member, employer and Crown in the period since the last member statement; and
- the total value of the member's interest in the scheme.

New sections 128B, 128C and 128D ensure that legislative terms are implied into the existing trust deeds. These sections cover:

- back-dated validation of enrolment (section 128B);
- lump sum payment by a CSF (section 128C); and
- compulsory employer contributions (section 128C).

In addition, section 128A has been amended to ensure that the legislative terms relating to the member tax credit are implied into existing trust deeds rather than the law.

Amendment of trust deed governing KiwiSaver scheme

Section 129 has been amended to ensure that if trustees of a KiwiSaver scheme propose to make any changes to any participation agreement entered into between the scheme trustees and any employer, the solicitor of the scheme must provide certification that the amendment is consistent with the requirements of the KiwiSaver Act and the Superannuation Schemes Act.

Certain sections of Securities Act 1978 modified in relation to KiwiSaver Scheme

Section 210 has been amended so that if an involuntary transfer arises under KiwiSaver, the amount that is transferred is, at a minimum, the member's accumulation.

Fee subsidies

Section 225(2) has been amended to remove the ability for the Chief Executive of the Ministry of Economic Development to delegate authority for administration of the $1,000 Crown contribution.

Crown contribution

Section 226 has been amended to provide flexibility around when the Crown contribution (the $1,000 kick-start contribution) must be paid to employees and members transferring from a CSF to a KiwiSaver Scheme, and so that the Crown contribution is paid only into an account that is fully vested in the member.

Regulations relating to a mortgage diversion facility

Section 229 has been amended so that:

- the mortgage diversion facility will apply for the remainder of the term of the loan after the diversion is made available, but only in relation to a mortgage over the person's principal residence; and
- the amount that can be diverted under mortgage diversion is no more than half the member contribution received by a provider, including both member contributions paid via Inland Revenue and those received directly from the member.

Contributions to a CSF can be diverted and applied towards payments of the person's mortgage, provided the same conditions that apply to KiwiSaver mortgage diversion are met.

Protection for non-compliance: Taxation (KiwiSaver) Act 2007

Section 234 was introduced as a transitional measure. This provisional measure ensures that if as a result of the amendments made in the Taxation (KiwiSaver) Act there has been non-compliance with other Acts (for example, investment statements issued under the Securities Act 1978) before 1 February 2008, the non-compliance is ignored unless it continues on or after 1 February 2008.

KiwiSaver Amendment Regulations 2008 (2008/6): exemption from regulation 7A(4) of Securities Regulations 1983

These regulations, which came into force on 1 February 2008, exempt providers of KiwiSaver schemes from regulation 7A(4) of the Securities Regulations 1983 in relation to an investment statement first distributed before 1 April 2008. The providers are exempted in respect of information that must be disclosed in an investment statement because of changes to the scheme or the securities arising from any provision of the Taxation (KiwiSaver) Act 2007. The exemption expires on 31 July 2008.

The effect of the exemption is that investment statements first distributed before 1 April 2008 need not be set out as required by regulation 7A(4). This enables providers, until 31 July 2008, to indicate the changes or corrections to investment statements required because of the Taxation (KiwiSaver) Act 2007 by way of an insert or supplement distributed with investment statements. However, information provided in the inserts or supplements must be set out in a style or format consistent with the investment statement.

KiwiSaver scheme rules

Clauses 12(2) and (3) of the KiwiSaver scheme rules (Schedule 1 of the KiwiSaver Act) have been amended to ensure that the serious illness withdrawal facility applies only when the member is permanently and totally disabled or when death is imminent. The member can then withdraw the $1,000 Crown contribution.

Clause 13 of the KiwiSaver scheme rules has been amended to ensure that applications for withdrawal on the grounds of serious illness can be made without the need to complete a statutory declaration of the assets and liabilities of the applicant. Accordingly, a statutory declaration of the member's assets and liabilities is only required for applications for withdrawal on the grounds of significant financial hardship.

Fund withdrawal tax

New section CS 10B of the Income Tax Act 2004 ensures that permitted KiwiSaver or CSF withdrawals are not subject to fund withdrawal tax.

KiwiSaver-related changes to the Tax Administration Act 1994

Interpretation

The definition of "tax" in section 3(1) of the Tax Administration Act (TAA) has been amended to include compulsory employer contributions to a KiwiSaver scheme or CSF from 1 April 2008.

Construction of certain provisions

Section 4A of the TAA has been amended so that a compulsory employer contribution to a KiwiSaver scheme or CSF is treated as if it were a deduction under the PAYE rules from 1 April 2008.

Keeping of business records

Section 22 of the TAA has been amended so that employers and PAYE intermediaries are required to keep records of amounts relating to employer tax credits from 1 April 2008.

Tax credit relating to KiwiSaver and CSF members: member credit form

Section 68 of the TAA has been amended from 1 April 2008 to:

- provide that the claim form must contain the tax file number "if known"; and
- allow providers to make a claim (including making a supplementary claim) to Inland Revenue for members who have had contributions deducted during the member credit year but which have not been received by providers.

Persons excluded

Section 120B of the TAA has been amended so that a failure to pay a compulsory employer contribution does not result in a liability to pay use-of-money interest from 1 April 2008.

Knowledge offences

Section 143A (Knowledge offences) of the TAA applies when the employer fails to make compulsory employer contributions to a KiwiSaver Scheme from 1 April 2009.

Deduction of tax from payments due to defaulters

Section 157 (Taxpayer default in payment of income tax) of the TAA applies where the employer fails to make compulsory employer contributions to a KiwiSaver Scheme from 1 April 2008.

Repeal of section 216 of the KiwiSaver Act

The reference to section 216 of the KiwiSaver Act 2006 will be omitted in sections 138L(2)(ab), 183A(1)(h), 183ABA(3A) and 183D(1)(bc) of the TAA as a consequence of the repeal of that section from 1 April 2009

KiwiSaver-related changes to the Superannuation Schemes Act 1989

Interpretation

The definition of "participation agreement" in section 2 of the Superannuation Schemes Act has been inserted to clarify that it has the meaning as defined in section 4(1) of the KiwiSaver Act 2006. This amendment applies from the date of assent – 19 December 2007.

Dealing with applications for CSFs

Section 34 of the Superannuation Schemes Act has been amended to clarify that a person seeking approval to become a complying fund needs to provide the necessary information to satisfy the requirements set out in section 35. This amendment is treated as coming into force on 1 April 2007.

Forms of notice under section 37

Sections 37 and 38 have been amended to require notices to be sent to the Government Actuary when there is a change in any information required to be specified in the register of CSFs. The amendments include changes to the name of the fund, changes to the trustees or changes to the financial year end of the fund. These amendments apply from 1 April 2008.

Matters to be specified in annual reports

Schedule 2 of the Superannuation Schemes Act has been amended so that a summary of amendments to the participation agreements relating to CSFs in any year must be included in the annual report. This amendment applies from 1 April 2009.

SSCWT exemption and participation agreements

An amendment has been made to section 35(1)(e) of the Superannuation Schemes Act to ensure that the CSF SSCWT exemption applies to participation agreements or schemes which replace those that were in place on 1 July 2007. However, the exemption does not apply if an employer enters into a participation agreement after 1 July 2007, if no agreement had been previously held.

Changes to the KiwiSaver Regulations 2006

The following changes came into force on the date of assent, 19 December 2007.

Regulations 6 and 7 replaced

Regulation 6 has been amended and Regulation 7 of the KiwiSaver Regulations 2006 will be revoked, as they deal with the requirement to provide an annual report and will be redundant.

Fee subsidy

Regulation 20 has been amended from the date of assent to ensure that the fee subsidy is applied according to the current investment allocation instructions that the member has elected or been allocated to (if it is a default provider).

Mortgage diversion facility

The KiwiSaver Regulations 2006 have been amended to ensure that:

- they extend to CSFs in respect of the mortgage diversion facility; and
- include within the eligibility for the first home ownership withdrawal second-chance buyers that have a determination from Housing New Zealand that they are in the same financial situation as first home buyers.

KiwiSaver-related changes to the Holidays Act 2003

The Holidays Act 2003 has been amended to explicitly exclude employer contributions to a superannuation scheme from the definition of "gross earnings", "relevant daily pay" and "ordinary weekly pay". These amendments are treated as coming into force on 17 May 2007.

MORTGAGE DIVERSION REGULATIONS – QUESTIONS WE'VE BEEN ASKED

This section of the TIB sets out answers to some questions we've received on the mortgage diversion regulations applying to KiwiSaver which may be of general interest to readers.

All references are to the KiwiSaver Regulations 2006 unless otherwise stated.

Q: In relation to regulation 23(1)(b) "secures obligations in respect of the mortgagor's principal residence", it is not clear what the intention of this regulation is. It is not clear whether this regulation covers mortgages that secure obligations in respect of the mortgagor's principal residence, or whether these words extend to mortgages that secure

obligations in respect of the mortgagor's principal residence and other obligations. As an example, would a mortgage that secures obligations in respect of the mortgagor's principal residence and a car fall within the regulation? Also, it is not clear from the wording of Regulations 23(1)(c) and 23(2) if revolving credit facilities and contracts payable in instalments are both excluded from participation in the facility.

A: Regulation 23(1)(b) "secures obligations in respect of the mortgagor's principal residence" includes mortgages that secure obligations in respect of the mortgagor's principal residence and other obligations.

"All obligations" mortgages to secure residential lending are almost universal across the banking sector. These types of mortgages allow banks to allocate consumer debts to increase home loan debt in times of default. Due to the prevalence of these security instruments, it was not considered possible to exclude these mortgages while at the same time maintaining a widely accessible KiwiSaver mortgage diversion scheme.

It was recognised that it is difficult for banks to determine with any precision whether a loan given by a bank is being used principally to fund the purchase of a home. While the regulations could impose such a requirement, it is unlikely that banks could police such a provision without incurring substantial costs.

Regulation 23 provides the types of mortgages that qualify for participation in the facility. A mortgage qualifies if it is a mortgage over the mortgagor's principal residence, secures obligations in respect of the mortgagor's principal residence, and is not a mortgage that secures obligations under a revolving credit contract. This means that where a mortgage secures both a revolving credit facility, a home loan, and other obligations, the entire mortgage is excluded from mortgage diversion by virtue of the revolving credit contract. A revolving credit contract is defined under Regulation 23(2).

Fixed-rate loan contracts are not excluded from mortgage diversion, by virtue of the wording in Regulation 23(2)(b) "does not include a contract that provides for a known or determinable amount of credit by instalments if known or determinable amounts".

Q: It is not clear who mortgage diversion applies to or who the mortgagor and borrower must be.

A: For the purposes of understanding mortgage diversion, the principles of mortgage diversion in section 229 of the KiwiSaver Act 2006 and the regulations need to be read together. The principles in the KiwiSaver Act provide that the facility is available to a person at any time after 12 months have expired since the earlier of: the date the Commissioner received the first contribution for that member, or the date that a provider received the first contribution for that person's membership of a KiwiSaver scheme. Mortgage diversion can only apply to mortgagors who are KiwiSaver members.

Q: What is the meaning of "principal residence" and how does mortgage diversion work when the mortgagor consists of two people and only one of them lives in the relevant residence?

A: Mortgage diversion is available in relation to a mortgage over the person's (the KiwiSaver member's) principal residence. Therefore, a member of a scheme can only divert money to pay the mortgage on a property if the member is the mortgagor and the mortgage is over the member's principal residence. Therefore, mortgage diversion will not be available to a person who has a mortgage over a residence, but who does not live in that residence. If there is a mortgage in joint names and only one of the mortgagors lives in the residence, the person living in the residence can participate (provided they are a KiwiSaver member and meet the other requirements of mortgage diversion – for example, 12 months have expired since the first contribution was received in respect of their membership (by either the Commissioner or their scheme)). In other words, not all parties to the mortgage must have that property as their principal residence (or participate in mortgage diversion) – only the KiwiSaver member applying for mortgage diversion.

Q: The regulations should be clarified regarding the part of the mortgage that the diverted payments must be applied to. Can the facility be used to make up the minimum mortgage payment? Can diverted funds be credited into the loan funding account?

A: The regulations are silent on this matter, to allow industry the flexibility to develop new products that allow for the amount diverted in the minimum payment. Industry feedback during consultation was that it would not be feasible for amounts diverted under a mortgage diversion facility to form part of the minimum mortgage repayment amount. Doing so would introduce risks, due to the involvement of a third party (Inland Revenue) in terms of timing issues, the potential for amounts to vary, and monitoring and enforcing mortgage payments. It is therefore recognised that it is likely that any payment received by banks will be additional amounts over and above existing repayment obligations. Banks should ensure that any money diverted under mortgage diversion facility cannot be redrawn by the mortgagor before being applied to the loan.

Q: Can a KiwiSaver member avail themselves of the mortgage diversion facility when a family trust or other party is the only mortgagor of the relevant mortgage?

A: Because the KiwiSaver Regulations require a member participating in mortgage diversion to be a mortgagor (although not necessarily the only one), the answer is no. Read cumulatively, Regulations 24 to 27 show this requirement exists. The terms of Regulations 24, 26 and 27 show that the mortgagee involved in the facility must be the member's mortgagee. Regulation 25 meanwhile requires certain actions from mortgagees who have agreed to participate in the facility in respect of a mortgagor.

KiwiSaver application date(s)

The following table summaries the principal application dates relating to KiwiSaver.

Act	Title of section and section reference	Application date
KiwiSaver-related amendments to the Income Tax Act 2004	• Exclusion of permitted withdrawals from KiwiSaver schemes and CSFs, new section CS 10B. • Amendments to the member tax credit rules, section KJ 2(a). • Tax credit amount, section KJ 3. • Payment, section KJ 4. • Rules, section KJ 5. • New or amended definitions of "complying fund rules" (paragraph b), "creditable membership" and "member credit contributions" in section OB 1.	These amendments are treated as coming into force on 1 July 2007.
KiwiSaver-related amendments to the Income Tax Act 2004	• Contributions to employee's superannuation schemes, new section DC 6(1B). • Amendments to the member tax credit rules, sections KJ 6 to KJ 12. • Omission of the definition of "salary or wages" in section NE 3(6). • New or amended definitions of "complying fund rules", "compulsory employer contribution", "employee's superannuation accumulation", "employer contribution", "PAYE period" and "salary or wages" in section OB 1.	These amendments are treated as coming into force on 1 July 2008.
KiwiSaver-related amendments to the Income Tax Act 2004	Repeal of paragraph (a)(ib) in the definition of "superannuation scheme" in section OB 1.	This amendment is treated as coming into force on the date of assent – 19 December 2007.
KiwiSaver-related amendments to the Tax Administration Act 1994	Tax credit relating to KiwiSaver and CSF members: member credit form, section 68C.	This amendment is treated as coming into force on 1 July 2007.
KiwiSaver-related amendments to the Tax Administration Act 1994	• Interpretation: the definition of "tax" amended in section 3(1). • Construction of certain provisions, new section 4A(3)(bc). • Keeping of business records, section 22 (2)(1). • Tax credit relating to KiwiSaver and CSF members: member credit form, section 68C (4). • Persons excluded, new section 120B(bb). • Deduction of tax from payments due to defaulters, new subsections (h) and (i) in section 157(10).	These amendments come into force on 1 April 2008.

Act	Title of section and section reference	Application date
KiwiSaver-related amendments to the Tax Administration Act 1994	• Interpretation: the definition of "civil penalty" amended in section 3(1). • Consequential amendments to the Tax Administration Act 1994 as a result of the repeal of section 216: – challenging civil penalties, section 138L(2)(ab) – knowledge offences, section 143A(5)(g) – remission for reasonable cause, section 183A(1)(h) – emission in circumstances of qualifying event, section 183ABA(3A) – remission consistent with collection of highest net revenue over time, section183D(1)(bc).	These amendments come into force on 1 April 2009.
Amendments to the KiwiSaver Act 2006	• Meaning of provider, section 5(1). • New or amended definitions of "employer", paragraph (b) in the definition of "independent trustee" and "private domestic worker" in section 4(1). • Opt-out: – how to opt out, section 17 – extension of opt-out period, section 18. • PAYE intermediaries, new section 23A. • Eligibility of employers who have schemes established under master trusts, new subsection (c) in section 28. • How to opt in, new subsection (5) in section 34. • Commissioner must supply information pack, section 40. • Effect of employer choice of KiwiSaver scheme, section 48(1) and (2). • Commissioner provisionally allocates certain people to default KiwiSaver schemes and sends investment statement, sections 50(1) and (3). • Completion of allocation to default KiwiSaver scheme if person does not choose KiwiSaver scheme, sections 51(4)(a) and 51(5). • Involuntary transfer, section 57(3). • Initial and confirmed back-dated validation of invalid membership, new subpart 4 of Part 2 (section 59A to D). • When subpart 1 of Part 3 does not apply, section 62(c). • How subpart 1 of Part 3 applies to private domestic workers, section 63A. • Deductions entered in and paid out of holding account, section 73(3). • Initial contributions stay in holding account for 3 months, sections 75(1) and (3). • Small amounts of contributions may be held until big enough to be on-paid, section 77(3). • Refund by Commissioner of amounts paid in excess of required amount of deduction or if employee opts out, section 80(1). • How subpart 3 of Part 3 applies to private domestic workers, new section 92A.	These amendments are treated as coming into force on 1 July 2007.

Act	**Title of section and section reference**	**Application date**
	• Short payments if not enough employer contribution remitted to cover all employees, section 99(2). • Terms relating to members' tax credits implied into trust deed, section 28A. • Terms relating to back-dated validation implied into trust deed, section 128B. • Duty of Commissioner under section 50 modified in certain cases in which section 210 applies, sections 211(1)(b) and (2). • Penalty for employer who fails to provide information, section 215(2)(a). • Consent to electronic transactions, new subsection (2) in section 219. • Refunds made by direct credit to bank account, section 221. • Crown contribution, section 226. • Schedule 1, clause 14(2) of the KiwiSaver Scheme Rules.	
Amendments to the KiwiSaver Act 2006	• Effect of registration of KiwiSaver scheme under section 150, section 153(d).	This amendment is treated as coming into force on 1 October 2007.
Amendments to the KiwiSaver Act 2006	• New or amended definitions of "deduction rate", "defined benefit scheme member", "employer", "employer contribution", "employer's superannuation contribution", "KiwiSaver scheme", "PAYE period", "private domestic worker" and paragraphs (a) and (b) in the amended definition of "salary or wages" in section 4. • New section 4(2). • Application, section 6. • Outline, new section 8(6). • Temporary employment, section 12. • How to opt out, section 17(6). • PAYE intermediaries, new section 23A. • How to opt in, section 34(5). • Obligation to make deductions: – general rule, section 66 – transitional rule, section 66A. • Deductions treated as received on 15th of month for interest purposes, section 85. • Employer contributions paid via Commissioner, section 93. • Short payments: – by employers if not enough money remitted to Commissioner to cover all of employees' deductions and employer contributions, new subsection (3)(e) in section 98 – quantifying short payments for the purposes of Income Tax Act 2007 and Tax Administration Act 1994, new section 98A – if not enough employer contribution remitted to cover all employees, section 99.	These amendments come into force on 1 April 2008.

Act	Title of section and section reference	Application date
	• Compulsory employer contributions to KiwiSaver schemes and CSFs, new subpart 3A of Part 3: sections 101A to 101 H. • Restrictions on transactions, new section 117A. • Requirement for annual report, sections 123(4). • Terms relating to lump sum payments by CSFs, new section 128C. • Terms relating to compulsory employer contributions implied into trust deed, section 128D. • Effect of registration of KiwiSaver scheme under section 150, section 153(d).• Purpose of register, section 158(a). • Additional contents of register, section 161. • Government Actuary may refuse access to or suspend operation of register, or omit or remove, or restrict public access to, information and documents in register, section 162(2). • Amendments to register, section 163. • Powers of Government Actuary in event of scheme operating in contravention of this Act, section 169(3). • Objections and appeals against decisions of Government Actuary, section 186(5). • Duty to give notice to Government Actuary about fee increases, new section 189B. • Powers of High Court in relation to unreasonable fees, section 189C. • Investment statements must contain responsible investment statement, section 205A. • Penalty for employer to fail to make deductions or to incorrectly make deductions, the heading to sections 216, 216(1)(c), 216(2)(a) and 216(4). • Clauses 8(8) and 14(2) of Schedule 1 of the KiwiSaver schemes rules and new Schedule 4 of the KiwiSaver scheme rules.	
Amendments to the KiwiSaver Act 2006	• Interest on money in holding account, new section 84(3). • Failure to pay Government Actuary's duties, section 101I and Commissioner, section 101J. • Recovered amounts, section 101K. • Application of sections 215 and 216, section 214. • Penalty for employer to fail to provide information, section 15(4). • Section 216 is repealed.	These amendments are treated as coming into force on 1 April 2009.
Amendments to the KiwiSaver Act 2006	• Amendments to paragraph (a) in the definition of "independent trustee", section 4(1). • Who automatic enrolment rules apply to, section 10. • Meaning of new employment, section 11. • Effect of opting in by employees, section 36. • Employer may choose scheme for employees, section 46. • Notification of transfers and requirement to transfer funds and information, section 56(3)(c)(iv). • Refund by provider of amounts paid in excess of required amount of contribution, section 81(1).	These amendments come into force on date of assent – 19 December 2007.

Act	Title of section and section reference	Application date
	• Interest on money in holding account, section 84(2). • Interest rate, section 86. • Refunds of employer contribution by provider, section 101. • Who may apply for contributions holiday, section 102(b)(iii). • Refund of initial contributions, sections 113(5) and (6). • Further modifications to application of sections 8 to 11 of Superannuation Schemes Act 1989, section 121(3)(a). • Requirement for annual report, amended sections 123(5)(a), 125(5)(e) and 123(6). • Requirement for annual personalised statement of contributions and accumulations for members, section 125A. • Amendment of trust deed governing KiwiSaver scheme, section 29. • Duty to notify changes to Government Actuary, section 164(2). • Factual description of, or transmission of information about KiwiSaver scheme, not investment advice, section 206. • Certain sections of Securities Act 1978 modified in relation to KiwiSaver scheme, section 210(2)(b)(ii). • Penalty for employer to fail to: – provide information, section 215(3) – make deductions or to incorrectly make deductions, section 216(3). • Fee subsidies, section 225(2). • Crown contribution, section 226(1C) and 226(2B). • Regulations relating to mortgage diversion facility, section 229. • Regulations relating to compulsory employer contributions, section 230A. • Protection from non-compliance: Taxation (KiwiSaver) Act 2007, section 234; and • Schedule 1 of the KiwiSaver scheme rules, clauses 2(2) to (5), 4(3), 12(2), 12(3)(a) and 13(1).	
KiwiSaver-related amendments to the Superannuation Schemes Act 1989	• CSFs, section 34(2).	This amendment is treated as coming into force on 1 April 2007.
KiwiSaver-related amendments to the Superannuation Schemes Act 1989	• Dealing with applications for CSFs, section 35.	This amendment is treated as coming into force on 1 July 2007.
KiwiSaver-related amendments to the Superannuation Schemes Act 1989	• The duty to notify changes about CSFs to Government Actuary, new section 37. • Form of notice under section 37, new section 38. • Duty to give notice to Government Actuary about fee increases, new section 39. • Powers of High Court in relation to unreasonable fees, new section 40.	This amendment comes into force on 1 April 2008.

Act	Title of section and section reference	Application date
KiwiSaver-related amendments to the Superannuation Schemes Act 1989	• Matters to be specified in annual report, Schedule 2, new clause 1(o)(iv).	This amendment comes into force on 1 April 2009.
KiwiSaver-related amendments to the Superannuation Schemes Act 1989	• Interpretation, new definition of "participation agreement", section 2(1). • When Government Actuary may approve transfers without consent of members and beneficiaries, section 9BAA. • Implied term as to reduction of scheme insurance upon transfer out of CSF, section 9D.	These amendments come into force on the date of assent – 19 December 2007.
	• CSFs, new section 34(3). • Transitional provision relating to lodging of participation agreements, section 41. • Matters to be specified in annual report, Schedule 2, new clause 1(o).	
KiwiSaver Regulations 2006	• Purpose of annual return regulations, new Regulation 6. • Regulation 7 is repealed. • Fee subsidy, Regulation 20(4). • Mortgage diversion facility, Regulation 21. • What scheme provider must do to participate in mortgage diversion facility, Regulation 27. • Qualifying person, Regulation 30. • Notice, Regulation 31.	These amendments come into force on the date of assent – 19 December 2007.
KiwiSaver-related amendments to the Holidays Act 2003	• Meaning of ordinary weekly pay, section 8(1)(c)(v). • Meaning of relevant daily pay, section 9(1)(c). • Meaning of gross earnings, section 14(c)(iii).These amendments are treated as coming into force on 17 May 2007.	These amendments are treated as coming into force on 17 May 2007.
KiwiSaver-related amendments to Income Tax Act 2007	• Exclusion of permitted withdrawals from KiwiSaver schemes and CSFs, section CS 10B. • Contributions to employees' superannuation schemes, section DC 7. • Tax credits for superannuation contributions, section MK 1. • New cross-heading "Tax credits for fund providers", inserted before section MK 2. • Eligibility requirements, section MK 2. • Payment of tax credits, section MK 3. • Amount of tax credit, section MK 4. • Credit given by fund providers, section MK 6. • Treatment of tax credits on permanent emigration, section MK 8(2)(a). • Tax credits for employers, sections MK 9 to MK 16. • Salary or wages, sections RD 5(1)(c)(iv) and RD 5(1)(d). • Complying fund rules, section RD 66.	These amendments come into force on 1 April 2008.

Act	Title of section and section reference	Application date
	• New or amended definitions of "compulsory employer contribution", "creditable membership", "employee's superannuation accumulation", "employer contribution", "member credit contributions" and "superannuation scheme" in section YA 1. • New Schedule 28 inserted.	
KiwiSaver-related amendments to Income Tax Act 2007	• Schedule 49.	This amendment is treated as coming into force on 1 November 2007.

RESEARCH AND DEVELOPMENT

RESEARCH AND DEVELOPMENT TAX CREDITS

Sections LA 6(1)(db), LH 1 to LH 17, OB 4(3)(eb), OB 7C, OK 2(3)(cb), OK 4B, OP 5(2)(bb), OP 7(3)(fb), OP 11B, YA 1, YB 2 to YB 4, YB 7, YB 9 to YB 11, YB 13 to YB 18, YB 20(2)(ob) and Schedule 21 of the Income Tax Act 2007; sections 3(1), 22(2) and (7), 33A(2), 43A(2), 68D and 68E, 91AAP, 91C(4), 108(1B), 108B(3)(d), 113(1), 113D, 141(7C) and (7D) of the Tax Administration Act 1994

New tax rules have been introduced, which provide a tax credit for New Zealand businesses that perform R&D on their own behalf, or that commission others to perform R&D for them, provided the R&D is performed predominantly in New Zealand. The definition of R&D is in line with comparable jurisdictions where it has proved to be sustainable. The new tax credit applies not just to "white-coat" research, but to the development of new or improved products or processes in a variety of industries.

R&D expenditure that is eligible for the credit includes the cost of employee remuneration, training and travel of employees conducting R&D, depreciation of tangible property, consumables, certain overheads and payments to entities conducting R&D on behalf of the claimant.

The credit applies at the rate of 15 percent of eligible expenditure in a year, and is claimed in the annual income tax return, offsetting the tax liability of the claimant. Surplus credits are refundable. This means that businesses that have a tax loss or have only tax-exempt income receive the credits in cash.

Background

The government first raised the option of introducing an R&D tax credit in the Business Tax Review discussion document, released in July 2006. This was followed by an issues paper in November 2006 which proposed general eligibility criteria, a definition of R&D and a list of eligible expenditure. The government announced the introduction of the credit as part of the Business Tax Reform package in Budget 2007.

R&D tax incentives are common overseas with a body of international evidence suggesting that tax incentives are effective at encouraging business R&D. The rationale for them is that there is under-investment by businesses in R&D because the investing firm does not capture all of the benefits of the investment. There are likely to be spill-over benefits to New Zealand when businesses invest in R&D and providing an R&D tax credit will encourage firms to invest more in R&D.

Key features

Eligibility for the credit (sections LH 1 to LH 3 and LH 7 of the Income Tax Act 2007)

To be eligible, a claimant must be in business in New Zealand. Non-residents must be in business in New Zealand through a fixed establishment in New Zealand. The expenditure for which a claim is made must relate to that business or an intended business of the claimant. An exception to the requirement to be in business exists for industry research co-operatives which have special rules.

Crown Research Institutes, tertiary institutions, District Health Boards, their associates, and entities under the control of any combination of them, are not eligible for the credit. R&D performed by a business in partnership with these entities is also ineligible.

Claimants must bear the financial risk associated with the R&D project, have control over the work and effectively own the project results. When R&D is outsourced, this distinguishes the person who commissions the R&D (who is eligible for the credit) from the person who merely performs the R&D on behalf of someone else. The performer is not eligible for the credit – the incentive is provided to the party making the R&D investment decisions.

The claimant must also spend at least $20,000 of eligible expenditure in the year a claim is made unless the R&D services are purchased from an unassociated

listed research provider. These are entities that perform research for others on a commercial basis.

The business must conduct R&D activities as these are defined in section LH 7. They must be systematic, investigative and experimental activities that either seek to advance science or technology through the resolution of scientific or technological uncertainty or that involve an appreciable element of novelty. In either case, the activities must be directed at acquiring new knowledge or creating new or improved products or processes. These are "SIE" (systematic, investigative and experimental) R&D activities. Certain activities are excluded, as they are in other jurisdictions, generally to delineate more clearly the boundary between innovative and routine activity.

Activities that support SIE activities, but that are not systematic, investigative and experimental in themselves, are eligible if they are wholly or mainly for the purpose of the SIE activities and are required for, and integral to, them.

Rate of credit (section LH 4)

The credit applies at the rate of 15 percent of eligible expenditure.

Eligible expenditure (sections LH 3(1)(e), LH 5, LH 6, LH 8, Schedule 21)

Expenditure is eligible only if it is of a type listed in Schedule 21, Part A and not listed in Part B. The expenditure must also generally be deductible in the year it is incurred, although there are exceptions from this requirement for certain expenditure.

Eligible expenditure includes the cost of employee remuneration, training and travel, depreciation of tangible assets used in conducting R&D, certain overhead costs, consumables and payments to third parties for R&D performed on behalf of the claimant.

Ineligible expenditure is listed in Schedule 21, Part B. The main items are interest, loss on sale or write-off of depreciable property, the cost of acquiring core technology (technology used as a basis for further R&D), expenditure funded from a government grant or the required co-funding, expenditure on intangible assets and professional fees in determining eligibility.

Expenditure on R&D done overseas is not eligible unless it is part of a project based in New Zealand. The amount of overseas eligible expenditure available for the tax credit is limited to 10 percent of the eligible expenditure incurred on the project in New Zealand.

Cap on internal software development (sections LH 9 to LH 13, LH 17)

There is a cap of $3 million on eligible expenditure when the R&D activity is "internal software development". Internal software development includes the development of software without the main purpose of sale to non-associates, as well as the development of software which is used in administration of the claimant's business or to provide its customers with services other than the use of its computer technology or software. The cap applies whether the activity is a SIE activity or a support activity. The level of the cap can be increased by the Minister of Finance when it is in the national interest. Claimants under common control that undertake internal software development will be required to calculate their expenditure as a group and to allocate the cap between members.

Administrative procedures (sections OB 4(3)(eb), OB 7C, OK 2(3)(cb), OK 4B, OP 5(2)(bb), OP 7(3)(fb), OP 11B of the Income Tax Act 2007; sections 3(1), 22(2) and (7), 33A(2), 43A(2), 68D and 68E, 91AAP, 91C(4), 108(1B), 108B(3)(d), 113(1), 113D, 141(7C) and (7D) of the Tax Administration Act 1994)

Businesses will claim the tax credit in an income tax return. They will work out their liability for tax in the normal way, and then subtract the amount of the credit. When the amount of the credit exceeds the tax liability, the balance is used to reduce other tax liabilities, or is refundable in cash.

The credit will reduce residual income tax, which will reduce provisional tax liability, allowing businesses that pay provisional tax to receive the benefit of the credit closer to the time they incur R&D expenditure. This reduction will be immediate for people who estimate provisional tax, but delayed for people who use the "uplift" method for calculating provisional tax.

Companies and Māori authorities will receive a credit in their imputation credit accounts for an income tax liability that is satisfied by way of the credit.

To be eligible for the credit, a business must provide – in addition to the income tax return – a detailed statement of R&D activities and expenditure. This is collected for administrative and evaluation purposes.

From a date to be appointed by the Governor-General by Order in Council (but no later than 1 April 2010), a potential claimant will be able to apply to the Commissioner to determine whether an activity is R&D, whether a person is eligible for the credit, and whether expenditure is eligible for the credit. Binding rulings are not available on these matters.

There are a number of other minor and consequential amendments to the Tax Administration Act 1994 relating to the new tax credit.

Application date

The credit will apply from the 2008–09 income year.

Detailed analysis

Unless otherwise indicated, examples assume a standard income year and section references are to the Income Tax Act 2007.

Who can claim the credit (section LH 1)

In business in New Zealand (subsection (1))

To be eligible, a claimant must carry on business in New Zealand. Non-residents must carry on business in New Zealand through a fixed establishment.

This requires activities to be a profession, trade, manufacture or undertaking with an intention to make a pecuniary profit. All types of New Zealand businesses are eligible, whether incorporated or not, including businesses that earn only exempt income.

In the case of partnerships, the business test is applied at the partnership level, rather than to individual partners. (See discussion below on section LH 3(3)(a).)

An exception exists for industry research co-operatives which do not need to be in business. However, there is a requirement that the members of the co-operative be in business. That requirement is discussed further below in relation to section LH 3 and other requirements in relation to the co-operatives are discussed below in relation to section LH 16.

Crown Research Institutes, tertiary institutions and District Health Boards (subsection (2))

Crown Research Institutes, tertiary institutions, District Health Boards, and their associates, and entities controlled by any combination of those entities, are not eligible for the credit. These entities are defined in section YA 1 through cross-references to their enabling Acts. Crown Research Institutes are defined in section 12 of the Crown Research Institutes Act 1992. A tertiary institution is a body established under section 162 of the Education Act 1989. A District Health Board is a board established under section 19 of the New Zealand Public Health and Disability Act 2000.

Association is determined using the 1988 version provisions (section YB 20(2)(ob)). However, the tripartite test does not apply for the purpose of determining who is associated under section LH 1(2) (section YB 4(3B)). R&D performed by a person in partnership with one of these entities is also not eligible. (See discussion below on section LH 3(2).)

Example

ACo is 25 percent owned by a Crown Research Institute, 26 percent owned by a trust whose beneficiary is a tertiary institution, and 49 percent is owned by a private firm, BCo. ACo is not an eligible person.

BCo purchases 5 percent of the shares from the trust and thereby takes a controlling share in ACo which it later sells to a tertiary institution. ACo is an eligible person for the period that BCo has a controlling interest.

Entitlement to the credit (section LH 2)

Section LH 2(2) provides for the tax credit and section LH 2(1) sets out the broad requirements for entitlement to the credit.

To claim the credit, a claimant must, for a year or part-year:

- be an eligible person under section LH 1(1) – that is, carry on business in New Zealand;
- meet the requirements in section LH 3 – in essence, do R&D related to the business, have the requisite control of the R&D project and effective ownership of the results and incur eligible expenditure or depreciation on the R&D that is tax deductible in the year;
- perform the R&D activities on its own behalf and not on behalf of another person;
- incur $20,000 or more (or a pro-rated amount) of eligible expenditure or depreciation unless the R&D is outsourced to an unassociated listed research provider; and
- file a detailed R&D statement in relation to that year by a due date (new sections 68D or 68E of the Tax Administration Act 1994).

The amount of the credit is set out in section LH 4 at 15 percent of "eligible expenditure".

Minimum expenditure threshold (subsections (3) and (4))

A claimant must have eligible expenditure (as calculated under section LH 4) of at least $20,000 to qualify for the credit. This is pro-rated when a person is eligible under section LH 1(1) for part of a year only (for example, when the person carries on business for part of a year only).

An exception to the minimum threshold exists if the R&D services are outsourced to an unassociated listed research provider.

If a provider is delisted, payments under an arrangement entered into when the provider was still listed are not subject to the minimum threshold. This is to ensure that the claimant will not be subject to the minimum threshold if the provider is delisted subsequent to the parties agreeing on the arrangement for services. The claimant and the provider must not have been associated at the time the arrangement was entered into.

The requirements to be a listed research provider are set out in section LH 15.

A partnership can meet the minimum expenditure threshold for R&D activities carried out by the partnership and the individual partners claim credits in relation to their share of the expenditure. (See discussion below on section LH 3(2).)

Example

In 2010, ACo incurs $10,000 of eligible expenditure on R&D performed inhouse. This is not eligible for the credit.

In 2010, BCo spends $10,000 contracting an unassociated listed research provider to do its R&D. The part of the $10,000 that is eligible expenditure will not be subject to the minimum threshold.

In 2010, CCo spends $100,000 on eligible expenditure undertaking its own R&D. This expenditure exceeds the minimum threshold.

Expenditure treated as incurred in a year (subsection (5))

Expenditure that is deductible in a year but added back as income under the timing rules in Part CH at the end of the year is not eligible for the credit in that year. It becomes eligible for the credit in a subsequent year when it ceases to be added back. Because the expenditure is not actually incurred in that subsequent year, it needs to be treated as incurred in that year to satisfy the provisions listed. This applies to the opening value of trading stock, unexpired amounts of expenditure under section DB 50 and unpaid employment income under section DB 51.

It applies also to overseas eligible expenditure that is incurred in one year and is eligible for the credit in a subsequent year (subsection (5)(d)).

Treatment of credits (subsection (6))

The credit is applied to satisfy a claimant's tax liability for as far as the credit extends. Surplus credits are applied, in turn, to satisfy an income tax or provisional tax liability that is payable in relation to other years, or any amount due and payable under an Inland Revenue Act (such as GST, or PAYE). Any excess credits are refunded.

Eligibility requirements (section LH 3)

To claim the credit, the claimant must satisfy the requirements of subsection (1) which are listed below.

R&D must be related to the business of the claimant (paragraph (a))

A claimant must perform on its own behalf, or have another person perform on its behalf, R&D related to the claimant's business or intended business.

This means that there must be a connection or link between the R&D activity and the general area of the claimant's business. This requirement will generally be satisfied when the results of the activity (if successful) would have a direct and beneficial application in the claimant's business. Similarly, the requirement would be satisfied if the activity results in an extension of that business.

To show that the R&D relates to an intended business, the claimant must have a reasonable expectation, at the time that the activity is carried out, to exploit the results commercially in an extension of its business or in a new business if the R&D is successful.

In the case of industry research co-operatives, the R&D must be related to the business of an industry member. The requirements for industry research co-operatives and industry members are discussed below in relation to section LH 16.

Claimants must bear the risk, have control over the project and effectively own the results (paragraph (b) to (d))

Claimants must be able to show that they control the R&D activities, bear the financial risk associated with the project and effectively own the project results.

The tests in section LH 3(1)(b) to (d) are intended to ensure that the tax credit goes to the party making R&D investment decisions – that is, the party deciding what R&D should be undertaken to enhance its business activity. They aim to maximise the capture of spillover benefits.

If R&D activities are subcontracted, the rules act to prevent double dipping. The credit goes to the party commissioning the R&D, and not to someone who performs the R&D on behalf of the other person.

In some cases, no one will be eligible to claim a tax credit for the R&D activity carried out in New Zealand. This could happen if the activity is being carried out on behalf of an ineligible entity, or because no entity can demonstrate that it controls, bears the financial risk of, and effectively owns the results of the activity.

Parties to an unincorporated joint venture, or partners of a partnership (if the partnership consists of only eligible partners), can apply these tests as though the joint venture or partnership performed the R&D activity as an entity in its own right. See the discussion below on sections LH 3(3) and (4).

Controlling the R&D activity

Claimants must have control of the R&D activity. This means they must have the ability to:

- determine the R&D activities to be undertaken;
- decide on major changes of direction;
- stop an unproductive line of research;
- follow up on an unexpected result; and
- terminate the activities or project.

The control requirements can still be met if the R&D activity is contracted out to a provider who is responsible

for the day-to-day management of the work. The commissioner of the research will be eligible for the credit as long as it meets the control requirements above.

This may mean that the claimant exercises that control at the beginning of an arrangement and is bound by it for the duration of the work. For example, a provider may only undertake a programme of work if the party commissioning it agrees to bind itself to finance the whole programme. In these situations the claimant is not considered to have given away control, but made choices in the contract in advance. Even then, the claimant should be entitled to check that the programme is being carried out and require the researcher to act according to the arrangement.

If a business contracts another entity to carry out the R&D activity on its behalf, and that entity subcontracts that work to a third party, the R&D activity is still done on behalf of the original commissioning business, not on behalf of the intermediary contractor.

It is possible to exercise control decisions before a project begins. For example, before the work begins the parties could agree what R&D will be undertaken and what criteria should be used to determine whether a line of research is unproductive and should be terminated.

Where a major researcher determines a programme of research and actively seeks industry participants to fund the work, it may still be possible for the industry participants to meet the control requirements.

While the researcher may have independently formulated the R&D programme and control day-to-day management, it is subject to the agreement between the industry participants and the researcher. Essentially, the industry participants exercise joint control when they choose to participate and enter into the arrangement to fund the work programme.

A business's owners have the ultimate ability to control the activity by exercising their proprietary rights, but this does not undermine the demonstration of control of the activities by the business.

Financial risk

The claimant must bear the financial risk of the R&D activity.

If the R&D activity is outsourced, the claimant can be taken to be bearing the financial risk if it is required to pay for the activity to be carried out, regardless of the outcome of the activity. A party receiving payment for carrying out R&D regardless of the outcome of the activity is unlikely to be bearing the financial risk in relation to those funds.

"At risk" contracting is where the contractor works on the basis that its fee is not payable unless the R&D work succeeds. In this situation, the party contracting out the work would not be eligible for the tax credit. The contractor may be eligible for the tax credit if it meets the eligibility requirements in its own right.

Businesses may want to reduce the financial risk of undertaking R&D by finding another party to contribute to financing of the work. If they enter into an agreement to fund eligible R&D activity with another person, they may be eligible for the tax credit for their share of the expenditure. They are required to bear the financial risk in relation to their expenditure, not for all of the expenditure on the work.

The application of funds from donations to carry out R&D activities does not in itself mean that the claimant is not bearing the financial risk of carrying out the R&D activity. An expectation that the funds be applied for a particular purpose is not in itself fatal to the claim by the recipient that it bears the financial risk of doing the R&D.

Effective ownership of results

Effective ownership of the results of the R&D activity means that the claimant must have the ability to exploit the results for gain without further fee or payment. That is, the claimant must have gained the right to use the results of the activity in its business without incurring further costs. It does not require the claimant to formally own the intellectual property or results arising from the project.

While ownership can be shared, the claimant must retain sufficient rights to have reasonable commercial use of the results, commensurate with its contribution to the work.

Effectively owning the results does not require the claimant to own the intellectual property. Intellectual property such as copyright, a patent or a registered design, may not be available to protect the results.

It is also possible to have all the advantages of ownership without actually owning the intellectual property. The claimant may have the right to use a patent, to require the patent to be licensed, to restrict or direct further development based on the patent, all without further fee or payment, and not be the formal holder of the patent.

Some rights of ownership may be given to others without denying the effective ownership of the results. For example, a business having R&D carried out on its behalf might completely control commercial use of the results of that R&D (including further development of those results for commercial purposes), but allow the researcher exclusive scientific publication rights.

Similarly, actual use of particular results may only be possible in limited ways or for limited purposes, which means limited rights can amount to full effective ownership. For example, exclusive rights of commercial use and development for only a few years might amount to full ownership in a particularly fast-changing area.

A share in ownership of overall results may also amount to acceptable ownership. For example, if a business does R&D that builds on existing research results belonging to another person, the business may take a share of the overall results. The interest must match its contribution to the overall research.

If the R&D activity does not result in a product or patent, but results in new knowledge (perhaps published in a scientific paper), one way this requirement could be satisfied is if the business has been granted a preferential right to use the results of the activity. A preferential right could be access to unpublished results or early access to results.

Subsequent sale of the results does not change the effective ownership of the results at the time the eligible R&D was conducted. However, R&D carried out under an agreement that required the disposal of results or commercial rights for inadequate return will suggest less than effective ownership of the results.

It is possible that the R&D activity is unsuccessful and there are no exploitable results from it. This does not mean that the claimant does not effectively own the results of the activity.

Deductible expenditure or depreciation loss (paragraph (e))

The claimant must incur expenditure or depreciation that is of a type listed in Schedule 21, Part A and not a type listed in Part B. It must also be deductible in the year in which it is incurred. There are exceptions to the deductibility requirement for expenditure in deriving tax-exempt income, certain capital expenditure referred to in section LH 5(4) and deferred expenditure referred to in section LH 5(5).

For tax-exempt income, the requirement is that the expenditure or depreciation would be deductible if the person derived income other than tax-exempt income.

Partnership with entities excluded under section LH 1(2) (subsection 2)

R&D activities done in partnership with an entity referred to in section LH 1(2) are not eligible for a tax credit. Section LH 1(2) excludes anyone who is:

- a Crown Research Institute, a tertiary institution, or a District Health Board;
- associated with a Crown Research Institute, a tertiary institution, or a District Health Board; or
- controlled by one or more of these entities.

This is to prevent partnership structures being used to circumvent the requirements for eligibility.

Partnerships (subsection 3)

Paragraph (a) makes it possible for the business tests and the minimum threshold to be applied at the partnership level even though individual partners will be claiming the tax credit in relation to R&D activities carried out on behalf of the partners.

The requirements for claimants to be in business in New Zealand (section LH 1(1)(a)), for their R&D activity to be related to either that business or an intended new business (subsection (1)(a)(i)), and the minimum threshold for eligible expenditure can be applied at a partnership level, with the partnership treated as the entity performing the R&D activities.

Partners will be taken to have met these requirements in relation to the R&D activity if the partnership (treated as the entity carrying out the R&D activities) would meet those requirements.

Paragraph (b) allows partnerships consisting of only eligible partners to apply the requirements to control the R&D activity, bear the financial risk of undertaking the work, and effectively own the results of the activity at the partnership level.

If the partnership, treated as an entity performing the R&D activities, meets those requirements, the partners will be treated as meeting those requirements.

Partners in partnership with partners who do not meet the requirements of section LH 1 must meet the control, risk, and ownership requirements in their own right. This is to prevent partnership structures being used to circumvent the requirements for eligibility.

The government will review these rules once the Limited Partnership Bill is enacted.

Example

A and B have been in business for the whole year as partnership C. A and B have equal interests in the partnership.

1. The firm carries out R&D and has eligible expenditure of $15,000. A has other eligible expenditure on R&D activities of $16,000. A can claim the concession in relation to $23,500 of expenditure. She meets the minimum threshold in her own right.
2. The firm carries out R&D and has $22,000 of eligible expenditure. B has other eligible expenditure on R&D of $5,000. B can claim the concession in relation to $11,000 (her share of the firm's eligible expenditure). The firm has met the threshold, but B does not meet the threshold in her own right and therefore cannot claim the credit in relation to the other $5,000 of eligible expenditure.
3. The firm carries out R&D and has eligible expenditure of $18,000. A has other eligible expenditure on R&D activities of $4,000. A is not eligible to claim the concession. Neither the firm nor A (in her own right) has met the minimum threshold.

Joint ventures (subsection 4)

Subsection 4 allows parties performing R&D as part of an unincorporated joint venture to apply the requirements to control the R&D activity, bear the financial risk of

undertaking the work, and effectively own the results of the activity at the joint venture level.

If the joint venture, treated as an entity performing the R&D activities, meets those requirements, then the parties to the joint venture will be treated as meeting those requirements. While the financial risk can be shared between the parties, each party can only claim the tax credit in relation to their share of the expenditure for which they bear the financial risk.

Parties may establish a company to carry out R&D activities (incorporated joint venture). For the company to claim the credit it will need to show the R&D activities have been carried out on its own behalf and not on behalf of its shareholders. The company will be required to meet the requirements to control the activity, bear the financial risk of doing the work, and own the results. The fact that the shareholders may expect an indirect benefit through dividends does not mean the company is carrying out R&D activities on their behalf.

Amount of tax credit (section LH 4)

The amount of the tax credit is 15 percent of "eligible expenditure". This is the amount of expenditure or depreciation that is listed in Schedule 21, Part A, not excluded under Part B, and deductible in the year after making adjustments as required under sections LH 5 and LH 6.

Adjustments in calculating "eligible expenditure" (section LH 5)

Expenditure added back under timing rules (subsection (2))

Expenditure that is added back as income under subpart CH for tax purposes generally is also added back for the purpose of calculating the credit. This applies also to expenditure that would be added back under that subpart if the R&D expenditure was not deferred under section EJ 23 or if the claimant did not derive only exempt income

Example 1

In March 2009, ACo incurs $100,000 of eligible expenditure on R&D services to be provided by a Crown Research Institute. The services have not been performed by the end of ACo's income year. The amount of the unexpired portion calculated under section EA 3 is therefore $100,000, which is income of ACo in the 2008–09 year under section CH 2. The amount that is eligible for the credit in that year is therefore $0 ($100,000 deductible eligible expenditure less $100,000 added back as income). The services are provided in May 2009 so the $100,000 becomes deductible in the 2009–10 income year. The $100,000 is therefore eligible for the credit in the 2009–10 income year.

Example 2

BCo is owned by B, who is a shareholder/employee of the company. B is engaged as an employee conducting R&D. In March 2009, BCo accrues a liability for B's salary but has not paid it out by the last date for filing its return of income as provided in section EA 4(3). The salary is therefore added back as income under section CH 3(2) and is not eligible for the credit in the 2008–09 year. The salary is paid out in the 2009–10 year and therefore becomes eligible for the credit in that year.

Under section LH 3(3), there is an exception to the requirement to add back certain expenditure for the purposes of calculating the amount eligible for the credit. This is for stock to which section CH 1 applies if it is feedstock under clause 8 of Schedule 21, Part A that has been processed or transformed in the R&D. If expenditure on stock has been incurred but the stock has not yet been processed or transformed in the R&D activities, the adjustment applies.

Example

In February 2009, ACo buys or manufactures $100,000 of trading stock which it intends to process or transform in R&D. It is still on hand and has not been processed or transformed in the R&D activity at 31 March 2009. The value of the closing stock is therefore added back as income in the 2008–09 year. This add-back also applies for the purpose of calculating the credit. The opening value of the stock ($100,000) is then deducted in the 2009–10 year. In April 2009, the trading stock is processed or transformed in the R&D activity. The stock is still on hand at 31 March 2010 but there is no add-back of the value of the stock for the purposes of the credit.

Under clause 8 Schedule 21, Part A, if the market value of the stock is $30,000, only $70,000 will be eligible for the credit and it will be eligible in the 2009–10 year.

Certain capital expenditure (subsection (4))

An exception to the rule that expenditure be deductible in the year it is incurred is available for certain capital expenditure that is not deductible under section DB 34. The intention is that the rule applies to expenditure that would be deductible but for the capital limitation. While not in the current legislation, this provision is proposed to be modified so that it only applies to expenditure that would be deductible if not for the capital limitation.

Eligible capital expenditure incurred in seeking to create or improve a depreciable intangible asset that is developed as the object of the R&D activities attracts the credit when it is incurred.

Example

ACo has $100,000 R&D salary expenditure in developing software which is intangible depreciable property. The expenditure falls into three categories. Some is revenue expenditure and some is expenditure that is expensed for accounting and is immediately deductible for tax under section DB 34. Both those categories of expenditure therefore satisfy section LH 3(1)(e) and the credit applies in the year the expenditure is incurred. The third category is development expenditure that is capitalised for tax and accounting. Section LH 5(4) applies to this and it attracts the credit in the year in which it is incurred.

Capital expenditure incurred in seeking to construct or improve a **depreciable *tangible*** asset that is developed as the object of the R&D activities (such as a trial model or preliminary version) attracts the credit when it is incurred only when its sole intended use is in the R&D process of that business.

Example

In the 2008–09 year, ACo incurs eligible salary and materials costs in constructing a preliminary version of a product that it intends to add to its range of trading stock. The sole purpose of the prototype is its use in the R&D process in developing a model for the trading stock. It treats these costs as capital costs for accounting and tax. The expenditure attracts the credit in that year. Depreciation on facilitative assets used in the construction of the prototype also attracts the credit in that year.

Capital expenditure in seeking to construct or improve a trial model or prototype that is not solely to be used in the R&D process does not attract the credit as it is incurred and is discussed in the section on depreciation of assets used in R&D (Schedule 21, Part A, clause 2).

Consideration is being given to limiting the credit under this provision in circumstances where the property is subsequently used for non-R&D purposes.

Deduction deferred under section EJ 23 (subsection (5))

Eligible expenditure is calculated as if deferral of a deduction under section EJ 23 were not allowed. If a business elects to defer a deduction for R&D expenditure under section EJ 23, the expenditure is therefore eligible for the credit in the year in which the expenditure is incurred, and not the year in which the deduction is taken. For the purposes of calculating the credit, the expenditure is still subject to the add-back rules in subpart CH (by virtue of the words "or would apply" in section LH 5(2)).

Example 1

ACo is owned by A, who is a shareholder/employee of the company. A is engaged as an employee in conducting R&D. In March 2009, ACo pays a salary to A but elects to defer a deduction for this expenditure under section EJ 23. The expenditure is eligible for the credit in the 2008–09 year.

Example 2

BCo is owned by B, who is a shareholder/employee of the company. B is engaged as an employee in conducting R&D. In March 2009, BCo accrues a liability for B's salary but has not paid it out by the last date for filing its return of income as provided in section EA 4(3). BCo elects to defer a deduction for the expenditure under section EJ 23. For the purposes of calculating the credit only, there is an assumed add-back of the salary under section CH 3(2) and the salary is not eligible for the credit in the 2008–09 year.

Expenditure on overseas R&D (section LH 6)

Expenditure on R&D activities carried out overseas is not eligible for the tax credit unless it is part of a project based in New Zealand, and meets the definition of overseas eligible expenditure.

Subsection (1) excludes expenditure or an amount of depreciation loss on R&D performed overseas unless it is part of a R&D project. "Research and development project" is defined in subsection 4. (See discussion below.)

Subsection (2) excludes expenditure or an amount of depreciation loss on R&D performed outside New Zealand as part of a R&D project, unless it is overseas eligible expenditure.

A "research and development project" is defined in subsection (4) and means a process:

- consisting of co-ordinated R&D activities controlled by the business;
- having start and finish dates;
- undertaken collectively to achieve a specified objective within constraints of time, cost and other resources;
- for which the business bears the financial risk and effectively owns the results, if any; and
- for which the business incurs on R&D activities performed in New Zealand more than half of the total amount of expenditure and depreciation loss that would be eligible expenditure under section LH 4 in the absence of subsection (2).

For an R&D project to exist, more than half of the expenditure that would be eligible under section LH 4

must be incurred on R&D activities performed in New Zealand. If that is not the case, then the expenditure incurred on activities performed outside New Zealand will not be eligible for the credit. However, the expenditure incurred in New Zealand will still be eligible.

"Overseas eligible expenditure" is defined in subsection (5). The expenditure must be:

- expenditure that would be eligible under section LH 4 (in the absence of a restriction on overseas R&D);
- incurred on R&D performed outside New Zealand in or after the 2008–09 income year; and
- limited to 10 percent of the total eligible expenditure incurred in New Zealand in or after the 2008–09 year as part of the same R&D project.

The 10 percent rule applies over the life of the project. Therefore, eligible expenditure incurred on R&D activities performed overseas can be carried forward until sufficient local eligible expenditure is incurred on the same project. Similarly, the eligible overseas expenditure can be incurred in years subsequent to years in which the eligible local expenditure is incurred.

"New Zealand" is defined in section YA 1.

Example 1

Company A performs eligible R&D activities. The activities are carried out over three years, starting in the 2008–09 income year. Some of the activity is carried out in New Zealand, and some is done in Australia.

In the first year, the company spends $100,000 on eligible expenditure in New Zealand and $15,000 on eligible expenditure in Australia. The company is entitled to claim the tax credit in relation to $110,000 of expenditure. This is made up of $100,000 of local expenditure + $10,000 Australian expenditure. The remaining $5,000 of Australian expenditure has to be carried forward until there is sufficient eligible local expenditure to claim the credit.

In the second year of the project, the company spends $100,000 on eligible expenditure in New Zealand and $2,000 on eligible expenditure in Australia. The company is entitled to claim the tax credit in relation to $107,000 of expenditure, made up of $100,000 local expenditure + $5,000 Australian expenditure carried forward from the previous year + $2,000 Australian expenditure from the current year.

In the third year, the company has no eligible expenditure in New Zealand and $40,000 of eligible expenditure in Australia. The company is entitled to claim the tax credit in relation to $3,000 of expenditure, made up of $3,000 of Australian expenditure, for which sufficient local expenditure was incurred in the previous year and the resulting entitlement carried over to this year.

Example 2

Company B performs R&D activities which are carried out over three years, starting in the 2007–08 income year. Some of the activity is carried out in New Zealand, and some is done in Brazil.

In the 2007–08 year, the company spends $100,000 in New Zealand and $15,000 in Brazil. The company is not entitled to claim the tax credit in relation to any of expenditure because the R&D is done before the credit is in effect.

In the second year, the company spends $100,000 on eligible expenditure in New Zealand and $15,000 on eligible expenditure in Brazil on the same R&D project. The company is entitled to claim the tax credit for $110,000 of expenditure, made up of $100,000 local expenditure + $10,000 Brazilian expenditure.

In the third year, the company spends $20,000 on eligible expenditure in New Zealand and $200,000 on eligible expenditure on the same project in Brazil. The company is entitled to claim the tax credit in relation to the $20,000 of New Zealand expenditure for that year.

However, the project no longer comes within the definition of an R&D project (because more eligible expenditure has being incurred in Brazil than in New Zealand in or after the 2008–09 income year) and therefore the company must revise its tax credit claim for the previous year and pay back the credit for the Brazilian expenditure incurred in that year.

Definition of R&D activities (section LH 7)

Only R&D activities as defined in section LH 7 are eligible for the tax credit.

The definitions of "research" and "development" in section DB 35, which apply to allow tax deductibility to follow accounting treatment, remain and have been updated. As the tax treatment is so closely linked to accounting, the accounting definitions have been retained for that purpose only and are not relevant for the credit.

The legislation defines research and development activities as:

- systematic, investigative and experimental activities (SIE) that are performed for the purposes of acquiring new knowledge or creating new or improved materials, products, devices, processes or services and that:
  - are intended to advance science or technology through the resolution of scientific or technological uncertainty; or
  - involve an appreciable element of novelty.

- other activities that are wholly or mainly for the purpose of, required for, and integral to, the carrying on of the activities in paragraph (a).

The definition is not limited to basic research and is expected to apply to a wide range of development activities in a variety of industries. However, routine business activities directed at improving efficiency that do not seek to advance science or technology, or that do not involve an appreciable element of novelty, are not eligible.

The definition draws on elements of the R&D definitions in the United Kingdom, Ireland, Canada and Australia. It is most similar to the Australian definition, which has advantages for businesses operating on both sides of the Tasman and also for Inland Revenue, which will be required to implement the credit within a short timeframe. In particular, it is expected that application of the "appreciable element of novelty" limb will draw on Australian experience.

Activities described in paragraph (a) are SIE activities and activities in paragraph (b) are support activities. This is relevant in relation to the excluded activities in Schedule 21, Part C.

The creation of new or improved production equipment and machinery is included in paragraph (a) as new or improved products.

R&D need not be successful to qualify for the credit.

There is legislative clarification of the meaning of some of the terms used in the definition. Further elaboration on the definition is included in guidelines.

Systematic, investigative and experimental activities (subsection (2))

Claimants must demonstrate that the R&D process followed a planned, logical progression of work involving hypothesis, experiment, observation and evaluation.

Scientific or technological uncertainty (subsection (3))

This exists when knowledge of whether something is scientifically or technologically possible, or how to achieve it in practice, is not publicly available or deducible by a competent professional working in the field. This definition, and the definition of "technology" are derived from the United Kingdom's R&D definition.

Novelty (subsection (4))

For activities to be "novel" there must be some development of the technology or a new use of existing technology. To establish whether something is new, it should be compared with what is already available in the public arena on a reasonably accessible world-wide basis at the time in that technology.

The "appreciable element of novelty" limb is drawn from the Australian R&D definition and the statutory clarification discussed in the paragraph above is based on the explanation of that term in the Australian *R&D Guide* (Part B, page 16). The provisions should be very similar in scope. In particular, "appreciable" means meaningful or significant in the context of the activities undertaken.

Technology (subsection (5))

For the purposes of the R&D definition, "technology" is the practical application of scientific principles and knowledge.

Simultaneous R&D

Under the definition, R&D qualifies if it is done by two firms simultaneously and independently doing the same innovative work or when work has already been done, but this is not public knowledge because it is a trade secret, and another firm repeats the work.

Improvements to existing products/processes

Incremental development and improvements to existing products or processes can qualify as R&D. However, the improvement sought would have to involve an appreciable element of novelty or attempt to advance science or technology. It therefore should be more than routine upgrading.

Support activities (paragraph (b) of R&D definition)

Supporting activities that are wholly or mainly for the purpose of, required for, and integral to the carrying on of SIE activities referred to in paragraph (a), but which in themselves are not systematic, investigative and experimental, are eligible R&D. Support activities are eligible only if there is a SIE activity, though the support activities need not occur in the same income year as the SIE activity.

The requirement that activities be wholly or mainly for the purpose of SIE R&D is intended to exclude the following types of activity:

- construction of an asset with an innovative component when the main purpose of construction is sale of the asset or use for commercial purposes; and
- activities carried out simultaneously for routine business purposes and R&D if R&D is not the main purpose. For example, if a business collects data mainly for its routine business operations but also uses it as an input to R&D, it is not an eligible support activity.

Example 1

ACo is a boat building company that designs innovative components for its boats. It develops a new type of keel which advances boat building technology and is R&D. The keel is to be tested on a boat it is building for a

customer. Construction of the boat is not a qualifying support activity as the boat is not built mainly for R&D. It is built mainly for sale to a customer. This means that none of the construction costs are eligible for the credit.

Example 2

BCo is a developer constructing an apartment complex on reclaimed land. It has commissioned an engineering firm to design a new type of base to provide maximum protection in the event of an earthquake. Construction of the building is not an eligible support activity as the main purpose of construction is use in BCo's business. None of the construction costs are eligible for the R&D credit.

"Required for" means that the supporting activity must be only to the degree necessary to support the project. For example, if a drilling company is developing an innovative piece of drilling equipment that can be adequately tested using computer simulation, drilling is not "required for" the SIE R&D activity. If drilling is required to test the equipment, only drilling that is the minimum necessary qualifies.

"Integral to" means that such activities must be part of an R&D project (rather than indirect supporting activities such as cleaning and administration, which are dealt with as expenditure on overheads).

Examples of support activities that could be eligible include scientific or technological planning activities, mathematical analysis or modelling used to analyse the results of the experiments and routine data collection.

Activities excluded from SIE activities (Schedule 21, Part C)

Certain activities are routinely excluded from R&D tax incentives. This can be because governments do not wish to incentivise a particular activity through an R&D tax concession, to remove uncertainty over whether a particular activity could be considered R&D, to clarify the boundary between development and post-development activity or innovative and routine work.

The activities listed below are excluded from being SIE activities in paragraph (a) of the R&D definition:

- prospecting, exploring or drilling for minerals, petroleum, natural gas or geothermal reserves;
- research in social sciences, arts or humanities;
- market research, market testing or market development, or sales promotion (including consumer surveys);
- quality control or routine testing of materials, products, devices, processes or services;
- the making of cosmetic or stylistic changes to materials, products, devices, processes or services;
- routine collection of information;
- commercial, legal and administrative aspects of patenting, licensing or other activities;
- activities involved in complying with statutory requirements or standards;
- management studies or efficiency surveys;
- the reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information; and
- pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs.

The exclusions are similar to those in Australia. As in Australia, these activities are excluded from being SIE activities only – they may still be support activities within paragraph (b) of the definition. For example, routine data collection will not be eligible as a SIE activity but can qualify as a support activity.

Prospecting, exploring or drilling for minerals, petroleum, natural gas or geothermal energy (clause 1)

It is possible to have R&D in extractive industries – for example, R&D to develop new exploration techniques, but the exploration itself is not R&D. Drilling can be a supporting activity if it is wholly or mainly for the purpose of, required for and integral to the development of a new exploration technique or new equipment – for example, testing new drilling equipment.

Research in social sciences, arts or humanities (clause 2)

Research in these disciplines is excluded in each of the jurisdictions considered in the development of the R&D definition. The focus of R&D tax incentives is on extending business scientific and technological know-how rather than promoting research in these areas which are funded by other means.

The exclusion covers, for example, research in economics, classics, languages, literature, music, philosophy, history, religion, and visual and performing arts. Examples of activities excluded would be the study of the historical development of a language or the role of the family in society, or writing a novel or screenplay.

If a business is developing an innovative product and the development process satisfies the definition in section LH 7, the development is not excluded simply because the product is used in the arts or humanities. For example, if a business develops computer software for use in the film industry in a process that satisfies the criteria in the definition, the software development is not

excluded under this paragraph. Similarly, if a business develops and manufactures innovative ceramic glazes, the development is not excluded under this paragraph because glazes are used in the visual arts.

As with the other exclusions, this research is excluded from being a SIE activity only. When research in these fields is required for development of a new product or process, the research can be an eligible support activity. For example, if research into human behaviour is required for the development of an innovative product, the research can be an eligible R&D support activity.

Market research, market testing or market development, or sales promotion (including consumer surveys) (clause 3)

Conducting of market research is excluded. However, it can be a supporting activity if the research is wholly or mainly for the purpose of, required for and integral to development of, a product or process.

Example

ACo is developing a new can opener for use by people with arthritic hands. It has two options for handle design and selects a group to test both trial models to determine which handle is more easily manipulated. This market testing is eligible as a support activity.

Quality control or routine testing of materials, products, devices, processes or services (clause 4)

Quality control in itself is excluded as a SIE activity. However, the development of new or improved methods of quality control testing can be eligible R&D. Quality control may also be a supporting activity – for example, in the development of a new manufacturing process, checking that the products in a trial run meet the desired quality.

Making cosmetic or stylistic changes to materials, products, devices, processes or services (clause 5)

Changes that are purely cosmetic or stylistic (such as changes to colour or pattern) are excluded from being a SIE activity. For example, this would include design changes for fabrics and wallpapers.

However, work to create a desired cosmetic or aesthetic effect through the application of science or technology can advance the science or technology and be R&D.

Cosmetic or stylistic changes that meet the requirements in paragraph (b) of the R&D definition can also be a supporting activity. For example, if a firm is improving a product it manufactures in a way that falls within the definition of a SIE activity, work on required associated stylistic changes can be eligible R&D.

Commercial, legal and administrative aspects of patenting, licensing or other activities (clause 7)

This is post-R&D work which is very unlikely, even in the absence of the exclusion, to qualify as a SIE activity. It is also unlikely to be a supporting activity because patenting or licensing would seldom be wholly or mainly for the purpose of, or required for, a SIE activity.

Activities involved in complying with statutory requirements or standards (clause 8)

This exclusion targets routine testing and analysis of materials, products and processes to check that they comply with statutory requirements or standards. It does not apply to development of new technologies to comply with standards. Activities involved in developing, rather than complying with, standards is also not excluded. Checking that new products meet relevant standards can be an eligible R&D support activity.

Management studies or efficiency surveys (clause 9)

This includes studies relating to inventory control (such as Just-in-Time), work practices, industrial relations and feasibility analysis, and time and motion studies. The exclusion also covers industry research – for example, when a company carries out a survey into a particular industry's characteristics and future needs.

These studies or surveys can be a supporting activity. For example, if a manufacturer's improvement to a process is R&D, a monitored test to determine how efficient the new process is would be eligible as a supporting activity.

The reproduction of a commercial product or process by a physical examination of an existing system or from plans, blueprints, detailed specifications or publicly available information (clause 10)

No R&D is involved in simply reproducing an existing product or process from the plans or publicly available information. As a result, this is excluded as a SIE activity.

Pre-production activities, such as demonstration of commercial viability, tooling-up and trial runs (clause 11)

This paragraph is intended to clarify the boundary between R&D and post-R&D pre-production activities. Activities either satisfy the definition of SIE activities in paragraph (a) of the R&D definition or fall within the exclusion. If activities that satisfy the definition of R&D in paragraph (a) arise during a pre-production process, they will be eligible regardless of the exclusion. However, most pre-production activity is unlikely to be eligible as SIE R&D.

Trial runs could be eligible as a qualifying supporting activity, as could tooling up (for example, to test a new manufacturing process). It is unlikely that demonstration of commercial viability satisfies the test to be a supporting activity.

Eligible expenditure (Schedule 21, Part A)

Only the following expenditure is eligible for the credit:

- salaries and other remuneration of employees conducting R&D;
- depreciation of tangible assets used in conducting R&D;
- costs of staff training, recruitment, relocation and travel incurred directly as a result of R&D;
- the cost of materials incorporated into prototypes;
- certain overheads that relate to administration, human resources, repairs and maintenance, cleaning and security;
- rates, utilities, insurance and leasing of buildings, plant and equipment;
- the cost of items consumed, and the net cost of items processed or transformed in R&D activities; and
- payments to an entity or person for R&D services performed on behalf of the claimant.

Salary and other remuneration of employees conducting R&D (clause 1)

Salary, wages, allowances, bonuses, commissions, extra salary, overtime, fringe benefits, holiday pay and long-service pay paid to an employee who is conducting SIE or supporting R&D activities are eligible for the credit. Superannuation contributions, fringe benefit tax, specified superannuation contribution withholding tax and insurances paid for such employees are also eligible.

If an employee works part-time on R&D, the credit only applies to remuneration in relation to that portion of the employee's time that is spent on R&D.

Depreciation of tangible property (clause 2))

Annual depreciation on **tangible** property used in conducting R&D is eligible (depreciation on intangible property is excluded under Part B, clause 15). The credit is available to the extent the property is used in conducting R&D (the excess above this is excluded under Part B, clause 5).

Depreciation attracts the credit in two circumstances:

- for "facilitative" assets that are used in the R&D process but are not the object of the R&D; and
- for certain "end-result" assets that are the object of the R&D and are used in the R&D process (for example, for testing, analysis and data recording).

Example: Facilitative assets

ACo has a computer that is used 20 percent of the time on R&D, and 20 percent on other activities. For the remaining 60 percent of the time it is idle (evenings, weekends and holidays). The credit may be claimed in relation to 50 percent of the annual depreciation deduction.

End result assets

Paragraphs (b) and (c) relate to depreciable tangible assets that are developed as the object of the R&D activities and that are to be used in the business other than in the R&D process. Expenditure on developing these assets does not attract the credit when it is incurred. Rather, the credit may be able to be claimed in relation to depreciation on such an asset while it is being used in the R&D process (for example, for testing) provided construction of the asset is an eligible R&D activity. This requires that either the construction itself is a SIE activity (a sufficiently innovative construction technique) or that it is a support activity (mainly for the purpose of, required for and integral to, the SIE activity).

Example

ACo is a utility company experimenting with a new material for underground pipes. It constructs a small area of the network for testing before rolling out the pipes in the region. Assume that the construction of that part of the network is an eligible support activity (that is, it is mainly for the purpose of, is required for and integral to, the SIE R&D). The pipes supply gas to the neighbourhood and will remain in place following the test if they are satisfactory. The salary and materials inputs into construction of the pipe network are not eligible for the credit when they are incurred, but depreciation on the network may be eligible while it is being tested.

Construction of an asset that is mainly for non-R&D commercial purposes is not eligible for the credit at all.

The credit does not apply to depreciation of an end-result asset if the expenditure incurred in its development would be eligible for the credit as it is incurred.

No clawback or loss on sale

To minimise compliance costs, there is no clawback of credits on disposal of assets for more than their tax book value. When an asset is sold to an associate for more than its book value, the price above the vendor's book value does not attract the credit in the hands of the associated purchaser (Part B, clause 6).

Generally, any loss on sale or write-off of depreciable property also does not attract the credit. However, there is an exception in relation to certain end-result assets that are a failure and written off. The exclusion in relation to loss on sale is discussed further below under "ineligible expenditure" (Schedule 21, Part B – clause 2).

Pooled property

The credit does not apply to depreciable assets in a tax depreciation pool unless the pool consists solely of R&D assets used wholly in conducting R&D.

Depreciation of asset by business with tax-exempt income

Special rules are provided in section LH 14 to calculate the amount of depreciation loss in relation to tax-exempt entities.

Employee training, recruitment, relocation and travel (clause 3)

The cost of training, recruitment, relocation and travel of employees is eligible when it is incurred directly as a result of R&D activities.

Materials incorporated into prototype products and plant (clause 4)

The cost of materials incorporated into a trial model or preliminary version of a product or plant is eligible for the credit.

Overhead costs (clauses 5 and 6, and section LH 8)

Certain listed expenditure on overheads is eligible for the credit. Apportionment is required when overheads are only in part incurred directly for R&D activities.

If the overheads relate to administration of internal business activities, the human resources section of a business, repairs and maintenance, or cleaning and security, then employee remuneration, consumables and payments to contractors for services are eligible.

Rates, utilities (including telecommunications) and insurance and the cost of leasing buildings, plant and equipment are also eligible.

Overheads must be incurred ***directly*** for R&D activities. For example, while part of a cleaner's salary will be eligible if he cleans the R&D laboratory, and part of the secretary's salary will be eligible if she supports R&D personnel, the cleaning of the secretary's office is not eligible.

There is a regulatory power to exclude overheads that are too remotely connected with the R&D. The broad intention is that overheads not eligible for the 125 percent concession in Australia will be excluded in New Zealand. Examples include directors' fees, entertainment expenses, and canteen and recreational facilities.

Remuneration of employees performing SIE or support R&D activities are eligible under clause 1, not clause 5. Support activities must be integral to – that is, part of – SIE activities. This would include, for example, the salary of a technician collecting data used in experiments. Human resources personnel, cleaners and security officers generally do not perform activities that would be part of the R&D project so their remuneration will be eligible (if at all) as overheads under clause 5.

This clause does not include depreciation deductions, which may only be claimed under clause 2.

Example

ACo has an R&D division with employees engaged full-time in R&D. The human resources officer spends on average 10 percent of her time attending to issues relating to that division. These are considered to be directly related to R&D activities, so 10 percent of her remuneration is eligible.

ACo employs a cleaner who spends 10 percent of her time cleaning the R&D division. Again, this is considered to be directly related to R&D activities, so 10 percent of her remuneration is eligible. However, the cleaning of the human resource officer's office is not directly related to R&D activities.

Items consumed in R&D activities (clause 7)

Items consumed in the R&D process are eligible for the credit. This would include, for example, laboratory chemicals and stationery.

Net cost of items processed or transformed in R&D process (clause 8)

For items that are processed or transformed during R&D activities, only the net expenditure is eligible – that is, the excess of the cost of the items which are the subject of processing or transformation, over the value of the output. The value of the output is the sale proceeds when the products are sold in an arm's-length transaction and, when they are not, the market value of the products.

The provision applies to the acquisition or production of raw materials or products that are "put through" an R&D process. This will most often be trading stock and would include the catching of fish put through an experimental fish processing plant, milk processed into powder in an experimental drying process, sheep shorn or cows milked in an experimental process and timber acquired and cut using a novel technique.

It encompasses the manufacture or acquisition of a product that does not change during the R&D process or changes in a manner that is not visible.

Payments to a person for R&D services (clause 9)

When part or all of an R&D project is outsourced, a payment to the person or entity conducting the R&D is eligible. The performer of the R&D does not get a credit because it would fail the requirement to control the project, bear the risk and effectively own the results. When the R&D is outsourced to an associate, some of the payment is likely to be ineligible under Part B, clause 3.

The payment must relate only to the R&D conducted by the third party. If the payment is for multiple items (such as R&D services and marketing), costs must be separately identified.

The provision applies to payments for both SIE and supporting activities and covers the costs of engaging independent contractors, agency workers and temporary staff to work on R&D.

To be eligible for the credit, expenditure must be listed in Schedule 21, Part A and not listed in Schedule 21, Part B. The intention is that generally expenditure in Part B is ineligible whether it is incurred by the claimant in doing its R&D inhouse or when the R&D is contracted out to a third party.

For example, if a Crown Research Institute, performing contract R&D for an eligible business, arranges for the work to be subcontracted overseas, the expenditure limit in relation to overseas R&D still applies. The same principle applies to internal software development.

The wording of certain restrictions – for example, section LH 6 (for R&D done overseas) and Part B clause 9 (internal software development) – achieves this already. However, it is not so clear in relation to other clauses in Part B. The government will review this at the earliest opportunity. Businesses should not be able to avoid rules relating to excluded expenditure by outsourcing R&D.

Ineligible expenditure (Schedule 21, Part B)

The following expenditure is ineligible:

- interest;
- loss on sale or write-off of depreciable assets (except in one situation);
- profits on R&D services and property provided by an associate;
- amounts in excess of market value for leasing property of an associate;
- depreciation attributable to the time an asset is not used in R&D;
- certain depreciation deductions on assets acquired from an associate;
- the cost of feedstock other than the net cost referred to in Part A, clause 8;
- the cost of acquiring core technology (technology used as a basis for further R&D);
- in-house software development costs exceeding $3 million (unless the cap is increased by Ministerial waiver);
- expenditure funded from a government grant or any required co-funding;
- donations;
- professional fees in determining whether the person, activities or expenditure are eligible;
- the cost of acquiring intangible assets; and
- expenditure of an industry research co-operative funded by an ineligible person.

Some of this expenditure (for example, professional fees and donations) would not be eligible in any event, as it would not fall within the list of eligible expenditure in Part A. It has been inserted to make the provisions as clear as possible, and to avoid doubt.

Interest (clause 1)

Expenditure incurred under a financial arrangement – essentially, interest – in financing R&D activities is not eligible.

Depreciation loss on disposal or write-off of assets (clause 2)

To reduce compliance costs, there is no clawback of credits when depreciable property used in R&D is sold for more than its adjusted tax value. There is generally a corresponding restriction in relation to a loss on disposal of depreciable assets and the write-off when depreciable items are no longer used (sections EE 11(3) to (5) and EE 39). No credit is available in relation to this loss or write-off.

Example

ACo purchases an asset for $1 million which is used wholly in R&D for three years. Credits are claimed in relation to that depreciation. The adjusted tax value at the time of sale is $700,000. The asset is sold for $650,000. No credit is available for that $50,000 loss.

End-result assets to be used for commercial purposes

As noted earlier, the cost of assets that are the object of the R&D (such as prototypes) do not attract the credit when they are incurred unless their sole intended use is in R&D. If they are to be used in commercial activity, either simultaneously or subsequently to their R&D use, and if the construction of the asset is an R&D activity, the credit

may be claimed in relation to depreciation on the asset for the time it is used in R&D.

If the asset is a failure and is written off, the credit can be claimed for the balance of the costs provided the conditions in Part B, clause 2, paragraphs (a) to (c) and Part A, clause 2 are met. In particular, the asset must be wholly or mainly used in the R&D activities and not used after they end, and development costs must not be eligible for the credit in the year they are incurred.

Example

ACo is an energy distribution company that is developing an innovative household meter. It instals the meters in 100 households before installing them more widely and plans a monitoring and testing programme over two months. Construction and installation of the test meters is an eligible support activity as the meters are mainly constructed and installed for the SIE R&D activities, and are required for and integral to them. However, if they are satisfactory, they will be left in place and used in ACo's normal business operations. The expenditure in constructing and installing the meters is treated by ACo as capital expenditure for tax and accounting. The materials and labour in constructing the meters are therefore not eligible for the credit as they are incurred. However, depreciation on the meters attracts the credit during the testing period.

One month after the trial begins, ACo finds that the meters are unsuitable. It removes and scraps them. The balance of the construction and installation cost of the meters are eligible for the credit at that stage.

R&D services and property purchased from an associate (clause 3)

When R&D is outsourced to an associate of the claimant, or property used in R&D is acquired from an associate, the credit cannot be claimed for any profit margin of the associate in supplying the services or property. The credit is payable on the lesser of the amount paid to the associate (eligible under Part A, clause 9) and the eligible expenditure of the associate incurred in a third-party transaction.

Example

ACo contracts its sister company BCo to perform R&D services. BCo obtains all the services and property used to perform the R&D from third parties unassociated with the company (for example, employees and contractors). Unassociated T Co provides core technology to BCo to enable BCo to perform the services. BCo spends $30,000 on the core technology and incurs $50,000 eligible expenditure on performing the R&D services (salary of employees and depreciation on equipment). BCo charges ACo $100,000 for the services. ACo may claim the credit only on $50,000.

Property leased from an associate (clause 4)

When property is leased directly or indirectly from an associate at more than market value, the excess over market value is not eligible for the credit.

Depreciation in excess of time asset used in R&D (clause 5)

This is the apportionment rule for depreciation on assets used in performing R&D. (See the explanation of Part A, clause 2.)

Depreciation deduction on property purchased from associate (clause 6)

Because there is no clawback of credits when depreciable property used in R&D is sold for more than its tax book value, a rule is required to prevent associated entities claiming credits twice for depreciation. Clause 6 therefore provides that when depreciable property is sold to an associate for a price in excess of the vendor's tax book value, the excess over the vendor's tax book value does not attract the credit in the hands of the purchaser. This rule is required even if the sale price is less than the vendor's cost (that is, it is required even though there are restrictions on the associated purchaser's ability to deduct depreciation under section EE 40).

Example

ACo sells computer equipment used in its R&D to associated BCo for its market value of $1,300. The equipment cost $2,000 and has a tax book value of $1,000. The $300 is not eligible for the credit in the hands of BCo.

Feedstock expenditure in excess of net expenditure (clause 7)

This excludes all feedstock expenditure in excess of the sale proceeds or market value of the end product.

While not in current legislation, consideration is being given to restriction of the credit when other property developed in the R&D process is sold.

Core technology (clause 8)

Core technology is technology which is used as a basis for further R&D. It may be intellectual property or a tangible asset such as a prototype. Core technology that is acquired or leased from another person is ineligible for the credit. The definition is in substance the same as it is in Australia.

Cap on certain in-house software development (clause 9)

This is discussed under sections LH 9 to LH 13 and LH 17 at the end of this report.

Grants and required co-funding (clauses 10, 11, 12)

Expenditure funded by a grant from a public authority or local authority or from funds required as a condition of the grant (co-funding) by the public or local authority is ineligible for the tax credit. This is because the R&D project is already subsidised by government.

The rule applies when the co-funding is required from the recipient of the grant or from another party.

"Public authority" and "local authority" are defined in section YA 1 of the Income Tax Act 2007.

Example 1

ACo receives an R&D grant of $50,000 from the Foundation for Research Science and Technology. As a condition of the grant, ACo is required to contribute $100,000 of its own funds towards the project. The $150,000 is used to pay for R&D salaries and to purchase items consumed in the R&D. None of it is eligible expenditure.

As part of the R&D activity ACo spends a further $20,000 on items consumed in the R&D activity. This amount is eligible for the credit because neither the grant exclusion nor the required co-funding exclusion applies to it.

As a condition of the grant to ACo, BCo is required to fund $20,000 of salary expenditure on another R&D activity. A tax credit is not available to BCo for its expenditure of $20,000.

Example 2

CCo receives a grant of $40,000 from a local authority for R&D activities. The total expenditure on the activity by CCo will be $120,000, consisting of $90,000 for the purchase of core technology and $30,000 of salary expenditure. The local authority has not stipulated that CCo should apply the funds to the purchase of core technology or to paying salaries. CCo can therefore apply the grant to the purchase of core technology and claim a tax credit in relation to the salary expenditure.

Donations (clause 13)

Making donations towards the R&D of others is not eligible. In Australia, making of donations is excluded as an activity.

Professional fees in determining eligibility (clause 14)

Fees paid to accountants, lawyers, scientists and others in determining whether claimants, activities and expenditure are eligible and calculating the amount of the claim are not eligible for the credit. This includes payments paid to Inland Revenue for a determination under section 91AAP of the Tax Administration Act 1994.

Cost of acquiring intangible assets (clause 15)

The credit is not available for the cost of purchasing, leasing or obtaining the right to use intangible assets. Expenditure on intangibles can be by way of royalties or a lump sum capital cost.

The extent to which they can be included in eligible expenditure requires careful consideration as such assets tend to be the focus of tax avoidance schemes. This policy work will be done once the R&D credit is in effect.

Example

ACo acquires a licence to use software in its R&D process. Depreciation on, or licence fees for, the software are not eligible.

The paragraph does not exclude the cost of creating intangible assets from R&D.

Certain expenditure of an industry research co-operative (clause 16)

Clause 16 provides that expenditure of an industry research co-operative that is sourced from funds contributed by a person who does not have a business in New Zealand or who is ineligible under section LH 1(2) is not eligible expenditure of the co-operative. This is to prevent co-operatives being used to circumvent the requirements for eligibility.

Industry research co-operatives are discussed in more detail in relation to section LH 16.

Listed research providers (section LH 15)

Section LH 15 sets out the requirements to be listed with the Commissioner as a research provider and the administrative rules for listing. Payments to an unassociated listed research provider are not subject to the minimum threshold of $20,000 of eligible expenditure each year. However, the payment must be for eligible expenditure (as calculated under section LH 4).

If a provider is delisted, payments under an arrangement entered into when the provider was still listed are not subject to the minimum threshold. (See discussion above on section LH 2(3) and (4).)

To be listed, a person must give notice to the Commissioner that it has the capability to perform contracted R&D, has R&D facilities in New Zealand and undertakes to meet the continuing requirements set out in subsection (3).

The continuing requirements are that the provider will charge fees on commercial terms, be available to

undertake work on behalf of unrelated parties, and will maintain records to show that it satisfies the requirements to be listed and to show the amounts derived and incurred in carrying out R&D on behalf of others.

Inland Revenue will check the first two requirements and list the research provider if it is satisfied they are met. Listing does not constitute an endorsement of the provider. It means the research provider has satisfied Inland Revenue it has the capability to undertake R&D for others and has facilities in New Zealand. The list will be publicly available on the Inland Revenue website from 1 April 2008.

The provider is listed until it seeks to be removed from the list or is delisted by the Commissioner. Either party must give notice to the other and subsections (6) and (7) set out the dates on which the delisting takes effect.

The Commissioner may refuse to list a person who has been delisted in the past if the Commissioner considers that the person does not meet the start-up requirements or will not meet the continuing requirements on listed research providers.

No challenge is available to the Commissioner's decision to delist a provider.

Industry research co-operatives (section LH 16)

Industry research co-operatives fall into two categories. They can be organisations, generally in the primary sector, that collect levies from those in an industry and apply them to various purposes, including R&D.

Outside the primary sector, they may be co-operatives set up within an industry that receive contributions for various activities, including R&D.

These organisations are unlikely to be in business, but the R&D they either conduct or commission on behalf of businesses in the relevant industry is eligible for the credit. Those in business in the industry and making payments to the co-operative will not be eligible for the credit in relation to those levies or contributions. Industry research co-operatives are therefore not required to be in business. (See discussion above on section LH 1(1)(b).) The exemption does not flow through to entities controlled by the co-operative.

The co-operative must be undertaking or commissioning R&D mainly on behalf of its members, who:

- must be New Zealand businesses (either as residents or through a fixed establishment in New Zealand);
- would meet the requirements in section LH 2 if they carried out or commissioned the R&D and if the minimum threshold did not apply; and
- contribute to the financing of the R&D activity.

Also, the R&D activities must relate to the businesses of those who make contributions or pay levies. (See discussion above on section LH 2(2)(a)(ii).)

Expenditure of an industry research co-operative that is sourced from funds contributed by a person who is not eligible is not eligible expenditure of the co-operative. This is to prevent co-operatives being used to circumvent the requirements for eligibility. (See discussion above on ineligible expenditure Schedule 21, Part B, clause 16.)

Depreciation base for tax-exempt entities (section LH 14)

R&D tax credits are potentially available to most entities undertaking an R&D activity, including charities and not-for-profit entities which have only exempt income.

The normal rules for calculating depreciation loss are ineffective for entities which generate only exempt income from an asset. Section LH 14 provides rules to calculate a notional amount of depreciation loss these entities can claim a credit for.

When an entity conducting or commissioning R&D has not previously been allowed a deduction for an amount of depreciation loss for an asset because it derives only exempt income, it is treated as acquiring the asset on the first day of the 2008–09 income year for market value, or on the actual date of acquisition at cost, whichever is the later.

These entities are then considered, solely for the purposes of calculating the amount of depreciation loss for the purposes of the credit, to have had deductions for depreciation in every year since acquisition. This does not allow the entity to actually claim a deduction for depreciation loss, but does lead to the correct amount of depreciation loss to use in calculating the amount of R&D tax credit. (See example on facing page.)

R&D tax credits and imputation accounts (sections OB 4(3)(eb), OB 7C, OK 2(3)(cb), OK 4B, OP 5(2)(bb), OP 7(3)(fb) and OP 11B)

In other jurisdictions, such as Australia, tax credits to companies are "clawed back" when paid out as dividends. The New Zealand credit has been designed to reduce such "clawback".

If an entity has an imputation credit account or a Māori authority credit account, an R&D tax credit will lead to a credit to that account. A refund of R&D tax credit (including a transfer of surplus credit) will lead to a debit. The net result is that the entity receives an imputation credit for the income tax liability satisfied by way of the credit.

Example (Depreciation base for tax-exempt entities (section LH 14)

A, a charitable society, undertakes R&D in 2010–11. A Digital Serial Analyser, purchased new in 2007, is mainly used in the R&D activity and the resulting depreciation loss would be deductible if A derived assessable income. A's income year runs from 1 April to 31 March, and an independent valuation of the analyser on 1 April 2008 puts its market value at $35,000.

For the purposes of calculating the depreciation loss which is eligible for the credit in 2010–11, A assumes the analyser was purchased on 1 April for $35,000. The applicable depreciation rate for the analyser is 26.4 percent (diminishing value rate for an oscilloscope with 20 percent loading).

A is treated as being allowed a deduction for depreciation loss in each of the 2008–09, 2009–10, and 2010–11 income years, being the completed income years following deemed acquisition. Therefore, the assumed amounts of depreciation loss and adjusted tax values (ATV) in each year are:

Income year	ATV at beginning of year	Depreciation loss
2008–09	Cost = $35,000	26.4% x $35,000 = $9,240
2009–10	$35,000 – $9,240 = $25,760	26.4% x $25,760 = $6,800
2010–11	$25,760 – $6,800 = $18,960	26.4% x $18,960 = $5,005

In the 2010–11 income year, A can claim a tax credit for $5,005 of eligible depreciation loss.

If the Digital Serial Analyser, instead of being purchased new in 2007, was previously used in New Zealand, the applicable depreciation rate for the analyser would be 22 percent (diminishing value rate for an oscilloscope without 20 percent loading).

The credit is equal to the amount of the R&D tax credit (sections OB 7C, OK 4B and OP 11B), and the debit is equal to the amount of the refund (or transfer). The credit arises on the day the relevant income tax return is received by Inland Revenue.

Examples: Tax credit leads to credits and debits to imputation credit account

1. Company A receives a tax credit of $10,000 for expenditure incurred in its 2008–09 income year, reducing its tax-to-pay to $100,000. Company A's income tax return for the 2008–09 year is received by Inland Revenue on 1 June 2009. On 1 June 2009, there is a credit to A's imputation credit account of $10,000.
2. Company B receives a tax credit of $10,000 for expenditure incurred in its 2008–09 income year, pushing it from tax-to-pay of $5,000 to a tax refund of $5,000. Company B's income tax return for the 2008–09 year is received by Inland Revenue on 1 March 2010. B receives a cash refund of $5,000, being the amount of the surplus refundable tax credit, on 1 April 2010. On 1 March 2010, there is a credit to B's imputation credit account of $10,000. On 1 April 2010, there is a debit to B's imputation credit account of $5,000.

To prevent more than one imputation credit arising because of an R&D tax credit, there is no credit for income tax paid by an R&D tax credit (sections OB 4(3)(eb), OK 2(3)(cb) and OP 7(3)(fb)). In addition, where a consolidated imputation group has a credit to its imputation credit account for an R&D tax credit, the same credit does not arise in the accounts of any of the members of the group (section OP 5(2)(bb)).

Claiming the credit

Businesses will claim the tax credit in an income tax return. The claimant will work out the liability for tax in the normal way, and then subtract the amount of the credit. If the amount of the credit exceeds the tax liability the balance is used to reduce other tax liabilities, or is refundable in cash.

The credit will reduce residual income tax, which will reduce provisional tax liability, allowing taxpayers to receive the benefit of the credit closer to the time the related eligible expenditure is incurred. This reduction will be immediate for people who estimate provisional tax, but delayed for people who use the "uplift" method for calculating provisional tax.

To be eligible for the credit, the claimant must provide – in addition to the income tax return – a detailed statement of R&D activities and expenditure, containing essential information for administrative purposes, by a due date.

Example: Claiming the tax credit

In 2010, Company A has assessable income of $200,000 and allowable deductions of $170,000, $100,000 of which is eligible expenditure on R&D. A claims an R&D tax credit of $15,000 and files a detailed statement by the due date.

Assessable income	$200,000
Less	
Deductions	$170,000
Net income	$30,000
Tax liability (@ 30%)	**$9,000**
Less	
R&D tax credit	$15,000
Tax to pay	**$0**
Refund of surplus credit	**$6,000**

Addendum

Credit to imputation credit account	$15,000 (on date return is received)
Debit to imputation credit account	$6,000 (on date refund is paid)

Requirement for a detailed supporting statement (section LH 2(1)(d) of the Income Tax Act 2007; sections 68D and 68E of the Tax Administration Act 1994)

A business claiming a tax credit in an income tax return is required to file electronically a detailed supporting statement. The detailed statement contains essential information to be used for audit, forecasting, statistical and evaluation purposes.

If a business is a member of an internal software development group, the detailed statement must be filed by a nominated member of the group on behalf of all group members.

A partnership may elect to file the detailed statement, in relation to the partnership's R&D activities, on behalf of all the partners, for convenience.[17] A partnership which elects to file a statement on behalf of all the partners, and does internal software development, is not an internal software development group merely because it makes this election. Alternatively, if the partnership does not make this election, partners must separately file their own detailed statements, including their share of the partnership's eligible expenses and tax credit.

The statement must be filed by the due date. If a statement is filed late, there will be no tax credit for the year and there could be use-of-money-interest and penalties to pay.[18]

Because businesses and their agents need sufficient time to prepare the statement, the statement is never required to be filed before the due date for the associated income tax return.

The due date for the detailed statement for an individual is 30 days after the due date for the business's income tax return (including any extensions of time). The due date for an internal software development group is 30 days after the latest income tax return due date of any of the group's members. The due date for a partnership which elects to file a statement for all the members of the partnership is 30 days after the latest income tax return due date of any of the partners.

Example: Due date for filing a detailed statement

A's income year runs from 1 April to 31 March. B and C have income years which run from 1 November to 31 October. A, B and C are members of an internal software development group and have amounts eligible for a tax credit. B and C have a tax agent who is granted an extension of time, until 31 March 2020, to file B and C's 2018–19 income tax returns. A's internal accountant files its income tax return.

A must file its 2018–19 income tax return by 7 July 2019. B and C have until 31 March 2020. The group's detailed statement must therefore be furnished by 30 April 2020.

It is possible that a business will be required to file (or have filed on its behalf by a group or partnership) more than one detailed statement for an income year.

Special rules for 2008–09 and 2009–10 years

In the early years of the R&D tax credit, it is recognised that some businesses will still be coming to grips with the requirements of the new rules. Some additional flexibility has been provided for businesses which do not initially file a claim for an R&D tax credit, enabling them in some cases to file their detailed statements at a later date.

In the 2008–09 and 2009–10 years, if a business has not claimed an amount of R&D tax credit in the relevant income tax return, the due date for the detailed statement for an individual is two years after the due date for the income tax return. If none of the members of an internal software development group have claimed an amount of R&D tax credit in the relevant income tax returns, the due date for the group's detailed statement is two years after the latest due date for filing an income tax return for any of the group members. If none of the partners in a partnership electing to file a detailed statement on behalf of all partners has claimed an amount of R&D tax

[17] This ability to elect is being reviewed and may be removed in a future tax bill.

[18] There may be an exception in one situation: when a group return is filed on time but is incorrect because of a simple oversight, the Commissioner has discretion to grant an extension of time to file a corrected version. This exception was created to avoid the situation in which a group accidentally omits a member from its group return, causing the other members of the group to lose entitlement to their credits. It is not intended that the exception would be used in other situations.

credit in the relevant income tax returns, the due date for the partnership's detailed statement is two years after the latest due date for filing an income tax statement of any of the partners.

If a business (or any member of an internal software development group or any partner) has claimed an amount of R&D tax credit in the relevant income tax return, the special rules for 2008–09 and 2009–10 do not apply. A detailed statement must be filed by the normal due dates.

Provisional tax (section YA 1 of the Income Tax Act 2007; section 3(1) of the Tax Administration Act 1994 – definition of residual income tax)

The R&D tax credit reduces residual income tax. Taxpayers therefore have the option of reducing their provisional tax payments in anticipation of an R&D credit at the end of the year.

> **Example: Estimating provisional tax, including a tax credit**
>
> Company A expects to have a tax liability of $100,000 for the 2008–09 income year (before credits). A also expects to receive a credit of $40,000, so estimates its residual income tax to be $60,000. A furnishes this estimate to Inland Revenue and thereby elects to use the estimated provisional tax method. On each provisional tax instalment date, A pays provisional tax payments of $20,000.

Changes to the disputes and reassessment rules

Time limit for notice of proposed adjustment (section 3(1) of the Tax Administration Act 1994 – definition of response period)

Because claimants and their agents will require time to prepare and check their claims for tax credits, the time for reassessing the amount claimed has been extended from the standard four months.

In the case of a notice of proposed adjustment (NOPA) relating solely to an amount of R&D tax credit, the time limits within which the claimant can issue the NOPA are:

- for a business that is neither a member of an internal software development group nor a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, one year following the date the income tax return is received by Inland Revenue; and
- for a business that is a member of an internal software development group or a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, from the date the business's income tax return is received by Inland Revenue, up until one year after the due date for the group's detailed statement of R&D activities.

> **Example: Claimant issues NOPA within the new response period**
>
> Company A is in the process of internally auditing its R&D expenditure. On 15 March 2020, A's agent files A's 2018–19 income tax return and files a detailed statement of R&D activities, claiming a $50,000 tax credit. Inland Revenue receives the tax return on 17 March. When A completes its audit, A discovers that it was actually entitled to a tax credit of $60,000 and issues a notice of proposed adjustment relating solely to the R&D tax credit.
>
> As long as Inland Revenue receives the notice of proposed adjustment by 16 March 2021, the disputes process will begin and, subject to the outcome of the process, A could receive the additional $10,000 credit. If the notice of proposed adjustment is received after 16 March 2021, the notice will not be effective.

Issuing a NOPA solely for an amount of R&D tax credit does not allow the business to reopen any other aspect of the income tax return.

Special rules for 2008–09 and 2009–10 years

In parallel with the extension of time to file a detailed statement, in some cases during the early years of the credit the time periods for issuing a NOPA relating solely to an R&D tax credit are also extended.

For the 2008–09 and 2009–10 income years, the time periods within which a NOPA relating solely to an amount of R&D tax credit may be issued are:

- for a business that is neither a member of an internal software development group nor a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, two years following the date the income tax return is received by Inland Revenue; and
- for a business that is a member of an internal software development group or a partner in a partnership electing to apply section 68E of the Tax Administration Act 1994, from the date the business's income tax return is received by Inland Revenue, up until two years after the due date for the group's detailed statement of R&D activities.

Time limit for Commissioner's reassessment (sections 108(1B) and 113D of the Tax Administration Act 1994)

Overseas experience suggests that when businesses are given long periods to reconsider their original claims, practitioners have incentives to trawl through past years' accounts and identify R&D expenditure that the business was unaware was R&D. This practice of "grave-digging" is at odds with the intent of the R&D tax credit policy, which is that the credit should provide an incentive to undertake R&D. If credits are being given for R&D which the business was unaware it was

undertaking, it is clear that the credit has not provided any incentive.

To prevent "grave-digging", the Commissioner cannot reassess an amount of R&D credit upwards if one year has passed since the end of the tax year in which the original income tax return was filed.

Example: Claimant requests amendment after more than a year

Company A claims a $50,000 credit for R&D undertaken in the 2018–19 year, by filing an income tax return on 6 June 2019. The return is filed in the 2019–20 tax year, which ends on 31 March 2020.

On 1 June 2021, A discovers that it was actually entitled to a $60,000 credit for R&D and asks the Commissioner to amend the amount originally self-assessed. However, Inland Revenue cannot amend the amount to $60,000 after 31 March 2021.

There is an exception to the new rule. When the claimant has issued a NOPA on its claim for an R&D credit within the response period for doing so, the Commissioner has the normal period to reassess the amount of credit, allowing time for disputes procedures to be completed. In no case, however, may the Commissioner increase the amount of the R&D tax credit by more than the adjustment proposed in the NOPA which arrived within the original response period.

Example: Claimant requests amendment after more than a year, having issued a NOPA

Company A claims a $50,000 credit for R&D undertaken in the 2018–19 year, by filing an income tax return on 6 June 2019. The return is filed in the 2019–20 tax year, which ends on 31 March 2020.

On 1 June 2020, A discovers that it was actually entitled to a $60,000 credit for R&D and issues a notice of proposed adjustment. The notice is issued within the response period (one year following the date the tax return was received), so the disputes process begins. The disputes process is concluded on 30 August 2021, and Inland Revenue agrees the credit should be $60,000. Normally, Inland Revenue would be unable to reassess the amount of the credit, since the date for doing so (31 March 2021) has passed. However, because the claimant had issued a NOPA relating to the amount of the R&D tax credit, Inland Revenue will reassess the amount to $60,000.

Example: Claimant requests amendment after more than a year, having issued multiple NOPAs

Company A claims a $50,000 credit for R&D undertaken in the 2018–19 year, by filing an income tax return on 6 June 2019. The return is filed in the 2019–20 tax year, which ends on 31 March 2020.

On 1 June 2020, A discovers that it was actually entitled to a $60,000 credit for R&D and issues a notice of proposed adjustment. The notice is issued within the response period (one year following the date the tax return was received), so the disputes process begins.

On 20 August 2020, A issues another NOPA, revising up the credit again to $70,000.

The disputes process relating to the first NOPA is concluded on 30 August 2021, and Inland Revenue agrees the credit should be $60,000. Because the claimant issued a NOPA relating to the amount of the R&D tax credit within the response period, Inland Revenue will reassess the amount to $60,000.

The second NOPA is ineffective because it was issued outside the relevant response period, being the first year after the income tax return was originally filed. Inland Revenue is unable to reassess the tax credit amount above $60,000.

Special rules for 2008–09 and 2009–10 years

For R&D tax credits arising in the 2008–09 and 2009–10 years, the Commissioner cannot reassess an amount of R&D credit upwards if two years have passed since the end of the tax year in which the original income tax return was filed. This is in line with the extensions, in some circumstances, for filing detailed statements or issuing a NOPA relating solely to an amount of R&D tax credit.

Determinations (sections 91AAP and 91C(4) of the Tax Administration Act 1994)

Businesses that are uncertain about their eligibility for the tax credit will be able to apply for a determination of whether:

- they meet the eligibility criteria in section LH 3 of the Income Tax Act 2007;
- their expenditure or depreciation loss meets the requirements of the definition of "eligible expenditure" in section LH 4; and
- their activity meets the requirements of the definition of "research and development activities" in section LH 7.

Businesses will not be able to obtain binding rulings about these matters.

There will be regulations to prescribe how businesses should apply for a determination on these matters. The determinations will be binding on the Commissioner, from the date the determination is signed by the Commissioner, but not binding on the person who applies for the determination.

When there is an amendment to or repeal of the law relevant to the determination, and it would detrimentally

affect the business to continue relying on the determination, the determination does not have to be relied on.

Where the applicant has misrepresented or omitted facts relevant to the determination, whether intentionally or not, the determination is no longer binding and cannot be relied upon.

Inland Revenue may withdraw the determination by notice, at which point it can no longer be relied upon. There is an exception, however – when the business is already undertaking an activity in reliance on the determination, and was doing so before the notice of withdrawal, the business can continue to rely on the determination as originally set down for the activity.

A determination may not be disputed or challenged.

The ability to apply for a determination will not be available immediately. The provision allowing for determinations will come into force by Order in Council, no later than 1 April 2010.

Record-keeping (sections 22(2) and 22(7) of the Tax Administration Act 1994)

Claimants must keep sufficient records to support their claim for an R&D tax credit. For a business, general record-keeping requirements are laid out in detail in section 22(1). An entity which does not derive assessable income is expected to keep records of a similar standard to support its claim for a tax credit.

In addition, all entities claiming a tax credit will be expected to keep a wider range of records than specified in section 22(1). For example, non-accounting documents such as project plans or test-reports might be required to provide evidence of a systematic, investigative and experimental approach to an activity.

Listed research providers must keep additional records to show that they meet the requirements of section LH 15(2) and (3) of the Income Tax Act 2007, and to show the amounts derived and incurred by them in performing R&D activities on behalf of other persons.

No exemption from filing an annual return of income (sections 33A(2) and 43A(2) of the Tax Administration Act 1994)

A business that has a tax credit under section LH 2 of the Income Tax Act 2007 must file a return of income for the year the credit relates to. The exemption from filing in section 33A does not apply to a person who claims the tax credit.

A non-active company which has a tax credit under section LH 2 ceases to be a non-active company and must file an income tax return.

Use-of-money interest and penalties (section 141(7C) of the Tax Administration Act 1994)

Use-of-money interest and penalties generally apply to amounts of tax credit as they would apply to other amounts of tax.

However, there is an exception to the normal shortfall penalty rules, applying only to internal software development groups. When the members of an internal software development group reallocate the credits for internal software development undertaken by the group, there will not be a shortfall as long as the reallocations are offsetting. This recognises that group members who file a tax return early might not yet know the internal software development expenditure of other group members.

Example: Reallocation of credits for internal software development (no shortfall)

Company A and Company B, standard balance date companies, are members of an internal software development group from 1 October 2008 to 31 March 2009.

The following expenditure is undertaken:

- Company A spends $1 million on internal software development in the period from 1 April 2008 to 30 September 2008, and $2 million on internal software development in the period from 1 October 2008 to 31 March 2009. Company A also spends $6 million on other R&D over the year.
- Company B spends $0.5 million on internal software development in the period from 1 April 2008 to 30 September 2008, and $1.5 million on internal software development in the period from 1 October 2008 to 31 March 2009. Company B also spends $4 million on other R&D over the year.

Company A files its tax return on 1 May 2009, claiming a tax credit for $8,495,890 of R&D expenditure ($1 million of internal software development expenditure before it was part of the group, $1,495,890 of internal software development expenditure afterwards, and $6 million for other R&D expenditure). This gives a total credit of $1,274,383.

Company B files its tax return on 1 July 2009, claiming a tax credit for $4.5 million of R&D (internal software development expenditure of $0.5 million incurred before it was part of the group, and $4 million of other R&D expenditure). This gives a total tax credit of $675,000. Company B would also like to claim for internal software development expenditure incurred while in the group, but is aware that the group's expenditure cap has been reached.

Company B negotiates with Company A. Company A files a notice of proposed adjustment and reduces its claims for tax credits by $90,000 (relating to eligible expenditure on internal software development of $600,000). Company B files a notice of proposed adjustment and increases its claim for tax credits by $90,000. The Commissioner makes both adjustments. Because $90,000 is less than the credits Company A received for internal software development expenditure incurred while in the group, and because Company B is entitled to more than $90,000 of credits for internal development expenditure incurred while in the group, Company A has no tax shortfall.

The provision only applies when there is reallocation of credits for internal software development expenditure incurred while in the group. It allows neither reallocation of any credits for expenditure incurred outside the group nor reallocation of any credits for expenditure which is not on internal software development. The business that is allocated a greater amount of credits must also have sufficient eligible expenditure relating to internal software development undertaken while in the group to justify those credits.

Refunds of surplus credits not subject to GST (section 6 of the Goods and Services Tax (Grants and Subsidies Order) 1992)

A refund of surplus tax credits under section LH 2 of the Income Tax Act 2007 is not subject to GST.

Cap on internal-use software expenditure eligible for a credit (sections LH 9 to LH 13 and LH 17)

A maximum of $3 million of internal software development expenditure will be eligible for an R&D tax credit in any year. Where businesses undertaking internal software development are under common control, they form an internal software development group and must count their expenditure on such development towards a single $3 million cap.

In exceptional cases, the level of the cap may be increased by the Minister of Finance for an individual or an internal software development group if certain conditions, essentially relating to national interest, are met.

In other jurisdictions, claims for R&D incentives relating to internal software development have been problematic. In Australia, the 125 percent and 175 percent deductibility R&D tax incentives are not available for software developed for solely internal use.

The New Zealand credit allows claims for internal software development, but caps these claims to limit the fiscal risk of abuse.

The cap does not affect a business's entitlement to credits for expenditure that does not relate to internal software development.

Outline of the sections

Section LH 9 adjusts the eligible expenditure on internal software development a business can claim a credit for. Subsection (1) determines when a business is eligible for a credit for internal software development and therefore has to apply section LH 9. Subsection (2) determines which other sections to use in adjusting the eligible expenditure.

Section LH 10 adjusts eligible expenditure on internal software development for periods when the business is not a member of an internal software development group.

Section LH 11 adjusts eligible expenditure on internal software development for periods when the business is a member of an internal software development group in which all members have the same income year.

Section LH 12 adjusts eligible expenditure on internal software development for periods when the business is a member of an internal software development group in which not all members have the same income year.

Section LH 13 sets the maximum annual eligible expenditure on internal software development, and allows for Ministerial discretion to increase the maximum in certain circumstances.

Section LH 17 defines the terms "associated internal software developer", "internal software development", "internal software development controller" and "internal software development group".

Internal software development

In section LH 17, "internal software development" is defined as a research and development activity of developing software that:

- does not have as its main purpose sale, rent, license, hire or lease to two or more people who are not associated with the developer or with each other; or
- has as a purpose the use of the software in the internal administration of the business activities of the developer (such as payroll, bookkeeping or personnel management) or of an associate; or
- has as a purpose the provision of services to customers of the developer or an associate, if the main reason those customers use the services is to obtain services other than the use of the developer's (or associate's) computer technology or software (such as if they use the services to obtain accounting, consulting or banking services).

There is an exception to the definition – software which is an integral part of an electrical or mechanical device for which the software is developed is not internal software development if the electrical or mechanical device is developed mainly for sale, rent, lease or license to customers as part of the developer's business.

Software developed as a supporting activity, as well software developed as a SIE activity, is subject to the cap.

Examples: Definition of internal software development (main purpose of sale)

1. Company B is undertaking R&D to develop software which it will use internally. The cap applies, because Company B is developing the software with no purpose of sale. Company B may not claim credits in any year for more than $3 million of its software development expenditure.
2. Company C is undertaking R&D to develop software which it will sell to Company D, its parent. The cap applies, because Company C is developing the software with a purpose of sale only to an associate.
3. Company E is undertaking R&D to develop software which it will use internally. The board members of Company E have also discussed the possibility of sale of the software to other large companies that are not competitors, to recoup some development costs. The board members have instructed a staff member to investigate the potential market for the software and to ensure that the software is easily customised. The developers have been advised that they need to build some flexibility into the design of the software. The cap applies, because Company E has a purpose of sale of the software, but does not have a main purpose of sale of the software. The purpose of sale is ancillary to the purpose of internal use.
4. Company F is undertaking R&D to develop software which it will sell to utility companies. It has signed contracts with three companies to supply the software and it is actively marketing to other interested parties. F will not be using the software in the internal administration of its business. None of these companies is connected in any way to Company F or to each other. In this case, the cap is unlikely to apply, since the main purpose of development is sale to multiple non-associates.

Examples: Definition of internal software development (internal use or use to provide services)

1. Company G is undertaking R&D to develop software which it will sell to utility companies. It has signed contracts with eight companies to supply the software and it is actively marketing to other interested parties. G's parent company will also be using the software to bill its customers. The cap applies, since there is a purpose of using the software in the internal administration of the business activities of an associate of G.
2. Company H is undertaking R&D to develop software to integrate a new enterprise resource planning package with its legacy information systems. Once it has done this, it intends to sell an integration package to other companies with the same legacy systems. The cap applies even though there is a purpose of sale of the software, because there is another purpose of using the software in the internal administration of the business.
3. Company J, a management consultant, is undertaking R&D to develop software that will allow its clients to view all work they have commissioned and all past communications between the client and J. The software will run on J's web server. A portion of clients' fees implicitly entitles them to authenticated access to a website controlled by the software. The cap applies – clients are using the service mainly to obtain management consulting services they have commissioned, and not mainly to obtain the use of J's computer technology or software.
4. Company K, a telecommunications company, is undertaking R&D to develop software which will allow its customers to independently configure account settings, and add and remove lines and services. K plans to charge customers a licence fee for using the software. The cap applies because the software will be used by K's customers mainly to obtain a telephone service, and not mainly to obtain the use of K's computer technology or software.
5. Company L, a bank, is undertaking R&D to develop web-banking software. L plans to charge its customers a licence fee for using the software. The cap applies because the software will be used by L's customers mainly to obtain a banking service, and not mainly to obtain the use of L's computer technology or software.
6. Company M, a bank, is undertaking R&D to develop a computer game which simulates financial markets. The game is to be played on-line, and will run on the bank's servers. M plans to license access to the game to schools, and will not use the R&D for any other purpose. The cap is not likely to apply in this case, since schools which buy an access licence are doing so primarily to obtain the use of the software and not to obtain another (for example, banking) service.

Examples: Definition of internal software development (exception when integral to hardware)

1. Company N develops a stand-alone video recorder for sale. Software is developed to run inside the recorder and remove offensive language or images from incoming video as it is recorded. Assume the software development meets the definition of R&D. The software is written specifically for the video recorder and the video recorder cannot operate without it. The video recorder is developed for sale to the public. The software is integral to the recorder, and the recorder is developed for sale to customers as part of N's business, so the cap does not apply.

2. Company P develops software to be used for conducting cash transfers between its customers over the internet. P also buys computer hardware and modifies it to prevent physical tampering. The software will run on the tamper-proof hardware, which will be administered by P's customer at its own premises. P intends to mass-produce the modified hardware and sell it to non-competitors who can use it to run their own security-sensitive applications. The software is not integral to the modified hardware and will not be supplied as part of the hardware when sold to external customers. It could also, with minor modifications, be run on other hardware. The software is subject to the cap, because it is not integral to the modified hardware and is not developed with the main purpose of sale.

Internal software groups (section LH 17)

To prevent multiplication of caps through the use of subsidiaries or other controlled entities, businesses that undertake internal software development are required to group themselves with other developers under the same control. The expenditure of the entire group counts towards a single cap.

Each business undertaking internal software development (a "developer") has an internal software development controller (a "controller"). The controller is the person, or group of people, who have ultimate control over the developer. In simple cases, the developer and the controller might be the same person. The intent is to ensure that the ultimate controller is identified, rather than any intermediate entity in a chain of controlling entities.

The test for control of an entity by a person is that the person has the power to govern the financial and operating policies of the entity to obtain benefits from its activities. The test is based on the definition of "control" in New Zealand International Accounting Standard 27 (Consolidated and Separate Financial Statements), so if two people would be required to consolidate for financial reporting purposes, it is highly likely that they would be under common control.

When a business has the same controller as other businesses, those businesses are members of an internal software development group (a "group"). A business is a member for as long as its controller does not change, provided that there is at least one other business with the same controller at the same time.

A business can be a member of no group for all or part of the year, one group for all or part of the year, and more than one group over the course of a year.[19]

[19] The legislation refers to the expenditure of members of an internal software development group for income years corresponding to a tax year (sections LH 11(5)(a) and 12(4)(a)). This includes only expenditure for the period the businesses are members of the group, since any other expenditure is no longer expenditure of a "member".

Examples: Mechanics of internal software development groups

- ACo, BCo and CCo have the same internal software development controller (implying they undertake internal software development) and are therefore members of an internal software development group. ACo stops doing internal software development. Therefore, ACo no longer has an internal software development controller, and ACo is not a member of the group any longer. The group continues to exist, however, with BCo and CCo as members.
- DCo, ECo and FCo have the same internal software development controller and are therefore members of an internal software development group. DCo and ECo stop doing internal software development. Therefore, DCo and ECo no longer have an internal software development controller, and are not members of the group any longer. FCo no longer has any other person having the same internal software development controller, so the group ceases to exist.
- GCo and HCo both have the same, single shareholder, Carol. GCo undertakes internal software development, and Carol is GCo's internal software development controller. HCo does not undertake internal software development. HCo begins internal software development. Therefore, GCo and HCo are now the members of an internal software group.
- JCo and KCo are the members of an internal software development group, X, controlled by Mrs X. LCo and MCo are the members of another internal software development group, Y, controlled by Mr Y. Mr Y sells LCo and MCo to Mrs X. Group Y ceases to exist, and LCo and MCo become members of Group X.
- At the beginning of the year, NCo, OCo and PCo have the same internal software development controller and are therefore in an internal software development group, Z. OCo is sold to a non-associate in the middle of the year. QCo is purchased by PCo in the last quarter of the year. NCo, OCo, PCo and QCo are all members of Z at some time over the course of the year. NCo and PCo are members for the entire year, OCo is a member for the first half of the year and QCo is a member for the last quarter of the year.

Allocation of the cap (sections LH 10 to LH 13)

When not a member of any group (section LH 10)

For the period a developer is not a member of any internal software development group, the developer will have eligible expenditure on internal software development.

The eligible expenditure on internal software development for which a credit may be claimed is capped. The cap is $3 million for a full year. If the period for which the business is not a member of any group is not a year, then the formula in section LH 10(1)(b) prorates the $3 million on a daily basis.

Example: Credit for internal software development when not in a group

ACo undertakes internal software development. For the first 73 days of the year, ACo is not under common control with any other developer. However, on 13 June 2008, BCo – also a developer – purchases 100 percent of ACo. For the purposes of claiming a credit, ACo adjusts down its eligible expenditure on internal software development, for the period it was not in any group, to a maximum of $3 million x 73 ÷ 365 = $600,000. If ACo's eligible expenditure for the period in the absence of section LH 10 is $300,000, ACo will be able to claim a credit for $300,000. If ACo's actual eligible expenditure for the period in the absence of section LH 10 is $700,000, ACo will only be able to claim a credit for $600,000.

Allocation when a member of a group (sections LH 11 and 12)

For the period that a business is a member of an internal software development group, it is not entitled to any credits for eligible expenditure relating to internal software development, but might be entitled to a share of credits for the combined eligible expenditure of group members.

The entitlement to credits for a share of the combined eligible expenditure of group members depends on the nature of the group, but in no case can a group allocate more than $3 million across all its members for a full year. The group members are free to decide the exact allocation, subject to the restrictions described below.

An overriding requirement in all cases is that no member may have eligible expenditure relating to internal software development which is greater than the eligible expenditure that business would have had, during the period of membership, in the absence of sections LH 9 to LH 13.

Note that in the special case where a business leaves a group and one member or no-one is left in the group, the group ceases to exist. In that case, the business leaving and the business remaining (if any) will have their entitlement to credits determined on the basis of part-year membership.

Members of a group with identical income years (section LH 11)

If all the members of the group have the same income year (same length of year and same balance date), a member can have eligible expenditure allocated to it and claim a credit.

The maximum eligible expenditure relating to internal software development that is available to be allocated to all group members is $3 million for a full year, and this amount is required to be prorated on a daily basis where the period for which the member is in the group is less than a full year.

Members of a group with non-identical income years (section LH 12)

If any member, X, of the group has an income year which differs from the income year of another member, X will only be able to receive an amount of credit if X has been a member of the group for X's entire income year.

The maximum eligible expenditure relating to internal software development that is available to be allocated across all group members is $3 million for a full year.

Examples: Allocation of the cap

- ACo and BCo are members of an internal software development group. ACo and BCo have the same (standard) income years, and are members of the group for the entire year. ACo would have eligible expenditure relating to internal software development expenditure of $2.2 million for the year, in the absence of sections LH 9 to LH 13. BCo would have eligible expenditure of $1.5 million. ACo and BCo may share credits for eligible expenditure of $3 million. The allocation may be made as the parties see fit, as long as ACo receives credits for no more than $2.2 million and BCo receives credits for no more than $1.5 million.
- CCo and DCo, which have standard income years, are not members of any internal software group, but are under common control. CCo and DCo begin internal software development on 1 July 2008. Therefore, they are the members of an internal software development group from 1 July. The group exists for 274 days of the income year (1 July 2008 to 31 March 2009), and CCo and DCo are members for this entire period. CCo would have eligible expenditure relating to internal software development of $4 million in the absence of sections LH 9 to 13. DCo would have eligible expenditure of $5 million. CCo and DCo can share credits for eligible expenditure of $3 million x 274 ÷ 365 = $2,252,054 (see subsection LH 11(5)). This can be shared in any way.
- ECo and FCo are members of an internal software development group. ECo and FCo have the same (standard) income years, and are members of the group for the entire year. ECo would have eligible expenditure relating to internal software development of $2.2 million for the year, in the absence of sections LH 9 to 13. FCo would have eligible expenditure of $1.5 million. GCo, an internal software developer with a standard income year, is bought by FCo on 1 July 2008,

so is a member of the group for 274 days of the year. In the absence of sections LH 9 to 13, GCo would have eligible expenditure relating to internal software development of $1 million for the first 91 days of the year, and $3 million for the other 274 days. GCo calculates that the group can allocate up to $3 million x 274 ÷ 365 = $2,252,054 to it for the period it is a member (according to section LH 11). ECo and FCo calculate that the group can allocate up to $3 million to the pair for the full-year period they are members (again according to section 11). Assume GCo has received a credit for the full $2,252,054 available for the period it was a member. Then of the $3 million of eligible expenditure allocable to the group over the (full-year) period of ECo and FCo's membership, $747,946 is left for distribution to ECo and FCo. This distribution may be made as the pair see fit. GCo is also entitled to a credit for $3 million x 91 ÷ 365 = $747,945 for eligible expenditure relating to internal software development incurred during its time outside the group.

- HCo and ICo are members of an internal software development group. HCo and ICo have the same (standard) income years, and are members of the group for the entire year. HCo would have eligible expenditure relating to internal software development of $2.2 million for the year, in the absence of sections LH 9 to 13. ICo would have eligible expenditure of $1.5 million. JCo, an internal software developer with an income year ending 31 December 2008, is bought by ICo on 1 July 2008, so is also a member of the group for 184 days of its income year. In the absence of sections LH 9 to 13, JCo would have eligible expenditure relating to internal software development of $2 million for the first 181 days of the year and $2 million for the other 184 days. HCo and ICo share credits for an eligible amount of $3 million (according to subsections LH 12(3) and (4)). The allocation may be made as the parties see fit, as long as HCo receives no more than $2.2 million and ICo receives no more than $1.5 million. JCo receives no credit for the internal software expenditure incurred while a member of the group, because it is a member for less than its full income year (see subsection LH 12(2)). JCo is, however, entitled to a credit for $3 million x 181 ÷ 365 = $1,487,671 for the eligible expenditure relating to internal software development incurred during its time outside the group (section LH 10).
- KCo and LCo are members of an internal software development group. KCo has an income year ending 31 March and LCo has an income year ending 30 April. KCo would have eligible expenditure relating to internal software development of $2.2 million for the year, in the absence of sections LH 9 to 13. LCo would have eligible expenditure of $1.5 million. KCo is liquidated on 30 November 2008, and the group ceases to exist on this date. KCo and LCo are members of the group for only part of their 2008–09 income years and have different income years, so receive no credit relating to internal software development expenditure incurred while members of the group. LCo is entitled to credits for such expenditure incurred after the group dissolves, according to the formula in section LH 10.

Level of the cap (section LH 13)

The level of the cap is $3 million for a year. This is the level for an individual and for an internal software development group.

The $3 million cap is not expected to impact on most claimants, as few are likely to have more than $3 million of eligible expenditure on internal software development. In exceptional cases when expenditure does exceed the cap, a different level of the cap may be determined for an individual or an internal software development group, for a period, by notice in the New Zealand *Gazette*. The increase of the cap may be granted on application to the Minister of Finance if the Minister considers that three requirements, broadly relating to national interest, are met.

The three requirements are based on similar requirements for obtaining government-provided incentives in Australia and New Zealand, and are:

- That the internal software development will be exploited mainly for the benefit of the New Zealand economy.
- That New Zealand will derive a substantial net benefit from intended completion of the internal software development.
- That the person (or in the case of the cap being increased for an internal software development group, the internal software development controller) has a commitment to retain the value of their business in New Zealand.

An increase in the level of the cap under section LH 13 does not automatically entitle a person or internal software group to an amount of R&D tax credit. All the other requirements in the legislation, such as the requirement that the activity meet the legislated definition of R&D, must still be met.

The Minister of Finance may impose conditions on a determination to increase the level of the cap, and the determination will not apply unless those conditions are met.

COMPLIANCE AND PENALTIES

COMPLIANCE AND PENALTY RULES

The compliance and penalties rules in the Tax Administration Act 1994 came into effect on 1 April 1997. They were designed to promote effective and fairer enforcement of the Inland Revenue Acts by providing better incentives for taxpayers to comply voluntarily with their tax obligations.

The discussion document, *Tax penalties, tax agents and disclosures*, was released in October 2006. The discussion document examined the current compliance and penalty rules, and identified several areas where the rules could be clearer, more consistent and better targeted to encourage voluntary compliance. It discussed options for the relaxation of penalties when taxpayers have genuinely and consistently tried to do the right thing. The discussion document also proposed that, in future, before recognising a person as a "tax agent" the Commissioner must be satisfied that doing so is consistent with the protection of the integrity of the tax system.

The following amendments result from the proposals outlined in the discussion document.

THE DEFINITION OF "TAX AGENT"

Sections 3, 34B, 37(4B) and 81(4)(lc) of the Tax Administration Act 1994

The amendment gives Inland Revenue a discretion to withhold recognition or remove a person as a tax agent when the action is necessary to protect the integrity of the tax system.

Background

Before this amendment, provided a person met the limited criteria required, Inland Revenue could not refuse to register a person as a tax agent even if, for example, that person had a long record of non-compliance in their own tax affairs or those of their clients, or they had been convicted of offences involving serious dishonesty.

The amendments will allow Inland Revenue to withhold recognition of, or remove, a person as a tax agent when the action is necessary to protect the integrity of the tax system.

Key features

New rules governing who can be a tax agent have been introduced. New section 34B of the Tax Administration Act 1994 gives Inland Revenue a discretion to withhold recognition or remove a person as a tax agent when the action is necessary to protect the integrity of the tax system.

Operational guidelines will set out the circumstances in which the discretion might be exercised. It is envisaged that the discretion not to grant, or to remove, tax agent status will be exercised only in a very small number of cases. Potential factors that might be taken into account, while not necessarily definitive, include:

- whether a person has been found guilty of an offence or breach by the disciplinary body of a professional organisation of which they are a member – for example, the New Zealand Institute of Chartered Accountants;
- whether the person is an undischarged bankrupt or an insolvent entity;
- whether the person has been convicted of a crime involving dishonesty (within the meaning of section 2(1) of the Crimes Act 1961) and has been sentenced for that crime within the last seven years;
- whether the person is prohibited from being a director or promoter of a company, or taken part in the management of a company under sections 382, 383 or 385 of the Companies Act 1993;
- whether the person has been convicted of an offence under the Tax Administration Act 1994; and
- the person's compliance history– including both their own tax affairs and their level of compliance as an agent.

Under the amendments, Inland Revenue is required to give a tax agent notice of the intention to revoke the agent's status and give reasons for the intended revocation. The agent will be given a 30-day period (or a shorter period if Inland Revenue is concerned that there is a substantial risk to the revenue and a longer period if it is appropriate in the circumstances) in which to resolve the matters raised in the notice of intended revocation. If the agent does not resolve the matters to the satisfaction of Inland Revenue, the agency status will be revoked and the agent and taxpayers linked to that agent advised accordingly. If, because of a revocation of tax agency status, a taxpayer fails to meet a filing deadline, the legislation allows for an extension to the deadline so that penalties are not imposed.

Entities can be recognised as tax agents along with individuals, provided that the entity supplies Inland Revenue with the names of:

- each person having the duties of tax manager, chief financial officer, chief executive officer or director if the entity is a body corporate other than a closely held company;
- each shareholder if the entity is a closely held company;
- each partner if the entity is a partnership; and

- each member if the entity is an unincorporated body.

The information is necessary to enable the Commissioner to be satisfied on an ongoing basis that, given the involvement of these individuals, it is consistent with protection of the integrity of the tax system for the entity to have agency status. Individual agents currently recognised by Inland Revenue as tax agents are not required to reapply for their agency status. Entities currently listed will continue to be listed as tax agents provided they supply Inland Revenue with the above information by December 2008. When introduced, the amendment required that Inland Revenue be notified of any changes within three months. This period has been extended to 12 months.

Inland Revenue's secrecy provisions have been amended so that information relevant to a decision to remove a person as an agent can be provided to professional bodies (for example, the New Zealand Institute of Chartered Accountants).

Application date

The amendment applies from 19 December 2007 (the date of enactment).

LATE FILING PENALTY

Section 139A(5) and (6) of the Tax Administration Act 1994

The amendment specifies that when an employer monthly schedule is filed late a warning will be given, and that late filing penalties will be imposed on subsequent late filing.

Background

The late filing penalty rules require Inland Revenue to impose the penalty when an employer monthly schedule is filed late. However, in practice, the first time an employer monthly schedule is late Inland Revenue warns the taxpayer. If the employer is again late in filing the schedule (within 12 months of the first schedule being filed late), the late filing penalty is assessed on the subsequent late schedule.

The legislation has been amended to reflect Inland Revenue's current practice.

Key features

The late filing penalty rules have been clarified to reflect the current practice of not imposing a late filing penalty the first time an employer monthly schedule is filed late, but rather advising the taxpayer that the schedule is late and warning that subsequent breaches will be penalised. A late filing penalty is payable if a subsequent schedule is filed late in the 12 months following the first breach. If all schedules are filed on time for a year, the process will start again – that is, if a schedule is late, the taxpayer is warned.

Application date

The amendment applies to tax positions taken on or after 1 April 1999 (the date the employer monthly schedule was introduced).

LATE FILING PENALTIES FOR GST RETURNS

Sections 139AAA, 142(1) and 142(1B) of the Tax Administration Act 1994

A late filing penalty has been introduced for GST returns that are not filed by the due date.

Background

Previously, when taxpayers failed to file their GST returns, Inland Revenue issued a default assessment. A default assessment is an estimation of tax liability and remains in place until the taxpayer files the return. A default assessment is likely to present a slightly larger debt than a self-assessment as it is intended to encourage taxpayers to file their returns.

The discussion document, *Tax penalties, tax agents and disclosures*, noted that the default assessment is in many cases an excessive response to non-filing and that imposing a late filing penalty is a more appropriate response, with the default assessment reserved for significant or ongoing non-compliance.

Key features

A late filing penalty will be imposed for failing to file a GST return on time. There are two levels of penalty: if the taxpayer accounts for GST on an invoice or hybrid basis the late filing penalty is $250, and for taxpayers who account for GST on a payments basis the penalty is $50.

As is the practice in relation to late filed employer monthly schedules, the first time a GST return is filed late Inland Revenue will advise the taxpayer that the return is late and warn that subsequent breaches will be penalised. A late filing penalty will be payable if any GST returns are filed late in the 12 months following the first breach. If all returns are filed on time for a year, the process will start again – that is, if a subsequent return is late, the taxpayer will be warned.

Application date

The amendment applies to tax positions taken on or after 1 April 2008.

LATE PAYMENT PENALTY NOTIFICATION

Section 139B(1) to(3A) of the Tax Administration Act 1994

The amendment provides that Inland Revenue will notify a taxpayer the first time their payment is late rather than imposing an immediate late payment penalty. If payment is not made by a certain date, the penalty will be imposed.

Background

One of the basic obligations of taxpayers is to pay their taxes on time. To encourage taxpayers to do this, those who pay late face late payment penalties. The late payment penalty is imposed in two stages: the initial late payment penalty and the incremental late payment penalty. The initial late payment penalty is also applied in two steps: a 1 percent penalty imposed the day after the due date and a 4 percent penalty imposed at the end of the sixth day if the tax owing remains outstanding. The incremental late payment penalty is 1 percent and is imposed each month the tax remains outstanding.

The amendment ensures that those taxpayers who are usually compliant, but have inadvertently missed a payment, do not have late payment penalties imposed on them. In these cases, the penalty can be disproportionately high compared with the severity of the breach. The effect of the amendment is therefore to give consideration to the taxpayer's previous record of compliance before imposing the late payment penalty.

Key features

Inland Revenue will notify taxpayers the first time their payment is late. The notification will explain that if the payment is not made by a certain date, a late payment penalty will be imposed. The notification will also state that if taxpayers make late payments within the next two years, further leniency will not be granted. Inland Revenue will not send the taxpayer any further notifications for two years, and the initial late payment penalty will be imposed in the normal manner.

If the warning does not result in payment, the late payment penalty will be imposed in the normal manner as if the warning had not been given.

All taxpayers start with a clean slate. After 1 April 2008, the first time a taxpayer pays late (irrespective of whether a payment has been paid late in the previous two years) a warning will be given.

The amendment does not apply to provisional tax. It is not until after the due date that the final tax liability is determined and late payment penalties, where applicable, would be imposed retrospectively. As noted previously, the proposal is aimed at taxpayers who are generally compliant but inadvertently miss a payment – this is not the case where the late payment penalty is imposed on late payment of provisional tax.

Application date

The amendment applies to late payments of tax that are due on or after 1 April 2008.

ASSOCIATED PERSONS

Section 141(7) and (7B) of the Tax Administration Act 1994

This amendment enables Inland Revenue to treat return periods that overlap as the same return period for associated persons, allowing a tax refund to be used to reduce an associated person's tax shortfall.

Background

Occasionally, taxpayers include transactions in the wrong entity's return – for example, in an associated person's return. Because they do not know they have included the transaction in the wrong return, the tax shortfall does not show up when reconciliation is undertaken. These shortfalls are often not voluntarily disclosed because the taxpayer is unaware they have occurred and the shortfall cannot be considered "temporary".

If there is a tax shortfall in one taxpayer's return and, as a result, an associated taxpayer's return is adjusted, resulting in an entitlement to a refund or an increased refund, the refund may be used to reduce the tax shortfall of the associated taxpayer. However, before this amendment, the returns had to be for the same tax type and return period.

Problems arose when the return periods were not the same – for example, when one associated taxpayer filed the GST return on odd months and the other associated taxpayer filed on even months. Because the return periods were not the same, the refund could not be used to reduce the tax shortfall. The amendment allows periods that overlap to be treated as the same return period for an associated taxpayer.

The earlier provision also applied only when adjustment resulted in a refund or an increased refund for the second taxpayer. The provision now also applies when the adjustment results in less tax to pay for the second taxpayer.

Key features

Inland Revenue will now be able to treat return periods that overlap as the same return period for associated persons, allowing a tax refund to be used to reduce an associated person's tax shortfall. This discretion will

not apply when the tax shortfall arises as the result of an abusive tax position or evasion – for example, if a taxpayer knowingly claimed an input tax credit in the wrong entity to claim the refund early.

The provision also applies when the adjustment results in less tax to pay for the second taxpayer.

Application date

The amendment applies to tax positions taken on or after 1 April 2008.

TAX ADVISORS AND THE SHORTFALL PENALTY FOR NOT TAKING REASONABLE CARE

Section 141A(2B) of the Tax Administration Act 1994

The legislation prescribes the circumstances in which a shortfall penalty for not taking reasonable care can be imposed when taxpayers have used a tax advisor.

Background

Taxpayers who rely on the advice of a tax agent will usually be considered to have exercised reasonable care. This principle was not set out in the legislation but had developed over time through practice. The practice was that taxpayers who use an agent may still be exposed to a penalty for not taking reasonable care if they:

- failed to provide adequate information when seeking advice;
- failed to provide reasonable instructions to a tax agent; or
- unreasonably relied on a tax advisor or on advice that they have reason to believe is not correct.

Outside these exceptions, the shortfall penalty for not taking reasonable care was generally not assessed if the taxpayer had used a tax agent. This does not apply to the unacceptable tax position shortfall penalty, which is assessed if the tax position taken does not meet the standard of "being about as likely as not to be correct" and the tax shortfall is greater than the prescribed thresholds. In this case, the penalty might have been assessed, irrespective of whether an agent is used.

Because the scope of the unacceptable tax position shortfall penalty was being reduced it was seen as necessary to also clarify the scope of the penalty for not taking reasonable care. The standard of "reasonable care" is not excessive and does not require perfection. However, many taxpayers use an agent because agents have more knowledge about the requirements of the tax system.

The discussion document, *Tax penalties, tax agents and disclosures*, noted that there needed to be a better balance, however, between recognising that tax agents are not infallible, while providing a greater incentive for them to, as far as possible, determine the taxpayer's correct tax position. Accordingly, the legislation has been amended to prescribe the circumstances in which a shortfall penalty for not taking reasonable care can be imposed when taxpayers have used a tax advisor.

As well as incorporating current practice, the amendment takes into account the situation of the taxpayer having had a tax shortfall previously and the same error or action being repeated in relation to the same tax type. In this situation the taxpayer may have been expected to be aware that there was a known risk associated with a particular action. Depending on the facts, it may have been reasonable for the taxpayer to check that the correct tax position had been taken in the second instance.

Key features

The legislation prescribes the circumstances in which a shortfall penalty for not taking reasonable care can be imposed when taxpayers have used a tax advisor. The circumstances include:

- failing to provide adequate information to the advisor;
- failing to provide adequate instructions to the advisor;
- unreasonably relying on an agent or advisor; and
- having, in the past four years, had a previous tax shortfall for the same error or action.

The general principle, that a taxpayer who relies on the services of a tax advisor, does not apply if the advisor is an employee of the taxpayer.

The amendment also applies where a tax advisor has been engaged by a company in the same group of companies as the taxpayer.

Application date

The amendment applies to tax positions taken on or after 1 April 2008.

REFINING THE SCOPE OF THE UNACCEPTABLE TAX POSITION SHORTFALL PENALTY

Sections 141B(2) and (3)(b), and 141KB of the Tax Administration Act 1994

The amendments remove GST and withholding-type taxes from the scope of the unacceptable tax position shortfall penalty. The thresholds for the assessment of the unacceptable tax position shortfall penalty have been increased.

Background

An unacceptable tax position shortfall penalty of 20 percent of the shortfall is assessed if, viewed objectively, a taxpayer's tax position fails to meet the standard of being "about as likely as not to be correct". The penalty is applied only in cases where the tax shortfall is significant – which before the current amendments was a tax shortfall of more than $20,000 and the lesser of either 1 percent of the total tax figure or $250,000. The penalty does not apply to tax shortfalls that arise from mistakes in the calculation or recording of numbers in a return.

Taxpayers who make and acknowledge errors in taking a particular tax position cannot be regarded as having met the standard of being "about as likely as not to be correct". If the standard is not met, unacceptable tax position shortfall penalties may apply. The legislation has had an adverse effect on taxpayer behaviour by proving to be a disincentive to disclosing errors to Inland Revenue. To counter this problem, a recent amendment, section 141KB, provided Inland Revenue with the discretion to either cancel or not impose the unacceptable tax position shortfall penalty if:

- the tax position taken is the result of a clear mistake or simple oversight;
- the shortfall arising from the tax position is or would be subject to a reduced penalty because the shortfall was voluntarily disclosed before notification of a pending tax audit or investigation, or is a temporary shortfall; and
- it is appropriate that the taxpayer not be liable to pay an unacceptable tax position shortfall penalty in relation to the tax position taken.

Section 141KB applied retrospectively from 1 April 2003. When introduced, the discretion was signalled as a short-term solution only because:

- it gave rise to significant increases in administrative and compliance costs;
- it did not fit well with the self-assessment environment; and
- the words "clear mistake and simple oversight" in the penalties context were uncertain and could create a revenue risk if interpreted more broadly over time.

The amendments limit the penalty to income tax only and apply higher thresholds. Consequently section 141KB has been repealed.

Key features

The discretion allowing Inland Revenue to cancel or not impose the unacceptable tax position shortfall penalty in some situations has been repealed and replaced with other measures that narrow the scope of the penalty.

GST and withholding-type taxes have been removed from the scope of the unacceptable tax position shortfall penalty so that the penalty applies only to tax positions relating to income tax. For other types of tax, the shortfall penalty for not taking reasonable care may apply in appropriate cases.

The thresholds above which the unacceptable tax position shortfall penalty is assessed have been increased. The penalty will apply when the tax shortfall arising from the taxpayer's tax position is more than both:

- $50,000; and
- 1 percent of the taxpayer's total tax figure for the relevant return period.

As well as increasing the minimum threshold to $50,000 (from $20,000), the amendment removes the upper threshold of $250,000, thus significantly further increasing the thresholds. Removing the $250,000 limit is intended to ensure that the penalty will not apply to what may be regarded as everyday transactions for some large corporates.

Application date

The amendments apply to tax positions taken on or after 1 April 2008.

ABUSIVE TAX POSITION SHORTFALL PENALTY THRESHOLD

Section 141D(4) of the Tax Administration Act 1994

The threshold for imposing the abusive tax position shortfall penalty has been repealed.

Background

An abusive tax position shortfall penalty of 100 percent of the tax shortfall applies when the tax position taken is an unacceptable tax position that has a dominant purpose of reducing or removing a tax liability or giving tax benefits.

Before this amendment, for an abusive tax position shortfall penalty to be imposed the tax shortfall had to be greater than $20,000. Although an abusive tax position is an unacceptable tax position, it is also at the more aggressive end of the non-compliance scale. While it is appropriate that the unacceptable tax position shortfall penalty has a threshold, as it would be overly onerous to apply the standard to all tax positions, this does not hold true for abusive tax positions.

Key features

The $20,000 threshold for the imposition of the shortfall penalty for having an abusive tax position has been repealed.

Application date

The amendment applies to tax positions taken on or after 1 April 2008.

LATE PAYMENT OF EMPLOYER MONTHLY SCHEDULE AMOUNTS

Sections 141E, 141ED, 149(2), 149(5), 183A(1)(i), 183D(1)(bd) and 183F(1)(bb) of the Tax Administration Act 1994

A new graduated penalty has been introduced that applies when an employer has filed an employer monthly schedule but not paid the associated tax and replaces the shortfall penalties that might apply in these circumstances. Inland Revenue will contact the employer and, if payment or an arrangement for payment is not made, a 10 percent penalty will be imposed. This reduces to 5 percent if the employer pays the outstanding amount within one month of the penalty being imposed. If the payment is not made, the process repeats itself – that is, another 10 percent penalty is imposed, which reduces to 5 percent if payment is made or an instalment arrangement is entered into within one month. The penalty is capped at 150 percent – the rate of the shortfall penalty for evasion.

Background

One of the basic tax obligations of employers is to withhold PAYE on behalf of their employees and pay the PAYE and other amounts deducted to Inland Revenue by specific dates. If the employer fails to pay Inland Revenue on time, penalties will apply. Non-payment of these amounts may be regarded more seriously than failure to pay other taxes, as they place a special responsibility on the employer to make payment on behalf of the employee.

The penalties that may generally apply in relation to this obligation include late filing penalties, late payment penalties, shortfall penalties for evasion and prosecution.

The discussion document, *Tax penalties, tax agents and disclosures*, noted that when considering non-compliance in relation to these obligations there are a number of possible scenarios, including:

- employers who have some or all of their employees outside the PAYE system;
- employers who pay the amounts deducted to Inland Revenue but do not file the employer monthly schedule; and
- employers who file the employer monthly schedule but do not pay the deductions to Inland Revenue.

In relation to the first scenario, it was considered that the penalty rules should continue to apply. In the second scenario, penalties would be limited because the tax is paid. In the third situation, when the employer files the schedule but does not pay the amount deducted, the previous rules gave rise to a number of concerns:

- *Distortionary outcomes in different situations*: A taxpayer with a good record of tax compliance incurred the same (or a higher) level of penalty as a taxpayer with a record of non-compliance. An employer who failed to file an employer monthly schedule could be eligible for a 75 percent reduction for voluntary disclosure, while an employer who filed an employer monthly schedule, but did not pay, was not eligible for any voluntary disclosure penalty reduction as disclosure had already occurred. This effectively provided a disincentive for employers to file.
- *A lack of opportunity for taxpayers to correct non-compliance*: The shortfall penalty for evasion could be imposed the day after the amounts deducted have not been paid to Inland Revenue, leaving taxpayers with little opportunity to address non-payment.
- *A perception that the current rules may be harsh*: In theory, taxpayers could incur shortfall penalties for evasion (150 percent of the unpaid amount) plus the initial late payment penalties, even if payments were made only a few days late.

The amendment introduces a new penalty aimed at encouraging employers to pay any outstanding amounts associated with employer monthly schedules by providing better incentives to comply.

Key features

The new penalty is intended to better reflect the degree of seriousness shown by employers in meeting their PAYE obligations, while adopting a more graduated approach is intended to provide better incentives for taxpayers to correct any non-compliance.

Shortfall penalties for evasion will not be imposed if the employer files the employer monthly schedule but does not pay the amounts deducted. Instead, Inland Revenue will contact the employer to establish the reason for the non-payment and offer to assist the employer to establish or enhance its systems to ensure future compliance.

Inland Revenue is required to notify the employer that a 10 percent shortfall penalty for not paying the employer monthly schedule amount will be imposed if payment, or an arrangement for payment, is not made within a month.

If the employer does not make the payment or enter an instalment arrangement, the shortfall penalty of 10 percent of the unpaid amount will be imposed. If the amount is paid within a month of the penalty being imposed, the penalty will reduce from 10 percent to 5 percent.

If payment is not made, the process repeats itself – that is, another 10 percent penalty will be imposed, which will

reduce to 5 percent if payment is made within a month. The penalty will not exceed 150 percent in total – the rate of the shortfall penalty for evasion.

This penalty is aimed at encouraging employers to pay the outstanding tax associated with an employer monthly schedule. Compliance includes entering into an instalment arrangement. If the employer enters an instalment arrangement the new penalty does not apply, unless the employer defaults on an instalment arrangement. In this case, the penalty is imposed at 10 percent, with no reduction to 5 percent.

The normal late payment penalties, use-of-money interest and ability to prosecute continue to operate in the normal manner.

The new penalty does not apply if a receiver or liquidator is appointed after the end of the return period and they have insufficient funds to pay the outstanding amount. Inland Revenue already has a debt priority in relation to PAYE, which ensures that liquidators and receivers adopt the measures available towards payment of amounts deducted from employees to Inland Revenue.

The penalty can be written off under the debt and hardship rules, and can be remitted for reasonable cause (section 183A) and if remission is consistent with Inland Revenue's duty to collect the highest net revenue over time (section 183D). As is the normal practice with penalties, the penalty is not imposed on amounts of less than $100.

Application date

The amendment applies to tax positions taken on or after 1 April 2008.

PENALTY REDUCTIONS FOR VOLUNTARY DISCLOSURES

Sections 141G(3)(a) and 141J(2) of the Tax Administration Act 1994

The shortfall penalty for not taking reasonable care, taking an unacceptable tax position or having an unacceptable interpretation will not be imposed when a tax shortfall is voluntarily disclosed before notification of a pending tax audit or investigation.

Background

Shortfall penalties may be reduced if taxpayers voluntarily disclose tax shortfalls. Before these amendments, penalties were reduced by:

- 75 percent if the disclosure was made before the taxpayer was notified of a pending tax audit or investigation; or
- 40 percent if the disclosure was made after the taxpayer was notified of the pending tax audit or investigation but before the audit or investigation began.

The penalty reduction was intended to reflect the lower administrative cost of having the tax shortfall identified before resources are committed to an investigation. It also recognises the taxpayer's intention to comply and co-operate with Inland Revenue.

The discussion document, *Tax penalties, tax agents and disclosures*, notes, however, that the rules did not adequately encourage taxpayers to disclose a tax shortfall. Imposing shortfall penalties in cases when taxpayers wished to voluntarily disclose tax shortfalls, even though the penalties were reduced, diminished the incentive for taxpayers to make a disclosure.

The amendment is intended to encourage taxpayers to come forward and tell Inland Revenue when they discover they have a tax shortfall.

Key features

To increase the incentive for taxpayers to comply voluntarily, shortfall penalties payable for "not taking reasonable care", "unacceptable tax positions" and "unacceptable interpretations" will be reduced by 100 percent when the tax shortfalls are voluntarily disclosed before taxpayers are notified of pending tax audits or investigations.

The 75 percent reduction will still apply to the gross carelessness, abusive tax position and evasion shortfall penalties if the disclosure is made before notification of an audit. The 40 percent reduction also continues to apply if the disclosure is made after the taxpayer has been notified of an audit but before the audit begins.

Application date

The amendment applies to voluntary disclosures made on or after 17 May 2007 (the date the bill was introduced).

TEMPORARY SHORTFALLS

Section 141I(3) of the Tax Administration Act 1994

The legislation has been clarified to reflect Inland Revenue's practice in relation to temporary tax shortfalls. An amendment has been made so that a tax shortfall will be treated having been "permanently reversed or corrected" if it appears from the taxpayer's actions or through operation of law that the shortfall will be remedied. For a shortfall to be considered "temporary" it must be permanently reversed or corrected within four years of the tax position being taken.

Background

A shortfall penalty is reduced by 75 percent if the tax shortfall is temporary. The legislation sets out what is meant by "temporary".

When the compliance and penalty rules were first introduced, there was considerable criticism relating to the imposition of shortfall penalties in cases where there had been little or no fiscal risk. This problem was particularly obvious when a GST refund check was made by Inland Revenue and a timing difference was detected. The rules reducing the penalty for temporary shortfalls require the taxpayer to permanently reverse or correct the situation in a subsequent tax-return period. However, in some cases, there was little or no opportunity for this to occur.

Inland Revenue's *Standard Practice Statement* INV-231, released in May 1998, dealt with this concern. The legislation requires that the temporary shortfall is:

> … permanently reversed or corrected before the taxpayer is first notified of a pending tax audit or investigation.

The Standard Practice Statement states that:

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

The legislation has been clarified to reflect Inland Revenue's practice.

Key features

The legislation has been amended, in line with current practice, to ensure that the reduction for a temporary shortfall applies even though the opportunity has not yet arisen to deal with it in a subsequent return, if:

- it appears from the taxpayer's actions that steps taken will remedy the tax shortfall; or
- through operation of law or circumstances, the matter will reverse itself.

The amendment also requires the temporary shortfall to be permanently reversed or corrected within four years of the tax position being taken.

Application date

The amendment applies to tax positions taken on or after 1 April 2008.

DUE DATE FOR PAYMENT OF TAX

Section 142A of the Tax Administration Act 1994

Section 142A has been amended to allow a new due date to be set irrespective of whether a return has been filed.

Background

Under section 142A, if the Commissioner increases an assessment (for example, following an audit of the taxpayer), the increased amount of tax and any shortfall penalty has a new due date for payment set. However, before the amendment, if there was no assessment of tax (because the taxpayer did not, or was not required to file a return) and Inland Revenue assessed tax, the increased amount of tax did not have a new due date for payment set. This could have resulted in both late payment penalties and shortfall penalties being imposed.

Key features

Section 142A has been amended to require the Commissioner to set a new due date for payment irrespective of whether the return has been filed.

The amendment ensures that when the taxpayer is not required to file a return (and is not self-assessing a liability, as may be the case with non-resident withholding tax) a new due date can be set so that the late payment penalty is not inappropriately applied.

When the taxpayer is required to file a return (and self-assess) but fails to do so, the amendment also provides for a new due date to be set, although the filing penalty may be incurred.

Application date

The amendment applies from 1 April 2008.

TAX COMPLIANCE INITIATIVES – LIMITED AMNESTIES

Section 226B of the Tax Administration Act 1994

Inland Revenue has been given the ability to offer limited amnesties to specific industries where tax evasion is a significant concern.

Background

The discussion document, *Options for dealing with industry-wide tax evasion*, was released in August 2004.

The discussion document noted that New Zealand's tax laws contain severe penalties for evasion. This can make it difficult for people who have failed to meet their tax

obligations in the past and who want to comply with the law to come forward and sort out their tax affairs. The document also noted that the existing rules did not deal with the problem of industry-wide tax evasion because the rules were designed to apply to individual businesses. This failed to recognise that a different approach to promoting compliance may be required when evasion becomes commonplace within an industry.

The discussion document recommended that Inland Revenue be given the ability to offer limited amnesties to specific industries in which tax evasion is a significant problem. Following the amnesty, the affected industry would be subject to increased audit, and any tax shortfalls detected would face the full range of penalties and other sanctions provided in the legislation.

Key features

Under the new rules, an affected person will have to pay tax on previously undisclosed income from the specific industry for two years (covering the current filing year and the year before that).

Inland Revenue will be able to offer a limited amnesty to a specific targeted industry or activity. The terms of the offer will specify the taxes that are included in the amnesty and a period in which a person can come forward under the amnesty. It will also be clearly communicated that after the amnesty offer expires, investigations and audits of the affected industry will begin. The amnesty will apply to those who have undisclosed income earned from the targeted industry.

The overall determination of the person's liability for the period being assessed will include use-of-money interest and shortfall penalties. The shortfall penalties will be reduced by 75 percent for voluntary disclosure and 50 percent for previous good compliance, if appropriate.

The amnesty will apply only to income from the specific industry. If an affected taxpayer discloses income from another source, the two-year limit will not apply to that other income. The assessment of this income will also include use-of-money interest and possible shortfall penalties. If the income is not disclosed and the taxpayer is investigated, the full rate of the relevant shortfall penalty may apply.

Any consequential effects of disclosing income for family assistance, student loans and child support liabilities will also be included in the assessment.

Having qualified for one amnesty, a taxpayer cannot then qualify under another amnesty. This is because the objective of the amnesty is to give affected taxpayers a single opportunity to come forward and start to comply.

Affected taxpayers coming forward under an amnesty will not be prosecuted under the amendment.

Application date

The amendment applies from 19 December 2007 (the date the bill was enacted).

OTHER POLICY MATTERS

COMPANY TAX RATE REDUCTIONS – CONSEQUENTIAL AND TRANSITIONAL AMENDMENTS

Sections ME 8(1), MG 8(1) and MG 10(1) of the Income Tax Act 2004; sections CD 43(27)(b), GB 27(3), HA 15, LE 8, LE 9, LF 1, LF 6, LF 7, LP 2, LP 5, LP 8, OA 18, OB 7B, OB 16(1), OB 73, OB 75, OB 78, OB 80, OC 29, OD 1, OD 22, OE 2, OP 99, OZ 7 to OZ 17, RE 2(5)(i) and YA 1 and Table O1 of the Income Tax Act 2007; sections 140B, 140BB, 140C and 140CA of the Tax Administration Act 1994

A number of mainly transitional amendments have been made to the Income Tax Act 2007 and the Tax Administration Act 1994 in relation to imputation and dividend withholding payment (DWP) credit ratios, qualifying company election tax (QCET), branch equivalent and conduit memorandum accounts and foreign investor tax credits (FITC). These changes follow the reduction in the company tax rate, the tax rate for widely held savings vehicles and the top rate for portfolio investment entities (PIEs) from 33% to 30%. In addition, a few changes were made to the Income Tax Act 2004.

All section references are to sections of the Income Tax Act 2007 unless otherwise specified.

Background

In July 2006, the government released the Business Tax Review discussion document for public comment. It set out a range of possible business tax initiatives, including reducing the company tax rate to 30%, to help transform the New Zealand economy by enhancing productivity and improving our international competitiveness.

The resulting reduction in the company tax rate is intended to encourage more investment into New Zealand by businesses that have decided to locate here. This will tend to increase New Zealand's stock of plant, equipment and buildings, which will boost labour productivity.

The lower tax rate is also intended to reduce biases between different investments that companies undertake, leading to further capital productivity.

Finally, the reduction in the company tax rate will tend to encourage New Zealand companies to stay here, rather than shift to Australia or elsewhere. It will also increase the after-tax profits of companies, which means more funds are available for reinvestment.

Key features

Imputation and DWP credit ratios

The reduction in the company tax rate to 30% will automatically cause the maximum imputation credit

ratio and the DWP ratio ("the tax credit ratio") to fall to 30/70 credits to cash. To ensure that shareholders are not disadvantaged by this, a transitional period has been introduced. During this period, a company will be able to allocate imputation and DWP credits at a maximum tax credit ratio of 33/67 on profits that have been taxed at 33%. The transitional period will run from the beginning of a company's 2008–09 income year to the end of its 2009–10 tax year (being 31 March 2010).

When the 33/67 tax credit ratio is used during the transitional period, the amount of imputation and/or DWP credits included as a credit against shareholder companies and widely held savings vehicles income tax liability will be capped at the 30/70 tax credit ratio, although the full credit will flow through to any imputation credit accounts.

Attribution of income from personal services

Relief is provided from double taxation by exempting dividends when a company paying dividends meets certain criteria.

Branch equivalent and conduit memorandum accounts

Effectively the net balances in these accounts that relate to periods when the tax rate was 33% will be reduced to reflect the lower corporate tax rate. This is necessary because credits in these accounts will be used to match future actual or potential income tax liabilities that will have been calculated using the lower company tax rate.

FITC

A reduction in the company tax rate will affect how FITC is calculated. When a dividend is imputed at 30/70 or less, the new 30/70 FITC formula will apply. If imputation credits exceed 30/70, they will be apportioned between 33% credits and 30% credits. As a result, two FITC formulas will apply during the transitional period.

Application dates

Most of the amendments apply from the beginning of the 2008–09 income year. The main exceptions are:

- the amendments that relate to a portfolio tax rate entity that does not choose to be subject to section HL 22, which will apply on and after 1 April 2008; and
- the removal of the references to imputation years in sections ME 8, MG 8 and MG 10 of the Income Tax Act 2004, which applies from 1 October 2007. This ensures that the maximum ratio by which a dividend can be credited is income-year related, and not imputation-year related.

Detailed analysis

The legislative changes are broadly grouped into two areas:

- new sections OZ 7 to OZ 17 (which are the substantive transitional amendments), and the "sign posts" to these sections; and
- a new imputation and DWP penalty tax in the Tax Administration Act for companies that over-distribute their 33/67 tax credits during the transitional period.

Technical issues

The amending Act (the Taxation (Business Taxation and Remedial Matters) Act 2007) contains a number of errors relating to the company tax rate change, generally attributable to the almost contemporaneous introduction of the Income Tax Act 2007. This item presumes that these errors have been fixed, but notes the corrections when appropriate. These errors are scheduled at the end of this TIB item. Generally they will be corrected retrospectively.

Terminating provisions

Imputation and DWP crediting ratios – now income year related

From the 2008–09 income year, the maximum imputation credit ratio in section OA 18 will change automatically from 33/67 to 30/70, in line with the company tax rate reduction. Sections ME 8, MG (8) and MG (10) of the Income Tax Act 2004 have had the reference to imputation year removed, so it is clear that the maximum permitted crediting ratio is income year related, not imputation year related. Section OA 18 of the Income Tax Act 2007 will be retrospectively amended to also provide this effect.

Moving directly to a maximum 30/70 imputation credit ratio in 2008–09 would have been the simplest option. However, it might have been difficult for some companies that want to distribute profits that have been taxed at 33% with full credit for these taxes before 2008–09.

A maximum tax credit ratio of 30/70 applying from 2008–09 would have potentially disadvantaged shareholders on income derived by companies before the new rate applied. "Trapped" credits may have occurred when the underlying tax that generated unused imputation credits was paid at 33%.

A number of shareholders would also have been disadvantaged because they would have needed to pay more tax than if the distribution had been made before the reduction in the company tax rate.

Override of maximum tax credit ratio – new transitional section OZ 8

An immediate credit ratio change to 30/70 for dividends at the start of companies' 2008–09 income year has the potential to disadvantage some groups of shareholders if the income that underpins the dividend has been taxed at 33%. In particular, presuming that for New Zealand shareholders company tax is a withholding tax, there would not be a full flow-through of credit for the underlying tax.

To deal with this problem, new section OZ 8 allows companies a transitional period in which the core imputation and DWP maximum ratios set out in section OA 18 can be overridden. The section sets out how companies can elect to allocate imputation and DWP credits up to a maximum ratio of 33/67 from the 2008–08 income year until the end of their 2009–10 tax year (being 31 March 2010), to the extent the underlying income was taxed at 33%.

The transitional rule has been crafted to ensure that the underlying income could have been that of another company, where that income has been passed up by way of dividend to a corporate shareholder (the corporate intermediary), whether in the transitional period, or before it. The corporate intermediary must be able to confirm that the relevant credits arose at the 33% tax rate. It could be that the dividend was fully credited at 33/67, or the corporate intermediary may have specific knowledge that the credits result from tax paid at 33%.

RWT may be deducted from a dividend or interest received by a company. When RWT has been deducted while the company tax rate was 33% the resulting imputation credits can be allocated at a ratio up to 33/67. However, RWT may be deducted at 33% when the company tax rate is 30%. This latter RWT is not available for 33/67 imputation credits as the credit does not arise from the application of the old company tax rate.

New transitional section OZ 9 – benchmark dividends

New section OZ 9 alters the benchmark dividend ratios in sections OB 61(4) and OC 48(4) when an election has been made to use the 33/67 tax credit ratio. Its purpose is to ensure that a change of tax credit ratio from 33/67 does not necessarily cause the benchmark dividend ratio to be changed.

In particular, companies can pay a subsequent dividend at the 30/70 ratio without having to go through the ratio change processes. This applies when a subsequent dividend is credited at 30/70 and the benchmark dividend is 33/67 because it was paid out before the start of the company's 2008–09 income year (in either the 2007–08 tax year for early balance date companies, and in the 2008–09 tax year for late balance date companies).

Likewise, when a subsequent dividend is credited at 30/70 and the benchmark dividend is 33/67 (which was paid using the provisions of section OZ 8 to over-credit), no ratio change declaration is necessary if the reversion is caused by the 33/67 credits running out.

Shareholders' tax credits – transitional section OZ 10

It should be noted that section OZ 10 will be retrospectively amended to have the following effects.

Sections LE 8 and 9, and sections LF 6 and 7 set out rules that determine or limit, in particular circumstances, the amount of imputation credit or FDP credit regarded as being attached to a dividend for shareholders. At a 30% company tax rate, this maximum is expressed by the ratio 30/70.

As discussed above, section OZ 8 allows for over-credited dividends to use a 33/67 ratio during the transitional period. This means that sections LE 8 and 9 and sections LF 6 and 7 need to be overridden to allow for the new section OZ 8 over-credited dividends. New section OZ 10 increases the maximum tax credit ratio to 33/67 in sections LE 8 and 9 and sections LF 6 and 7, when the actual tax credit ratio of the dividend is greater than 30/70 and less than or equal to 33/67 to allow for over-credited dividends.

Limits on the amount of shareholders' tax credit – transitional section OZ 11

Section OZ 11 limits the imputation and FDP credits attached to dividends received that can be claimed as a credit against their tax liability by taxpayers whose tax rate is 30% (new tax rate persons). These taxpayers are companies and the various savings funds whose tax rate is 30%. The credit against tax liability is limited to 30/70, if the crediting ratio of the actual dividend received is higher than this.

The section LA 9 pointer to section OZ 11 will be retrospectively repealed and instead, a pointer in section LE 1(1) will be provided, to go with the existing section LF 1(1) pointer.

The policy rationale for the limitation is set out in the following example. Consider a new tax rate person that receives $100 of income during the 2007–08 income year and pays tax of $33 on this income. No further income tax implications would arise if the income was passed out to the new tax rate person as a dividend during the 2007–08 income year. This is the appropriate policy outcome, given that the company tax rate and tax rate on savings vehicles were aligned for the 2007–08 income year at 33%.

If, however, the dividend was received during the new tax rate persons' 2008–09 income year as a 33/67 dividend, in the absence of capping, the shareholder would have a grossed-up dividend of $100 on which $30 of gross tax would be payable. If section OZ 11 had not been introduced, this would be offset by a tax credit of $33, which would lead to a net tax credit of $3. This $3 of net credit would offset the tax due on $10 of other income, which is inappropriate.

(Note that where the recipient of the dividend is a company that keeps an imputation or FDP credit account, the full credit is credited. This is conceptually necessary to ensure that shareholders in this company can also receive the benefits of the 33/67 credit ratio.)

Credits for non-resident investors – transitional section OZ 12

Note that sections LP 2(2) and OZ 12 will be retrospectively amended to have the following effects.

In the Income Tax Act 2007, the amount of the credit for dividends paid to non-resident investors is determined according to the amount of the imputation credits that would have been allocated to the shareholder in the absence of subpart LP.[20] The credit is calculated by multiplying the amount of imputation credits that would have been attached by a formula in section LP 2(2). This formula, as amended by the Taxation (Business Taxation and Remedial Matters) Act 2007, uses a ratio of 7/10. Given that the rewrite of the Income Tax Act changed the basis of the formula, this ratio should be 7/17, and this change will be made retrospectively.

However, this formula is not appropriate when the dividend is imputed at a higher ratio than 30/70 under the transitional rules. Transitional section OZ 12 provides that the section LP 2(2) formula shall be 67/120 when the dividend is imputed to 33/67. This will be retrospectively amended to 67/187 because of the change in the methodology from the Income Tax Act 2004 to the Income Tax Act 2007.

When the dividend is imputed between 30/70 and 33/67, the credits are apportioned and the section LP 2(2) formula is amended to 67/120 (and as above, this will be retrospectively corrected to 67/187).

Section OZ 12 also amends the relevant tax rate in the section LP 8(2) formula to 33% where appropriate, to parallel the treatment described above, and modifies the effects of section LP 5 to allow for the transitional formula.

Available subscribed capital amount – transitional section OZ 13

The concept of "available subscribed capital" is relevant when a company cancels its shares and pays consideration to compensate a shareholder for the cancellation. The calculation required to ascertain the extent of crediting of a dividend is set out in section CD 43(26). When the actual credit ratio exceeds 30/70 it is deemed to be 30/70 for the purposes of section CD 43(26).

Dividends from qualifying companies – transitional section OZ 14

When a qualifying company pays a dividend, the amount of the dividend that is taxable is limited to the amount that can be fully credited with imputation of FDP credits. The formula for this is set out in section HA 15. This provision has been over-ridden by section OZ 14 to allow for dividends to be over-credited during the transitional period.

Statutory producer boards and co-operative companies – transitional section OZ 15

Statutory producer boards and co-operative companies which are imputation credit account or FDP companies may allocate imputation credits or FDP credits to cash distributions and to notional distributions.

For a statutory producer board, the allocation of imputation credits to cash distributions must be done according to the formula in section OB 73(4). Section OB 75(2) allocates imputation credits for statutory producer boards' notional distributions.

For a co-operative company, the allocation of imputation credits to cash distributions must be done according to the formula in section OB 78(3). Section OB 80(2) allocates imputation credits for co-operative companies' notional distributions.

Transitional section OZ 15 amends the imputation provisions relating to statutory producer boards and co-operative companies to allow them to credit at 33/67 during the transitional period.

Branch equivalent tax account (BETA) and conduit tax relief account (CRTA) – transitional sections OZ 16 and OZ 17

All entries that relate to 2007–08 and earlier years are to be adjusted to reflect the reduced company tax rate of 30% by multiplying them by 30/33.

Other amendments

Attribution of income from personal services

The attribution rule is an anti-avoidance rule designed to buttress the 39% rate. It targets higher income individuals who channel their income through an intermediary, frequently a company. It does this by deeming, in defined circumstances, the person providing the personal services to derive income that would otherwise be derived by the intermediary. Some double taxation can occur when the attribution rule is applied to income derived by a company because the cash still has to be extracted from the company as dividends.

Section OB 16 provides for an imputation credit to arise when income is attributed to help limit the double taxation. Before the tax rate changes, the credit was 49.25% of the amount attributed, which partially or fully relieves, depending on the circumstances, the double taxation that could otherwise occur. As a result of the change in the company tax rate to 30%, the imputation credit that arises under the section has been reduced to 42.86%, consistent with the new maximum imputation credit ratio of 30/70.

[20] This is a change from the Income Tax Act 2004.

The reduction to 42.86% increases the potential for double taxation to arise. Further relief against double taxation has been provided (by way of amendments included at the request of the Finance and Expenditure Committee) by the new sub-section GB 27(4). After further amendment, this will allow the company, subject to meeting certain criteria, to elect to pay out the underlying cash that relates to the amount attributed as an exempt dividend. The election is made merely by paying out the dividend using the qualifying company mechanism discussed in the next paragraph and making the appropriate ICA entry.

This relief is provided by ensuring that dividends paid by eligible companies are either fully imputed or exempt from tax, as if the company was a qualifying company. When a company uses this treatment, any credit that arises under section OB 16 in respect of the attributed income should be contemporaneously cancelled on the last day of the relevant tax year, but before the debit from paying the dividend arises. The legislation will be retrospectively amended to achieve this last point.

Relief applies if a company's only activity is the one from which the income has been attributed. Also, it would be acceptable if it earned some incidental interest. The legislation is currently incorrect on the temporal aspects of this – and will be amended so that the qualifying company treatment concession will only apply when a company has never earned any income other than from the provision of personal services, or from interest/financial arrangements. These amendments will be in the June 2008 tax bill which should be enacted before 31 March 2009, the first date that these amendments become practically effective.

If a company engaged in other activities, dividends would be subject to tax in the normal way, and a credit would arise under section OB 16. This prevents the concessionary qualifying company type exempt tax treatment being manipulated to gain unintended benefits.

Section 103 of the Taxation (Business Taxation and Remedial Matters) Act 2007, which introduced new section GC 14EB into the Income Tax Act 2004, will be retrospectively repealed. The concessionary qualifying company treatment is intended to apply only to dividends paid out in relation to the 2008–09 and subsequent years' income.

Section OB 1 – definitions

Two new definitions reflect the reduced company tax rate:

- New tax rate person – a person who uses a 30% basic tax rate that applies from the 2008–09 and later income years and a portfolio tax rate entity – that is, companies and savings vehicles.
- Old company tax rate – the 33% tax rate that applied before the 2008–09 income year.

Imputation and DWP penalty tax

Section 140B of the Tax Administration Act provides that where an imputation credit account has a debit balance at 31 March 2010, the company must pay further income tax equal to the debit balance plus a 10% imputation penalty tax.

If a company elects to over-impute dividends in accordance with the new section MZ 10, and in doing so, causes a debit balance to arise in relation to the number of 33/67 credits, a new 10% transitional imputation penalty tax will apply.

New section 140BB – imputation penalty tax payable in some circumstances

New section 140BB sets out how the transitional imputation penalty tax should be applied and calculated. The 10% penalty will only be applied at 31 March 2010 if the taxpayer has distributed more 33/67 credits than were available.

When a taxpayer is in a debit position in both their 33/67 and overall imputation account, two imputation penalties will apply. However, the section 140B penalty will be reduced to the extent of any section 140BB penalty.

New section 140CA – dividend withholding payment penalty tax in some circumstances

New section 140CA sets out how the transitional DWP penalty should be applied and calculated.

It applies to the FDP account in exactly the same way as section 140BB applies to the imputation account.

Resident withholding tax

The resident withholding tax rate for interest and dividends is unchanged. Inland Revenue is currently considering the merits of an operational review of RWT to determine whether efficiencies can be made.

As a result, when a taxpayer who is subject to RWT receives a dividend fully imputed using the 30/70 tax credit ratio, they will be subject to withholding tax deductions of 3%.

A concession has been made for unit trusts and group investment funds that have not previously accounted for RWT on dividends. These entities will be able to calculate RWT at 30/70ths of the cash dividend. The amount payable will be after deducting any imputation credits. This will generally mean that no RWT is payable by those entities. The rationale for the concession is that a number of unit trusts and group investment funds that pay dividends have no RWT system in place as to date they have only paid fully imputed dividends and therefore have not needed to deduct RWT. It is inappropriate to require these entities to implement systems to account for RWT at 33/67 when consideration is being given to reviewing the RWT system.

Clarification of policy – business restructuring to take advantage of the reduction in the company tax rate

In a very high percentage of cases the restructuring of a business into a corporate form cannot be considered to be "tax avoidance". However, applying the tax avoidance provisions may be considered if the restructuring results in the alienation of income that is essentially personal services income. In some cases the alienation also effectively undermines some of the government's social assistance programmes, such as Working for Families tax credits, which are based on the tax definition of "assessable income".

For example, surgeons who corporatise their private practice but don't receive most of the taxable income from that structure may be asked if their use of the corporate structure is appropriate from a taxation perspective.

Schedule of proposed legislative changes

The following table contains the extraneous section MZ references in the Income Tax Act 2004 that will be retrospectively repealed:

Taxation (Business Taxation and Remedial Matters) Act 2007 section references	Income Tax Act 2004 section references
12	CD 32(26)(b)
105	HG 13(3)(a) & HG 13(4)(a)
134	LB 1(1)(c)(d)(e)
135(1)	LB 2(2)
139	LD 8(1)(a)
141	LE 2
142	LE 3(6)
157(2)	ME 8(6)
159	ME 31
160	ME 33
161	ME 36
162	ME 38
163	MF 3
164	MF 4
166	MF 8
168(2)	MG 8(8)
169(2)	MG 10(2)
170	MI 3
171	MI 4
172	MI 5
173	MI 15
174	MI 17
175	MI 18

The following changes are also proposed for the Income Tax Act 2004, on the basis that they are supposed to apply from either 1 April 2008 of the 2008–09 income year and therefore don't belong in the Income Tax Act 2004:

- repeal of new section GC 14EB (section 103 of the amending act);
- repeal of new subparagraph NF 1(2)(xi) (subsection 179(2) of the amending Act);
- repeal of the amendments to subsection NF 8(1) (section 180 of the amending Act); and
- repeal of the new section OB 1 definition of "old company tax rate" (subsection 182(31) of the amending Act).

The following changes are proposed to the Income Tax Act 2007:

- subsection GB 27(4) will be amended to ensure that the relevant company from which the income is attributed will qualify for the exempt qualifying company treatment if its only income has never been from the personal services that have been attributed, or from interest income;
- the section LA 9 pointer to section OZ 11 will be repealed;
- section LP 2(2) will be amended to change the tax credits for supplementary dividends formula to 7/17;
- subsection LE 1(1) will be amended to provide a pointer to section OZ 11;
- section OA 18 will be amended to remove the reference to "tax year" (the Income Tax Act 2007 does not use the term "imputation year");
- subpart OB will be amended to provide an imputation credit account debit when an attributing company elects to pay out an exempt dividend under subsection GB 27(4);
- the transitional section OZ 10 reference to subsections OZ 5(2) and (3) will be removed and replaced with references to sections LE 8 and 9, and sections LF 6 and 7;
- section OZ 12 which states how supplementary dividends are calculated when dividends are imputed to more than 30/70, will be amended so that the formula is 67/187.

CHANGES TO THE TAXATION OF LEASES

Sections EE 28(4), EE 46(2), EE 52(7), EX 21(30), FC 8H, FC 8I and OB 1 (definitions of "finance lease" and "lease") of the Income Tax Act 2004; sections CH 6, DB 51B, EE 35(4), EE 55(2), EE 61(8), FA 11, FA 11B and YA 1 (definition of "finance lease") of the Income Tax Act 2007

Changes to the taxation of leases mean that certain lease arrangements involving assets used overseas will be classified as finance leases, or that lessors will have allowable depreciation deductions for lease assets reduced.

Background

The changes are necessary to prevent depreciation losses being claimed on overseas assets in which the New Zealand taxpayer has no real economic interest. Such schemes undermine the New Zealand tax base.

Key features

The definition of "finance lease" has been widened to include certain lease arrangements that satisfy three conditions:

- they involve use of the lease asset wholly or mainly overseas; and
- they involve income of a person other than the lessor that is not subject to New Zealand income tax; and
- substantially all the risks and rewards incidental to ownership of the lease asset lie with a person other than the lessor.

Leases entered into on or after 20 June 2007 that are covered by the changes to the definition of "finance lease", either at inception or at a specified later time will be classified as finance leases for tax purposes. If the lease was an operating lease at inception, the change to a finance lease will require an adjustment to assessable income or deductions (almost certainly income rather than deductions) in the year of change.

Operating leases entered into before 20 June 2007 but covered by the new part of the definition of "finance lease" on that date may continue as operating leases. However, allowable depreciation deductions will be reduced by one-sixth, with one-sixth of any previously claimed depreciation recognised as additional assessable income in the income year beginning after 20 June 2007.

Application date

The new rules apply to all leases entered into on or after 20 May 1999 (being the date the finance lease rules became effective), and for the income year including 20 June 2007 and later income years.

Detailed analysis

Expanded definition of "finance lease" (section OB 1 of the Income Tax Act 2004 and section YA 1 of the Income Tax Act 2007)

A new paragraph (c) has been added to the definition of "finance lease" and contains three tests. The new paragraph applies to leases that were entered into on or after 20 May 1999, for income years including 20 June 2007 and later income years.

The remainder of the definition is unaffected by the change and continues to apply as normal.

The paragraph (c) tests

The three tests in paragraph (c) are:

- an "overseas use" test (subparagraph (i));
- an "income not subject to tax" test (subparagraph (ii)); and
- an "economic substance" test (subparagraph (iii)).

Overseas use test (subparagraph (i))

The lease, or an arrangement of which the lease is a part, must involve use of the lease asset outside New Zealand for all or most of the term of the lease.

Example 1: Overseas use not for most of the term

Air Wellington has an aeroplane which is surplus to requirements and leases it to Air Napier for five years. Air Napier uses the aircraft between Napier and Auckland for the first three years of the lease. In year 4 of the lease, the terms of the lease change in such a way that the definition of "finance lease" must be checked again (see **Application of the tests** below).[21] At this time, Air Napier is using the aircraft between Sydney and Melbourne, under a contract with an Australian airline. It expects it will continue to be used abroad until the end of the lease. The lease asset should not be regarded as used wholly or mainly outside New Zealand, because for 60 percent of the lease it was used inside New Zealand.

Example 2: Overseas use for most of the term

The facts are as in Example 1, except that Air Napier uses the aircraft between Napier and Auckland only for the first two years of the lease. For the rest of the lease, it is expected to be used overseas. The lease asset should be regarded as used mainly outside New Zealand.

[21] When the terms of the lease change, the examples assume, for simplicity, that the same lease continues with the changed terms. In reality, taxpayers will need to assess whether for tax purposes the existing lease continues (including as a consecutive or successive lease) or a new lease is created. The examples should not be taken as providing any guidance for this assessment.

Income not subject to tax test (subparagraph (ii))

The lease, or an arrangement that includes the lease, must involve a person other than the lessor who derives certain classes of income from the use – by any person – of the asset. The income must be excluded income, exempt income or non-residents' foreign-sourced income. The test may be satisfied by a sub-leasing arrangement, if any of the lessees in the chain of lessees derive these types of income.

The definition is not expected to be satisfied in relation to the lease when there are two parties to the lease and both are fully subject to New Zealand income tax.

Example 3: One party not subject to New Zealand income tax

NZ Co leases equipment to Aus Co, which derives income from use of the equipment in Australia. The income is non-residents' foreign-sourced income. The test in subparagraph (ii) is satisfied and the lease may be a finance lease if the other tests are also satisfied.

Example 4: Both parties subject to New Zealand income tax

Boat Co leases fishing vessels to Catch Co, which uses them for trawling. Catch Co is subject to New Zealand income tax on all its income, so the test in subparagraph (ii) is not satisfied and the lease is not a finance lease under paragraph (c) of the definition of finance lease (even if the boats are used mainly outside New Zealand).

Economic substance test (subparagraph (iii))

The lease, or an arrangement that includes the lease, must be:

- an arrangement under which substantially all the risks and rewards incidental to ownership, as if assessed at the beginning of the lease but taking account of all changes in terms which have actually occurred,[22] are borne by persons other than the lessor; and/or
- a finance lease under NZ IAS 17, either for the taxpayer or for another company in the same group of companies that derives assessable income from the arrangement.

The two limbs of the economic substance test are similar. The test based on NZ IAS 17 is intended to reduce compliance costs. If a taxpayer (or group company that derives assessable income from the arrangement) is accounting for the lease as a finance lease under NZ IAS 17, there is no need to apply the other limb of the test; the lease is automatically a finance lease. It is expected that most taxpayers engaging in the leasing of assets overseas would be required to comply with NZ IAS 17.

When the lease is not treated as a finance lease under NZ IAS 17, the other limb of the test must be evaluated. The assessment of risks and rewards under that limb is done as if at the time of entering the lease, but taking account of all changes in terms that are known about when the evaluation takes place.

As in NZ IAS 17, it is intended that risks include (but not be limited to) "the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions" and that rewards include (but not be limited to) "the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value" (see paragraph 7 of that standard). Paragraphs 10 to 12 of that standard provide some further guidance.

Example 5: Economic substance test not satisfied

XYZ Bank leases rolling stock to an Australian company for seven years. Lease payments are fixed and the lease cannot be cancelled. There is no guaranteed minimum residual value in the lease. Assume, for the sake of the example, that the lease is an operating lease for tax purposes. After six years, XYZ Bank notes that the market price for the asset is considerably higher than the residual value it is expecting, and so buys residual value insurance to lock in the likely profits on sale of the asset following the end of the lease. The lease would probably not be a finance lease at this point. Imagining oneself at the beginning of the lease, but knowing that XYZ will buy residual value insurance in year 6, substantial risk still remains with XYZ (the residual value could change unpredictably up to year 6).

Example 6: Economic substance test satisfied

The facts are as in Example 5, but with the insurance purchased after only three months of the lease term. This is likely to be a finance lease because, when viewed from the outset, XYZ has only insubstantial risk (three months of market price movement out of a seven-year lease).

Example 7: Economic substance test not satisfied

ABC Bank leases a ship to a Norwegian company for 11 years. The lease is a non-cancellable operating lease with fixed payments, but no guaranteed minimum residual value. Assume, for the sake of the example, that the lease is an operating lease. After 10 years, ABC signs a contract to sell the ship to an unrelated third party for the current market value of the ship, with settlement deferred until after the end of the lease, thereby removing any risk due to market-value fluctuations over the last year of the lease. ABC also changes the terms of the lease to require the Norwegian company to prevent the ship's railings from rusting, and this change of terms requires the new paragraph of the finance lease

[22] "… determined as at the time the person enters into the lease and taking into account later changes to the arrangement".

definition to be checked (see **Application of the tests** below). The lease would probably not be a finance lease, even though there is (essentially) no risk remaining for ABC at the point of checking. Viewed from the outset, and knowing about the change in terms in year 10, ABC still has significant risk over the lease term as a whole.

A "group of companies" is defined in section IG 1(2) of the Income Tax Act 2004 (section IC 3(1) of the Income Tax Act 2007) essentially as "any group of companies having a 66 percent or greater common shareholding". When another company in the same group classifies the lease as a finance lease under NZ IAS 17, the economic substance test is taken to be satisfied, even if the taxpayer does not classify the lease as a finance lease under NZ IAS 17. This might occur, for example, when a company enters into the lease and a parent company contemporaneously enters into a transaction with the lessee to make a residual value payment (it is likely that in such cases the other limb of the economic substance test will be satisfied anyway).

Group companies that do not derive assessable income from the lease (or an arrangement of which the lease is a part) are excluded from the test. However, existing transfer pricing rules in the Income Tax Act may apply when these companies are involved in the lease arrangement, if there are non-arm's length terms. (The role of these companies may also be considered as part of a wider review of leasing rules, which was signalled in the announcement of the government's tax policy work programme on 26 October 2007.)

Application of the tests

The three tests in paragraph (c) are applied:

- If the lease is entered into on or after 20 June 2007, when the lease is entered into and again whenever the terms of the lease (or of an arrangement of which the lease is a part) change in a way which changes the allocation or size of the risks and rewards incidental to ownership of the lease asset.
- If the lease is an operating lease entered into before 20 June 2007, on 20 June 2007 (in this case the three tests are invoked by section FC 8I(1) in the Income Tax Act 2004 or section FA 11B(1) in the Income Tax Act 2007, and the text before subparagraph (i) in the definition is ignored).

Example 8: Applying the three tests – lease entered after 20 June 2007

A Co leases equipment to B Co. The lease was entered into on 1 August 2007. A Co must check if the lease meets the new paragraph (c) of the definition of "finance lease" on 1 August 2007. Assume it does not. A change in the terms of the lease, which requires B Co to purchase the equipment at the end of the lease for a fixed price, is made on 1 April 2008. A Co must again check if the lease meets the three tests.

Example 9: Applying the three tests – lease entered into before 20 June 2007

The facts are as in Example 8, except that the lease was entered into on 1 April 2006 and was an operating lease at that time. Once the new legislation applies, A Co must check if the lease met the tests in the new paragraph (c) of the definition of "finance lease" on 20 June 2007.

Leases entered into on or after 20 June 2007 (section FC 8H of the Income Tax Act 2004 and sections CH 6, DB 51B and FA 11 of the Income Tax Act 2007)

Most leases entered into on or after 20 June 2007:

- will be classified as finance leases from the outset if the three tests in paragraph (c) of the definition of "finance lease" are satisfied at the outset; or
- will have to be reclassified as finance leases from a date the three tests are satisfied, if they are not satisfied at the outset.

In the case of reclassification, there will be a consequential adjustment to income or deductions (almost certainly income rather than deductions).

Example 10: Finance lease at the outset of the lease – lease entered into after 20 June 2007

NZ Co leases equipment with an estimated useful life of 10 years to Aus Co for 7 years, to be used entirely in Australia. Aus Co is not subject to New Zealand income tax. Aus Co is responsible for all costs associated with the operation, maintenance and insurance of the equipment, and guarantees to pay $1 million to NZ Co at the conclusion of the lease, at which time NZ Co will regain possession.

At inception, the lease meets all three tests of the new paragraph (c) of the definition of "finance lease". The lease is a finance lease.

Example 11: Finance lease after the outset of the lease – lease entered into after 20 June 2007

NZ Co leases equipment to Aus Co, which is not subject to New Zealand income tax, to be used entirely in Australia. The lease is an operating lease because NZ Co bears (substantial) residual value risk in relation to the lease asset, because NZ Co will regain possession of the asset at the end of the lease, and because the lease period is less than 75 percent of the asset's estimated useful life. After six months, NZ Co and Aus Co change the terms of the lease so that Aus Co guarantees to purchase the equipment for $1 million at the conclusion of the lease, being the expected residual value when the lease was entered into.

The lease becomes a finance lease because of the change of terms. If the risks and rewards incidental to ownership of the asset were assessed on entry to the lease, taking into account the guaranteed residual value to be paid by Aus Co, it would be concluded that Aus Co faced substantially all the risks and rewards.

The consequential adjustment to income or deductions, in the case of reclassification, is determined according to section FC 8H of the Income Tax Act 2004 (formerly section FC 8H/8I) or section FA 11 of the Income Tax Act 2007. The adjustment is assessable income or a deduction in the income year in which the reclassification occurs. In the Income Tax Act 2007, sections CH 6 and DB 51B deem the income or deduction to exist, consistent with the structure of the new Act.

Example 12: Consequential adjustment to income – lease entered into after 20 June 2007

The facts are as in Example 11. Suppose that net income for the first six months under the operating lease was $500,000, and $750,000 for the second six months under the finance lease, and that the total of $1,250,000 was included in the return of income for the relevant year. Under a finance lease, net income for the whole of that year would have been $1,500,000. Under sections FC 8H of the Income Tax Act 2004 or FA 11 of the Income Tax Act 2007, NZ Co must include further income of $250,000 in its return of income. In total, NZ Co recognises $1,500,000 of net income in the return.

Section FC 8H of the Income Tax Act 2004 and section FA 11 of the Income Tax Act 2007 are intended to have the same practical consequences for leases not affected by paragraph (c) of the definition of "finance lease" as sections FC 8H/8I and FA 11 (respectively) had before the rule change.

Example 13: Consequential adjustment to income where new part of definition does not apply

A car, used entirely within New Zealand, is leased by A Co to B Co under an operating lease for two years. At the end of the two-year period, the lease term is extended to eight years. The net income of A Co under the operating lease in the first two years is calculated as $10,000. The net income under a finance lease would have been $15,000

Paragraph (c) of the definition does not apply – the asset is not used outside New Zealand. Section FC 8H of the Income Tax Act 2004 (or section FA 11 of the Income Tax 2007) still applies, however, because of paragraph (b) of the definition of finance lease and the extended term of the lease (section FC 8H(1)(a) or FA 11(1)(a) respectively). Net income of $5,000 will be recognised by A Co in the year of the change, as would have occurred in the absence of the new legislation.

A lease which becomes a finance lease remains a finance lease until the end of the lease term (which may include the term of consecutive or successive leases).

Leases entered into before 20 June 2007 (sections EE 28(4), EE 46(2), EE 52(7) and FC 8I of the Income Tax Act 2004, and sections EE 35(4), EE 55(2), EE 61(8) and FC 11B of the Income Tax Act 2007)

For most operating leases entered into before June 2007:

- the leases will continue to be operating leases (unless they become finance leases at a later date other than under paragraph (c) of the definition of "finance lease");
- the New Zealand lessor will have to reduce the depreciation deductions that would normally be allowed for the lease asset by one-sixth; and
- the New Zealand lessor will have to recognise, as income, one-sixth of depreciation deductions already allowed for the lease asset over the lease term.

If the three tests in paragraph (c) of the definition of "finance lease" are satisfied by the lease on 20 June 2007 (ignoring the requirements that the lease be entered into on or after 20 June and that the lease is being entered into or the terms of the lease are changing) then the lessor must make an adjustment to income and to future depreciation deductions.

Example 14: Tests satisfied on 20 June 2007 – lease entered into before 20 June 2007

NZ Co leases equipment to Aus Co under a lease which did not meet the definition of "finance lease" before new paragraph (c) was added. The lease was entered into on 1 April 2000, and the terms of the lease have not changed since. On 20 June 2007, the lease satisfied the three tests in paragraph (c) of the definition – the asset was used wholly overseas by a company which was not subject to New Zealand income tax, and Aus Co had substantially all the risks and rewards incidental to ownership of the lease asset.

NZ Co must make the adjustments in sections FC 8I(3) and (7) of the Income Tax Act 2004 or sections FA 11B(3) and (6) of the Income Tax 2007, and reduce depreciation in subsequent income years according to section FC 8I(8) of the Income Tax Act 2004 or section FA 11B(7) of the Income Tax Act 2007.

No effect on some leases (section FC 8I(1) of the Income Tax Act 2004 and section FA 11B(1) of the Income Tax Act 2007)

Section FC 8I of the Income Tax Act 2004 and section FA 11B of the Income Tax Act 2007 apply only to leases entered into on or after 20 May 1999. It has no effect on leases entered into before 20 May 1999.

The new rules will also have no effect on leases that are entered into before 20 June 2007 that either end before the beginning of the income year following 20 June 2007, or become finance leases before the end of the income year following 20 June 2007. In the former case, the existing depreciation rules will ensure that any excess depreciation is recovered (provided there is disposal of the asset). In the latter case, section FC 8H of the Income Tax Act 2004 or section FC 11 of the Income Tax Act 2007 will apply.

Adjustment relating to past deductions

In the income year following 20 June 2007, the lessor must recognise an adjustment to income equal to one-sixth of depreciation deductions previously allowed for the lease asset. Deductions allowed for depreciation losses for periods before the start of the lease are not included. The adjusted tax value (ATV) of the lease asset, at the beginning of the income year following 20 June 2007, is increased by the amount of the adjustment to income.

Example 15: Consequential adjustment to income – lease entered into before 20 June 2007

The facts are as in Example 14. NZ Co was allowed deductions for depreciation losses in relation to the leased equipment of $29,127,974 over the period 1 April 2000 to 31 March 2008 (the end of the income year including 20 June 2007). The adjusted tax value of the equipment is $5,872,026 after subtracting all depreciation allowed up to 31 March 2008.

NZ Co recognises additional income in the 2008–09 income year of $29,127,974 ÷ 6 = $4,854,662. The adjusted tax value of the equipment on 1 April 2008 is $5,872,026 + $4,854,662 = $10,726,688.

Subsequent depreciation deductions reduced

In income years following 20 June 2007, and while the lease remains an operating lease, the depreciation losses which would otherwise be allowed are reduced by one-sixth. The losses which would otherwise be allowed are taken to be the deductions which would have been allowed in the absence of section FC 8I of the Income Tax Act 2004 (section FA 11B of the Income Tax Act 2007), except that the adjusted tax value calculated under that section should apply.

Example 16: Reduction of depreciation deductions – lease entered into before 20 June 2007

The facts are as in Examples 14 and 15. The economic rate used by NZ Co for the equipment would be 20 percent (DV) in the absence of section FC 8I (or FA 11B). In the 2008–09 year, using the ATV determined under section FC 8I (or FA 11B) but otherwise ignoring section FC 8I (or FA 11B), NZ Co would be allowed a depreciation deduction of $10,726,688 x 20% = $2,145,338. This is reduced by one-sixth under section FC 8I (or FA 11B), so that a deduction of $1,787,782 is actually allowed. The ATV is then adjusted down in the normal way to $10,726,688 – $1,787,782 = $8,938,906. In the 2009–10 year, the deduction allowed is $8,938,906 x 20% x 5 ÷ 6 = $1,489,818 and the ATV is adjusted down to $7,449,088.

There are consequential amendments to sections EE 28(4), EE 46(2) and EE 52(7) of the Income Tax Act 2004, and to sections EE 35(4), EE 55(2) and EE 61(8) of the Income Tax Act 2007. These are effectively prompts to readers of the depreciation rules that the lease provisions may affect the allowable deduction.

Depreciation recovery income under section EE 41(1) of the Income Tax Act 2004 or section EE 48(1) of the Income Tax Act 2007, and deductions allowed for loss on sale under section EE 41(2) of the Income Tax Act 2004 or section EE 48(2) of the Income Tax Act 2007, are not reduced by one-sixth by the new rules.

Example 17: Depreciation recovery income or loss on sale – lease entered into before 20 June 2007

The facts are as in Examples 14, 15 and 16. If the equipment is sold in the 2010–11 year, for $10,000,000, NZ Co will have depreciation recovery income under section EE 41(1) of $10,000,000 – $7,449,088 = $2,550,912. If, instead, the sale price is $5,000,000, the taxpayer will be allowed a deduction for depreciation losses under section EE 41(2) of $2,449,088.

When section FC 8I of the Income Tax Act 2004 or section FA 11B of the Income Tax Act 2007 applies to a lease, it will continue to apply until the end of the lease term unless the lease becomes a finance lease. Such a lease may become a finance lease, for example, because an extension of the lease term means paragraph (b) of the definition of "finance lease" is satisfied. In this case, section FC 8H of the Income Tax Act 2004 or section FA 11 of the Income Tax Act 2007 would apply.

Other consequential amendments

In the Income Tax Act 2004, there is a consequential amendment to the definition of "lease", because the former sections FC 8H and FC 8I have now been consolidated into section FC 8H. A similar change has

been made in section EX 21(30) of that Act. These changes are not required in the Income Tax Act 2007.

IMPLEMENTING THE FAIR DIVIDEND RATE AND CERTAIN EQUITY CAPITAL GAINS EXCLUSIONS IN LIFE INSURANCE

Sections CX 55, EY 43, EY 43B, EY 43C, HL 2, HL 3, HL 5B, HL 11, HL 14 and YA 1 of the Income Tax Act 2007

Under current life insurance tax rules, a life insurer pays tax on what is commonly referred to as the life office base (which taxes all income from the business of life insurance) and policyholder income (which taxes net investment income accruing to policyholders). Tax paid on the life office base generates imputation credits which can be used to meet the policyholder income tax liability. The amendments discussed below integrate fair dividend rate (FDR) and certain portfolio investment entity (PIE) rules into the life insurance rules.

The FDR treatment of portfolio share interests in non-resident companies other than Australian-listed companies has been extended to a life insurer's policyholder income calculation. The change is intended to correct an anomaly arising from implementing FDR for life insurers.

Life insurers can also elect to have New Zealand and Australian-listed equity gains from investment-linked insurance products excluded from tax. The change allows policyholders with investment-linked life insurance products to access some of the benefits of the new PIE rules.

Background

Under recent changes to the taxation of offshore portfolio equity, all portfolio shares with interests of less than 10 percent in non-resident companies other than Australian-listed companies are taxed on a deemed FDR of 5 percent instead of actual returns (dividends, plus realised gains for revenue account holders). The FDR is effective from the beginning of the first income year beginning after 31 March 2007. However, entities electing to become PIEs have the option of making the FDR apply from 1 October 2007, regardless of their income year.

The FDR is applied to the relevant non-Australian listed foreign equities when calculating tax on the life office base as this is done using standard tax rules. However, tax on policyholder income is calculated on actual returns (through movements in reserves) of those equities rather than by the FDR method. The policyholder income tax calculation therefore required a change so that the FDR applies to both calculations.

While life insurers are allowed to invest through PIEs, a life insurance fund cannot be a PIE itself. If a life insurer invests through a PIE, then realised New Zealand and Australian-listed equity gains are excluded from the life office base calculation by the operation of section CX 55. Some life insurers offer products known as investment-linked funds. These products are similar to managed funds, and should be able to benefit from the Australasian equity gain exclusion. The amendments extend this exclusion to the life office base and policyholder income calculations of these products.

Key features

Life office base

Section CX 55 extends the exclusion of realised New Zealand and listed Australian equity gains to a life insurer, for the part of the business that is a "portfolio investment-linked life fund".

A "portfolio investment-linked life fund" is defined in section YA 1 to mean a fund where investments are held, subject to a life policy under which benefits are directly linked to the value of investments held in the fund. The portfolio investment-linked life fund must also be eligible to be, and elect to be, and has not ceased the election to be, a portfolio investment entity. New sections HL 3(7), (8), (9), (10) and (11) prescribe the eligibility requirements for life insurers to be a portfolio investment entity. New section HL 5B (1)(c) defines an investor in a portfolio investor entity which is a portfolio investment-linked life fund (not held through a portfolio investor proxy), as "a person whose benefits under the relevant life insurance policy are directly linked to the value of investments held in the portfolio investment-linked life fund".

Life insurers who elect into the new rules will have a deemed disposal of the excluded shares with any tax to pay spread over a period of three years, pursuant to section HL 14 (2).

Policyholder income

The policyholder income formula in section EY 43 (1) has been amended by amounts referred to in subsection (5B) as the "FDR adjustment" and in subsection (5C) as the "PILF adjustment". The amount of these adjustments are determined by whether the relevant equities are held on behalf of policyholders in portfolio investment-linked life funds, or in other life insurance products.

For the FDR adjustment, FDR income attributed from portfolio investment entity investments other than by portfolio investment-linked life funds are excluded from policyholder income. For the PILF adjustment, FDR income and New Zealand and Australian-listed equity gains derived by portfolio investment-linked life funds are also excluded.

FDR adjustment

New section EY 43B describes the "FDR adjustment" for life insurance savings products other than for those in portfolio investment-linked life funds with an attributing interest in a FIF, or a "portfolio tax rate entity" that the life insurer has directly or indirectly invested in, and for which the FDR is used. These include traditional participating life insurance savings products such as whole of life and endowment policies, and also investment-linked products which the life insurer has not elected to be portfolio investment-linked life funds.

The definition of a "portfolio tax rate entity" in section YA 1 has been amended to not include a portfolio investment-linked life fund. For the purposes of section EY 43B (1), subsection (2) provides that a life insurer is treated as indirectly investing in a portfolio tax rate entity (PTRE A) when a portfolio tax rate entity has invested in PTRE A and the investments may be traced back through an unbroken chain of investments in portfolio tax rate entities to a direct investment by the life insurer in a portfolio tax rate entity.

The life insurer may calculate the FDR adjustment either under the formula contained in subsection (5), or based on adjustments of actual amounts credited. The formula in subsection (5) is:

0.6 x (FIF result – FDR income)

"FIF result" is defined in subsection (7) as the life insurer's gains and losses for the income year, for the property, calculated using accepted accounting practice.

"FDR income", which is defined in subsection (8), refers to the amount of FDR income on that property, calculated using any reasonable method for the information available to the life insurer. It will be the same amount that was calculated in the life insurer's life office base income calculation.

The "0.6 factor" is a typical amount of the income included from these products in the annual policyholder base calculation and is used to minimise compliance costs.

As the intention of the provision is to ensure that the correct amount of policyholder income is taxed, as an alternative the life insurer can, using any reasonable method for the information available to the life insurer, use actual amounts credited to actuarial reserves of the relevant income after allowing for the FDR method to be applied. As a practical matter, it is anticipated that life insurers would adopt this approach rather than the formula in subsection (5), except if the actual allocation cannot be accurately calculated or if the compliance costs to do so would be material. The allocation method adopted must be used consistently between income years to prevent artificially maximising the policyholder income exclusion.

PILF adjustment

New section EY 43C (1) to (9) prescribes the "PILF adjustment" for assets held in a portfolio investment entity to the extent to which property that the life insurer holds to support actuarial reserves for a portfolio investment-linked life fund is:

- an attributing interest in a FIF held by the life insurer directly or by a portfolio tax rate entity that the life insurer has invested in directly or indirectly, and for which the life insurer or portfolio tax rate entity uses the FDR; or
- shares described in section CX 55 (Proceeds from certain disposals by portfolio investment entities or New Zealand Superannuation Fund).

In using the policyholder income formula, the life insurer can choose to calculate the PILF adjustment by either using the formula in subsection (5) or based on adjustments of actual amounts credited. The formula in subsection (5) is:

0.9 x (FIF result – FDR income) + 0.9 excluded shares

The part of the formula (FIF result – FDR income) is effectively the same as discussed earlier. The adjustment factor of 0.9 reflects the typical amount of income included in policyholder income with these products.

Also excluded from the calculation of policyholder income is 0.9 of "excluded shares". These are defined in subsection (9) and include realised gains or losses of New Zealand and listed Australian equities that were excluded from the calculation of tax under the life office base income calculation, in addition to unrealised gains or losses on those equities, but excludes dividends or distributions from these shares other than from a portfolio tax rate entity to which section CX 56 (2) applies.

Life insurers can, using any reasonable method for the information available to the life insurer, use the actual amounts credited to actuarial reserves of the products, after allowing for the FDR method and dividends or distributions from New Zealand and Australian-listed equities other than a distribution from a portfolio tax rate entity to which section CX 56 (2) (Portfolio investor allocated income and distributions of income by portfolio investment entities) applies. The allocation method adopted must be used consistently between income years.

Other amendments

Consequential amendments for portfolio investment-linked life funds are contained in sections HL 2(2), HL 3 and HL 11(2B), and to the definitions in section YA 1 for "portfolio investment entity", "portfolio listed company" and "portfolio tax rate entity".

Application dates

The new sections are treated as coming into force on 1 October 2007.

The FDR adjustments and PILF adjustments will be effective from:

- the beginning of the 2008–09 income year; or
- on or after 1 October 2007, if an election by the life insurer to do so is received by the Commissioner before 1 April 2008; or
- an income year beginning on or after 1 April 2007 if an election by the life insurer to do so is received by the Commissioner before 1 April 2008.

However, a life insurer can choose that the adjustments do not apply to them by furnishing a return of income for the 2008–09 tax year that ignores the adjustments.

THE ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR TAXATION PURPOSES

Sections DB 26, DB 27, EB 6, EB 9, EB 12, EB 19, EB 22, ED 1, EW 14 to EW 24, EW 25B, EW 26, EW 29, EW 31 and EW 48B of the Income Tax Act 2004; sections DB 34, DB 35, EB 6, EB 9, EB 12, EB 19, EB 22, ED 1, EW 14 to EW 24, EW 25B, EW 26, EW 29, EW 31 and EW 46B of the Income Tax Act 2007; section 141B(1C) of the Tax Administration Act 1994

Some taxpayers adopted international financial reporting standards (IFRS) for financial reporting purposes from 1 January 2005. For certain other taxpayers, the standards became mandatory from 1 January 2007. The Income Tax Act 2004, Income Tax Act 2007 and the Tax Administration Act 1994 have been amended to incorporate the adoption of IFRS for taxation purposes, where appropriate.

Background

Current taxation rules are linked to accounting practice in areas such as the trading stock valuation rules, research and development expenditure rules, and in areas where the courts and tax legislation have relied on generally accepted accounting practice. Tax rules' reliance on accounting practice in these areas is "ambulatory" in principle. To the extent that certain tax rules rely on accounting practice, changes in accounting practice arising from the adoption of IFRS are also brought into effect for tax purposes (in other words, they are automatically reflected in tax law). However, some areas, such as the research and development expenditure and trading stock valuation rules, require legislative amendments to incorporate the specific changes brought about by the adoption of IFRS.

IFRS have introduced significant changes to the methods of accounting for income and expenditure of financial arrangements. In many cases these changes bring financial accounting methods closer in line with existing tax timing rules. The legislative amendments clarify that taxpayers who adopted IFRS methods can rely on the same methods for taxation purposes. They also provide alternative methods that these taxpayers can adopt. Consequently, Determination G30, which provides the transitional rules for IFRS taxpayers, is expected to be withdrawn later this year.

Key features

A number of technical changes have been made to the research and development expenditure rules, the trading stock valuation rules and the financial arrangements rules in the Income Tax Act 2004 and Income Tax Act 2007. The Tax Administration Act 1994 has also been amended to provide a legislative relief from the unacceptable tax position penalty in some circumstances. These amendments:

- update the existing trading stock rules and research and development expenditure rules to reflect changes following the adoption of IFRS;
- modify the existing financial arrangement timing rules to allow taxpayers to use the method they adopt under IFRS, with alternative spreading methods provided to limit the volatility of income and expenditure calculated for taxation purposes; and
- provide legislative relief for taxpayers who adopt IFRS before the 2007–08 income year from unacceptable tax position penalties, in some circumstances.

Detailed analysis

Research and development expenditure

Sections DB 26 and DB 27 of the Income Tax Act 2004 and sections DB 34 and DB 35 of the Income Tax Act 2007

The research and development expenditure rules in sections DB 26 and DB 27 of the Income Tax Act 2004 and sections DB 34 and DB 35 of the Income Tax Act 2007 have been updated to reflect changes brought about by the adoption of IFRS. The amended rules rely on IFRS accounting standards, instead of the old accounting standards, to determine when research and development expenditure is deductible for taxation purposes.

Under IFRS, the treatment of research and development expenditure is dealt with under the general accounting standards on intangibles (NZ IAS 38). The core standards for capitalisation of development costs under NZ IAS 38 (paragraphs 54 to 67) are substantially the same as the old accounting standards and should be appropriate for taxation purposes. However, some provisions in the old standards (such as paragraphs 2.3 and 5.4 of FRS-13) are

no longer applicable and the Acts have been amended accordingly.

Application dates

The IFRS-based accounting standards on research and development expenditure must be adopted for taxation purposes from the 2007–08 income year or the first income year for which a person adopts IFRS for financial reporting purposes, whichever is earlier.

Trading stock

Sections EB 6, EB 9, EB 12, EB 19, EB 22 and ED 1 of the Income Tax Act 2004 and the Income Tax Act 2007

IFRS have been incorporated into the trading stock valuation rules in sub-part EB and the valuation rule for excepted financial arrangements in section ED 1. The old accounting standards that have been used in these provisions have been replaced with new standards NZ IAS 2 and NZ IAS 8, under IFRS.

Section EB 6(1B) has been inserted in the Income Tax Act 2004 and Income Tax Act 2007. This provision allows primary sector producers to continue valuing their trading stock at cost.

Application dates

The amended valuation rules for trading stock and excepted financial arrangements apply from the 2007–08 income year or the first income year for which a person adopts IFRS for financial reporting purposes, whichever is earlier.

Financial arrangements rules

Sections EW 14 to EW 24, EW 25B, EW 26, EW 29, EW 31 and EW 48B of the Income Tax Act 2004; sections EW 14 to EW 24, EW 25B, EW 26, EW 29, EW 31 and EW 46B of the Income Tax Act 2007

The financial arrangement spreading rules have been amended for taxpayers who adopt IFRS for financial reporting purposes (IFRS taxpayers). These taxpayers would generally be required to use IFRS accounting methods for taxation purposes but alternative spreading methods are available in some circumstances. Taxpayers who do not prepare IFRS accounts will continue to apply the current spreading rules for financial arrangements.

A summary of the spreading methods available to taxpayers under the amended financial arrangement rules is presented in Figure 1 (on page 82).

An amendment to section EW 26 of the Income Tax Act 2004 and the Income Tax Act 2007 further clarifies that taxpayers can change between one of the pre-IFRS spreading methods and the new spreading methods for IFRS taxpayers when they start or stop preparing IFRS financial statements. IFRS taxpayers can choose to delay using the new spreading methods for taxation purposes until the 2007–08 income year.

Spreading methods

IFRS taxpayers are required to use one of the new spreading methods in sections EW 15B to EW 15E of the Income Tax Act 2004 and sections EW 15B to EW 15I of the Income Tax Act 2007. These methods include the IFRS method, alternative methods set out in specific determinations, expected value method, modified fair value method and mandatory non-IFRS methods.

IFRS method

An IFRS taxpayer must use the IFRS method in section EW 15C of the Income Tax Act 2004 and section EW 15D of the Income Tax Act 2007, unless the mandatory non-IFRS methods apply or the taxpayer elects to use the alternative spreading methods. Under the IFRS method, the taxpayer would calculate income and expenditure of a financial arrangement using the IFRS accounting rules.

Different methods are used to calculate income and expenditure of financial arrangements depending on their classification under IFRS. These IFRS accounting methods are accepted for taxation purposes under section EW 15C of the Income Tax Act 2004 and section EW 15D of the Income Tax Act 2007. For example, NZ IAS 39 allows income and expenditure of a financial arrangement to be calculated using either the "fair value method" or the "effective interest method" as appropriate.

Furthermore, income and expenditure calculated under the IFRS method would include fees that are "integral" to the financial arrangement. Sections EW 15(1) and EW 31(7) of the Income Tax Act 2004 and the Income Tax Act 2007 have been amended accordingly.

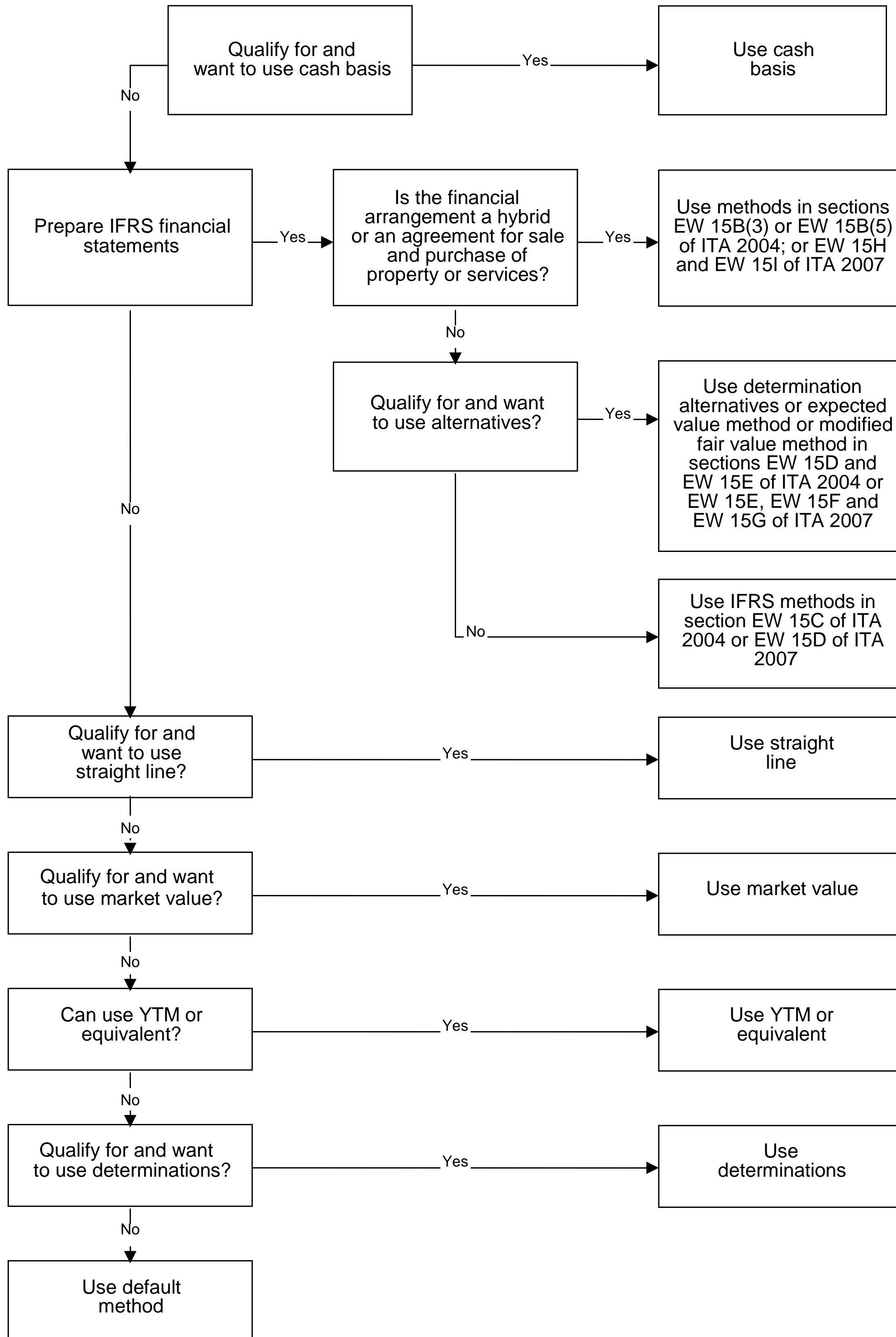
Taxpayers who adopt the IFRS method for taxation purposes are expected to make two modifications. First, income and expenditure reported under IFRS in both the income statement and the statement of changes in equity must be included for taxation purposes. Secondly, credit impairment adjustments made to a financial asset under IFRS must be reversed out for taxation purposes. Credit impairments of financial arrangements will only be deductible for taxation purposes in accordance with the bad debt rules in section DB 23 of the Income Tax Act 2004 or section DB 31 of the Income Tax Act 2007.

Specific determinations

An IFRS taxpayer can elect to use the alternative methods in the specific determinations listed in section EW 15D of Income Tax Act 2004 and section EW 15E of the Income Tax Act 2007:

- Determination G9C – Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach;
- Determination G14B – Forward contracts for foreign exchange and commodities: an expected value approach; and
- Determination G27 – Swaps.

Figure 1: New financial arrangement spreading rules



In addition, the Commissioner may issue further determinations when this is necessary.

These methods are available if the IFRS taxpayer is able to meet the conditions in the relevant determinations and the anti-arbitrage requirement (which is discussed in a separate section below), subject to a specific modification to the election criteria in Determinations G9C and G14B.

(i) Method in Determinations G9C and G14B

An IFRS taxpayer that adopts Determinations G9C and/or G14B must comply with the principles in paragraph 4 of these determinations. Broadly, the basic principles under these determinations are:

- income or expenditure from a financial arrangement is the total of an expected component and an unexpected component;
- the expected component must be measured at the time a financial arrangement is entered into. The expected component is measured by converting expected payments under the financial arrangement into New Zealand dollars on the basis of forward rates;
- the net expected New Zealand dollar amount should be spread over the term of the financial arrangement based on the yield to maturity method;
- the unexpected component must be recognised when it is realised as the difference between the actual New Zealand dollar payments and the expected New Zealand dollar payments.

An IFRS taxpayer has to meet the terms set out in paragraph 3 of Determinations G9C and G14B. However, the election criteria in Determinations G9C and G14B have been relaxed for new companies that begin operation part-way through a year and companies that enter into a transaction that is covered by the determinations part-way through a year. The amendment allows these companies to use Determinations G9C and G14B if an election is made in writing on or before the 63rd day after they enter into the financial arrangement, or a later date allowed by the Commissioner (section EW 15D(3)(b) of the Income Tax Act 2004 and section EW 15E(3)(b) of the Income Tax Act 2007). For example, it is envisaged that an election at a later date would be allowed for the 2007–08 income year because the amended legislation was enacted part-way through that income year and taxpayers may not be in a position to make an election within the 63-day period.

Contracts for differences

The definition of "forward contract" has been amended for the purpose of section EW 15D of the Income Tax Act 2004 and section EW 15E of the Income Tax Act 2007. This is to clarify that "contracts for differences" are forward contracts even though it is not anticipated that the property or services that are the subject of the contracts would be delivered or performed.

This amendment allows "contracts for differences" and other similar contracts to be treated as forward contracts. The example below illustrates how a contract for differences might be dealt with in accordance with the principles set out in Determination G14B.

Example: Contracts for differences

Company A is an energy consumer. It enters into a contract for differences with a strike price of 5 cents per kWh. The contract was entered into with a third party at the prevailing market forward rate for electricity. The contract is set at a volume of 1,000 kWh per month for two years. The counter party to this contract is an energy supplier. Company A chooses to use the expected value method under Determination G14B.

Although the contract is expressed as an agreement to buy and sell electricity, the 1,000 kWh of electricity under the contract will never be delivered. Instead the counter party promises to pay Company A the difference if the market price for electricity is higher than the strike price at the end of the month. Company A promises to pay the counterparty if the market price is lower than the strike price. This ensures that the price Company A would have to pay for its electricity would never be higher (or lower) than 5 cents per kWh for 1,000 kWh per month.

The contract could be seen as a series of forward contracts with settlements at monthly intervals. The expected component of the contract is zero as the strike price for the contract is the prevailing market forward rate for electricity. This means there is nothing to spread under the "expected value" method.

However, the unexpected component must be recognised when payments are made under the contract. In this case, income and expenditure will arise when the contract is settled at the end of each month. Company A would report a gain if the market price for electricity is higher than the strike price at the end of the month, or a loss if the market price is lower than the strike price.

(ii) Methods in Determination G27

IFRS taxpayers can elect to use the methods in Determination G27 if they meet the terms set out in paragraph 3 of that determination. Having elected, they must apply the principles and methodology in the determination.

Methodology in Determination G27

Determination G27 contains a number of spreading methods for swaps agreements. The main spreading method is the method known as Method C in the determination. This method requires a taxpayer to calculate income and expenditure on a swap by treating each side of the swap as a separate, simultaneous and mutual loan between the taxpayer and the other party of the swap. Income and expenditure on these separate deemed loans should be calculated in accordance with normal financial arrangements rules. Paragraphs 6(4) and 6(7) of Determination G27 outline the rules for calculating income and expenditure on these separate loans. IFRS taxpayers that elect to use this determination must comply with these provisions.

Other spreading methods are also specified in Determination G27. It is anticipated that the status of these spreading methods and the availability of other spreading methods for IFRS taxpayers will be clarified as part of the remedial work discussed at the end of this item.

(iii) Alternatives to Commissioner's Determination

IFRS taxpayers can use an alternative method to those set out in Determinations G9C, G14B and G27 or another determination issued by the Commissioner. An alternative method may be used if it:

- has regard to the purposes of the financial arrangements rules under section EW 1(3);
- is for a financial arrangement similar to one to which the methods set out in Determinations G9C, G14B and G27 may apply; and
- results in the allocation to each income year of amounts that are not materially different from those that would have been allocated using one of the methods set out in the determinations.

Expected value method

Section EW 15E(2) of the Income Tax Act 2004 and section EW 15F of the Income Tax Act 2007 provide an expected value method that IFRS taxpayers can use instead of the IFRS methods. A taxpayer that qualifies and wishes to use the expected value method must elect to use this method by notifying the Commissioner at the time of filing a return of income. The election applies to the taxpayer and all the companies in the taxpayer's group.

IFRS taxpayers can elect to use the expected value method to calculate income and expenditure of derivative financial instruments and foreign currency denominated financial arrangements, if the financial arrangements have been entered into in the ordinary course of the taxpayers' business and the taxpayers are not in the business of dealing in the financial arrangements. In addition, the IFRS taxpayers must satisfy the anti-arbitrage requirement (which is discussed in a separate section below).

- *Ordinary course of business*

  The amended legislation does not define the term "ordinary course of business". Facts and circumstances of a taxpayer's business would determine whether a financial arrangement has been entered into in the ordinary course of the taxpayer's business. For example, a taxpayer who borrows in a foreign currency, say in US dollars, to fund its subsidiaries in the US would most likely be considered to have entered into the loan as part of its ordinary course of business. A taxpayer who enters into a derivative contract to hedge a particular business risk would also be considered as having entered into the derivative contract in the ordinary course of its business. For example, an energy company may enter into contracts for differences to fix the price of electricity.

- *Business of dealing in the financial arrangement*

  An IFRS taxpayer cannot apply the expected value method to a financial arrangement if the taxpayer is in the "business of dealing in the financial arrangement". Again, facts and circumstances would determine when a taxpayer is in the business of dealing in the financial arrangement. For example, a company that enters into a financial arrangement to hedge a business risk would most likely not be considered as in the business of dealing in that financial arrangement.

  On the other hand, a company that buys and sells a financial arrangement regularly for profit would probably be in the business of dealing in that financial arrangement. Nevertheless, it is envisaged that taxpayers may have two portfolios of a type of financial arrangements (say swaps) and only buy and sell regularly for profit from one of those portfolios. These taxpayers are not prevented from using the expected value method to calculate income and expenditure of financial arrangements in the "non-trading" portfolio.

- *Expected value methodology*

  The amended legislation defines the expected value method by reference to the methodology in Determinations G9C and G14B. This means the principles that apply in those determinations should be relevant here. Broadly, these principles are:

  - income or expenditure from a financial arrangement is the total of an expected component and an unexpected component;
  - the expected component must be measured at the time a financial arrangement is entered into and spread over the term of the financial arrangement; and
  - the unexpected component must be recognised when it is realised as the difference between

the actual New Zealand dollar payments and the expected New Zealand dollar payments.

IFRS taxpayers who adopt a method that is consistent with these principles would be considered to have allocated a reasonable amount for each income year of the term of the financial arrangement, having regard to the purposes of the financial arrangements rules under section EW 1(3).

The following examples illustrate how the expected value method applies to certain types of futures, options and swaps contracts.

Example 1: Futures contracts

Company A enters into a futures contract to buy 1 million US dollars against delivery of New Zealand dollars. The futures contract has a standard settlement date of 31 December 2010. The contract was entered into on 30 April 2008 for no consideration. The contract rate is US$0.76 to NZ$1, which is the market forward rate. Company A qualifies and elects to use the expected value method to spread income and expenditure under the futures contract.

At the time Company A becomes a party to the futures contract, the expected New Zealand dollar net amount is zero. Therefore, the futures contract has no expected income or expenditure and there is nothing to spread under the expected value method. Company A will recognise the unexpected income or expenditure from the futures contract when it is realised.

Example 2: Options contracts

Company A enters into an options contract to buy 100 units of commodity at $15 per unit. The option is exercisable in two years. Company A paid a premium of $175. The market interest rate is 8% per annum. Company A qualifies and elects to use the expected value method.

Under the expected value approach, the expected gain under the option contract for Company A is equal to the difference between the amount of the premium paid and the forward price of the option. Broadly, the forward price is equal to the spot price on issue plus the cost of carrying to maturity. In the example above, the forward price of the option contract is $204 (being 175×1.08^2). The $29 difference between the premium paid ($175) and the forward price ($204) is the expected gain of Company A. This expected gain should be spread by Company A under the expected value method over the two-year period. Company A would have income of $14 in the first year resulting from the expected component.

If at the end of year two the spot price of the commodity is $18 per unit, Company A will realise an unexpected gain of $96 (which is the difference between the $300 gain that Company A will derive from exercising the option, less the $204 expected gain). In addition, Company A would have income of $15 from the expected component in the second year. The total of $111 would be income of Company A in the second year. This amount will show up as a result of the base price adjustment:

consideration – income + expenditure + amount remitted
($300 – $175) – 14 + 0 + 0 = $111

Example 3: Swaps

Company A enters into a swaps agreement under which it promises to pay a variable rate of interest in exchange for receiving a fixed rate of interest. The swaps agreement will be settled every six months until 31 December 2010, when the last payment will be made. The contract was entered into on 30 April 2008 at the prevailing market rate for no consideration and the variable rate under the swaps agreement will be re-fixed regularly. Company A qualifies and elects to use the expected value method to spread income and expenditure under the futures contract.

As the swaps agreement has been entered into at the prevailing market rate for no consideration, the expected NZD net amount is zero when Company A enters into the swaps agreement. Therefore, the swaps agreement has no expected income or expenditure and there is nothing to spread under the expected value method. Company A will recognise the unexpected income or expenditure from the swaps agreement when payments are made at the six-monthly interval.

Modified fair value method [23]

Section EW 15E(3) of the Income Tax Act 2004 and section EW 15G of the Income Tax Act 2007 provide another alternative spreading method for IFRS taxpayers. An IFRS taxpayer who qualifies can elect to use this method by notifying the Commissioner at the time of filing a return of income. The election applies to the taxpayer and all the companies in the taxpayer's group.

As with the expected value method, the alternative method in this section is only available for derivative financial instruments and foreign currency denominated financial arrangements that have been entered into in the ordinary course of an IFRS taxpayer's business and the taxpayer is not in the business of dealing in the financial arrangements. In addition, the anti-arbitrage requirement (which is discussed in a separate section below) must be met.

[23] This is also referred to as the equity free fair value method under section EW 15E(3) of the Income Tax Act 2004.

An IFRS taxpayer who elects to use this method must use the IFRS method to calculate income and expenditure of a financial arrangement, but the amount which has been allocated to equity reserves under IFRS can be excluded from tax. For example, income and expenditure of a derivative instrument that is a cashflow hedge may be reported as part of equity reserves in IFRS accounts. This amount would ordinarily be included if a taxpayer relies on the IFRS method for taxation purposes. However, the modified fair value method in section EW 15E(3) of the Income Tax Act 2004 and section EW 15G of the Income Tax Act 2007 would allow this amount to be excluded from tax.

Compulsory non-IFRS methods

Sections EW 15B(3) to (5) of the Income Tax Act 2004 and sections EW 15H and EW 15I of the Income Tax Act 2007 preserve the existing, pre-IFRS spreading methods for some financial arrangements. It is mandatory for IFRS taxpayers to apply these spreading methods instead of the methods they have adopted for financial reporting purposes. These compulsory methods apply to a financial arrangement that includes an excepted financial arrangement, a financial arrangement that is treated partly or wholly as an equity instrument under IFRS, or an agreement for the sale and purchase of property or services.

Section EW 15B(3) of the Income Tax Act 2004 and section EW 15H of the Income Tax Act 2007 list the following determinations that must be applied if the financial arrangement is covered by the determinations:

- Determination G5C: Mandatory conversion convertible notes;
- Determination G22: Optional conversion convertible notes denominated in New Zealand dollars convertible at the option of the holder;
- Determination G22A: Optional convertible notes denominated in New Zealand dollars;
- Determination G29: Agreements for sale and purchase of property denominated in foreign currency: exchange rate to determine the acquisition price and method for spreading income and expenditure.

An alternative method may be used instead of those set out in the determinations above if it:

- has regard to the purposes of the financial arrangements rules under section EW 1(3);
- is for a financial arrangement similar to one to which the methods set out in the determinations above may apply; and
- results in the allocation to each income year of amounts that are not materially different from those that would have been allocated using one of the methods set out in the determinations.

For financial arrangements that are not covered by the determinations listed above, sections EW 15B(4) and (5) of the Income Tax Act 2004 and section EW 15I of the Income Tax Act 2007 require one of the following spreading methods to be used:

- the yield to maturity method;
- Determination G26: Variable rate financial arrangements; or
- a determination made by the Commissioner under section 90AC(1)(ba) of the Tax Administration Act 1994.

Again, an alternative method may be used instead of those set out in the determinations above if it:

- has regard to the purposes of the financial arrangements rules under section EW 1(3);
- is for a financial arrangement similar to one to which one of the methods above may apply; and
- results in the allocation to each income year of amounts that are not materially different from those that would have been allocated using one of the above methods.

Example: A financial arrangement with an excepted financial arrangement

An IFRS taxpayer is a party to a financial arrangement that includes an excepted financial arrangement. How should this financial arrangement be treated under the amended financial arrangements rules?

There are two possible routes for determining the tax treatment of this financial arrangement under the amended rules. If the financial arrangement is covered by determinations G5C, G22, G22A or G29 in section EW 15B(3) of the Income Tax Act 2004 and section EW 15H of the Income Tax Act 2007, income and expenditure of the financial arrangement must be spread in accordance with the relevant determination. The taxpayer's IFRS treatment may be accepted as an alternative if it produces results that are not materially different from the method in the relevant determination.

If the financial arrangement is not covered by determinations G5C, G22, G22A or G29, then the excepted financial arrangement should be separated from the financial arrangement in accordance with section EW 6 of the Income Tax Act 2004 and the Income Tax Act 2007. The taxpayer must apply to the remaining financial arrangement one of the methods in sections EW 15B(4) and (5) of the Income Tax

Act 2004 and section EW 15I of the Income Tax Act 2007. This means that the taxpayer would have to use the yield to maturity method, or a method provided in Determination G26: Variable rate financial arrangements, or a method in a determination made by the Commissioner, or an alternative method. Again, the taxpayer's IFRS treatment may be accepted as an alternative if it produces results that are not materially different from the yield to maturity method, the method in Determination G26 or another method in a determination made by the Commissioner, whichever is relevant.

Example: An agreement for the sale and purchase of property or services

An IFRS taxpayer is a party to an agreement for the sale and purchase of property. How should this agreement be treated under the amended financial arrangements rules?

An agreement for the sale and purchase of property or services in which the settlement is deferred is a financial arrangement if the deferral is more than 93 days (that is, a long-term agreement). This rule has not been amended.

If the long-term agreement is denominated in a foreign currency, income and expenditure on the agreement must be spread using one of the methods under Determination G29. If the agreement is denominated in New Zealand dollars, then it is expected that the yield to maturity method in section EW 15B (5) of the Income Tax Act 2004 and section EW 15I of the Income Tax Act 2007 would apply.

The taxpayer's IFRS treatment is not, prima facie, an acceptable spreading method under the amended financial arrangements rules. This is because the taxpayer's IFRS treatment does not necessarily recognise the interest element in a long term property agreement. However, the taxpayer's IFRS treatment may be accepted as an alternative in some circumstances if it produces results that are not materially different from Determination G29 or the yield to maturity method, whichever is relevant.

Example: A financial arrangement treated as equity instrument under IFRS

An IFRS taxpayer issues an instrument that is a "financial arrangement" under the financial arrangements rules but the instrument is treated as equity in its IFRS financial reports. Payments made under this instrument are also treated as dividends for financial reporting purposes. How should this financial arrangement be treated under the amended financial arrangement rules?

If the financial arrangement is covered by determinations G5C, G22, G22A or G29 in section EW 15B(3) of the Income Tax Act 2004 and section EW 15H of the Income Tax Act 2007, income and expenditure of the financial arrangement must be spread in accordance with the relevant determination. The taxpayer's IFRS treatment may be accepted as an alternative if it produces results that are not materially different from the method in the relevant determination.

If the financial arrangement is not covered by Determinations G5C, G22, G22A or G29, then the taxpayer must apply one of the methods in section EW 15B(5) of the Income Tax Act 2004 and section EW 15I of the Income Tax Act 2007. This means that the taxpayer would have to use the yield to maturity method, or a method provided in Determination G26: Variable rate financial arrangements, or a method in a determination made by the Commissioner, or an alternative method. The taxpayer's IFRS treatment may be accepted as an alternative method under this provision if it produces results that are not materially different from the yield to maturity method, the method in Determination G26 or a method in a determination made by the Commissioner, whichever is relevant.

Consistency requirements

An IFRS taxpayer who elects to use one of the spreading methods under the amended financial arrangements rules must comply with the consistency requirements in section EW 25B of the Income Tax Act 2004 and the Income Tax Act 2007.

Consistency over time

A change of spreading method is allowed if the IFRS taxpayer has changed its accounting method for financial reporting purposes. For example, an IFRS taxpayer who has been using the IFRS method may wish to change method if the IFRS treatment changes and the taxpayer considers the new method to be inappropriate for taxation purposes. Conversely, an IFRS taxpayer who has been using one of the alternative spreading methods may wish to change method if its accounting treatment changes and the taxpayer considers the new treatment to be appropriate.

The change of method in these circumstances has to occur in the same income year as the change in IFRS accounting treatment. The IFRS taxpayer must also meet the relevant legislative requirements for the new method. These conditions are set out in section EW 25B(2) of the Income Tax Act 2004 and the Income Tax Act 2007.

An IFRS taxpayer who does not qualify for a change of method must use the same method over time.

Example: Change of method

An IFRS taxpayer is a party to a foreign currency denominated financial asset which has been classified under IFRS as a "held to maturity" investment. The effective interest method (which is similar to yield to maturity) would apply under IFRS and the taxpayer has decided to use the same method under the financial arrangements rules. When the IFRS classification for this financial asset changes to "available for sale", the IFRS method would become the fair value method. The taxpayer has decided to change method for taxation purposes. Is this allowed?

Yes. The IFRS taxpayer can change method under these circumstances, as long as the change of method occurs in the same income year as the change in IFRS accounting treatment. The new spreading method could be the method in Determination G9C or the expected value method if the taxpayer can meet the relevant legislative provisions. A change of method adjustment would be required.

If the taxpayer is unable to meet the legislative criteria to use one of these alternative methods, the taxpayer would have to continue using the IFRS method. The income and expenditure recognised under IFRS would be income and expenditure under the IFRS method in section EW 15C of the Income Tax Act 2004 and section EW 15D of the Income Tax Act 2007. This includes any income and expenditure associated with the change of accounting method recognised for financial reporting purposes. No change of method adjustment would be required in this case.

Change of spreading methods

An IFRS taxpayer who changes spreading methods is required to perform either a change of method adjustment under sections EW 26 and EW 27 of the Income Tax Act 2004 and the Income Tax Act 2007, or a base price adjustment.

A change of method adjustment is required when IFRS taxpayers change their spreading methods. This adjustment is also required when non-IFRS taxpayers become IFRS taxpayers or vice versa, and have to change their spreading methods. The change of method adjustment would produce income and expenditure for the first income year taxpayers adopt IFRS for taxation purposes.

A base price adjustment is required when IFRS taxpayers change from a fair value method to another spreading method. Section EW 29(13) of the Income Tax Act 2004 and the Income Tax Act 2007 has been inserted to ensure that this is the case. Section EW 48B of the Income Tax Act 2004 and section EW 46B of the Income Tax Act 2007 have also been added to deem the IFRS taxpayer who is changing out of the fair value method as having been paid an amount equal to the market value of the financial arrangement on the date of change.

Example 1: Forward contract for five years

Company A is a party to a forward contract with settlement in five years. The fair value of the forward contract is 0 at inception, ($100) at the end of year 1 and $50 at the end of year 2. The forward contract was settled at the end of year 5 with a gain of $100 for Company A.

Company A uses the IFRS fair value method in the first income year and recognises a loss of $100. Company A meets the criteria for changing method and decides to change out of the fair value method at the end of the second year. Company A elects and is able to use the expected value method as the new spreading method.

Company A is required to perform a base price adjustment in the second income year. The base price adjustment would produce income for the second year of $150, which is calculated as:

consideration – income + expenditure + amount remitted

($50 – $0) – 0 + 100 + 0 = $150

The expected value of the forward contract will be spread under the expected value method. There is no expected income or expenditure to spread in this example because the forward contract has no value at inception. Therefore, Company A would have no income or expenditure in the third and fourth income years. The expected value method would not be applied retrospectively to the first and second income years because the base price adjustment has already been performed at the end of the second year.

The real base price adjustment would be required at the end of the fifth year, producing income of $50, calculated as:

consideration – income + expenditure + amount remitted

($100 – $0) – 150 + 100 + 0 = $50

Example 2: Same example, different fair value pattern

What if the fair value of the forward contract is 0 at inception, $50 at the end of year 1, ($100) at the end of year 2 and the forward contract was settled at the end of year 5 with a gain of $100 for Company A?

If Company A uses the IFRS fair value method in the first income year, it would recognise income of $50. In the second income year, Company A would be required to perform a base price adjustment because of the change of method. The base price adjustment would produce expenditure of $150, which is calculated as:

consideration – income + expenditure + amount remitted

(-$100 – $0) – 50 + 0 + 0 = ($150)

As the forward contract has no expected component, Company A would have no income or expenditure to spread in the third and fourth income years.

The real base price adjustment would be required at the end of the fifth year, producing income of $200, calculated as:

consideration – income + expenditure + amount remitted

($100 – $0) – 50 + 150 + 0 = $200

Example 3: Same example, non-zero expected value at the beginning of contract

What if Company A paid $50 to enter into a forward contract with a forward/fair value of $100 at inception, $50 fair value at the end of year 1, ($100) at the end of year 2 and the forward contract was settled at the end of year 5 with a gain of $100 for Company A?

If Company A uses the IFRS fair value method in the first income year, it would recognise an expenditure of $50 from the decline in the fair value. In the second income year, Company A would be required to perform a base price adjustment because of the change of method. The base price adjustment would produce expenditure for the second year of $100, which is calculated as:

consideration – income + expenditure + amount remitted

(-$100 – $50) – 0 + 50 + 0 = ($100)

For the purpose of spreading under the new method, Company A would have to calculate the expected component of the forward contract at the inception and spread the expected component based on the yield to maturity method. The expected component in this case is $50 (being the difference between $100 forward value at the inception and the $50 paid by Company A) and has to be spread over the five year period on a yield to maturity basis. This would produce income of $9.8 and $11.3 for the third and fourth income year, respectively.

The real base price adjustment would be required at the end of the fifth year, producing income of $128.9, calculated as:

consideration – income + expenditure + amount remitted

($100 – $50) – 21.1 + 100 + 0 = $128.9

Consistency across financial arrangements

The same spreading method should be applied consistently across all financial arrangements that are the same or similar, unless different accounting treatments apply under IFRS. For example, investments in debt securities can be classified as "held to maturity" investments or "available for sale" financial assets under IFRS. Different accounting treatments can be applied depending on this classification even if the investments are exactly the same in commercial terms. In this case, different spreading methods would be allowed for taxation purposes.

Different spreading methods can be used for taxation purposes if the accounting treatment can be differentiated in one way or another. For example, swaps can be classified as a fair value hedge or a cashflow hedge under IFRS. Although both types of swaps are measured at fair values, gains and losses on the fair value hedge are reported in the income statement while gains and losses on the cashflow hedge can be reported in equity reserves for accounting purposes. Different tax treatments would be allowed for these swaps.

Anti-arbitrage requirement

Sections EW 15D(1)(d) and EW 15E(1)(c) of the Income Tax Act 2004 and sections EW 15E(1)(c), EW 15F(1)(c) and EW 15G(1)(c) of the Income Tax Act 2007 restrict the use of the specific determinations, the expected value method and the modified fair value method. These methods cannot apply to a financial arrangement that is hedging another financial arrangement if the taxpayer has adopted the IFRS fair value method or another IFRS method that accounts for gains and losses related to the hedged risks to account for the other financial arrangement.

This restriction ensures that IFRS taxpayers use similar spreading methods to account for financial arrangements that are in a hedged relationship. Taxpayers are not allowed to apply IFRS methods which take into account market value movements on one side of the hedge and apply the alternative methods that do not bring in market value movements on the other side of the hedge.

Example: Foreign currency loans in a hedge relationship under IFRS

An IFRS taxpayer has a foreign currency denominated *borrowing, which is hedged by a forward currency contract. The forward contract qualifies and is treated as a hedge under IFRS. The taxpayer wishes to use the IFRS treatment to account for the foreign currency denominated borrowing and the expected value method to calculate income and expenditure of the forward currency contract. Is this allowed?*

No. If the taxpayer uses the IFRS method for foreign currency denominated borrowing, the taxpayer is prohibited from using the expected value method to calculate income and expenditure of the forward currency contract. This is because the IFRS treatment for foreign currency denominated borrowing (under NZ IAS 21) would include foreign exchange gains and losses as income and expenditure. The taxpayer must use the IFRS method to calculate income and expenditure on the forward contract. Alternatively, the taxpayer may choose to use the expected value approach

for both the foreign currency borrowing and the forward currency contract.

Example: Floating rate loans in a hedge relationship under IFRS

An IFRS taxpayer has a loan that is paying a floating rate of interest. The cashflow on this loan has been hedged by a series of pay-fixed, floating interest rate swaps. The swaps are not fully effective but they qualify and have been treated as a cashflow hedge under IFRS. The floating rate liability is accounted for under IFRS using the effective interest method, which does not account for the gains and losses related to the hedge. The taxpayer wishes to use the IFRS method to account for the floating rate loan and the method in Determination G27 for the swaps. Is this allowed?

Yes. The anti-arbitrage restriction does not apply in this case because the IFRS method used to account for the floating rate liability is the effective interest method, which does not include gains and losses related to the hedge. [24]

Treatment of fees

The treatment of fees has been modified to the extent that an IFRS taxpayer adopts the IFRS method under the amended financial arrangements rules. The IFRS treatment of fees is adopted for taxation purposes when the IFRS method is used. This alignment ensures that taxpayers who adopt IFRS methods for taxation purposes do not need to identify different types of fees that have been included in the IFRS calculation and apply tax rules to them individually.

The existing treatment of fees continues to apply to non-IFRS taxpayers and when IFRS taxpayers use the alternative methods that are not based on an IFRS accounting treatment. "Contingent fees" would be spread over the term of a financial arrangement in these circumstances.

Integral fees and methods based on IFRS

If an IFRS taxpayer uses the effective interest method under IFRS, then "integral" fees would be included as part of the effective yield of a financial arrangement. These "integral fees" would be included as income or expenditure under the financial arrangement rules in the same way.

When a financial arrangement is fair valued under IFRS, fees that are integral to the financial arrangement are recognised immediately as income or expenditure. The same treatment is acceptable under the amended financial arrangement rules for a taxpayer who adopts the IFRS fair value method.

Definition of integral fees

"Integral" fees under IFRS include transaction costs, being incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. The IFRS rules for determining whether fees are "integral" to a financial arrangement would be accepted for taxation purposes when the IFRS method is used.

Application dates and transitional rules

The amended financial arrangements rules apply generally from the 2007–08 income year. Taxpayers who had to adopt IFRS for financial reporting purposes from 1 January 2007 can apply IFRS for taxation purposes concurrently. This alignment ensures that taxpayers do not have to prepare two sets of accounts and that any transitional adjustment can be dealt with at the same time. However, taxpayers who are not early adopters of IFRS are in a position to adopt the new spreading methods for taxation purposes from the 2008–09 income year if they have an early balance date between 1 October and 30 December.

Early adopters of IFRS

The amended financial arrangements rules can apply retrospectively to taxpayers who are early adopters of IFRS and have applied IFRS for taxation purposes from the income year beginning on or after 1 January 2005. This allows early adopters of IFRS to use the IFRS method for financial reporting and taxation purposes concurrently.

Alternatively, these early adopters can continue to apply the pre-IFRS spreading methods for the 2005–06 and 2006–07 income years. The transitional rule in section EZ 50 of the Income Tax Act 2004 and section EZ 32B of the Income Tax Act 2007 facilitates this by allowing IFRS taxpayers to rely on the methods in sections EW 16, EW 18 and EW 20, despite being unable to use the same method for financial reporting purposes as IFRS may prescribe a different spreading method.

Unacceptable tax position penalty

Section 141B(1C) of the Tax Administration Act 1994

A legislative relief from an unacceptable tax position penalty is provided for taxpayers who adopt IFRS before the 2007–08 income year. This legislative relief is available for the 2005–06 and 2006–07 income years with respect to an IFRS-related tax position, provided that the taxpayer has adopted an interpretation for tax purposes that is "as likely as not" to represent acceptable accounting practice under IFRS and full disclosures are provided to Inland Revenue.

[24] As noted at the end of this section, the legislation will be amended to better reflect this policy intention.

Further developments

A number of issues have arisen after the enactment of the Taxation (Business Taxation and Remedial Matters) Act 2007. These issues will be addressed by way of remedial amendments, which will be included in the next taxation bill.

The anti-arbitrage requirement in sections EW 15D(1)(d) and EW 15E(1)(c) of the Income Tax Act 2004 and sections EW 15E(1)(c), EW 15F(1)(c) and EW 15G(1)(c) of the Income Tax Act 2007 will be amended to better reflect the policy intention. IFRS taxpayers should only be restricted from using the spreading methods in these sections if the financial arrangement is a hedge of another financial arrangement that has been accounted for using the IFRS fair value method or another IFRS method that accounts for gains and losses related to the hedged risks.

The compulsory non-IFRS methods in sections EW 15B(3) to (5) of the Income Tax Act 2004 and sections EW 15H and EW 15I of the Income Tax Act 2007 will be amended to cover finance leases that are treated as operating leases under IFRS. It is envisaged that IFRS taxpayers will apply the yield to maturity method or an alternative to the yield to maturity method to these finance leases.

Some IFRS taxpayers are allowed to prepare their financial accounts in a functional currency that is not New Zealand dollars. However, it is not intended that these taxpayers would be allowed, for taxation purposes, to calculate their income and expenditure on financial arrangements in that functional currency. The remedial amendment will clarify that if these taxpayers elect to use the IFRS accounting method, they are required to apply IFRS rules as if New Zealand dollars are their functional currency.

A number of minor remedial amendments will also be proposed to ensure that:

- Early adopters of IFRS can continue to rely on pre-IFRS financial reporting practices under section EW 21 for the 2006 and 2007 income years.
- Early adopters of IFRS who adopted the IFRS method in 2006 income year will be allowed to change their choice of method in the 2007 or 2008 income year. These taxpayers have made their choice of spreading method for the 2006 income year before the enactment of the Taxation (Business Taxation and Remedial Matters) Act 2007 and may not have information about the full range of methods available to them. It would be fair to give these taxpayers another, one-off opportunity to elect into the new spreading methods.
- Determination G9A, Determination G14 and the market valuation method referred to in Determination G27 should not be available to IFRS taxpayers. Instead, IFRS taxpayers should be allowed to use the spreading methods provided in the amended rules.
- IFRS taxpayers should be allowed to change from the straightline method and the market valuation method when they transition into IFRS-based spreading rules. A change of method adjustment or a base price adjustment would be required.

GREATER TAX INCENTIVES FOR CHARITABLE DONATIONS

Sections DB 41, DV 12 and LD of the Income Tax Act 2007

Tax incentives for donations of money made by individuals, companies and Māori authorities have been greatly enhanced. The changes include removing the maximum limit on the tax credit for donations made by individuals, removing the 5 percent deduction limit on donations made by companies and Māori authorities, and extending the company deduction to apply to close companies not listed on a recognised stock exchange.

The changes are aimed at facilitating greater giving to charities and other non-profit organisations and encouraging a culture of generosity in New Zealand.

All legislation relating to the changes is contained in the newly enacted Income Tax Act 2007. Unless otherwise stated, the legislative references in this item refer to the Income Tax Act 2007.

Background

As part of the Confidence and Supply Agreement between Labour and United Future, the government released the October 2006 discussion document, *Tax incentives for giving to charities and other non-profit organisations*. The discussion document canvassed a range of options for encouraging greater giving to charities and other non-profit organisations and for making it easier to give in time, money and skills to these organisations.

Among the options canvassed in the discussion document were proposals to increase the limits on the current tax incentives for cash donations made by individuals, companies and Māori authorities. In response to submissions on the discussion document, the government agreed to remove the current limits altogether. These changes represent the first stage in the government policy commitment, *Fostering a culture of charitable giving*, which was announced as part of Budget 2007.

The changes were included in the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill, which was introduced in May 2007. The changes

amended the Income Tax Act 2004 and applied from the 2008–09 income year.

As the bill passed through its final legislative stage, the Income Tax Act 2007 was enacted. The Income Tax Act 2007 contains rewritten Parts F to the end of the Act, including schedules and consolidated parts A to E. In particular, the Income Tax Act 2007 restructured and rewrote section KC 5 of the Income Tax Act 2004, which contained the tax rebate for donations made by individuals, and consolidated the provisions providing tax relief for donations made by Māori authorities and companies.

As a result, a Supplementary Order Paper was introduced at the final legislative stage of the bill. Its purpose was to cancel the amendments to the Income Tax Act 2004 and insert those amendments (with appropriate modifications) in the Income Tax Act 2007. Because the amendments and the provisions of the Income Tax Act 2007 apply for the 2008–09 income years and later tax years, amendments to the Income Tax Act 2004 were unnecessary.

Key features

Company deduction

Section DB 41 allows a company to claim a deduction for all charitable or other public benefit gifts it makes to a society, institution, association, organisation, trust or fund of any kind described in section LD 3(2) or set out in Schedule 32. The deduction is limited to the amount that would be the company's net income before taking into account the donation deduction.

The deduction is also available to close companies that are not listed on a recognised exchange.

Māori authority deduction

Section DV 12 allows a Māori authority to claim a deduction for all donations it makes to a Māori association[25] and all charitable or other public benefit gifts it makes to a society, institution, association, organisation, trust or fund of any kind described in section LD 3(2) or set out in Schedule 32. The deduction is limited to the amount that would be the Māori authority's net income before taking into account the donation deduction.

Individuals' tax credit

Section LD 1 provides that a person who makes a charitable or other public benefit gift in a tax year and who meets the requirements of section 41A of the Tax Administration Act 1994 is entitled to a tax credit equal to the amount calculated using the following formula:

Total gifts x 33⅓%

"Total gifts" means the total amount of all charitable or other public benefit gifts made by the person in the tax year.

[26] "Māori association" is defined in the Māori Community Development Act 1962.

The equivalent provision in the Income Tax Act 2004 (section KC 5) has been rewritten and restructured in subpart LD and Schedule 32. The following detailed analysis explains both the structural changes and new terminology used.

Application date

The changes apply for the income years corresponding to the 2008–09 and later tax years.

Detailed analysis

Individuals' tax credit

Section KC 5(1) of the Income Tax Act 2004 contained the tax rebate for donations made by individuals. This provision was rewritten and its various parts relocated in subpart LD and Schedule 32. Consequential amendments were also made to section 41A of the Tax Administration Act 1994 to take into account new terminology used and renumbering of certain sections.

The tax rebate for donations is now a "tax credit". Part L contains most of the rules relating to the application of tax credits. In particular, subpart LA identifies when a tax credit arises, and sets out how the Act applies a tax credit to satisfy a person's obligations under section BB 2.

Section LD 1 allows a person who makes a "charitable or other public benefit gift" in a tax year to claim a tax credit for the tax year equal to one-third of the total amount of all charitable or other public benefit gifts made in that tax year.

The tax credit is treated as a "refundable tax credit" under section LA 7 and is not to be taken into account for the purposes of sections LA 2 to LA 6 (which relate to a person's income tax liability).

Section LD 2 states that an absentee taxpayer, company, public authority, Māori authority, unincorporated body or a trustee liable for income tax under subpart HC and section HZ 2 are not eligible for the tax credit.

Section LD 3(1) defines a "charitable or other public benefit gift". It means a gift of $5 or more that is paid to a society, institution, association, organisation, trust or fund described in section LD 3(2) or listed in Schedule 32. It also includes a subscription paid to a society, institution, association, organisation, trust or fund, only if the subscription does not confer any rights arising from membership in that or any other society, institution, association, organisation, trust or fund. The term does not include testamentary gifts.

Section LD 3(2) describes the entities or trusts referred to in section LD 3(1). The equivalent provisions are located in sections KC 5(1)(aa) to (ad) of the Income Tax Act 2004.

Schedule 32 contains the list of named organisations that are listed in sections KC 5(1)(ae) to (cu) of the Income Tax Act 2004. These organisations are now referred to as "recipients of charitable or other public benefit gifts".

Section 41A of the Tax Administration Act 1994 has also been rewritten to reflect the renumbering and new terminology used in the Income Tax Act 2007. Therefore, the restrictions on the amount of the tax credit are unaffected.

Company and Māori authority deduction provisions

The term "charitable or other public benefit gift" is also used in section DB 41 (which relates to companies) and section DV 12 (which relates to Māori authorities).

The equivalent provisions of the Income Tax Act 2004 use the term "gift of money".

TAX RELIEF FOR REDUNDANCY PAYMENTS

Sections KC 6, OB 1 and OD 8(3) of the Income Tax Act 2004; subpart ML and sections YA 1 and YB 20 of the Income Tax Act 2007; and section 41B of the Tax Administration Act 1994

The Income Tax Act 2004, Income Tax Act 2007, and the Tax Administration Act 1994 have been amended to provide a new rebate (renamed "tax credit" in the Income Tax Act 2007) for redundancy payments. The rebate is a flat rate of six cents in the dollar, capped at the first $60,000 of redundancy payments in relation to each redundancy event. The rebate applies retrospectively to redundancy payments paid on or after 1 December 2006.

Background

Before this amendment, depending on the level of a person's earnings, receipt of a redundancy payment arguably could result in over-taxation when the redundancy payment pushed the person's total earnings over an income threshold and therefore onto a higher marginal tax rate. There was no tax relief available for redundancy payments.

Key features

A new definition of "redundancy payment" has been included in legislation. A definition is required so that redundancy payments qualifying for the rebate relate to payments which arise from a genuine redundancy and have been subject to the PAYE rules.

Claiming the rebate

The process for obtaining the rebate is straightforward. Recipients of redundancy payments simply calculate the rebate as a separate claimable and refundable amount, similar to the current rebates for charitable donations. A new redundancy rebate form is available for rebate claims from April 2008.

A rebate claim may be made following receipt of the redundancy payment. There is no requirement to wait until the end of the tax year to claim a rebate, or any requirement to file any income tax return as a consequence of receiving a redundancy payment and submitting a rebate claim. However, there is a requirement to submit evidence to support each redundancy payment forming the basis of each rebate claim.

Evidence to support the redundancy payment and rebate claim is consistent with other rebates available outside the income tax return filing system. Providing supporting evidence for rebates is an essential factor in maintaining the integrity of the tax system and the tax base.

Evidence to support the rebate claim must be written verification of any information the Commissioner requires, including:

- the amount of the redundancy payment for which a rebate is claimed;
- the name of the payer of the redundancy payment; and
- the date on which the redundancy payment was made.

The written verification which includes the above details must be in a document signed by the payer of the redundancy payment or other form satisfactory to the Commissioner.

In circumstances when being made redundant or receiving an employment termination payment is predictable or may be a natural consequence of particular positions or industries, these payments will not qualify for the rebate. Section KC 6(3) of the Income Tax Act 2004 (subpart ML of the Income Tax Act 2007) provides a list of redundancy payments for which a rebate is not allowed. A rebate is not allowed for a redundancy payment:

- relating to retirement from employment;
- relating to loss of seasonal employment if the loss arises from the normal seasonal work cycle;
- relating to a contract of employment for a fixed term or for the duration of a project;
- relating to employment for a period following notice of termination of employment;
- paid to a director of a company by a company or by a person associated with the company under section OD 8(3) of the Income Tax Act 2004 (section YB 20 of the Income Tax Act 2007);
- paid to a person by another person associated with the person under section OD 8(3) of the Income Tax Act 2004 (section YB 20 of the Income Tax Act 2007); or
- paid by a person to an employee who has been paid a redundancy payment by another person associated with the person under section OD 8(3) of the Income Tax Act 2004 (section YB 20 of the Income Tax Act 2007).

The rebate is not allowed for a redundancy payment paid, directly or indirectly, by a person who is "associated" or related to you. Payments that may not qualify for the rebate include redundancy payments paid directly or indirectly by:

- a company to its director, or to a shareholder-employee;
- an employer who is a close relative of the employee, or spouse, or civil union or de facto partner;
- a partnership to any of its partners; or
- a trustee to an employee who is also a beneficiary or a settlor of the trust.

Examples

Example 1: Jill receives a redundancy payment of $20,000. Her redundancy payment rebate claim will be $1,200 ($0.06 x $20,000).

Example 2: Simon receives a redundancy payment of $80,000. His redundancy payment rebate is capped at the maximum of $60,000 redundancy payment, giving a rebate of $3,600 ($0.06 x $60,000).

Example 3: Sue is made redundant and receives her redundancy compensation of $100,000 in two instalments – the first payment is $30,000, while the second payment is $70,000. Sue can only claim the maximum rebate of $3,600 as the total redundancy payments in relation to the redundancy are capped at $60,000. Note that it is the total amount of redundancy payments in relation to each redundancy that is relevant. Note also that Sue could claim the rebate for the first payment of $30,000 – a rebate of $1,800 ($0.06 x $30,000) – and then make a second claim for the remainder, up to the cap amount – another claim for $1,800 ($0.06 x $30,000).

Example 4: Josh is made redundant twice in a 12-month period by separate employers. For the first redundancy, he receives $70,000. For the second redundancy, he receives $5,000. Josh can claim the maximum $3,600 in relation to the first redundancy (the $60,000 cap applies). He can also claim $300 ($0.06 x $5,000) for the second redundancy – it is the redundancy event that is relevant for the redundancy payment cap

Application date

The new redundancy rebate will apply to all redundancy payments made on or after 1 December 2006.

TAX EXEMPTION FOR TOKELAU AND NIUE INTERNATIONAL TRUST FUNDS

Sections CB 4(1), CB 9 and OB 1 of the Income Tax Act 1994; sections CW 49C, CW 49D and OB 1 of the Income Tax Act 2004; sections CW 59B and YA 1 of the Income Tax Act 2007 and section 73(2) of the Estate and Gift Duties Act 1968

Amendments to the Income Tax Act 1994, the Income Tax Act 2004, Income Tax Act 2007 and the Estate and Gift Duties Act 1968 ensure that the contributions received, income earned and distributions made by the Tokelau and Niue International Trust Funds are exempt from taxation.

Background

The Tokelau and Niue International Trust Funds were established by the New Zealand Government in 2000 and 2004 respectively. Trust Deeds for the Trust Funds were subsequently executed, with the parties to the Trust Deeds agreeing to ensure that the Trust Funds be exempt from all direct taxation.

Existing tax provisions did not appear to provide the certainty needed to ensure that the income earned, distributions made or contributions received by the Tokelau and Niue International Trust Funds were exempt from tax.

The amendments therefore ensure that the contributions received, income earned and distributions made by the Tokelau and Niue International Trust Funds are exempt from taxation, and that the legislative amendments apply from the date the Tokelau and Niue International Trust Funds were established.

Key features

Sections CB 4(1) and CB 9 of the Income Tax Act 1994 have been amended and new sections CW 49C and CW 49D of the Income Tax Act 2004 and CW 59B of the Income Tax Act 2007 have been added to ensure that income earned by the Tokelau International Trust Fund or the Niue International Trust Fund is exempt from income tax, and distributions made from the Tokelau International Trust Fund or the Niue International Trust Fund are not subject to taxation.

Section 73(2) of the Estate and Gift Duties Act 1968 has been amended to ensure that any contributions made to the Tokelau International Trust Fund or the Niue International Trust Fund are not subject to gift duty.

Application dates

The amendments apply to the Tokelau and Niue International Trust Funds from the start of the tax year in which contributions were first made to the funds – namely, the 1999–2000 tax year for the Tokelau International Trust Fund and the 2003–2004 tax year for the Niue International Trust Fund.

CONFIRMATION OF ANNUAL INCOME TAX RATES FOR 2007–08

The Taxation (Annual Rates of Income Tax 2007–08) Act 2007 is one of three Acts to result from the passage of the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill, introduced in May 2007. The new Act received Royal assent on 19 December 2007.

Schedule 1, Income Tax Act 2004

The income tax rates that will apply for the 2007–08 tax year are as follows:

Policyholder income	33 cents for every $1 of schedular taxable income
Māori authorities	19.5 cents for every $1 of taxable income
Companies	33 cents for every $1 of taxable income
Trustee income (including that of trustees of superannuation funds)	33 cents for every $1 of taxable income
Trustees of group investment funds in respect of Category A income	33 cents for every $1 of schedular taxable income
Taxable distributions from non-qualifying trusts	45 cents for every $1 of taxable distribution
Other taxpayers (including individuals)	
– Income not more than $38,000	19.5 cents for every $1 of taxable income
– Income more than $38,000 but not more than $60,000	33 cents for every $1 of taxable income
– Income more than $60,000	39 cents for every $1 of taxable income
Specified Superannuation Contribution Withholding Tax	
Where the employer has made an election under section NE 2B and the amount of salary or wages given by section NE 2B is:	
– not more than $11,400	15 cents for every dollar of contribution
– more than $11,400 and not more than $45,600	15 cents for every dollar of contribution
– more than $45,600	33 cents for every dollar of contribution
Where no election under section NE 2A(2) or section NE 2B is made	33 cents for every $1 of contribution

ORGANISATIONS APPROVED FOR CHARITABLE DONEE STATUS

Section KC 5(1) of the Income Tax Act 2004 and Schedule 32 of the Income Tax Act 2007

The following organisations have been granted charitable donee status from the 2007–08 tax year.

- Hamlin Charitable Fistula Hospitals Trust;
- Hope Foundation Development Trust;
- Hope International Charitable Trust;
- Limbs 4 All Charitable Trust;
- New Zealand Disaster Assistance Response Team Trust;
- Operation Restore Hope Charitable Trust; and
- The World Swim for Malaria Foundation (New Zealand).

Donee status entitles donors to certain tax relief. For the 2007–08 tax year, the following limitations apply:

- Individual taxpayers will be entitled to a rebate of 33⅓ percent of the amount donated, to a maximum rebate for all donations of $630 per annum.
- A non-closely held company, or a closely held company which is listed on a recognised stock exchange, will be entitled to a deduction from its net income to a maximum of 5 percent of that income.
- A Māori authority may claim a maximum deduction of 5 percent of its net income donated to charitable organisations and/or a body that has been defined as a Māori association under the Māori Community Development Act 1962.

The amounts that may be claimed for the 2008–09 and future tax years is outlined under "Greater tax incentives for charitable donations".

ACCELERATED WRITE-DOWN RATES FOR SHUTTLE STALLIONS

Sections EC 41, EC 41(1)(b) and EC 41(1B) of the Income Tax Act 2004, and sections EC 41, EC 41(1)(b) and EC 41(1B) of the Income Tax Act 2007

Changes have been made to the write-down rules for bloodstock in relation to shuttle stallions.

Background

Shuttle stallions are stallions that are owned overseas but are brought to New Zealand for a breeding season. Previously, if shuttle stallions had been used for breeding in New Zealand and were subsequently bought by a New Zealand breeder, they had to be written down over five years, even though they were new to New Zealand ownership. This was not consistent with the treatment of stallions that had previously been used for breeding, but not in New Zealand. If such stallions were purchased by New Zealand studs, they could be written down over two years, or at a 75 percent reducing value.

Key features

Section EC 41 of the Income Tax Act 2004 and the Income Tax Act 2007 has been amended so that shuttle stallions are included in the list of types of bloodstock that can be written down as if they were new to breeding in New Zealand, despite having been used for breeding in New Zealand in the past. Accordingly, shuttle stallions qualify for the same write-down rates as other stallions that are new to New Zealand ownership.

Application date

The amendments apply to shuttle stallions purchased on or after 1 August 2007.

ACC – WITHHOLDING TAX ON PERSONAL SERVICE REHABILITATION PAYMENTS

Sections CE 12, CF 1, CW 28B, DF 4, LD 1B, LD 1C, OB 1 and OB 2 of the Income Tax Act 2004; sections CE 12, CF 1, CW 35, DF 4, LB 7, LB 8, RD 3, YA 1 and Part I of Schedule 4 of the Income Tax Act 2007; sections 33A and 33C of the Tax Administration Act 1994; Part F of the Schedule to the Income Tax (Withholding Payments) Regulations 1979

A withholding tax of 15 cents in the dollar will apply to payments made to a claimant by the Accident Compensation Corporation (or an employer that is an accredited employer under the Injury Prevention, Rehabilitation, and Compensation Act 2001) that are for personal rehabilitation.

Backround

Changes were enacted in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006 that provided for a withholding tax to be imposed on ACC attendant care payments. The withholding rate was to have been set by regulations. Details of these changes are set out on page 112 of *Tax Information Bulletin* Vol 18, No 5 (June 2006).

The Taxation (Business Taxation and Remedial Matters) Act 2007 repeals the changes in the 2006 Act and re-enacts them with some modifications, and delays the application date from 1 April 2008 to 1 July 2008.

Key features

Payments made by the Accident Compensation Corporation (or an employer that is an accredited employer under the Injury Prevention, Rehabilitation, and Compensation Act 2001) for attendant care, home help, child care, training for independence and escorted travel (collectively referred to as "personal service rehabilitation payment") are to be subject to a withholding tax of 15 cents in the dollar.

If the ACC recipient fully uses the after-tax payment received to purchase care, the total amount of the payment will be treated as exempt income to the recipient. The amount paid to the care provider, together with the amount of the withholding tax will be taxable to the care provider, with the tax credit available to the care provider to be offset against his or her tax liability.

Example

Mary was involved in a car accident that reduces her ability to care for herself. ACC assess her entitlement for attendant care at $500 a week. ACC deducts withholding tax of $75.00 from this and pays Mary a net amount of $425.00. Mary fully uses this to pay

Molly to come and assist her. Because Mary has fully used the amount she received, her payment is treated as exempt income. Molly's income for tax purposes is the amount received ($425) plus the amount of the withholding tax that was deducted ($75), making a total of $500. Molly is given credit for the tax deducted (the $75) to offset against her tax liability.

However, if the ACC recipient retains part of the payment, the payment is taxable income to the ACC recipient, with a deduction allowed for the pre-tax equivalent amount, and the tax credit is apportioned between the two.

Example

In the previous example, instead of using the full amount received to pay for a caregiver, Mary arranges for her sister, Sally, to assist her for $340 a week. Mary is taxable on the $500 payment less a deduction equal to the pre-tax equivalent of the amount she paid, which is $400, making her net taxable income $100. She receives the proportional amount of the total tax deduction of $75, which in this example is $15.00. Sally is taxable on the amount she received ($340), plus her proportion of the tax credit, which in this example is $60.00, making her total taxable income $400, with a tax credit of $60.

An ACC claimant whose only income is from personal service rehabilitation payments will not be required to file a tax return. The care provider will not be required to file a tax return if his or her total income for the tax year does not exceed $9,500.

Application date

The provisions apply from 1 July 2008.

TECHNICAL AMENDMENTS TO BRANCH EQUIVALENT TAX ACCOUNT RULES

Sections MF 5 and MF 10 of the Income Tax Act 1994; sections MF 5 and MF 10 of the Income Tax Act 2004; and sections OE 7 and OP 101 of the Income Tax Act 2007

The rules applying to branch equivalent tax accounts (BETAs) have been amended to clarify that for companies and consolidated groups, access to debits is limited to the amount necessary to offset the tax on their foreign income (before any New Zealand losses are taken into account).

Background

BETAs prevent companies being taxed twice on their foreign income. Generally, New Zealand companies are taxed on all foreign income as it is earned (the "accrual taxation" method). Accrual taxation can give rise to economic double taxation if dividend withholding payments (DWP) are also imposed when foreign profits are repatriated as dividends. BETAs provide relief from such double taxation by allowing companies, in effect, to offset tax paid on one stream of income against tax due on the other stream through a system of debits and credits.

The law allows debits in excess of the income tax liability on foreign income (after New Zealand losses have been allowed) to be converted into a loss which can be carried forward and set against future income. These changes make explicit the underlying assumption that debits can only be converted into a loss to the extent that this is necessary to offset income tax on attributed controlled foreign company (CFC) income in the absence of New Zealand losses. If companies could convert debits into losses regardless of the level of their attributed CFC income, they could use those losses to relieve other income that is properly taxable in New Zealand.

Key features

Sections OE 7(2) and (3) and sections OP 101(2) and (6) of the Income Tax Act 2007 provide that a company or a consolidated group may elect to use BETA debits to reduce their liability to tax on attributed CFC income. Sections MF 5(4) and (5) and section MF 10(3) and (4) of the Income Tax Act 2004 and the Income Tax Act 1994 make equivalent provision.

Section OE 7(3B) and section OP 101(2B) have now been added to the Income Tax Act 2007. Likewise, section MF 5(5B) and (5C) and section MF 10(4B) to (4D) have been added to the Income Tax Act 2004 and the Income Tax Act 1994. These new subsections now expressly provide that an election is invalid to the extent to which it, and related elections, would allow the company or consolidated group to access more BETA debits than is necessary to offset the tax on its foreign income before any New Zealand losses are taken into account.

Application date

The changes apply for the 1997–98 and later income years unless a return based on the unamended version of the law was made before 17 May 2007.

COMMISSIONER'S ACCEPTANCE OF A TAXPAYER'S NOTICE OF PROPOSED ADJUSTMENT

Section 89J of the Tax Administration Act 1994

An amendment has been made to the Tax Administration Act 1994 to clarify when the Commissioner of Inland Revenue can begin a new tax dispute. The change makes it clear that the Commissioner cannot issue a notice of proposed adjustment (NOPA) on the same issue after

accepting (or being treated as having accepted) a taxpayer NOPA except when the taxpayer, in relation to the adjustment:

- was fraudulent; or
- wilfully misled the Commissioner.

Background

A NOPA is the document that begins the disputes resolution process. The Commissioner may issue a NOPA to alter a return as filed or amend an existing assessment. A taxpayer can also issue a NOPA.

Taxpayer NOPAs play an important role in the disputes process. They disclose taxpayers' positions while allowing them to minimise their exposure to shortfall penalties. They also require the Commissioner to focus on an issue and explicitly decide on the correct position. This provides certainty for taxpayers.

Section 89H(2) states that if the Commissioner does not, within the two-month response period, reject an adjustment contained in a taxpayer NOPA, the Commissioner is considered to have accepted the proposed adjustment and section 89J applies.

Under section 89J, if the Commissioner accepts or is treated as having accepted the proposed adjustment/s in the taxpayer's NOPA, the Commissioner must include or take account of the adjustment/s in a notice of assessment issued to the taxpayer. This is intended to be the end of the disputes process for issues included in that NOPA.

While the intention behind the disputes procedures was for all parties to be bound by the time limits incorporated in the rules, the law was uncertain (and had been challenged in at least two recent cases) on whether the Commissioner could begin a new dispute on the same issue once a time limit has been exceeded.

Key features

The disputes procedures were introduced in the Tax Administration Act 1994 (Part IVA) from 1 October 1996. The disputes procedures involve various steps that are undertaken when the Commissioner and a taxpayer cannot agree on a matter. A key feature of the disputes rules is the timeframe allocated to parties to lodge notices and respond to notices received from the other party.

Underpinning the response time limits is a deemed acceptance rule that applies when a party fails to respond within the specified period. However, the law was uncertain about whether the Commissioner could issue a new NOPA to replace a taxpayer's NOPA when the Commissioner had accepted an earlier taxpayer NOPA in relation to the same issue or had failed to respond within the statutory time period.

A change has therefore been made to clarify that the Commissioner cannot generally issue a NOPA on the same matter after accepting (or being treated as having accepted) a taxpayer NOPA. This change ensures that the disputes procedures have their intended effect. Revenue concerns have been addressed by still allowing this timeframe to be overridden in cases where the taxpayer, in relation to the adjustment in question, wilfully misleads the Commissioner, or there is fraud.

Application date

The amendment applies from 19 December 2007.

GST AND EXPORTED GOODS

Section 11(1)(eb) of the Goods and Services Tax Act 1985

The Goods and Services Tax Act 1985 has been amended to allow, in limited circumstances, non-resident purchasers to receive in New Zealand zero-rated exported goods. The amendment is intended to apply to commercial exports to non-residents that are removed from New Zealand by the non-resident – for example, by carrying the exported goods on the non-resident's vessel.

Background

When the possession or delivery of goods occurs in New Zealand, GST generally applies at the rate of 12.5%. This is consistent with the objective that GST applies to goods that are consumed in New Zealand. If the goods are available for use in New Zealand for the purpose for which they are intended, consumption is considered to have occurred and GST applies. This outcome can be problematic, for example, if the exported goods are supplied on "free on board" terms and title to the goods passes to the non-resident – who is in New Zealand – when the goods are physically supplied. This can occur when goods are loaded over a ship's rail at the export port.

Under the general zero-rating provisions, goods supplied in such circumstances cannot be zero-rated as it is necessary for the New Zealand exporter to enter the goods for export under the Customs and Excise Act 1996 and export the goods.

To satisfy the requirements of the GST Act, exporters have in the past used arrangements that treat the non-resident purchaser as the exporter's agent. The amendment removes the necessity for such arrangements in situations where the non-resident purchaser takes title to goods for the purposes of removing them from New Zealand.

The amendment was added to the bill in response to a submission to the Finance and Expenditure Committee concerning the supply of oil extracted from New Zealand's natural field reserves to non-residents who take delivery of the product using their own oil tankers.

Key features

New section 11(1)(eb) allows non-residents to take delivery of zero-rated goods in New Zealand, subject to

the application of the 28-day rule in section 11(4) of the GST Act, if the following cumulative conditions are met:

- the goods have been entered for export by the supplier under the Customs and Excise Act 1996 (or will be entered for export as a condition of the supply);
- the goods are exported by the recipient;
- the recipient does not intend to reimport the goods into New Zealand (this intention must be documented);
- the goods are not used or altered by the recipient, except to the extent necessary to prepare the goods for export;
- the goods leave New Zealand under an arrangement agreed by the supplier and the recipient at or before the time of supply; and
- the goods do not leave New Zealand in the possession of a passenger or crew member of an aircraft or ship.

Consequential changes have also been made to sections 11(4) and 11A(1)(m) of the GST Act.

The amendments do not affect the current GST rules as they apply to personal or duty-free items acquired by non-resident tourists while in New Zealand.

Application date

The change applies from 17 May 2007, the date the bill was introduced.

GST AND CONSUMABLE STORES SUPPLIED TO DEPARTING AIRCRAFT AND COMMERCIAL SHIPS

Section 11(1)(l) of the Goods and Services Tax Act 1985

Changes have been made to clarify the circumstances when the supply of consumable stores to departing aircraft and commercial ships may be zero-rated.

Background

Section 11(1)(l) of the Goods and Services Tax Act 1985 governs when the supply of consumable stores may be zero-rated. The changes to section 11(1)(l) clarify when consumable stores provided to aircraft and commercial ships are considered to be exported from New Zealand and treated as zero-rated supplies.

The term "consumable stores" is defined in section 11(9) and includes goods such as fuel and lubricants and other goods that are available to be consumed by passengers or crew on board an aircraft or ship. "Consumable stores" does not include spare parts.

The changes are intended to zero-rate supplies of consumable stores in the following circumstances:

- consumable stores provided to aircraft or commercial ships that are in transit in New Zealand as part of an international flight or voyage – for example, an aircraft or ship that travels from Christchurch to Auckland en-route to Singapore; and
- consumable stores provided to commercial ships that do not necessarily travel to countries outside New Zealand but carry consumable stores to other commercial ships that are leaving New Zealand or fishing ships operating outside New Zealand fisheries waters. For example, motherships used to support fishing fleets operating outside New Zealand fisheries waters.

The changes also deal with the situation when consumable stores are contractually supplied to a non-resident broker but the goods are physically delivered directly to the operator of the aircraft or commercial ship that is departing New Zealand. The changes ensure that the contract for the supply of consumable stores with the non-resident broker does not preclude the supply from being zero-rated.

Key features

The application of section 11(1)(l) has been amended by removing the requirement that the consumable stores must be for use outside New Zealand. Instead, the section requires that the consumable stores are intended for use on an aircraft or commercial ship that is going to a destination outside New Zealand.

In addition, new section 11(1)(l)(iib) allows the supply of consumable stores to ships, other than pleasure craft, which are in turn used to provide consumable stores to "foreign-going ships" or "fishing ships" to be zero-rated.

Consequential changes have also been made to the definitions of "consumable stores" and "foreign-going ship" in section 11(9).

Application date

The changes apply to consumable stores supplied on and after 24 October 2001, the date that section 11(1)(l) was last substantially amended.

GST – SHARED TAX INVOICES

Sections 2(1) and 24BA of the Goods and Services Act 1985

Changes have been made to the Goods and Services Tax Act 1985 to allow, in certain circumstances, two or more suppliers to invoice a customer using one tax invoice.

The change is intended to simplify the way in which suppliers are required to invoice customers for bundled supplies of goods and services for GST purposes.

Background

A tax invoice is a document that contains the required details set out in the GST Act. These requirements generally include the name and address of the supplier and their GST registration number in addition to a description of the goods and services sold, the name and address of the recipient and the date the invoice is issued.

A situation may arise where two GST-registered persons, Supplier A and Supplier B, provide goods and services to the same customer, although Supplier B is the only supplier with whom the customer has actual communication. Before the amendment, the GST Act did not clearly contemplate a single invoice for these types of transactions.

To simplify the invoice issuing requirements, amendments have been made to the GST Act to allow members of the same GST group or parties to arrangements created by statute to use "shared" tax invoices.

Key features

The GST Act has been amended by inserting new section 24BA to allow a single shared tax invoice to be issued by one principal supplier on his or her own behalf and on behalf of other GST-registered suppliers.

Section 24BA specifies that shared invoices can be issued in two situations:

- when suppliers have statutory obligations which make it practical to use a single invoice (for example, a levy imposed by statute); or
- when suppliers are part of the same GST group of companies.

Section 24BA also specifies what information should be contained on a shared tax invoice for it to be considered a valid tax invoice. This information is similar to the current requirements of a standard tax invoice.

Section 2, the definition section of the GST Act, has also been amended to include the new section 24BA in the definition of "tax invoice".

Application date

The amendments apply from 19 December 2007.

INFORMATION SHARING BETWEEN INLAND REVENUE AND CUSTOMS

Subsection 81(4)(fc) of the Tax Administration Act 1994, sections 280J, 280K and 280L of the Customs and Excise Act 1996, subsection 103(1C) and Schedule 3 of the Privacy Act 1993

Rules have been introduced to allow information sharing between Inland Revenue and the New Zealand Customs Service. The purpose of information sharing is to allow Inland Revenue to identify when certain persons with outstanding child support debt (liable persons) are entering or leaving New Zealand.

Background

At present, outside of its reciprocal agreement with Australia, New Zealand has limited authority to enforce payment from liable persons who are overseas. This highlights the importance of Inland Revenue having the ability to contact liable persons when they are in New Zealand to make arrangements for the payment of their outstanding child support liability.

Expedient recovery action is often required while a liable person, who may be living overseas, is still in New Zealand. Inland Revenue currently has the ability to obtain an arrest warrant to detain liable persons who attempt to leave New Zealand to avoid child support liabilities. However, this power is restrained by being reliant on third parties advising Inland Revenue when a liable person has arrived in, or is about to leave, New Zealand. In addition, Inland Revenue often does not have New Zealand contact information for liable persons living overseas.

Changes have been made to help Inland Revenue identify when liable persons enter and leave New Zealand. If a liable person is known to be in New Zealand, more effective steps can be taken to recover outstanding child support before that person subsequently attempts to leave the country.

Key features

The new rules allow for an information match of child support information between Inland Revenue and Customs.

Inland Revenue will provide Customs with the names and other identifying information of liable persons. An information match will occur by Customs comparing this information against arrival and departure information it holds for the same persons. If Customs has arrival or departure information relating to any liable person, it will supply Inland Revenue the information relating to that person.

This information will give Inland Revenue the opportunity to take the administrative and legal steps necessary to recover outstanding debt from liable persons when they are located in New Zealand and, if necessary, take steps to prevent liable persons from subsequently leaving New Zealand to avoid meeting their child support obligations.

The Commissioner of Inland Revenue and the Chief Executive of Customs will enter into an agreement to determine the frequency, form and method for the exchange of information.

Application date

The changes will apply from a date to be fixed by the Governor-General by Order in Council or 1 April 2009, whichever is earlier.

TAX EXEMPTION FOR HOSPITALS OPERATING AS CHARITIES

Sections CB 3(b)(ii)(A) and CB 4(3) of the Income Tax Act 1994; sections CW 32(4)(c)(i), CW 34(3) and CW 35(2) of the Income Tax Act 2004, and sections CW 39(4)(c)(i), CW 41(4) and CW 42(2) of the Income Tax Act 2007

The amendments re-instate an income tax exemption for hospitals operated as charities by council-controlled organisations (CCOs). Activities of CCOs generally do not qualify for the charitable tax exemption.

Background

Generally, activities that are beneficial to the community would qualify for the charitable tax exemption, but the policy intention is that commercial activities of councils should not. As a result, income derived by CCOs is specifically excluded from the charitable exemption.

However, District Health Boards are exempt from income tax because there is no reason why income derived by a hospital operated as a CCO should be denied the charitable tax exemption.

Key features

Income derived by hospitals that are operated as charities by CCOs now qualify for the charitable tax exemption. Consistent with the tax treatment of other charities, the hospitals must register under the Charities Act 2005.

Application date

The amendments are effective from 1 April 2001.

TAXATION REVIEW AUTHORITY – COSTS AND FEES

Sections 22B and 30(2)(e) of the Taxation Review Authorities Act 1994

Changes have been made to the Taxation Review Authorities Act 1994 to allow the Taxation Review Authority to make an award of costs for filing fees and to empower the government to make regulations in relation to the ability of the Authority to provide a fee waiver.

Background

In 2001, the Working Party on Civil Court Fees set up by the Minister for Courts initiated a review to determine an appropriate level of fees for general civil courts.

In 2004, following the review, the then government decided in relation to the Taxation Review Authority to:

- allow the Authority to award costs for fees; and
- enable the Authority to waive filing fees in appropriate circumstances.

Two amendments have implemented these decisions.

Key features

New section 22B allows the Authority to order the Commissioner to pay to an objector or a disputant an amount of costs. The amount of costs will be limited to the amount of the filing fee paid by the objector or the disputant.

New section 30(2)(d) empowers the government to make regulations for the purpose of allowing the Authority to refund, remit or waive any fee in whole or in part.

Application dates

Section 22B of the Taxation Review Authorities Act will apply from 1 April 2008.

Section 30(2)(d) of the Taxation Review Authorities Act applies from 19 December 2007.

RETIREMENT SCHEME CONTRIBUTION TAX

Sections BE 1, CX 42B, KD 1(1), LB 3, LD 4, LD 12, NEB 1 to 7, NF 1(2), NG 16B and OB 1 of the Income Tax Act 2004; sections BE 1(5B), CX 50B, LB 6, LE 7B, LO 2B, MB 1(5B), MB 6, RA 1, RA 6B, RA 10, RA 15, RA 24, RD 1, RE 2, RF 16, RH 1 to 6, YA 1, and Schedule 1, Part D, clause 7 of the Income Tax Act 2007, and sections 28C, 29 (1), 31(1), 47B and 48B of the Tax Administration Act 1994

The Taxation (Business Taxation and Remedial Matters) Act 2007 amends the Income Tax Act 2004, the Income Tax Act 2007 and the Tax Administration Act 1994 to enact a new tax structure for taxing certain contributions to a retirement savings scheme. The new rules allow retirement scheme contributions that would be taxable in the hands of the person who benefits from the contribution to be subject to a final withholding tax instead. The effect of these rules is that this income is treated as excluded income and therefore not taken into account for student loan, child support and Working for Families tax credit purposes. The withholding tax

imposed on the contribution is based, generally, on the contributor's tax rate in either of two previous income years before the contribution is made.

Background

Te Rūnunga o Ngāi Tahu (TRoNT) asked the government to consider new rules for taxing contributions to a retirement saving scheme. TRoNT was setting up a retirement savings scheme for its members, and was planning to make contributions to the scheme on behalf of its members. Members' funds, including contributions made by TRoNT, would be locked-in until retirement. However, early withdrawals would be permitted in certain circumstances, such as to assist with the purchase of a first home.

Under current law, any contribution that TRoNT made to the scheme on behalf of members would be taxable in the hands of the member and subject to income tax, with that income being taken into account for social assistance purposes. TRoNT proposed that these contributions should be subject to a final withholding tax rather than income tax so members would not have to include this income in their tax returns, given this income was locked into a retirement saving scheme. TRoNT also proposed that the contributions should not be taken into account for social assistance purposes, because contributions would be locked in and unavailable for day-to-day living expenses. This treatment is consistent with the treatment of employer superannuation contributions, fringe benefits and portfolio investment entity (PIE) income.

Although the impetus for developing these rules came from TRoNT, the rules apply to companies (but not close companies), widely held unit trusts and Māori authorities.

Key features

Income tax amendments

New subpart RH of the 2007 Act and subpart NEB of the 2004 Act enact the Retirement Scheme Contribution Tax rules (RSCT rules). The RSCT rules are an elective regime that allows a retirement scheme contribution such as a taxable Māori authority distribution or a dividend made by a retirement scheme contributor to a retirement savings scheme to be subject to retirement scheme contribution tax. Section BE 1 of both Acts has been amended to treat RSCT as a withholding liability. If the retirement scheme contributor does not apply the RSCT rules, the contribution will be subject to existing tax rules and taxable in the hands of the member or shareholder of the retirement scheme contributor.

A retirement scheme contribution is defined in section RH 2 of the 2007 Act (section OB 1 of the 2004 Act) as a contribution in money made by a retirement scheme contributor to a retirement savings scheme for the benefit of a person who is a member of, or has an ownership interest in, the contributor. For example, a taxable Māori authority distribution made by a Māori authority to a retirement savings scheme on behalf of its members would be subject to the RSCT rules if the contributor applied the RSCT rules. The amount of the contribution includes any imputation credit or Māori authority credit attached to the distribution.

For an entity to be a retirement scheme contributor for a person in an income year, section RH 4 of the 2007 Act (section NEB 6 of the 2004 Act) provides that the entity must be:

- a widely held unit trust;
- a company other than a close company; or
- a Māori authority.

The person must be a unit holder, shareholder or member of the entity during or before the year that the entity makes a retirement scheme contribution. (For the purposes of this *TIB* item, the term "member" is used when referring to this person.) This is the person who benefits from the contribution.

New section RH 3 of the 2007 Act (section NEB 5 of the 2004 Act) specifies that for an entity to be a retirement savings scheme for the purposes of the RSCT rules, the entity must be:

- a portfolio investment entity;
- hold the funds from a retirement scheme contribution for the member; and
- the distribution rules governing the distributions of funds by the scheme are approved by the Commissioner as fair and reasonable and meet the rules relating to distributions which are set out in section RH 3 of the 2007 Act (section NEB 5 of the 2004 Act). In general, the funds cannot be distributed before the person reaches the age of retirement as set out in the rules. However, early withdrawals are permitted in certain circumstances, such as to assist with the purchase of the first home, assist with tertiary study or repay a student loan, and withdrawals allowed for by the KiwiSaver rules (for example, significant financial hardship).

The retirement scheme contributor is required to withhold the tax from the contribution at the time the payment is made at the RSCT rate for the member (the retirement scheme prescribed rate). RSCT is payable by the 20th of the month following the month in which the contribution was made and deducted. The retirement savings scheme, if appointed by the retirement scheme contributor, can act as the contributor's agent in relation to the calculation and payment of the tax.

The RSCT rate is set out in Schedule 1, Part D, clause 7 of the 2007 Tax Act and in the definition of "retirement scheme prescribed rate" in the 2007 and 2004 Acts. Table 1 sets out the amount of tax payable.

Table 1

Criteria for determining rate	*Retirement scheme prescribed rate*
If none of the following situations apply.	39%
If none of the following situations apply and the member has, in either of the two income years preceding the year in which the contribution is made, taxable income of $60,000 or less and has provided his or her tax file number.	33%
If the situation below does not apply, and (i) the member has, in either of the two income years preceding the year in which the contribution is made, taxable \income of $38,000 or less and provided his or her tax file number; (ii) the member is a non-resident and the retirement scheme contributor is a Māori authority and the amount of the distribution is $200 or less; (iii) the member is a non-resident and the retirement scheme contributor is a Māori authority and has provided a tax file number.	19.5%
If the member is a non-resident at the time of the contribution and the contribution is a non-resident's withholding income.	0% (in this case the contribution is subject to non- resident withholding tax)

Sections LE 7B and LO 2B of the 2007 Act (sections LB 3 and LD 4 of the 2004 Act) allow imputation credits and Māori authority credits to be used to meet the RSCT liability of the retirement scheme contributor. If the amount of the credit exceeds the RSCT liability, the amount of that excess credit can be claimed by the member as if it were a credit attached to a distribution made to the member. The retirement scheme contributor must give notice, within 30 days of the contribution, of the amount of the excess.

Section CX 42B of the 2004 Act and section CX 50 of the 2007 Act treats retirement scheme contributions that are subject to the RSCT rules as excluded income. This provision applies to the member (that is the person for whose benefit the contribution is made) and the retirement savings scheme. However, a retirement scheme contribution is not treated as excluded income in the following situations:

- if the member provides the retirement scheme contributor or the retirement savings scheme with a tax rate that is less than the member's rate;
- the member includes the retirement scheme contribution in a return of income for the year in which the contribution is made; or
- the member is a non-resident and the contribution is non-resident passive income (non-resident withholding income).

If the retirement scheme contribution is not treated as excluded income, section LB 6 of the 2007 Act (section LD 12 of the 2004 Act) allows a credit for the amount of the RSCT withheld. In the case of the non-resident, the amount of the credit is the excess amount of the RSCT withheld over the non-resident withholding tax paid in relation to the contribution.

Section RE 2 of the 2007 Act (section NF 1 of the 2004 Act) which deals with resident passive income (resident withholding income) has been amended to provide that:

- a taxable Māori authority distribution that is subject to the RSCT is not treated as resident passive income; and
- a dividend that is treated as excluded income by virtue of being subject to RSCT is not resident passive income.

New section RF 16 of the 2007 Act (section NG 16B of the 2004 Act) provides that when RSCT is paid in respect of a member who is non-resident and the contribution is subject to the non-resident withholding tax rules, the contributor is treated as having withheld an amount of non-resident withholding tax equal to the lesser of the amount of the RSCT paid or the non-resident withholding tax payable. If excess RSCT is paid, section LB 6 of the 2007 Act (section LD 12 of the 2004 Act) allows a credit for the excess.

Consequential amendments have been made to subpart RA of the 2007 Act to incorporate the RSCT rules into the general withholding and payment obligations.

The Working for Families tax credits rules in section MB 1 of the 2007 Act (section KD 1 of the 2004 Act) have been amended to ensure that retirement scheme contributions that are not treated as excluded income are not included in the assessable income for the purposes of the tax credit rules. In addition, a new section MB 6 of the 2007 Act (section KD 1(1)(hh) of the 2004 Act) allows, in limited circumstances, a distribution of a retirement scheme contribution from a retirement savings scheme to be included in a person's assessable income for calculating the person's entitlement to these tax credits.

Sections RA 2 and RA 24 of the 2007 Act (section NEB 7 of the 2004 Act) and the definition of the RSCT rules provide that:

- the provisions of the 2007 Act, 2004 Act and the Tax Administration Act 1994 apply to a person who is liable for RSCT as if RSCT were income tax imposed under section BB 1;
- sections 170(2), 171 and 172 of the Tax Administration Act (recovery of unpaid resident withholding tax) apply; and
- Part 9 of the Tax Administration Act (penalties) applies.

Tax administration amendments

The RSCT rules have amended a number of provisions in the Tax Administration 1994. In particular:

- section 22 (keeping of records) has been amended to require a retirement scheme contributor to keep records of every contribution and the value of those contributions, including the details of the recipient of the contribution;
- section 29 (shareholder dividend statement to be provided by company) has been amended to require RSCT information to be shown on the dividend statement as appropriate; and
- section 33 (Māori authority to give notice of amounts distributed) has been amended to require RSCT information to be shown on notices as appropriate.

New section 28C requires that a person who gives notice that their tax rate is less than 39% for the purposes of calculating the RSCT on contributions, must provide their tax file number in the notice.

New section 47B requires a retirement scheme contributor or a retirement savings scheme to provide a statement to the Commissioner showing the amount of the RSCT and any other information required. The statement must be provided no later than the 20th of the month after the month in which the RSCT was withheld. A statement is only required if the RSCT to be withheld is not satisfied by imputation credits or Māori authority credits attached to the retirement scheme contribution.

Section 48B requires a reconciliation statement to be filed each year if a retirement scheme contributor makes a contribution. The reconciliation statement must be received by Inland Revenue by the end of the second month after the end of the income year.

Application dates

The amendments to give effect to the RSCT rules in the 2004 Act and the Tax Administration Act 1994 come into force on 1 April 2007. The amendments in the 2007 Act come into force on 1 April 2008, except for section 554(3) (which inserts the basic rates of RSCT into Schedule 1, Part D), which comes into force on 1 July 2008. The delay in this section coming into force is a drafting error as it was never intended this provision be delayed. Inland Revenue considers that section ZA 3(1) of the Income Tax Act 2007 applies to allow the provisions in the 2007 Act to be interpreted as a reference to the Income Tax Act 2004 to the extent necessary to reflect sensibly the intent of the legislation. It is not the intent of the legislation that no withholding rates apply during the period 1 April 2008 to 30 June 2008. This is on the basis that the references in sections RH 5 and RH 6 to Schedule 1, Part D, clause 7 of the 2007 Act are references to the corresponding provision in the 2004 Act, which is the definition of "retirement scheme withholding rate". This ensures that the withholding rates apply to any contributions made during the period 1 April 2008 to 30 June 2008.

REMEDIAL AMENDMENTS

TECHNICAL AMENDMENTS TO THE OFFSHORE PORTFOLIO SHARE INVESTMENT RULES

Sections CD 26, CQ 5, DN 6, EX 33, EX 33B, EX 33C, EX 33D, EX 40, EX 40B, EX 41, EX 44, EX 44B to EX 44E, EX 45B, EX 47, EX 50, EX 51, EX 54B, EX 56 and OB 1 of the Income Tax Act 2004; section CG 15 of the Income Tax Act 1994; section 91AAO of the Tax Administration Act 1994; sections EX 31, EX 32, EX 36, EX 37, EX 37B, EX 38, EX 39, EX 46, EX 51, EX 52, EX 53, EX 56, EX 59, EX 62, EX 63, EX 67, EX 68, EZ 32 and YA 1 of the Income Tax Act 2007

A number of remedial amendments have been made to the new tax rules for offshore portfolio investment in shares. These amendments ensure that the new rules achieve their intended policy effect.

Background

New tax rules for offshore portfolio investment in shares were enacted by the Taxation (Savings, Investment, and Miscellaneous Provisions) Act 2006. The new rules apply for income years beginning on or after 1 April 2007.

The new rules generally apply to an investment by a New Zealand resident in a foreign company when the investor owns less than 10 percent of the company. Under the new rules, offshore portfolio investment in shares is taxed consistently, regardless of the country where the investment is located and whether the investment is made by an individual directly or through a collective investment vehicle.

The new tax rules for offshore portfolio investment in shares mainly involve changes to the foreign investment fund rules. The main changes are that the "grey list" exemption in the foreign investment fund rules has been removed and a new fair dividend rate method – which broadly taxes 5 percent of a person's offshore share portfolios' opening value each year – has been introduced.

A number of technical problems have been identified with the new rules. These problems have been addressed by remedial amendments which are consistent with the policy intent of the new rules.

Application dates

The amendments contained in the Income Tax Act 2004 are effective from 1 April 2007. The equivalent amendments to the Income Tax Act 2007 are effective from 1 April 2008. One amendment (section EX 46(10)(c)), concerning restrictions on the use of the fair dividend rate method, is only being included in the Income Tax Act 2007, effective from 1 April 2008. The relevant amendments to the Tax Administration Act 1994 are effective from 1 April 2007.

Detailed analysis

$50,000 minimum threshold for application of foreign investment fund rules

Amendments have been made to the $50,000 minimum threshold rules in sections CQ 5 and DN 6 of the Income Tax Act 2004 and the Income Tax Act 2007 to ensure that the deemed disposition and reacquisition that occurs when there is a change in application of foreign investment fund exemptions, changes between the comparative value method and fair dividend rate method, and entry into the foreign investment fund rules is ignored for the purposes of the $50,000 minimum threshold rules. The $50,000 exemption in section CG 15 of the Income Tax Act 1994 has been similarly amended for changes in application of foreign investment fund exemptions. These amendments ensure that the original cost basis applies for the relevant shares.

Australian-resident listed company exemption

Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange (ASX), such as the All Ordinaries index, are exempt from the foreign investment fund rules. To assist compliance with this exemption in section EX 33C of the Income Tax Act 2004 and section EX 31 of the Income Tax Act 2007, the previous requirement that the Australian-resident company must be included in an approved ASX index at all times during the income year has been replaced generally by a requirement that the company's shares must be included in an approved ASX index at the beginning of the income year. The amendment ensures that the exemption will apply for an income year if a company's shares are listed on an approved ASX index at the beginning of the year but are omitted from the index during the year.

In the situation where a person acquires shares in an Australian-resident listed company during the income year and did not previously hold any shares in that company in that year, the relevant time for testing whether the company's shares were listed on an approved ASX index is on the day of that acquisition. This different testing time has been provided because the investor would probably have based their decision on the status of the company on the date they acquired shares in it and they should not be expected to ascertain the listing status of the company at the beginning of their income year when they did not hold any shares in the company.

The other requirements in the Australian-resident listed company exemption, such as the requirement that the company be resident in Australia, have been amended so that they only need to be satisfied at all times in the income year when the New Zealand investor holds a right in the company rather than necessarily at all times in the income year.

A further amendment to the exemption for shares in Australian-resident listed companies provides that the exemption does not apply to stapled securities. This means that a share in an Australian-resident listed company which would otherwise qualify for the exemption does not qualify if it is stapled to another security. Stapled securities are two or more securities that are contractually bound together so they can only be sold together and not separately. The effect of this amendment is that the foreign investment fund rules (and most likely the fair dividend rate method) apply to investments in Australian stapled securities.

Australian unit trusts exemption

Section EX 33D of the Income Tax Act 2004 and section EX 32 of the Income Tax Act 2007 provide that investments in certain types of Australian unit trusts are exempt from the foreign investment fund rules. The minimum investment turnover requirements in these provisions have been amended to provide that they apply only to shares held by the unit trust and not to all assets as previously provided. A clarifying amendment also ensures that the turnover requirement relates to the unit trust's accounting year which ends in the investor's income year.

The RWT proxy requirement has been amended so that it must be satisfied when the Australian unit trust makes a distribution to investors.

The exemption has also been expanded to include investments in Australian unit trusts that distribute at least 70 percent of their income and use an RWT proxy. This minimum distribution requirement addresses the policy concern that these investment vehicles could be used to defer New Zealand tax.

Venture capital exemption

The exemption in section EX 33(3) and (4) of the Income Tax Act 2004 and sections EX 36 and EX 37 of the Income Tax Act 2007 for certain venture capital investments has been expanded and clarified.

One of the criteria that must be satisfied for the venture capital exemption is that the relevant grey list company has a fixed establishment in New Zealand, or owns a company in New Zealand, that conducts a minimum level of activity. Previously, this minimum level of activity in New Zealand included only incurring expenditure (other than interest) of at least $1 million or engaging 10 or more full-time employees or contractors. This minimum level of activity has now been expanded to include the situation where the relevant company through its fixed establishment in New Zealand incurs at least 25 percent of its expenditure or has at least 25 percent of its employees in New Zealand. This change is designed to benefit smaller venture capital start-ups.

One of the criteria that previously had to be satisfied for the venture capital exemption was that the relevant company has to be resident in New Zealand for a minimum of 12 months. This criterion has been changed to require the relevant company to carry on a business in New Zealand for a minimum of 12 months. This change should accommodate situations where venture capital start-ups have been operating for 12 months or more, but have not been incorporated for that long or were restructured shortly before the company migrated to a grey list country or became owned by a grey list company.

The venture capital exemption has also been amended to ensure that the exemption continues to apply if an original investor acquires more shares after the relevant company is listed.

The reference to a grey list company directly or indirectly owning a New Zealand-resident company has been clarified to refer to the grey list company holding more than 50 percent of the voting interests in the New Zealand-resident company.

A separate venture capital exemption has been enacted for persons who co-invest with New Zealand Venture Investment Fund Limited under a venture investment agreement. A "venture investment agreement" is defined in section CW 11C(6) of the Income Tax Act 2004 and section CW 13(6) of the Income Tax Act 2007 and ensures that a substantial level of activity in New Zealand is maintained.

Finally, a clarifying amendment has been made to ensure that the references to $1 million of expenditure include expenditure over $1 million.

Employee share purchase scheme exemption

The exemption for certain employee share purchase schemes in section EX 33(5) of the Income Tax Act 2004 and section EX 38 of the Income Tax Act 2007 has been amended to remove the requirement that the relevant share purchase agreement must include a restriction on disposal of the shares that affects the value under section CE 3 of the benefit to the person under the agreement. The relevant criterion now requires only that the share purchase agreement includes a restriction on the disposal of the relevant shares.

Restrictions on using the fair dividend rate method

It is the policy intent that the fair dividend rate method for calculating foreign investment fund income cannot be used for investments that are akin to New Zealand dollar denominated debt investments. Several amendments have been made to sections EX 40 of the Income Tax Act 2004, section EX 46 of the Income Tax Act 2007 and section 91AAO of the Tax Administration Act 1994 to better effect this policy intent.

A more effective test for excluding certain types of investments from the fair dividend rate method has been inserted as new section EX 46(10)(c) of the Income Tax Act 2007. This test is effective from 1 April 2008 and provides that the fair dividend rate method cannot be used for an interest in a non-resident entity holding directly or indirectly assets of which 80 percent or more by value consist of financial arrangements providing funds to a person or fixed rate shares. These financial arrangements or fixed rate shares must be denominated in New Zealand dollars or if they are denominated in foreign currency they must be hedged back to New Zealand currency with that hedging at least 80 percent effective. Whether such hedging arrangements are at least 80 percent effective is determined under New Zealand Equivalent to International Accounting Standard 39.

The Commissioner's power to make a determination under section 91AAO of the Tax Administration Act 1994 has been widened to allow the Commissioner to determine that the fair dividend rate method may be used for an investment even though the specific requirements of the legislation may not otherwise allow it to be used. This is designed to allow the fair dividend rate method to be used for investments which are not, in substance, debt in nature.

The criteria in section 91AAO(2) of the Tax Administration Act 1994 for when the Commissioner may make a determination that the fair dividend rate method may or may not be used for a type of investment, have been amended to better reflect the factors that should be taken into account when a determination is made. The criteria that the Commissioner may take into account include:

- the principle that the fair dividend rate method should not be used for an investment that is economically equivalent to New Zealand denominated debt, taking into account the whole arrangement, including any interposed entities or financial arrangements;
- the extent to which the assets of a foreign entity are loans, fixed rate shares or arrangements with a fixed economic return;
- the extent to which the assets of a foreign entity are denominated in New Zealand dollars or are hedged to achieve the effect of New Zealand dollars; and
- compliance costs.

These criteria are inclusive only and therefore do not restrict the flexibility of the determination-making process to deal with cases close to the boundary.

The amendments effectively widen the Commissioner's power to determine when the fair dividend rate method can or cannot be used for a certain type of investment. For example, if the Commissioner considers that the compliance cost of applying the fair dividend rate method to an investment would be higher than is appropriate and that not applying the method would not pose a revenue risk, the Commissioner can make a determination that the fair dividend rate method may not be used for that investment.

The application date provisions for fair dividend rate method determinations have also been amended. Determinations may be made for the income years specified by the Commissioner in the determination. However, a determination does not apply for a person and an income year beginning before the date of the determination unless the person chooses that the determination apply for the income year. This election would typically be evidenced by the investor completing their income tax return for the relevant year in accordance with the determination.

The Commissioner's general policy for specifying the income years for which a determination applies is that a determination would normally apply to income years starting after the date of the determination. However, the Commissioner may also specify the income year in which the determination is made if this would be consistent with the general policy of the fair dividend rate method (that the method should not be used for investments akin to a New Zealand dollar denominated debt investment) and would reduce compliance costs.

Another amendment to the Commissioner's determination-making power provides that the Commissioner must notify the making of a determination in the *Gazette* within 30 days of the date of determination. The determination itself will be published in the *Tax Information Bulletin* as soon as possible. A copy will also be available on the Inland Revenue Department's website.

Fair dividend rate method amendments

Several amendments have been made to the fair dividend rate method provisions in sections EX 44B to EX 44E of the Income Tax Act 2004 and sections EX 52 and EX 53 of the Income Tax Act 2007.

An amendment allows any person to choose to use the fair dividend rate method in section EX 44D of the Income Tax Act 2004 and section EX 53 of the Income Tax Act 2007 if they determine the market value of their foreign shares on a daily basis.

For the purposes of applying the fair dividend rate method, an original share in a foreign company that is subject to a returning share transfer is treated as being held by the share supplier and not the share user. Therefore, it is the share supplier rather than the share user that is subject to the fair dividend rate method in respect of an original share which is acquired under a returning share transfer. Although the share supplier is treated as holding the original share for the purposes of the fair dividend rate method, the share user will still derive a dividend paid on the original share (with any replacement payment for the dividend being deductible to the share user and taxable to the share supplier).

A clarifying amendment confirms that the average cost basis is used for both the peak holding adjustment and quick sale gains components of the quick sale adjustment in the fair dividend rate method.

The deemed sale and reacquisitions that occur under sections EX 51(5) or EX 54B of the Income Tax Act 2004 and sections EX 63(5) or EX 67 of the Income Tax Act 2007 are ignored for the purposes of the quick sale adjustment in the fair dividend rate method.

Cost method

Several amendments have been made to the cost method in section EX 45B of the Income Tax Act 2004 and section EX 56 of the Income Tax Act 2007.

An investor with publicly available audited accounts may choose to use as its opening value under the cost method the net asset value of its shares in foreign companies if the foreign company also has publicly available audited accounts.

Another amendment allows investors to use their actual cost for their opening value under the cost method, instead of obtaining an independent valuation, for interests acquired in the 2005–06 or 2006–07 income year. This amendment is designed to reduce compliance costs for persons using the cost method for the 2007–08 income year instead of requiring such persons to obtain an independent valuation.

The definition of "opening value" in the cost method has also been amended to require an independent valuation on entry into the cost method when a person has an attributing interest for which no foreign investment fund or loss arose because the interest was previously covered by the $50,000 minimum threshold. This amendment is necessary because it would not be appropriate to allow what could be a very old historical cost to be used as the opening value.

It has also been clarified which of the paragraphs in the definition of "opening value" has priority in a particular case.

Average cost definition in fair dividend rate and cost methods

The definitions of "average cost" in the fair dividend rate and cost methods have been amended to refer to expenditure incurred in acquiring or increasing the attributing interest during the relevant period instead of referring to expenditure incurred in a particular period. This amendment is designed to cater for deferred purchase situations.

Currency conversion rules

The foreign currency conversion provisions in sections EX 44C and EX 44D of the Income Tax Act 2004 have been amended to include references to amounts derived. The currency conversion provision in section EX 57 of the Income Tax Act 2007 already caters for this situation and therefore does not need to be amended.

Imputation credit under the trans-Tasman imputation rules

Section LB 2 of the Income Tax Act 2004 and section LE 1 of the Income Tax Act 2007 have been amended to ensure that an investor is entitled to an imputation credit under the trans-Tasman imputation rules when they receive a dividend from an investment in an Australian-resident company which is subject to the distribution exclusion in section EX 47 of the Income Tax Act 2004 and section EX 59 of the Income Tax Act 2007. Also, the amount of "gains" under the comparative value method in section EX 44 of the Income Tax Act 2004 and section EX 51 of the Income Tax Act 2007 is grossed up by the amount of this imputation credit.

Consequences of changes in method

Section EX 51 of the Income Tax Act 2004 and section EX 63 of the Income Tax Act 2007 have been amended to include a rule for changing between the fair dividend rate and comparative value methods. The rule provides that there is a deemed disposal and reacquisition of the interest at its market value at the start of the income year to which the new method applies. This deemed disposition is ignored for the purposes of the quick sale rules in the fair dividend rate method and is also ignored for the purposes of the $50,000 minimum threshold rules.

Default calculation method

The default calculation method in section EX 41 of the Income Tax Act 2004 has been amended to cater for the situation where the accounting profits method is allowed but it is not practical to use it. This situation was covered previously but was inadvertently omitted when the current section EX 41(2) was enacted in 2006. The default calculation method in section EX 48 of the Income Tax Act 2007 covers this situation and therefore does not need to be amended.

Family trust definition

Certain family trusts, along with natural persons, are allowed to use the comparative value method for their offshore portfolio share investments in years in which the foreign investment fund income would be lower under that method than under the fair dividend rate method. A number of remedial amendments have been made to the definition of "family trust" that is used for this purpose in sections EX 40(6) and EX 50(8) of the Income Tax Act 2004 and sections EX 46(6) and EX 62(8) of the Income Tax Act 2007. The remedial amendments, which ensure that this safety net option is available to family trusts as intended, are that:

- The ordinary definition of the term "settlor" – which is limited to dispositions of property at less than market value – is used. The reference to "settlor "also includes a deceased person, to ensure that a testamentary trust qualifies for this purpose.
- The person who requests another person to make a settlement of a nominal amount is treated as the settlor rather than the other person.
- Family trusts that have been resettled can still qualify as a family trust for the purposes of this provision if the trust and the settlors of the trust from which the resettlement is made satisfy the primary family trust definition requirements.
- The "natural love and affection" requirement must be satisfied at all times in the income year rather than only at the time of a trust's establishment.
- The qualifying trust (Income Tax Act 2004) or complying trust (Income Tax Act 2007) criterion is now expressed by reference to distributions because the qualifying trust or complying trust terms are defined in relation to distributions.

Interest in grey list company falling below 10 percent during an income year

The fair dividend rate method in the Income Tax Act 2004 and the Income Tax Act 2007 has been amended to ensure that there is no foreign investment fund income under that method in the situation when a 10 percent or more holding in a grey list company at the start of an income year falls below 10 percent during the year. This is consistent with the general fair dividend rate treatment, which ignores purchases of shares during a year (other than quick sales). For example, in the case of a person with a 30 percent interest in a grey list company at the start of an income year who reduces their interest to 8 percent during the year, they should be treated as having acquired an 8 percent interest during the year the opening value for which would be zero.

However, when a person's interest in a grey list company falls below 10 percent during an income year, and the fair dividend rate method can be applied to the interest (resulting in nil foreign investment fund income for that year), the interest holder remains liable to income tax or dividend withholding payments on any dividends received in that year. This continued taxation of dividends is achieved by amendments to sections EX 47 and CD 26 of the Income Tax Act 2004 and sections EX 59 and CD 36 of the Income Tax Act 2007.

Transitional rules

Offshore investments which become subject for the first time to the foreign investment fund rules enter those rules at their market value. This is achieved by a deemed disposition and reacquisition under section EX 54B of the

Income Tax Act 2004 and section EX 67 of the Income Tax Act 2007. These transitional provisions have been amended to ensure that they apply as intended to persons that intended to become portfolio investment entities and who elected to defer the start date of the foreign investment fund rules to the same date that they became subject to the portfolio investment entity rules.

The deemed disposition and reacquisition under the transitional rules also applies to any shares for which a person is a share supplier in a returning share transfer. This ensures that a tax liability may still arise for a person who holds their offshore shares on revenue account before those shares enter the foreign investment fund rules and who lends their shares under the share lending rules at the time the person becomes subject to the foreign investment fund rules. The treatment of any dividend paid on the lent shares will continue unchanged – that is, the dividend is taxable to the share user under ordinary rules, with the replacement payment for the dividend being deductible to the share user and taxable to the share supplier.

Measurement of cost

Section EX 56 of the Income Tax Act 2004 and section EX 68 of the Income Tax Act 2007 have been amended to replace the cost flow using an average cost approach with a FIFO (first-in-first-out) cost flow identification approach. These provisions are subject to the LIFO (last-in-first-out) approach used for the purposes of calculating quick sale gains under the fair dividend rate method.

TECHNICAL AMENDMENTS TO THE PORTFOLIO INVESTMENT ENTITY RULES

Sections CB 4B, CX 44C, CX 44D, DB 43B(2)(a), EG 3, EX 1(1B), HL 2, HL 3, HL 4(2), HL 5B, HL 5C, HL 6, HL 7(3), HL 9, HL 10, HL 11, HL 11b(1)(a), HL 12, HL 13, HL 16(2)(e), HL 20, HL 21, HL 23, HL 24, HL 25, HL 27, HL 31(3)(d), IG 1(2B), KD 1(1)(e)(viii), ME 9(4) and OB 1 of the Income Tax Act 2004; sections CB 26, CX 55, CX 56, DB 53, HL 2, HL 3, HL 4(2(a), HL 5B, HL 5C, HL 6, HL 7(3), HL 8, HL 9, HL 10, HL 11, HL 12, HL 13, HL 14, HL 17(2), HL 21, HL 22, HL 24, HL 25, HL 26, HL 27, HL 29, HL 33(3)(d), IC 3, MB 1(5), OB 66(2) and YA 1 of the Income Tax Act 2007; sections 28B, 31B, 33, 38(1B), 57B and 61 of the Tax Administration Act 1994

A number of remedial changes have been made to the new portfolio investment entity (PIE) rules.

Background

New tax rules for collective investment vehicles that meet the definition of a "portfolio investment entity" were enacted by the Taxation (Savings Investment and Miscellaneous Provisions) Act in December 2006. The rules apply from 1 October 2007.

Portfolio investment entities are not taxable on realised share gains made on New Zealand and certain Australian companies. Portfolio investment entities pay tax on investment income based on the tax rates of their investors (capped at 30% from 1 April 2008). Income earned via a portfolio investment entity generally does not affect investors' entitlements to family assistance, their student loan repayments or child support obligations.

A number of technical issues with the operation of the new rules were identified as they were implemented. Remedial amendments to the rules were made in the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill in 2007, during the select committee and committee of the whole House stages.

Application dates

Most remedial changes contained in the Income Tax Act 2004 are effective from 1 October 2007. The effect of the new rules combined with the transitional provisions contained in the Income Tax Act 2007 ensure that the portfolio investor rate will be 30% from the 2008–09 income year, to be consistent with the reduction in the company tax rate.

The remedial changes contained in the Income Tax Act 2007 are effective from the 2008–09 income year.

Detailed analysis

Re-organisation of sections HL 2 and HL 3

Sections HL 2 and HL 3 of the Income Tax Act 2004 and the Income Tax Act 2007 have been replaced. These new provisions are intended to convey more clearly the overall structure and scheme of the portfolio investment entity tax rules.

Investor requirements

Investor requirements for superannuation schemes that are declining in size

Under the previous rules, problems could arise when superannuation funds that were established before introduction of the portfolio investment entity rules decreased in size. Because the number of investors in the fund can fall, the fund can fall below the investor requirements in sections HL 6 and 9 of the Income Tax Act 2004 and Income Tax Act 2007. This was a particular problem for existing superannuation funds because their trust deeds may not have sufficient flexibility to reorganise the membership of their funds so that this does not happen.

Superannuation funds that were in existence before the introduction of the Taxation (Savings Investment and Miscellaneous Provisions) Bill 2006 on 17 May 2006 are

therefore not required to meet the investor test, provided that no investor (other than the fund's manager or trustee) can control the investment decisions relating to any of the entity's funds. This applies only to superannuation funds that, if they were unit trusts, meet or would have once met paragraphs (a) and (c) to (e) of the definition of "qualifying unit trust".

Qualifying unit trust safe harbour applies to portfolio investor class

To qualify as a portfolio investment entity, an entity must generally meet the investor membership requirement in section HL 6 of the Income Tax Act 2004 and Income Tax Act 2007 and the investor interest size requirement in section HL 9 of the Income Tax Act 2004 and Income Tax Act 2007. There are exemptions to these requirements if the entity, if it were a unit trust, would meet the requirements of one or more of paragraphs (a) and (c) to (e) of the "qualifying unit trust" definition. These exemptions are designed to provide widely held savings vehicles with more certainty that they will meet the portfolio investment entity eligibility requirements. These exemptions previously applied if the entity could satisfy the qualifying unit trust definition. The problem with this was that it could result in a portfolio investor class of a qualifying entity gaining portfolio investment entity status even though that particular class is not widely held. This is inconsistent with the policy intent of the rules. Therefore, these exemptions have been amended so that each "portfolio investor class", rather than the entity itself, is required to meet paragraphs (a) and (c) to (e) of the definition of "qualifying unit trust" (if the entity were a unit trust).

Investors can benefit differently from proceeds of a portfolio investment if difference only due to different tax rates

For a group of investors to constitute a single "portfolio investor class" each investor must participate equally (in proportion to their percentage holding in the fund) in the underlying investments of the fund. An issue arises where the portfolio investment entity holds financial arrangements that provide investors with capital guarantees. Typically, under these arrangements if investors suffer a capital loss over the investment term the portfolio investment entity exercises the capital guarantee and receives a taxable amount that, after application of investors' portfolio investor rates, is sufficient to compensate each investor for their capital loss.

As investors can have different portfolio investor rates there is an argument that this results in investors potentially having different interests in a portfolio entity investment (the capital guarantee being the portfolio entity investment). In many cases, the financial arrangement that provides the capital guarantee would not be a portfolio entity investment as the arrangement would not generally be entered into with the prospect of deriving a positive return. People who invest in a portfolio investment entity that holds such a capital guarantee should not be prevented from being part of the same portfolio investor class merely because they have different portfolio investor rates.

The definition of "portfolio investor class" in section HL 5B of the Income Tax Act 2004 and Income Tax Act 2007 has therefore been clarified so that investors can benefit differently from the proceeds of a portfolio entity investment in the case of a capital guaranteed investment if that difference results only from the application of different portfolio investor rates over the term of the investment.

Exception to investor membership requirement if Auckland Regional Holdings is an investor

The investor membership requirement in section HL 6(1) of the Income Tax Act 2004 and Income Tax Act 2007 has been amended to allow a portfolio investor class to qualify if it has fewer than 20 investors if one of the investors is "Auckland Regional Holdings". The reason for providing this exception is that current exceptions apply for similar government-owned entities, such as the Accident Compensation Corporation, the New Zealand Superannuation Fund and Earthquake Commission.

Exception to investor interest size requirement if Auckland Regional Holdings is an investor

The investor interest size requirement in section HL 9(4) of the Income Tax Act 2004 and Income Tax Act 2007 has been amended to allow Auckland Regional Holdings to hold an interest in a portfolio investment entity that would otherwise cause the portfolio investment entity to breach the investor interest size requirement. The reason for providing this exception is that current exceptions apply for similar government-owned entities, such as the Accident Compensation Corporation, the New Zealand Superannuation Fund and Earthquake Commission.

Investment type requirements

Investment type requirements include land not currently in use

Section HL 10(1) of the Income Tax Act 2004 and Income Tax Act 2007 requires that an entity must use or have available to use 90 percent or more by value of the entity's assets in deriving income from owning an interest in land. This section has been amended to ensure that the provision covers land that is not currently in use, but will be in the future. An example of this is when land is vacant or when property is under construction. This has been done by removing the current income derivation wording. Therefore, the investment type requirement is that 90 percent or more by value of the entity's assets must be qualifying assets.

Operating expenses for land

The following amendments have been made:

- section HL 10(2) of the Income Tax Act 2004 and the Income Tax Act 2007 has been amended to include replacement payments;

- section HL 10(2)(b)(iii) of the Income Tax Act 2004 and Income Tax Act 2007 has been amended to include payments from lessees that relate to their interest in land, such as operating expenses; and
- section HL 10(2)(iv) of the Income Tax Act 2004 and Income Tax Act 2007 has been amended so that it is clear that the provision only captures proceeds from the disposal of property referred to in section HL 10(1).

Investments in other portfolio investment entities not taken into account for the entity shareholding investment requirement

Section HL 10(4) of the Income Tax Act 2004 and Income Tax Act 2007 has been amended so that it is clear that investments in PIEs and certain other collective investment vehicles are not considered when applying the shareholding investment requirements in section HL 10(3).

Portfolio listed companies

Qualifying unit trust requirement removed for portfolio listed companies

Previously, under section HL 11B of the Income Tax Act 2004 and section HL 12 of the Income Tax Act 2007, an unlisted company must have met the requirements of paragraph (a) of the definition of "qualifying unit trust" in order to be treated as a portfolio listed company. This requirement has been replaced with a requirement in section HL 11B of the 2004 Act and section HL 12 of the Income Tax Act 2007 that the company has at least 100 shareholders, as this ensures that the company is widely held.

Taxation of trustee income

The policy underlying the portfolio investment entity rules is that the maximum tax rate on any investor in a portfolio investment entity should be 30% from 1 April 2008. Previously section CX 44D(3)(b) of the Income Tax Act 2004 could result in a trustee investor in a portfolio listed company being taxed at 33% on their imputed income from the portfolio listed company. As this treatment is not consistent with the policy intent, the law has been changed so that New Zealand-resident trustee investors in portfolio listed companies are treated the same as individual New Zealand-resident investors in respect of imputed income from portfolio listed companies and are taxed at 30% from 1 April 2008.

Portfolio land companies should be subject to the income type requirement

Portfolio investment entities can own and lease land and buildings to active businesses as long as they are not themselves active businesses. Examples of non-active businesses include listed property trusts that own commercial property.

The income type requirement in section HL 10(2) of the Income Tax Act 2004 and the Income Tax Act 2007 provides that the majority of the entity's income must be passive income, such as dividends, interest and rent.

Currently, this requirement does not apply to a portfolio land company, which is a subsidiary of a portfolio investment entity. This is contrary to the policy intent of the rules. The definition of "portfolio land company" in section OB 1 of the Income Tax Act 2004 and section YA 1 of the Income Tax Act 2007 has therefore been amended to ensure that it must meet the requirement in section HL 10(2).

Superannuation funds: transfer of unvested contributions if vesting schedule is longer than five years

Section HL 16(2) of the Income Tax Act 2004 and section HL 17(2) of the Income Tax Act 2007 have been amended to cater for superannuation schemes that existed on or before 17 May 2006, and where investors' interests have been transferred to a new scheme that came into being after 17 May 2006. Under the amended rules, the new superannuation fund can apply a member's prescribed investor rate to unvested employer contributions regardless of the length of the vesting period. The transfer must be from a superannuation scheme that existed before 17 May 2006 to a new superannuation scheme, and there must be no change in substance to the benefits a member will receive from unvested contributions. If these conditions are met, the income from unvested employer contributions will continue to be taxed as if the transfer had not occurred. This means that income relating to the unvested contributions will continue to be taxed at the portfolio investor's rate.

Changing December due date to 15 January

Section HL 23 of the Income Tax Act 2004 and section HL 24 of the Income Tax Act 2007 have been amended so that any due date for a return or payment which falls on 31 December is changed to the following 15 January.

Tax calculation

Zero-rated investor deduction should refer to the portfolio tax rate entity's tax year

Section DB 43B(2) of the Income Tax Act 2004 and section DB 53 of the Income Tax Act 2007 provides that zero-rated and certain exiting investors in portfolio investment entities are generally allowed a tax deduction for losses that flow through to them from those portfolio investment entities. Currently, the provision requires investors in "quarterly zero" portfolio tax rate entities (portfolio tax rate entities that pay tax under section HL 21 of the Income Tax Act 2004 and section HL 22 of the Income Tax Act 2007) to recognise such losses in the investor's income year that includes the end of the portfolio investment entity's portfolio calculation period (usually a quarter). To maintain consistency with other

similar provisions in the rules, section DB 43B of the Income Tax Act 2004 and section DB 53 of the Income Tax Act 2007 have been amended to provide that the investor has a deduction for the amount of portfolio investor allocated loss in the investor's income year that includes the end of the portfolio investment entity's income year.

Definition of "portfolio investor rate"

The definition of "portfolio investor rate" in section OB 1 of the Income Tax Act 2004 and section YA 1 of the Income Tax Act 2007 has been amended so that the portfolio investor rate applies to a portfolio allocation period rather than a portfolio calculation period. This will also clarify that if an investor notifies a correction to their portfolio investor rate at any time during the year, the new portfolio investor rate will apply to any amount for which the tax liability has not already been calculated.

Paragraph (b)(ii) has been amended so that the "portfolio investor rate" is the rate that the investor notifies the entity as their prescribed investor rate, and that notification is the latest notification. The "portfolio investor rate" for the investor is the latest notified prescribed investor rate at the time the entity calculates the portfolio entity tax liability for the investor and their income, or calculates a payment under section HL 23B of the Income Tax Act 2004 or section HL 25(1) of the Income Tax Act 2007 that they intend to be a final payment of the portfolio entity tax liability.

Option to not use excess foreign tax credits from one portfolio investor class to offset tax from other portfolio investor classes

The intention of the rules is that portfolio tax rate entities and portfolio investor proxies should be allowed, but not required, to use excess foreign tax credits received for an investor from one portfolio investor class against the tax liability of that investor from other portfolio investor classes. This flexible approach is appropriate as the sophistication of systems will vary across providers. It was not clear whether section HL 27 of the Income Tax Act 2004 or section HL 29 of the Income Tax Act 2007 provides portfolio tax rate entities and portfolio investor proxies with the option of not using excess foreign tax credits from one portfolio investor class to offset tax from other portfolio investor classes. Section HL 27(10B)(b)(ii) of the Income Tax Act 2004 and section HL 29(11)(b)(ii) of the Income Tax Act 2007 have been clarified to provide this flexibility.

Foreign tax credits

It is common for people to hold a portfolio of investments via a custodian. These are often referred to as "wrap accounts" and provide investors with the same benefits of direct ownership of the underlying investments. In addition, the custodian will often provide a range of investment services including, in some cases, the deduction of resident withholding tax (RWT) on dividends and interest.

The portfolio of investments that the custodian holds for the investor is likely to include interests in managed funds. The portfolio investment entity rules have been designed so that a custodian (referred to in the legislation as a "portfolio investor proxy") can calculate tax on behalf of its investors when someone invests through a custodian into an underlying portfolio investment entity. This is consistent with the current tax treatment for wrap accounts, because the custodian is likely to be deducting RWT for the investor on the investor's non-portfolio investment entity investments.

The rules achieve this treatment by the portfolio investment entity applying a zero percent tax rate to the portfolio investment entity income earned on behalf of the portfolio investor proxy, with the portfolio investment entity income flowing through to the portfolio investor proxy. The portfolio investor proxy is then required to calculate and deduct tax on that income as if the portfolio investor proxy were a portfolio investment entity. Broadly, this means that the portfolio investor proxy can treat the person's separate investments in underlying portfolio investment entities as if they were a single investment in an underlying portfolio investment entity. The person's separate investments in underlying portfolio investment entities, from the perspective of the portfolio investor proxy, are treated as separate portfolio investor classes in the same portfolio investment entity. This approach allows the rules relating to investor exit, use of tax credits and losses to work appropriately.

The problem with the rules as originally enacted was that a portfolio investor proxy's foreign tax credits were restricted to the lesser of the allocated credits or the maximum tax liability on the allocated income. The tax credit rules in section HL 27 of the Income Tax Act 2004 and section HL 29 of the Income Tax Act 2007 have therefore been amended so that portfolio investor proxies can use the full amount of foreign tax credits received from portfolio investment entity investments to offset tax on portfolio investment entity income. This aligns the foreign tax credit rules that apply to portfolio investor proxies investing in portfolio investment entities with those applying to portfolio tax rate entities that invest in other portfolio investment entities.

Portfolio investor proxies can satisfy PIE tax on behalf of investors by directly accessing cash accounts

Under the rules, portfolio tax rate entities will generally pay tax on behalf of investors by reducing investors' interests in the portfolio investment entity. In contrast, some portfolio investor proxies have been structured to pay portfolio investment entity tax on behalf of investors by directly accessing the cash accounts that investors hold with the portfolio investor proxy. There is no policy reason why a portfolio investor proxy should not be able to satisfy portfolio investment entity tax on behalf of its investors in this way, and section HL 7 of the Income Tax Act 2004 and the Income Tax Act 2007, and section HL 31 of the Income Tax Act 2004 and HL 33 of the Income Tax Act 2007 have been amended to explicitly provide for this option.

Portfolio investor rate that is lower than the prescribed investor rate

Previously, section CX 44D of the Income Tax Act 2004 and section CX 56 of the Income Tax Act 2007 could be interpreted so that the portfolio investor allocated income of an investor for the year was not excluded income if the investor had provided the portfolio investment entity at the start of the year with a portfolio investor rate that was lower than their prescribed investor rate. This could result in portfolio investor allocated income being taxed to investors even if the investor had provided their correct rate before the portfolio investment entity performed a final tax calculation for the investor. Therefore, section CX 44D of the Income Tax Act 2004 and section CX 56 of the Income Tax Act 2007 have been amended so that portfolio investor allocated income remains excluded income for a year and the portfolio investment entity applies the investor's correct rate when performing a final tax calculation or a calculation under section HL 23B of the Income Tax Act 2004 or section HL 25 of the Income Tax Act 2007 that the entity intends to be final. This ensures that portfolio investor allocated income will continue to be excluded income to the investor if the investor provides to the portfolio investment entity a portfolio investor rate that is lower than their prescribed investor rate and the portfolio investment entity has not subjected that income to a final tax calculation.

Timing of receipt of tax credits

Section HL 27(6) of the Income Tax Act 2004 and section HL 29(6) of the Income Tax Act 2007 have been amended to ensure that credits for both zero-rated investors and exiting investors are treated as being received in the investor's income year that includes the end of the portfolio investment entity's income year. This ensures that the same timing rules apply to receipt of credits for both zero-rated investors and exiting investors.

Allocation of credits by portfolio tax rate entities

Section EG 3 of the Income Tax Act 2004 and Income Tax Act 2007 allows portfolio investment entities to recognise amounts for tax purposes at the same time they recognise those amounts for unit pricing and financial reporting purposes. The section has been clarified so that it allocates tax credits to the same period as the income to which the credits relate.

Investor expenditure

Section HL 20 of the Income Tax Act 2004 and section HL 21 of the Income Tax Act 2007 have been amended to ensure that expenditure transferred from an investor under subpart DV is deductible as investor expenditure under section HL 20 of the Income Tax Act 2004 or section HL 21 of the Income Tax Act 2007. This allows a non-portfolio investment entity superannuation fund that invests in a portfolio tax rate entity to gain the benefit of a deduction for the expenditure at the portfolio tax rate entity level.

Exiting investors

Accommodation of partial withdrawals and switches within the same portfolio investment entity

Section HL 23B of the Income Tax Act 2004 and section HL 25 of the Income Tax Act 2007 now accommodate partial withdrawals and switches between investor classes within the same portfolio investment entity. The previous wording of section HL 23B of the Income Tax Act 2004 and section HL 25 of the Income Tax Act 2007 could be interpreted as only applying when an investor reduces their total interest in the portfolio investment entity. The provision has therefore been amended so that it is clear that it applies when an investor switches their investment from one class in the portfolio investment entity to another class in the same portfolio investment entity.

Exiting investors do not have to return excess tax credits

Section HL 27(9) of the Income Tax Act 2004 and section HL 29(9) of the Income Tax Act 2007 have been repealed to ensure that exiting investors do not have to return excess tax credits.

Under the previous section HL 27(9) of the Income Tax Act 2004 and section HL 29(9) of the Income Tax Act 2007, investors in portfolio tax rate entities needed to return any excess New Zealand tax credits in their tax return if they exceeded the investor's share of the portfolio entity tax liability for the portfolio investor exit period. This was contrary to the policy intention that investors in portfolio tax rate entities should have no further tax obligations if they fully exit a fund, and any excess tax credits should be rebated to the entity.

Grouping rules

Portfolio investment entities can be part of a group

Section IG 1 of the Income Tax Act 2004 and section IC 3 of the Income Tax Act 2007 have been amended so that the grouping provisions can apply to a group of companies if the only entities in the group are portfolio tax rate entities and portfolio land companies. The grouping rules can apply only when a portfolio tax rate entity parent owns 100 percent of the voting interests in the portfolio tax rate entities and portfolio land companies.

Portfolio investment entities can be part of a group for GST purposes

Section 55 of the Goods and Services Tax Act has been amended to allow portfolio investment entities to be part of a group for GST purposes. Portfolio investment entities can be part of a group for GST purposes if they would have been eligible to be a group for income tax purposes (in the absence of the prohibition on portfolio tax rate entities being part of a group under section IG 1 of the Income Tax Act 2004).

Portfolio investment entity income does not affect family tax credits for exiting investors

Section KD 1 of the Income Tax Act 2004 and section MB 1(5) of the Income Tax Act 2007 have been amended to ensure that portfolio investment entity income will not affect family tax credits for exiting investors who are required to file tax returns for their portfolio investment entity income. This reflects the policy that portfolio investment entity income should not affect family tax credits.

Cancellation of shares

Section HL 7 of the Income Tax Act 2004 and the Income Tax Act 2007 has been amended so that a fund can cancel units at any time up to the end of the relevant period. The current references to "period" in section HL 7(3)(a) have also been made consistent.

Exclusion of Australasian share gains

Anti-avoidance rule

The Act has introduced new section CX 44C(1)(c) to the Income Tax Act 2004 and section CX 55(1C) to the Income Tax Act 2007, which provide that the Australasian share gains exclusion does not apply when the gain on the share was guaranteed. This anti-avoidance rule was originally contained in proposed section CX 44C(d) in clause 12 of the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill 2006 as introduced. It was intended that this provision be amended to focus on the time of acquisition of the relevant share, but this provision was inadvertently omitted at the Finance and Expenditure Committee stage of the bill. Accordingly, the provision has been reinstated.

Disposal of certain shares by a portfolio investment entity after declaration of a dividend

Section CB 4B of the Income Tax Act 2004 and section CB 24 of the Income Tax Act 2007 provide that when a share is sold between the date a dividend is declared and the date it is paid, an amount representing the unimputed dividend must be included in the portfolio investment entity income calculation. The section has been amended so this applies on a net basis.

New Zealand Superannuation Fund subject to dividend stripping rule

Under section CX 44C of the Income Tax Act 2004 and section CX 55 of the Income Tax Act 2007, the New Zealand Superannuation Fund (NZSF) has been provided with the exclusion from tax on gains from the disposal of New Zealand and certain Australian shares. This is the same exclusion that portfolio investment entities benefit from. Section CB 4B of the Income Tax Act 2004 and section CB 24 of the Income Tax Act 2007 have therefore been amended so that the dividend stripping rule applies to the NZSF, in the same way that it applies to portfolio investment entities.

Filing and information requirements

Resident investors should be required to advise the portfolio tax rate entity of a tax file number

Section 28B of the Tax Administration Act 1994 has been amended to require that all New Zealand-resident investors investing in a portfolio tax rate entity provide their tax file number to the entity.

This amendment applies from 1 April 2008.

Timeframe for providing information to zero-rated portfolio investors

Section 31B of the Tax Administration Act 1994 has been amended to specify a timeframe for providing information to zero-rated portfolio investors. A portfolio tax rate entity must now give notice before the end of the one-month period beginning after the period to which the notice relates

Provision of information–"annual provisional tax" portfolio investment entities with non-standard balance dates

Section 31B of the Tax Administration Act 1994 has been amended so that it caters for "annual provisional tax" portfolio tax rate entities (portfolio investment entities that pay tax under section HL 22 of the Income Tax Act 2004 and section HL 23 of the Income Tax Act 2007) with non-standard balance dates.

Returns by portfolio tax rate entities and section HL 23B payments

Section 57B of the Tax Administration Act 1994 has been amended to require that optional payments of tax made by portfolio tax rate entities under section HL 23B of the Income Tax Act 2004 or section HL 25 of the Income Tax Act 2007 are made with a tax return.

Changing December due date to 15 January

Section 57B(3)(a)(ii) has been amended and new section 57B(3B) introduced so that any due date for a return or payment which falls on 31 December should be changed to the following 15 January. This applies to returns or payments made by an "annual exitor" portfolio tax rate entity (portfolio investment entities that pay tax under section HL 23 of the Income Tax Act 2004 and section HL 24 the Income Tax Act 2007).

This is consistent with a number of provisions in the Inland Revenue Acts that provide that if the due date for a return or payment falls on 31 December, that due date is changed to the following 15 January.

Assessments for "quarterly zero" and "annual exitor" portfolio tax rate entities

New section 33(1C) of the Tax Administration Act 1994 provides for an assessment for "quarterly zero" and "annual exitor" portfolio tax rate entities which have provided the tax returns required under section 57B.

Section 57B (7) has been inserted to require quarterly zero and annual exitor portfolio tax rate entities that make optional payments in terms of section HL 23B to file a tax return if one was not already being filed for the period.

Transitional issues

Imputation credits earned before entity was a portfolio investment entity

Section ME 9(4) of the Income Tax Act 2004 and section OB 66(2) of the Income Tax Act 2007 has been amended. The amendment allows an entity to the end of the income year in which it becomes a portfolio investment entity to pay any further income tax that arose from a debit balance in its imputation credit account at the time it stops being an imputation credit account company and becomes a portfolio investment entity. This ensures that a portfolio investment entity can distribute the benefit of imputation credits to its investors when those imputation credits have arisen from the entity's tax obligations before it became a portfolio investment entity.

Removal of penalties and interest when provisional tax increased as a result of becoming a portfolio investment entity

Section HL 13 of the Income Tax Act 2004 and section HL 14 the Income Tax Act 2007 have been amended to provide relief in situations when an increased provisional tax liability arises due to an entity becoming a portfolio investment entity. Without this amendment, portfolio investment entities with investments in other portfolio investment entities that are zero-rated and exempt from resident withholding tax may incur an increased provisional tax liability. Entities with a standard balance date that elect to become portfolio investment entities on 1 October 2007 would have had their first provisional tax payment due on 7 July 2007, so could not have prevented an underpayment.

This relief applies for provisional tax payments that have already been made for the income year in which the transition occurs, and any provisional payments falling due within the two months of becoming a portfolio investment entity.

Share lending rules and deemed sale and reacquisition of Australian shares

Under section HL 12(3) of the Income Tax Act 2004 and section HL 13(3) of the Income Tax Act 2007, there is a deemed sale and reacquisition of Australian shares held at the time an entity becomes a portfolio investment entity. This provision ensures that any gain or loss on Australian shares that are held on revenue account by entities becoming portfolio investment entities is realised at the time of entry into the PIE rules. Before this amendment, section HL 12(3) of the Income Tax Act 2004 and section HL 13(3) of the Income Tax Act 2007 referred to "shares held by the entity". This wording may not have captured shares subject to share lending transactions whereby shares are lent shortly before an entity enters into the portfolio investment entity rules (the earliest date being 1 October 2007) and reacquired after that date. The share lending rules could have prevented a tax liability arising for the intending portfolio investment entity. This is because the shares are not held by the intending portfolio investment entity on the transition date and therefore would not have been caught by section HL 12(3) of the Income Tax Act 2004 and section HL 13(3) of the Income Tax Act 2007. The share lending rules themselves would prevent there being a taxable event on the date the shares are lent and the Australasian share trading exclusion for portfolio investment entities in section CX 44C of the Income Tax Act 2004 and section CX 55 of the Income Tax Act 2007 would still seem to apply when the relevant shares are eventually sold.

Section HL 12(3) of the Income Tax Act 2004 and section HL 13(3) of the Income Tax Act 2007 have therefore been amended to ensure that for the purposes of that provision any original share subject to a returning share transfer is treated as being held by the share supplier (that is, the intending portfolio investment entity) and not by the share user. The treatment of any dividend paid on the lent shares will continue unchanged – that is, the dividend will be taxable to the share user under ordinary rules with the replacement payment for dividends being deductible to the share user and taxable to the share supplier.

Minor drafting corrections

A number of amendments have been made to correct minor drafting and cross-referencing errors. The key amendments are:

- Section CX 44D(2) and (3) of the Income Tax Act 2004 and section CX 56(2) and (3) of the Income Tax Act 2007 have been amended to make it clear that they apply to a dividend from a portfolio tax rate entity or a portfolio listed company that is not a distribution.
- Section HL 4(2) of the Income Tax Act 2004 and the Income Tax Act 2007 have been amended so that an entity ceases to be eligible to be a portfolio investment entity only if a portfolio investor class of the entity fails to meet a requirement under sections HL 6 or HL 9 of the Income Tax Act 2004 and the Income Tax Act 2007. These amendments will ensure consistency with sections HL 6 and HL 9 which apply on a portfolio investor class basis. The failure to meet a requirement under section HL 10 of the Income Tax Act 2004 and the Income Tax Act 2007 is tested on an entity basis as the section HL 10 requirements apply on this basis.
- The references to "tax year" in section HL 7(3)(a)(ii) of the Income Tax Act 2004 and the Income Tax Act 2007 have been replaced with a reference to the entity's "income year".
- An amendment has been made to section HL 12 of the Income Tax Act 2004 and the Income Tax Act 2007 providing that for the purposes of section NH 4(5)(f) the relevant DWP account credit balance is that existing immediately before the entity becomes a portfolio investment entity on

1 October 2007. An entity becoming a portfolio investment entity is not able to receive a refund of DWP it has paid under section NH 4(5) (which allows a refund of DWP when a company ends up with a net loss for an income year). In particular, section NH 4(5)(f) provides that the DWP refund cannot exceed the company's DWP account credit balance at the end of the imputation year – in this case 31 March 2008. In the case of a company which became a portfolio investment entity on 1 October 2007, its credit balance will be nil, which will prevent a DWP refund being made. If the company had not become a portfolio investment entity it could have received a refund of DWP.

- The definition of "portfolio land company" in section OB 1 of the Income Tax Act 2004 and section YA 1 of the Income Tax Act 2007 requires that 90 percent of the company's assets must be land assets and that this must be the case for 80 percent of the year. This requirement has been changed so that it will be met if it is for 80 percent or more of the year.
- Section 57B(1)(b) has been reworded to clarify due dates at the end of the calendar year for certain portfolio investment entities.

Drafting consistency with core provisions

The following drafting amendments have been made to ensure that the portfolio investment entity rules interact correctly with the Income Tax Act's core provisions and are consistent with the rewrite of that Act:

- Sections HL 21 and HL 23 of the 2004 Act have been amended to clarify that the income tax liability of quarterly zero portfolio tax rate entities and annual exitor portfolio tax rate entities is equal to the portfolio entity tax liability for the portfolio calculation periods in the tax year.
- Section HL 22 of the 2007 Act has been amended to clarify that the income tax liability of annual provisional tax portfolio tax rate entities is equal to the portfolio entity tax liability for the portfolio calculation periods in the tax year.
- Portfolio investment entity rebates for excess credits and losses have been excluded from the section OB 1 definition of allowable rebates in the 2004 Act.

ALIGNING GST AND PROVISIONAL TAX PAYMENTS

CHANGES TO THE INCOME TAX ACT

Section RC 7(6) of the Income Tax Act 2007 and section MB 6(5) of the Income Tax Act 2004; section RC 8 of the Income Tax Act 2007 and section MB 7 of the Income Tax Act 2004; section RC 9(7) of the Income Tax Act 2007 and section MB 8(6) of the Income Tax Act 2004; section RC 9 of the Income Tax Act 2007 and section MB 8 of the Income Tax Act 2004; section RC 10(1)(b) of the Income Tax Act 2007 and section MB 9(1)(b) of the Income Tax Act 2004; sections RC 16(2) and RC 16(5) of the Income Tax Act 2007 and sections MB 15(2) and MB 15(11) of the Income Tax Act 2004; section RC 17(4)(a) of the Income Tax Act 2007 and section MB 15(8)(a) of the Income Tax Act 2004; sections RC 18(2) and RC 18(4) of the Income Tax Act 2007 and sections MB 17(2) and MB 17(4) of the Income Tax Act 2004; section RC 19(2) of the Income Tax Act 2007 and section MB 18(2) of the Income Tax Act 2004; sections RC 21(2) and (3), of the Income Tax Act 2007 and sections MB 20(2) and (3) of the Income Tax Act 2004; section RC 25(6) of the Income Tax Act 2007 and section MB 24(5) of the Income Tax Act 2004; section RC 26(5) of the Income Tax Act 2007 and section MB 25(5) of the Income Tax Act 2004; Schedule 13 part B of the Income Tax Act 2007 and of the Income Tax Act 2004

A number of remedial amendments have been made to the provisions which align the payments of provisional tax with GST payments and provide a new method of calculating provisional tax based on a percentage of GST taxable supplies – the GST ratio method. These amendments give effect to the original intent of the scheme.

Key features

- Section RC 7(6) of the Income Tax Act 2007 and section MB 6(5) of the Income Tax Act 2004 have been amended to provide that taxpayers who, after the first instalment, cease using the GST ratio method to calculate their provisional tax liability can elect to pay GST six-monthly. This amendment corrects a legislative oversight whereby the incorrect payment due dates were specified in section RC 7(6) of the Income Tax Act 2007 and section MB 6(5) of the Income Tax Act 2004. The amendment correctly specifies that taxpayers who change from paying GST every two months to paying GST six-monthly will pay their provisional tax in two instalment on the dates specified in columns C and F of Schedule 13, part A.
- Sections RC 8(3) and RC 8(7) of the Income Tax Act 2007 and sections MB 7(3) and MB 7(7) of the Income Tax Act 2004 have been amended. The legislation previously required taxpayers who used the GST ratio calculation method to base their GST ratio on information from two years ago, being the latest available information. However, there will be instances when taxpayers will have to calculate the GST ratio based on information from three years ago if they have an extension of time to file their later year's tax returns. Two new subsections have been inserted, sections RC 8(3B) and RC 8(7B), to enable information from three years ago to be used

to base the ratio calculation on, provided that the information is available for that year and the year is not a transitional year, or the assessment for that year is not subject to a dispute or challenge.

- An amendment has been made to section RC 9(7) of the Income Tax Act 2007 and section MB 8(6) of the Income Tax Act 2004 to correct a cross-referencing error. The reference to section RC 7 of the Income Tax Act 2007 and section MB 6 of the Income Tax Act 2004 has been removed.
- Section RC 9(9) of the Income Tax Act 2007 and section MB 8(8) of the Income Tax Act 2004 have been amended to clarify that new provisional taxpayers are liable to pay use-of-money interest as if they were liable to pay provisional tax in either: three, two or one instalment depending on when they start their taxable activity.
- Section RC 9(9)(b)(ii) of the Income Tax Act 2007 and section MB 8(8)(b)(ii) of the Income Tax Act 2004 have been amended to clarify that the subparagraph only applies to six-monthly GST payers who start business part-way through a year, and not in any other circumstance.
- Two cross-referencing changes have been made to section RC 10(1)(b) of the Income Tax Act 2007 and section MB 9(1)(b) of the Income Tax Act 2004. The section now also refers to sections RC 9(7) and (8) of the Income Tax Act 2007 and sections MB 8(6) and (8) of the Income Tax Act 2004.
- To ensure consistency of terminology between the provisional tax legislation and that used in the Income Tax Act 2007, the following amendments have been made:
  - the reference in section RC 16(2) of the Income Tax Act 2007 and section MB 15(2) of the Income Tax Act 2004, to "preceding tax year" has been replaced by "preceding tax year and corresponding income year"; the reference to "whole tax year" has been replaced by "whole income year"; and
  - the reference in section RC 16(5) of the Income Tax Act 2007 to "the tax year before" has been replaced by "a tax year earlier than".
- When a taxpayer does not file a GST return for 60 days after the due date, he or she is required to discontinue use of the ratio method. However, taxpayers can apply to the Commissioner to continue to use the ratio method if the failure was due to circumstances beyond their control and they had a reasonable justification or excuse for the failure. Currently, the application must be in writing. However, an amendment has been made to section RC 17(4)(a) of the Income Tax Act 2007 and section MB 15(8)(a) of the Income Tax Act 2004 that allows taxpayers to apply by phone or in writing.
- A minor amendment has been made to section RC 18 (2) of the Income Tax Act 2007 and section MB 17(2) of the Income Tax Act 2004 to correct an incorrect cross-reference. The reference to subsections (3) and (4) has been replaced with references to subsections (4) and (5).
- An amendment has been made to section RC 18(4) of the Income Tax Act 2007 and section MB 17(4) of the Income Tax Act 2004 that allows taxpayers who have elected to use the ratio method to subsequently decide, before the first instalment, not to use the ratio method. The amendment ensures that taxpayers who decide not to use the ratio method before the first instalment, for the purposes of the use-of-money interest rules, they are deemed never to have elected to use the ratio method.
- Section RC 19(2) of the Income Tax Act 2007 and section MB 18(2) of the Income Tax Act 2004 allows taxpayers who use the GST ratio method to calculate their provisional tax liability to adjust the calculation to take account of asset sales. An amendment has been made to this section to ensure that if taxpayers are on a payments basis for GST purposes they can only make the adjustment to the extent that they have received payment for the asset. The calculation of the ratio for the following year will also be reduced by the value of the asset sold, and again, only to the extent that the taxpayer has received payment for the asset.
- Sections RC 21(2) and (3) of the Income Tax Act 2007 and section MB 20(2) and (3) of the Income Tax Act 2004 have been amended to provide that when the due date for the payment of provisional tax would normally fall in April, the due date will move to 7 May. This is to allow additional time for businesses and tax agents to file GST/provisional tax returns previously due during the Easter period.
- Changes have been made to section RC 25(6) of the Income Tax Act 2007 and section MB 24(5) of the Income Tax Act 2004 which deal with consequences resulting from changes in balance dates. When, as a result of a change in balance date, a taxpayer changes from provisional tax dates in even months to odd months or from odd months to even months, the last period before the change in balance date will be for a part-period. The amendment ensures that the due dates for the payment of provisional tax for the part-period is 28 days after the end of that period unless the part-period ends in November, when the due date will be the 15 January, or the part-period ends in March, when the due date will be 7 May.
- Taxpayers who pay GST six-monthly and subsequently cancel their GST registration are required to change their provisional tax payment dates and move from two provisional tax payments to three. An amendment has been made to section RC 26(5) of the Income Tax Act 2007 and section

MB 25(5) of the Income Tax Act 2004 to allow taxpayers to specify that the change in payment date takes effect from a future date, to align with the date they cancel their GST registration.

- Schedule 13, part B of the Income Tax Act 2004 and the Income Tax Act 2007 has been amended to correct a drafting oversight. In the first column of the table for GST ratio taxpayers, the reference to "7-" should be "7-8".

Application date

The amendments apply from the beginning of the 2008–09 income year.

CHANGES TO THE TAX ADMINISTRATION ACT 1994

Sections 120KC(1)(b), 120KD(1) and (2) and 139C(2)(ab)

Key features

- Section 120KC(1)(b) has been amended to provide that for the purposes of the use-of-money interest rules, a taxpayer's residual income tax for a year is payable in two instalments on:
  - dates specified in columns C and F of Schedule 13, Part A of the Income Tax Act 2007 if the taxpayer pays GST on a six-monthly basis; and
  - dates specified in columns D and F of Schedule 13, Part A of the Income Tax Act 2007 if they begin business after instalment B and more than 30 days before instalment D.
- Section 120KD has been amended by:
  - correcting a cross-referencing error in subsection (1) by correctly referring to both sections 120KE(1) and (3); and
  - removing the reference in subsection (2) to the due date being the 28th of the month and referring to the date on which the instalment is due under section RC 21 of the Income Tax Act 2007. Section RC 21 sets the due date as either the 28th of the month unless the date specified in Schedule 13, Part A is 15 January (due to Christmas) or 7 May (due to Easter).
- Section 139C(2)(ab) has been inserted to provide a late payment penalty on late payments of provisional tax by taxpayers who use the GST ratio method of calculating provisional tax. Taxpayers who fail to pay on time will be liable for a late payment penalty on the lower of the actual ratio for the year or the ratio that applied at the due date. The late payment penalty will be imposed after the end of the income year when the actual ratio for the year is known.

Application date

The amendments apply from the beginning of the 2008–09 income year.

CHANGES TO THE GST ACT 1985

Section 17(1)

Key feature

Section 17(1) has been amended by inserting new subsection (1B) which sets out the due date for special GST returns. The new subsection provides that the due date for special returns is the 28th of the month following the month in which the relevant sale was made. However, the due date for special GST returns for the November and March periods is 15 January and 7 May respectively.

Application date

The amendment applies to taxable periods ending on or after 30 November 2007.

WORKING FOR FAMILIES TAX CREDITS PROVISIONS

Section GC 28, subpart KD and section MD 1 of the Income Tax Act 2004; sections GB 44, LA 7, LB 4 and subparts MA to MF and MZ of the Income Tax Act 2007; sections 80E, 80KD, 80KK, 80KN to 80KR, 80KU, 80KW, 84 and 85G of the Tax Administration Act 1994

The re-naming of family assistance to Working for Families Tax Credits and name changes for some of the component credits has required a large number of remedial amendments in the Revenue Acts, as well as consequential amendments in other legislation not administered by Inland Revenue.

Three other remedial amendments were necessary to:

- introduce modifications to the formula for calculating the parental tax credit – to be used in specific circumstances;
- clarify the meaning of "net family scheme income" in the Income Tax Act 2007, to ensure that the minimum family tax credit is calculated from a base of after-tax income in all cases; and

- ensure that the end-of-year calculation formula when there have been 53 weekly or 27 fortnightly interim instalments applies, regardless of whether those interim instalments have been paid by Inland Revenue or by the Ministry of Social Development.

NAME CHANGES FOR TAX CREDITS FOR FAMILIES

Key features

The name changes to the tax credits for families are as set out in the following table:

Former names	Names applying from 1 April 2007
Family Assistance	Working for Families Tax Credit
Family support	family tax credit
In-work payment	in-work tax credit
Parental tax credit	parental tax credit
Family tax credit	minimum family tax credit

The grouping of the credits as "family support" and "family plus" has been removed.

The names have been replaced as shown in the table whenever they occur in subpart KD of the Income Tax Act 2004 and in subparts MA to MF and MZ of the Income Tax Act 2007, and elsewhere as cross-references in:

- the Income Tax Act 2004;
- the Tax Administration Act 1994;
- the Housing Restructuring and Tenancy Matters Act 1992;
- the Rates Rebate Act 1973;
- the Social Security Act 1964;
- the Health Entitlement Cards Regulations 1993;
- the Social Security (Temporary Additional Support) Regulations 2005; and
- the Student Allowances Regulations 1998.

The amendments to the Income Tax Act 2004, other than the amendments to subpart KD, are in Part 1 while the amendments to the Tax Administration Act 1994 are in Part 2. The amendments to other Acts, including the Income Tax Act 2007 and Regulations are in Part 3 and Schedule 2, and the amendments to subpart KD of the Income Tax Act 2004 are in Schedule 1.

Application date

The amendments to the Income Tax Act 2004 apply from the tax year beginning 1 April 2007.

The amendments to the Income Tax Act 2007 apply from 1 April 2008 when that Act comes into force.

PARENTAL TAX CREDIT

The parental tax credit is paid for a maximum of 56 days immediately following the birth of a child. Parents can choose to receive it as a lump sum. However, when a child is born in the last 56 days of the tax year and parents choose to receive a lump sum, the calculation formula, because it spans two tax years, formerly conceded entitlement at levels of income that should extinguish entitlement.

Key features

New section MD 16 of the Income Tax Act 2007 introduces the formula to be used when parents choose a lump sum payment of the parental tax credit for a birth that has occurred within the last 56 days of the tax year.

Application date

The new section applies from the tax year beginning 1 April 2008.

NET FAMILY SCHEME INCOME

The minimum family tax credit tops up after-tax income to an annually specified amount. Former provisions had the effect of assuming that tax had been paid for certain types of income when it had not and vice versa for certain other items of income.

The new provision for "net family scheme income" ensures that the minimum family tax credit is calculated from a base of after-tax income in all cases.

Key features

New section ME 3 in the Income Tax Act 2007 provides a definition of "net family scheme income" that applies for the purpose of subpart ME, which contains the rules for the minimum family tax credit.

Application date

The new section applies from the tax year beginning 1 April 2008.

WRITE-OFF OF ADDITIONAL INSTALMENT IN SOME YEARS

Because a year cannot be divided evenly into weeks or fortnights, there are some years in which more than 26 fortnightly or 52 weekly instalments fall within the tax year.

The Income Tax Act already provides for the automatic write-off of a 27th fortnightly instalment paid by Inland Revenue or a 53rd weekly instalment paid by the Ministry of Social Development. The amendments provide for the automatic write-off of a 53rd interim weekly instalment paid by Inland Revenue or a 27th interim fortnightly instalment paid by the Ministry of Social Development in the years in which those events occur, to ensure no-one is disadvantaged.

Key features

The amendments to sections 80KW(2)(b) and 80KW(4)(a)(ii) of the Tax Administration Act 1994 will ensure that the end-of-year calculation formula when there have been 53 weekly or 27 fortnightly interim instalments applies regardless of whether those interim instalments have been paid by Inland Revenue or by the Ministry of Social Development.

Application date

The amendments apply from the tax year beginning 1 April 2008.

LARGE BUDGET SCREEN PRODUCTION GRANTS

Sections DS 1, DS 2, DS 2B, EJ 4(1), EJ 5(1), EJ 7(1) and EJ 8(1) of the Income Tax Act 2004, and sections DS 1, DS 2, DS 2B, EJ 4(1), EJ 5(1), EJ 7(1) and EJ 8(1) of the Income Tax Act 2007

The amendments do two things. Firstly they clarify the deduction and timing rules for films that attract large budget film grants and ensure that their original policy intent is correctly reflected in the legislation. They clarify that deductions are allowed for costs incurred in acquiring or producing a film, irrespective of whether a large budget screen production grant is paid.

Secondly, they provide (via new sections DS 2B of the Income Tax Act 2004 and DS 2B of the Income Tax Act 2007) that when a film asset is created with the intention of being sold, the expenditure is treated as expenditure on revenue account property. Existing section EA 2 of the Income Tax Act 2004 and section EA 2 of the Income Tax Act 2007 allows the deduction to be available when the film asset is sold. This reflects current practice for overseas-owned films that are made in New Zealand by a New Zealand-resident company.

Application date

The amendments apply from the 2005–06 income year, the same application date as the Income Tax Act 2004.

VENTURE CAPITAL EXEMPTION

Section CW 11B of the Income Tax Act 2004 and section CW 12 of the Income Tax Act 2007

Section CW 11B of the Income Tax Act 2004 and the equivalent provision in the Income Tax Act 2007 have been amended to address concerns that the existing legislation may not operate as intended when the venture capital exemption applies on the basis of a Tax Information Exchange Agreement (TIEA) rather than a double tax agreement (DTA).

Background

Section CW 11B was introduced, with effect from 1 October 2005, with the intention of facilitating increased offshore venture capital investment into New Zealand. The section removes a potentially significant tax obstacle to in-bound venture capital investment, by removing any risk that a qualifying non-resident venture capital investor selling shares in an eligible New Zealand company could be subject to New Zealand income tax on any gain arising from the sale.

One of the requirements of section CW 11B is that the investor must be from a jurisdiction approved by the Governor-General by Order in Council. Broadly, a jurisdiction will be approved only if effective exchange of information arrangements are in place with New Zealand. Until recently, New Zealand has only entered into exchange of information arrangements through its DTAs. It is understood that most venture capital investment is structured to come through nil or low-tax jurisdictions. However, New Zealand generally does not conclude DTAs with nil or low-tax jurisdictions. Therefore section CW 11B may have had limited effect on encouraging venture capital investment into New Zealand.

New Zealand is now negotiating TIEAs with nil or low-tax jurisdictions. TIEAs will satisfy the requirement for effective exchange of information arrangements. However, the existing legislation needed to be amended to ensure that it operates correctly when the relevant treaty is a TIEA rather than a DTA.

Key features

Determining the residence of the investor

Section CW 11B requires a determination of the investor's residence. Two tests for residence are prescribed: in the presence of a DTA between New Zealand and the other jurisdiction, residence is to be determined under the DTA;

in the absence of a DTA, residence is to be determined under the domestic law of the other jurisdiction.

Technically, a TIEA is a DTA for the purposes of the Income Tax Act, but TIEAs do not generally include any tests for residence. Therefore an investor from a nil or low-tax jurisdiction may fail to satisfy the residence requirement of section CW 11B for purely technical reasons.

The tests for determining the investor's residence have therefore been amended to provide that, notwithstanding the existence of a DTA, if residence cannot be determined under that DTA then it is to be determined under the domestic law of the other jurisdiction.

Reference to "taxation laws"

Section CW 11B defines three separate categories of qualifying investor – "foreign exempt person", "foreign exempt entity" and "foreign exempt partnership". Each definition requires the investor to be specifically treated in a certain manner by the taxation laws of the jurisdiction concerned. Broadly, the intention is that the investor must be tax-exempt in their home jurisdiction, and hence unable to claim any relief or benefit for New Zealand tax (in other words, they have no home jurisdiction tax to credit New Zealand tax against).

A nil or low-tax jurisdiction may not actually impose income tax, but because there is no specific taxation law rendering the investor exempt, section CW 11B could fail to apply.

The wording of section CW 11B has therefore been amended to ensure that investors from nil or low-tax jurisdictions do not fail to qualify simply because their home jurisdiction has no applicable taxation laws.

Mechanism for detecting New Zealand ownership of offshore entities

Many nil or low tax jurisdictions operate an "offshore sector", in which it is relatively simple to set up a foreign-owned legal entity such as an international business company (IBC). However, section CW 11B contains no mechanism for detecting, for example, the case of a New Zealander setting up an IBC in a nil or low-tax jurisdiction to hold shares (either directly or indirectly) in a New Zealand company. Therefore, by means of a simple structuring arrangement, a New Zealander could gain access to an exemption from any gain on the sale of shares that would otherwise be taxable in New Zealand.

A "look-through" rule has therefore been inserted into the legislation to prevent any New Zealand direct or indirect owner or member of an offshore entity established in a nil or low tax jurisdiction from gaining the benefit of the section CW 11B exemption.

Application date

The amendments apply from 19 December 2007.

QUALIFYING COMPANY ELECTION TAX

Section ME 4 of the Income Tax Act 2004 and section OB 7B and Table O1 of the Income Tax Act 2007

Qualifying company election tax (QCET) has, up to now, where a company has elected to become a qualifying company, been a final tax on that part of a company's shareholder's funds that are not sheltered by imputation credits. From 17 May 2007, payments of QCET are credited to the imputation credit account (ICA) and so they become more of a withholding tax.

Background

When the qualifying company rules were introduced in the early 1990s it made little difference whether QCET was a final tax or a withholding tax. However, given that QCET is payable at the company rate of tax, the new 30% tax rate for companies exacerbated the issue of whether QCET should be a final tax or a withholding tax.

Key features

The sections that govern imputation credit handling have been amended to provide that payments of QCET are creditable against the company's ICA, so that when the associated income is distributed, it retains its taxable nature in the shareholders' hands, but the credits for the QCET are attached as imputation credits. This is because of the core qualifying company rules that provide that dividends are imputed to the extent of imputation credits available.

Application date

The amendments apply from the date of their announcement, 17 May 2007.

MISCELLANEOUS TECHNICAL AMENDMENTS

TAXABLE BONUS ISSUE DEFINITION

Section OB 1 of the Income Tax Act 1994

The definition of "taxable bonus issue" in the Income Tax Act 1994 has been amended to reflect changes to the definition of "taxable bonus issue" made in the Income Tax Act 2004 from 16 November 2004. The new definition recognises that taxable bonus issues that are exempt dividends in the hands of shareholders can be treated as taxable bonus issues, but only to the extent of the value of the reserves capitalised.

Application date

The amendment applied from 16 November 2004, the date when the equivalent changes were made in the 2004 Act.

AUSTRALIAN IMPUTATION ACCOUNT COMPANY ELIGIBILITY

The repeal of section ME 1(2)(a) in 2006 had the unintended consequence of restricting eligibility to be an Australian imputation credit account company. Former section ME 1(2)(a) – which provided that a non-resident company could not maintain an imputation credit account – was repealed because it was a redundant provision. Section ME 1A of the Income Tax Act 2004 and section OB 2 of the Income Tax Act 2007 have been amended to reinstate the previous ability of certain Australian-resident companies to elect to establish and maintain New Zealand imputation credit accounts.

Application date

This amendment applies for the 2005–06 and subsequent income years.

LEGAL DECISIONS – CASE NOTES

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

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

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

PHYSICAL RECEIPT OF INCOME NOT NECESSARY TO BE AFFECTED BY A TAX AVOIDANCE ARRANGEMENT

Case: TRA Decision Number 04/08

Decision date: 08 February 2008

Act: Income Tax Act 1976

Keywords: Avoidance, procedure.

Summary

The taxpayer applied to have the proceedings dismissed on the ground that he cannot possibly have avoided tax if he did not receive any income, which is a fact he alleged the Commissioner admitted.

It is not necessary to physically receive income to be affected by a tax avoidance arrangement. Whether the disputant was so affected can only be determined after the evidence is heard.

Facts

The taxpayer ran a template avoidance scheme for many years during the 80s and 90s, which he sold to clients. The scheme involved the taxpayer's companies and the taxpayer's clients sharing the tax benefits resulting from the scheme. In 2002 the Commissioner assessed him for his profits from operating the scheme. The assessments were the result of applying section 99 of the Income Tax Act 1976 (which was the anti-avoidance provision relevant to the years in question).

This judgment relates to what was effectively an interlocutory application by the taxpayer to have the proceedings dismissed. The taxpayer contended that as he has never received any of the money assessed to him, he cannot possibly be liable for tax on it as he cannot have gained a tax advantage. The taxpayer admitted that he controlled all the relevant entities, but argued this was irrelevant as he never received any of the income personally. The anti-avoidance provisions operate to counter situations where a taxpayer has received income in a non-taxable form (such as exempt income) where the Income Tax Act does not anticipate such results.

The Commissioner argued that the taxpayer received direct and indirect benefits, and that the evidence will show the taxpayer was operating a tax avoidance arrangement, and that he was a person affected by that arrangement. It is not necessary that a person be a part of that arrangement, only that they were affected by it. In any case, it is too early in the proceedings to be dealing with such an application.

Decision

The Taxation Review Authority (TRA) accepted the Commissioner's submissions that it is not necessary to receive income, as long as the taxpayer is affected by an arrangement. His Honour agreed that it is too early to determine whether the taxpayer in this case was so affected. Such a conclusion can only be drawn once the evidence has been heard. His Honour also noted that in any case, it appears that the taxpayer had so much control over the income flows that they can be considered to be received by him. The taxpayer's application was dismissed.

COMMISSIONER ENTITLED TO RECOVER INTEREST AND OUTSTANDING TAXES

Case: The Commissioner of Inland Revenue v Ron West Motors (Otahuhu) Limited

Decision date: 12 February 2008

Act: Companies Act 1993

Keywords: Liquidation

Summary

Commissioner able to recover interest on a sum paid into Court and company ordered to pay balance of the tax debt otherwise it would be liquidated. The interest sum did not have to be applied to the outstanding debt.

Facts

The taxpayer faced liquidation at the petition of the Commissioner. The debt (originally $78,734.35) was a result of the re-assessment of the taxpayer under Track A of the Russell template. The age of this matter meant it was under the old deferred tax rules and the taxpayer was obliged to pay half the tax in dispute ($39,385.66). The Commissioner had previously commenced liquidation proceedings for the unpaid non-deferred half of the tax in dispute. In those proceedings the taxpayer had paid half the tax in dispute into Court to stay those proceedings. The Court ordered that the "successful party" would receive the payment plus any interest it had earned.

By the time the taxpayer's various tax challenges and judicial reviews were resolved, the sum held by the Court was just under $100,000. Once the non-deferred tax sum was paid to the Commissioner approximately $58,000 in interest remained.

In the meantime, the Commissioner commenced another liquidation petition for the balance of the tax unpaid $39,348.69. The taxpayer opposed on a number of grounds—these are re-countered as the issues below.

Decision

His Honour dismissed each of the taxpayer's arguments:

1. The debt was not able to be disputed. His Honour considered that on the facts there was no evidence that the debt was assessed to and paid by someone else. Even if there were he referred to *Wire Supplies* (2007) 23 NZTC 21,404 to conclude that it was for this other person who had been assessed to raise the issue of the taxpayer's assessments for the same money in that other person's own tax affairs.
2. The facts precluded the application of *Withey No 2* as there was evidence that a new due date had been properly applied.
3. His Honour ruled there was no "election" by the Commissioner to apply the interest received from the payment into court to the taxpayer's benefit. The Judge accepted the Commissioner had been the successful party and that the interest element had not been earmarked to be used for the taxpayer's benefit. His Honour was not satisfied the alleged "election" was any more than a mistake and, also, he concluded the "election" was irrelevant as the initial Court order remained effective.

The end result is that the Commissioner is entitled to receive the interest without having to apply it to the taxpayer's debt and the taxpayer was given a week to pay the outstanding debt and court costs ($59,978.69) or it would be put into liquidation.

ORDERS FOR DISCOVERY

Case:	TRA decision number 03/08
Decision date:	22 January 2008
Act:	Taxation Administration Act, 1994; District Court Rules; Taxation Review Authorities Regulations 1998; Taxation Review Authorities Act 1994
Keywords:	General discovery, particular discovery

Summary

General discovery by each party was ordered but confined to a particular forestry partnership.

Facts

The Commissioner had sought an order for discovery. At the Directions Hearing the taxpayer sought an order that the general discovery sought by the Commissioner should not be made and if one is to be made, then the taxpayer also seeks discovery from the Commissioner.

The substantive proceedings concern an alleged tax avoidance arrangement involving a forestry partnership.

Taxpayer's Submissions:

- The Commissioner's application for discovery is an interlocutory application and therefore the onus is on the Commissioner to establish that the order is justified. (Regulation 12(5) of the Taxation Review Authorities Regulations 1998 (TRAR)). This has not been established.
- A discovery order in the context of a dispute which has been fully subject to Part IVA procedures is inconsistent with section 138G (Evidence exclusion rule) of the Tax Administration Act (TAA).

Commissioner's Submissions:

- The scheme and purpose of the legislation supports the litigant's entitlement to general discovery.
- Section 138G (Evidence exclusion rule) does not affect the Commissioner's right to general discovery.
- There is no onus of proof in respect of whether the Commissioner is entitled to general discovery as it is a matter of law.

Decision

The TRA agreed with the Commissioner and ordered general discovery by each party but confined it to one partnership as agreed between the parties.

Discovery is essential to ensuring that the necessary evidence is before the Authority. If any tax legislation sought to remove a litigant's right to discovery this

intention would have been expressed clearly and not left to inference.

It is inconsistent with the encouragement of openness in the TAA not to order discovery. This is particularly so as the Commissioner is entitled to establish what documents are in the possession of the taxpayer and whether the taxpayer was forthcoming and open during the disputes process.

To understand the impact of the evidence exclusion rule on discovery a distinction needs to be drawn between particular discovery and general discovery. Particular discovery allows a party to obtain a court order for discovery of specified documents or a class of documents. The evidence exclusion rule needs to be taken into account when making such an order. With regard to general discovery the evidence exclusion rule is not a bar to obtaining this. No court order is required for general discovery and no requirement that discovery must be necessary prior to a party having discovery obligations.

Under the District Court Rules 1991, the defendant has the right to require general discovery. The requirement of necessity, which applies to particular discovery does not apply to general discovery unless an order is sought under R 319. The evidence exclusion rule is therefore not applicable to routine general discovery under the Rules.

His Honour stated that for the evidence exclusion rule to operate in the manner envisaged in the TAA general discovery is required. This is because, as it is not possible for the party receiving general discovery to know what documents are going to be discovered, in the ordinary course the application of the evidence exclusion rule cannot be ascertained. General discovery is therefore necessary before the application of s138G can even be determined. General discovery is entirely consistent with full disclosure as it enables an assessment of whether there has been such full disclosure.

General discovery being allowed is consistent with the purpose of a Commission of Inquiry, being to establish the correct position from the available evidence.

General discovery is essential to achieve the purpose of the TRA, being to determine challenges in accordance with the law and taking into account all available and admissible evidence.

There is nothing in TRA regulations or in any other statutory provision which makes general discovery before the TRA an interlocutory application.

JUDICIAL REVIEW

Case:	Gary James Christieson v The Commissioner of Inland Revenue
Decision date:	27 February 2008
Act:	Taxation Administration Act, 1994; Judicature Amendment Act 1972
Keywords:	Judicial Review, strict compliance with Statutory timeframes in response to default assessments, Notice of Proposed Adjustment (NOPA) and tax returns must be filed

Summary

The taxpayer failed to file income tax returns with his NOPA in response to a default assessment, as a result the Commissioner rejected the taxpayer's NOPA. The taxpayer considered the Commissioner's decision to reject the NOPA was unreasonable and therefore commenced Judicial Review proceedings in the High Court.

Facts

This was an application for judicial review filed by the plaintiff against a decision of the Commissioner.

The taxpayer and his wife failed to file income tax and Goods and Services Tax returns for three income years. An investigation was conducted and the Commissioner issued default assessments. Mr Christieson failed to comply with the statutory time limits for filing returns and responding with a Notice of Proposed Adjustment. The taxpayer admitted it in his affidavit that returns were filed one month out of time yet he contended by way of review, that the Commissioner had improperly exercised his statutory powers

Decision

His Honour found that the taxpayer had been advised of the time limits set out in the Tax Administration Act 1994 when the Commissioner issued the default assessments. Counsel for the Commissioner had prepared a table of all the relevant dates which his Honour incorporated into his decision. The table, supported by affidavit evidence had not been contested by the taxpayer. His Honour held that no case had been made out and the plaintiff abandoned his claim. His Honour stated:

> [6] Counsel for the taxpayer must have been aware of the requirement for strict compliance with statutory timeframes in this area: *Allen v The Commissioner of Inland Revenue* [2006] 3 NZLR 1 (CA). Mr Christieson's failure to exercise his statutory right ended his entitlement to invoke the dispute procedure unless the Commissioner invoked his discretionary power to further extend time. He can, of course, only do so in exceptional circumstances. There is no evidential basis for suggesting that he should have done so here.

His Honour held that the claim was ill-founded, ill-advised and completely devoid of merit. His Honour held that the plaintiff's allegations "verge on the scurrilous" and were "gratuitous and unsubstantiated denigration of the motives of the Commissioner's employees". His Honour awarded costs to the Commissioner on an indemnity basis.

REGULAR FEATURES

DUE DATES REMINDER

April 2008

7 End-of-year income tax

- **7 April 2005**

  2007 end-of-year income tax due for clients of agents with a March balance date

21 Employer deductions

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

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

May 2008

7 GST return and payment due

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 2008–2009*. This calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum.

YOUR CHANCE TO COMMENT ON DRAFT TAXATION ITEMS BEFORE THEY ARE FINALISED

This page shows the draft binding rulings, interpretation statements, standard practice statements and other items that we now have available for your review. You can get a copy and give us your comments in these ways.

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Draft depreciation determination	*Comment deadline*
☐ DDG0133: Hired out baby gear	30th April 2008
☐ DDG0136: Flight simulators	30th April 2008

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