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TAX INFORMATION Bulletin

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly 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 a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at **www.ird.govt.nz**. On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington

You can also subscribe to receive regular email updates when we publish new draft items for comment.

Below is a selection of items we are working on as at the time of publication. If you would like a copy of an item please contact us as soon as possible to ensure your views are taken into account. You can get a copy of the draft from **www.ird.govt.nz/public-consultation/** or call the Team Manager, Technical Services Unit on 04 890 6143.

Ref	Draft type/title	Description/background information
PUB0160	Deductibility of break fee paid by a landlord to exit early from a fixed interest rate loan; and, Deductibility of break fee paid by a landlord to vary the interest rate of an existing fixed interest rate loan	These two public rulings consider the deductibility of a break fee paid by a landlord to a lender to exit early from, or vary the interest rate of, a fixed interest rate loan. The two draft public rulings are being released as a single document with a combined commentary.
IS3571	Retirement villages – GST treatment	This draft interpretation statement addresses the GST treatment of payments made to the owners or operators of retirement villages and their entitlement to input tax credits on supplies received for the purpose of a retirement village. It was previously released for consultation in February/March of this year, and now takes account of submissions received during that time.
DDG0143	Loose furniture for short-term hire	This general depreciation determination sets out the rate for the asset class "Furniture (loose)" in the "Hire equipment (short-term hire of 1 month or less only)" asset category. An example of this is furniture hired to prospective home vendors. This determination replaces provisional depreciation determination PROV17, issued on 16 February 2007.
ED 0118	Reimbursing shareholder-employees for motor vehicle expenses	This draft QWBA clarifies the use of the mileage rate published by Inland Revenue to reimburse shareholder-employees. In particular it clarifies the employee criteria and whether the 5,000 km limitation on using that mileage rate applies in these circumstances.

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BINDING RULINGS

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

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

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

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

PRODUCT RULING BR PRD 09/08: NEWMONT MINING NZ COMPANIES (CONSOLIDATED GROUP)

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Persons to whom the Ruling applies ("the Applicants")

This Ruling has been applied for by Newmont Mining NZ Companies (Consolidated Group) ("Newmont").

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of sections CA 1(2), CB 1, CC 1(1), CD 1 and CE 1 of the Income Tax Act 2007.

The Arrangement to which this Ruling applies

The Arrangement is the payment to persons pursuant to the Amenity Effect Programme ("AEP").

Newmont is required to comply with the Resource Management Act 1991 ("the RMA"), which includes the obligation to minimise any adverse effect of its operations on the environment and its neighbours. Consequently, Newmont endeavours to use industry-leading methods to manage, monitor and record the effect of its operations on the environment and on others living in the vicinity of its operations. However, based on the results of monitoring and modelling, Newmont has identified properties within the area of the Martha and Favona mines whose amenity may be measurably affected by mining activity specifically by noise, dust and blast-induced vibration effects ("the affected area").

In response to this, Newmont has developed the AEP the full details of which have been provided to Inland Revenue in a letter dated 12 March 2009. The details are not repeated here, save to note that the AEP is not compensation for non compliance with any of the conditions imposed under the RMA.

Occupiers of residential property within the affected area will be offered an opportunity to participate in the AEP. However, any Waihi resident may request to be included in the AEP. Their inclusion or exclusion will be based on the results of monitoring and modelling at their property over the six-month payment period or a period sufficient to confirm potential effects on amenity.

Inclusion in the AEP is voluntary and an application to participate in the AEP can be made any time.

Residents who apply to participate and are accepted into the AEP ("enrolled residents") will receive an initial one-off "enrolment payment". The enrolment payment is currently $500.

Enrolled residents will also be eligible for six-monthly retrospective effect-based payments for the greater of either noise or vibration effect based on its routine environmental monitoring results.

The quantum of the effect-based payments will vary with the actual loss of amenity experienced. If there is no effect, or the effect is to a greater or lesser extent, the payment will be varied.

Payments are carefully targeted to compensate for adverse amenity effects that residents have suffered.

Assumptions made by the Commissioner

This Ruling is not subject to any assumptions.

Conditions stipulated by the Commissioner

There are no conditions stipulated by the Commissioner.

How the Taxation Laws apply to the Applicant and the Arrangement

The Taxation Laws apply to the Arrangement as follows:

The payments received by persons under the AEP are not income under sections CA 1(2), CB 1(1), CC 1(1), CD 1 and CE 1 of the Income Tax Act 2007.

The period or income year for which this Ruling applies

This Ruling will apply for the period from 12 March 2009 to 31 March 2012.

This Ruling is signed by me on 4 August 2009.

James Mulcahy
Investigations Manager, Assurance

PRODUCT RULING BR PRD 09/09: AIR NEW ZEALAND LIMITED

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the Person who applied for the Ruling

This Ruling has been applied for by Air New Zealand Limited.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of sections CA 1(2), CB 1, CB 3, CB 4, CB 5, CE 1, CX 2(1), CX 2(2), EW 3, EW 5(21), and EW 31.

The Arrangement to which this Ruling applies

The Arrangement is the accruing by a Member of the Air New Zealand Airpoints Programme of Airpoints Dollars provided by Air New Zealand as a result of expenditure incurred by the Member's employer on the Member's work related travel and the redemption of those Airpoints Dollars for air travel and other rewards ("Rewards"). The Arrangement does not include employees of Air New Zealand and its subsidiaries (as they are not entitled to accrue Airpoints Dollars in respect of work related travel). Further details of the Arrangement are set out in the paragraphs below. Capitalised terms are defined in the Airpoints Members' Guide as provided to the Commissioner on 13 May 2009.

1. Air New Zealand operates a loyalty scheme known as the "Airpoints Programme", referred to in this Ruling as the Programme. Under the Programme, Airpoints Dollars accrue to Members by reference to the value of the fare paid and region of the world travelled, and Airpoints Dollars have a value identical to dollars on redemption for Rewards. Airpoints Dollars may also accrue to Members from expenditure incurred on goods and services sold by scheme partners ("Partners"), for example hotels and hire car companies.
2. Airpoints Dollars accruing to or accumulated by a Member can be used by them to purchase an equivalent dollar value of travel or to purchase other Air New Zealand products (such as Koru Club membership), or hotel accommodation, travel insurance, car hire and other rewards ("Rewards").
3. The terms and conditions of the Programme are contained in the Airpoints Members' Guide provided to the Commissioner on 13 May 2009 ("Terms and Conditions").

Employees of Air New Zealand's commercial customers

4. Employees of Air New Zealand's commercial customers may accrue Airpoints Dollars on travel undertaken for work purposes and paid for by their employer. The employer may pay for this travel by paying Air New Zealand for the tickets that are issued to the employee, or by reimbursing the employee for payments made by them. Any such employees wishing to accrue Airpoints Dollars would first need to become an Airpoints Member.
5. Airpoints Dollars accrue to Members by virtue of a Member's individual membership. The employer may pay the $50 membership fee, by either reimbursing the employee or paying on the employee's behalf.
6. Members' employers will not provide any consideration to Air New Zealand for Airpoints Dollars provided to those Members. Air New Zealand will not provide discounts (other than an ordinarily available discount for corporate customers provided for reasons unrelated to Airpoints Dollars) to corporate customers who request that Airpoints Dollars not be issued to their employees in respect of work related travel.
7. Employers have no influence over the Airpoints Dollars to be provided to Members (except to the extent that they purchase air travel). Airpoints Dollars will accrue to Members on the basis provided for in the Terms and Conditions, regardless of whether travel is undertaken for private purposes or for work related purposes and regardless of who pays for the travel. Airpoints Dollars accrue and are redeemed for Rewards on the same basis for any Member of the Programme, irrespective of the Member's employer.

Airpoints Membership

8. Airpoints Membership is available to residents of all countries.
9. The Membership joining fee is a cost of NZ$50 for New Zealand residents and AU$50 for Australian Members. Residents of all other countries will be

charged the local currency equivalent of NZ$50. This fee may not be paid for using Airpoints Dollars and must be paid for in cash.

10. Complimentary Membership is available to eligible first class and business class passengers who have paid for and travelled Business Premier class on Air New Zealand Operated Flights for international Sectors. Complimentary Membership is available to current fully paid-up members of Air New Zealand Koru Club.
11. Each Member may maintain only one Account. Membership is not transferable.
12. No individual Member's Account information or details will be discussed or amended or transacted unless the Member's correct Membership number along with their Personal Access Code is first quoted.
13. The Membership Card is used to assist in the earning of Airpoints Dollars and to obtain access to or the provision of Rewards. The Member agrees that his/her signing of a Card and/or quoting his/her Membership number to Air New Zealand or to any of its Partners, employees or agents for the purposes of the Airpoints Programme means that he/she has read and understood the Terms and Conditions of the Airpoints Programme and accepts them.
14. Air New Zealand reserves the right to cancel a Member's Membership in the Programme at any time without notice and without giving a reason for so doing. Air New Zealand will not provide any consideration for Airpoints Dollars earned but not redeemed at the time of termination of Membership.
15. Membership will terminate on the death of a Member. Airpoints Dollars or any other benefits earned but not redeemed at the time of death will be cancelled with no consideration. Transfer of Airpoints Dollars on the death of a Member is permitted in the situation set out in clause 8.8.2 in accordance with clause 8.5 of the Terms and Conditions (see paragraphs 31 to 32 below).

Earning Airpoints Dollars

16. Airpoints Dollars may be earned through expenditure on Air New Zealand and Partner Airline flights and on goods and services purchased from non-airline Partners (including car rental, hotel accommodation, GlobalPlus accounts and travel insurance). Transfer of credit card points/credits into Airpoints Dollars is available in some cases. Airpoints Dollars are provided by Air New Zealand regardless of whether the entitlement arises from the purchase of Air New Zealand or Partners' goods and services.

Using Airpoints Dollars

17. Rewards may be paid for using Airpoints Dollars. One Airpoints Dollar has the equivalent value of $1 in relation to the number of Airpoints Dollars required to acquire Rewards. A combination of Airpoints Dollars and cash for the acquisition of a Reward is not permitted, unless otherwise specified in writing by Air New Zealand.
18. Airpoints Dollars may be used to obtain Reward flights with Air New Zealand and Partner Airlines. Any Reward ticket that is cancelled and is refundable will be refunded by a re-crediting of Airpoints Dollars. Taxes, levies, or surcharges cannot be paid for using Airpoints Dollars and must be paid for in cash. The only exception to this is where the published fare is inclusive of taxes, levies and/or surcharges, for example on Air New Zealand Operated Flights within New Zealand or where the published fare is inclusive of insurance and fuel charges.
19. Non-flight and non-airline Rewards are available, subject to the applicable Partner's terms and conditions where those Rewards are not provided by Air New Zealand. Rewards include Koru Club membership, car hire and hotel accommodation. GlobalPlus Credit Card customers may have the ability to redeem their Airpoints Dollars on a limited range of other non-airline products (such as holiday passes, wine and CD vouchers).

Non-convertibility

20. Under the Terms and Conditions, Airpoints Dollars and Rewards cannot be redeemed, sold, assigned, gifted or otherwise transferred by a Member for cash or other consideration. The relevant clauses of the Terms and Conditions in this respect are as follows.
21. Clause 3.1.24 of the Terms and Conditions states:

    > In accepting a Reward, you agree that (subject to these Terms and Conditions and in particular the Gifting provisions in clauses 4 below and 3.4.3.10 and 3.4.4.11) you won't combine any Rewards with anyone else or sell, assign or otherwise transfer the right to a Reward to anyone else. Air New Zealand has the right to ask you for proof that you have complied with this clause in addition to any evidence required in accordance with clause 12.

22. Clause 3.1.25 of the Terms and Conditions states:

    > Rewards offered by Partners will be on the applicable Partner's terms. If you redeem a Reward in conjunction with any other loyalty programme (where such programme has our consent to use Airpoints Dollars) you agree that you won't combine any Rewards with anyone else or sell, assign or otherwise transfer Rewards for Cash or anything else. Air New Zealand is not responsible for Reward offers by Partners or their conditions, or for the Partners' performance or provision of such Rewards.

23. Clause 4.1.8 of the Terms and Conditions states:

    You must not receive any Cash or other consideration as payment for any Rewards you gift.

24. Clause 9.7 of the Terms and Conditions states:

    Notwithstanding any other provision in these Terms and Conditions or the terms and conditions of any other loyalty programme offered by a Partner and/or authorised by Air New Zealand, you can't redeem for Cash or sell your Airpoints Dollars and/or Rewards or assign or transfer them for Cash or any other consideration.

25. Clause 15.5 of the Terms and Conditions states:

    Airpoints Dollars may not be used to acquire any goods or services other than in conjunction with:

    - the Air New Zealand Airpoints Programme in accordance with these Terms and Conditions
    - any other loyalty programme, that we have given written consent to use Airpoints Dollars and in accordance with such loyalty programme's terms and conditions.

26. Clause 15.6 of the Terms and Conditions states:

    Airpoints Dollars are not convertible into Cash. Any Rewards offered by Partners or any use of Airpoints Dollars in conjunction either with the Programme or with any other loyalty programme that we have authorised the use of Airpoints Dollars in conjunction with, are subject to the restriction that you can't sell, assign or transfer any Rewards or Airpoints Dollars for Cash or any other consideration.

27. If a Member cancels a refundable Ticket, then in accordance with clause 3.1.16 the refund will be a re-credit of the Airpoints Dollars to the Member's Account. Airpoints Dollars may also be re-credited if an Upgrade for which Airpoints Dollars were redeemed is not available.

Gifting

28. Gifting is the process whereby a Member authorises the deduction of Airpoints Dollars from his/her account where such Airpoints Dollars are redeemed to provide a person resident in the same Household as the Member with a Ticket for Reward Travel or for Non-Airline Rewards. Companion Tickets may not be Gifted.

29. Gold, Gold Elite Members (Members who have accrued a specified number of Airpoints Dollars from qualifying flights) or GlobalPlus Platinum cardholders are additionally entitled to nominate as giftees two individual persons who do not need to reside in the same Household as the Gold Elite Member.

30. Air New Zealand will monitor each Member's Gifting Register to ensure that no fraudulent activities occur.

Transfer of Airpoints Dollars

31. Clause 8.5 provides for the transfer for Airpoints Dollars in accordance with clauses 1.4.5.1 and 11.4.1. Clause 1.4.5.1 provides as follows:

    1.4.5.1 Transfer of credit cards points/credit transfers to Airpoints Dollars are only available in certain countries – and in accordance with these Terms and Conditions and those of the relevant credit card issuer. Please contact your credit card issuer for full details including details on membership eligibility and transfer fees.

32. Clause 11.4.1.1 provides that Airpoints Dollars may be transferred between parties in accordance with clauses 11.4.1.2 and 11.4.1.3, which provide as follows:

    11.4.1.2 If the Nominated Earner of a joint Global Plus branded credit card (including a joint GlobalPlus Business Card) or, a joint GlobalPlus Home Loan account or a joint BNZ Credit Card dies, 100% of the Airpoints Dollars accrued from that person's joint account, and that have not yet been redeemed, may be transferred from the Nominated Earner's Airpoints Account to the other joint account holder's Airpoints Account, once the BNZ has provided verification to us of the Member's death and type of bank account.

    11.2.1.3 In the case of either separation or divorce, 50% of the Airpoints Dollars accrued from a joint GlobalPlus branded credit card (including a joint GlobalPlus Business Card) or, a joint GlobalPlus Home Loan account or a joint BNZ credit card, and which have not yet been redeemed, may be transferred from one joint account holder's Member's Account – as long as both Members ask for the transaction. The Membership details and PAC numbers for both Members must be sent to the Air New Zealand Contract Centre with supporting documentation from the solicitor of the Member from whose Account the Airpoints Dollars will be transferred. Once the Air New Zealand Contact Centre has received and verified the documentation, the relevant Airpoints Dollars that have not already been redeemed for Rewards will be equally divided and distributed into the relevant Member' Accounts.

Combining Airpoints Dollars

33. A Member may be permitted by Air New Zealand, at Air New Zealand's sole discretion, to combine his/her Airpoints Dollars with another Member's Airpoints Dollars for the purpose of booking a rental car Reward and/or a hotel Reward for a period in each case of two or more consecutive days, provided that each Member has sufficient Airpoints Dollars to redeem a rental car Reward for a minimum of one day and/or a hotel Reward for a minimum of one night.

Monitoring

34. Air New Zealand will monitor Airpoints Membership Accounts and the Programme. In particular, clause 12.2 of the Terms and Conditions states:

> If you commit fraud in connection with Airpoints Dollars or abuse your Airpoints Dollars accumulation or Rewards use or breach these Terms and Conditions, you'll be subject to appropriate administrative and/or legal action by Air New Zealand that includes, but is not limited to, Membership termination, Membership suspension, the forfeiture of all accumulated Airpoints Dollars and unused Rewards and an action to recover the monetary value of the Airpoints Dollars and credits concerned.

Termination

35. A Member may terminate his/her Membership in the Programme at any time by giving notice in writing and returning the Membership Card to Air New Zealand.
36. Partners may discontinue their participation in the Programme and their provision of Rewards at any time without notice.
37. Air New Zealand gives no warranty as to the continuing availability of the Programme and reserves the right to terminate the Programme upon giving not less than six months' notice to Members, or at any time without notice if Air New Zealand ceases to operate as an airline. Air New Zealand will not provide any consideration for Airpoints Dollars earned but not redeemed at the time of termination of the Programme.

Access to other benefits

38. Under no circumstances are the Terms and Conditions interchangeable with those of the Air New Zealand Koru Club or any other club or loyalty programme operated by Air New Zealand or any of its Partners. Membership of the Programme does not give access to the benefits of any other Air New Zealand club, facility or loyalty programme unless so stated in the conditions of membership of such other club, facility or loyalty programme.

Changes to the Programme

39. The Terms and Conditions may be amended at any time, pursuant to clause 9.1 of the Terms and Conditions.

Ruling not applicable to other loyalty programmes

40. This Ruling does not consider or rule on the tax treatment of any other loyalty programme to which, in accordance with clauses 15.5 and 15.6 of the Terms and Conditions, Air New Zealand has given written consent to use Airpoints Dollars in accordance with the terms and conditions of that other loyalty programme.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) Under no circumstances will the Terms and Conditions allow Airpoints Dollars or Rewards (including any goods or services received from redeeming Rewards such as vouchers) to be redeemed for cash or sold, assigned or transferred by a Member for cash or other consideration.

b) In any circumstance where a Reward is cancelled or unavailable or where for any other reason the Member is entitled to a refund of Airpoints Dollars, the refund is by way of re-crediting to the Member's Account the Airpoints Dollars redeemed by the Member for that Reward.

c) Employees of Air New Zealand and its subsidiaries cannot accrue Airpoints for work related travel.

d) Membership of the Programme is a contract between a Member and Air New Zealand. Employers are not entitled to enter into that contract on behalf of their employees.

e) The membership fee payable to Air New Zealand constitutes a legal liability owed by the applicant to Air New Zealand.

f) Where the Member is an employee of a Partner or a Partner Airline, the Member does not redeem Airpoints Dollars for any Reward offered by that Partner or Partner Airline.

g) Where the employer has either paid the membership fee on behalf of the employee or reimbursed the employee for that fee, the receipt or the possibility of the receipt by the employee of Airpoints Dollars or Rewards is not taken into account by the employer in determining that employee's remuneration (whether by the relative reduction of remuneration or otherwise).

h) Where the employer has either paid the membership fee on behalf of the employee or reimbursed the employee for that fee, the employer, when purchasing travel in respect of which that employee derives Airpoints Dollars, does not pay substantially more for that travel than the cost of equivalent air travel services with a more than incidental purpose of the provision of Airpoints Dollars or Rewards to that employee.

i) No changes to the Programme are made pursuant to clause 9.1 of the Terms and Conditions that are material to the tax treatment of Airpoints Dollars and Rewards derived by employees in respect of work related travel.

How the Taxation Laws apply to the Arrangement

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

- No income arises to the Member under sections CA 1(2), CB 1, CB 3, CB 4, CB 5 or CE 1 when they receive Airpoints Dollars or Rewards.
- The employer of the Member is not liable under sections CX 2(1) or CX 2(2) for FBT on any benefits obtained by the Member as a result of receiving Airpoints Dollars or Rewards.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2009 and ending on 31 March 2014.

This Ruling is signed by me on the 10th day of August 2009.

Howard Davis
Director (Taxpayer Rulings)

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.

DETERMINATION FDR 2009/03: A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND FOR WHICH A PERSON MAY NOT USE THE FAIR DIVIDEND RATE METHOD (PIMCO FUNDS: GLOBAL INVESTORS SERIES PLC GLOBAL BOND 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 position of Policy Manager, Policy Advice Division, under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Shares in the PIMCO Funds: Global Investors Series plc Global Bond Fund (PIMCO) to which this determination applies 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 investment in units in PIMCO each year.

PIMCO invests in global fixed interest securities for which PIMCO has made foreign currency hedging arrangements to provide investors with a New Zealand dollar denominated return on these debt instruments. Section EX 46(10)(c) of the Income Tax Act 2007 would not apply to prevent the use of the fair dividend rate (FDR) method but would apply if the New Zealand dollar denominated share class was the only class of shares issued by PIMCO.

The policy intention is that the FDR method of calculating FiF income should not be applied to investments that provide a New Zealand-resident investor with a return similar to a New Zealand dollar denominated debt investment. It is appropriate for the Commissioner to take into account the whole of the arrangement, including any interposed entities or financial arrangements, in ascertaining whether an investment in a FiF provides the New Zealand-resident investor with a return akin to a New Zealand dollar denominated debt investment.

On this basis, where the New Zealand-resident investor invests in New Zealand dollar denominated shares in PIMCO, I consider that it is appropriate for the investor holding that investment in PIMCO to be excluded from using the FDR method for the 2010–2011 and subsequent income years.

Scope of determination

This determination applies to an attributing interest in a FiF held by New Zealand-resident investors where:

1. The FiF:
   a) is an Irish company, that issues multiple classes of shares;
   b) is known as "The PIMCO Funds: Global Investors Series plc Global Bond Fund (PIMCO)";
   c) invests into an undivided pool of global bond investments;
   d) undertakes hedging in proportion to the shares issued in each currency. The NZD hedging therefore only covers the proportion of the pool of assets that corresponds to the number of NZD shares.
2. The investors in PIMCO:
   a) invest into that pool of bond assets through classes of shares that are denominated in various currencies, including one which is denominated in New Zealand dollars (NZD shares);
   b) that are New Zealand residents invest in the New Zealand dollar class of shares of PIMCO.

Interpretation

In this determination unless the context otherwise requires:

"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 2007.

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 2010–2011 and subsequent income years. However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination also applies for an income year beginning before the date of this determination for an investor in PIMCO that chooses that the determination applies for that year.

Dated at Wellington this 10th day of September 2009.

David Carrigan
Policy Manager, Policy Advice Division

DETERMINATION FDR 2009/5: USE OF FAIR DIVIDEND RATE METHOD FOR A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND THAT IS A DERIVATIVE INCOME 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)

Units in a non-resident issuer ("the issuer") to which this determination applies are attributing interests in a foreign investment fund (FIF) for portfolio investment entities (PIE) managed by New Zealand Funds Management Limited (NZFM). Each PIE is required to apply the FIF rules to determine its tax liability in respect of units in the non-resident issuer each year.

As the issuer holds New Zealand denominated cash, the balance of which may in exceptional circumstances exceed 80% or more by value of its assets, section EX 46(10)(cb) of the Act could apply to prevent the PIE from using the fair dividend rate method in the absence of a determination under section 91AAO of the Tax Administration Act 1994.

Despite the fact that the issuer may hold assets which 80% or more by value consist of financial arrangements denominated in New Zealand dollars, 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) contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument.

Scope of determination

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

a) is a unit trust that is established and tax-resident in Australia;

b) has appointed, as Investment Manager, NZFM (a company incorporated and tax-resident in New Zealand) or an entity which is associated with NZFM;

c) issues New Zealand dollar denominated units (not being fixed rate shares or non-participating redeemable shares) to a PIE (or PIEs) for which NZFM is the Investment Manager;

d) has been established to hold derivative contracts to take or hedge equity or commodity risk by a single investor that is the PIE;

e) invests proceeds from the issue of units in assets which are foreign currency accounts, New Zealand dollar accounts and financial arrangements that do not provide funds to the issuer;

f) to the extent to which it invests in foreign currency accounts (or other financial arrangements that provide funds to the issuer, in relation to which the return is determined by reference in any way to underlying non-New Zealand dollar-denominated fixed-interest securities), does not invest in any currency arrangements which provide an overall economic return as if the securities were denominated in New Zealand dollars;

g) has investment guidelines that prohibit the investment manager from entering into currency arrangements (whether in the issuer itself or through any associated, or commonly controlled, entity) that are intended by the investment manager to achieve an effective hedge of more than 80% of the issuer's foreign currency exposure;

h) may make distributions to the unit holders on a regular basis, but does not guarantee that any income will be derived or that a distribution will be made;

i) may pay to the PIE an amount exceeding the issue price of the unit on redemption, but does not guarantee that the redemption price of a unit will exceed its issue price;

j) the PIE has removed no more than 80% of the foreign currency risk associated with the units.

It is a further condition of this determination that the investment in the issuer is not part of an overall arrangement that seeks to provide the PIE with a return that is equivalent to an effective New Zealand dollar-denominated interest exposure.

Interpretation

In this determination, unless the context otherwise requires:

"Associated" means associated within the meaning of subpart YB of the Act;

"Financial arrangement" means a fixed-rate share under section LL 9 of the Act;

"Investment Manager" means the person or entity appointed by the trustee to carry out the investment activities of the trustee;

"Non-participating redeemable share" means a non-participating redeemable share under section CD 22(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 2007.

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 2009–10 and subsequent income years. However, under section 91AAO(3B) of the Tax Administration Act 1994, this determination does not apply for an income year beginning before the date of this determination for an investor in the issuer unless that investor chooses for this determination to apply for that year.

Dated at Wellington this 24th day of September 2009

David Carrigan
Policy Manager, Policy Advice Division

CANCELLATION OF DETERMINATION G30: DEBT SECURITIES, FINANCE LEASES AND HIRE PURCHASE AGREEMENTS DENOMINATED IN NEW ZEALAND DOLLARS

It should be noted that Determination G30 was withdrawn from use on 1 October 2009 as advised in the *Gazette* published on 8 October 2009.

This determination was introduced as an interim measure for use with certain New Zealand currency financial arrangements which were either held or issued by IFRS taxpayers who were in the business of lending money. It is understood that only a few taxpayers applied Determination G30 to eliminate volatility on applicable financial arrangements following the introduction of the original IFRS tax legislation.

The revised IFRS tax rules available from the 2009–10 income year, particularly the introduction of Determination G3 (yield to maturity), mean that this determination is no longer required.

Application date

The notice cancelling Determination G30 was signed on 1 October 2009.

FOREIGN CURRENCY AMOUNTS – CONVERSION TO NEW ZEALAND DOLLARS

This article provides the exchange rates acceptable to Inland Revenue for converting foreign currency amounts to New Zealand dollars under the controlled foreign company (CFC) and foreign investment fund (FiF) rules for the six months ending 30 September 2009. These exchange rates are found in Table A.

Table B, which provides the exchange rates on the last day of the month is no longer necessary for the CFC or FiF rules but is continued to be provided to assist taxpayers that may need exchange rates on those days.

From 1 October 2009, Inland Revenue changed its information source and is using wholesale rates from Bloomberg for both Table A and Table B.

You need to choose between using the actual rate for the day for each transaction (including closing market value) and the average rate for the 12 months or period. The conversion method chosen must be applied to all interests you use the FiF or CFC income calculation method for and be used in that and each later year.

To convert foreign currency amounts to New Zealand dollars for any country listed, divide the foreign currency amount by the exchange rate shown. Round the exchange rate calculations to four decimal places wherever possible.

If you need an exchange rate for a country or a day not listed in the tables, please contact one of New Zealand's major trading banks.

Note: An overseas currency converter is available in the "Work it out" section of our website at **ww.ird.govt.nz**.

This calculator can only be used where you have actual details for each month. The calculator cannot be used where details are only available on an annual total basis, in which case you will need to use the 12-monthly average rate in Table A.

Table A – 12-month average

Table A is the average of the end of month exchange rates for that month and the previous 11 months, ie the 12-month average.

Use this table to convert foreign currency amounts to New Zealand dollars for:

- FiF income or loss calculated under the accounting profits, comparative value, fair dividend rate, deemed rate of return, or cost methods under sections EX 49(8), EX 51, EX 57 and EX 56 of the Income Tax Act 2007
- branch equivalent income or loss calculated under the CFC and FiF rules pursuant to section EX 21(4) of the Income Tax Act 2004 for accounting periods of 12 months
- foreign tax credits calculated under the branch equivalent method for a CFC or FiF under section LC 4(1B) of the Income Tax Act 2004 for accounting periods of 12 months.

Example 1

A taxpayer with a 30 September balance date purchases shares in a Philippines company (which is a FiF but does not produce a guaranteed yield) on 7 September 2009. Its opening market value on 1 October 2009 or its closing market value on 30 September 2009 is PHP 350,000. Using the fair dividend rate the opening market value is converted as follows:

PHP 350,000 ÷ 34.3916 = $10,176.90

Example 2

A CFC resident in Hong Kong has an accounting period ending on 30 September 2009. Branch equivalent income for the period 1 October 2008 to 30 September 2009 is 200,000 Hong Kong dollars (HKD), which converts to:

HKD 200,000 ÷ 5.6060 = $35,676.06

Table A: End of month rates

Currency	Code	30/04/2009	31/05/2009	30/06/2009	31/07/2009	31/08/2009	30/09/2009
Australia Dollar	AUD	0.7790	0.7991	0.8008	0.7918	0.8120	0.8194
Bahrain Dinar	BHD	0.2131	0.2413	0.2434	0.2495	0.2583	0.2725
Britain Pound	GBH	0.3821	0.3954	0.3924	0.3960	0.4206	0.4525
Canada Dollar	CAD	0.6739	0.6981	0.7505	0.7132	0.7492	0.7733
China Yuan	CNY	3.8600	4.3700	4.4100	4.5200	4.6800	4.9300
Denmark Kroner	DKK	3.1823	3.3687	3.4271	3.4568	3.5574	3.6787
Euporean Community Euro	EUR	0.4272	0.4524	0.4602	0.4642	0.4780	0.4941
Fiji Dollar	FJD	1.2447	1.3528	1.3165	1.3450	1.3654	1.3966
French Polynesia Franc	XPF	50.9411	53.9869	54.8923	55.3706	56.9923	58.9099
Hong Kong Dollar	HKD	4.3805	4.9650	5.0050	5.1286	5.3099	5.6060
India Rupee	INR	28.2798	30.1541	30.9347	31.8128	33.5107	34.7751
Indonesia Rupiah	IDR	6017.9900	6620.9100	6623.5300	6568.3700	6906.3100	6986.8300
Japan Yen	JPY	55.7400	61.0300	62.2200	62.6500	63.8000	64.8700
Korea Won	KOR	726.0428	803.4685	822.8638	808.6538	855.2901	849.8595
Kuwait Dinar	KWD	0.1645	0.1841	0.1857	0.1902	0.1968	0.2072
Malaysia Ringit	MYR	2.0117	2.2381	2.2727	2.3315	2.4126	2.5039
Norway Krone	NOK	3.7069	4.0285	4.1532	4.0481	4.1211	4.1764
Pakistan Rupee	PKR	45.4545	51.8135	52.6316	54.9451	56.8182	60.2410
Phillipines Peso	PHP	27.1299	30.1362	31.0467	31.7237	33.4179	34.3916
PNG Kina	PGK	1.5979	1.7176	1.6939	1.7020	1.8280	1.9343
Singapore Dollar	SGD	0.8372	0.9249	0.9348	0.9524	0.9873	1.0197
Solomon Islands Dollar*	SBD	4.5471	5.0566	5.1178	5.3221	5.4980	5.7580
South Africa Rand	ZAR	4.7763	5.0855	4.9817	5.1358	5.3280	5.4322
Sri Lanka Rupee	LKR	68.0272	73.5294	74.0741	75.7576	78.7402	83.3333
Sweden Krona	SEK	4.5492	4.8275	4.9742	4.7597	4.8777	5.0363
Swiss Franc	CHF	0.6447	0.6830	0.7013	0.7068	0.7255	0.7494
Taiwan Dollar	TAI	18.7266	20.8768	21.1864	21.6920	22.5527	23.2514
Thailand Baht	THB	19.9435	21.9810	21.9943	22.5228	23.3035	24.1888
Tonga Pa'anga*	TOP	1.2079	1.3252	1.3328	1.3108	1.3242	1.3867
United States Dollar	USD	0.5652	0.6405	0.6457	0.6618	0.6851	0.7232
Vanuatu Vatu	VUV	64.1026	69.9301	68.0272	68.4932	70.9220	70.9220
West Samoan Tala*	WST	1.5975	1.7162	1.6903	1.7217	1.7423	1.7919

Notes to table:

All currencies are expressed in NZD terms, ie 1NZD per unit(s) of foreign currency.

The currencies marked with an asterisk * are not published on Bloomberg in NZD terms. However, these currencies are expressed in USD terms and therefore the equivalent NZD terms have been generated as a function of the foreign currency USD cross rate converted to NZD terms at the NZDUSD rate provided.

The rates provided represent the Bloomberg generic rate (BGN) based on the last price (mid rate) at which the currency was traded at the close of the New York trading day. Where the date specified was not a trading day, then the rate reflects the last price on the preceding business day.

Source: Bloomberg CMPN BGN

Table B – 15th of the month

Table B is the exchange rate on the 15th day of the month, or if no exchange rates were quoted on that day, on the next working day on which they were quoted.

This table lists the mid-month exchange rates acceptable to us for the six-month period ended 15 October 2009. They are provided simply as a service but are not relevant for the CFC or FiF rules.

You can use the mid-month rate if you have chosen to use actual rates for conversion. This mid-month rate is acceptable to Inland Revenue as equivalent to an actual rate for transactions occurring in that month.

You can also use the mid-month rate where a branch equivalent income or loss is calculated under the CFC or FiF rules pursuant to section EX 21(4) of the Income Tax Act 2007 where the accounting period is less than or greater than 12 months.

Example 3

A resident individual with a 31 September 2009 accounting period acquires a FiF interest in a Japanese company in June 2009 for 10,500,000 yen. The interest is sold in September 2009 for 10,000,000 yen. Using the comparative value method, these amounts are converted as:

JPY 10,500,000/61.7400 = $170,068.03

JPY 10,000,000/64.1900 = $155,787.51

Example 4

A CFC resident in Singapore was formed on 21 April 2009 and has a balance date of 30 September 2009. During the period 1 May 2009 to 30 September 2009, branch equivalent income of 500,000 Singaporean dollars was derived.

(i) Calculating the average monthly exchange rate for the complete months May–September 2009:

0.8614 + 0.9212 + 0.9416 + 0.9790 + 1.0005 = 4.7037 ÷ 5 = 0.9407

(ii) Conversion to New Zealand currency:

SGD 500,000 ÷ 0.9407 = $531,519.08

Table B: Mid-month rates

Currency	15/04/2009	15/05/2009	15/06/2009	15/07/2009	15/08/2009	15/09/2009	15/10/2009
Australia Dollar	0.8053	0.7812	0.7938	0.8078	0.8148	0.8165	0.8089
Bahrain Dinar	0.2174	0.2202	0.2379	0.2445	0.2556	0.2658	0.2282
Britain Pound	0.3875	0.3857	0.3867	0.3950	0.4100	0.4276	0.3911
Canada Dollar	0.7017	0.6901	0.7151	0.7240	0.7449	0.7559	0.7044
China Yuan	3.9400	3.9900	4.3100	4.4300	4.6400	4.8100	4.1358
Denmark Kroner	3.2449	3.2280	3.4045	3.4239	3.5547	3.5800	3.2963
Euporean Community Euro	0.4356	0.4335	0.4572	0.4599	0.4776	0.4810	0.4426
Fiji Dollar	1.0122	1.2497	1.2804	1.3321	1.3550	1.3805	1.1823
French Polynesia Franc	51.9369	51.7111	54.5550	54.8206	57.0050	57.2868	52.7570
Hong Kong Dollar	4.4699	4.5358	4.8914	5.0280	5.2572	5.4638	4.6927
India Rupee	28.7885	28.8861	30.1098	31.5450	32.7246	34.2912	29.4367
Indonesia Rupiah	6277.9300	6115.9200	6388.3100	6565.2100	6735.5200	6974.2100	6,430.7058
Japan Yen	56.8500	55.7000	61.7400	61.1400	64.3800	64.1900	57.0117
Korea Won	772.3743	740.2273	800.8030	825.6780	840.7025	854.8829	791.3967
Kuwait Dinar	0.1678	0.1694	0.1822	0.1863	0.1947	0.2019	0.1734
Malaysia Ringit	2.0944	2.0772	2.2268	2.3130	2.3863	2.4679	2.1494
Norway Krone	3.8315	3.8202	4.0737	4.1430	4.1252	4.1491	3.9132
Pakistan Rupee	46.5116	47.3934	51.2821	53.1915	55.8659	58.1395	49.1197
Phillipines Peso	27.6939	27.7939	30.3162	31.0446	32.5788	34.1220	28.9382
PNG Kina	1.6952	1.6039	1.6886	1.6911	1.8278	1.8925	1.6325
Singapore Dollar	0.8674	0.8614	0.9212	0.9416	0.9790	1.0005	0.8892
Solomon Islands Dollar*	4.6299	4.6465	4.9780	5.1515	5.3535	5.6278	4.7700
South Africa Rand	5.2721	5.0977	5.1088	5.2656	5.4858	5.1923	5.3247
Sri Lanka Rupee	66.6667	68.9655	72.4638	74.6269	78.1250	80.6452	69.2691
Sweden Krona	4.7352	4.6331	4.9532	5.0366	4.8795	4.9004	4.7130
Swiss Franc	0.6571	0.6565	0.6887	0.6970	0.7270	0.7296	0.6713
Taiwan Dollar	19.6353	19.2588	20.7843	21.3833	22.3103	23.0006	20.0714
Thailand Baht	20.4948	20.2352	21.5326	22.1015	23.0860	23.9030	20.9167
Tonga Pa'anga*	1.2218	1.2156	1.2845	1.3083	1.3329	1.3568	1.2510
United States Dollar	0.5768	0.5852	0.6311	0.6488	0.6783	0.7050	0.6056
Vanuatu Vatu	65.7895	64.5161	67.1141	68.4932	69.9301	69.4444	66.2341
West Samoan Tala*	1.6248	1.6050	1.6564	1.8189	1.8088	1.7660	1.6868

Notes to table:

All currencies are expressed in NZD terms, ie 1NZD per unit(s) of foreign currency.

The currencies marked with an asterisk * are not published on Bloomberg in NZD terms. However, these currencies are expressed in USD terms and therefore the equivalent NZD terms have been generated as a function of the foreign currency USD cross rate converted to NZD terms at the NZDUSD rate provided.

The rates provided represent the Bloomberg generic rate (BGN) based on the last price (mid rate) at which the currency was traded at the close of the New York trading day. Where the date specified was not a trading day, then the rate reflects the last price on the preceding business day.

Source: Bloomberg CMPN BGN

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.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

COMMISSIONER ENTITLED TO DISCOVERY

Case	RadioWorks Limited v Commissioner of Inland Revenue; TVWorks Limited v Commissioner of Inland Revenue
Decision date	27 July 2009
Act	Tax Administration Act 1994
Keywords	Discovery

Summary

The Commissioner sought general discovery against the plaintiffs and non-party discovery against two non-parties. The plaintiffs opposed general discovery on the grounds that general discovery is not appropriate in tax litigation, other than for exceptional cases.

Impact of decision

This judgment provides a clear and concise summary of the relationship between discovery and the provisions of the Tax Administration Act 1994 ("TAA"). It confirms that the Commissioner is entitled to discovery in tax litigation, notwithstanding his powers under the TAA and the evidence exclusion rule.

Facts

The plaintiffs, who are related companies and part of the CanWest group, issued optional convertible notes ("OCNs") as part of intra-group funding arrangements. The OCNs were issued to off-shore related companies. The Commissioner investigated the issue of the OCNs on the basis that he considered that it was part of a tax avoidance arrangement. During the course of his investigation, the Commissioner issued notices under section 17 of the TAA to the plaintiffs requesting documents and information.

When the Commissioner received the plaintiffs' Statements of Position ("SOP"), the SOPs raised a new issue, being whether the off-shore company to whom the OCNs were issued was in fact part of the CanWest group. The plaintiffs have since advised that they will not pursue the argument that the off-shore company was not a related company.

The plaintiffs applied for an order that general discovery was not appropriate. The Commissioner applied for non-party discovery against two non-parties, NZ Guardian Trust Company Limited and the parent company of the plaintiff, Media Works NZ limited.

Decision

General discovery

Onus

High Court Rule 8.17 provides that the Court must make an order for discovery in standard track proceedings if it is appropriate. There is no specific provision for seeking or opposing general discovery. In principle, the person seeking discovery has the onus of establishing that discovery is appropriate, but the threshold is low and there is an assumption that discovery will be appropriate in standard track proceedings. If the party opposing general discovery raises issues that suggest that discovery is not appropriate, the party seeking discovery must show that discovery is appropriate, notwithstanding the issues raised.

Limitation of discovery in tax cases

The plaintiffs argued that discovery was not appropriate in tax litigation, other than for exceptional cases. They gave two reasons: first, the Commissioner has powers under section 17 of the TAA to obtain all relevant documents from taxpayers; and secondly, section 138G of the TAA excludes discovery.

The Court held that the scheme of the TAA (sections 17 and 138G) does not preclude general discovery; and there is jurisdiction to order general discovery in tax cases. The jurisdiction is supplementary to the information exchange provisions of the disputes resolution process. The Commissioner can be expected to have used his section 17 powers during the investigation, but there is no certainty that he will obtain all the relevant information this way. Section 138G of the TAA does not preclude discovery because documents obtained from discovery may fall within the category of documents identified in the SOPs or it may fall within the exclusion to 138G or it may be a basis for cross-examination.

The Court held that the Commissioner had established that discovery was appropriate in this case.

Non-party discovery

The Court also held that the Commissioner had established that non-party discovery was relevant and necessary in this case as it may be relevant to the issue of whether the OCNs would have value to a third party. The Court held that section 17 was not a bar to non-party discovery. The Court also stated that there was a distinction between discovery and admissibility and that the Courts do not have to determine admissibility at the time of making an order for non-party discovery.

APPLICATION OF HIGH COURT ORDERS STAYED BY COURT OF APPEAL

Case	Commissioner of Inland Revenue v Chesterfields et al
Decision date	29 August 2009
Act	Court of Appeal (Civil) Rules
Keywords	Costs, stay of High Court orders

Summary

The Commissioner was successful in staying the application of orders made in the High Court pending resolution of his appeal to the Court of Appeal.

Impact of decision

This is an interlocutory step in a protracted litigation with the taxpayers.

The case highlights that the mere fact an appeal has been lodged does not stay the effect of any orders a lower court may have made: this requires a formal stay application.

Also of note is the Court's concern as to the solvency of the taxpayers when the costs were being considered. In the absence of clear evidence of solvency in the advent the Commissioner's appeal succeeds, the balance was in favour of staying the payment of costs to the taxpayers. This factor seems to create an evidential onus upon the taxpayer (in this case) to prove their solvency if costs are subject to an application for a stay.

Facts

At the High Court the taxpayers were successful in a judicial review against the Commissioner and in gaining a substantial award of costs payable to them by the Commissioner (see: *Chesterfield Preschools Ltd v CIR* (2009) 24 NZTC 23,148 and *Chesterfield Preschools Ltd v CIR* (2009) 24 NZTC 23,504). These cases were the result of an earlier judicial review: see (2007) 23 NZTC 21,125.

The Commissioner applied to the Court of Appeal to stay the application of both the substantive decision and the costs decision. The taxpayer opposed the application. The Commissioner had earlier obtained an interim stay of the judgments, pending a fully argued case upon the application before the Court of Appeal.

Before the Court of Appeal the Commissioner argued that:

> "… without a stay the appeals would be rendered nugatory because the Commissioner would be required to give irreversible effect to the High Court's orders. The Commissioner also says the respondents are probably insolvent and there is no realistic security for repayment of costs if the Commissioner is successful. Against this background, the Commissioner says the status quo should be preserved and third parties would not be prejudiced." (par [12])

The taxpayer opposed this arguing (as summarised by the Court):

> "[14] First, Mr Hampton [for the taxpayers] points to the adverse effect on the respondents of delays in resolving the issues between the parties. He notes the respondents' assets have been the subject of freezing orders since 2005. Mr Hampton says that those orders impact on the ability of the respondents to fund the litigation and on the well-being and security of the assets.
>
> [15] Secondly, the respondents submit that the Commissioner's appeals would not be rendered nugatory because Ms Sisson's undertaking gives sufficient security for the Commissioner.
>
> [16] Thirdly, Mr Hampton emphasises that the Commissioner did not appeal against the first judgment. The judicial review appeal is, he submits, a back-door means of challenging the Judge's original findings which were not appealed.
>
> [17] Finally, Mr Hampton says the various factors were appropriately considered by Fogarty J in the Judge's decision declining a stay and there is no good reason for this Court to take a different view."

Decision

The Court of Appeal granted the stays sought by the Commissioner.

In granting the stays the Court applied the test found in *Duncan v Osborne Buildings Ltd* (1992) 6 PRNZ 85 which requires the Court to balance the competing rights of the party who obtained the judgment appealed from, and the benefits of that judgment, against the need to preserve the appellant's position against the event of the appeal succeeding.

The considerations, in granting a stay, required to be taken into account are found in *New Zealand Insulators Ltd v ABB Ltd* (2006) 18 PRNZ 459 at [11].

Despite some reservations regarding the effect of delay upon the taxpayers' financial position, the Court accepted the Commissioner's submission that the lack of a stay would force him to take statutory steps (under the High Court decisions) which could not be reversed and thus render the appeal pointless:

> "[24] The judicial review appeal would be rendered nugatory because, absent a stay, the Commissioner would have to take steps in terms of the relevant statutory powers to give effect to the second judgment that could not then be undone. It is not an answer to this point to say the Commissioner did not appeal the first judgment. That factor appears to have been influential in Fogarty J's decision to decline a stay. It was however, open to the Commissioner to act on the first judgment on the assumption that reconsideration would resolve the matter. The fact that reconsideration resulted in a further challenge does not alter the balance of convenience in the context of a stay application."

The Court also accepted that the apparent insolvency of the taxpayers meant the costs judgment should also be stayed saying;

> "Nor does the fact of Ms Sisson's undertaking alter the position. Over the course of the hearing there was some discussion about the respondents' assets and the extent to which they are encumbered. There is material in the evidence before us on the stay application which suggests that as at late 2008, there were issues about solvency but it is difficult to get a clear picture of the current state of the assets. In the end, this is not critical because Mr Hampton accepts that if the Commissioner's decisions as to the tax owing are upheld on appeal the respondents will be insolvent. In our view, the fact the costs would be paid to a party who is possibly insolvent weighs strongly in favour of a stay. Plainly, the costs appeal too would be rendered nugatory if a stay were not granted. The fact of the respondents' insolvency, should the Commissioner succeed, is also relevant to the interests of third parties (creditors) which might otherwise be relevant in this context." (at par [25])

LEGAL EXPENSES NON-DEDUCTIBLE

Case	TRA Number 05/08; Decision Number 14/2009
Decision date	20 August 2009
Act	Income Tax Act 1994
Keywords	Dairy cooperative merger, milk payout, legal expenses, deduction, capital or revenue

Summary

Legal expenses incurred in challenging the differential between the milk payouts to the taxpayers of a merged dairy cooperative were capital in nature and therefore non-deductible.

Impact of decision

This judgment confirms that whether or not legal expenses are deductible will depend upon the reason for incurring the expense.

Facts

The disputants were dairy farmers who had been supplying milk solids to a dairy cooperative (Company A). In 1996, Company A merged with another dairy cooperative (Company B).

The directors for both Company A and Company B, expected Company A's shareholders to benefit to a greater degree from the merger than Company B's shareholders. In terms of increased payouts, the merger agreement provided that, following the merger, Company A shareholders would receive a lower payment per unit of milk product supplied to the merged entity (Company B). The difference between the rates of payment for milk products supplied was referred to as "the differential".

The disputants unsuccessfully challenged the differential in the High Court and subsequently appealed the decision to the Court of Appeal where they were also unsuccessful.

For the 2002 to 2005 income tax years, the disputants claimed a deduction for their legal expenses incurred in the High Court and Court of Appeal proceedings. The disputants claimed that the legal expenses were incurred in order to obtain further revenue and were therefore deductible.

The Commissioner disallowed those claims and argued that the differential the disputants sought to recover in the High Court and Court of Appeal proceedings were capital in nature and therefore non-deductible.

Decision

The expenditure incurred by the disputants in seeking to recover the differential must be calculated from a practical and business point of view in order to determine whether it is capital or revenue in nature.

The Authority found that the differential reflected the value which Company A brought to the merger compared with what Company B brought to the merger. The merger gave company A shareholders a greater benefit than Company B shareholders in terms of an increased payout for milk-products supplied.

Part of the price to be paid by the disputants to participate in and benefit from the merger and to become supplying shareholders of the merged company, was that they accepted less income than other shareholders in Company B.

The Authority agreed with the Commissioner that the reduction in income for the first three or four seasons post merger was the price which the former Company A shareholders paid to belong to the new merged company and it was that price that the disputants sought to recover in the High Court and Court of Appeal litigation.

The fact that the price paid was taken out of the disputants income did not mean that they funded the litigation to achieve more income but that they were seeking to reduce the price required from them by the merged company for the right to supply their milk products to the merged company.

The Authority found that on the evidence presented before it, there was no rational approach to apportionment in this case, because the expenses were wholly capital in nature.

COURT OF APPEAL SAYS PRIVY COUNCIL DECISION IN RELATION TO BANK CHEQUES AND DRAFTS BINDING

Case	Westpac BNZ ANZ v Commissioner of Inland Revenue (Unclaimed Money)
Decision date	26 August 2009
Act	Unclaimed Money Act 1971
Keywords	Bank cheques, drafts, nature of instruments and unclaimed money

Summary

The Court of Appeal held that it must follow the Privy Council decision in *CIR v Thomas Cook (NZ) Limited* (2006) 2 NZLR 722 (PC), as it considered unpresented bank cheques fell under the definition of unclaimed money in section 4 of the Unclaimed Money Act 1971 ("UMA").

Impact of decision

Unless the Supreme Court agrees to hear an appeal and finds otherwise, bank cheques and drafts which remain unclaimed, will be treated as unclaimed money under the UMA. The decision of the Privy Council in *CIR v Thomas Cook* will apply.

Background facts

The Appeal relates to the meaning and effect of the UMA. In the High Court McKenzie J was satisfied that in respect of bank cheques the issuing banks are holders of unclaimed monies under section 4(1)(e) of the UMA.

McKenzie J held that the decision of the Privy Council in *CIR v Thomas Cook* [2006] 2 NZLR 722 (PC) was dispositive of the case. However he also reached the conclusion independently of the Privy Council decision.

The Court of Appeal indicated that if they found the decision of the Privy Council in *CIR v Thomas Cook* binding they would not need to decide on the independent decision of McKenzie J.

Issues and decision

Whether or not the Court of Appeal is bound in the circumstances by the decision in *Thomas Cook*? Young P and Robertson J addressed the arguments presented by Mr Kós:

Alleged incorrect legal or factual assumptions by the Privy Council as to the liabilities of the drawer of a bills of exchange

The Court of Appeal was satisfied that their Lordships fully comprehended the nature of the instruments involved and that the definitions contained in section 4(1) of the UMA had to be read within the context of the UMA and not just as an adjunct to the Bills of Exchange Act 1908.

Absence of full argument before the Privy Council on present liability to pay

Although it was apparent that the basis upon which *Thomas Cook* was decided in the Privy Council arose for the first time in that court, the Court of Appeal was satisfied that the metes and bounds of the argument were discussed, assessed and adjudicated upon.

Alleged assumption that the obligations of Thomas Cook were within section 4(1)(e)

The Privy Council in *Thomas Cook* ruled that the amounts for which the bank cheques and drafts were drawn are "money" within section 4(1)(e) of the UMA and were owing and payable to the banks' customers. The Court of Appeal disagreed with Mr Kós that this was a mere assumption on the part of the Privy Council. It was found that the particular issue had been live in the Court of Appeal and was resolved against Thomas Cook. The conclusions by the Privy Council that the obligations of Thomas Cook were money for the purposes of section 4(1)(e), was a necessary part of the ratio of the case and is binding on the Court of Appeal.

The statutory history of the UMA

Mr Kós argued that the course events took in the Privy Council meant that the statutory history of the UMA was overlooked. The overlooked statutory history was described by Robertson J as "too frail a premise" for the Court to decide that the Privy Council judgment was decided *per incuriam*. Furthermore the interpretation argued for was selective and ignored earlier, consistent definitions of "payable".

Separate findings of Baragwanath J

Baragwanath J, agreed with Young P and Robertson J and held that the Privy Council was right because it recognised that its task was to construe the UMA not the Bills of Exchange Act 1908. Section 4 of the UMA states what unclaimed money shall consist of. He saw no reason why the money should become a "windfall" in the hands of the bank. Part (1)(e) of section 4 can be construed textually to like effect to (1)(a) to (d) and there is no reason why it should receive a purposive construction to different effect. Part (1)(e) states:

> (e) Any other money, of any kind whatsoever, which has been **owing** by any holder for the period of 6 years immediately following the date on which the money has become **payable** by the holder:
>
> [Emphasis added]

He then found that the broader and not the narrower construction of "owing" and "payable" must be adopted.

The Appeal was dismissed and costs awarded to the Commissioner.

AVOIDANCE ARRANGEMENT AND COMMISSIONER'S RECONSTRUCTION CONFIRMED

Case	TRA Dec No 15/2009
Decision date	17 September 2009
Act	Income Tax Act 1976
Keywords	Avoidance, vendetta, time bar, Commissioner's Policy Statement

Summary

The Commissioner's assessments based upon section 99 and section BG1 that income was personal income and not earned by business entities was confirmed.

Impact of decision

Limited to the specific facts.

Facts

The disputant was personally assessed for income tax on income derived by various business entities on the basis that the use of those entities (which involved locating and exploitation of loss carrying companies by use of management and agency agreements) were an avoidance arrangement to disguise the fact that the income had been earned by personal exertions.

The disputant challenged the assessments (the tax years 1985 to 2000) on both substantive and procedural grounds.

The case is a complex factual one and the summary above does not include all the finer detail. For this, the decision should be consulted.

Decision

The Taxation Review Authority ("TRA") found there were no procedural defects or any substantive errors in the assessments and these were confirmed.

Procedural challenges

These are summarised at paragraph [9] of the judgment. Looking at each the Authority found:

- *Did the assessor have the necessary delegation under section 99 and BG1?* Yes at paragraphs [14] to [23];
- *Did the assessor have the necessary delegations to lift the statute bar?* Yes at paragraphs [36] to [72]. The Authority concluded at paragraph [71] that of the two options open to the Commissioner for lifting the statute bar, he may rely upon one or the other or both together.
- *Did the assessor comply with the Commissioner's Policy Statement (Feb 1990)?* Yes, even though this was not strictly necessary according to the O'Neil decision at the Privy Council. See TRA decision at paragraphs [24] to [35].

- *Was there a vendetta by the Commissioner against the disputant?* No (at par [73] to [102]). The Authority concluded there was no evidential basis for concluding there was a vendetta and further concluded that, even if there had been, if the vendetta had not made the assessments incorrect then its existence was irrelevant anyway (see at paragraph [74]).

Substantive challenges

Having dealt with the procedural points the Authority turned to address the actual assessments:

- *Was there an arrangement?* Yes, all the parties to the transactions were represented by the disputant in various different capacities and were in effect his alter egos) see decision at [131] to [170];
- *Was there tax avoidance?* Yes at paragraphs [171] to [189]. The authority referred extensively to the Court of Appeal and Supreme Court decisions in Accent Management case to conclude the use of losses in the way the disputant's arrangement achieved was not in the contemplation of Parliament: "An objective viewing of the facts in terms of commercial sense clearly leads to the conclusion that the arrangement was to avoid tax by using losses in a manner not approved by the law." (at paragraph [187])
- *Was the disputant a person affected?* Yes, at paragraph [190] to [206] saying "I now add that those monies were earned by the disputant's personal exertions. He is clearly a person affected by the tax avoidance arrangement because only he controls the profits of that arrangement." (at paragraph [206])
- *Did the disputant receive an advantage from the arrangement?* Yes, at paragraphs [207] to [216] as his personal exertions income was not taxed as a consequence of the tax avoidance arrangement.

The Commissioner's reconstruction was confirmed (at paragraphs [217] to [278]). In particular the Authority accepted that a lack of a deduction to the disputant's client (under section 104 of the 1976 Act) did not mean the disputant was not obliged to account for the receipt (see at paragraph [237]) as the fee was not addressed using section 99 or BG1 then the alleged protection of section 99(4) did not apply (at [240]).

The Abusive Tax Position Shortfall Penalty was also confirmed with the Authority wondering why a penalty for Evasion had not been applied (at paragraph [284]).

JUDICIAL REVIEW ACTION AGAINST COMMISSIONER STRUCK OUT BECAUSE DISPUTES PROCESS NOT FOLLOWED

Case	Raureti Reginald Ruka KORAKO v Commissioner of Inland Revenue
Decision date	18 September 2009
Act	Tax Administration Act 1994, section 8 of the Judicature Amendment Act 1972
Keywords	Amended and default income tax assessment, bankruptcy proceedings, judicial review and disputes process

Summary

The Commissioner took bankruptcy proceedings against the taxpayer, who then took Judicial Review proceedings against the Commissioner claiming abuse of process with assessments. The High Court struck out the proceedings because the taxpayer did not follow the disputes process in the first instance.

Impact of decision

The case follows similar strike out cases which confirm that the courts are unlikely to consider a judicial review of the Commissioner's actions in relation to the disputes process unless the Plaintiff has correctly followed the statutory process set down for disputing assessments.

Facts

The Plaintiff was the subject of amended income tax assessments and default income tax assessments for the years ending 31 March 2003, 2004 and 2005. He did not challenge the assessments within the time periods prescribed in the Tax Administration Act 1994. A default judgment was obtained by the Commissioner and bankruptcy proceedings were commenced.

On 5 March 2009, the Plaintiff's tax agent filed tax returns for the years ending 31 March 2003, 2004 and 2005. The returns contained no supporting material. Although contact was made with the investigator to establish that the returns had been received nothing further occurred. In particular no Notice of Proposed Adjustment ("NOPA") or other response notice was made in relation to the assessments.

The Plaintiff commenced judicial review proceedings seeking:

(a) an order staying the bankruptcy proceedings, and

(b) an order that the Commissioner allow the plaintiff to dispute the tax assessments through the disputes process provided for in the Act.

The Commissioner applied to strike out the proceedings on the grounds that they were clearly untenable and that the proceedings amounted to an abuse of process.

The Plaintiff then applied for an interim order under section 8 of the Judicature Amendment Act 1972, staying the bankruptcy proceedings until the determination of the judicial review proceedings.

Decision

On the facts of the case Allan J found that the Plaintiff's ignorance of the assessments stemmed from his decision to entrust the conduct of his business and tax affairs to others and his failure to pay proper attention to the conduct of his affairs. There was no evidence to say that the Plaintiff had no knowledge of the assessments. The evidence of the investigator that the Plaintiff failed to attend several meetings was also undisputed. Even now the Plaintiff has not formally responded to the Commissioner or engaged in the disputes process.

The affidavit evidence of the Plaintiff argued more about the derivation of the income which was assessed. The argument was irrelevant for judicial review purposes.

Allen J agreed that there was no breach of natural justice under the Bill of Rights Act (*Daganayasi v Minister of Immigration* [1980] 2 NZLR 130) and that it cannot be argued that the Commissioner was bound to accept excessively late filing of self-assessment on behalf of the Plaintiff. Nor was there any foundation for a pleading that the Commissioner's refusal to accept the recent tax returns (which contained no supporting evidence or explanation) amounted to an abuse of process.

The remaining cause of action (directing Commissioner to engage in disputes process) was seen as premature as the Plaintiff could still engage the disputes process.

The strike out action succeeds and the Commissioner is entitled to costs.

REPARATION AND SECTION 109 OF THE TAX ADMINISTRATION ACT 1994

Case	The Queen v Karl Andre Allan
Decision date	25 September 2009
Act	Tax Administration Act 1994, Sentencing Act 2002
Keywords	Reparation, section 109 of the Tax Administration Act 1994, disputed facts hearing

Summary

Mr Allan appealed against his conviction and sentence for aiding and abetting a company to knowingly fail to file a Goods and Services Tax ("GST") return intending to evade the payment of GST. The Court dismissed the appeal against conviction, but upheld the appeal against the amount of reparation that Mr Allan had been ordered to pay to Inland Revenue.

Impact of decision

This decision differentiates between an assessment and a loss for the purposes of reparation. Where a convicted person wants to raise evidence at sentencing that was not called at trial, but relates to aggravating or mitigating factors, the court must hold a disputed facts hearing. There is no infringement of section 109 of the Tax Administration Act ("TAA") where the amount of reparation is challenged, as the convicted person is challenging the loss to Inland Revenue, not the assessment.

Reparation is limited to core tax; penalties and use of money interest should not be included in reparation orders.

Facts

Mr Allan ran a small business of buying and selling electrical equipment. He incorporated Logical Choice Ltd in December 2003. Initially his mother was the sole director and shareholder, though it was not disputed that Mr Allan ran the business. For the first nine months following incorporation until September 2004, the company filed two-monthly GST returns, all of which claimed input tax credits. Over the following 18 months to 1 March 2006, no GST returns were filed.

In June 2006, Mr Allan asked his chartered accountant to file these returns, but only provided the necessary information in August 2006. In the meantime, he filed a GST return in July in which he claimed an input tax credit. The outstanding returns were filed in September showing that the company owed $64,000 in GST. Following this, the shareholding and directorship of the company was transferred from his mother to Mr Allan and he put the company into voluntary liquidation. However, Mr Allan continued to operate his business and in November 2006 set up a new trading company.

Mr Allan was prosecuted for, and convicted of, nine counts of aiding and abetting a company (Logical Choice Ltd) knowingly to fail to file a GST return, intending to evade the payment of GST.

After conviction, but before sentencing, Mr Allan provided a letter from his new accountant saying that the GST appeared to have been overstated. The Judge refused to take the letter into account at sentencing.

Mr Allan was sentenced to one year's imprisonment and ordered to pay reparation of $80,000 (which included GST ($64,000) plus late payment penalties and interest).

Decision

Conviction appeal

The Court dismissed the conviction appeal. It dismissed the Crown's submission that the amount of GST owing was irrelevant at trial, as the amount of GST could be relevant to whether or not Mr Allan had an intention to evade the payment of GST by the company. However the Court dismissed Mr Allan's conviction appeal on the basis that there was ample evidence of intent, such that there was no risk that the new evidence could lead to a not guilty verdict.

Sentence appeal

At hearing, Mr Allan abandoned his challenge to the sentence of one year's imprisonment and limited his challenge to the amount of the reparation order, on the basis of the new accountant's evidence. The four issues arising are as follows:

Should the Judge have held a disputed facts hearing?

Mr Allan submitted that a disputed facts hearing should have been held before sentencing because the amount of GST was an aggravating fact that affected the amount of reparation. The Crown conceded that the amount of GST may be an aggravating factor for the purposes of sentencing, but argued that section 24(1)(a) of the Sentencing Act and the wide discretion that the trial Judge has to decide what facts were proved at trial allowed a Judge to decline to hold a disputed facts hearing where section 24(2)(b) is satisfied.

The Court stated that the accused has an absolute right not to present any evidence at trial and to put the Crown to proof. The trial Judge may therefore only hear Crown evidence on a point without any contrary evidence. The Court held that natural justice required that a disputed facts hearing be held when a convicted person wishes to call evidence that was not called at trial but which is relevant to any aggravating or mitigating factors. Under section 24(2)(a) of the Sentencing Act, the court must indicate to the parties the weight it would be likely to attach to the disputed fact if it were found to exist, and its significance to the sentence or other disposition of the case.

The Court held that a disputed facts hearing should have been held unless section 109 of the TAA precluded Mr Allan from challenging the amount of GST.

What is the relevance of section 109 of the TAA?

Section 109 of the TAA provides that no disputable decision may be disputed in a court and shall be deemed to be taken as correct. Section 24(2)(c) of the Sentencing Act provides that if a fact is relevant and disputed, the prosecutor must prove beyond reasonable doubt the existence of any disputed aggravating fact.

Mr Allan submitted that section 109 only applies to civil proceedings. The Crown submitted that on its plain meaning section 109 applies to both criminal and civil proceedings and relied on the Court of Appeal and Supreme Court judgments in *R v Smith* (2009) 24 NZTC 23,004 and Smith v R (2009) 24 NZTC 23,176 where the Supreme Court stated that there was no justification for giving the words of section 109 anything other than their plain meaning. The Crown submitted that there was no impairment of any right or freedom under the Bill of Rights Act.

The Court accepted that there was no impairment of the Bill of Rights Act, but rejected the Crown's submission as contrary to the essential principles of a fair trial. The Court held that there was no conflict between sections 24(2)(b) and (c) and section 109. Reparation is concerned with loss. A challenge to a reparation order is not a challenge to an assessment. The Court held that the Court of Appeal and Supreme Court's comments in Smith were obiter.

The Court stated that if it were wrong and there was a conflict, sections 24(2)(b) and (c) of the Sentencing Act would prevail over section 109. Alternatively, the Court would have read down section 109 as applying only to civil proceedings.

Should section 32(3) of the Sentencing Act have been considered?

On behalf of Mr Allan, it was submitted section 32(3) of the Sentencing Act should have been considered by the District Court Judge as if Inland Revenue had made default assessments, it would have mitigated its loss. The Court dismissed Mr Allan's submissions and held that the responsibility for the offending rested with Mr Allan and he could not blame Inland Revenue.

Should penalties and use of money interest be included in any reparation figure?

The Crown conceded that the loss to Inland Revenue is limited to the core tax evaded and that penalties and use of money interest should not be included as part of a sentence of reparation, as neither are a loss to Inland Revenue. The Court agreed with the concession made by the Crown as to penalties and use of money interest.

The Court granted Mr Allan's application to adduce further evidence and the appeal against sentence to reduce the amount of reparation to $51,407.70.

NO RIGHT OF APPEAL FROM TAXATION REVIEW AUTHORITY'S INTERLOCUTORY DECISIONS

Case	Jacqueline Jiao, Hsueh W Huang & Shou-Chen Chiao v Commissioner of Inland Revenue
Decision date	15 September 2009 (Oral Judgment of Venning J)
Act	Taxation Review Authorities Act 1994
Keywords	Interlocutory application, appeal, determination

Summary

The determination of the Taxation Review Authority ("TRA") can be appealed to the High Court under section 26A of the Taxation Review Authorities Act 1994. However, there is no right of appeal from interlocutory decisions of the TRA.

Impact of decision

The judgment confirms that there is no right of appeal on interlocutory matters from the TRA and that an application for recall is in the nature of an interlocutory application.

Facts

The Taxpayers sought to appeal the TRA decision delivered on 5 August 2009 (Decision No 13/2009, TRA No. 024/07) refusing to recall an earlier judgment that the Authority delivered on 14 May 2009 (Decision No 11/2009, TRA No 024/07).

Decision

The Commissioner argued that no right of appeal exists under section 26A of the Taxation Review Authorities Act 2004 from the decision to decline the recall application on the ground that a recall application is in the nature of an interlocutory application rather than a final determination. The Commissioner relied on the Court of Appeal decision *M & J Wetherill Company Ltd v Taxation Review Authority* (2004) 21 NZTC 18,924. In *Wetherill*, the Court of Appeal held that no right of appeal existed from interlocutory decisions of the TRA.

The Taxpayer submitted that *Wetherill* could be restricted to the consideration of interlocutory applications in the course of the substantive proceedings.

Venning J dismissed the appeal. His Honour held that the issue was determined by the wording of the relevant statutory provision (section 26A). There is no right of appeal against the decision of the TRA to decline the application for recall as it was not a determination of a challenge.

CHALLENGE TO JURISDICTION OF TAXATION REVIEW AUTHORITY FAILS

Case	J D and CE Henson Partnership & Ors v Commissioner of Inland Revenue
Decision date	22 September 2009
Act	Income Tax Act 1976, Tax Administration Act 1994
Keywords	Assessment, validity of assessment, notice of assessment, jurisdiction of the Taxation Review Authority, procedural requirements of the Revenue Acts

Summary

The appellants' challenge to the jurisdiction of the Taxation Review Authority was unsuccessful. The appellants' argued that the notices of assessment issued by the Commissioner were invalid, as they did not quantify the amount of tax owing. The appellants contended that the Taxation Review Authority did not have jurisdiction to determine a challenge when the notices of assessment issued were invalid.

The Court of Appeal confirmed that the jurisdiction of the Taxation Review Authority to determine tax challenges arises from section 138B of the Tax Administration Act 1994 ("TAA"). A notice of assessment commences the statutory time periods to initiate a challenge to an assessment, but is a separate and ancillary step to the assessment itself.

Impact of decision

This judgment confirms the existing case law regarding the distinction between assessments and notices of assessment. It reiterates that in accordance with section 114 of the TAA, the Commissioner's failure to comply with procedural requirements of the Revenue Acts will not invalidate an assessment.

Facts

The appellants' partnership had business interests in farming and an electrical equipment company. Following an investigation into the partnership's tax affairs, the Commissioner issued manual notices of assessment for the 1992–1995 income tax years on 17 September 1996. The notices of assessment set out the adjustments to be made to the assessable income returned by the appellants, but did not quantify the amount of tax payable. On 15 October 1996, the Commissioner issued statements of account.

Further discussions regarding the assessments were held with the appellants and subsequent notices of assessment were issued on 20 February 1997. These notices were also manually prepared and specified the adjusted assessable income of the appellants and did not quantify the amount of tax to be paid. On 26 February 1997 statements of account were issued to reflect the re-assessments made.

Following a disagreement over the validity of the Commissioner's assessments and the appellants' dispute of the assessments, the appellants commenced Judicial Review proceedings against the Commissioner. The Judicial Review proceedings were settled by way of Deed. The Settlement Deed stated that the Commissioner agreed to accept the appellants' notices of proposed adjustment outside the statutory response period.

The appellants' challenge to the correctness and the validity of the assessments were unsuccessful before the Taxation Review Authority and the High Court. The appellants then appealed to the Court of Appeal, challenging the jurisdiction of the Taxation Review Authority to hear the challenge proceedings.

Decision

The appeal was dismissed.

The Court of Appeal reiterated at paragraph [19], that it is settled law that an assessment is a decision by the Commissioner quantifying the amount of tax payable by the taxpayer; it must be definitive as to the taxpayer's liability and is subject to challenge only through the statutory disputes process.

The Court noted that the legislation contemplates that a taxpayer is to be given notice of an assessment as soon as convenient (section 111 of the TAA), but that failure to give such notice does not affect the validity of the assessment itself (section 111(6) of the TAA).

A taxpayer's liability to pay tax arises when an assessment is made, the notices of assessment gives rise to the procedural process of the disputes resolution and challenge process contained in Part IVA and VIIIA of the TAA (paragraph [22] of the Judgment).

The Court of Appeal stated at paragraph [26] of the judgment that the jurisdiction of the Taxation Review Authority arises from section 138B of the TAA, not from the notice of assessment. The notice of assessment determines the commencement of the statutory time period for the challenge proceedings to be commenced.

ENTITLEMENT TO DEREGISTER FROM GST AND DECISION ON WHETHER OR NOT A SALE WAS PLANNED RESULTS IN PARTIAL WIN FOR THE COMMISSIONER

Case	LGH Thompson v Commissioner of Inland Revenue
Decision date	21 August 2009
Act	Goods and Services Tax Act 1986
Keywords	GST de-registration, *Lopas* Test, Court's power to vary interest and penalties

Summary

The case was a partial win for the Commissioner and Taxpayer. The Court found that the Taxpayer was not entitled to de-register on 30 November 1999. The Commissioner's assessment which assessed output tax on two property transactions sold in the Goods and Services Tax ("GST") period after the Taxpayer's de-registration was consequently upheld. The third property transaction which the Commissioner had assessed in a later GST period was found incorrect; rather the Court found that the output tax on that property should be returned by the Taxpayer as a deemed disposition in the Taxpayer's unregistered capacity pursuant to section 5(3) of the Goods and Services Tax Act ("the Act").

Impact of decision

For the purposes of determining if transactions are relevant to the projection of whether a Taxpayer's taxable activities will exceed the legislative threshold over the ensuing 12 months, a transaction will be "planned" prior to de-registration if there is evidence that the transaction, has at that time been advanced "in a sufficiently choate way that it is to be seen as connected with the conduct of the business, even when it is being downsized". Neither contemplation nor intention to sell will be enough. It appears that "major steps" must have been taken in relation to the sale. Therefore it would seem that the test in *Lopas v CIR* (2006) 22 NZTC 19,726 has been narrowed.

It is important to note that an amendment to section 10(8) of the Act with application on and after 10 October 2000, has removed the opportunity for Taxpayers to reduce their liability for GST by de-registering and paying GST on the cost price of the goods rather than the market value. With one exception the amendment has the effect of requiring GST to be paid on the market value of the goods. However for goods acquired prior to the introduction of GST on 1 October 1986, GST is either payable at the lower of cost or market price of the goods.

Facts

The Taxpayer had been registered for GST since 1986, on a six-monthly return basis. In November 1999, he sought to deregister. The Commissioner initially accepted the Taxpayer's de-registration application from 30 November 1999 and advised him of this in December 1999. The Taxpayer then disposed of the relevant land in three transactions, in December 1999, March 2000 and September 2000 and did not account for GST on the sales. Default assessments for GST were raised in July 2004 for the six months to 31 July 2000. A subsequent assessment was also issued in January 2005, for the period ending 31 January 2001.

The Taxpayer argued that the sales went ahead only after he was deregistered and, accordingly, liability was confined to a deemed disposition to himself in his unregistered capacity (ie one ninth of the original acquisition cost) pursuant to section 5(3) of the Act.

The Commissioner contended that the Act entitled him to revisit an approval to de-register where he was not fully informed at the time of giving approval to de-register. In this case, the Commissioner considered that he was entitled under section 52(3) of the Act to treat the Taxpayer as re-registered until all the transactions had been undertaken. Accordingly, the Taxpayer was assessed for output tax for the consideration on all three of the transactions based on the sale price rather than the original acquisition costs.

In March 2005, the Taxation Review Authority ("TRA") upheld the Taxpayer's challenge to the decision of the Commissioner to re-register him. The Commissioner appealed the decision. However, before the hearing of the appeal, the Court of Appeal delivered its decision in *Lopas v CIR* (2006) 22 NZTC 19,726. *Lopas* was a decision with similar issues where the Court of Appeal found that the TRA had erred because the projected extent of taxable supplies should include the value of deemed or actual dispositions of property that had been used in the GST registered business.

These proceedings were in part an appeal by the Taxpayer from a further aspect of the TRA decision as to the de-registration date and also a dispute over the correctness of the GST assessments.

Decision

Issue One – Whether the Taxpayer was entitled to deregister on 30 November 1999

Before considering the liability of the Taxpayer to account for GST output tax on the three land transactions, his Honour analysed the decision in *Lopas*. Dobson J stated that the facts in *Lopas* were "slightly different", in that the

Taxpayer in this case did not account for the deemed or actual disposal of any of the properties, on any basis, at the time of de-registration.

The Lopas decision

His Honour agreed with the Commissioner that the Court of Appeal's reasoning in *Lopas* "does not recognise any material distinction between immediate cessation and a staged winding-down of an about to be de-registered business". Dobson J stated that section 5(3) applies irrespective of whether the business is going to cease upon de-registration, or continue in a reduced form but in a level less than $30,000 taxable supplies for the ensuing 12 months.

His Honour also noted that the Court of Appeal in *Lopas* interpreted the proviso in section 51(1) as only applying in situations where an initial obligation to register would otherwise be triggered by the circumstances of cessation, namely, where the deemed disposal would for the first time push the scale of taxable activities over $30,000. Accordingly, in the present case, Dobson J concluded that the three land transactions were relevant to the projection of whether taxable activities would exceed $30,000 over the ensuing 12 months, on whatever basis they are to be valued.

Further, his Honour noted that in *Lopas* the Court held that where transactions were planned as at the date of de-registration, the sale will be treated as part of the taxable activity. His Honour rejected the Commissioner's argument that the test was whether a sale was "in contemplation". Rather, the transactions need be planned and firmly in place to be effected. This will require a fact specific assessment in each case to determine whether the transactions are planned in a "sufficiently choate way that is to be seen as connected with the conduct of the business, even when it is being downsized". Dobson J considered that *Lopas* suggests that an intention to sell will not be enough.

The three land transactions

Dobson J concluded that the Taxpayer was not entitled to de-register until 31 July 2000.

As for the first land transaction, his Honour concluded that it was sufficiently planned as at the de-registration date and so the Taxpayer was obliged to account for GST on the sale price. With regard to the second transaction, while his Honour determined that more would have been needed for it to be planned; he did not accept that "each transaction can be viewed in isolation". In his opinion, because of the first transaction, "the second transaction is to be assessed as it occurred within the following six month period". Accordingly, the Taxpayer was also obliged to account for GST on the second sale on the basis of the sale price.

However, as for the third transaction, Dobson J concluded that it was not planned as at 31 July 2000. Accordingly, given the Taxpayer was in a de-registered status at that time, he was only obliged to account for GST on an apportioned component of the original acquisition price pursuant to section 5(3) of the Act.

His Honour did note that, notwithstanding the land sales, the rental income derived would have amounted to more than the required level of supplies.

Issue Two – Whether the steps taken by the Commissioner to de-register and re-register the Taxpayer were adequate

His Honour also discussed the arguments raised by the Taxpayer over the adequacy of steps taken by the Commissioner to de-register and re-register the Taxpayer. Dobson J concluded that "although inconsistencies in communications from the Department are unfair, they could not be sufficient to deprive an assessment for a subsequent period of its lawful effect". His Honour stated that any unfair communication could not affect the extent of basic GST for which the Taxpayer is liable.

Issue Three – The correctness of the assessments

The Taxpayer had also asserted that the default assessments issued were incorrect. His Honour agreed that the default assessment for the 31 July 2000 period was in error because the rental income, on which output tax had been assessed, ought to have been offset against the expenses incurred in earning that rental income. Further, the default assessment for the 31 January 2001 period was wrong by virtue of the inclusion of the third sale. In addition, a further extension of his re-registration beyond 31 July 2000 was not warranted in the absence of a planned transaction. Accordingly, Dobson J held that the default assessment for the period prior to 31 July 2000 be increased as a result of the deemed disposition. Consequently, the default assessment for the period from 1 August 2000 was considered incorrect and should be cancelled.

Issue Four – The application of the anti-avoidance provision in section 76

His Honour concluded that it was unnecessary to consider whether the anti-avoidance provision applied given his conclusion on the earlier issues.

Issue Five – Whether the interest and penalties imposed on the Taxpayer should be varied

His Honour concluded that he did not have jurisdiction to vary the extent of the late payment penalties or interest but invited the Commissioner to exercise his discretion to remit the penalties under section 183D of the Tax Administration Act 1994.

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TAX INFORMATION Bulletin

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NEW LEGISLATION

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.

TAXATION (INTERNATIONAL TAXATION, LIFE INSURANCE, AND REMEDIAL MATTERS) ACT 2009

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill was introduced into Parliament on 2 July 2008. It received its first reading on 6 August 2008, the second reading on 4 August 2009 and its third reading on 15 September 2009.

At the report-back stage of the bill the Finance and Expenditure Committee recommended a number of changes to the legislation, including deferring the application dates of many of the reforms. A number of substantial amendments were also made by Supplementary Order Papers 224, 34 and 35. The resulting Act received Royal assent on 6 October 2009.

The new Act amends the Income Tax Act 2007, Income Tax Act 2004, Tax Administration Act 1994, Income Tax Act 1994, Income Tax Act 1976, Estate and Gift Duties Act 1968, Stamp and Cheque Duties Act 1971, Taxation Review Authorities Act 1994, Taxation (Business Taxation and Remedial Matters) Act 2007, Companies Act 1993, Insolvency Act 2006, Income Tax (Depreciation Determinations) Regulations 1993, Goods and Services Tax Act 1985, Goods and Services Tax (Grants and Subsidies) Order 1992, KiwiSaver Act 2006 and the KiwiSaver Regulations 2006.

NEW RULES FOR TAXING CONTROLLED FOREIGN COMPANIES AND FOREIGN DIVIDENDS

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 introduces new rules for the taxation of foreign companies controlled by New Zealand residents and for foreign dividends received by New Zealand companies.

The new rules represent a fundamental change to how New Zealand taxes offshore income earned through controlled foreign companies. The old system of taxing that income as it is earned is replaced by one that exempts the active offshore income of these companies. Further important features of the changes are an exemption from tax for most foreign dividends paid to companies and measures to protect the tax base as a result of adopting an active income exemption.

The purpose of these reforms is to bring New Zealand's tax rules into line with the practice in other countries and help New Zealand-based business to compete more effectively in foreign markets by freeing them from a tax cost that similar companies in other countries do not face. The changes will improve the competitiveness of New Zealand's tax system and encourage businesses with international operations to remain, establish and expand.

Previously, New Zealand residents were taxed on their share of all income earned by controlled foreign companies (CFCs) as that income accrued but with two significant exemptions:

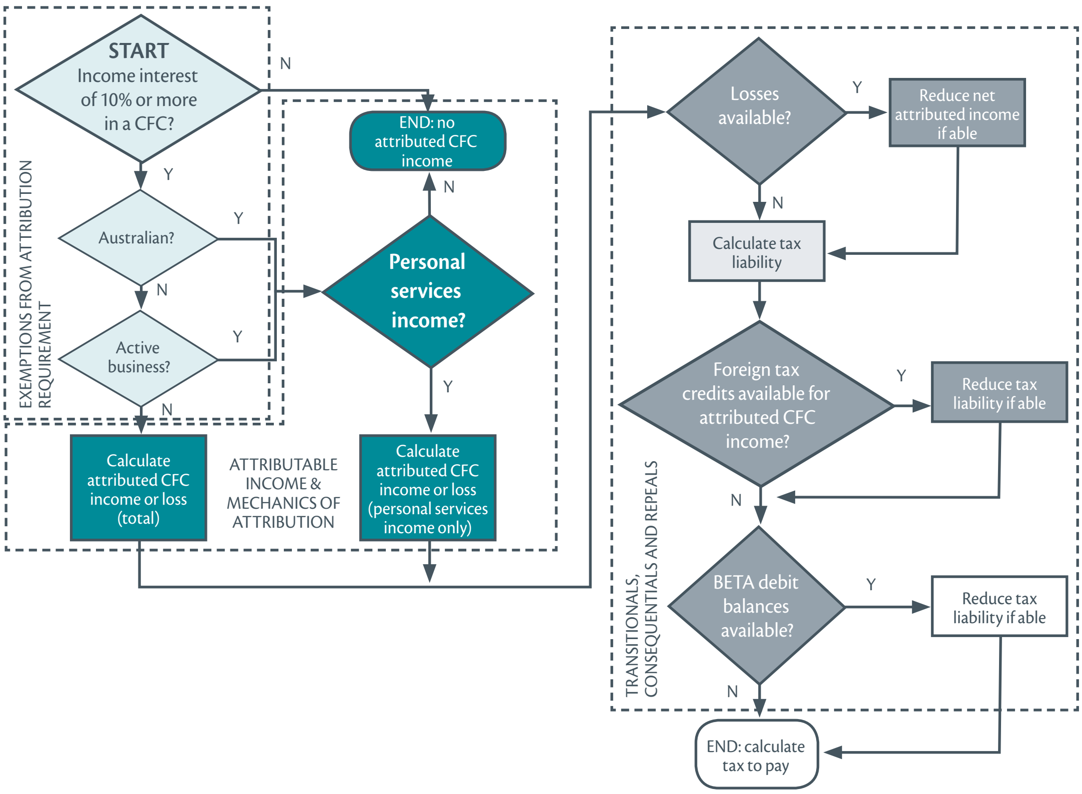
- The "grey list" provided an exemption from accrual taxation for CFCs based in one of eight listed countries (Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States).
- Conduit tax relief provided an exemption from accrual taxation for a New Zealand company with an income interest in a CFC to the extent that the New Zealand company was owned by non-residents.

New Zealand companies receiving foreign dividends were generally required to make a foreign dividend payment (FDP). Credits were available for foreign withholding taxes on the dividend, and also, for non-portfolio dividends, for foreign taxes on the underlying profits. A company receiving a non-portfolio dividend from a grey list country qualified for a deemed underlying foreign tax credit equal to its FDP liability on the dividend. Credits were also available under the branch equivalent tax account (BETA) mechanism to prevent double New Zealand taxation under the CFC and FDP rules.

Under the new rules, only certain types of income derived by CFCs will be attributed back to New Zealand shareholders. A "signposting" provision in section EX 18A shows how to find a person's attributed CFC income or loss under the amended legislation.

Figure 1 below summarises how the new CFC rules are applied and where in this report they are explained.

Figure 1: Using the new CFC rules



Attributable income

Attributable income is referred to in the Act as the *attributable CFC amount* (a gross concept defined in section EX 20B) and as *net attributable CFC income or loss* (a net amount determined under sections EX 20C to EX 20E). In very broad terms, attributable income comprises passive income such as rent, royalties, certain dividends and interest. Taxing this income on accrual protects the domestic tax base against New Zealand-sourced income being shifted offshore to avoid tax.

In earlier policy documents, the terms "passive income" and "passive income definition" were used to describe the *attributable CFC amount.*

Exemptions from attribution requirement

Under the new rules, the grey list and conduit exemptions have been repealed. Two categories of CFC are now exempt from the requirement to attribute income:

- *Non-attributing active CFCs* (section EX 21B). If less than 5 percent of a CFC's total income is attributable income, it is a non-attributing active CFC and neither its income nor its losses are attributable. This test may be undertaken either by applying the tax rules for measuring income (section EX 21D) or by reference to financial accounts, subject to certain adjustments (sections EX 21C and EX 21E).
- *Non-attributing Australian CFCs* (section EX 22). Broadly, if a CFC is resident and subject to tax in Australia, it is a non-attributing Australian CFC and is exempt from attribution.

Interest allocation rules

The interest allocation rules in subpart FE are designed to prevent an excessive amount of debt from being allocated against the domestic tax base. Previously, these rules only applied to New Zealand entities controlled by non-residents. Now that much of the income derived by CFCs remains outside the New Zealand tax base, the rules have been extended so that they also apply to *outbound entities* – New Zealand residents with CFC interests, regardless of whether the entity is controlled by a non-resident.

The rules place an upper limit on interest deductions that can be taken against domestic income. Subpart FE already contains safe harbours and these also apply to outbound entities: interest deductions are not restricted unless the New Zealand group debt percentage is more than 75 percent (and, for a company or a trustee, is also more than 110 percent of the worldwide group debt percentage).

Additional safe harbours and reliefs have been introduced for outbound entities which have most of their assets in New Zealand or have only modest interest deductions.

Treatment of foreign dividends

The FDP rules in subpart RG have been repealed so that most foreign dividends received by New Zealand companies will now be wholly exempt.

Foreign dividends that are tax-deductible for the foreign company and dividends on fixed-rate shares are subject to income tax (section CW 9(2)(b) and (c)). If the foreign company is a CFC and the fixed rate or deductible dividend is paid to another CFC or New Zealand company, these distributions will be deductible in the same way as interest when calculating net attributable CFC income or loss. This prevents economic double taxation of attributable CFC income subsequently repatriated as a taxable dividend.

Dividends from non-attributing portfolio FIFs (that have less than 10 percent interest in a foreign company as described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39) will also be subject to income tax.

Application date

The new rules apply for all income years beginning on or after 1 July 2009.

Example 1

Company A has a 30 April balance date. For its income year of 1 May 2009 to 30 April 2010 it will continue to apply the previous international tax rules. From its income year beginning 1 May 2010 it will apply the new international tax rules.

Example 2

Company B has a 30 June balance date. From its income year beginning 1 July 2009 it will apply the new international tax rules.

Example 3

Company C has a 30 November balance date. From its income year beginning 1 December 2009 it will apply the new international tax rules.

EXEMPTIONS FROM ATTRIBUTION REQUIREMENT

Sections CQ 2, DN 2, EX 21B to EX 21E, EX 22 and EX 23 of the Income Tax Act 2007; section 91AAQ of the Tax Administration Act 1994

Key features

Active business exemption

A person with an income interest of 10 percent or more in a CFC will not generally have to include attributed CFC income or loss in the person's gross income if the CFC passes an active business test. This is expected to save most CFCs the work of calculating attributed income.

A CFC will pass the active business test and be a *non-attributing active CFC* if it has attributable income that is less than 5 percent of its total income. Attributable and total income, for the purposes of the test, are measured using either financial accounting or tax measures of income. These measures are defined in the legislation.

It is expected that most people will prefer to use accounting measures of income, because they will be more readily available or easier to calculate. Accounting measures may be used to calculate the ratio if they are taken from accounts that comply with international financial reporting standards (IFRS) and certain other conditions are met. Accounting measures of income based on pre-IFRS New Zealand financial reporting standards may also temporarily be used by some people, primarily small and medium-sized enterprises.

For people who do not wish to or are unable to use accounting measures of income, tax measures of income may also be used to calculate the ratio of attributable income to total income.

CFCs in the same country may be consolidated for the purposes of the calculation of the 5 percent ratio calculation, subject to certain conditions.

A CFC will also be a *non-attributing active CFC* for a person with an income interest in the CFC, if the person has applied for and obtained a determination from Inland Revenue that the CFC is an active insurance business.

Australian exemption

A person with an income interest of 10 percent or more in a CFC will not have to include attributed CFC income or loss in the person's gross income if the CFC is resident and subject to income tax in Australia, and meets certain other conditions. A CFC that meets these conditions is a *non-attributing Australian CFC.*

Personal services income

There is an exception to the active business and Australian exemptions for CFCs. If a CFC derives certain personal services income or incurs a loss in deriving such income, such income or loss is always attributed, even if the CFC is a non-attributing active CFC or a non-attributing Australian CFC.

Detailed analysis

How to use the rules

The goal is to work out whether a CFC qualifies for either the Australian or active business exemption.

Go to section EX 22 to work out whether or not the Australian exemption applies to a CFC.

If the Australian exemption does not apply, decide whether to use tax measures of income or accounting measures of income to check if the CFC qualifies for the active business exemption.

Use of accounting measures of income

If accounting measures of income are to be used, they can be used for a single CFC or for a *test group* of CFCs.

If the measures are to be used for a test group, go to subsection EX 21E(2) to see which CFCs can be members of the test group.

Go to section EX 21C to determine whether a suitable accounting standard is available for the CFC or the test group and, if there is, choose that as the *applicable accounting standard*.

If no *applicable accounting standard* is available for the CFC or the test group, you will have to use tax measures of income.

If an *applicable accounting standard* is available, calculate the formula in subsection EX 21E(5) using accounts that comply with that standard. The formula is the ratio of attributable income to total income. There are six components in the formula, which are further explained in subsections EX 21E(7) to (12). Rules in subsection EX 21E(4) govern how the calculation is to be done. Subsection EX 21E(3) explains, based on the result of the calculation, whether the CFC or the CFCs in the test group qualify for the active business exemption.

If a CFC qualifies to use the active business exemption using accounting measures of income, there may still be some attributed CFC income or loss from the CFC under subsections CQ 2(2B) and DN 2(2).

If a CFC does not qualify to use the active business exemption using accounting measures of income, try again using tax measures of income.

Use of tax measures of income

If tax measures of income are to be used, they can be used for a single CFC or for a *test group* of CFCs.

If the measures are to be used for a test group, go to subsection EX 21D(1) to see which CFCs can be members of the test group.

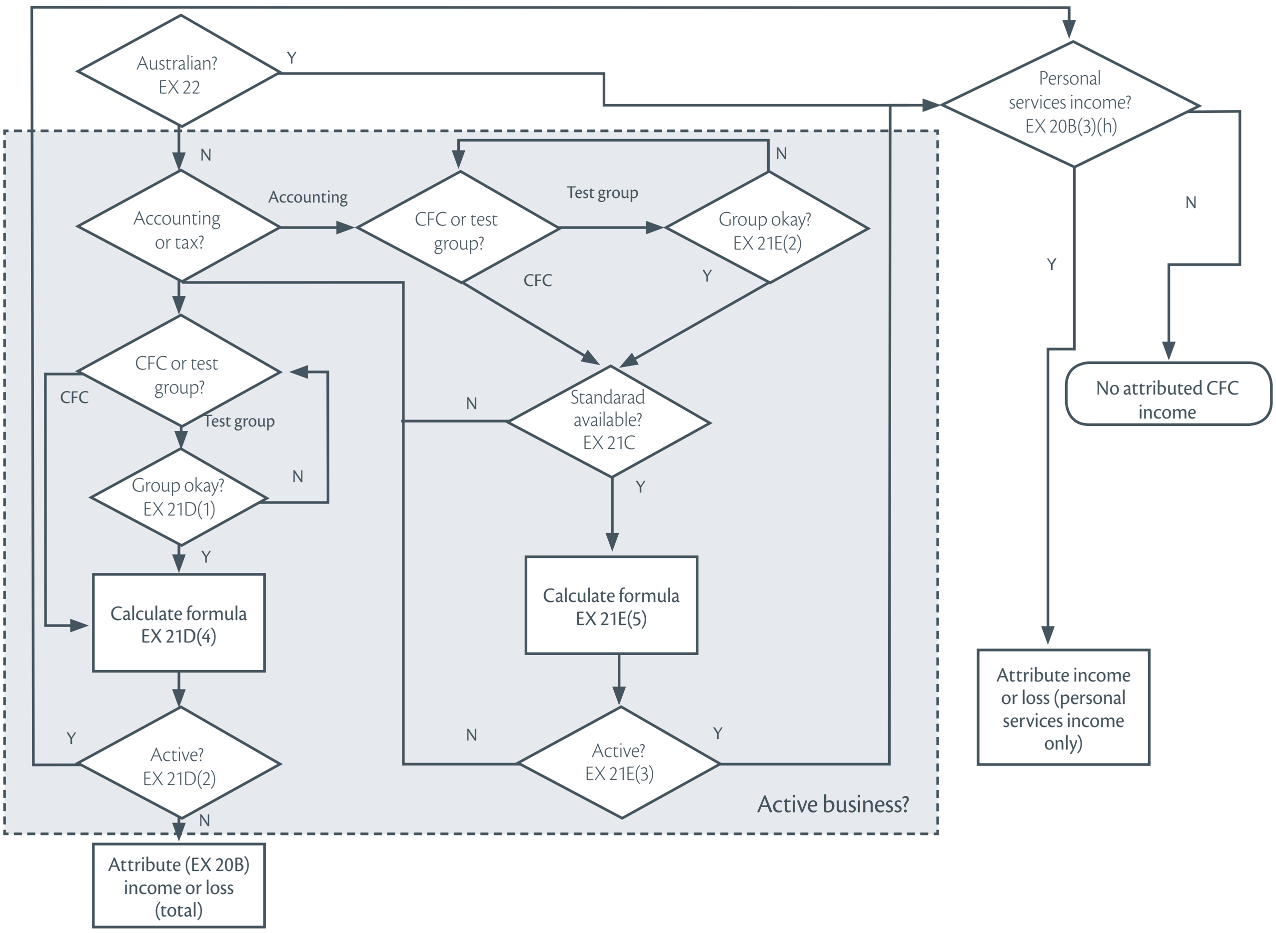
Go to subsection EX 21D(4) and calculate the formula there. This formula is the ratio of attributable income to total income. There are four components in the formula, which are further explained in subsections EX 21D(6) to (9). Rules in subsection EX 21D(3) govern how the calculation is to be done. Subsection EX 21D(2) explains, based on the result of the calculation, whether the CFC or the CFCs in the test group qualify for the active business exemption.

If a CFC qualifies to use the active business exemption using tax measures of income, there may still be some attributed CFC income or loss from the CFC under subsections CQ 2(2B) and DN 2(2).

If a CFC does not qualify to use the active business exemption using tax measures of income, certain income (see section EX 20B) from the CFC will be attributable under sections CQ 2 or DN 2.

Figure 2 illustrates the process described above.

Figure 2: How to use the rules



Sections CQ 2 and DN 2 of the Income Tax Act 2007

New paragraphs CQ 2(1)(h), CQ 2(1)(i), DN 2(1)(h) and DN 2(1)(i) apply to a person who holds an income interest in a CFC. If the CFC is a *non-attributing active CFC* or a *non-attributing Australian CFC*, the interest-holder does not have attributed CFC income under subsection CQ 2(1) or attributed CFC loss under subsection DN 2(1). In other words, these paragraphs implement the active business and Australian exemptions. The terms "non-attributing active CFC" and "non-attributing Australian CFC" are further defined in sections EX 21B and EX 22 respectively.

A holder of an interest in a non-attributing active CFC or a non-attributing Australian CFC may still have attributed CFC income under subsection CQ 2(2B), or attributed CFC loss under subsection DN 2(2). These subsections apply if the CFC derives income that is an amount of personal services income described by section EX 20B(3)(h). This income is always attributable.

Paragraph CQ 2(1)(g) has been repealed because there is no longer an exemption from attribution of CFC income for CFCs resident in grey list countries.

The active business exemption (sections EX 21B to EX 21E of the Income Tax Act 2007)

Section EX 21B

Section EX 21B defines a non-attributing active CFC as a CFC that:

- meets the requirements of section EX 21D (has a ratio of attributable to total income, using tax measures of income, of less than 5 percent); or
- is able to and chooses to apply section EX 21E, and meets the requirements of that section (has a ratio of attributable to total income, using accounting measures of income, of less than 5 percent); or
- meets the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 (is a CFC with an active insurance business).

A CFC may meet the requirements of sections EX 21D or 21E alone or as part of a *test group*. The income of the CFCs in a test group is consolidated for the purposes of calculating the ratio of attributable to total income, which can be advantageous for taxpayers. If the test group meets the requirements, all CFCs in the group are non-attributing active CFCs. There are additional requirements which must be met in order to use a test group. These are explained further in the analysis of sections EX 21C to 21E.

A CFC is a non-attributing active CFC for an accounting period of the CFC. If a CFC does not meet the requirements to be a non-attributing active CFC in one accounting period, it will not be a non-attributing active CFC in that period, regardless of whether it has been one in the past or will be one in the future. "Accounting period" is defined in section YA 1.

A CFC is a non-attributing active CFC for a person who holds an interest in that CFC. It is theoretically possible that one person with a 10 percent or greater interest in a CFC will be able to count that CFC as a non-attributing active CFC, but another person with a 10 percent or greater interest in the same CFC will not. This is expected to be rare in practice.

To meet the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 for a particular accounting period, the taxpayer must first have applied for and obtained the determination and it must not have expired or been revoked. Section 91AAQ regulates this process. Secondly, any requirements laid out in the determination must also be satisfied. A CFC that fails to obtain a determination or to meet the requirements of the determination may still be a non-attributing active CFC if it meets the requirements of sections EX 21D or EX 21E.

Accounting standards that may be used (section EX 21C)

Section EX 21C states the sets of accounting standards that may be used to calculate the ratio of a CFC's attributable income to total income under section EX 21E, when a person holds an interest in that CFC. Certain conditions must be satisfied before any particular set of accounting standards can be used.

This means the person may be unable to use any of the sets of accounting standards because the relevant conditions are not satisfied. A person may also choose not to use any of the sets of accounting standards, even if they are available. In either case, the ratio of a CFC's attributable income to total income will be calculated under section EX 21D using tax measures of income.

If section GB 15C, which relates to use of the test in section EX 21E to avoid tax applies, it is not possible to use any of the sets of accounting standards in section EX 21C and so section EX 21D must be used to calculate the ratio of attributable income to total income. (See the analysis of section GB 15C for further information.)

If, under section EX 21C, a person is able use one or more sets of accounting standards to apply section EX 21E for a particular CFC or a particular test group of CFCs, only one set of accounting standards (called the *applicable accounting standard*) may be used for that purpose.

Subsection EX 21C(2) allows the use of generally accepted accounting practice with IFRS for a particular CFC if accounts exist that include the accounts of that CFC, those accounts comply with generally accepted accounting practice with IFRS, and specified audit requirements are met.

The accounts may be for the CFC alone or for a group of companies that includes the CFC. In the latter case, further work is likely to be required to separate amounts relating to the CFC when applying section EX 21E. The accounts may be held by the person who holds an interest in the CFC or by someone else. Under existing rules applying before enactment of section EX 21C, Inland Revenue can require that the accounts be produced to verify a tax position taken. (The comments in this paragraph apply equally to subsections EX 21C(4) and EX 21C(6)).

The term "generally accepted accounting practice with IFRS" means generally accepted accounting practice, as defined in section 3 of the Financial Reporting Act 1993, but with a restriction. The restriction is that the New Zealand equivalents to International Financial Reporting Standards must be used as the financial reporting standards referred to in that section. These New Zealand standards, referred to as "IFRS" in section YA 1 of the Income Tax Act 2007, have initially been issued by the International Accounting Standards Board, then approved, with modifications, by the New Zealand Accounting Standards Review Board. Some entities qualify to use a subset of these standards (the "framework for differential reporting for entities applying the New Zealand equivalents to the international financial standards reporting regime"). That subset is also acceptable for the purposes of section EX 21E.

The accounts must comply with generally accepted practice with IFRS. Often, absolute compliance is not practical but audited accounts will be treated as complying anyway. The analysis of subsection EX 21C(9) below provides further explanation.

The audit requirements are specified in subsection EX 21C(8). Analysis of that subsection below provides more information.

Subsection EX 21C(3) allows a person to use *generally accepted accounting practice with IFRS* for a *test group* of CFCs if accounts exist that include the accounts of the CFCs in the test group, the first-mentioned accounts comply with generally accepted accounting practice with IFRS, and specified audit requirements are met.

The *test group* is defined under subsection EX 21E(2) as a group of CFCs a taxpayer has an interest in, that are resident in the same country and that meet certain other requirements.

The complying accounts must include the accounts of all the CFCs in the test group. The complying accounts may also include the accounts of other entities, such as all the entities in a worldwide group. In that case, further work is likely to be required to separate amounts relating to the test group when applying section EX 21E. The accounts may be held by the person who holds an interest in the CFCs in the test group or by someone else. Under existing rules applying before the enactment of section EX 21C, Inland Revenue can require that the accounts be produced to verify a tax position taken. (Comments in this paragraph apply equally to subsections EX 21C(5) and EX 21C(7)).

The term "generally accepted accounting practice with IFRS" has the same meaning as in subsection EX 21C(2).

Subsection EX 21C(4) allows a taxpayer to use *IFRSEs* for a particular CFC if accounts exist that include the accounts of the CFC, the first-mentioned accounts comply with IFRSEs, and specified audit requirements are met.

An "IFRSE" is defined in section YA 1 as "an International Financial Reporting Standard approved by the International Accounting Standards Board, as amended from time to time". In other words, subsection EX 21C(4) allows the use of accounts that comply with international financial reporting standards. Those standards are either required to be used or may be used in over 100 countries. In contrast, subsection EX 21C(2) allows the use of *New Zealand equivalents to* international financial reporting standards. In most respects, international financial reporting standards and the New Zealand equivalents to those standards are identical. However, that may not always be the case.

Subsection EX 21C(5) allows a taxpayer to use *IFRSEs* for a test group of CFCs if accounts exist that include the accounts of the CFCs in the test group, the first-mentioned accounts comply with IFRSEs, and specified audit requirements are met.

The term "IFRSEs" has the same meaning as in subsection EX 21C(4).

Subsection EX 21C(6) allows a person to use *generally accepted accounting practice without IFRS* for a particular CFC if specific requirements are met.

The term "generally accepted accounting practice without IFRS" means generally accepted accounting practice as defined in section 3 of the Financial Reporting Act 1993, but with the restriction that the financial reporting standards referred to in that section must not be New Zealand equivalents to international financial reporting standards. Pre-IFRS financial reporting standards (usually referred to as FRSs) will be used instead.

Subsection EX 21C(6) exists because a large number of small and medium-sized entities are not yet required to comply with New Zealand equivalents to international financial reporting standards, pending completion of a review of financial reporting requirements by the government. The subsection is intended to be temporary. It may be replaced or repealed as the future of reporting requirements becomes clearer or as FRS become outdated. The subsection is not to be used when accounts that comply with IFRS are available; IFRS accounts are to be preferred in that case.

The requirements that must be met to use generally accepted accounting practice without IFRS are that a company that is resident in New Zealand must:

- hold accounts that include the accounts of the CFC, that comply with generally accepted accounting practice without IFRS, and that meet specified audit requirements;
- not have revenue under either Financial Reporting Standard 34 or Financial Reporting Standard 35 (the intent is that insurance businesses will not be able to use generally accepted accounting practice without IFRS for the purpose of section EX 21E);
- not be an issuer under section 4 of the Financial Reporting Act 1993 in the current accounting period and not have been an issuer in the preceding accounting period;
- not be required by section 19 of the Financial Reporting Act 1993 to file its accounts with the Registrar of Companies;
- not be a large company under section 19A(1)(b) of the Financial Reporting Act 1993; and
- not have accounts (and not be a subsidiary of a company having accounts) that are prepared and audited under generally accepted accounting practice *with* IFRS (if such accounts are available, generally accepted accounting practice with IFRS should be used for the purposes of EX 21E).

Most but not all of the requirements match those in *Accounting Standards Review Board Release 9* (ASRB 9). ASRB 9 specifies the entities that are permitted to defer compliance with New Zealand equivalents to international financial reporting standards. In the event that ASRB 9 is withdrawn, amended or superseded, the requirements in the legislation will be unaffected.

Subsection EX 21C(7) allows a taxpayer to use *generally accepted accounting practice without IFRS* for a test group of CFCs if certain requirements are met. The requirements are mostly the same as those in subsection EX 21C(6), except that the accounts must include the accounts of all the CFCs in the test group, rather than just the accounts of the CFC. It is acceptable for the accounts to include the accounts of other entities, in addition to the CFCs in the test group. In that case, additional work is likely to be required to identify and separate amounts relating to the test group.

Subsection EX 21C(8) contains the two audit requirements that must be met in each of subsections EX 21C(2) to (7).

The first requirement in subsection (8) is that the accounts in question must be audited by a chartered accountant who is independent of the CFC and of the person who holds the accounts. In the case of a test group, the chartered accountant must be independent of all the CFCs in the test group.

The use of the term "chartered accountant" is regulated by the Institute of Chartered Accountants of New Zealand Act 1996, and requires membership of the New Zealand Institute of Chartered Accountants (NZICA). Because the accounts of a CFC will commonly be audited in a country other than New Zealand, requiring membership of NZICA in all cases is impractical. For that reason, it is also acceptable for the auditor to be a person who is not a chartered accountant (as defined in New Zealand legislation), provided they meet a professional standard, in their country, that is equivalent to the professional standard a chartered accountant must meet in New Zealand.

The second requirement in subsection (8) is that the auditor must have given an unqualified audit opinion or – in countries in which the term "unqualified audit opinion" is not used or has a different meaning – a type of audit opinion that is used in that country and is of a standard that is equivalent to an unqualified audit in New Zealand.

Subsection EX 21C(9) sets out the circumstances in which accounts will be treated as complying with a particular set of accounting standards for the purposes of subsections EX 21C(2) to (7). The subsection is required because accounts will rarely comply completely with accounting standards at a detailed level, even though they comply in all material respects. The fact that there is non-compliance at a detailed level should not, in general, prevent the use of the accounts for the purposes of applying section EX 21E.

The accounts will be treated as complying with the relevant standards if there is a statement in the accounts that they comply, the audit requirements of subsection EX 21C(8) are satisfied, and there is not evidence of wrong-doing or incompetence.

In the case of wrong-doing or incompetence, Inland Revenue must have reasonable grounds to suspect fraudulent activity, preparation of the accounts with an intent to mislead, or incompetence of the auditor. "Fraudulent activity" is fraudulent activity by the person who holds the interest in the CFC, by the CFC itself, by a CFC in the CFC's test group, or by the auditor. "Mislead" and "incompetence" are not further defined.

Subsection EX 21C(9) does not affect in any way the requirements to keep records relating to CFCs, or the powers of Inland Revenue to require the production of records and other information relating to the CFC. If these records or information give Inland Revenue reasonable grounds to suspect fraud, an intent to mislead or incompetence, the accounts will not automatically be treated as complying with a particular set of accounting standards.

The active business exemption using tax measures of income (section EX 21D)

Section EX 21D sets out the rules for calculating the ratio of attributable income to total income when using tax measures of income. The ratio may be calculated either for a single CFC or, if certain requirements are met, for a test group of CFCs. If the ratio is not less than 0 and is less than 0.05, then in the case of a single CFC it will be a non-attributing active CFC, unless it is prevented from being one for some other reason (such as the application of section GB 15C). In the case of test groups, all the CFCs in the test group will be non-attributing active CFCs unless they are prevented from being non-attributing active CFCs for some other reason.

The ratio calculation, with only one exception, is based on amounts of income and no deductions for expenditure or losses incurred are included in the calculation.

Subsection EX 21D(1) contains the requirements that must be met for the ratio to be calculated for a test group of CFCs.

The first requirement is that all the companies must be resident in the same country. The test for residence in this case is that all of the companies are liable for income tax in the same country by reason of domicile, residence, place of incorporation, or centre of management. This is intended to exclude a CFC that is liable for tax in a country merely because of, for example, the presence of a permanent establishment in that country.

The second requirement is that the person undertaking the calculation (the person with the interest in the CFC) holds an income interest of more than 50 percent in each of the CFCs in the test group. This is intended to prevent a CFC being a part of a test group for more than one interest holder.

The third requirement is that all CFCs in the group must make the same choice of method and currency under subsection EX 21(4). They must either all make the choice to convert all transactions to New Zealand dollars at the applicable daily rate, or all make the choice to use the same reporting currency. If the reporting currency is used, subsections EX 21(5) and (6) must be observed in the normal way, and section EX 21(7) will apply to certain financial arrangements. The purpose of this provision is to limit the scope for manipulating the test by the deliberate choice of different reporting currencies for CFCs within the group.

The fourth requirement is that the CFCs in the test group must be consolidated for the purposes of the test (and only for the purposes of the test). Consolidation requires the elimination of all balances, transactions, income and expenses between CFCs in the group, and the use of like tax treatments for like transactions. For example, it would not be appropriate for different CFCs in the test group to use different options for calculating financial arrangement income for the same type of financial arrangement. It is expected that elimination will be carried out in a way that is consistent with accepted accounting principles. It is not expected or intended that there will be rigid compliance with any particular set of financial accounting standards. The rules for consolidation in subpart FM of the Income Tax Act 2007 are not to be used for the consolidation of CFCs.

Subsection EX 21D(2) designates a CFC (whether alone or as part of a test group) as a non-attributing active CFC if the ratio of attributable income to total income in subsection EX 21D(4) is less than 0.05 and, if zero, is not zero because of the application of paragraph EX 21D(3)(f). The ratio may be zero because attributable income is zero and there is some total income. In that case, the CFC is a non-attributing active CFC. If the ratio is zero for any other reason (paragraph EX 21D(3)(f) applies), the CFC is not a non-attributing active CFC. In that case, the formula has produced an unusual, and possibly unintended, result, so attribution is required.

Subsection EX 21D(3) explains how to apply the formula in subsection EX 21D(4).

If the formula is being applied for a test group, the test group is effectively treated as a single consolidated entity (using the consolidation described in the analysis of subsection EX 21D(1) in this report). Consolidated amounts are used in the formula. Consistent with the single-notional-entity approach, special rules apply if it is necessary to determine whether the test group is associated with a person or in the same group of companies as a person, such as in parts of section EX 21B. The person is associated with the test group if the person is associated with a member of the test group but is not a member of the test group. The person is a member of the same group of companies as a test group if the person is in the same group of companies as a member of the test group, but is not a member of the test group (these rules apply only for the purposes of calculating the formula and do not affect, for example, the application of the loss offset rules in Part I).

If either the numerator or denominator in the formula is negative, it is treated as being zero. The ratio calculation has been designed in such a way that a negative numerator or denominator should not be possible. If a negative result is produced, this is unintended and the result is set to zero.

If the denominator in the ratio formula is zero, the ratio is set to zero and the CFC will not be a non-attributing active CFC. A nil denominator implies either an unintended result or no activity on the part of the CFC. Because of the possibility of an unintended result, attribution is required. If the CFC is inactive, the calculation of attributed income should be trivial.

Subsection EX 21D(4) contains the formula for calculating the ratio of attributable income to total income.

The numerator contains the calculation of attributable income, being the attributable CFC amount for the CFC (or test group notionally treated as a single CFC) under section EX 20B, less two optional adjustments specified in subsection EX 21D(7).

The attributable CFC amount under section EX 20B is calculated using the rules in section EX 21. Those rules, broadly speaking, treat the CFC as resident in New Zealand for the purposes of the calculation. They also allow the use of a foreign currency for the bulk of the calculation, if certain conditions are met.

The first adjustment, if the holder of the interest in the CFC chooses to apply it, is to remove certain amounts relating to personal services under paragraph EX 20B(3)(h). These amounts are always attributable, but the adjustment means a CFC may qualify for the active business exemption in relation to its other income. It is not possible to remove the amount if it would also come within another paragraph of subsections EX 20B(3) or (4). The removal of the amount is only for the purposes of applying the active business exemption. When attribution is required, as it will be under either of subsections CQ 2(1) or (2B), the amount is included.

The second adjustment, which is again optional, is the subtraction of the cost of revenue account property if there would be an amount under paragraph EX 20B(3)(k) as a result of the disposal of the property. That paragraph includes the gross proceeds of the disposal as an attributable CFC amount. The effect of the adjustment is that only a net amount is included in attributable income. The adjustment is limited to the part of the cost of the property that would be allowed as a deduction for the period under section EX 20C, but also may not be more than the amount under paragraph (k). In this way, net losses on disposal are not possible. This is for partial consistency with the use of gross amounts in the ratio calculation. If any amounts would be required to be added back in relation to the deduction under subpart CH of the Income Tax 2007, they must also be added back in the formula.

The denominator in the formula contains the calculation of total income, being annual gross income for the accounting period less up to four adjustments.

Annual gross income is calculated, broadly speaking, as if the CFC were a resident (the term "annual gross income" is defined in section BC 2). As with the calculation of the attributable CFC amount under section EX 20B, section EX 21 applies to the calculation. Income under subpart CQ of the Income Tax Act 2007 is not included in the measure of annual gross income because existing "look-through" rules treat CFC or FIF interests held by a first CFC as held directly by the interest-holder in the first CFC. This is to prevent double-counting of gross income.

The first adjustment is only required if optional adjustments were made to the numerator in the formula. If amounts were subtracted from the numerator, they must also be subtracted from the denominator.

The second adjustment is the removal of any expenditure or loss included in the calculation of the attributable CFC amount under section EX 20B. In practice, there should never be any such amounts, because section EX 20B includes only income; this adjustment is a purely protective measure, to be used in the event that section EX 20B does not operate as intended. The subtraction of personal services income or the cost of revenue account property from the numerator of the formula, under subsection EX 20D(7), is not expenditure or loss under section EX 20B, but is in any case removed in the first adjustment.

The third adjustment is the removal of income derived by the CFC from a company, if the CFC and the company could be members of the same test group under subsection EX 20D(1). The purpose of this adjustment is to prevent the inflation of total income by transactions between associated entities. In determining whether the CFC and the company could be members of the test group, it is not relevant that the required consolidation has actually been undertaken or not. It is relevant that if a person *were to* undertake the required consolidation, the CFC and the company would be eligible to be members of the same test group.

The fourth adjustment is the removal of income derived by the CFC from a supply to a company that could not be a member of a test group with the CFC, if the supply was made with the purpose of inflating the measure of total income (the analysis of section GB 15B in this report provides further information). The third and fourth adjustments have a similar purpose, with the following differences:

- The third adjustment applies to income derived by a CFC from a company that could be part of a test group with the CFC, while the fourth adjustment applies when the company could not be part of a test group with the CFC.
- The third adjustment does not require any purpose, while the fourth adjustment requires the purpose of increasing the measure of total income.

The ratio in the formula in subsection EX 21D(4) will never be less than zero (subsection EX 20D(3) ensures this). The ratio may be zero if attributable income is zero, or because of the application of paragraph EX 21D(3)(f).

The active business exemption using accounting measures of income (section EX 21E)

Section EX 21E contains the rules for calculating the ratio of attributable income to total income when using accounting measures of income. The availability of an applicable accounting standard under section EX 21C is a prerequisite for the use of section EX 21E. The ratio may be calculated either for a single CFC or, if certain requirements are met, for a *test group* of CFCs. If the measure of total income is more than zero and the measure of attributable income is not negative, and the ratio is less than 0.05, then the CFC (or every CFC in the test group) will be a non-attributing active CFC. This is subject to any limitations imposed by other provisions, such as section GB 15C.

The calculation requires, firstly, a base calculation of attributable income, subsequently altered by some compulsory adjustments and some optional adjustments. Secondly, it requires a base calculation of total income, also subsequently altered by some compulsory adjustments and some optional adjustments. The altered measure of attributable income is finally divided by the altered measure of total income.

Amounts used in the ratio calculation must comply with the applicable accounting standard, but will often be taken to comply in the absence of strict compliance at a detailed level (see the analysis of subsection EX 21E(13) in this report). It is accepted that the accounting standards may change over time. Any guidance provided in this report about the meaning of particular terms under accounting standards may be made obsolete by changes in the standards.

The use of section EX 21E is purely optional (see subparagraph EX 21B(2)(b)(ii)). If a person chooses to apply the section but its requirements are not met for a CFC, subsection EX 21B(3) and section EX 21D must also be applied to the CFC (subject to other provisions such as section GB 15C). In other words, there is no automatic requirement to attribute CFC income or loss when the requirements of section EX 21E are not met; it will depend on whether it is a non-attributing CFC by some other means.

Most amounts used in the ratio calculation are gross amounts, with no deductions for expenditure or losses incurred. However, and in contrast to the ratio calculation that uses tax measures of income (section EX 21D), some amounts relating to derivatives and non-derivative financial assets are included even if they are losses or expenditure. This is not "net" treatment in the sense of subtracting all expenditure incurred in earning a particular item of income. Rather, losses or expenditure on some derivatives or financial assets are netted off against income or gains on other items. This is done to reduce the cost of calculating the ratio, in recognition that ledger accounts and items on the face of financial statements will often be reported net, or net of derivative gains and losses.

By allowing the use of net amounts in some cases, the legislation creates the possibility of negative measures of attributable income or total income. As is clear from the restrictions on the measures of attributable income (which must not be negative) and total income (which must be positive), a CFC with negative measures of income is not a non-attributing active CFC under section EX 21E.

Subsection EX 21E(1) contains the requirement that an applicable accounting standard under section EX 21C be available to the person for undertaking the ratio calculation.

Subsection EX 21E(2) contains the requirements that must be met for the ratio to be calculated for a test group of CFCs. Section EX 21C imposes further requirements relating to the sets of accounting standards (the *applicable accounting standard*) that may be used by the test group. It is possible that the requirements of subsection EX 21E(2) will be met, but that no applicable accounting standard will be available for use under section EX 21C. In that case, the ratio may not be calculated for the test group under section EX 21E.

The first requirement for using a test group is that all the CFCs in the group are required by the applicable accounting standard to be consolidated for the accounting period. Typically, this means all the CFCs will be under common control, but the accounting standard is the authoritative reference. If the applicable accounting standard does not require that a CFC is to be consolidated with all the other CFCs in the test group for the whole of the accounting period, the CFC is not to be included in the test group. It is acceptable for the CFC to be required to consolidate, under the applicable accounting standard, with entities outside the test group as well as those in the test group. If there are entities outside the test group, additional work is likely to be required to identify amounts pertaining to the test group.

The second requirement for using a test group is that all the companies in the test group must be resident in the same country. This is the same requirement imposed on a test group under section EX 21D.

The third requirement for using a test group is that the person applying the test (the person with an income interest in the CFC) holds an income interest of more than 50 percent in every company in the group. Again, this is the same requirement imposed on a test group under section EX 21D.

The fourth requirement for using a test group is that all the CFCs must use the same functional currency. The calculations under section EX 21E will effectively be undertaken using the functional currency of a CFC (see the analysis of paragraph EX 21E(4)(g)), and the use of different functional currencies within a test group would therefore complicate that calculation.

The final requirement for using a test group is that audited and consolidated financial statements, complying with the applicable accounting standard, must exist. These must contain the accounts of all the CFCs in the test group. As with the first requirement, it is acceptable for the consolidated financial statements to also include the accounts of companies not in the test group, but additional work is likely to be required in this case to isolate the amounts applicable to the test group. Subsection EX 21E(13) states that the financial statements (being accounts) will be taken to comply with the applicable accounting standard if they meet the requirements of section EX 21C in relation to that standard (see especially subsection EX 21C(9)).

Subsection EX 21E(3) is the rule that makes a CFC a non-attributing active CFC if the CFC's ratio of attributable income to total income is less than 0.05, its attributable income is not negative, and its total income is greater than zero.

Subsection EX 21E(4) explains how the ratio calculation in subsection (5) is to be undertaken.

Amounts used in the calculation must be determined under the applicable accounting standard. Amounts will be taken to be determined under the applicable accounting standard if they are actually determined under that standard, or if the requirements in subsection EX 21E(13) are met. Some of the adjustments to base measures of attributable income and total income require the use of tax measures of income or expenditure. In those cases, it is clear that the amount will not be determined under the applicable accounting standard.

Each item in the formula (there are six items) must be adjusted so that there is no double-counting of amounts. Double-counting could occur if, for example, an amount was both income from a financial asset under paragraph EX 21E(7)(f) and income from property used to back insurance assets under paragraph EX 21E(7)(h). Double-counting across items, rather than within an item in the formula should be automatically prevented by the structure of section EX 21E.

Paragraph EX 21E(4)(g) requires that amounts are to be determined for a CFC using the functional currency of the CFC. The functional currency of a CFC is determined by the applicable accounting standard and cannot be freely chosen. The concept of "functional currency" is much more restrictive than the concept of "the currency of the CFC's financial accounts" in subsection EX 21(4).

Amounts may have to be translated from a currency that is not the functional currency of the CFC, such as when the CFC makes sales outside its own country. In that case, conversion to the functional currency must comply with the applicable accounting standard (with one exception). Translation under the applicable standard will frequently result in the recognition of an exchange rate gain or loss, and the gain or loss may need to be included in measures of attributable or total income. The one exception to the general rule is that exchange differences arising on a monetary item that forms part of a net investment of the CFC in a foreign operation are ignored. A monetary item that is part of a net investment in a foreign operation is an item for which settlement is neither planned nor likely to occur in the foreseeable future (see the definition in International Accounting Standard 21, for example).

If the ratio in subsection EX 21E(5) is calculated for a test group, the test group is – broadly speaking – treated as a single CFC for the purposes of the calculation. Amounts for the test group must be consolidated under the applicable accounting standard. This requires elimination of transactions, balances, income and expenses between the group members. If consolidated financial accounts exist that include the accounts of companies in the test group and only those companies, it may be possible to use those accounts without alteration. If consolidated accounts include entities that are not members of the test group, a sub-consolidation will be required for the test group. Information from consolidation worksheets may be used for this purpose, providing it meets the requirements of subsection EX 21E(13).

Because the test group is effectively treated as a single entity for the purposes of section EX 21E, there are special rules for determining when a person who is not a member of the test group is associated with the test group, or is a member of the same group of companies as the test group. The analysis of subsection EX 21D(3) in this report provides more information.

Each item in the formula is to be adjusted to remove amounts attributable to minority interests. "Minority interest" is not further defined in the legislation. However, it is clear from the context that a minority interest is an interest in the CFC held by a person who is not the interest-holder calculating the ratio.

Removal of amounts attributable to minority interests is most relevant for test groups. For an individual CFC, removal of these amounts is expected to affect all amounts equally so that the ratio in the formula is unchanged. For a test group, removal of these amounts is necessary to prevent, for example, *all* the income of an active business that is only partly owned by a New Zealand resident from sheltering attributable income of a company that is wholly owned by that resident.

Example: Removal of minority interest

Gordon has a 70% income interest in CFC A and a 55% income interest in CFC B.

CFC A is an investment company that buys, holds, and sells intellectual property, bonds and shares. It also has a sideline in rubber importing. CFC A does not develop any intellectual property itself. CFC A has intra-group transactions comprising $15,000 of sales of rubber to CFC B and $86,000 of interest income from a loan to CFC B.

CFC B is a shoe manufacturer.

Gordon initially wishes to consolidate the two CFCs for the purpose of the active business test using accounting measures of attributable income and total income.

The accounts of the CFCs are shown below.

$000s	**CFC A**			**CFC B**			**Consolidated**
	To/from CFC B	**To/from 3rd parties**	**Total**	**To/from CFC A**	**To/from 3rd parties**	**Total**	
Income							
Sales	15	13	28		20254	20254	20267
less costs of goods sold		17	17	15	14811	14826	14828
Gross profit			11			5428	5439
Other income							
Interest	86	351	437			0	351
Dividend		901	901			0	901
Royalties		574	574			0	574
Operating expenses							
Interest			0	86	2913	2999	2913
Loss on financial assets		33	33			0	33
Rent		5	5			0	5
Other expenses			0		5020	5020	5020
Net profit before tax			1885			–2591	–706
Attributable income (before removal of minority interests						0	892
Total income (before removal of minority interests)						20254	21159
Ratio							4.2%

	30% minority interest removed			***45% minority interest removed***			
$000s	**CFC A**			**CFC B**			**Consolidated**
	To/from CFC B	**To/from 3rd parties**	**Total**	**To/from CFC A**	**To/from 3rd parties**	**Total**	
Income							
Sales	11	9	20		11140	11140	11149
less costs of goods sold		12	12	8	8146	8154	8158
Gross profit			8			2985	2991
Other income							
Interest	60	246	306			0	246
Dividend		631	631			0	631
Royalties		402	402			0	402
Operating expenses							
Interest			0	47	1602	1649	1602
Loss on financial assets		23	23			0	23
Rent		4	4			0	4
Other expenses			0		2761	2761	2761
Net profit before tax			1320			–1425	–121
Attributable income (after removal of minority interests							624
Total income (after removal of minority interests)							11773
Ratio							5.3%

Attributable income comprises:

- Interest
- Royalties
- Loss on financial asset (this is not a share)

Total income comprises:

- Sales income
- Interest
- Royalties
- Loss on a financial asset

[Note that dividends are removed under EX 21E(9)(a) and EX 21E(12)(b).]

If the two CFCs were consolidated without consideration of minority interests (as in the top half of table) there would be attributable income of $892,000 and total income of $21,159,000, giving a ratio – using the formula in subsection EX 21E(5) – of 4.2%.

However, minority interests must be removed line-by-line because, conceptually, Gordon has rights and obligations in respect of only 70% of all the income and expense items of CFC A, and 55% of all the expense income and expense items of CFC B.

So, for example, Gordon counts only $437,000 × 70% = $305,900 of interest income from CFC A and eliminates $86,000 × 70% = $60,200 (being his share of the amount received from CFC B), giving consolidated interest income of $246,700 (as in the interest income line in the bottom half of the table).

After removing minority interests in the consolidation there is attributable income of $624,400 and total income of $11,773,200, giving a ratio of 5.3%. If a test group is used, the CFCs in the test group are *not* non-attributing active CFCs.

Gordon opts not to use a test group. CFC B, on its own, satisfies the test for being a non-attributing active CFC, since it has no attributable income. CFC A does not.

A test group applies the same rules for exchange rate conversion as an individual CFC. Consolidated financial accounts are presented in a *presentation currency*, which may differ from the functional currency of any of the entities whose accounts are being consolidated. Because all the entities in a test group will have the same functional currency, conversion to a different presentation currency is unnecessary and the functional currency should be used. For the avoidance of doubt, the legislation requires that if a presentation currency is used to calculate amounts, translation of all amounts from the functional to the presentation currency must be undertaken using an average exchange rate for the year. The effect is that the amounts in presentation currency will be nothing more than a scaled-up or scaled-down version of the amounts in the functional currency.

Subsection EX 21E(5) contains the formula for calculating the ratio of attributable income to total income using accounting measures of income.

The intent, in defining the items used in the numerator in the formula, was to define a measure of attributable income that was a reasonable approximation to the tax measure of attributable income, while not requiring excessive adjustments to readily available accounting measures. Similar comments apply to the denominator. In cases in which net amounts are allowed to be used in the formula, the approximation will not be to tax measures of gross income, but to tax measures of net income or loss.

The numerator in the formula consists of a base measure of attributable income *(reported passive)*. There are subsequent compulsory upward adjustments *(added passive)* and then optional downward adjustments *(removed passive)*. Double-counting and double-elimination are prevented by requiring that amounts are included in *added passive* only to the extent they are not already included in *reported passive*. Amounts are included in *removed passive* only to the extent that they are already in *added passive* or *reported passive*.

The denominator in the formula consists of a base measure of total income *(reported revenue)*. There are subsequent optional upward adjustments *(added revenue)* and compulsory downward adjustments *(removed revenue)*. As with the numerator, double-counting and double-elimination are prevented.

Subsection EX 21E(7) defines the base measure of attributable income *(reported passive)*.

The measure includes dividend, royalty, rental and lease income, whether or not in the ordinary course of business, and all are measured on a gross basis. It is intended that these terms have the meanings they have under the applicable accounting standard, rather than their meanings in the Income Tax Act 2007. For example, if generally accepted accounting practice with IFRS or IFRSEs are used, International Accounting Standard 18 (Revenue) provides some guidance about the recognition of dividends and royalties when received in the ordinary course of business. International Accounting Standard 17 (Leases) provides some guidance about the recognition of interest, rents and other lease income under a lease. If the applicable standard provides no guidance, the meanings of dividend, royalty, rental and lease should be determined according to the general understanding of accountants who would apply the standard.

It is important to note that the label given to a component of income in the accounts or on the face of financial statements does not determine the character of the amount. For example, if an amount would be a royalty under International Accounting Standard 18, but is included in "Other income" in the income statement because it is not in the ordinary course of business, it is still a royalty for the purposes of subsection EX 21E(7).

Another component of reported passive income is interest income. This is measured on a gross basis (with no deduction for expenses). Interest income is recognised under generally accepted accounting practice with IFRS and IFRSEs under the Revenue Standard (International Accounting Standard 18), if the interest is received in the course of ordinary activities of the entity. That standard specifies that the effective interest method (set out in International Accounting Standard 39) is to be used to calculate the amount of interest (this is essentially a yield-to-maturity calculation). Interest income may also be recognised other than under the Revenue Standard, such as when not in the ordinary course of activities of the entity. Again, the effective interest method would normally be used. It is expected that similar principles would apply under generally accepted accounting practice *without* IFRS, although there is no relevant standard to spell this out.

A further component of reported passive income relates to income or loss from a financial asset that is not a derivative.

The income or loss is included if it is a change in the reported fair value of the financial asset, a gain or loss on the derecognition of the asset or a foreign exchange gain or loss on the asset. Income or loss is to be included regardless of whether or not it appears in the income statement or elsewhere in the accounts. Losses will occur if the reported fair value declines, there is a loss on derecognition of the asset or there is a foreign exchange loss on the asset. Losses will not occur because expenditure, such as the cost of borrowing to purchase the asset, has been incurred in deriving income from the asset. Such expenditure is ignored for the purposes of the ratio calculation.

Not all amounts of income that relate to financial assets are included under paragraph EX 21E(7)(f). For example, some interest income is recognised under paragraph EX 21E(7)(b) even though it flows from the holding of a financial asset. If an amount is included under paragraph (f) *and* another paragraph, subparagraph EX 21E(4)(a)(ii) allows an adjustment to prevent double-counting.

Example 1: Income or loss from a financial asset (held-to-maturity)

Sandy owns SPECo, a CFC with a functional currency of CUA*. On 1 April 2011 SPECo purchases a bond newly issued by a foreign government, for CUB973,357. The bond has a term of 3 years, a face value of CUB1,000,000, and pays interest six-monthly at a rate of 6% per annum. The effective interest rate on the bond is 7% per annum. The CUA/CUB exchange rate is initially 1.00, but rises to 0.50 (CUA appreciates) on 31 March 2012. The bond is classified as a held-to-maturity investment under NZIAS 39, so is to be measured (subsequent to recognition) at amortised cost using the effective interest method.

On 31 March 2012, following the usual payment of interest, the foreign government announces that it is facing a fiscal crisis and will be unable to service its debt as previously agreed. In future, it will pay no interest and will repay only 80% of the face value of bonds on maturity. On 31 March 2013, SPECo sells the bond for CUB700,000.

The following table shows the financial accounting calculation of income and losses from the bond.

At recognition (CUB)								
	Cash flows	Accrued Interest	Interest received	Amortised cost				
1-Apr-11	−973357			973357				
30-Sep-11	30000	34068	30000	977425				
31-Mar-12	30000	34210	30000	981635				
30-Sep-12	30000	34357	30000	985992				
31-Mar-13	30000	34510	30000	990502				
30-Sep-13	30000	34668	30000	995169				
31-Mar-14	1030000	34831	30000	0				
Effective rate	7.00%							

Actual outcome (CUB)								
	Bond	Accrued Interest	Interest received	Amortised cost	Impairment		Sale price	Gain/loss on sale
1-Apr-11	−973357			973357				
30-Sep-11	30000	34068	30000	977425				
31-Mar-12	30000	34210	30000	697154	−284481			
30-Sep-12	0	24400	0	721554				
31-Mar-13	0	25254	0	746809			700000	−46809
30-Sep-13	0	26138	0	772947				
31-Mar-14	800000	27053	0	0				

Actual outcome (CUA)								
	Exchange rate	Accrued Interest	Interest received	Amortised cost	Impairment	Forex gain/loss	Sale price	Gain/loss on sale
1-Apr-11	1.00			973357				
30-Sep-11	1.00	**34068**	30000	977425		0		
31-Mar-12	0.50	**17105**	15000	348577	**−142240**	**−488712**		
30-Sep-12	0.50	**12200**	0	360777		0		
31-Mar-13	0.50	**12627**	0	373404		0	350000	**−23404**

Attributable income in relation to the bond comprises the accrued interest earned over the period of ownership, the foreign exchange loss in the period ended 31 March 2012, and a loss on sale in the period ended 31 March 2013 (see bold type in the table above). The impairment loss is also intended to be included in attributable income. There is a total loss over the period of ownership, for the purposes of the test, of $578,357.

* CUA = Currency A
CUB = Currency B

Example 2: Income or loss from a financial asset (at fair value through profit and loss)

The same bond used in Example 1 is accounted for as a financial asset at fair value through profit and loss.

Actual outcome (CUB)							
	Cash flows	Interest received	Interest rate	Fair value	Fair value gain/loss	Sale price	Gain/loss on sale
1-Apr-11	–973357		7.00%	973357			
30-Sep-11	30000	30000	7.00%	977425	4068		
31-Mar-12	30000	30000	7.00%	697154	–280271		
30-Sep-12	0	0	6.50%	726808	29654		
31-Mar-13	0	0	6.75%	748616	21808	700000	–48616
30-Sep-13	0	0					
31-Mar-14	800000	0					

Actual outcome (CUA)							
	Exchange rate	Interest received	Fair value	Forex gain/loss	Fair value gain/loss	Sale price	Gain/loss on sale
1-Apr-11	1.00		973357				
30-Sep-11	1.00	**30000**	977425	0	**4068**		
31-Mar-12	0.50	**15000**	348577	**–488712**	**–140135**		
30-Sep-12	0.50	**0**	363404	0	**14827**		
31-Mar-13	0.50	**0**	374308	0	**10904**	350000	**–24308**

Attributable income comprises interest received, changes in the reported fair value of the asset (which include a forex loss, a loss due to market interest rate movements and a loss due to the government announcement), and a loss on sale. There is a total loss over the period of ownership, for the purposes of the test, of $578,357.

Example 3: Income or loss from a financial asset (available-for-sale)

The same bond used in Example 1 is accounted for as an available-for-sale financial asset.

Actual outcome (CUB)										
	Cash flows	Accrued Interest	Interest received	Amortised cost	Impairment	Interest rate	Fair value		Sale price	Gain/loss on sale
1-Apr-11	–973357			973357		7.00%	973357			
30-Sep-11	30000	34068	30000	977425		7.00%	977425			
31-Mar-12	30000	34210	30000	697154	–284481	7.00%	697154			
30-Sep-12	0	24400	0	721554		6.50%	726808			
31-Mar-13	0	25254	0	746809		6.75%	748616		700000	–46809
30-Sep-13	0	26138	0	772947						
31-Mar-14	800000	27053	0	0						

Actual outcome (CUA)										
	Exchange rate	Accrued Interest	Interest received	Amortised cost	Impairment	Forex gain/loss	Fair value	Fair value gain/loss	Sale price	Gain/loss on sale
1-Apr-11	1.00			973357			973357			
30-Sep-11	1.00	**34068**	30000	977425		0	977425	**0**		
31-Mar-12	0.50	**17105**	15000	348577	**–142240**	**–488712**	348577	**0**		
30-Sep-12	0.50	**12200**	0	360777		0	363404	**2627**		
31-Mar-13	0.50	**12627**	0	373404		0	374308	**–1723**	350000	**–23404**

Attributable income comprises interest income (using the effective interest method), changes in the reported fair value of the asset (whether the corresponding entries are in the income statement, such as for exchange rate changes and impairment, or directly in equity), and a loss on sale.

On sale of the bond, any amounts recorded directly in equity – which have already been counted as attributable income – are transferred to the income statement by including them in the loss on sale. However, it is not intended that the income or loss be counted again when this occurs. So although the loss on sale reported in the accounts is $23,404, the gain of $904 that is being transferred from equity is removed, giving a loss on sale to be recognised in the test of $24,308. This gives a total loss over the period of ownership of the bond, for the purposes of the test, of $578,357.

The definitions of "financial asset", "derivative" and "derecognition" are contained in NZ IAS 39 (the New Zealand equivalent to International Accounting Standard 39), regardless of the applicable accounting standard being used in section EX 21E. In the case of "financial asset", the definition is by reference to the definition in NZ IAS 32. The definitions from NZ IAS 39 are used only for the purposes of identifying which assets are non-derivative financial assets and when they are effectively disposed of, not for determining how these assets are measured. If, for example, generally accepted accounting practice without IFRS is being used as the applicable accounting standard, a person will use NZ IAS 39 to identify which assets of the CFC are financial assets. Having identified the assets, the person may use the values of those assets as determined under generally accepted accounting practice without IFRS. The use of the definitions from NZ IAS 39 is necessary because generally accepted accounting practice without IFRS does not rigorously define "financial asset" or "derivative".

Income or losses from shares that are not revenue account property are excluded from the ambit of paragraph EX 21E(7)(f). This is to obtain a better approximation to tax measures of income; the assumption is that gains or losses on these shares would not be income or loss if tax measures of income were used. The term "revenue account property" is defined in section YA 1 of the Income Tax 2007 and is intended to have that meaning.

Another component of reported passive is income or loss from a derivative instrument. "Derivative instrument" is to be given the definition in NZ IAS 39. As with the use of NZ IAS 39 definitions for the purposes of paragraph EX 21E(7)(f), the definition is used only to identify which items the CFC holds are derivative instruments. Subsequent measurement is undertaken using the applicable accounting standard, whatever that may be.

Income or loss from a derivative may be recorded directly in the income statement in a set of accounts (profit and loss), or may be recorded directly as a component of equity and only later recognised in the income statement. It is only to be included in reported passive when it is recognised in the income statement. This is intended to prevent excessive volatility when cashflow hedges are used and the hedged cashflow has not yet occurred (assuming that hedge accounting can be used).

Income or loss from a derivative instrument is included only if the instrument is held for dealing, not held in the ordinary course of business, or is hedging the accounting measure of attributable income or a transaction that would give rise to such attributable income. In general, derivative income or losses will *not* be in reported passive to the extent they are the result of hedges of active income (income that is not attributable). This recognises that CFCs with active business will use derivatives to limit risk. For example, derivatives may be used to remove the risk that the exchange rate will fluctuate when sales of goods are made in a foreign currency.

The terms "ordinary course of business" and "dealing" are not further defined in the legislation.

A "hedging relationship" must be one of a type defined in NZ IAS 39. Again, this applies only to identify when there is a hedging relationship, not to determine how to measure any income or loss from a derivative instrument that is in a hedging relationship. NZ IAS 39 defines three types of hedging relationship. The two that are expected to be most common in practice are:

- a hedge of the exposure to changes in fair value of an asset or liability;
- a hedge of the exposure to variability in cashflows that could affect profit and loss and that is attributable to a particular risk associated with an asset or liability or to a highly probable transaction.

It is not necessary for the hedging relationship to qualify for hedge accounting treatment (under generally accepted accounting practice with IFRS or IFRSEs, this requires proper designation of the hedge and that the hedge be highly effective). However, the effectiveness of the hedging relationship and the existence of documentation of a hedge may be relevant in determining whether a hedge really exists. If a purported hedging relationship is not effective or only partly effective, it is likely that income from the hedge will be attributable income anyway (it is either not held in the ordinary course of business or the business deals in derivatives).

When the hedge is effective enough that a hedging relationship exists, but the hedge is still partly ineffective, the part of the gain or loss that reflects the ineffective portion of the hedge will normally be included in attributable income. This is because the legislation refers to "income or loss […] from a hedging relationship [with the accounting measure of attributable income]", and does not limit the income or loss to the amount attributable to the effective portion of the hedge. This is the case even though income or loss from the ineffective portion of the hedge may be presented in a different line item in the accounts.

If a CFC uses a derivative to hedge both non-attributable and attributable income (or transactions that give rise to both non-attributable and attributable income), the hedge gain or loss is recognised only to the extent it relates to the hedging relationship with attributable income. This will require apportionment on a reasonable basis. Any income or loss attributable to the ineffective portion of a hedge will usually be included in the amount to be apportioned.

Example: Derivative gain (foreign currency hedge)

CFCA, which has a functional currency of Canadian dollars takes out a single contract for exchange rate cover. It covers $1,000,000 of US dollar sales and interest income over the following income year.

CFCA subsequently receives US$700,000 of sales income and US$100,000 of interest income at the end of the year. The Canadian/US dollar exchange rate ends up higher than expected at the time the hedge was taken out. There is a gain on the foreign currency hedge of CA$333,333. This offsets sales and interest income that was CA$300,000 lower than expected because of the stronger exchange rate.

The exchange rate cover contract is a derivative instrument. The instrument is in a hedging relationship (a cashflow hedge) with non-attributable income (sales). The instrument is also in a hedging relationship with attributable income (interest), and the income attributable to this hedging relationship should be included in *reported passive*.

A reasonable apportionment of the hedge gain in this case would be CA$41,667, being US$100,000 ÷ (US$700,000 + US$100,000) × CA$333,333.

The hedge is not completely effective, and $33,333 of the derivative gain is attributable to the ineffective portion of the hedge. In the foregoing apportionment, one-eighth of the ineffective portion is attributed to the hedging relationship with interest income.

The final amount included in *reported passive* is income or gains from a business of insurance. This includes premium income from insurance or re-insurance activities. It also includes income or gains from property used to back insurance assets, such as interest, dividends, rents or fair value changes flowing from assets held to satisfy future insurance claims. If generally accepted accounting practice with IFRS or IFRSEs are used, International Financial Reporting Standard 4 or its New Zealand equivalent are likely to apply to such income.

There should be no income from a business of insurance if using generally accepted accounting practice *without* IFRS. CFCs are prevented from using that set of standards as the applicable accounting standard if they have insurance income under the relevant FRSs.

Subsection EX 21E(8) defines the compulsory upward adjustments to the base measure of attributable income *(added passive)*. There are four adjustments.

The first adjustment is to add income from a life insurance policy that would be included in the attributable CFC amount under paragraph EX 20B(3)(g). This adjustment was included primarily because some life insurance products, even though excluded from the scope of the financial arrangement rules in the Income Tax Act 2007 and the financial instrument rules in NZ IAS 39, are close substitutes for interest-bearing investments. The amount to include is to be determined under tax concepts (see the analysis of section EX 20B in this report for more information). If an accounting measure of such income has already been included under subsection EX 21E(7) but the tax measure is higher, the difference must be added.

The second adjustment is to add income from the disposal of revenue account property that would be included in the attributable CFC amount under paragraph EX 20B(3)(k). The adjustment does not apply to the disposal of a share, a financial arrangement or a life insurance policy, because other provisions are designed to capture gains in those cases. The adjustment also does not apply unless the property is used in a way giving rise to income or gains that increase the accounting measure of attributable income. The amount of the upward adjustment is the same as the amount that would be included under paragraph EX 20B(3)(k), except to the extent the amount is already included in *reported passive*. See also the analysis of paragraph EX 21E(9)(d), which may allow removal of the cost of the property.

The remaining adjustments add income from services that would be part of the attributable CFC amount under paragraphs EX 20B(3)(l) to (n), which relate to income from services physically performed in New Zealand and certain income from the supply of telecommunications services. The amount of the upward adjustment is the same as the amount that would be included under the relevant paragraphs in subsection EX 20B(3), except to the extent the amount is already included in *reported passive*.

Subsection EX 21E(9) defines the optional downward adjustments to the base measure of attributable income *(added passive)*. There are four adjustments. If a person chooses not to apply the adjustments, there is no adjustment.

The first adjustment is the removal of dividend income that would not be part of an attributable CFC amount under paragraphs EX 20B(3)(a) to (c). First, the amount that would not be part of the attributable CFC amount under those paragraphs is determined. That amount is then removed, but only to the extent that it was included in *reported passive* or *added passive* to begin with.

The second and third adjustments are the removal of royalty or rental income that would be attributable CFC amounts but are not, because they come within one or more of the exceptions in paragraphs EX 20B(5)(a) to (d) and EX 20B(7)(a) to (c). The amount to remove is the amount determined under those paragraphs, using tax measures of income. Removal is permitted only to the extent the amounts were already included in reported passive or added passive.

The fourth adjustment is the removal of the cost of revenue account property that, on disposal, produced an attributable CFC amount under paragraph EX 20B(3)(k). Such an amount was included, on a gross basis, in *added passive*. The effect of subtracting the cost is that only the net profit from the sale is included in attributable income. In order to be removed, further requirements must be met. The first requirement is that the amount of cost subtracted would have been an allowable deduction of the CFC in the accounting period if the CFC were resident in New Zealand. The second requirement is that the amount subtracted may not exceed the gross proceeds of the sale already included in *added passive* or (less likely) *reported passive*. Any amounts that would have to be added back in relation to the deductions under subpart CH of the Income Tax Act 2007, if the CFC were a New Zealand resident, reduce the amount of cost that is subtracted.

Subsection EX 21E(10) defines the base measure of total income *(reported revenue)* used in the ratio of attributable income to total income.

The core item of reported revenue for most CFCs with active businesses will be "revenue". If the applicable accounting standard is *generally accepted accounting practice with IFRS* or *IFRSEs*, the amount of revenue to recognise is dictated by International Accounting Standard 18 (IAS 18, Revenue). If the applicable accounting standard is generally accepted accounting practice *without* IFRS, the amount of revenue to include is the amount reported as *operating revenue*. It is expected that revenue, under any standard, will usually include income from interest, dividends and royalties. It might not include income from leases because most lease income is excluded from IAS 18; if there is lease income that is not included in revenue under IAS 18, this income is included separately under paragraph EX 21E(10)(b). Revenue is also expected to include most income from the supply of services, such as attributable CFC amounts under paragraphs EX 20B(3)(l) to (n).

Another component of reported revenue is gains or losses on certain non-derivative financial assets. The description of this item is identical to the description in paragraph EX 21E(7)(f). The amount to be recognised may, however, be different from the amount under subsection (7), depending on whether some of the income is already included in revenue (there should be no double-counting).

A further component of reported revenue is gains or losses on certain derivative instruments. The description of this component is very nearly the same as the description in paragraph EX 21E(7)(g). The only difference is that instead of the hedging relationship being with the accounting measure of attributable income or transactions that would give rise to such attributable income, the hedging relationship must be with the accounting measure of total income. In practice, this component of reported revenue should bring in nearly all hedges except those that relate to expenses or liabilities.

Example: Derivative gain (foreign currency hedge of income and expenses)

CFCB, which has a functional currency of Canadian dollars, takes out a single contract for exchange rate cover. It covers US$100,000 of *net* costs over the following income year, being US dollar purchase costs less US dollar sales and interest income.

The exchange rate cover contract is a derivative instrument. The instrument is in a hedging relationship (a cashflow hedge) with expenditure. More precisely, it is in a hedging relationship with the amount of expense that is forecast to exceed income.

The amount of any hedge gain or loss is not included in *reported revenue*, because the hedging relationship is not with income.

The final component of reported revenue is insurance income. The description of this component is the same as the description in section EX 21E(7)(h). This will often have the character of revenue, but income from insurance contracts that is dealt with in International Financial Reporting Standard 4 (and its New Zealand equivalent) is explicitly excluded from the revenue standard IAS 18 (and its New Zealand equivalent).

Subsection EX 21E(11) defines the optional upward adjustments to the base measure of total income *(added revenue)*. There are two adjustments. They add certain income from a life insurance policy or certain income from the disposal of revenue account property. These adjustments are described in the analysis of subsection EX 21E(8). The assumption behind these adjustments is that such amounts are more likely than others not to be included in revenue or operating revenue, because they will often not be in the ordinary course of business.

Subsection EX 21E(12) defines the compulsory downward adjustments to the base measure of total income (*removed revenue*). There are seven adjustments.

The first adjustment is the removal of the cost of revenue account property, if it was also removed from the measure of attributable income under paragraph EX 21E(9)(d).

The second adjustment is the removal of the amount of a dividend, if it was also removed from the measure of attributable income under paragraph EX 21E(9)(a). Bearing in mind the desire to produce a reasonable approximation to the tax measure of total income, the basis for removal is that these dividends would not be gross income of a New Zealand-resident company. However, to reduce compliance costs, if the dividends are not removed from the measure of attributable income, they are not required to be removed from total income either.

The third adjustment is the removal of personal services income that would be an attributable CFC amount under paragraph EX 20B(3)(h). This income is disregarded for the purposes of the ratio calculation, though will still be taxable under subsections CQ 2(2B) and DN 2 if the CFC qualifies for the active business exemption. In contrast, the personal services income was not explicitly removed from attributable income (the numerator in the formula), because it is unlikely to have been included in any of the categories of attributable income using accounting measures.

The fourth adjustment is the removal of income or loss from a share that is not revenue account property. "Revenue account property" is defined in section YA 1. The income or loss may have been included in reported revenue (as operating revenue, for example, if generally accepted accounting practice without IFRS was the applicable accounting standard). This adjustment is for greater consistency with the tax measure of total income (gross income).

The fifth adjustment is the removal of income derived by the CFC from a second CFC, if the second CFC could be part of a test group with the first CFC. This is to prevent the inflation of total income by arrangements between associates.

The sixth and seventh adjustments apply only when the applicable accounting standard is generally accepted accounting practice without IFRS. The inclusion of *operating revenue*, which is a very wide measure, in *reported revenue* makes these adjustments necessary; they are not thought to be required in relation to the much narrower measure of revenue as defined under IAS 18 or the New Zealand equivalent.

The sixth adjustment removes income if it is income from a liability, such as a reduction of a provision. It is possible that such income would be included in operating revenue, although this would be rare. Income from a liability is not removed if it is income in the ordinary course of business from a sale or supply of services. This might be the case, for example, when a prepaid service is provided, with the income in that case corresponding to a reduction of an unearned income liability.

The seventh adjustment removes income if it is income from an asset that is not a financial asset and not revenue account property. "Financial asset" is defined in NZ IAS 32, but that standard is used only to identify relevant assets, not to measure income relating to those assets. "Revenue account property" is defined in section YA 1. This adjustment prevents, for example, revaluations of real property from being included in the measure of total income. It could be possible, although unusual, for such amounts to be included in "operating revenue". The adjustment is intended to provide a closer approximation to tax measures of income.

Subsection EX 21E(13) sets out the conditions under which accounts are taken to meet the requirements of the applicable accounting standard. Strict compliance at a detailed level with the requirements of the standard will often not be practical, and an unqualified audit opinion will usually require compliance only in all material respects. Therefore, this subsection does not require strict compliance.

The primary requirement in subsection EX 21E(13) is that the accounts meet the requirements of section EX 21C for the applicable accounting standard (see particularly section EX 21C(9)). This means, in simplified terms, the accounts must state they comply with the relevant standard, the accounts must have received an unqualified audit by an independent chartered accountant, and there must not be reasonable grounds to suspect fraud, intent to mislead or incompetence.

If only information taken directly from published accounts were used in the test, this primary requirement could be sufficient.

However, this will sometimes not be the case. For example, in producing consolidated accounts for a corporate group, each CFC might provide information in a relatively aggregated form (such as line items actually appearing in the financial statements). When more detailed information is required, this will not be taken from the accounts that have been audited but directly from the CFC's internal accounting systems or from other similar sources.

This information will still be taken to comply with the relevant accounting standard, as long as:

- it is information that is drawn from the compliant accounts (even though not appearing on the face of financial statements), or that was used to prepare the compliant accounts (such as detailed information from CFC accounts that has been aggregated before being provided for the preparation of the compliant accounts); and

- the information is consistent with the compliant accounts; and
- there is no evidence of fraud, intent to mislead or incompetence (see the analysis of subsection EX 21C(9) for further information).

The word "consistent" is not further defined, so has its ordinary meaning. One implication of the consistency requirement is that information from the compliant accounts should be used if available, in preference to other information.

As with subsection EX 21C(9), nothing in subsection EX 21C(13) affects requirements to keep records or information, or to make those available when required by Inland Revenue.

The Australian exemption (sections EX 22 and 23 of the Income Tax Act 2007)

Section EX 22 defines a non-attributing Australian CFC.

A CFC qualifies to be a non-attributing Australian CFC if it is resident in Australia and is subject to income tax in Australia.

"Resident in Australia" means resident in Australia according to the Income Tax Act 2007. See, for example, section YD 2. There is also a requirement that the CFC is treated as a resident of Australia under every tax treaty between Australia and another country. This requirement might not be satisfied if, for instance, the CFC was incorporated in Australia but was managed from another country. In that case, it would be common for a tax treaty to treat the CFC as resident in the other country and Australia would lose worldwide taxing rights over the CFC.

For a CFC to be "subject to tax" requires one of two things. Firstly, the CFC can itself be subject to Australian income tax. Or secondly, the CFC can be part of a consolidated group for Australian tax purposes, if that consolidated group (through the "head company") is itself subject to Australian income tax. It is not sufficient for a person with an income interest in the CFC to be subject to Australian tax on the CFC's income.

A CFC will not qualify to be a non-attributing Australian CFC if its liability for Australian income tax has been reduced by an exemption from or reduction of income tax for certain offshore business income. These restrictions also applied to prevent Australian CFCs qualifying for the grey list exemption when there was a grey list.

If a non-attributing Australian CFC holds an interest in another CFC, the Australian exemption will not automatically apply to that other CFC. This is because the other CFC is effectively treated as held by the resident holders of interests in the first CFC, rather than by the first CFC (this is not a change of law; see existing sections EX 10 and EX 21(13)(c)). The eligibility of the other CFC for the exemption must be separately assessed.

If a non-attributing Australian CFC holds an interest in a FIF, the Australian exemption will not automatically apply to that other FIF. Again, this is because the FIF is effectively treated as being held by the resident holders of interests in the CFC, rather than by the CFC itself (see section EX 58).

Section EX 23 previously applied to CFCs resident in grey list countries that received certain tax concessions and thereby did not qualify for the grey list exemption. This has been repealed along with the grey list exemption for CFCs. If an Australian-resident CFC is not a non-attributing Australian CFC because it has reduced its income in a way described in section EX 22(1)(b), it is treated in the same way as any other CFC. It may be a non-attributing active CFC, or there may be attributed CFC income or loss from the CFC.

Anti-avoidance rules for the active business exemption (sections GB 15B and 15C)

Two anti-avoidance rules may affect the application of the active business exemption (sections EX 21D and EX 21E). The presence of these rules is not intended to imply anything about the general anti-avoidance provision (section BG 1). They are included for clarity. They may apply alone or in addition to the general anti-avoidance provision.

Section GB 15B

Section GB 15B applies when a CFC makes a supply with the purpose of increasing the tax measure of its total income in section EX 21D. This is an anti-avoidance rule. Increasing total income lowers the ratio of attributable income to total income, and the rule makes it clear that supplies made for this purpose are to be ignored.

It is expected that two CFCs who repeatedly sell goods back and forth between each other would come within the rule. Similarly, a sale which is put through an intermediate CFC with the purpose of increasing the intermediate CFC's total income for the purposes of section EX 21D would be caught.

However, the purpose of inflating total income must be the main purpose for section GB 15B to apply. It is accepted that there will commonly be sales between CFCs, such as between a regional supplier and country offices, that have no tax motivation.

Section GB 15B does not apply if the CFC makes a supply to a person who could be a member of a test group with the CFC. Separate rules apply in that situation (see section EX 21D(9)(c)) to require the removal of the income from the measure of total income.

Section GB 15C

Section GB 15 applies when a person enters an arrangement having a purpose, that is more than incidental, of enabling a CFC to meet the requirements of section EX 21E (active business exemption based on accounting measures of income) when the CFC would not meet the requirements of section EX 21D (active business exemption based on tax measures of income) to be a non-attributing active CFC.

This is an anti-avoidance rule to prevent manipulation of the active business exemption when using accounting measures of income. Accounting measures of income may often be used to determine whether a CFC qualifies for the active business exemption (see section EX 21E). The use of accounting measures is allowed because it can reduce compliance costs for taxpayers. Some effort has been made to align accounting and tax measures of income (see the required adjustments in section EX 21E, for example). However, accounting measures of income will inevitably be different from tax measures. There is therefore a risk that some taxpayers will attempt to exploit the differences to benefit from the active business exemption when, under tax measures of income, it is clear they should not benefit.

There are two conditions that must be satisfied before the section applies.

The first is that a person, being any person at all, must have entered an arrangement with a purpose, that is more than incidental, of enabling a CFC to meet the requirements of section EX 21E. It is expected that it will be rare for a person who enters into a normal commercial transaction, not motivated by tax concerns, to satisfy this requirement. The purpose must be "more than incidental". Here there is a parallel with the definition of "tax avoidance arrangement" in section YA 1 ("not merely incidental"). However, that definition refers to arrangements having a purpose "or effect" of tax avoidance, whereas section GB 15 refers only to a purpose. It is accepted that an arrangement will, from time to time, have the effect of enabling a CFC to meet the requirements of section EX 21E even when the CFC would not meet the requirements of section EX 21D. It is the purpose that matters.

The second condition is that the CFC would not meet the requirements of section EX 21D. If, in the presence of the arrangement, the CFC would qualify for the active business exemption using tax measures of income, the anti-avoidance rule does not apply. In this case, there does not seem to be an exploitation of differences between the accounting and tax measures of income.

The anti-avoidance rule has a wide application.

While not limiting that general application in any way, two specific situations in which the rules are intended to apply are:

- when financial arrangements between CFCs, or between a CFC and a New Zealand resident, are entered into with a purpose of generating accounting losses when there is no economic loss for the group; and
- when artificial transactions such as repeated sales are used to inflate the measure of total income used in the ratio of attributable income to total income.

There were originally separate rules for these two situations, but they were removed from the bill during the Parliamentary process because they were considered to be redundant.

In relation to the first situation, the Finance and Expenditure Committee, in its report to Parliament on the bill, stated: "The amendment we propose is general and would capture, for example, situations where taxpayers use loans (or make financial arrangements) between related parties with different functional currencies to shelter passive income".

The anti-avoidance rule has to cover such situations. When tax measures of income are used, all significant financial arrangements are measured in New Zealand dollars. However, translation of all financial arrangements to New Zealand dollars was thought to be inappropriate when using accounting concepts of income. This is because the use of accounting concepts is intended – as much as possible – to allow taxpayers to use pre-prepared financial accounting information. It is only the existence of the anti-avoidance rule that has allowed this approach to be enacted.

Example: Financial arrangements

CFCA, which has a functional currency of Australian dollars, lends US$1 million to CFCB, which has a functional currency of US dollars (for simplicity, the loan is made in such a way that no cash changes hands). The Australian dollar strengthens compared with the US dollar, resulting in a foreign exchange loss for CFCA because the loan is now worth less in its functional currency of Australian dollars. The attributable loss may be offset against other attributable income. CFCB has no corresponding income, because the loan is worth exactly the same in its functional currency of US dollars. There is no economic loss for the group, but net income has been reduced.

The anti-avoidance rule may apply if the financial arrangement was entered into with a purpose of generating the attributable loss for CFCA so that CFCA could meet the requirements of section EX 21E.

Example: Inflating the measure of total income

CFCA sells factory automation equipment. CFCB, in another country, is a finance company for the group. CFCA sells its equipment to CFCB, which then sells it to a third party. This inflates CFCB's total income and allows it to qualify for the active business exemption using accounting measures of income.

Assume for the purposes of the example that if tax concepts of income were used, CFCB would not qualify for the active business exemption (for example, because section EX 21D(9)(d) requires the removal of the sales).

The anti-avoidance rule may apply if the sales are made through CFCB for the non-incidental purpose of allowing CFCB to meet the requirements of section EX 21E.

If section GB 15C applies, the CFC in question does not qualify for the active business exemption (as it is not a non-attributing active CFC) and its income or loss must be attributed.

In addition, if the arrangement involves a financial arrangement between the CFC and an associated CFC, it is possible that the associated CFC also does not qualify for the active business exemption. This occurs if the arrangement produces a foreign exchange loss for the first CFC and allows it to reduce its accounting measure of attributable income. This rule is designed to include matching economic gains and losses on either side of a financial arrangement, rather than just the loss, but may apply more widely.

Commissioner's determination for active insurance CFCs

Under section EX 21B(3), an insurance CFC will be a *non-attributing active CFC* if:

- a person with an interest in the CFC has applied for and obtained a determination from Inland Revenue under section 91AAQ of the Tax Administration Act 1994 that the CFC is an active insurance business; and
- the CFC satisfies any requirements laid out in the determination.

The determination facility is an interim measure until further work is done to consider special rules for extending the active income exemption to accommodate financial institutions. The active income exemption and active business tests for CFCs do not currently accommodate "active" insurance CFCs as insurance premiums and many types of investment income are included in the attributable CFC amount in section EX 20B.

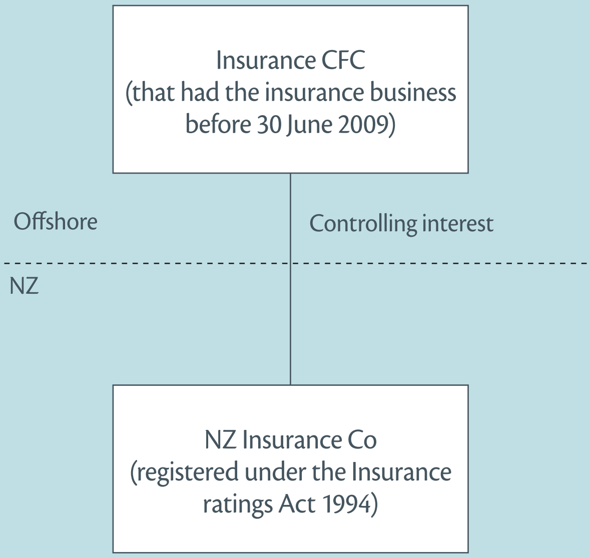
For a determination to be granted, the insurance CFC must satisfy the criteria set out in section 91AAQ of the Tax Administration Act 1994. Some criteria relate to the legal status and organisation of the insurance business and its New Zealand parent, while others relate to the activities through which the insurance business earns its income.

Organisational criteria

In the simplest case, the entity criteria in subsection 91AAQ(2) will be met if the insurance CFC is controlled by a New Zealand insurance company and the CFC carried out an insurance business in its country of residence before 30 June 2009.

Example: Organisational criteria

The following structure would satisfy the organisational criteria in subsection 91AAQ(2):



The organisational criteria are designed to accommodate more complex structures that are economically equivalent to this basic structure. For example, a New Zealand owner can still qualify if it is in the same group of companies as a New Zealand company that is registered under the Insurance Ratings Act 1994. Similarly, a group of insurance or insurance-related CFCs can apply for the determination on a country-consolidated basis under section 91AAQ(3). Finally, a New Zealand-controlled offshore insurance branch operation that existed before 30 June 2009 and that was subsequently converted into an insurance CFC could qualify so long as the CFC was in the same group of companies as the previous branch business.

Activity criteria

The activity criteria in subsection 91AAQ(4) will be met if the CFC's insurance business is carried out with the main purpose of producing a commercial return on the CFC's capital and it produces "all or nearly all" of its income from insurance premiums covering risks within the CFC's jurisdiction or from investment income from assets that are commensurate with these risks. Income from the reinsurance of other companies' insurance contracts does not count towards "income from insurance premiums".

The determination for insurance CFCs is intended as a temporary proxy measure for the active business exemptions that apply for other CFCs. This suggests that "all or nearly all" can be read to mean "at least 95 percent" of the CFC's total income. However, the determination does not specify an exact threshold as it may be appropriate to take into account a CFC's particular circumstances and historic benchmarks in some cases. Similarly, the interpretation of "commensurate" will require judgement as to the level of investment assets that would be reasonably required to cover the insurance risks based on the size and risk profile of the insurance business. Historical results and competitor benchmarks may be used to provide guidance on this point.

Subsection 91AAQ(5) lists some factors that the Commissioner may take into account when considering if a CFC meets the activity criteria. These include the amount of deductions that the New Zealand owner takes to support the CFC compared with the amount of assessable income earned by the CFC.

ATTRIBUTABLE INCOME

Section EX 20B of the Income Tax Act 2007

Section EX 20B insets a definition of income that is attributable to a CFC (referred to in the legislation as the *attributable CFC amount*). This definition is central to the new CFC rules. The definition is applicable, in the first instance, in the active business test to decide whether a CFC is active or passive. If the CFC fails the active business test, it will have attributable income that must be attributed to the New Zealand shareholders.

Key features

Attributable income (section EX 20B of the Income Tax Act 2007)

The definition of "attributable CFC amount" can be divided into broad categories. The types of income that come under the definition include interest, royalties and rents, being income that is highly mobile and not location-specific. However, exceptions apply when the income is associated with an active business and there is limited risk to the New Zealand tax base.

The broad categories of *attributable CFC amount* are as follows:

- certain types of dividend;
- interest;
- royalties;
- rents;
- other attributable income (income from offshore insurance businesses, life insurance policies, personal services and the disposal of revenue account property);
- certain income related to telecommunications services; and
- base company services income.

A number of exceptions are also provided for under section EX 20B. For example carve-outs are provided for certain royalty payments, certain rents and telecommunication services. If an item of income falls within the scope of any one of the exceptions, that item of income will be excluded from the definition of "attributable CFC amount" unless that item of income is caught in another paragraph of subsection EX 20B(3) or (4).

Detailed analysis

Certain types of dividend (subsections EX 20B(3)(a) to (c))

The dividends that are included in the attributable CFC amount match the foreign dividends that would be subject to income tax (not exempt under section CW 9) if received by a company resident in New Zealand. They also include unimputed dividends received from New Zealand companies. More specifically, the attributable dividends are:

- dividends from a less than 10 percent interest in a FIF described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39 (section EX 20B(3)(a)). These comprise shares in ASX-listed Australian companies, Australian unit trusts with adequate turnover or distributions, certain venture capital investments into New Zealand companies that have since migrated to a grey list country, and shares in Guinness Peat Group plc;
- dividends from fixed-rate foreign equity (section EX 20B(3)(c));
- dividends from deductible foreign equity (section EX 20B(3)(c));
- dividends received by CFCs from New Zealand companies to the extent that they are unimputed (section EX 20B(3)(b)).

If the CFC holds an attributing interest in a FIF that is calculated using the comparative value, deemed rate of return or fair dividend rate methods, any dividends from this FIF will not be included in the attributable CFC amount. This is because these FIF interests have no income other than FIF income under section EX 59(2).

Fixed-rate foreign equity and deductible foreign equity are defined in section YA 1.

Fixed-rate foreign equity includes foreign dividends that are a specific, fixed percentage of the amount paid for the equity (as well as variations on this) and any dividend that is regarded as equivalent to payment for money lent.

A deductible foreign equity distribution is a dividend where the foreign company paying the dividend (or another company owned by or on the same group as the foreign company which pays the dividend) is allowed a deduction for the payment of the dividend against foreign income tax.

Subsection EX 20B(3)(b) deals with dividends paid by a New Zealand company to the CFC. A New Zealand dividend that is fully-imputed will not be included in the attributable CFC amount. A partly imputed dividend will only be attributed to the extent to which it is not imputed.

Example

A CFC receives $100 of dividends from a New Zealand company with $21 of imputation credits attached (that is, the dividend is half-imputed). $50 of this dividend will be treated as part of the attributable CFC amount.

Note that although there is an exemption for dividends paid within a New Zealand wholly owned group (section CW 10), a dividend paid by a New Zealand company to a CFC that is in the same wholly owned group as the New Zealand company will still be attributable to the extent to which it is not imputed.

Financial arrangement income and interest (subsections EX 20B(4) and EX 20B(12))

The definition of "attributable CFC amount" includes income from financial arrangements held by a CFC. Section EX 20B(4)(a) and (b) sets out the criteria when financial arrangement income is caught within the definition of "arrangement income". Paragraph (a) includes a financial arrangement or short-term agreement for sale and purchase for which the CFC has made an election under section EW 8 *(Election to treat certain excepted financial arrangements as financial arrangements)* into the definition of "arrangement income". However, income from a financial arrangement that is not a derivative instrument is not attributable if the financial arrangement is:

- a loan provided by the CFC to an associated active CFC in the same jurisdiction (section EX 20B(12)(a)); or
- an agreement for the sale or purchase of property or services or a hire purchase agreement that is entered in the ordinary course of a business by the CFC or for property or services produced or used in the CFC's business (section EX 20B(12)(b)).

Income from financial arrangements that are derivative instruments is attributable if the derivative instrument is held for the purposes of dealing in the derivative instrument, is not entered in the ordinary course of the CFC's business or is a hedge instrument for attributable income or for a transaction that produces income that is attributable (section EX 20B(4)(b)).

Under the financial arrangements rules, an instrument will give rise to either income or expenditure. If an arrangement gives rise to income, that income is included in a CFC's attributable CFC amount, subject to the rules described above. Expenditure under a financial arrangement is dealt with separately, under the rules for calculating net attributable CFC income or loss in sections EX 20C to EX 20E. There is no "netting off" between financial arrangements. Thus, if a CFC holds one financial arrangement giving rise to income and another that gives rise to, say, an equal amount of expenditure, income and expenditure from the two instruments cannot be directly offset against each other. Rather, income from the first arrangement must be included as appropriate under section EX 20B and expenditure under the second arrangement must brought in under sections EX 20C to EX 20E.

Royalties (subsection EX 20B(5))

The general rule under the new international tax rules is that royalties (as defined in section CC 9 of the Income tax Act 2007) are included within the definition of "attributable CFC amount" unless they fall under one of four exceptions. The four exceptions ensure that when there are genuine commercial reasons for the intellectual property to be owned by a CFC, any royalties the CFC derives from that property will not be subject to attribution. The four exceptions are:

1. *Third-party active royalties (subsection EX 20B(5)(a))*

   This refers to royalties received by a CFC from a third party where:

   - the CFC has created, developed, or added substantial value to the intellectual property;
   - the CFC is regularly engaged in the activity of creating, developing, or adding substantial value to the intellectual property; and
   - the property does not have a prior link to New Zealand.

2. *Related-party active royalties (subsection EX 20B(b))*

   This refers to royalties received by a CFC from a related CFC where:

   - the CFC has created, developed, or added substantial value to the intellectual property;
   - the CFC is regularly engaged in the activity of creating, developing, or adding substantial value to the intellectual property;
   - the royalty is at an arm's-length amount under transfer pricing rules; and
   - the property does not have a prior link to New Zealand.

3. *Same jurisdiction active royalties (subsection EX 20B(5)(c))*

   This refers to royalties received by a CFC from a related CFC where:

   - the related CFC is within the same jurisdiction as the CFC;
   - the related CFC would pass the active business test; and
   - the property does not have a prior link to New Zealand.

4. *Royalties from property owned by a New Zealand resident (subsection EX 20B(5)(d))*

   This refers to royalties received by a CFC from a third party where:

   - the intellectual property is owned by a New Zealand resident and is licensed to the CFC; and
   - it is licensed between the New Zealand owner and the CFC for an arm's-length amount applying transfer pricing rules.

Third-party active royalties (subsection EX 20B(5)(a))

Royalty payments received from a third party are not considered to be attributable if the CFC satisfies the criteria set out in section EX 20B(5)(a). The criteria are:

- the CFC has created, developed, or added value to intellectual property;
- the CFC is regularly engaged in the activity of creating, developing, or adding substantial value to the intellectual property;
- the royalty is paid by a person who is not associated with the CFC; and
- the intellectual property does not have a prior link to New Zealand.

Example 1

CFC 1 operates a research facility in the United States. Its core business is to perform research on animal feed. In particular, it has been developing a special feed for sheep that would increase the quality of the wool the sheep produces. Through the research of its employees, CFC 1 discovered that a particular combination of grains results in a silkier texture to the wool produced by the sheep. It begins to license the formula to other companies that manufacture livestock feed. CFC 1 is not associated with any of the companies it receives royalties from.

In this example, the royalties CFC 1 receives from the unrelated third party will be excluded from the definition of "attributable CFC amount" under the third-party active royalty exclusion. CFC 1 is regularly engaged in the creation and/or the development of intellectual property, the royalty is from intellectual property that is developed by CFC 1 and the property has no prior link to New Zealand.

Example 2

Assume the same facts as above. CFC 1 is also engaged in buying ready-to-use formulas off its competitors and licenses them out to other companies also. In this case, the royalties received from the ready-to-use formulas will not be excluded from the definition of "attributable CFC amount", because the royalties did not arise from intellectual property that CFC 1 had created, developed or added substantial value to.

Related-party active royalties (subsection EX 20B(5)(b))

Royalty payments received from a related party are not considered to be attributable if the CFC meets the criteria set out in section EX 20B(5)(b):

- the CFC has created, developed or added value to intellectual property;
- the CFC is regularly engaged in that activity;
- the royalty is paid by a person who is not associated with the CFC;
- the royalties are at an arm's-length amount under transfer pricing rules; and
- the intellectual property does not have a prior link to New Zealand.

The criteria for this exclusion are the same as those in the third-party active royalty exclusion (section EX 20B(5)(a)), with the additional requirement that the royalty must be at an arm's-length amount under transfer pricing rules (section EX 20B(5)(b)(iv)).

Example

CFC 1 is based in Ireland. CFC 1 has always been in the business of producing vegetarian products under the Veges Cool brand. It owns the intellectual property rights to the Veges Cool brand. In particular, Veges Cool is a well known brand of quality vegetarian sausages in Europe. CFC 1 was recently acquired by NZ Co. NZ Co has many other CFCs in Europe. To save costs, NZ Co decides it would be more efficient for its other CFCs in Europe to directly manufacture the Veges Cool sausages and distribute the product to the local market rather than manufacture Veges Cool brand sausages from Ireland and distribute them to the rest of Europe.

To do this, CFC 2 in Belgium pays a royalty to CFC 1 for the use of the Veges Cool brand on the sausages it produces. The amount paid to CFC 1 is at an arm's-length price.

In this example, the royalty received by CFC 1 will be excluded from the definition of "attributable CFC amount". CFC 1 is regularly engaged in creating, developing and adding substantial value to the Veges Cool brand, the brand has no prior link to New Zealand and the royalty is an arm's-length amount.

Same jurisdiction active royalties (subsection EX 20B(5)(c))

Royalty payments received from a related party are not attributable if it meets the criteria set out in section EX 20B(5)(c):

- the related CFC is liable to tax in the same jurisdiction as the CFC;
- the related CFC would pass the active business test; and
- the property does not have a prior link to New Zealand.

While this exclusion only applies to related parties, it is important to note that the requirements are different from the related-party active royalty exclusion under section EX 20B(5)(b).

In particular, the CFC paying the royalty must pass the active business test, in the absence of applying this royalty exclusion (section EX 20B(5)(c)), the same jurisdiction rent exclusion (section EX 20B(7)(c)) and the same jurisdiction financial arrangement exclusion (section EX 20B(12)(a)). This issue of circularity will be discussed in more detail at the end of this section.

Example 1

CFC 1 is based in India. It holds a number of recipes for different condiments. None of the recipes it holds have a prior link to New Zealand. CFC 2, also based in India, licenses the recipe for ketchup off CFC 1 and manufactures it and distributes it for profit. CFC 3, also based in India, licenses the recipe for aioli from CFC 1 and manufactures it and distributes it for profit as well. Both CFC 2 and 3 are active CFCs, because both have less than 5 percent of attributable income, before the exclusions allowed under section EX 20B(5)(c), (7)(c) and (12)(a) are applied.

CFC 1, 2 and 3 are all owned by the same New Zealand shareholder – NZ Co. All three CFCs are liable to tax in India.

In this example, CFC 1 is merely a holding company. Any royalties it receives from CFC 2 and 3 will not be subject to attribution.

Example 2

Assume the same facts as in example 1, except that CFC 1 pays interest to CFC 3 on a loan CFC 3 made to CFC 1. CFC 3 does not pass the active business test taking into account the interest it receives from CFC 1 for the loan.

In this situation, the royalty CFC 1 receives from CFC 3 will not be excluded from attribution as CFC 3 is not an active CFC in the absence of the exclusion allowed under section EX 20B(12)(a).

Regularly engaged in creating, developing or adding substantial value to intellectual property (subsection EX 20B(5)(a) and (b))

Central to the third-party active royalty and related-party active royalty exclusions is the requirement that the CFC be regularly engaged in creating, developing or adding substantial value to intellectual property. The requirement that the CFC be regularly engaged in creating and/or enhancing intellectual property is aimed at ensuring that there is a genuine commercial rationale for the intellectual property to have been developed by a CFC in that particular jurisdiction. The exclusions are not intended to apply to CFCs that create and/or enhance intellectual property on a one-off basis.

Example 1

CFC 1 is a company based in the Netherlands. It has, for a number of years, owned research facilities in the Netherlands where it employs scientists, engineers and technicians who regularly perform experiments, tests and other technical activities that ultimately result in the creation or development of intellectual property that CFC 1 sells or licenses. CFC 1 often performs radical new research in fields where no current products are on the market. It will also often further develop intellectual property that it acquires from other companies.

Through the research of its staff, CFC 1 develops a design for a new robotic milking machine and subsequently licenses the design to other companies.

In this example, CFC 1 is a company that is regularly engaged in creating, developing, or adding substantial value to intellectual property.

Example 2

CFC 1 is a new company that has been operating in the United Kingdom for just under a year. Since it was established, the company has undertaken further research on a technique to produce low-calorie ginger beer. CFC 1 acquired the initial technique from another company in the United Kingdom. The new technique developed by CFC 1 proves to be extremely successful as it enhances the initial technique by substantially improving the taste of the ginger beer. CFC 1 is now able to produce low-calorie ginger beer with the flavour of a full-calorie ginger beer. CFC 1 begins to license the technique to other companies.

To date, CFC 1 has not created, produced or added substantial value to any other intellectual property.

In this example, while CFC 1 has only produced the single technique in making low-calorie ginger beer that retains the taste of full-calorie ginger beer, it is still considered to have been regularly engaged in creating, developing or adding substantial value to intellectual property. The fact that CFC 1 had been engaged in the research and development of this technique since the establishment of the company and continues to engage in research means it satisfies the *regularly engaged* requirement. CFC 1 added substantial value to the initial technique by improving the taste of the ginger beer. Although CFC 1 did not develop the initial technique, it improved it by substantially improving the taste of the ginger beer it produced.

Example 3

CFC 1 has been operating in China for the last 10 years. Its operations have mainly been manufacturing rubber soles for shoes. It employs a team of engineers to look after the machinery in its factories. By chance, one of the engineers discovers a new method of producing rubber soles which are 10 times more durable than regular soles. CFC 1 patents this method and begins receiving royalties from other companies that use this new method of rubber sole production.

In this example, CFC 1 has not satisfied the criteria that it is regularly engaged in the creation, development or adding substantial value to intellectual property. In particular, the creation or development of intellectual property is not part of the core day-to-day business of CFC 1.

Property linked to New Zealand (subsection EX 20B(13), (14) and (15))

Of the four royalty exclusions, three of them require that the intellectual property generating the royalty income not be linked to New Zealand. The reason for this is that intellectual property is highly mobile and can be easily transferred and held offshore, royalties relating to intellectual property that has a link to New Zealand are therefore attributable. However, it is recognised that there may be legitimate commercial reasons for intellectual property to be held offshore, therefore there is a mechanism in the legislation to allow the intellectual property to break its link to New Zealand.

Section EX 20B(14) sets out the situations when the intellectual property will create a link with New Zealand. It includes situations that are relatively straightforward. Subsection EX 20B(15) sets out the circumstances where the intellectual property's link to New Zealand is broken. In particular, this is when the intellectual property is sold offshore to an unrelated third party that is not a New Zealand CFC. Note that the intellectual property can re-establish its link to New Zealand, if at any time, it meets any one of the situations set out in subsection (14).

Example 1

CFC 1 owns the secret formula that allows normal meat cells to be grown into artificial meat suitable for consumption. Although CFC 1 is based in the Cayman Islands, it employs New Zealand scientists and engineers who perform all their research in Otago. As such, the development of the secret formula was all done in New Zealand by CFC 1's New Zealand-based employees.

In this example, the secret formula for growing artificial meat will have a link to New Zealand by virtue of having been created and developed in New Zealand.

Example 2

The news of this artificial meat is very well received and generates much international interest. As a result, multiple offers to buy the secret formula are made to CFC 1. In the end, CFC 1 decides to sell the formula to a German company. The German company is not associated with CFC 1 in any way, and it is not a New Zealand CFC.

At this point, the secret formula's link to New Zealand has been broken as provided for in section EX 20B(15). If the secret formula is subsequently owned by a CFC, there will be no prior link to New Zealand.

Example 3

The German company does further testing and discovers that there is little consumer interest in the artificial meat. In particular, the taste of the meat does not guarantee commercial success. As a result, the German company decides to sell the formula to try and recuperate some of its losses. The German company eventually sells the formula to an Austrian company. The Austrian company discovers there is a big market in New Zealand for the artificial meat as high-quality dog food. The Austrian company subsequently sets up a branch in New Zealand where it does further market testing of their product, with a view to selling the dog food in New Zealand first, then to the rest of the world.

At this point, the secret formula will have re-established its link to New Zealand by virtue of the property being used for the purposes of business carried on in New Zealand by virtue of the property being further developed in New Zealand. If the formula is later sold again to a New Zealand CFC, the New Zealand CFC will not be able to access any of the four royalty exclusions.

Royalties from property owned by a New Zealand resident (subsection EX 20B(5)(d))

Royalty payments received from a third party on property that is owned by a New Zealand resident are not attributable if the payments meet the criteria in section EX 20B(5)(d):

- the intellectual property is owned by a New Zealand resident and licensed to the CFC; and
- it is licensed between the New Zealand owner and the CFC for an arm's-length amount applying transfer pricing rules.

Note that if the property is owned by a New Zealand resident that is treated as non-resident under a double tax agreement, that person will not meet the residence requirement of this exclusion (section EX 20B(5)(d)(ii)).

This exclusion also contemplates the situation where an upper-tier CFC may sublicense the property to a lower-tier CFC which then licenses it to a third party (section EX 20B(5)(d)(i)).

Example 1

NZ Co owns the intellectual property rights on a special training programme for ballet dancers. Its programme is called "The Extreme Ballerina". The programme was extremely popular in New Zealand and NZ Co decides to expand to the international market. To do this, NZ Co would license its programme to its CFCs. CFC 1 is based in the Netherlands. It pays NZ Co a royalty for the use of the programme, and it subsequently sublicenses it to dance studios in the Netherlands. The royalty CFC 1 pays to NZ Co is an arm's-length amount. The dance studios that use "The Extreme Ballerina" are not associated with CFC 1.

In this example, the royalties CFC 1 receives from the dance studios will be excluded from attribution.

Example 2

Assume the same facts as in example 1. "The Extreme Ballerina" proves to be extremely successful in the Netherlands also. NZ Co now wants to expand into the Asian market. It sets up CFC 2 in Singapore, but decides to let CFC 2 sublicense "The Extreme Ballerina" from CFC 1 in the Netherlands. Like CFC 1, CFC 2 will license the programme to its local Singaporean dance studios.

In this example, the royalty received by CFC 2 from the dance studios will be excluded from attribution, as will the royalty it pays to CFC 1. The royalty paid to CFC 1 will only be excluded if CFC 2 had received the royalty from a non-associated third party. In this example, the non-associated third party would be Singaporean dance studios.

Rents (subsections EX 20B(3)(e), EX 20B(6) and EX 20B(7))

The general rule is that rent earned by a CFC will be treated as attributable income. Section EX 20B(6) sets out the types of rental payment that are subject to attribution. The following rents are attributable:

- a lease or sublease of land;
- a lease or sublease of personal property;
- a licence to use intangible property; and
- a hire or bailment.

However, it is recognised that rent is often associated with running an active business. For example, a CFC may be in the business of letting or it may hold property used by related CFCs for the purposes of running an active business and receive rental income from those CFCs.

For that reason, subsections EX 20B(7)(a) and (b) exclude rent from third parties from attribution if it is derived from a lease of real or personal property in the same jurisdiction as the CFC.

Furthermore, rent received by a CFC from a related CFC is not attributable when the related CFC would pass the active business test, as long as both CFCs are liable to tax in the same jurisdiction (section EX 20B(7)(c)).

Example 1

CFC 1 operates a car rental business in Bermuda where it leases vehicles to tourists. CFC 1 is liable to pay income tax on the income it derived in Bermuda.

In this example, the rental income CFC 1 derives from its car rental business will be excluded from attribution.

Example 2

CFC 1 is a holding company for CFC 2 and CFC 3. All three CFCs are based in the Netherlands and are all liable to income tax there. CFC 2 and CFC 3 both hire equipment off CFC 1 for its operations. CFC 2 passes the active business test because less than 5 percent of its income is subject to attribution, before the exclusions allowed under section EX 20B(5)(c), (7)(c) and (12)(a) are applied. The rental payment received from CFC 2 will be excluded attribution for CFC 1 under subsection EX 20B(7)(c).

CFC 3 does not pass the active business test, because more than 5 percent of its income is subject to attribution. For that reason, the rental income CFC 1 receives from CFC 3 will be subject to attribution.

Section EX 20B(7)(d) (Payment under hire purchase agreements and finance leases) and payments that fall within the definition of "royalty" under section CC 9 of the Income Tax Act 2007 are not considered as rent under the definition of "attributable CFC amount", but may be – and are likely to be in some cases – attributable under other provisions. For example, income from finance leases is attributable as *arrangement income* and payments that fall within the definition of "royalty" will be attributed under the royalty provision.

In the case of licence fees received for the use of intangible property, the royalty provisions will apply to these payments, as the royalty exclusions in subsection EX 20B(5) will apply (see subsection EX 20B(7)(g)). In short, the royalty exclusions are still applicable to rents from a licence to use intangible property, even though these payments fall outside the scope of the definition of "royalty".

Example

CFC 1 is based in Hong Kong and is in the business of developing software. Once a programme has been developed and the relevant testing done, CFC 1 then licenses its programme to its clients. Its clients are able to use the programmes in an unaltered state without the ability to exploit the programme – for example, clients are not allowed to make and sell copies of the programme. This is a classic example of "shrink-wrap software".

Licence fees for the use of "shrink-wrap software" do not fall within the definition of "royalty" under section CC 9 of the Income Tax Act 2009. However, subsection EX 20B(7)(g) extends the royalty exclusions in subsection EX 20B(5) to payments under a licence to use intangible property which does not fall within the definition of "royalty" under section CC 9.

Therefore CFC 1 will be able to exclude the licence payments from attribution if it meets the requirements of any one of the royalty exclusions (see subsection EX 20B(5)). In this example, it would appear that the *third party active royalties* exclusion (subsection EX 20B(5)(a)) will be the most relevant exclusion. Provided the licence payments meet all of the requirements of subsection EX 20B(5)(c), CFC 1 will be able to exclude those payments from attribution.

Other attributable CFC amounts

The definition of "attributable CFC amount" includes types of income other than dividends, interest, royalties and rents. These types of income relate to:

- offshore insurance businesses;
- life insurance policies;
- personal services; and
- the disposal of revenue account property.

Income from offshore insurance business (subsection EX 20B(3)(f))

Section EX 20B(3)(f) generally treats the premium of an insurance contract or a reinsurance contract as attributable income. However, when this type of income forms the core part of a CFC's insurance business, that CFC can apply for a Commissioner's determination. A process has been established (see *Determination of active insurance active business*) to enable active insurance CFCs to be considered to have passed the active business test (and be treated as a non-attributing active CFC). This is a temporary measure until special rules are considered for extending the active income exemption to financial institutions.

Example

CFC 1 is based in the Cayman Islands and only derives income from the premiums it receives from insurance contracts.

In this example, the income derived from insurance contracts by CFC 1 will be attributable unless CFC 1 applies for a Commissioner's determination and the Commissioner subsequently considers CFC 1 to have passed the active business test. In the absence of a Commissioner's determination, the premiums received from the insurance contracts will be considered as attributable income.

Income from life insurance policies (subsections EX 20B(3)(g) and EX 20B(8))

Income from life insurance policies is generally treated as attributable under section EX 20B(3)(g). Subsections EX 20B(8)(a) to (c) sets out the circumstances when the income from life insurance policies is considered an attributable CFC amount. Accordingly, income a CFC derives from holding a life insurance policy is treated as attributable income (subsections EX 20B(8)(a) and (b)). Additionally, income from a disposal of the life insurance policy is also attributable to the extent that these policies are on revenue account (section EX 20B(8)(c)).

However, section EX 20B(8) provides that income from life insurance policies that are FIF interests is not subject to attribution under the CFC rules, as that income is already attributed under the FIF rules. Net gains from the disposal of such interests will continue to be attributable where the net gain is not taxable under the FIF rules.

Income from personal services (subsections EX 20B(3)(h), EX 20B(9) and GB 27(3)(e))

Income from personal services is treated as attributable if it meets the criteria set out in subsection EX 20B(9). However, there is an important distinction between income from personal services and other forms of attributable income because this income will always be subject to attribution irrespective of whether the CFC passes the active business test. Another way to look at this is that a non-attributing active CFC will still be required to attribute any personal services income it receives even if it passes the active business test – because less than 5 percent of its total income is income that is subject to attribution.

Furthermore, such income will be disregarded for the purposes of applying the active business test (see subsections EX 21(D)(7) and EX 21E(12)(c)).

In many ways the criteria set out in subsection EX 20B(9) is an extension of the domestic attribution rule for income from personal services (see sections GB 27 to 29).

The personal services income will be considered as attributable income if it meets all of the following criteria:

- The "working person" is a New Zealand resident.
- The personal services are not essential support for a product supplied by the CFC.
- The individual and the CFC are associated persons under section YB 3 (Company and non-corporate 25 percent interest holder) or the individual is a relative of a person associated with the CFC under section YB 3 at the time the services are performed.
- At least 80 percent of the CFC's gross income from personal services during the tax year relates to services personally performed by the individual (or a relative of the individual).
- Substantial business assets are not a necessary part of the business structure that is used to derive the income from personal services. (That is, to derive the income, the CFC uses depreciable property that, at the end of the accounting period, has a total cost of more than either $75,000 or 25 percent or more of the CFC's total assessable income from services performed in that period.)

Note that section EX 20B(9)(b) provides that when the services personally performed by the individual are essential support for a product supplied by the associated entity, they are not subject to attribution. This is because the provision is not intended to apply to income earned from services that are provided in relation to the sale of goods by a CFC. Therefore income from personal services is not subject to attribution if the services are essential support for a product supplied by the CFC.

Another important point to note about the personal services rule under the CFC rules is that if the personal services income is attributed under those rules, the domestic attribution rule will be "switched off" (subsection GB 27(3)(e)). This will ensure that the personal services income will only be attributed once to the "working person".

Example

Joe is a graphic designer based in New Zealand. Joe's wife Jill is the sole shareholder of Jill Co – a CFC in the Bahamas. Jill Co derives most of its income from the services Joe provides as a graphic designer, and some royalty income from several patents it holds. Joe is the only graphic designer employed by Jill Co.

In this example, the income derived by Jill Co from Joe's services as a graphic designer will be subject to attribution as the income satisfies the requirements of subsection EX 20B(9) – in particular, that Joe is a New Zealand resident, the personal services are not essential support for a product supplied by Jill Co, Joe and Jill Co are associated under section YB 3, all of Jill Co's income from personal services is produced by Joe and substantial business assets are not a necessary part of the business structure that is used to derive the income from personal services.

In short, the personal services income derived by Jill Co will be attributable to Joe and subject to New Zealand tax. However, this income will only be subject to attribution once, as the domestic personal services rule is effectively "switched off" if that income is subject to attribution under the CFC rules (see subsection GB 27(3)(e)).

The personal services income derived by Jill Co will be ignored for the purposes of applying the active business test to Jill Co. In this example, the only other income derived by Jill Co is the royalties Jill Co receives from the patents it holds. Depending on whether the royalty income meets any of the exclusions under subsection EX 20B(5), that income may be exempt from attribution – in that Jill Co has less than 5 percent of attributable income, disregarding the personal services income that is already subject to attribution.

Income from the sale of shares (subsections EX 20B(3)(i) and EX 20B(10))

Section EX 20B(3)(i) defines income from the sale of shares that are on revenue account as attributable CFC income while section EX 20B(10) sets out the exceptions to this. Revenue account gains are disregarded when a CFC sells an interest in a FIF whose income is calculated using either the comparative value, deemed rate of return, fair dividend rate or the cost method. This is consistent with the way in which these gains would be treated if held directly by a New Zealand company.

Income from the disposal of share options (subsection EX 20B(3)(j))

Section EX 20B(3)(j) provides that income from the disposal of share options held on revenue account is treated as attributable income. This is consistent with the treatment of income from the disposal of shares held on revenue account, as discussed above.

Income from the disposal of revenue account property (subsection EX 20B(3)(k))

Gains from the disposal of revenue account property held by a CFC that is not used in an offshore active business will be treated as attributable income (section EX 20B(3)(k)).

However, this rule does not apply to income from the disposal of revenue account property if the property is a share, financial arrangement or life insurance policy, as these items are dealt with specifically in other parts of the definition of attributable CFC amount.

Base company income (subsection EX 20B(3)(l))

Under subsection EX 20B(3)(l), income derived by a CFC for a service that is wholly or partly performed in New Zealand is defined as attributable income of the CFC.

International telecommunications services are excluded from the base company income rule. Income derived from telecommunication services are dealt with in another subsection.

Example

Parent Co is based in New Zealand and has a subsidiary in the Cayman Islands (CFC 1). CFC 1 derives its income from providing consulting services all over the world, but with a large proportion of the services provided to New Zealand residents. The majority of the services are therefore performed in New Zealand.

Subsection EX 20B(3)(l) will treat the income CFC 1 derives from the consulting services that are performed in New Zealand as attributable income. However, any other income that is derived from the consulting service which is performed outside of New Zealand will not fall within the definition of attributable CFC amount.

Income from telecommunications services (subsections EX 20B(3)(m) to (n) and EX 20B(11))

Certain income from telecommunications services is attributable income.

Income from the use of a telecommunications asset outside any country (subsection EX 20B(3)(m))

Income derived from the use of a telecommunications asset that is wholly or partly located outside any country is attributable income. In the event that only part of the asset is located outside any country, apportionment will be required.

This rule only applies if the asset is owned by the CFC or another CFC that is associated with the CFC.

Assets that are subject to this subsection include (but are not limited to) telecommunications cables, satellites, and associated plant, equipment and facilities. The rule does not apply to a cellphone handset or transmitting equipment located on board a ship or aircraft.

The types of income that would be derived from the use of a telecommunications asset include (but are not limited to) income from the transmission of telecommunications data using the asset; the lease of the asset; and the licence or sale of rights – whether direct or indirect – to use the asset.

Income when telecommunications services performed in New Zealand (subsections EX 20B(3)(n) and EX 20B(11))

Consistent with "base company income", income as a result of providing a telecommunications service is generally taxable to the extent the service is physically performed in New Zealand (paragraph EX 20B(3)(n)).

However, an exception is made when the service is the transmission, emission or reception of information between New Zealand and the CFC's country of residence (subsection EX 20B(11)). In this instance, there is a decreased likelihood that the CFC has been established to escape New Zealand tax, because such a service typically must be partly performed in both locations. There also appears to be a greater-than-normal degree of practical difficulty in calculating the income attributable to services performed in New Zealand.

The exception applies only if two requirements are met. The first requirement is that there be a close connection between the CFC and a network operator. The term "network operator" is defined in the Telecommunications (Interception Capability) Act 2004. A sufficiently close connection exists if:

- the CFC is a network operator; or
- a person who is a network operator holds a 50 percent or greater income interest in the CFC; or
- a person who has a 50 percent or greater voting interest in a network operator also holds a 50 percent or greater income interest in the CFC.

The second requirement is that the service is not performed using equipment or staff of the CFC, or of an associated CFC, that is physically located in New Zealand. The expectation is that the New Zealand owner of a telecommunications CFC would use its own equipment and staff at the New Zealand end of the connection, rather than the CFC's. The second requirement reduces the incentive to substitute the CFC's staff or equipment merely to escape the tax that the New Zealand owner would ordinarily pay on these New Zealand operations.

The exception in subsection EX 20B(11) is only an exception to paragraph EX 20B(3)(n). For example, if paragraph EX 20B(3)(m) applies to an amount of income to which subsection EX 20B(11) also applies, the income is attributable.

Exclusions for rent, royalties and interest received from an associated CFC in the same jurisdiction (subsections EX 20B(5)(c), EX 20B(7)(c) and EX 20B(12)(a))

As noted in the sections above, certain rent, royalties and financial arrangement income from associated active CFCs in the same jurisdiction as the CFC is excluded from attribution (see subsections EX 20B(5)(c), (7)(c) and (12)(a)).

There is a possibility that the status of the associated CFC cannot be determined, because the associated CFC itself needs to apply the same exclusions.

Example

CFC A and CFC B are 100 percent commonly owned and are both resident in the same jurisdiction.

When it applies the active business test, CFC A has a numerator of $49,990 and a denominator of $1 million, but only if it can exclude royalties of $50,000 received from CFC B. CFC B has a numerator of $99,980 and a denominator of $2 million, but only if it can exclude interest of $100,000 received from CFC A.

CFC A can only exclude the royalties if CFC B is active, and CFC B can only exclude the interest if CFC A is active, but neither CFC is active until it applies the exclusion.

As a solution to this circularity problem, when a CFC (CFC A) determines the status of an associated CFC (CFC B), it will do so without applying any of the exclusions to CFC B. That is, for this purpose only, CFC B's status is to be determined assuming that any rent, royalties or interest it receives from an associated CFC in the same jurisdiction is subject to attribution.

Example

Continuing from the example above, CFC A would determine that CFC B's numerator was $199,980 and its denominator was $2,100,000, meaning that CFC B would not be active for this purpose. CFC A would then have to recognise the $50,000 of royalties as attributable income. Similarly, CFC B would be required to recognise the $100,000 of interest as attributable income.

MECHANICS OF ATTRIBUTION

Sections CQ 2, DN 2, EX 18A, EX 20C to EX 20E and EX 21 of the Income Tax Act 2007

There is a signposting provision in section EX 18A showing the scheme for finding a person's attributed CFC income or loss under the new rules.

Sections CQ 2 and DN 2 provide that a person has attributed CFC income or loss if the person has an income interest of 10 percent or more in a CFC that has net attributable CFC income or loss and is not a non-attributing active CFC or a non-attributing Australian CFC. Special rules apply to income from personal services.

The rules for calculating net attributable CFC income or loss for a CFC are set out in sections EX 20C to EX 20E and section EX 21 as follows:

- Section EX 20C provides that net attributable CFC income or loss is to be calculated using a prescribed formula and lays down the main rules concerning deductibility of expenditure.
- Sections EX 20D and EX 20E make provision regarding the deductibility of interest expenditure for excessively debt-funded CFCs.
- Section EX 21 applies the Act (subject to certain modifications) for specified purposes as though a CFC were a New Zealand resident. Those specified purposes include the calculation of net attributable CFC income or loss.

Key features

Net attributable CFC income or loss is the income or loss of a CFC that is attributed to New Zealand residents with an income interest of 10 percent or more. Non-attributing active CFCs and non-attributing Australian CFCs are not subject to attribution other than for any income or loss derived from personal services.

The starting point for calculating net attributable CFC income or loss for a CFC is to determine the attributable CFC amount in accordance with section EX 20B. This amount is then reduced to reflect expenditure incurred by the CFC, giving a net figure.

As a general rule, deductions for expenditure incurred other than under a financial arrangement will be allowed if the expenditure is incurred by the CFC in deriving an attributable CFC amount. Different rules apply to expenditure incurred by a CFC under financial arrangements because of the difficulties associated with matching debt to particular income streams.

Of expenditure (typically, interest) incurred under financial arrangements that provide funds to the CFC, only a fraction is deductible. The fraction is based on the value of the attributable assets of the CFC as a proportion of its total assets. If a CFC is excessively debt-funded, the fraction is calculated by reference to the assets of all the interest holder's CFCs. The same rule applies to certain dividends that are deductible for the purposes of calculating net attributable CFC income or loss, namely distributions relating to fixed-rate foreign equity and deductible foreign equity distributions made by the CFC to New Zealand-resident companies or to other CFCs.

The rules provide flexibility for intra-group financing arrangements, recognising that multinationals may operate financing subsidiaries to obtain debt finance on behalf of the group and then on-lend the funds to operating subsidiaries. An adjustment for on-lending may be made when calculating the net attributable CFC income or loss of a CFC. The effect of the adjustment is to allow a full deduction for expenditure incurred under financial arrangements that provide funds to the CFC and for any deductible dividends to the extent the funds are on-lent to associated CFCs. A similar adjustment may be made when determining whether a CFC is excessively debt-funded.

Expenditure incurred under financial arrangements such as derivative instruments that do not provide funds to the CFC is either deductible or non-deductible according to whether any income derived from the arrangement would be included in the CFC's attributable CFC amount.

Detailed analysis

When attributed CFC income or loss arises

Section CQ 2 sets out when a person has attributed CFC income from a foreign company. A number of criteria must be satisfied, including that the foreign company is a CFC with net attributable CFC income under section EX 20C (subsection (2)(f)(i)). Section DN 2 makes equivalent provision in relation to attributed CFC loss.

In general, a person does not have attributed CFC income or loss from a CFC that is a non-attributing active CFC or a non-attributing Australian CFC (section CQ 2(1)(h) and (i) and section DN 2(h) and (i)).

Income from personal services

Sections CQ 2(2B) and DN 2(2) make special provision for income or loss derived by a CFC from personal services under section EX 20B(3)(h). This income is always subject to attribution: under sections CQ 2 and DN 2 if the CFC is a non-attributing active CFC or a non-attributing Australian CFC; otherwise, under section EX 20B(3)(h) and (9). In view of this, income from personal services may be disregarded for the purposes of determining whether a CFC is a non-attributing active CFC (section EX 21D(7)(a)). Where such income is attributed under the CFC rules, the equivalent attribution rule in subpart GB does not apply (section GB 27(3)(e)).

Net attributable CFC income or loss

Net attributable CFC income or loss is calculated under sections EX 20C to EX 20E and provides the basis for attribution to resident shareholders, much as branch equivalent income did previously.

Net attributable CFC income or loss is the CFC's attributable CFC amount, determined under section EX 20B, less the CFC's allowable expenditure. The relevant formula is found in section EX 20C(2) and refers to two categories of allowable expenditure – limited funding costs and other deductions.

Limited funding costs

The item, limited funding costs, is an adjusted amount, based on a CFC's funding costs as defined in section EX 20C(6)(a). Limited funding costs are not fully deductible under the formula in section EX 20C(2); deductions are restricted by applying the fraction found under section EX 20C(8).

Funding costs comprise expenditure incurred under financial arrangements that provide funds to the CFC and distributions relating to fixed-rate foreign equity and deductible foreign equity distributions made by the CFC to New Zealand-resident companies or to other CFCs.

When determining limited funding costs from funding costs, an adjustment may be made under section EX 20C(5). The adjustment is based on the value of funds on-lent by the CFC to associated CFCs (group funding) as a proportion of the CFC's own funding. Where funding costs exceed limited funding costs, the difference is allowed as other deductions (section EX 20D(9)(b)). The significance of this re-characterisation is that, under the formula in section EX 20C(2), other deductions are allowed in full rather than being restricted through the application of a fraction.

The effect of this adjustment is that, if a CFC borrows and then on-lends funds to an associated CFC, it is allowed a full deduction for its own interest expenditure on those funds. Thus, if a quarter of a CFC's funding is on-lent to associated CFCs, three-quarters of its funding costs will be included as limited funding costs subject to restriction, with the remainder being fully deductible. The adjustment is arithmetical and does not allow for borrowed funds to be matched to amounts on-lent.

Other deductions

The item, "other deductions", is defined in section EX 20C(9). As noted earlier, other deductions are allowed in full rather than being restricted through the application of a fraction.

Paragraph (a) of section EX 20C(9) deals with deductions not relating to financial arrangements and shares. This expenditure is deductible if it is (i) incurred for the purpose of deriving an attributable CFC amount and (ii) not incurred for the purpose of deriving an amount that is not an attributable CFC amount. If an item of expenditure relates to both attributable and non-attributable amounts, the combined effect of subparagraphs (i) and (ii) is to require apportionment of that expenditure.

Paragraph (b) deals with any funding costs excluded from limited funding costs by virtue of the on-lending adjustment described earlier.

Paragraph (c) deals with deductions relating to financial arrangements that do not provide funds to the CFC. Deductions are allowed only if they relate to an arrangement referred to in section EX 20B(4), namely one that would produce an attributable CFC amount if it produced a net gain rather than a net loss.

Fraction

Section EX 20C(8) defines the item "fraction" that is applied under the formula in section EX 20C(2) to restrict deductions for limited funding costs. Section EX 20C(10) to (12) and sections EX 20D and EX 20E are also relevant.

Typically, the fraction is based on the proportion, by value, of the CFC's assets that produce an attributable CFC amount (section EX 20C(10) and (11)). Thus, a CFC that uses one-third of its assets to earn attributable CFC amounts will be able to set one-third of its limited funding costs against those amounts when calculating its net attributable CFC income or loss. If an asset is used to derive both attributable and non-attributable amounts, its value will need to be apportioned. Asset values are adjusted to reflect any adjustment for on-lending under section EX 20C(5).

As a backstop against structures that concentrate debt in CFCs with mainly attributable assets in order to maximise allowable deductions, section EX 20C(8)(b) caps the fraction for a CFC that is excessively debt-funded at the amount calculated under section EX 20D. This cap is determined by reference to the assets of all the interest holder's CFCs (section EX 20D(9) to (13)). A CFC is considered to be excessively debt-funded if it has a debt-asset ratio, determined under section EX 20D(4), of more than 0.75 and also has a relative debt-asset ratio, determined under section EX 20E, of more than 1.10.

Detailed calculation rules

Section EX 21 sets out detailed calculation rules which apply for the purposes specified in subsection (1) – calculating the attributable CFC amount under section EX 20B, calculating net attributable CFC income or loss under section EX 20C, and determining under section EX 21D whether a CFC is a non-attributing active CFC. Subsection (2) provides that, for those purposes, the rules in the Act are applied as if the CFC were always a New Zealand resident, subject to the modifications set out in the rest of the section.

INTEREST ALLOCATION RULES

Subpart FE of the Income Tax Act 2007

Subpart FE has been amended to apply the interest allocation rules to New Zealand residents with interests in CFCs. These rules are designed to prevent excessive interest deductions being allocated against the New Zealand tax base.

Key features

Interest allocation rules have been extended to outbound entities: New Zealand residents with an income interest in a CFC. The existing safe harbours apply. Interest deductions are not restricted unless the New Zealand group debt percentage is more than 75 percent (and, for a company or a trustee, is also more than 110 percent of the worldwide group debt percentage).

An outbound entity will not typically be required to apportion interest expenditure unless New Zealand group assets are less than 90 percent of the assets of the worldwide group and the total interest deductions of the New Zealand group are more than $250,000. In addition, an adjustment mechanism has been introduced for outbound entities with finance costs of less than $2 million. This eliminates apportionment for outbound entities with finance costs of up to $1 million and provides tapered relief for those with finance costs between $1 million and $2 million.

Various changes have been made to the definitions of "debt" and "assets" in subpart FE. Fixed-rate foreign equity and fixed-rate shares held by New Zealand residents are now included when determining total group debt for the New Zealand group. Equity investments in CFCs are no longer included within the total group assets of the New Zealand group. The rules for measuring the debt of the worldwide group have been aligned with those for measuring the debt of the New Zealand group.

Detailed analysis

Application of rules to outbound entities

Previously, the interest allocation rules only applied to New Zealand taxpayers controlled by a single non-resident. Subpart FE has been amended so that the rules also apply to outbound entities – New Zealand-resident companies, individuals and trustees with an income interest in a CFC (sections FE 1(1)(a)(i) and FE 2(1)(e) to (f)).

The safe harbours set out in section FE 5 apply to outbound entities as well as to entities controlled by non-residents. Thus, an outbound entity will not be subject to restriction of its interest deductions under subpart FE unless it has a New Zealand group debt percentage that is more than 75 percent (and, for a company or a trustee, is also more than 110 percent of the worldwide group debt percentage).

Additional carve-outs apply to outbound entities by virtue of section FE 5(1B). There is an exemption from the requirement to apportion interest expenditure if:

- the value of New Zealand group assets is 90 percent or more of the value of the assets of the worldwide group; or
- total interest deductions of the New Zealand group are not more than $250,000 and the group does not include an entity with an income interest in a CFC that derives rent from land in the country or territory in which the CFC is resident.

Apportionment of interest

Section FE 6 contains the formula for apportioning interest for an excess debt entity. The effect of the formula, when it applies, is to produce an additional amount of income for the entity. As well as interest, the formula includes dividends paid in relation to fixed-rate foreign equity or fixed-rate shares (subsections (2) and (3)(ab)).

An adjustment mechanism has been introduced for outbound entities with finance costs of less than $2 million (subsections (2) and (3)(ac)). The effect of the adjustment is to eliminate apportionment under this section for outbound entities with finance costs of up to $1 million. For outbound entities with finance costs of between $1 million and $2 million, tapered relief is available, gradually reducing as costs increase towards the $2 million cut-off point.

Determination of New Zealand group

For an outbound entity that is a company (an excess debt outbound company), the New Zealand group is determined by reference to the New Zealand parent (section FE 12(4)). The group comprises those companies for which control can be traced from the parent (section FE 28). The meaning of "control" for these purposes is determined under section FE 27. The New Zealand parent is identified under section FE 26 by tracing ownership interests up the chain of companies on a tier-by-tier basis until no New Zealand-resident company has an ownership interest of 50 percent or more in the last company in the chain (subsection (4B)).

For an outbound entity that is an individual or a trustee, the New Zealand group is determined under section FE 3. It includes all associated persons who are resident or have a fixed establishment in New Zealand or who derive New Zealand-sourced income that is not relieved under a double tax agreement. Excess debt outbound companies, and those within the New Zealand group of such companies, are not included.

The associated persons rules prevent the use of non-arm's-length arrangements to undermine the intent of the income tax legislation. In the context of the interest allocation rules, the application of these rules is intended to stop the use of close associates to bring excessive levels of debt within the New Zealand tax base, contrary to the policy intent. The rules governing when a person is associated with an individual or a trustee are set out in sections YB 1 to YB 16. Those provisions are discussed in detail elsewhere in this report.

Section FE 29 provides that companies or groups owned by the same natural person or trustee are to form a single New Zealand group.

Determination of worldwide group

It may also be necessary to determine the worldwide group of a company or a trustee that is an outbound entity, for the purposes of calculating the worldwide group debt percentage. For a company, the worldwide group is determined under sections FE 31B and FE 32 and includes the company, its New Zealand group, and its worldwide GAAP group (being all non-residents required to be included with the company in consolidated financial statements under generally accepted accounting practice). For a trustee, the worldwide group is determined under section FE 3 and includes the trustee, the trustee's New Zealand group, and all CFCs in which either the trustee or another member of the New Zealand group has an income interest.

Measurement rules

The general measurement rules set out in subpart FE apply to outbound entities for the purposes of calculating total group debt and total group assets of the New Zealand and worldwide groups. In particular, the New Zealand group debt percentage can be measured on various dates (section FE 8). Various bases for the valuation of total group assets may also be used (section FE 16), and the on-lending concession under section FE 13 applies to arm's-length debt provided by an outbound entity to its CFCs.

Various amendments have been made to the definitions of debt and assets in subpart FE. In particular:

- Fixed-rate foreign equity and fixed-rate shares held by New Zealand residents are now included when determining *total group debt* for the New Zealand group under section FE 15.
- Equity investments in CFCs are now excluded when determining *total group assets* for the New Zealand group under section FE 16.
- The rules in section FE 18 for measuring the debt of the worldwide group have been aligned with those for measuring New Zealand group debt. Accordingly, non-interest bearing liabilities and liabilities that do not provide funds are no longer treated as debt for the worldwide group, even if they are included as debt under generally accepted accounting practice.

FOREIGN DIVIDEND EXEMPTION

Sections CW 9 and HA 8B of the Income Tax Act 2007

Key features

Section CW 9 provides that a dividend from a foreign company is treated as exempt income if derived by a company resident in New Zealand. However, there are several exceptions to this general rule, including:

- dividends from a less than 10 percent interest in a FIF described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39. These comprise shares in ASX-listed Australian companies, Australian unit trusts with adequate turnover or distributions, certain venture capital investments into New Zealand companies that have since migrated to a grey list country, and shares in Guinness Peat Group plc;
- dividends from fixed-rate foreign equity; and
- dividends from deductible foreign equity.

The foreign dividend is subject to income tax in these instances.

Foreign dividends that are received by non-companies (such as individuals or trustees of a trust) remain subject to income tax. However it should be noted that if a foreign dividend is received by a company that is acting in its capacity as a trustee of a trust, that foreign dividend will be subject to income tax.

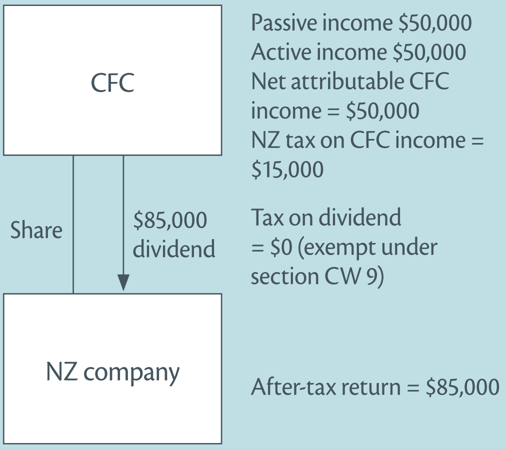
Qualifying companies are not be permitted to hold attributing interests in CFCs or non-portfolio FIFs. If a qualifying company holds such interests in any income year beginning on or after 1 July 2009, it will cease to be a qualifying company.

Detailed analysis

If a foreign company pays a dividend to a company that is resident in New Zealand that dividend will in most cases be treated as exempt income of the New Zealand company under section CW 9.

Example

A CFC (or FIF) pays an ordinary dividend to a New Zealand company.



However, the foreign dividend exemption in section CW 9 only applies to companies. Other New Zealand taxpayers are taxable on their foreign dividends. Some types of foreign dividend are also excluded from the exemption and are described below.

New Zealand taxpayers to which the foreign dividend exemption does not apply

Foreign dividends that are received by a portfolio tax rate entity will be subject to income tax as subsection CW 9(3) excludes these companies from the exemption.

Foreign dividends that are received by non-companies (such as individuals or trustees of a trust) are also subject to income tax. However, it should be noted that if a foreign dividend is received by a company that is acting in its capacity as a trustee of a trust, that foreign dividend will be subject to income tax. Branch equivalent tax accounts have been retained for non-companies (sections OE 17 to OE 22) to relieve any double taxation.

Under new section HA 8B, qualifying companies are not permitted to hold CFC income interests or interests in a FIF that are a direct income interest of 10 percent or more. This ensures that qualifying companies cannot be used as intermediaries to distribute untaxed foreign income to New Zealand shareholders (as dividends from qualifying companies are exempt under section CW 15 to the extent to which they are not fully-imputed). If a qualifying company holds a CFC income interest or non-portfolio FIF interest in any income year beginning on or after 1 July 2009 it will immediately cease to be a qualifying company.

Certain foreign dividends are subject to income tax

Certain types of foreign dividends are explicitly excluded from the section CW 9 foreign dividend exemption. These are listed in subsection CW 9(2) and are as follows:

- dividends from a less than 10 percent interest in a FIF described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39. These comprise shares in ASX-listed Australian companies, Australian unit trusts with adequate turnover or distributions, certain venture capital investments into New Zealand companies that have since migrated to a grey list country, and shares in Guinness Peat Group plc;
- dividends from fixed-rate foreign equity; and
- dividends from deductible foreign equity.

Income tax is payable on the foreign dividend in these cases.

If a person holds an attributing interest in a FIF that is calculated using the comparative value, deemed rate of return or fair dividend rate methods, any dividends from this FIF will be exempt. This is because these FIF interests have no income other than FIF income under section EX 59(2).

Fixed-rate foreign equity and deductible foreign equity are defined in section YA 1.

Fixed-rate foreign equity includes foreign dividends that are a specific, fixed percentage of the amount paid for the equity (as well as variations on this) and any dividend that is regarded as equivalent to payment for money lent.

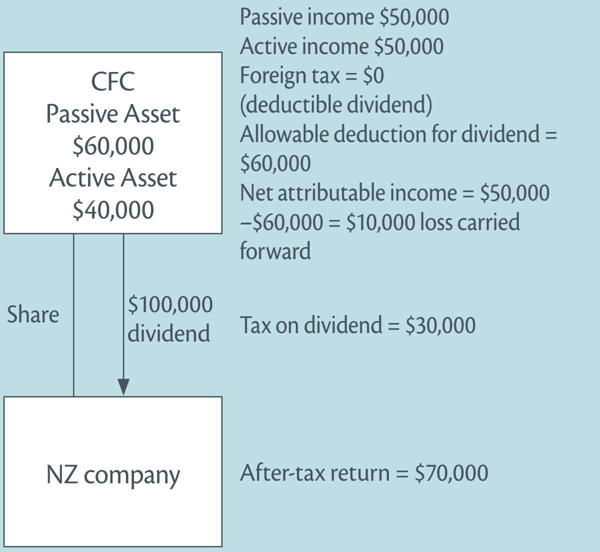
A deductible foreign equity distribution is a dividend where the foreign company paying the dividend (or a company in the same group or further up the chain as the foreign company) is allowed a deduction for the payment of the dividend against foreign income tax.

To prevent double taxation on fixed-rate foreign equity and deductible foreign equity a deduction will be available under section EX 20C(2) to a CFC in determining its net attributed CFC income in cases where the CFC pays these dividends to a New Zealand company or another CFC.

The deduction is apportioned to the extent to which the CFC has active assets to account for the fact that active CFC income is not attributed. More specifically the deduction is calculated according to the *fraction* found under section EX 20C(8).

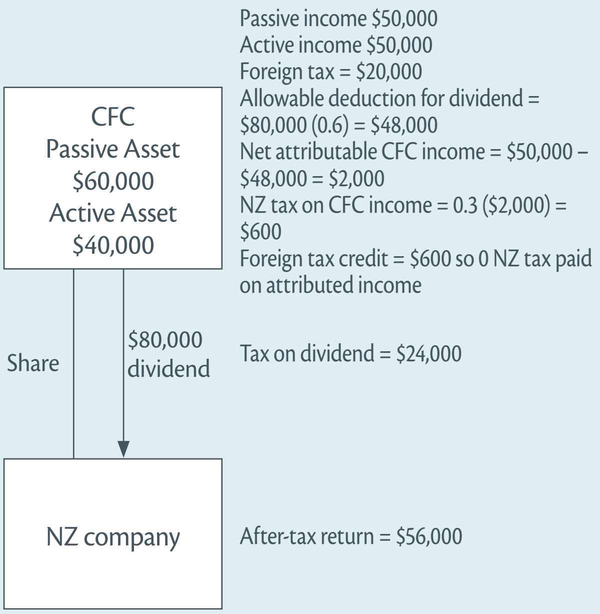
Example 1

A CFC pays a deductible dividend of $100,000 to a New Zealand company.



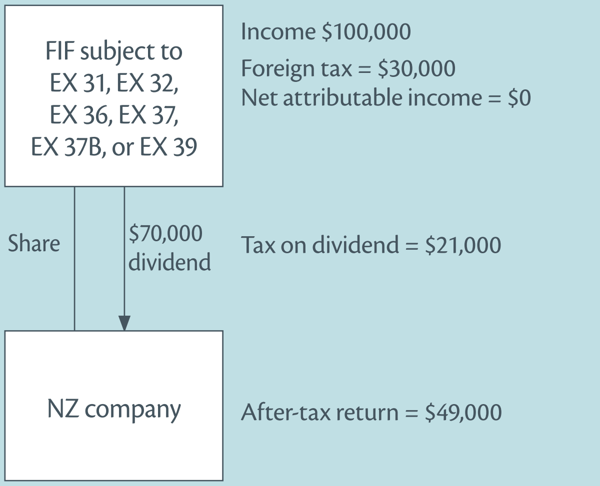
Example 2

A CFC pays a fixed-rate dividend of $80,000 to a New Zealand company.



Example 3

A non-attributing portfolio FIF pays a dividend of $70,000 to a New Zealand company.



TRANSITIONALS, CONSEQUENTIALS AND REPEALS

Sections EX 22, GZ 2, IQ 2B, LK 5B, LQ 1 to LQ 4, RG, OC 4, OC 5, OC 6, OC 8, OC 9, OC 10, OC 30 to OC 34, OD 4 to OD 8, OD 11, OD 23, OE 12 to OE, 16B, OP 56, OP 61, OP 62 and OP 105 to OP 108B of the Income Tax Act 2007

Provision has been made to deal with various transitional and consequential matters arising from the new rules for CFC income and foreign dividends. The changes are discussed below.

Key features

CFC net losses and foreign tax credits

Sections IQ 2B and LK 5B set out transitional rules to deal with attributed CFC net losses and foreign tax credits. In broad terms, the effect of these rules is that attributed CFC net losses and foreign tax credits accrued under the old rules can be carried forward into the new system, but will continue to be reduced by reference to total CFC net income (including non-attributable income).

Repeal of foreign dividend payments

Subpart RG has been repealed to remove the liability for resident companies to pay foreign dividend payments on dividends they receive from foreign companies.

Sections OC 4, OC 5, and OC 30 to OC 34 have been amended to replace "further FDP" with "further income tax".

Sections OC 6, OC 8, OC 9, OC 10, OP 56, OP 61 and OP 62 have been repealed to prevent new FDP credits from being generated.

Branch equivalent tax accounts

Sections OE 12 to OE 16 and OP 105 to OP 108 have been repealed to prevent branch equivalent tax accounts (BETA) debit balances from increasing under the new rules.

Sections OE 16B and OP 108B provide a BETA debit to extinguish any existing BETA credit balances as BETA credits are no longer required to relieve FDP once FDP has been repealed.

Repeal of the grey list exemption for CFCs

The exemption for CFCs resident in eight grey list countries available under the previous rules has been replaced with an exemption for a CFC resident in Australia. This is achieved by a modification to section EX 22.

Repeal of conduit tax relief

Sections LQ 1 to LQ 4 have been repealed to prevent further conduit tax relief (CTR) arising.

Section OD 4(3) has been amended so that a CTR company that elects to cease being a CTR company stops being a CTR company the day after the election is made (rather than at the beginning of the next tax year).

Sections OD 5 and OD 8 have been repealed to prevent new conduit tax relief credits from arising from conduit tax relief on attributed income or dividends.

Section OD 11 has been repealed as this square-up is obsolete now that FDP is no longer paid when a CTR credit is generated.

Section OD 23 has been repealed to remove the tax liability that can arise from CTR debits. In other words, CTR credits will cease to be a contingent liability unless the anti-avoidance rule in section GZ 2 applies.

Section GZ 2 claws back conduit tax relief from conduit arrangements that previously provided a tax benefit to New Zealand-resident shareholders (aside from the CTR company or a CTR holding company for that company).

Detailed analysis

Transitional loss carry-forward rules

A net loss incurred by a CFC is attributed to holders of non-portfolio income interests under subpart DN. FIF losses are likewise attributed to interest holders under subpart DN. A person may set an attributed CFC loss or a FIF loss from a given jurisdiction against attributed CFC income or branch equivalent FIF income from the same jurisdiction. Any excess becomes an attributed CFC net loss or a FIF net loss, which may be carried forward and used against future profits. Losses attributed from CFCs and branch equivalent FIFs are ring-fenced by jurisdiction, which means that a loss which arose in a given jurisdiction may only be set against CFC income or branch equivalent FIF income from the same jurisdiction.

Transitional rules are needed to deal with attributed CFC net losses and FIF net losses carried forward from the previous rules. This is because the measure of attributable income against which those losses can be set is narrower than that which applied at the time the losses accrued. The value of these historical losses should therefore be restricted under the new rules. This is achieved through section IQ 2B.

Subsection (1) provides that the amount of attributed CFC net loss or FIF net loss from a jurisdiction that a person has carried forward from the previous rules is the person's *available BE loss* for that jurisdiction. Subsection (2) provides that each year, some or all of this available BE loss is converted into an *equivalent CFC loss*, which is effectively an ordinary attributed CFC net loss under the new rules. The amount of available BE loss converted each year is the *converted BE loss*.

The amount of losses converted each year, and the rate of conversion, is determined under subsections (4) to (7). Separate calculations are required for each relevant jurisdiction. The rate of conversion depends on the relationship between a person's *jurisdictional attributed income* and the person's *jurisdictional BE income*. These terms are defined in subsection (9). The key difference is that jurisdictional attributed income only includes income from CFCs which is attributed under the new rules, whereas jurisdictional BE income includes the full branch equivalent income from CFCs that would have been attributable under the old rules. (Full branch equivalent FIF income is included under both terms.)

Subsection (4) deals with the typical scenario, in which a person's jurisdictional BE income is greater than jurisdictional attributed income. In that case, the converted BE loss is equal to the person's jurisdictional BE income (or to the available BE loss if this is lower). The equivalent CFC loss is equal to the person's jurisdictional attributed income (or the amount calculated under paragraph (b)(ii) if this is lower). What this means in practice is illustrated by the following example.

Example

In 2010–11, a person has jurisdictional attributed income of $75, jurisdictional BE income of $150 and an available BE loss for the jurisdiction of $210. The person must use $150 of the available BE loss to offset the jurisdictional attributed income of $75, giving $1 of historical loss an effective value in that year of 50 cents and leaving an available CFC loss of $60 to carry forward to 2011–12.

In 2011–12, the same person has jurisdictional attributed income of $80 and jurisdictional BE income of $120. The person sets the remaining $60 of the available CFC loss against the jurisdictional attributed income, its effective value being $40 (determined under paragraph (b)(ii) according to the relationship between jurisdictional attributed income and jurisdictional BE income in that year). This leaves jurisdictional attributed income of $40 still subject to New Zealand tax.

Subsection (5) deals with the less common situation in which jurisdictional attributed income exceeds jurisdictional BE income. In that case, the equivalent CFC loss is equal to the converted BE loss (giving $1 of historical loss an effective value of $1). The available BE loss to be converted is the amount needed to offset the person's jurisdictional attributed income for the year, assuming there are sufficient losses available.

Subsections (6) and (7) make equivalent provision for interest holders who are members of wholly owned groups that include other resident members. For a member of a wholly owned group, the conversion of historical losses to an equivalent CFC loss is done by reference to the *jurisdictional income ratio* of the group.

A person or a wholly owned group may elect, under subsection (8), to fix the jurisdictional income ratio using the average ratios over a two-year period, provided they had jurisdictional BE income in each of those years. A person may also elect, under subsection (3), not to carry forward historical losses from a given jurisdiction.

To minimise compliance costs, subsection (10) allows a person or a wholly owned group to use the net profit or loss from financial accounts as a proxy for the branch equivalent income or loss of a CFC for the purposes of calculating their jurisdictional BE income.

Transitional rules for foreign tax credits

Subpart LK makes provision for tax credits relating to attributed CFC income. A person who has attributed CFC income for an income year is allowed a tax credit for income tax and foreign income tax paid in relation to that income by the person or by the CFC. Surplus credits may be carried forward or transferred within the same wholly owned group, subject in both cases to jurisdictional ring-fencing. The tax credit rules for CFCs in subpart LK are applied to branch equivalent FIFs by section EX 50(8) and (9).

Equivalent transitional issues arise for subpart LK credits carried forward from under the previous rules as losses. These credits are therefore subject to similar restrictions, in this case under section LK 5B.

Subsection (1) provides that the credit relating to a jurisdiction carried forward from under the previous rules is the *available BE credit* for that jurisdiction. Subsection (2) provides that each year, some or all of this available BE credit is converted into an *equivalent tax credit*, and is effectively treated as an ordinary credit under subpart LK. The amount of available BE credit converted each year is the *converted BE credit*.

The credits converted each year, and the rate of conversion, is determined under subsections (4) to (7). The approach is the same as that taken for losses under section IQ 2B. An election to fix the jurisdictional income ratio using the average ratios over a two-year period under section IQ 2B(8) will also apply for the purposes of this section.

As for losses, a person may elect not to carry forward historical credits from a given jurisdiction (subsection (3)). Likewise, there is the same scope for a person to use net profit or losses from accounts, instead of BE income or loss, when determining the jurisdictional BE income (subsection (10)).

Repeal of foreign dividend payments

As a result of the exemption for most foreign dividends received by companies, foreign dividend payments (FDP) have been repealed and foreign dividend payment accounts will be gradually phased out.

Subpart RG has been repealed to remove the liability for resident companies to pay foreign dividend payments on dividends that they receive from foreign companies. As a result, most foreign dividends received by companies will be wholly exempt, but in some cases, income tax will be payable (see the section on "foreign dividend exemption" for details and examples).

If a company had an FDP debit at the end of the tax year (section OC 30) or when it migrates offshore (section OC 31) "further FDP" was payable under the previous rules. Under the new rules, this liability has been replaced with a liability to pay further income tax. Consistent with this change, section 140B of the Tax Administration Act has been amended so that imputation penalty tax is payable when further income tax is payable under section OC 30.

Several sections in subpart OC that give rise to FDP credits have been repealed as these sections are redundant with the repeal of the FDP liability in section RG. The repealed provisions are: section OC 6, which provided an FDP credit for FDP being paid, sections OC 8 and OC 10, which provided FDP credits when FDP was payable as a result of a CTR debit or CTR debit balance, and section OC 9, which allowed companies to convert any imputation credits earned on attributable foreign income into FDP credits. The repeal of section OC 6 only applies to dividends received after the new international tax rules came into force.

Example 1

NZ Co has a balance date of 30 June. It receives a foreign dividend on 20 June 2009 on which it is liable to pay FDP of $30. On 10 July 2009, NZ Co pays the $30 of FDP and has 30 FDP credits added to its FDP account balance.

Example 2

NZ Co receives a second foreign dividend on 1 July 2009. This dividend is wholly exempt so no FDP is paid and no FDP credit arises.

Companies will have five years to distribute their existing FDP credit balances to shareholders before any remaining balances are converted into imputation credits. This will be legislated for as part of a subsequent tax bill.

Branch equivalent tax accounts

The exemption for most foreign dividends received by companies means that branch equivalent tax accounts (BETA) for companies will be phased out. As income tax will continue to apply to foreign dividends received by non-companies, BETA accounts will be retained for non-companies.

Companies with BETA debit balances will be able to continue to use these debits to relieve any double taxation on attributed income for a two-year period. Any remaining BETA debits will then be extinguished. This will be legislated for as part of a subsequent tax bill.

The transitional period for BETA debits is intended only to prevent double taxation in the rare cases in which dividends have been paid significantly in advance of attributed passive income arising.

Example 1

Company C has a BETA credit balance of $200. At the beginning of its income year this balance is extinguished as BETA credits are no longer required with the repeal of FDP (BETA credits can only be used to relieve FDP).

Example 2

Company D has a BETA debit balance of $30. From the beginning of its income year, no more BETA debits will be generated. The company has $100 of net attributed (passive) CFC income it can use its BETA debit balance to relieve the $30 of income tax that would otherwise be payable on this income.

Repeal of the grey list exemption for CFCs

Taxpayers with a greater than 10 percent interest in a CFC that is resident in a grey list country will have to calculate their attributable CFC amount from the CFC unless it qualifies as a non-attributing active CFC under section EX 21B or is a non-attributing Australian CFC under section EX 22B.

The eight-country grey list for 10 percent or greater interests in FIFs in section EX 35 will be retained for the time being, while the possibility of extending the active income exemption to these entities is considered.

Example 1

NZ Co has a CFC that is resident in the UK. From the beginning of its income year on 1 August 2009, it will be required to attribute passive income from the UK CFC unless that CFC qualifies as a non-attributing active CFC under section EX 21B.

Example 2

NZ Co has a greater than 10 percent interest in a FIF that is resident in the UK. Because the section EX 35 grey list exemption still applies, NZ Co will not be required to attribute income from this FIF.

Repeal of conduit tax relief

Under the new rules, no further conduit tax relief will arise under the conduit mechanism. The conduit mechanism removes income tax on income that a New Zealand company receives from its CFC interests to the extent that the New Zealand company is owned by non-residents.

Section OD 23 has been repealed to remove the tax liability that can arise from CTR debits. In other words, CTR credits will cease to be a contingent liability. An exception to this is if the anti-avoidance rule in section GZ 2 is found to apply.

Example

CTR Co has a balance date of 31 July 2009. From 1 August it will no longer receive conduit tax relief on its CFC income and no new conduit credits will be added to its existing pool of $2 million CTR credits.

On 1 December 2009, CTR Co is bought by a NZ-resident company, which results in a change of more than 34 percent in its resident shareholding status. This will cause $2 million of CTR debits to arise under section OD 16 (extinguishing the CTR credit balance). Under the previous rules, this break in shareholder continuity would have generated an FDP liability under section OD 23, but no liability arises under the new rules unless the anti-avoidance rule in section GZ 2 is found to apply.

Section GZ 2 is intended to claw back conduit tax relief from arrangements that were entered into in anticipation of the repeal of section OD 23 that had the effect of reducing the tax liabilities of New Zealand shareholders. This reflects the fact that conduit tax relief was designed to relieve tax on non-residents investing through New Zealand into CFCs. Conduit tax relief was not intended to apply to income that was ultimately owned by New Zealand residents. Section GZ 2 applies to arrangements that generated conduit tax relief credits between 4 December 2008 (when an issues paper announcing this policy was released) and the date from which conduit tax relief was repealed. Section GZ 2 does not apply to conduit tax relief received by the conduit tax relief company itself, or by a CTR holding company for the CTR company.

Example

CTR Co has a balance date of 30 April. In the period from 4 December 2008 to 30 April 2010, CTR Co receives $1 million of conduit tax relief in respect of its CFC.

On 1 May 2010, CTR Co passes $0.5 million of conduit-relieved income through to its non-resident shareholders. Section GZ 2 would not apply to this amount.

On 1 June 2010, CTR Co ceases to be a conduit tax relief company and distributes the remaining $0.5 million of conduit-relieved income to a resident shareholder who is not a CTR holding company in the CTR Co. Section GZ 2 is likely to apply to this amount.

CTR companies will be able to continue to attach CTR credits to any dividends they distribute to their non-resident shareholders, for a period of two years. This provides time for conduit-relieved income (represented by CTR credits) to be channelled to non-residents and any CFC income on which New Zealand tax has been paid (represented by FDP credits) to be channelled to New Zealand residents.

Example

CTR Co has 42 CTR credits and 42 FDP credits. It pays a dividend of $100 to a non-resident to which it attaches the 42 CTR credits and pays a dividend of $100 to a New Zealand resident to which it attaches the 42 FDP credits. This is in accordance with the original policy intent for how income would be distributed from CTR companies.

CTR companies that do not wish to distribute their foreign income in this way, can, under the new rules, elect to cease to be a CTR company under section OD 4 and have their CTR credits extinguished with no liability. Subsection OD 4(3) has been amended to make it so this election will take effect from the day after the election was made as this allows companies to convert FDP credits into imputation credits (under the previous rules, these companies would have had to wait until the next tax year before the election took effect).

Example

CTR Co has 30 CTR credits and 30 FDP credits. On 1 August 2009 it elects to cease being a CTR company. From 2 August 2009 it is no longer a CTR company so the 30 CTR credits are extinguished (with no FDP liability). The company can choose to convert the 30 FDP credits into 30 imputation credits. If the company pays a dividend it will have no CTR credits to distribute to non-residents so if FDP credits (or imputation credits) were attached to a dividend it would have to attach these in the same ratio to all of its dividends.

Another option is for CTR companies to simply retain their CTR credits for the two-year transitional period, after which these credits will be extinguished with no tax liability.

The legislation for this final repeal of CTR accounts will be introduced as part of a subsequent tax bill.

DISCLOSURE REQUIREMENTS FOR CFCS

Consequential changes as a result of amendments to CFC rules

Residents must disclose an income interest of 10 percent or more in a CFC. To disclose an interest after the revised CFC rules apply, the new electronic IR 458 form on Inland Revenue's website (go to **www.ird.govt.nz**, keywords: CFC disclosure) must be used. To disclose an interest before the revised CFC rules apply, the IR 477 or IR 479 forms must be used.

Residents with an income interest of 10 percent or more in a foreign company that is not a CFC are still required to disclose that interest using a FIF disclosure form, an IR 477 or an IR 479, as applicable. Residents with an income interest of less than 10 percent in a CFC may be required to disclose the interest in a FIF disclosure form. Further information about these existing disclosure requirements is contained in 2009 International Tax Disclosure Exemption ITR20 (www.ird.govt.nz/technical-tax/determinations/other/other-int-tax-itr20.html).

TAXATION OF LIFE INSURANCE BUSINESS

Sections CR 1, CR 2, CW 59C, CX 55, DR 1 to DR 4, subpart EY, sections EZ 53 to EZ 63 IA 8, subpart IT, sections LA 8B, LE 2B, sections OC 2B, OC 20, OP 7(3), OP 17, OP 30(2), OP 33B, OP 44, OP 74 and section YA 1 of the Income Tax Act 2007

Significant changes have been made to the taxation of life insurance business. The changes update the rules to ensure that term insurance business is taxed on actual profits, as other businesses are taxed, and extend the tax benefits of the PIE rules to people who save through life products. The new rules tax life insurance business like other New Zealand companies but require separate calculations to reflect two bases of taxable income:

- a shareholder base (representing income derived for the benefit of shareholders); and
- a policyholder base (representing income derived for the benefit of policyholders).

Income and deductions will be recognised using ordinary tax principles, with the addition of special rules to deal with the unique timing and allocation issues inherent with life insurance products, particularly in respect of participating life policies.

Life insurer income will therefore be allocated between income earned on behalf of shareholders (the shareholder base) and income earned on behalf of policyholders (the policyholder base).

The shareholder base comprises the following items: risk profits, fees, share of participating profits, investment income on shareholder funds, and other income accruing to the life company, less allowable deductions. It will be taxed at the company rate, and be generally subject to ordinary rules for companies, including those for losses, continuity based on shareholding and memorandum account balances.

The policyholder base comprises investment income (less expenses) from policyholder funds, including the policyholders' share of net investment income from participating policies (allocated to policyholders in reflection of their contractual entitlements). Excess deductions and surplus imputation credits converted to deductions are carried forward for deduction in next year's policyholder base with no requirement to meet a continuity of ownership test.

The portfolio investment entity (PIE) exclusion for realised New Zealand and listed Australian equity gains has also been extended to policyholders in all life insurance savings products, which will then be taxed at the company rate of 30%. Life insurers can elect to attribute income in investment-linked products to each policyholder at their portfolio investment rate (19.5% or 30%).

The new rules also provide a transition period and rules for life insurance policies sold before the application date of the new rules.

Background

The new rules solve several problems that existed with the taxation of life insurance business in connection with term life insurance and savings-related life policies.

Taxing income from term life insurance business

Life insurance companies are companies that carry on a life insurance business and are registered under the Life Insurance Act 1908 to write life insurance policies.

Until the 1980s, the products most frequently offered by life insurance companies were the traditional whole of life and endowment products.[1] Since the enactment of the previous life insurance rules, term life insurance business has increased from being less than 10 percent of total industry premiums to now over 50 percent. Term life insurance is a pure risk product that pays out only on death (within the term of the policy). Term insurance policies do not contain a savings component in the premium which means they have more in common with general insurance (such as motor vehicle or home and contents insurance) than traditional savings-related policies.

The main problem with the previous rules is that calculation of taxable income was based on a formula that was not designed with term insurance products in mind. This formula has little connection with the profit earned from term insurance. The tax result under the previous rules is illustrated in Example 1.

Example 1: The problem with taxing term risk life policies under the previous rules

	Financial accounting	Under the previous rules
Premiums	100	
Claims (=Expected claims)	(45)	0
Investment income	10	10
Expenses	(40)	(40)
Premium loading (20% claims)		9
Accounting profit/tax (loss)	25	(21)

1 A frequently used way of describing life products is whether they are participating or non-participating policies. A participating policy (also known as a "with profit policy") is a policy entitled to participate in distributions of profit – as most whole of life and endowment policies are. Conversely, a non-participating policy (also known as a "without-profit policy") does not participate in distributions of profit, examples being term life insurance and most unit-linked policies.

As shown in the example, if the life insurer has a loss ratio (claims ÷ premiums) of 45 percent, a $25 accounting profit translates into a $21 tax loss. In effect, life insurers were not being taxed on the profit they make on term life risk business, generating losses that may have reduced overall tax paid.

Savings

Under the previous rules, individuals who saved through life insurance products faced a higher tax burden than other savers who invested directly or through managed funds that become PIEs. This effect served to distort consumer decisions about the type of saving vehicle used and placed life insurance polices at a competitive disadvantage.

Other

There were a number of other issues, such as measuring continuity and use of conduit rules, caused by the imperfect measurement of ownership that did not recognise the policyholder base as an "owner." This is because the life insurer was taxed on all its income, policyholder and shareholder together. This meant that concessions that were aimed at non-resident shareholders of a company, such as the tax relief under the conduit rules, were also provided to the resident policyholders.

Key features

Under the new rules, the shareholder base consists of:

- profits from the risk component of premiums less risk claims net of reinsurance;
- net investment income from shareholder funds;
- shareholder share of participating policy profits;
- fees from investment management and other services;
- income from annuities;
- income determined under ordinary principles from any other sources;
- less risk expenses and any other allowable deductions; and
- plus/less changes in risk reserves.

Ordinary provisions apply to shareholder base losses carried forward or subject to grouping, and to imputation credit and other remaining memorandum account balances carried forward.

The policyholder base consists of:

- net investment income from policyholder funds; and
- policyholder share of investment income (less expenses) from participating policies.

The shareholder base is taxed at the prevailing company rate. The policyholder base is ordinarily taxed at 30%, although life insurers may elect to attribute investment income from investment-linked products to each policyholder at their portfolio investment rate.

Any policyholder base loss is carried forward to the next income year. Excess imputation credits on the policyholder base income are grossed-up and applied as a loss against the policyholder base in the subsequent income year. In both cases there are no continuity requirements.

Sections EY 17, 18, 21, 22, 28 and 29 contain detailed rules on the allocation of income and expenditure or loss from profit-participation policies between the shareholder base and policyholder base.

In situations when the operation of new rules, particularly in subpart EY, gives rise to income or expenditure that would not be recognised by ordinary taxation principles, new sections CR 1, CR 2, DR 1, DR 2 and DR 4 ensure that the calculation of income and expenditure is consistent with the core principles of the Income Tax Act 2007.

Application date

The new rules apply from 1 July 2010. This date applies to the changes to the taxation of life insurance business and the application of the PIE taxation rules to all policyholder savings policies. The five-year grandparenting period also starts from that date.

To provide some flexibility, life insurers have the option to apply the new rules from the beginning of their income year if that year includes 1 July 2010.

When the application date bisects an insurer's tax year, the insurer is required to complete a separate calculation for the period before the specified date and another for the period after.

DETAILED ANALYSIS

The analysis of the new life insurance rules is in two parts. The first part deals with the operation of the new rules after the application date. The second part deals with the transitional rules and the effect of the grandparenting provisions.

Part I: The new rules

Scheme and operation of the new rules

The taxation base for life insurance business consists of the following elements:

- Shareholder base income, less allowable deductions, under the new life rules
- Other income (including general insurance) less allowable deductions

- Schedular policyholder base income, under the new life rules
- Life fund PIE income, less allowable deductions, attributed to each policyholder at their portfolio investment rate.

The recognition of income and expenditure under the Income Tax Act 2007 relies in the first instance on amounts that result from using generally accepted accounting practices. These amounts are then modified according to ordinary income tax principles to determine whether an asset is held on revenue account by the life insurer and whether any expenditure incurred is deductible. These amounts are then allocated under subpart EY to the two tax bases using formulas that are consistent with actuarial principles.

Section EY 1 sets out the core operation of the rules in subpart EY and provides for the taxation of life insurers on two separate bases. Sections EY 2 and EY 3 describe the general apportionment of income and deductions between the two bases. Section LA 8B provides some general rules for tax credits relating to the two bases. Parts L and O include tax credit rules and memorandum account rules specific to the two bases.

Section EY 1(3) prevents double counting of income or expenditure between the shareholder base and the policyholder base.

The shareholder base

Sections CR 2, CX 55, DR 1 to DR 4, subpart EY and section YA 1

The shareholder base comprises the following:

Risk income: The life risk components of life insurance products (excluding participating policies and annuities) will be taxed on the basis of their profits; being the difference between premiums less claims and expenses, including adjustments for certain reinsurance treaties. Reinsurance risk premiums paid and risk reinsurance claims received will be netted against such premiums and claims respectively, provided the reinsurance contracts were offered or entered into in New Zealand. Net risk income is adjusted for prescribed reserves (sections EY 23 to EY 27).

Fees: Fees and commissions from investment management or managing life insurance policies are treated as taxable income, whether explicitly charged or implicitly included in premium income (to the extent that the fees are not already included as risk income). Expenses incurred in deriving fee income are deductible.

Share of participating profits: The net return from participating policies is shared between shareholders and policyholders. Because of the complicated nature of these products, the allocation method is discussed under the heading "Participating policies".

Investment income: Amounts derived from investment income (less expenses) by the life insurer that has not already been included in the policyholder base becomes shareholder investment income. Sections EY 46 and EY 47 dealing with disposal of property have been repealed. One consequence is that the deeming of income arising from the disposal of property (other than financial arrangements) of the life insurance business has been removed. This means that whether a disposal of property by the life insurer is on revenue or capital account will have to be considered for particular taxpayers or circumstances under ordinary tax principles as amended by statutory provisions. The taxation of gains from the realisation of Australasian equities will be similarly treated.

Income earned from annuities: Net annuity income will continue to be determined using the old rules. Annuity premiums and claims are excluded from the shareholder base and annuity income is taxed using the formula in section EY 31(2). The terms of the formula are defined in sections EZ 53 to EZ 60. A positive amount is shareholder base income and a negative amount is a shareholder base allowable deduction. Net investment income arising from annuity is taxed in the shareholder base at 30%.

Deductions: The following deductions are allowed:

- Deductions will be generally allowed for expenditure or loss incurred for the cost of revenue account property in section DB 23. These deductions may have to be apportioned between the shareholder or policyholder base.
- Deferred acquisition costs, which are expenses connected with the sale of life policies – for example, commissions, will continue to be deductible under ordinary principles.
- Section DR 4 allows a deduction for the amount of expenditure or loss of a claim paid under a life insurance policy, or as an outstanding claims reserving amount under section EY 24.
- Deductions are also available for "premium payback amounts". Therefore, when an amount of life risk component premium is refunded in accordance with the terms and conditions of the relevant life insurance policy (or the discretion of the life insurer) that amount is deductible. The deduction is limited to premium payback amounts made at the end of the contracted policy term when those premiums have been previously returned as income under section EY 19(1) – subject to any transitional adjustments.

Other income and expenses: Other income and expenses determined under ordinary tax concepts are included.

Shareholder adjustment for reserves relating to non-participating policies – excluding annuities

Sections EY 23 to EY 27 and section YA 1

To reflect the unusual cashflows connected with certain life products, for example, premiums received upfront with large claim payments occurring later, life insurers use reserving methods to match revenue and expense recognition and to smooth profits.

New section EY 23 sets out the tax effects these reserves have on income and deductions relating to non-participating life products that are term insurance or savings products (that is, excluding profit-participation policies and annuities). Positive amounts are included as shareholder base income, while negative amounts constitute a deduction to the shareholder base. In other words, the movement in a reserve during the income year is; income if the reserve has decreased in value, a deduction if the reserve has increased in value.

Amounts calculated for the reserves must be actuarially determined for each class of policy. The rules relate to the calculation of reserves relating to premium income recognition, outstanding claims reserves, and capital guarantee reserves.

Premium income recognition – the unearned premium reserve and premium smoothing reserve sections – sections EY 25 and EY 26

For non-participating policies other than annuities, life insurers have the option of recognising premium income on an unearned premium reserve (UPR) basis or using a premium smoothing reserve (PSR) basis. The default option is the UPR. The choice of reserving method, once applied to a class of policies, is irrevocable – section EY 23(5) – except when the PSR can no longer be used, in which case the insurer reverts to the UPR method.

The PSR can only be used for:

- products which have premiums that are level (or substantially level for more than one year); or
- products which could result in a material mismatch in any one year between the incidence of life risk components and the timing of the premium payable, and the period is one or more years.

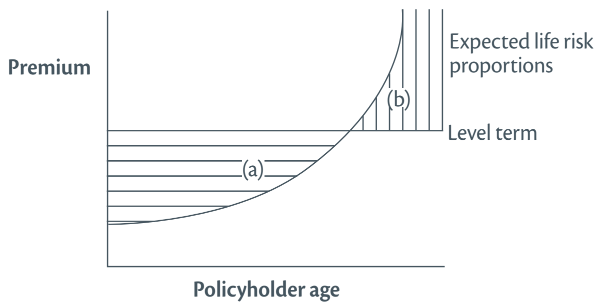
Life insurance policies may be grouped together under the PSR if the policies have the following in common:

- substantially the same contractual terms and conditions, other than the duration of the life insurance contracts; and
- substantially the same assumptions for pricing their life risk.

Unearned premium reserve: The UPR, calculated at the end of the current year under section EY 26, is based on the amount of premiums received in the current year (or an earlier year) net of related New Zealand-sourced reinsurance premiums paid that relate to unexpired life risk components and relevant costs.

Premium smoothing reserve: The PSR in section EY 25 is designed to spread the recognition of premium income and tax over the duration of the level-term premium and single premium term policies. The PSR premium income should be calculated net of related New Zealand-sourced reinsurance premiums. The intent of the PSR is illustrated in diagram 1.

Diagram 1: Premium smoothing reserve



(a) Negative PSR adjustment

(b) Positive PSR adjustment

The line in Diagram 1 representing the "expected life risk proportion", defined in section EY 25(6), represents the amount that would be the annual renewable term equivalent of the level term policy.

The "expected life risk proportion" could be determined using profit margins in a similar manner to a margin on services release of profits, or by reference to the probability of death in the year compared with the probability of death over the PSR period.

The outstanding claims reserve (OCR) – section EY 24

The OCR is a reserve held by an insurance company to provide for the future liability of claims which have occurred but which have not yet been reported to the insurance company or not yet been settled.

The new rules provide that life insurers are able to claim a deduction for movements in the OCR on life insurance policies, similar to the tax treatment to general insurers who sell general insurance policies.

One aspect of allowing the deduction is that the future claims (that is, claims recognised in the current accounting period that will be paid out in a future period) are discounted to their present value. The legislation (section YA 1) uses the term "present value (gross)" and means a present value calculation using the risk-free rate of return as the discount rate, gross of tax. If the whole discount period is less than a year the face value of the claim is used.

An appropriate risk margin is added to the estimated and actual values of life risk claims incurred and reported. However, where the amount of the claim is already known the appropriate risk margin would be zero.

The capital guarantee reserve – section EY 27

The capital guarantee reserve (CGR) applies to non-participating policies, excluding annuities, that have guarantees of capital invested or guarantees of minimum returns on capital invested. The reserve is the amount provided by the shareholder to top up the policyholder's future claim under the guarantee.

If a policy has a guaranteed minimum return, the reserve will typically be drawn upon to "top up" the amount credited to policyholders in time of poor investment performance. In times of good investment performance, a portion of the investment return will typically be added to the reserve to support future crediting rates. The legislation provides that movements in the reserve result in shareholder base income if there is an increase in the reserve and a shareholder base allowable deduction if there is a decrease in the reserve. These adjustments are reflected in the policyholder base, whereby any amount of shareholder income becomes a deduction in the policyholder base and any amount of shareholder deduction is income in the policyholder base.

Shareholder injections to support the capital guarantee, while rare, will have a revenue character for the shareholder base. Such guarantees when paid by the shareholder may have a capital character for individual policyholders and are therefore not subject to tax in the policyholder base. To be consistent, the loss that caused the depletion of capital is not deductible in the policyholder base.

Movements in the CGR representing shareholder payments for products guaranteeing a minimum return (investment guarantee) that is in excess of zero percent on capital invested are properly treated as revenue amounts in both the shareholder base and policyholder base.

The policyholder base

Sections CR 1, CX 55, DB 23, DR 1, EY 1, EY 2, EY 4, and EY 15 to EY 18 and section YA 1

The policyholder base will consist of investment income earned on behalf of policyholders, less expenses. The amount of investment income allocated to policyholders from the total life insurer investment income is calculated under section EY 15 for non-participating policies (including annuities), less allowable deductions under section EY 16, and under section EY 17 for participating policies (discussed under the heading "Participating policies"), less allowable deductions under section EY 18.

Consistent with the operation of the portfolio investment entity (PIE) rules, changes to section CX 55 allow life insurers to exclude realised equity gains from New Zealand and listed Australian companies from tax on the policy holder base. The exclusion applies to the extent the amount is determined to be policyholder base income. A life insurer can also elect to register its fund of investment-linked products as a Life Fund PIE and attribute income to each policyholder at their portfolio investment rate; otherwise the income is taxed at 30%.

The policyholder base can carry forward unused tax deductions and these will not be subject to any continuity of shareholding rules. This is because the policyholder base is a proxy tax for each individual policyholder - thus changes of membership are not relevant. Surplus imputation credits can also be converted to deductions for the following income year. Policyholder net taxable investment income cannot be offset with losses or credits from the shareholder base, except in the case of transitional losses, which is discussed later in Part II of this item.

Non participating policies including annuities

Sections EY 2 to EY 4, EY 15, EY 16, EY 19, EY 20 and section YA 1

Section EY 15 prescribes the methods for determining what income is included in the policyholder base and provides bases of apportionment where investment income could be included in both the policyholder and shareholder bases. Section EY 16 contains mirror provisions for deductions to the policyholder base.

As a compliance simplification measure, when the life insurer has actuarially determined that the life risk is one percent or less of the premium or life reinsurance claim, it can choose to treat that amount as not relating to the life risk component, thereby including the entire premium effectively as the deposit of principal in respect of a policy (section EY 15(5)).

Allocation of investment income under the new rules

Investment income, and expenses and credits, have to be allocated to either the shareholder base or policyholder base, depending on whose benefit the investment income is derived. The new rules prescribe default methods of allocation, but allow the life insurer to use a different basis of apportionment if it is "actuarially determined" and is more equitable and reasonable. It is anticipated that many life insurers would apportion in a manner consistent with financial reporting where relevant.

The life insurer's income from its life insurance business must be allocated to either the shareholder base or policyholder base. The allocation depends on whose benefit the income is derived. Section EY 1(2) provides that section EY 2 uses the taxable income in a life insurer's policyholder base income and the life insurer's policyholder base allowable deductions, to calculate its schedular policyholder base income. A life insurer's schedular income derived by its life fund PIE is excluded from the schedular policyholder base income, along with deductions from that income.

Expenses allocated to life fund PIEs are recognised by section EY 2(6). These expenses are apportioned to the policyholder base, but excluded from schedular policyholder base income.

Section EY 4(1) provides a default basis of allocation for tax credits received. These amounts must be apportioned between the policyholder and shareholder bases in the same proportion as the policyholder base income. The same apportionment rules apply to shareholder base income. The section is intended to ensure imputation credits are allocated on actual policyholder base and shareholder base earnings.

The new rules also allow the life insurer to use a different basis of apportionment if it is "actuarially determined" and is more equitable and reasonable than the default basis.

Participating policies

Sections EY 17, EY 18, EY 21, EY 22, EY 28, EY 29 and YA 1

Specific rules deal with the treatment of income and expenditure arising from "profit participation policy" (as defined in section YA 1) business. A typical profit participation policy involves a group of members (policyholders) who pool their money together, generate income, self-insure (possibly with some outside reinsurance) and periodically formally increase their vested entitlement to the pool, usually by way of bonus allocations. Expenses associated with running the pool are met from within the pool.

"Profit participation policy" as defined:

(a) means a class of life insurance policy having

(i) a segregated or identifiable asset base; and

(ii) policyholders who are entitled to a share of profits that is distributed to, or vested in, the policyholders from the asset base, and the policies provide for the entitlement; and

(iii) a fixed formula, expressed in terms of a proportion of a policyholder's share of profits from the asset base, that calculates a transfer to the benefit of the life insurer's shareholders from the profits of the asset base, and that fixed formula is consistently applied:

(b) includes a class of life insurance policy that substantially meets the requirements of paragraph (a) and that has a guarantee by the life insurer that capital invested will be returned or that a minimum return on capital will be paid, if—

(i) the life insurer has irrevocably chosen that the class be treated as a profit participation policy; and

(ii) the Commissioner receives a notice of the election before the start of the first income year to which it relates.

Paragraph (a) (iii) refers to what is commonly referred to as the "gate". The definition implies that shareholders obtain a positive profit from distributions. It therefore does not include life insurance policies such as investment-linked products, where the shareholder obtains no proportion of the policyholder's share of profits from the asset base.

The basis for taxing participating policies comprises the following:

Investment income *less* expenditure plus other profit

The new rules are designed to apportion net investment income between policyholders and shareholders in a way that recognises that part of the investment income is connected with policy liabilities (regarded as belonging to the policyholders) and part is connected with the existing surpluses (regarded as a source of future bonuses). Policyholders should, however, not be taxed on any other sources of gains when they are derived by policyholders trading among themselves. Therefore, any "Other Profit" is included in the shareholder base.

Premiums for traditional participating business are not treated as income under the new rules as these are, in substance, principal amounts invested. Similarly, claims paid under these products are not deductible. Premiums or life reinsurance claims that are incidental or minor, and included under the policyholder base under section EY 15(5), are not subject to tax under the shareholder base.

Treatment of income from disposal of investment shares – shareholder base

If income includes gains from realised Australasian equity the taxation of these gains, to the extent that they are allocated to the shareholder base, will be determined by ordinary tax principles.

Deductions and credits

The policyholder base (section EY 18) and shareholder base (section EY 22) have allowable deductions for profit participation polices equal to what they would have had under the income allocation formulas if:

- the life insurer is treated as having no assets other than the asset base; and
- the item asset base gross income is treated as being the annual total deduction for the policies' asset base.

Imputation and other credits will be apportioned between the shareholder and policyholder bases using the same ratio.

Taxation of participating policies sold before 30 June 2009 – separate rules

For policies sold before 30 June 2009, the date the bill was reported back to Parliament by the Finance and Expenditure Committee, life insurers are taxed using a simplified formula:

Investment income *less* Expenditure

This change was made at the recommendation of the Finance and Expenditure Committee as a means of simplifying the application of the rules to existing participating policies (including policies sold after 30 June 2009) as a result of conversion rights (for example, whole of life policies converting to endowment policies). The more complex formula which takes into account Other Profit for policies sold on and after 1 July 2009 is intended to protect against any potential manipulation of taxable income associated with future participating life contracts.

Actuarial advice and guidance, "actuarially determined" and "best estimate assumptions"

Sections EY 6 and YA 1

Some of the calculations and apportionment of amounts required by subpart EY, particularly in connection with reserves, uses actuarial determinations and judgement. The term "actuarially determined" is defined in section YA 1.

A new definition of "best estimate assumptions" has also been inserted to provide that these judgements are consistent with professional actuarial judgement and that the assumptions underlying these judgements are not deliberately overstated or understated.

Section EY 6 allows Inland Revenue to seek the advice of the Government Actuary or any other actuary on matters that are required to be actuarially determined under the new rules.

There is no requirement for sign-off from actuaries under the new rules. However, all working papers, methodologies and related documentation may be asked for by the Commissioner under the general powers already contained in the Tax Administration Act 1994.

Reinsurance

Sections CW 59C, DR 3, EY 5(8) and EY 12

The definition of "life insurance" includes reinsurance (section EY 14(3)) unless the context requires otherwise. Therefore, all the new rules dealing with life insurance generally also apply to life reinsurance.

There are, however, specific references to life reinsurance when calculating deductions under the shareholder base from insurance premiums and claims, in calculating reserving amounts, and under the policyholder base for profit participation. Section EY 12 defines "life reinsurance" as a contract of insurance between a life insurer and another person (person C) under which the life insurer is secured, fully or partially, against a risk by person C.

The term does not include a contract that:

- secures against financial risk unless, in the contract, it is incidental to securing against life risk; or
- is, or is part of, a tax avoidance arrangement.

The words "fully" and "partially" describe the extent to which the life insurer is secured against life risk; they do not describe the term for which the reinsurance is provided.

Sections EY 12(2) and (3) describe the meaning of "full reinsurance" and "partial reinsurance". Such reinsurance is limited to those contracts where the life insurer offered or was offered or entered into the life reinsurance policy or policies in New Zealand. If a life reinsurance policy is not offered or entered into in New Zealand, a deduction for the policy's life reinsurance premiums is denied under section DR 3 and the policy's life reinsurance claims are treated as exempt income under section CW 59C .

This means that all references to the relevant life reinsurance amounts in any of the calculations in the Act exclude the policies that are not offered or entered into in New Zealand.

There are two further express exclusions from the definition of "life reinsurance" that are also relevant when calculating taxable income under the new rules:

- general insurance, such as trauma insurance or non-life insurance policy riders such as total permanent disability benefits.
- financial arrangements – to ensure practical consistency with the definition of "life insurance policy" (which means a policy which states the terms under which life insurance is covered).

These exclusions are required to ensure elements of a contract that do not themselves qualify as life reinsurance are excluded from the definition. However, Inland Revenue considers that reinsurance of events related to life insurance (for example, policy lapse) are not excluded. Accordingly, reinsurance of lapses of policies and discontinuance profit (or loss), which are connected to life insurance, are also "life reinsurance".

Table 1 shows the effect of reinsurance transactions on a life insurer's taxable income.

Table 1: Effect of reinsurance on taxable income

Transactions	Gross income
Reinsurance commissions of $500,000 received under a contract of reinsurance. The total amount relates to the risk components of the claims paid.	+$500,000
Life insurance premium paid under a contract of reinsurance of $1,500,000.	–$1,500,000
$600,000 received under a profit sharing arrangement in relation to a contract of reinsurance.	+$600,000
$300,000 recovered as a refund of premiums paid under a contract of reinsurance.	+$300,000

Life financial reinsurance

Some types of reinsurance in substance focus more on capital management than on risk transfer, and section EY 12(5) excludes such arrangements from the definition of "life reinsurance". It does so by defining them as "life financial reinsurance".

Premiums for a reinsurance contract that is "life financial reinsurance" are non-deductible to the life insurer, and the investment income is brought to tax by the life insurer under the financial arrangement rules.

The life financial reinsurance rules look to the substance of an arrangement – in particular, whether the arrangement is a financing arrangement rather than reinsurance. Reinsurance – for example, should involve the transfer of insurance risk from the ceding insurer to the assuming insurer. A transfer of insurance risk may have taken place under a contract of reinsurance when it is reasonably possible that the assuming insurer may realise a loss from the contract; or be exposed to a range of potentially adverse outcomes under the contract.

Non-residents – reinsurance

Section EY 48 provides that the Income Tax Act 2007 applies to life insurance business carried on by a non-resident in connection with life insurance policies that are offered or entered into in New Zealand and life reinsurance policies that relate exclusively to those life insurance policies.

Transfers of life insurance business

Ordinary tax rules apply for transfers of life insurance business. However, section EY 5(4) prescribes that where a life insurer (the **transferor**) transfers life insurance business to another life insurer (the **transferee**), the transferor does a part-year calculation for each class of policy in the transferred business. The transferee also does a part-year calculation for the transferred policies.

The transferee's relevant opening part-year reserve amounts under sections EY 23 to EY 27 equal the transferor's relevant closing part-year reserve amounts. The transferee's relevant opening part-year reserve amounts are adjusted by adding life reinsurance value to the transferee's opening, and subtracting from the transferor's closing. The part-year calculations do not create any part-year tax obligations.

Part II: Transition

Grandparenting of term life products

Sections EY 30 and EZ 53 to EZ 60 and section YA 1

Overview of the transitional rules for term life products

Section EY 30 ensures that only existing policies contracted under the previous tax rules are grandparented and subject to transitional rules for a period of up to five years. The application of the previous life rules are therefore preserved for term policies sold before the start of the new life insurance rules. The start date for the transitional rules (the grandparenting start date) will, for most life insurers, be 1 July 2010, unless the insurer elects an earlier date.

The five-year transition period is directed at annual renewable term policies (also known as yearly renewable term, or age-related term policies).

If the policy is a single premium, level premium or guaranteed premium, it can be grandparented for the life of the policy or for the period for which the premium is guaranteed. These periods can be longer than five years.

Life insurers can elect out of transitional rules at any time – see section EY 30(6).

Life insurance contracts that materially change in nature – for example, when the level of life insurance cover provided is increased, are considered to be new contracts. New contracts should not enjoy the benefits of the previous rules over the grandparenting period.

Early grandparenting start date allowed

If a life insurer elects to apply the new rules from the beginning of its income year – which includes 1 July 2010, it can also make a further election that grandparenting will apply to policies entered into before the beginning of the same income year. If it does not make this election, grandparenting will apply to policies entered into before 1 July 2010.

Application of the grandparenting rules

Life insurers can elect that the grandparenting rules apply to:

- a product when it is "issued" (that is, the life insurer accepts the risk on the life of the individual); or
- when the policy is applied for and a deposit is received in respect of the application.

In either case, the event must have occurred before the grandparenting start-date.

A "deposit" has its ordinary commercial meaning as being a payment in advance to support a commercial transaction. For example, a debit authority by itself would not meet the statutory tests in section EY 30(2).

If an application is made and the deposit is received before the grandparenting start-date and the policy is ultimately not accepted, it would not be subject to grandparenting in any case.

Eligibility for grandparenting applies on a policy by policy basis. The calculation of the adjustment and the opt-out is done on a class of policy basis.

Special grandparenting rules for certain types of policies

Special grandparenting rules apply to the class of policies listed below:

- ***Single premium policies:*** The previous taxation rules will effectively apply for the life of the policy. Section EY 30(5)(a) applies to policies where one premium is only ever payable for the life policy.
- ***Level premium and guaranteed level premium policies:*** The previous taxation rules will effectively apply for the longer of five years or the period for which the premium is guaranteed. Section EY 30(5)(b) applies to policies where the premium cannot be changed over the period – for example, $500 for each year over 15 years, or if the premium does not in fact change over the period.

  Section EY 30(5) recognises the fact that although level term policies may, in some instances allow premiums to be changed at the insurer's discretion, commercial constraints mean that the insurer does not increase the premium payable.
- ***Group life master policies:*** Group life master policies are defined in section YA 1 as "a life insurance policy with multiple individuals' life insurance cover grouped under it, if the group of individuals is identified in the policy and the general public are excluded". The previous taxation rules will apply to lives insured under these policies. Employer-sponsored policies and credit-card repayment insurance are excluded and have their own separate rules.
- ***Employer sponsored group policy:*** The previous life insurance rules will effectively apply to lives insured under employer-sponsored group life policies. Section EY 30(4)(d) requires that there is no savings element in the policy and that the substantive and material terms of the policy do not change on or after the grandparenting start-day. The guarantee period applies only to rates that are guaranteed at the time of application of the proposed life tax rules for a maximum of five years from the application date.

  Officials are continuing discussions with life insurers about the practical effect of these rules.
- ***Credit card repayment insurance:*** The previous life insurance rules will effectively apply to credit card repayment insurance (CCRI) policies that are master policies. The life cover for each life insured does not need to be in place before the grandparenting start-day. As the amount of cover provided by a CCRI policy fluctuates on a regular basis and, by month to month, the amount of cover could increase by a substantial percentage. The insurer has no control over these credit limit increases. Given the nature of CCRI policies, the 10 percent cover increase requirement to these policies is not applied. All CCRI policies therefore have grandparenting for five years from the application date.
- ***Life reinsurance:*** Life reinsurance is included in the definition of "group life master policy" in section EY 30(14). The effect of this provision is to look-through the reinsurance treaty for transition purposes so that the terms applying to the individual reinsured policy, as set out in the treaty, should determine the extent of transition rules applying for that policy. Section EZ 62 provides a special transition rule for life financial reinsurance contracts that are entered into before the date the life insurer applies the new rules for the first time. The maximum transition period for life financial reinsurance is the shorter period of the life of the contract or five years.

Table 2 below summarises the operation of the grandparenting rules.

Table 2: Operation of grandparenting rules

Type of policy	Individual	Group life master policies (including life reinsurance policies)	Credit card repayment insurance	Employer-sponsored group policies
Subsections of section EY 30	**(2)**	**(3) & (14)**	**(4) & (11)**	**(4) & (12)**
Main criteria				
(5)(a) Single premium	Contract expiry (2)(b)	Contract expiry for each life (3)(b)	Not applicable	Not applicable
(5)(b) Fixed premium	Later: 5 years or end of continuous rate period 2(b), unless contract expiry is earlier	Not applicable	Not applicable	Not applicable
(5)(c) Variable premium	Earlier: contract expiry or 5 years (2)(b)	Earlier: contract expiry or 5 years (3)(b)	Earlier: contract expiry or 5 years (4)(b)	Earlier: contract expiry or 5 years (4)(b)
Other criteria				
New members excluded	Not applicable	Yes (3)(c)	No	Yes (4)(c)
No policyholder base income or deduction for the policy (excludes savings products; e.g. whole of life, endowment & unit linked)	Risk only (2)(a)	Risk only (3)(a)	Risk only (4)(a)	Risk only (4)(a)
Disqualification criteria				
Life cover % increase over "cover review period": > 10% opening cover > % movement in consumer price index	Applicable (2)(c)	Applicable for each life (3)(e)	Not applicable	Not applicable
Substantial & material terms & conditions have changed on or after grandparenting start day	Not applicable	Applicable (3)(d)	Applicable (4)(d)	Applicable (4)(d)

When grandparenting ceases to apply

Life policies sold before the grandparenting date will cease to be covered by the grandparenting rules if the policy is altered or modified in such a way that it is effectively a new policy. If the transitional rules cease to apply to a grandparented life policy, the new rules will have effect to that policy from the first day of the income year in which alteration or modification occurred.

There are, however, several situations when an event that creates a change or alteration will not result in the life policy being subject to the new rules:

- ***Reinstated policies:*** It is not uncommon for policies to lapse or be cancelled as a result of policyholders missing premium instalments. Under section EY 30(1)(a), policies entered into before the grandparenting application date but reinstated after that date continue to be subject to the transitional rules, provided that the reinstatements are made within 90 days of lapsing and that the insurer does not treat the reinstated policy as a new policy. The reinstated policy should have the same terms as the lapsed policy.
- ***Replacement policy when the life insurer is sold:*** A life policy that replaces an existing policy as a result of a life insurer being sold, or the life insurer selling its rights and obligations under the old policy, is treated as being issued at the same time as the old policy. The replacement

policy is therefore subject to the transitional rules provided it has substantially the same term as the old policy – EY 30(1)(b).

- ***Certain increases in life cover:*** Grandparenting is not affected in situations when the amount of insured cover does not increase by an amount up to the greater of an annual CPI adjustment or 10 percent of the previous year's amount – as described in section EY 30(2)(c). The date for considering if this threshold has been breached is determined by choosing the "cover review period". The "cover review period" starts on the first day of the life insurer's income year, for a class of policies unless it has chosen an alternative date during the income year. The alternative date, once chosen, is irrevocable. If the insured cover is breached under this rule, the class of policies is subject to full taxation under the new rules from the beginning of the income year in which the breach occurs, irrespective of the day of the actual breach.

Calculation of transition adjustment for grandparented life polices

Grandparented policies are taxed under the new rules but are allowed a deduction equal to the amount calculated under the expected death strain formula (life) in accordance with sections EZ 53 to EZ 60 (which relate to the transitional adjustment for expected death strain) for the income year.

Tax losses carried into the new rules

Sections EZ 61, IT 1 and IT 2

Under the old rules, a life insurer may have losses carried forward from either or both the life office base and policyholder base. The new rules provide that the only life office base loss is carried forward into the new tax rules as it better reflects the income of the entire life insurance business.

For life insurers with a 30 June balance date, or for taxpayers with other balance dates that elect to enter into the new rules on the first day of the income year that includes 1 July 2010, the new rules allow the existing life office base loss at the end of their income year ending 30 June 2009 to be available for carry-forward and allocated as a shareholder base loss. The loss can be offset with the life insurer's income (including, by way of election, policyholder base income subject to limitations as discussed below) and group company losses, subject to ordinary continuity and grouping rules.

Section EZ 61 effectively provides, on an annual basis, that the life office base loss carried forward is first applied against shareholder base income and any excess, up to the value of any base concession amount not yet used, can be elected to be deducted against any policyholder base income. The base concession amount is determined under section EZ 61 on entry into the new rules, and is the lower of the life office base loss carried forward and the policyholder base loss cancelled under section IT 1. The base concession amount is used up by election to be a policyholder base deduction amount.

Example 2, illustrates the use of tax losses under the previous rules that are carried into the new rules under section EZ 61.

Deemed sale

Section EZ 63

The previous life insurance rules provided that investment income in the life office base was calculated under ordinary rules, with some gains and losses being accounted for as taxable income when realised. Under the policyholder base, the reserve calculations had the effect of recognising changes in the value of investments on an unrealised basis. The effect of these rules had the potential to create timing differences when recognising income between the two bases.

To remove this difference, the new rules provide that investments taken into account in determining policyholder reserves for the policyholder base calculation under section EY 2 are treated as having been sold and reacquired at market value on entry into the new rules.

For investments in a PIE, that is not a "listed PIE" (as defined), the deemed disposal rule does not apply – section EZ 63(3).

Transitional year and end of transitional adjustments

Section EY 5

If a life insurer has a balance date other than 30 June and has not elected an early adoption of the new rules, the life insurer does part-year tax calculations for the income year bisected by 1 July 2010. The addition of the two calculations forms the assessment of tax for that income year.

Example 2: Carry-forward of losses into the new rules

Policyholder losses at 1 July 2010	500	Cancelled amount				
Life base losses at 1 July 2010	800					
Base concession amount	**500**					
		1st year	**2nd year**	**3rd year**	**4th year**	**5th year**
SH & PH bases current year before offsets and section EZ 61 election:						
SH base loss \ (net income)	Before loss offset	100	100	(100)	(100)	
PH base loss \ (net income)	Before loss offset	(200)	(200)	(100)	(100)	
Section EZ 61 election calculation:						
Used		0	200	400	500	
Available tax loss (carried fwd from earlier year)	i	800	700	600	400	300
Available concession (base concession less used)	ii	500	300	**100**	**0**	
PH base net income	iii	**200**	**200**	**100**	100	
Loss available to PH base	The least of: rows i, ii & iii.	200	200	100	0	
Section EZ 61 election & loss offsets:						
Deduction taken PH base		200	200	100	0	
Schedular PH base income		0	0	0	(100)	
Loss offset SH base				100	100	
SH base taxable income (being net income after loss offset) *		0	0	0	0	

* Meets the criteria of having no taxable income other than PH base income from 1 July 2010.

The following example illustrates a typical tax calculation of a life insurer with a balance date of 30 June for the first income year under the new life rules. The life insurer has a range of products such as non-participating policies including annuities and capital guaranteed investment policies, participating policies, annuities, international shares, Australasian shares, PIE investments and a life fund PIE.

This illustration is intended to assist life insurers to interpret the new life rules and meet their compliance obligations by providing a suggested format for reconciliation of taxable income to the life insurer's statutory accounts. It does not take into account all possible fact patterns and situations that could arise for a life insurer or reinsurer.

A simplified illustration of a typical life insurer's first year tax calculations under the new life rules

SHAREHOLDER BASE CALCULATION							
Profit & Loss Account							
Income							
Premiums							15,000
Reinsurance recovery							800
Investment income							6,000
							21,800
Expenditure							
Claims							–7,000
Reinsurance premium							–1,500
Expenses							–3,000
							–11,500
Policy reserves							
Net change in life insurance contract liabilities							–4,000
Net change in life investment contract liabilities							–2,000
							–6,000
Net profit before tax							**4,300**
			Less:				
Tax adjustments		*O\bal*	*C\bal*	*Adjustment*	*Section ref*		
Life insurance adjustments:							
Adjustments for all types of life policies:							
Premiums – life (total)				Remove			–10,000
Reinsurance recovery – life (total)				Remove			–600
Claims – life (total)				Remove			5,000
Reinsurance premium – life (total)				Remove			1,000
Net change in life insurance contract liabilities				Remove			4,000
Net change in life investment contract liabilities				Remove			2,000
Non-participating policies (excluding annuities):							
Premiums – life risk portion included in premiums in financial accounts				Include	EY 19		5,000
Claims – life risk portion included in claims in financial accounts				Include	EY 20		–2,000
Reinsurance recovery – life risk portion – policies offered or entered into in NZ	**1**			Include	EY 19 & DR 3		400
Reinsurance premium – life risk portion – policies offered or entered into in NZ	**1**			Include	EY 20 & CW 59C		–200
Outstanding claims reserve – life tax	**2**	500	600	Include	EY 24		–100
Premium smoothing reserve – life tax	**2**	100	80	Include	EY 25		20
Unearned Premium Reserve – life tax	**2**	600	650	Include	EY 26		–50
Capital guarantee reserve – life tax	**2**	10	12	Include	EY 27		–2

Participating policies:						
3 Underwriting profit participating policies – other income adjustments: estimates vs actuals				Include	EY 28 & EY 29	500
Annuities:						
Underwriting profit annuities	Formula: closing actuarial reserves – (0.99 x expected death strain)			Include	EY 31	–100
						4,868
4 Investment adjustments:						
Policyholder base allocations:						
Non-participating policies (including annuities):						
Investment income allocation to policyholder base				Remove	EY 15	–3,000
Investment expenses allocation to policyholder base					EY 16	300
Investment income allocation to multi-rate PIE				Remove	BC 7(4) & sub-part HM including HM 35	–1,000
Investment expenses allocation to multi-rate PIE				Remove		100
Participating policies:						
5 Investment income allocation to policyholder base				Remove	EY 17	–800
5 Investment expenses allocation to policyholder base				Remove	EY 18	400
Net transfers from shareholders to policyholders				Remove	EY 17	–20
Shareholder base adjustments:						
6 International shares subject to FDR & PIE allocated investments – share gains & losses and dividends paid (shareholder)				Remove		–520
6 & 7 FDR on international shares (5% of market value) & PIE allocated income (shareholder)				Include	EY 4	825
8 Unrealised gains & losses Australasian shares (shareholder)				Remove		–100
6 Accrued dividends excluding FIF (shareholder)		10	5	Remove		5
6 Imputation credits (shareholder)				Include	EY 4 & LA 8B	120
						–3,690
Non life insurance adjustments:						
2 Unearned Premium Reserve – non-life tax		1,000	900	Include	General principles	100
Transition adjustments:						
9 Gain on deemed disposal of assets supporting the actuarial reserves on entry				Include	EZ 63	1,000
Term policies issued before grandfathering start date1 July 2009 or earlier election						
	Formula: premiums – total net reserving amounts – (1.2 x expected death strain)				EZ 53 to EZ 58	
Policy categories:						
Annual renewable term				Include	EY 30	–2,000
Single premium				Include	EY 30	–100
Level premiums				Include	EY 30	–200
Group life master policies				Include	EY 30	–200
Credit card repayment insurance				Include	EY 30	–100
Employer sponsored group policy				Include	EY 30	–2,600
						–4,200

		O/bal	C/bal	Adjustment	Section ref	
Total tax adjustments						–2,922
Taxable income						1,378
Loss offset current period						978
						400
Tax liability at 30%						120
	Tax credits claimed					
	Imputation credits (shareholder)			Include	EY 4 & LA 8B	120
Residual income tax \ refund due						0
POLICYHOLDER BASE CALCULATION						
Policyholder Base (excluding life fund multi-rate PIE)						
			Less:			
		O/bal	*C/bal*	*Adjustment*	*Section ref*	
	Non-participating policies (including annuities) – attributed investment income:				EY 15	
	Investment income fund A, being a life fund PIE (not being a multi-rate PIE)			Include	EY 15(1)	1,000
	Investment income Fund B			Include	EY 15(1) & capped (2) & (3)	1,000
	Investment income Fund C			Include	EY 15(4)	1,000
4	Gross investment income					3,000
7	International shares subject to FDR & PIE investments – share gains & losses and dividends paid (policyholder)			Remove		–1,000
7	FDR on international shares (5% of market value) & PIE allocated income (policyholder)			Include	EY 15(1) to (4)	800
8	Gains (losses) excluded Australasian shares (policyholder)			Remove	EX 55	–500
	Accrued dividends excluding FIF (policyholder)	30	15	Remove		15
	Imputation credits (policyholder)			Include	EY 4 & LA 8B	400
						2,715
	Investment expenses (policyholder)			Include	EY 16	–300
	Net investment income					2,415

	Participating policies – attributed investment income less attributed investment expenditure					EY 17	
	Formulae:						
	Income: asset base gross income x (1 – retained earnings average – future shareholder transfers average) + net transfers					EY 17(1)	
	Deduction: asset base gross deduction x (1 – retained earnings average – future shareholder transfers average)					EY 18	
	(1 – retained earnings average – future shareholder transfers average)	80%					
5, 7 & 8	Asset base gross income	1,100	Taxable income		Include	EY 17(1)	870
5	Asset base gross deduction	500	Allowable deductions		Include	EY 18	–400
	Net transfers				Include	EY 17(1)	20
							490
	Policyholder Base Income						2,905
	Deduction for loss allocated from shareholder base						1,238
	Policyholder Base Schedular Income						1,667
	Tax at 30%						500
	Less Tax credits						
	Imputation credits					EY 4 & LA 8B	500
	Refund \ RWT credit available						0
				Less:			
	LIFE FUND MULTI-RATE PIE CALCULATION		*O/bal*	*C/bal*	*Adjustment*		
4	Total income Fund D				Include		1,000
	International shares subject to FDR & PIE investments – share gains & losses and dividends paid (multi-rate PIE)				Remove		–300
	FDR on international shares (5% of market value) & PIE allocated income (multi-rate PIE)				Include		250
8	Gains (losses) excluded Australasian shares (multi-rate PIE)				Remove		–100
	Accrued dividends excluding FIF (multi-rate PIE)		20	10	Remove		10
	Imputation credits (multi-rate PIE)				Include		100
							960
	Investment expenses (multi-rate PIE)				Include		–100
	Net attributed investment income						860
	Imputation credits (multi-rate PIE)				Include		100
	Attribution of net income & tax credits to each member & taxed at their portfolio investment rate (19.5 or 30%)						

SHAREHOLDER LOSSES CARRIED FORWARD

	Adjustment	*Section ref*	
Losses brought forward on entry		EZ 61	–13,000
Used in Shareholder Base	used above		978
Cancellation of loss when allowed in Policyholder Base		IT 2	1,238
Loss available to carry forward to next year			–10,784
Available concession amount			
Policyholder losses lost on entry		EZ 61	–12,000
Used policyholder		IT 1	1,238
Policyholder losses lost but not used		EZ 61	–10,762

Investment income reconciliation

	Non-participating* policyholder allocation	Non-participating* shareholder allocation	Multi-rate PIE	Participating policyholder allocation	Participating shareholder allocation	Total
Accounting Income	3,000	1,000	1,000	800	200	6,000
Tax adjustments						
Australasian shares	–500		–100	–50		–650
FDR & PIE accounting income	–1,000	–520	–300	–80	–20	–1,920
FDR & PIE tax income	800	825	250	100	25	2,000
Dividends accrued	15	5	10			30
Imputation credits	400	95	100	100	25	720
Gross tax income	2,715	1,405	960	870	230	6,180
Deductions	–300	–100	–100	–400	–100	–1,000
Net Taxable income	2,415	1,305	860	470	130	5,180

* Including annuities

NOTES: LIFE INSURER TAX RETURN CALCULATIONS					
1	**Life reinsurance**				
	Life reinsurance is not explicitly taken into account in these calculations. A life reinsurer's position may be different to that stated in this example.				
2	**Life (non-participating) & non-life reserves**				
	a	Premium reserves included in insurance contract liabilities in accounts		Include	EY 25, 26 & 27
	b	Outstanding Claims Reserve (OCR) included in claims:			
		– Life OCR		Include	EY 24
		– Non-life OCR	No adjustment required in this example for non-life OCR as the tax calculation is the same as accounting which uses the risk-free rate to discount.		
3	**Underwriting profit participating policies other income** formula amounts are net of reinsurance amounts offered or entered into in NZ on those policies.				
4	**Investment income** = gains, losses, dividends, interest and rent				
5	**Participating policies** – assuming that the asset base gross income and expenditure is the following amounts in the accounts which is apportioned between the shareholder and policyholder:				
	a	Gross income = investment income (after tax adjustments including imputation credits, FDR & PIE)			
	b	Gross expenditure = deductible expenses allocated to these participating policies			
6	**Shareholder investment adjustments** are for the shareholder portion of investment income of both participating and non-participating policies.				
7	**Assumes an amendment is made to section EY 15(1)(b)(i)** to ensure that attributed income for tax, such as FDR, is the relevant income subject to tax for policyholders and not the accounting income.				
8	**Australasian shares held directly**				
	a	Shareholder = only unrealised gains and losses on Australasian shares not subject to tax for shareholder.			
	b	Policyholder = all gains and losses (realised and unrealised) excluded from tax for policyholders.			
	c	Life Fund Multi-rate PIE = all gains and losses (realised and unrealised) excluded from tax for policyholders.			
9	**Accounting unrealised investment gains on entry for assets supporting the actuarial reserves** – as all the investment income has been removed no further removal is required.				

NEW LEGISLATION

TAX TREATMENT OF PAYMENTS FOR RELOCATION, OVERTIME MEALS AND CERTAIN OTHER ALLOWANCES

Sections CE 1(c), CE 5(3)(bb), CW 17, CW 17B, CW 17C, CX 19(1)(b), DD 4(3), DD 10(a), EA 3(7) and YA 1 of the Income Tax Act 2007; sections CE 1(c), CW 13, CW 13B, CW 13C, CX 17(1)(c), DD 4(3), DD 10(a), EA 3(7) and OB 1 of the Income Tax Act 2004; sections CB 12(1), CB 12(1B), CB 12(1C), CB 12(1D), CI 1(o)(v), EF 1(5A) and OB 1, schedule 6A of the Income Tax Act 1994; section 91AAR of the Tax Administration Act 1994

Amendments have been made to the Income Tax Acts 1994, 2004 and 2007 and the Tax Administration Act 1994 to specifically ensure that payments by employers when relocating their employees, and providing them with overtime meal allowances and certain other allowances, are exempt from income tax and fringe benefit tax when certain criteria are met. Most of these changes were signalled in the officials' issues paper, *Tax-free relocation payments and overtime meal allowances*, released in November 2007, with some additional changes being made at the Select Committee stage. The changes are designed to remove uncertainty about whether and when these payments are tax-free to the employees who receive them.

Background

Over recent years there has been uncertainty over the tax treatment of employer payments for relocations and overtime meals, and whether these payments constitute income of the employees who receive them. For many years these two types of payment have been generally treated as non-taxable by both taxpayers and Inland Revenue. Developments over time have, however, complicated the situation.

Before 1995 taxpayers required approval from Inland Revenue if a particular payment was to be treated as non-taxable, but since then taxpayers have self-assessed whether a payment is taxable or non-taxable.

In 2007 Inland Revenue attempted to identify more generally the circumstances under current tax law, including case law, when amounts paid by employers in relation to employee-related expenses would be exempt from income tax. These circumstances were outlined in a draft Interpretation Guideline (IG03162), which was released for public comment on 24 October 2007. The Interpretation Guideline specifically focused on those situations covered by section CW 13 of the Income Tax Act 2004.

The draft guideline concluded that there were three criteria that must be met: [1]

- The employee was performing an obligation under the contract of service at the time the expenditure was incurred.
- The obligation served the purpose of the income-earning process of deriving income from employment.
- The expenditure incurred by the employee was necessary as a practical requirement of the performance of the obligation.

Apart from relocations, these criteria also had implications for overtime meal allowances as these would have been taxable under the criteria, but had traditionally, in practice, been treated as non-taxable.

In response to these various developments, the government decided it would introduce amendments to the Income Tax Act to ensure these payments would clearly be exempt from income tax and, where relevant, fringe benefit tax, subject to clear limitations to prevent their use for purposes of salary substitution. This was announced in a joint media statement released by the Minister of Finance and the Minister of Revenue on 24 October 2007.

There are several reasons why these two employer payments should be non-taxable:

- The element of private benefit involved is considered to be small.
- The degree of private benefit is hard to measure.
- There is relatively little risk of recharacterisation of taxable salary and wages as non-taxable payments for relocation or as overtime meal allowances.

The changes also help employers and employees in making efficient employee relocation decisions by ensuring that tax considerations do not distort their decisions. This is particularly crucial given the mobility of skilled labour.

To further reduce uncertainty, the government announced that the changes should apply to payments made over the past four years, as well as to future payments. By statute, Inland Revenue is generally unable to increase an income tax assessment beyond four years from the time of the end of the tax year in which the taxpayer provided the tax return. Similarly, for taxpayers who have not filed an income tax return, Inland Revenue is generally unable to issue an income statement beyond four years from the time of the end of the tax year that follows the tax year to which

1 The criteria would not apply to payments that already have their own rules in legislation; for example the rules relating to reimbursement of additional transport costs are already set out in section CW 14 of the Income Tax Act 2004 (or CW 18 of the Income Tax Act 2007).

the income statement would apply. This meant backdating the changes to the beginning of the 2002–03 income year.

The changes were detailed in the officials' issues paper, *Tax-free relocation payments and overtime meal allowances*, and following submissions, were subsequently included in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill.

At the Select Committee stage, although submissions were generally supportive of the two allowances being non-taxable, one submission suggested that sustenance allowances paid to postal delivery workers should also be explicitly treated as tax-free in certain circumstances.

It is important to note that these changes do not remove the more general provision that determines whether allowances are tax-free or taxable. All they do is carve out particular allowances from the general provision (section CX 17 in the case of the Income Tax Act 2007) to ensure that they are non-taxable when the general provision might otherwise suggest that they were taxable. Consequently, making these payments and allowances tax-free does not imply that other allowances are automatically taxable.

A change has also been made to the general provision to ensure that allowances that incorporate some element of depreciation are not precluded from being non-taxable purely because of the depreciation element. A number of allowances, such as tool allowances to compensate employees for the costs associated with the use of their own tools at work, fall into this category.

Key features

Relocation payments

To be tax-free, all of the following criteria need to be met:

- The employee's relocation needs to be as a result of the employee:
  - taking up new employment with a new employer; or
  - taking up new duties at a new location with the employee's existing employer; or
  - continuing in the employee's current position, but at a new location.
- The employee's existing home must not be within reasonable travelling distance of the new work place (unless accommodation is provided as an integral part of the job).
- The expense needs to be on the list of eligible relocation expenses.
- The payment needs to reflect the expenditure incurred.
- The expenditure has to be incurred within certain time limits.

Tax will have already been paid on some past relocation payments. Because the legislative changes have been backdated, some employers and employees could be entitled to tax credits. Employers, in the first instance, will receive the tax credits that arise in relation to past relocation payments that were subject to PAYE deductions.

Overtime meal payments and certain other allowances

For an overtime meal allowance to be tax-free, the employee must have worked a minimum of two hours beyond their ordinary hours on the relevant day and:

- either the employee's employment contract needs to specify that the employee is eligible for a payment in relation to overtime hours worked, or an employer has to have a policy or practice of paying an overtime meal allowance; and
- the allowance needs to reflect the actual expenditure incurred by the employee or, alternatively, the allowance could be a reasonable estimate of the expected costs likely to be incurred by the employee or group of employees.

A specific definition of "overtime" has been provided.

For a sustenance allowances to be tax-free, all of the following need to be met:

- The employee works a minimum of seven hours on the day.
- Their employment requires them to work outdoors and away from their employment base for most of the day, and to undertake a long period of physical activity in travelling through a neighbourhood or district on foot or by bicycle.
- It is not practicable for the employer to provide sufficient sustenance on the day for the period when the employee is working outdoors.
- The allowance recognises both the arduous physical nature of the employee's work and that the employer would normally provide tea, coffee, water, or similar refreshments at the employment base in the course of their business.

Allowances with a depreciation component

Section CW 17 has been amended to refer to both "expenditure" and "depreciation loss".

Application date

The amendments largely apply from the 2002–03 income year. It was decided not to change this date despite the time that has passed since the policy was announced.

DETAILED ANALYSIS

Because the changes have been back-dated to the 2002–03 income year, they have been replicated in the three income tax acts that cover the period:

- the Income Tax Act 1994, which applied up to 31 March 2005;
- the Income Tax Act 2004, which applied from 1 April 2005 until 31 March 2008; and
- the Income Tax Act 2007, which came into force from 1 April 2008.

However, for the purposes of the discussion below on individual section changes we refer primarily to the 2007 Act unless otherwise stated. The wording used in the other two Acts may differ because of the difference in language used in those Acts, but the changes are intended to have the same effect as those in the 2007 Act.

The Tax Administration Act 1994 has also been amended.

Relocation

What payments are covered?

The changes relate to employer payments that cover the costs that employees have incurred in connection with carrying out their employment obligations. The circumstances in which these payments are treated as tax-free have traditionally been covered by section CW 17 of the Income Tax Act and its predecessors, section CW 13 of the Income Tax Act 2004 and section CB 12(1) of the Income Tax Act 1994.

Payments may be made in several ways. Employers may directly pay an account that is in the name of an employee (this is known as a payment on account of an employee). Alternatively, employees might seek reimbursement of an amount they have already paid, or the employer might provide them with an allowance to cover the estimated costs they are expecting to incur. Likewise, the relocation may arise from employees migrating to New Zealand, or migrating from New Zealand, or moving within New Zealand. The legislative changes cover all these types of situations.

These situations differ from those covered by the fringe benefit tax rules, although ideally the outcomes should be similar. Accordingly, some changes have been made to the fringe benefit tax rules too.

New section CW 17B(1) provides the specific income tax exemption for payments that cover expenses in connection with a "work-related relocation", with new section CW 17(5) making it clear that the more general provisions as set out in section CW 17 do not apply to amounts covered by new section CW 17B.

An equivalent change has been made to section CX 19 to cover any fringe benefits that arise from a work-related relocation.

This means that provided the various requirements are met, the relocation payment will be exempt from income tax and fringe benefit tax, irrespective of how the employer makes the payment.

The reason for limiting the scope of the exemption is to avoid the recharacterisation of other forms of expenditure or income. Although employers can largely be relied upon to confine their reimbursements to reasonable relocation expenses because their natural inclination is to minimise the costs that they incur, an exemption for one form of expenditure naturally creates an incentive to recharacterise other forms of expenditure or income to take advantage of that exemption.

Requirements

Actual expenditure

Section CW 17B(2) requires the amount paid must be no more than the actual eligible relocation expenses that the employee incurs from the work-related relocation. To be an eligible expense, it must be one of those listed in a determination issued by the Commissioner of Inland Revenue. Section CW 17B(6), in conjunction with new section 91AAR of the Tax Administration Act, enables the Commissioner to issue such determinations.

Although the legislation refers to actual expenses, this should be sufficiently wide to enable employers to provide an advance to an employee in anticipation of relocation expenditure being incurred, provided there is ultimately a square-up. Estimates of costs would not, however, be allowed, on the basis that it is not unreasonable to expect employees and employers to keep track and provide evidence of actual expenditure given the relatively small number of employees involved and the magnitude of the costs associated with a relocation.

Time limit

Section CW 17B(3) places a time limit on when the expenses must be incurred by, which is the end of the tax year following the tax year in which the employee relocates.

The purpose of this requirement is to avoid expenditure some years later being attributed to the relocation when that expenditure would have no bearing on the employee's decision to relocate.

The earlier draft legislation additionally required the expenditure to have also been incurred no earlier than the beginning of the income year in which the relocation takes place. This was too restrictive and has been removed, in acknowledgement that significant preparatory expenditure can take place ahead of the actual relocation.

The provision also now refers to "tax year" rather than "income year" to remove any doubt over which income year is involved. "Tax year" is a defined term and generally means the period from 1 April to 31 March.

Treatment of temporary moves that become permanent

The legislation generally does not distinguish between temporary and permanent relocations. For example, there is no minimum length of time that an employee has to stay in the new location. The only reference to "temporary moves" is in relation to allowing more flexibility around the time limit.

The legislation now says what time limit applies when a temporary move becomes a permanent relocation. The intention is that if the earlier temporary move has not been treated as an eligible relocation against which claims had been made, the temporary move is to be ignored and the time limit applies just in relation to the permanent relocation. If, however, an eligible relocation claim has been made in respect of the temporary move, then the time limit applies in relation to that temporary move.

In practice, most relocation costs will be incurred close to the time of relocation so the time limitation will not generally be a difficulty.

Work-related relocation defined

Section CW 17B(4) defines what is meant by "work-related relocation". Under the definition, the relocation will need to be as a result of an employee:

- taking up new employment with a new employer; or
- taking up new duties at a new location with the existing employer; or
- continuing in the employee's current position, but at a new location.

Reasonable distance requirement

A further requirement is that the relocation of the employee's residence (or home base) must be necessary to carry out the job. If the employee could have commuted to the new job from an existing residence there would be a clear monetary private benefit involved when the employer pays for the relocation costs and, in principle, this should be taxable. The specific legislative test set out in section CW 17B(4) is that the employee's existing residence must not be within reasonable daily travelling distance of the new workplace (the distance test).

Section CW 17B(5) includes an exemption from the distance test when a person's accommodation forms an integral part of his or her work. The exemption recognises that some employees may be provided with a house as a necessary part of their job, and that when they are required as part of that job to move to a new location, their residence automatically changes irrespective of the distance. This issue was originally raised in the context of the clergy, but it can also be relevant to other occupations.

In developing the policy in this area, two options were considered: that the employee's existing home must not be within reasonable daily travelling distance of the new workplace (the United Kingdom approach) and a specific minimum distance test (the United States approach). The United Kingdom's approach requires assumptions to be made about what is "reasonable", although reasonableness is a common concept within accounting. The United States' approach is more certain in this regard but is less flexible in handling genuine local relocations, such as within a major city where traffic congestion and transport difficulties may make shorter distance relocations more justifiable. The United Kingdom's approach of a reasonable daily travel distance has been adopted.

Guidance on reasonable daily travelling distance

"Reasonable daily travelling distance" is not defined in the United Kingdom legislation. Instead, taxpayers are expected to apply common sense and take account of local conditions. The usual time taken to travel a given distance is an indication of whether that distance is reasonable. For example, in the United Kingdom employees living within larger cities commonly travel much greater distances or take longer to travel the same distance to work than do employees elsewhere. In New Zealand, transport difficulties, such as traffic congestion on main arterial routes and limited public transport options in the major cities, may make long-distance commuting less likely.

A number of submissions during consultation asked for guidelines from Inland Revenue on what is meant by "reasonable travelling distance". As a result, some guidance will be provided in a subsequent *Tax Information Bulletin*.

Eligible relocation expenses

New section 91AAR of the Tax Administration Act 1994 provides some parameters around the Commissioner's power to issue determinations, and lists the types of expenditure that would qualify as eligible relocation expenses.

In particular, section 91AAR(3) sets out the factors that the Commissioner may take into account when considering whether a type of expenditure arises from a relocation of an employee rather than being costs, including capital costs, that would have been incurred gradually over time, irrespective of whether an employee had relocated. Factors that may be relevant are whether the expenditure is really a substitute for salary and wages, whether employers generally treat the expenses, as relocation expenses and the difficulty and costs of measuring any private benefit element. Losses on the sale of a house, for example, would not be considered to qualify as they are a potentially sizable capital loss that may have accumulated over time.

Section 91AAR(4) provides for a determination to be altered, subject to a minimum 30-day notice period before any change is implemented. The aim is to get from the outset as comprehensive a list as possible so that changes to the list items will need to relate only to future income years. Nevertheless it is important to have the ability to backdate changes as taxpayers may subsequently realise that a relocation expense item they have been paying or reimbursing tax-free in the past has been omitted from the list and should be on the list.

A person affected by a determination may dispute or challenge the determination under parts 4A (Disputes procedures) and 8A (Challenges) of the Tax Administration Act (see new section 91AAR(5)).

The Commissioner has exercised this power to issue a determination. A copy of the determination can be found on Inland Revenue's website (**www.ird.govt.nz**). It will also be included in a subsequent *Tax Information Bulletin*.

It is acknowledged that the passage of time may make it more difficult to substantiate that previous payments covered actual eligible expenses, particularly given that full evidence dating back possibly to October 2001 may not be available to employers. Accordingly, a degree of pragmatism is required in applying the test. Rather than trying to reflect this in the legislation, this will be handled administratively. Practically, the issue is likely to be of relevance for the relatively few employers who are likely to seek refunds or credits because tax has been paid on the relocation payments. These employers are more likely to have the standard necessary information, given that many of these cases are likely to have arisen from reassessments. An example would be greater lenience on the part of Inland Revenue in seeking information on whether the time limits associated with certain eligible expenses (such as accommodation expenses, which have to be incurred within three months) had been met.

Tax and associated adjustments

Given that the legislative changes are being backdated to the 2002–03 income year, some taxpayers will be entitled to a credit for over-paid tax if they paid tax on past qualifying payments. These adjustments are being handled through Inland Revenue's standard administrative practices.

There was general agreement with the suggestion in the Issues Paper that employers should receive the credit for over-paid PAYE when they have grossed up the payment to compensate the employee for the tax impost. No special legislative mechanism is needed to achieve this. Inland Revenue already has administrative practices in place that enable credits to be given for over-payments of PAYE. Even if an employee has not grossed up a payment but has nevertheless deducted PAYE, the employer, in the first instance, will receive the tax credit. An employer can request an adjustment to a past Employer Monthly Schedule (EMS), which the Commissioner will accept on the receipt of standard corroborating material. As noted earlier, given the passage of time since some past payments were made, Inland Revenue will apply lenience when seeking verification of whether the time limits associated with certain eligible expenses had been met.

Likewise, as would normally occur, employers receiving such credits should, where relevant, be adjusting their taxable income when they have treated the past PAYE payment as a cost of business.

Even when employers receive a credit for over-paid PAYE, employees will still be eligible for adjustments to their entitlements (to family tax credits) and liabilities (to pay child support and student loan repayments) that arise from readjusting their taxable income to exclude a previously taxed qualifying relocation payment. These adjustments redress the fact that some employees will have received lower entitlements and had higher liabilities as a result of the payments being previously subject to income tax.

Overtime meal payments

New section CW 17C(1) provides the specific income tax exemption for overtime meal payments, with new section CW 17(5) making it clear that the more general provisions as set out in section CW 17 do not apply to amounts covered by new section CW 17C.

The fringe benefit tax rules have not been changed. Fringe benefits arising outside of on-premises meals seem unlikely. If they do arise, they may get the benefit of section CX 5(3). That section states that to the extent to which a benefit that an employer provides to employees in connection with their employment would have been exempt income if it had been paid in cash, the benefit is not a fringe benefit.

Section CW 17C(3) specifies that for the payment to be eligible for the exemption, the employee must have worked at least two hours beyond his or her ordinary hours on the day of the overtime and either:

- the employee's employment agreement must provide for pay for overtime hours worked; or

- the employer must have an established policy or practice of paying for overtime meals. (This is to cover situations when salaried staff are required to work overtime in special periods of work pressure.)

A time limit is important to avoid an employee working only a few minutes of overtime to get a non-taxable overtime meal allowance. The general understanding is that two hours is the standard time either specified in employment contracts or that employers require before they pay an overtime meal allowance, so this limit is likely to fit with current practice.

Section CW 17C(5) provides that the overtime meal payment must only cover either actual expenses or a reasonable estimate of those expenses. This is similar to the options available under the more general allowances provisions in section CW 17. If actual expenses are being reimbursed, documentation is required to verify expenditure when the meal costs more than $20.

Section CW 17C(6) defines what is meant by "overtime". This is defined as the time worked for an employer on the day beyond the person's ordinary hours of work as set out in the person's employment agreement.

It is important that the amounts paid for overtime meals should either represent actual costs incurred or a reasonable estimate of those costs rather than having particular amounts automatically sanctioned. If amounts are paid out with no intention of expenditure actually being incurred, the amount paid equates to a salary substitute and should be taxed. Nevertheless, the legislation is intended to be sufficiently wide to accommodate situations when amounts have been specified in industrial awards, on the assumption that the award amounts are based on a reasonable estimate of the costs incurred, on average, across a group of workers.

Sustenance allowances

The exemption originates from a submission in relation to the tax treatment of an allowance paid to several thousand postal delivery workers, which covers the costs of their purchasing adequate food or liquid to ensure that they maintain their energy levels while completing their mail deliveries. It recognises that these employees do not have access to the usual employer-provided drink facilities that employees working in offices would normally have access to at no or little cost, and the additional costs associated with their particular situation.

Because these workers are required to carry bags of mail, either on foot or by bicycle, they do not have the capacity to carry energy drinks and other sustenance with them and therefore, must purchase these items along their mail route.

It was agreed by the Finance and Expenditure Committee, and subsequently by Parliament, that this sustenance allowance should be non-taxable and that the legislative changes should be widened to encompass it. There was a concern that without the specific exemption the allowance might be treated, under section CW 17, as a taxable meal allowance.

The wording of section CW 17C(2) picks up a number of the key attributes of a postal delivery worker's job. It is, however, possible that there are one or two other employment situations that have comparable features or circumstances and would, therefore, also qualify.

For a sustenance allowance to be tax-free, all of the following conditions must be met:

- The employee works a minimum of seven hours on the day.
- Their employment requires them to work outdoors and away from their employment base for most of the day, and to undertake a long period of physical activity in travelling through a neighbourhood or district on foot or by bicycle.
- It is not practicable for the employer to provide sufficient sustenance on the day for the period when the employee is working outdoors.
- The allowance recognises the arduous physical nature of the employee's work and that the employer would normally provide tea, coffee, water or similar refreshments at the employment base in the course of business.

A further requirement is that the employer must have an established policy or practice of paying a sustenance allowance (see section CW 17C(4)). Also, as with overtime meal allowances, the amount paid must be either the actual cost to the employee or a reasonable estimate of the cost likely to be incurred by the employee or a group of employees eligible for the payment.

Allowances including a depreciation component

Many employees use assets that they own during the course of their work, such as tools, computers and motor vehicles. Accordingly, employers often provide allowances to reimburse employees for the costs associated with the use of private assets for work purposes. Tool allowances and mileage allowances are common examples. Arguably, part of the reimbursement relates to the depreciation of those assets.

The main provision in the Income Tax Act determining whether allowances are non-taxable, section CW 17, refers only to payments to cover expenses. The Income Tax

Act treats depreciation as a capital loss rather than as an expense. Accordingly, there was an issue over whether the wording in section CW 17 adequately covered all elements that an allowance might cover. To remove doubt, section CW 17 has been amended to refer to both "expenditure" and "depreciation loss" (see new section CW 17(4)).

These changes have also been backdated to the 2002–03 income year so that equivalent provisions have been included in the 1994 and 2004 Income Tax Acts. For the period before the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 gained Royal assent, however, these changes are confined to past positions taken to ensure that only those taxpayers that had genuinely included a depreciation element in their allowances are able to use this change.

Inter-relationship with other parts of the Income Tax Act

Accommodation element of employment income

Section CE 1(c) ensures that the market value of accommodation provided by an employer to an employee is treated as income of the employee. If the provision of accommodation would qualify as an eligible relocation expense, it should be excluded from being income to the employee. An amendment has been made to section CE 1(c) to ensure this.

Inter-relationship with entertainment tax

The limitation rule in the entertainment tax rules that limits entertainment expenditure deductions to 50% does not apply to payments for overtime meals. To achieve this, section DD 4(3) of the Income Tax Act has been amended so that it refers also to new section CW 17C.

Expenditure on meals that qualifies as eligible relocation expenditure has also been exempted from the limitation on entertainment expenditure deductions.

Other consequential changes

Several references in other sections of the Income Tax Act 2007 that previously referred to the main provision that determines whether allowances are taxable or non-taxable (CW 17) now also refer to the new provisions relating to relocation payments and payments for overtime meals and certain other allowances. The relevant sections in the 2007 Act are:

- subsection DD 10(a) relating to reimbursement and apportionment of entertainment expenditure;
- subsection EA 3(7) relating to prepayments; and
- the definition of "employee" in section YA 1.

Comparable changes have been made to the 2004 and 1994 Income Tax Acts.

These amendments are merely consequential changes as a result of carving out the relocation payments and overtime meal allowances from the more general provision. They ensure that the rules covered by the amendments referred to above continue to apply also to the carved-out allowances.

PAYROLL GIVING – A NEW TAX CREDIT

Sections LD 4 to LD 8, RP 14(ab), RP 8(a)(iii) and (iv) of the Income Tax Act 2007, sections 22(2)(ed), 22(2)(ke), 24Q and 141E(1)(c) of the Tax Administration Act 1994, schedule 7 of the Companies Act 1993 and section 274(2)(aa) of the Insolvency Act 2006

The new voluntary payroll-giving scheme will be available on 7 January 2010. The scheme provides a tax credit for gifts of money that are deducted from an employee's pay through his or her employer's payroll. Employees receive an immediate reduction in tax by way of the tax credit each pay-period, eliminating the need to collect and keep receipts to claim the tax relief on gifts of money at the end of the year. To participate in the payroll-giving scheme the recipient organisation, such as a charity or school, must be a donee organisation.

The legislation only provides for the tax administration of the scheme. It does not prescribe the nature of the arrangements or relationships between employers, employees and donee organisations, or how the schemes should be set up in the workplace.

The scheme operates in addition to the current end-of-year donation tax credit claim system. Therefore, employees who do not or are unable to give through a payroll-giving scheme can still claim tax benefits on their donations through the existing end-of-year refund process.

Background

The government first raised the idea of introducing a voluntary payroll-giving scheme to New Zealand in the 2006 discussion document, T*ax incentives for giving to charities and other non-profit organisations*. This was followed by a further discussion document in November 2007, *Payroll giving: providing a real-time benefit for charitable giving*, which discussed several options for implementing payroll giving in New Zealand. Submissions made in response to these documents indicated a wide level of public support for introducing a payroll-giving scheme – in particular, for making giving to charitable and philanthropic causes easier.

Other countries, such as Australia and the United Kingdom have introduced payroll giving and their experiences suggest that payroll giving is a simple, convenient and effective way of supporting charitable giving. These countries have also found that payroll giving enables businesses to connect with their communities in ways that achieve tangible and mutual benefits for everyone involved. In particular, payroll giving offers donee organisations the benefit of stable funding that is free of fundraising costs – that is, donee organisations receive donations as a lump sum from each employer and this reduces their costs as donee organisations only need to process one donation made through each employer. Another benefit is that donee organisations are not required to issue receipts to the donors.

The non-prescriptive nature of New Zealand's new payroll-giving scheme is intended to provide flexibility to allow relevant parties to work together to establish schemes that operate best for them and to manage the associated costs. A key policy outcome of the payroll-giving scheme is that it has the potential to establish genuine partnerships between businesses and the community, while supporting employees' community activities.

The Finance and Expenditure Committee recommended a number of changes to the payroll giving provisions to better reflect policy intentions and to improve the overall equity of the scheme.

Key features

The rules for the new payroll-giving scheme are largely contained in new sections LD 4 to LD 8 of the Income Tax Act 2007 and in new section 24Q of the Tax Administration Act 1994. Unless otherwise indicated, section references are to the Income Tax Act 2007.

The key features of the scheme are:

- Participation in payroll giving is voluntary for employers and employees.
- Payroll giving is available only to employees whose employers file their employer monthly schedules and PAYE deduction forms electronically, using Inland Revenue's ir-File service, and who choose to offer payroll giving in their workplace.
- Employees who choose to make payroll donations will receive a tax credit on the amount of those donations each payday. The tax credit is calculated on a set rate of 33⅓% of the donation made. The tax credit is offset against the PAYE amount calculated on the employee's gross pay, thereby reducing the amount of PAYE payable for that period. The maximum tax credit permitted is limited to the tax portion of the PAYE deduction on the employee's pay each pay-period.
- Payroll donations must be made to a donee organisation. A donee organisation is a society, institution, association, organisation, trust or fund as described in section LD 3(2) or an organisation listed in schedule 32.
- Employees are responsible for ensuring that the chosen recipient is in fact a donee organisation and

for supplying to the employer relevant details that will enable the transfer of the payroll donations to the donee organisations. A full list of donee organisations can be found at **www.ird.govt.nz/donee-organisations**.

- Employers are responsible for ensuring that payroll donations are transferred to the chosen donee organisations within a specified period. They are also required to disclose certain information and keep adequate records to enable Inland Revenue to determine that payroll donations have in fact been transferred.
- Payroll donations are held in trust for employees who participate until these are transferred to the correct donee organisation
- Employees who donate through payroll giving are not eligible for the end-of-year donation refund on their payroll donations.

Example: Calculation of payroll donation

In this example an employee asks her employer to deduct $10.00 from her gross weekly wage of $762.00. The amount of the tax credit is $3.33 and it is used to reduce the amount of PAYE that is payable by the employee for the pay-period.

The employer must transfer the $10.00 donation to the chosen donee organisation on or before the PAYE payment due date which is closest to the end of the two months from the last day of the pay-period that the donation was deducted. See below for an example of how to determine this transfer date. The employee has a take-home pay for the week of $605.25. The charity receives $10.00. Inland Revenue receives a PAYE payment of $146.75.

Employee's gross wage for the week	$762.00
Donation amount	$10.00
PAYE on gross wage (includes ACC levy)	$150.08
Tax credit for payroll donation ($10 x 33⅓)	$3.33
PAYE less tax credit for payroll donation	$146.75
Employee's gross wage	$762.00
Less PAYE net of the tax credit for payroll donation	$146.75
Less donation	$10.00
Employee's take-home pay for the week	**$605.25**

Application date

The rules of the payroll-giving scheme come into force on 7 January 2010.

DETAILED ANALYSIS

Establishing payroll-giving schemes in the workplace

In New Zealand, a small number of employers have already established payroll-giving relationships with their employees and individual donee organisations. Under these schemes, donations are made from the after-tax pay of the employee. As long as they keep records, employees can claim the tax benefit of these donations at the end of the year through the current donation tax credit process, like any other charitable donation. The new payroll-giving scheme replaces the end-of-year claim process for employees donating via payroll giving.

As stated earlier, the payroll-giving scheme legislation does not prescribe the nature of the arrangements or relationships between employers, employees and donee organisations, or how the schemes should be set up. Matters that would need to be decided upon by the relevant parties include:

- the process for establishing a scheme that works best for all parties concerned;
- the level of employee education about payroll giving that may be needed;
- the process for selecting donee organisations to participate in the scheme;
- the number of donee organisations that can participate in the scheme;
- the level of engagement between donee organisations and employee donors; and
- any minimum payroll donation threshold.

The following examples illustrate three possible approaches to establishing payroll-giving arrangements based on current New Zealand and overseas experiences.

Example 1

The employer has established a charitable trust to receive its employees' payroll donations and to decide on the ultimate destination of those donations. The charitable trust is itself a donee organisation. Community organisations apply for grant funding from the trust. As there is employee representation in the grant-making process, employees have the ability to determine the ultimate destination of their payroll donations. Employees receive regular feedback about the impact of their support in the community.

The employer-established charitable trust offers the employer and its employees a flexible payroll-giving programme.

Example 2

The employer and its employees participate in selecting the donee organisations they wish to support. The number of donee organisations is limited to six organisations. Employee peer champions are selected to communicate the benefits of the payroll-giving programme to employees and to facilitate on-going engagement in the workplace. Employees must give at least $2.00 or more each pay. Employees receive advice detailing the amount donated and to whom each year.

The employer also provides a degree of matching donations. Employees are encouraged to increase their involvement with the selected donee organisations through the giving of volunteer time and expertise (pro bono work).

There is a high level of employer/employee engagement in facilitating the payroll-giving programme. The six donee organisations are also actively involved in the programme.

Example 3

The employer has partnered with a third-party intermediary (which is a donee organisation). The intermediary receives the employee payroll donations from the employer and decides who in the community should benefit. The intermediary ensures that payroll donations go to support certain community activities in the region in which the payroll donations are sourced. Employees have no control over where their payroll donations are applied.

A third-party intermediary offers efficiency gains in time and costs for the employer and its employees.

The new tax credit for payroll donations

Who can participate in the payroll-giving scheme (section LD 4(1))

Participation in payroll giving is voluntary for both employers and employees. Tax credits for payroll donations are available to any person:

- whose employer chooses to offer payroll giving in the workplace;
- whose employer files its employer monthly schedules and employer deduction forms by electronic means; and
- who chooses to make a payroll donation in a pay-period from their pay.

There is no registration process for payroll giving. An employer simply records any tax credits for payroll donations on the employer monthly schedule and then electronically files this form with Inland Revenue.

Amount of credit (section LD 4(2) and (3))

The credit applies at the rate of 33⅓% on the dollar value of all qualifying payroll donations made by the employee in a pay-period.

Maximum credit (section LD 4(4))

The maximum credit is limited to the income tax that the employee has paid for the pay period in which the donation has been deducted.

In the earlier example, the PAYE tables show a PAYE deduction of $150.08 for a weekly pay of $762.00. The amount of $150.08 includes the ACC earners' levy of $12.95. Therefore, the maximum tax credit limit is $137.13 as this amount represents the actual income tax portion of the PAYE deduction.

Non-refundable credit (section LD 4(5))

The tax credit for payroll donations is treated as a non-refundable credit.

No refunds for payroll donations (section LD 4(6))

Payroll donations are not eligible for the end-of-year donation refund.

Definition of "pay" (section LD 4(7))

A new definition of "pay" has been included for the purposes of payroll giving. The definition is intended to ensure that only people who earn income in connection with their employment can participate in the payroll-giving scheme.

Cancellation of the tax credit (sections LD 5, LD 6 and LD 7)

New section LD 5 extinguishes the tax credit when a calculation or filing error has occurred. This provision also restores the tax credit if the error is subsequently corrected by the employer.

New section LD 6 extinguishes the tax credit when an employer or PAYE intermediary transfers an employee's payroll donation to a recipient that is not a donee organisation. Extinguishing the credit would result in a shortfall in PAYE, and so the employee would have an additional PAYE liability to pay for the relevant pay-period. Ultimately, the employee would be liable to meet any shortfall in PAYE, as provided in section RD 4(1), and section 168 of the Tax Administration Act 1994.

New section LD 7 extinguishes the tax credit if the donation is returned to the employee. There may be instances when the employee receives a donation back (for example, the employer might have the donation returned if it had been provided to an ineligible donee organisation so the amount can be returned to the employee). The tax credit they previously received for that donation would be cancelled.

Meaning and ranking of payroll donations (section LD 8)

New section LD 8 provides that a payroll donation is the amount an employee requests an employer to transfer to a donee organisation for that pay-period.

Section LD 8 also provides that an employee must meet his or her tax and other obligations for each pay-period before he or she can make payroll donations for a pay-period. In practice, this means that the employer would make the required pay-period tax and social policy deductions (including student loan, child support payments and KiwiSaver obligations) and any other deductions required to be made from an employee's salary and, if there are sufficient funds, make the necessary adjustments for payroll donations.

This provision may affect the amount of payroll donations an employee may make in a pay-period and also the maximum amount of tax credit.

Transferring payroll donations (section 24Q of the Tax Administration Act 1994)

Section 24Q of the Tax Administration Act 1994 is intended to apply when an employer agrees to establish payroll giving in the workplace and an employee asks the employer to transfer an amount of payroll donation from the employee's pay to a donee organisation. The provision specifies that employers must transfer any payroll donations to donee organisations on or before the due date required by sections RA 15 and RD 4 that is nearest to the end of the two-month period from the last day of the pay-period in which the donation was deducted.

The table below illustrates how this rule works. Date A is the last day of the pay period. If the pay covers 1–12 February, the last day of the pay-period is 12 February. To find Date B, add two months to Date A. Date C is the nearest PAYE payment due date to Date B. Date C is the last day on which an employer must pass the donation to the chosen donee organisation before penalties may apply.

Table: Transfer of payroll donations

	Date A	Add 2 months	Date B	Date C
Monthly filer	12 February	+ 2 months	12 April	20 April
Twice-monthly filer	12 February	+ 2 months	12 April	5 April

Payroll donations must be held in trust for employees until transferred to the donee organisations.

Employees are responsible for checking that the organisation they are donating to is in fact a "donee organisation" and for supplying their employer with sufficient details of the recipient to enable the payroll donation to be made.

Priority of payroll-giving donations

Schedule 7 of the Companies Act 1993 and section 274(2)(aa) of the Insolvency Act 2006 have been amended to confirm that when an employer goes into bankruptcy or liquidation and has not passed on the employee's donations to a donee organisation, those donations will have the same priority for return to the employee in a bankruptcy or liquidation as unpaid wages.

Information disclosure and record-keeping requirements

New section RP 14(ab) requires PAYE intermediaries to transfer any payroll donations to the relevant recipients on or before the due date of the employer's EDF/IR 345 nearest to the expiry of the two-month period that follows the pay period in which the donation was deducted.

New sections RP 8(a)(iii) and (iv) require employers who use PAYE intermediaries to keep a record of the amount of payroll donations and any tax credit for payroll donations and provide this information to the intermediary.

New sections 22(2)(ed) and 22(2)(ke) of the Tax Administration Act 1994 provide that employers must maintain sufficient records to enable Inland Revenue to determine the transfer of an employee's payroll donation to the recipient of that donation.

Penalty and use-of-money interest provisions

Section RD 2(1)(b) provides that the payroll donation tax credit provisions are part of the PAYE rules. Therefore, the normal penalty and use-of-money-interest charges that apply to the determination and payment of PAYE also apply to the tax credit for payroll donations. It would be a question of fact and degree whether the current late payment penalties or any of the shortfall penalties would apply and the application of penalties would be on a case-by-case basis.

The only additional penalty for payroll giving is contained in section 141E(1)(c) of the Tax Administration Act 1994. This provides that employers are liable to pay a shortfall penalty of 150% if the employer knowingly does not transfer the payroll donations to the correct recipient. The penalty is imposed on the tax credit that is extinguished, because the credit would represent the short-paid PAYE.

NEW DEFINITIONS OF "ASSOCIATED PERSONS"

Sections CB 8(c), CD 5, CD 5(2B), CD 6(1)(a)(ii), CD 22(9), CD 25(4), CD 27(1)(b), CD 27(3)(a)(ii), CD 44(10B), CD 44(10C), CD 44(14B), CX 2(5), CZ 9B, DB 42(2), EB 13(2), EX 20B(5)(a)(i), EX 20B(9)(c), FE 21(3)(d)(ii), FE 21(7)(a)(i) and (ii), FE 21(8), GB 28(2), GB 48(1)(b), GB 48(3)(d) and (e), GC 5(5), HC 15(5)(a)(ii), HC 21(3), HC 27(1)(e), HC 27(3), HC 32(2), HC 35(4)(a), HC 36(5), RF 11, YA 1, YB 1 to YB 16 of the Income Tax Act 2007; sections 17(1C)(a), 89N(1)(c)(iii), 89N(1)(c)(v), 141(7)(c) and 141D(3B)(b) of the Tax Administration Act 1994

The definitions of "associated persons" in the Income Tax Act 2007 have been reformed by strengthening and rationalising them. The definitions are mainly used in an anti-avoidance capacity to counter non-arm's length transactions that could undermine the intent of the income tax legislation.

The reforms address a number of weaknesses in the previous definitions that posed a risk to the tax base. These weaknesses have significant base maintenance implications in areas such as the taxation of land sales, dividends and fringe benefits. The main changes:

- deal with the weaknesses in the previous definitions in relation to trusts. In particular, there are new tests focusing on a trust's settlor (that is, the person who provides the trust property);
- provide more robust rules aggregating the interests of associates to prevent the tests relating to companies being circumvented by the fragmentation of interests among close associates; and
- implement a tripartite test associating two persons if they are each associated with the same third person, thereby making the associated persons tests as a whole more difficult to circumvent.

The reforms narrow some current tests. For example, the ambit of the relatives test has been reduced from four to two degrees of blood relationship.

The reforms rationalise the income tax definitions of associated persons and other income tax provisions that employ a similar concept, such as the definition of "related persons" in the dividend rules. This represents a major simplification and makes the associated persons concept in the Income Tax Act more coherent.

The associated persons reforms are consistent with a key theme of the government's tax policy work programme, which is ensuring that the income tax system is robust.

Background

New Zealand tax law often subjects transactions between associated persons to special scrutiny because these transactions can pose a substantial risk to the tax base. Transactions between associated persons are more likely to lead to tax practices that undermine the intent of our tax laws because of the closeness of the relationships of the persons involved.

The associated persons definitions are used extensively in the Income Tax Act 2007 to determine whether persons are associated for the purposes of operative provisions in the Act. These operative provisions are often of an anti-avoidance nature, and recognise that transactions between related parties are more likely to be non-arm's length than transactions between independent parties, and that while associated persons are legally separate entities, they may not be economically independent. Because of their relationship to each other, associated persons can often be regarded as single economic entities because of their community of interests. This community of interests may justify these persons not being treated as independent entities for tax purposes.

An important application of the associated persons definitions in the Income Tax Act is in the area of land sales. Parliament's intent in 1973, when it enacted the current land sale tax rules, was that land dealers, developers and builders should generally be taxed on all gains on property sold within 10 years of acquisition, and they cannot claim to hold non-taxable investment portfolios. This legislative intent is clear from the parliamentary debate. Hon W E Rowling, Minister of Finance, who introduced the relevant legislation, said:

> "Profits and gains from real property will now be assessed when … the property was acquired by a land dealer and either was held as part of his land dealing business and later sold – in which case the profits will be assessable irrespective of the period between acquisition and sale – or, if it was not held as part of his land dealing business but is sold within 10 years of acquisition, for example, claimed to be held as an investment but sold within this 10-year period."

It was therefore a deliberate decision by Parliament that gains on land sold by property developers within 10 years of acquisition should generally be taxed.

The previous definitions of associated persons had a number of shortcomings. For example, the associated persons definition which applied for land sales contained loopholes which allowed land dealers, developers and builders to escape tax by operating through closely connected entities.

The Income Tax Act previously had no coherent overall scheme for defining associated persons. For example, some definitions did not consider some obviously close relationships as being associated (for example, a trustee and a beneficiary). On the other hand, they treated some remote relationships as being so (for example, fourth-degree relatives). The multiplicity of definitions and other provisions employing a similar concept (such as the company control definition) created unnecessary complexity in the Act.

The new associated persons definitions address the previous shortcomings in the associated persons definitions in the Income Tax Act – first by addressing their weaknesses and, secondly, rationalising these and similar provisions in the Income Tax Act.

Proposals to reform the definitions of associated persons were initially outlined in an officials' issues paper, *Reforming the definitions of associated persons*, released in March 2007. The reforms have been the subject of extensive consultation and the new associated persons definitions incorporate various amendments that arose during the policy development process.

This reform of the definitions of associated persons in the Income Tax Act, including the modifications arising from the consultation process, is the first comprehensive review since the inception of a definition of associated persons in the income tax legislation in 1968.

Key features

The reforms to the associated persons definitions in the Income Tax Act 2007 generally involve replacing the definitions with the objective of strengthening them. The other major part of the reforms involves rationalising these definitions and other income tax provisions which employ a similar concept.

The changes aim to give effect to the policy intention of capturing non-arm's length transactions, while not applying more widely than is necessary to protect the tax base.

The tests of association in the new associated persons definition in subpart YB are as follows:

- two companies;
- a company and a person other than a company;
- two relatives;
- a person and a trustee for a relative;
- a trustee and a beneficiary;
- trustees with a common settlor;
- a trustee and a settlor;
- a settlor and a beneficiary;
- a trustee and a person with the power of appointment or removal of the trustee;
- a partnership and a partner; and
- two persons who are each associated with the same third person (tripartite test).

All 11 associated persons tests generally apply for the purposes of the Income Tax Act. The main exception is in the land provisions where modifications are made so the associated persons definitions cover situations under the effective control of property dealers, developers and builders, but do not apply to other situations.

The tests for determining whether two companies, or a company and a person other than a company, are associated persons include rules that aggregate the interests of associates. This prevents the company-related tests being circumvented by the fragmentation of interests among associated persons.

The test for associating relatives is reduced from four degrees of blood relationship to two degrees only. This test is further limited to spouses and parents and their infant children for the purposes of the land provisions and compliance cost saving provisions relating to low turnover traders and adverse event livestock transfers.

The weaknesses in the previous general associated persons definition in relation to trusts have been addressed by including tests associating a trustee and beneficiary, trustee and settlor, two trustees with common settlor, settlor and beneficiary and a trustee and a person with the power of appointment or removal of the trustee. A number of modifications apply to the trust-based tests to ensure that the associated persons definitions do not apply more widely than is necessary to protect the tax base. They include:

- Not applying the beneficiary-based associated persons tests (the trustee-beneficiary and settlor-beneficiary tests), and the test associating a person and a trustee for a relative in the case of land sales. It is not necessary to apply these tests to catch the type of structures being used to circumvent the land sale tax rules; the structures causing concern can be caught by other associated persons tests – in particular, the settlor-based trust and tripartite tests.
- Not treating charitable organisations as beneficiaries for the purposes of the trustee and beneficiary and settlor and beneficiary tests and excluding charitable trusts from the trustee and settlor test.

- The definition of "settlor" that applies for the purposes of the associated persons tests will not include a person who provides services to a trust for less than market value.

Persons who are married, in a civil union, or in a de facto relationship are treated as the same single person for the purpose of identifying a common settlor under the two trustees with a common settlor test in section YB 7. This treatment prevents the new associated persons definition being circumvented by the use of "mirror trusts".

The new associated persons definition introduces a tripartite test which associates two persons if they are each associated with the same third person, under different associated persons tests. The tripartite test acts as an important buttress to the other associated persons tests and makes the associated persons definition as a whole more difficult to circumvent.

The reforms also rationalise the current income tax definition of associated persons and other income tax provisions that employ a similar concept, such as the definition of "related person" in the dividend rules. This represents a significant simplification and makes the associated persons concept in the Income Tax Act more coherent.

Application date

The general application date for the reforms (excluding those applying for the land provisions) is the 2010–11 and later income years. For the purposes of the land provisions (as defined in section YA 1), except for the section which relates to disposal of land within 10 years of completing improvements (section CB 11), the reforms apply to land acquired on or after 6 October 2009, the date of enactment. Given that association is tested in the land provisions at the time of acquisition, this means that for land acquired before 6 October 2009 the former associated persons definitions are the relevant provisions in determining whether the sale of such land is taxable. For the purposes of section CB 11, the reforms apply to land on which improvements started on or after 6 October 2009. Therefore, in the case of the land provisions, the relevant application date is 6 October 2009 irrespective of a person's balance date.

DETAILED ANALYSIS

Subpart YB containing the associated persons definition rules in the Income Tax Act 2007 has been substantially replaced. The new provisions consist of 11 tests of association, which are explained in this article.

New section YB 1(4) states the general rule that the various associated persons tests in subpart YB apply for the purposes of the whole Act unless a provision expressly states otherwise. The main situation where certain exceptions will apply in the new associated persons tests are the land provisions, which are defined in section YA 1. For example, a narrow range of relatives (namely, spouses, civil union partners, de facto partners, and infant children) applies in the new associated persons definitions for the purposes of the land provisions.

New sections YB 1(5) to (8) contain cross-references to several special rules that modify the associated persons definitions for the purpose of specific provisions. These special rules are contained in sections DS 4 (Meaning of film reimbursement scheme), EB 13 (Low-turnover valuation), EX 4 (Limits to requirement to include associated person interests in the controlled foreign company rules), and LP 2 (Tax credits for supplementary dividends). These special rules have not been changed as part of this reform.

Two companies test (section YB 2)

Section YB 2 contains the test for associating two companies. Two companies will be associated if:

- there is a group of persons whose total voting interests in each company are 50% or more – this is the primary test for associating two companies. The concept of voting interests is defined in subpart YC;
- a market value circumstance exists for either company and there is a group of persons whose total market value interests in each company are 50% or more. A "market value circumstance" is defined in section YA 1 and a "market value interest" is defined in subpart YC. Under the measurement of company ownership rules in subpart YC, a person's interest in a company is generally measured by reference to the person's voting interests in the company. If these voting interests in certain circumstances – coming within the definition of "market value circumstance" in section YA 1 – do not reflect accurately the person's economic interest in a company then the person's interests are also measured by reference to the person's market value interests in the company; or
- there is a group of persons who control both companies by any other means.

Aggregation rule

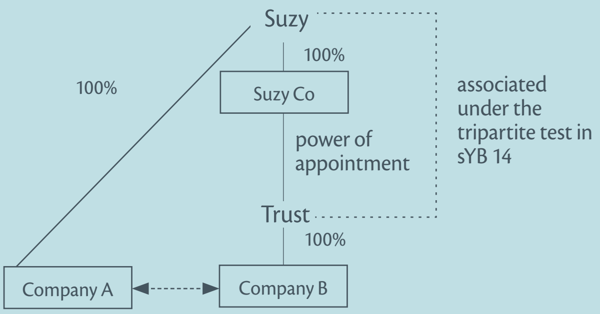
The test associating two companies contains a general aggregation rule which provides that in determining whether two companies are associated, a person is treated as holding anything held by persons associated with that person under sections YB 4 to YB 14 (section YB 2(4)). This rule applies for the purposes of the whole Act except the land provisions. The aggregation rule is designed to prevent the two companies test being circumvented by the fragmentation of interests among associated persons, resulting in the 50% interest threshold not being reached.

The two companies test contains a separate rule which aggregates the interests of associates for the purposes of the land provisions (section YB 2(5). Under this rule, a person is treated as holding anything held by persons associated with them under the limited relatives definition in section YB 4 (namely, spouses, civil union partners, de facto partners and infant children) and under the tests in sections YB 7, YB 8, and YB 10 to YB 14. This modification ensures that for the purposes of the land provisions, the general relatives test and the beneficiary-related trust tests do not apply in the aggregation rule for the test associating two companies.

When applying the rules aggregating the interest of associates, the rule is applied afresh to each person and it is irrelevant that a person does not directly hold any shares in a company before the application of the aggregation rule.

Example

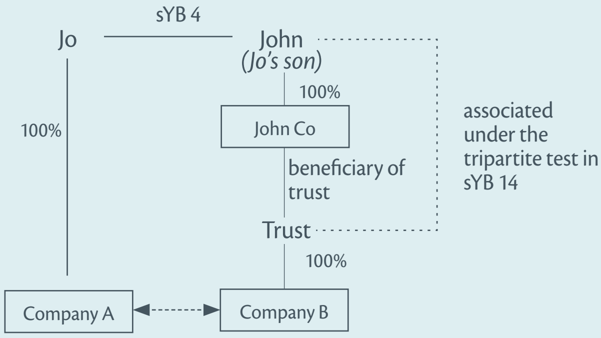
Application of general aggregation rule in two companies test



In this example the aggregation rule, in conjunction with the tripartite test, can be applied to treat Suzy as holding Trust's shares in Company B. Specifically, Suzy is associated with Suzy Co under the company and person other than a company test in section YB 3, and Suzy Co (with power of appointment of the trustees of Trust) is associated with Trust under section YB 11. Therefore, Suzy and Trust are associated under the tripartite test, and the aggregation rule in section YB 2(4) treats Suzy as holding Trust's shares in Company B. Taking into account the shares Suzy holds directly in Company A, Company A and Company B are associated under the two companies test in section YB 2.

Example

Application of general aggregation rule in two companies test



In this example, the question is whether Company A and Company B are associated.

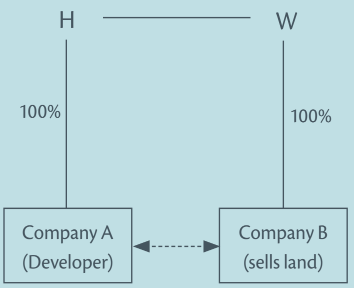
First, in conjunction with the relatives test in section YB 4, the aggregation rule in section YB 2(4) is applied so that John is treated as holding anything held by his associates. In this case, John is treated as holding Jo's shares in Company A through his association with Jo under the relatives test in section YB 4.

Secondly, the aggregation rule, in conjunction with the tripartite test, can also be applied to treat John as holding Trust's shares in Company B. This is because John is associated with Trust under the tripartite test in section YB 14. Specifically, John is associated with John Co under the company and person other than a company test in section YB 3, and John Co (as beneficiary of Trust) is associated with Trust under the trustee and beneficiary test in section YB 6. Therefore, John and the Trust are associated under the tripartite test, and the aggregation rule in section YB 2(4) treats John as holding Trust's shares in Company B. As a result, because John is treated as holding all the shares in Company A and Company B under section YB 2(4), Company A and Company B are associated under section YB 2.

It is irrelevant that John does not directly hold shares in Company A and Company B before the application of the aggregation rule in section YB 2(4).

Example

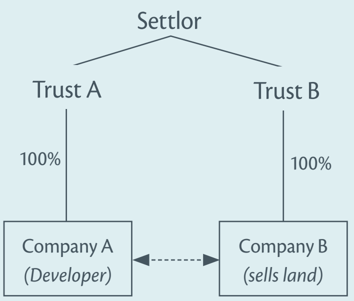
Application of aggregation rule in two companies test in the context of the land provisions



In this example, the husband owns 100% of the voting interests in Company A, which is a property developer, and his wife holds 100% of the voting interests in Company B, which sells some land within 10 years of acquisition. Without the aggregation rule in section YB 2(5), the two companies would not be associated despite their close community of interests. The application of the aggregation rule ensures that the two companies are associated under section YB 2, resulting in Company B being liable to tax on the sale of the land.

Example

Application of aggregation rule in two companies test in the context of the land provisions



In this example, Trust A and Trust B are associated under the two trustees with common settlor test in section YB 7. Trust A owns 100% of the voting interests in Company A, which is a property developer, and Trust B owns 100% of the voting interests in Company B, which sells some land within 10 years of acquisition.

The two companies are associated under the two companies test through the use of the aggregation rule contained in that test. Applying the aggregation rule to this example, Trust A is treated as holding anything held by persons associated with it. In this case, Trust A and Trust B are associated under the two trustees with common settlor test in section YB 7. Accordingly, taking into account Trust A's direct shareholding in Company A, Trust A is treated as holding all the voting interests in Company A and Company B, meaning these two companies are associated.

The aggregation rule can also be applied to treat the common settlor as holding all the voting interests in Company A and Company B because the settlor is associated with Trust A and Trust B under the trustee-settlor test in section YB 8. This also means the two companies are associated.

A result of Company A and Company B being associated is that Company B is liable to tax on the sale of land. Without the aggregation rule, Company A and Company B would not be associated despite their close community of interests.

Other features

The two companies test provides that the control by any other means limb in the test does not apply to a company that is a state enterprise, Crown Research Institute, Crown health enterprise or a company that is part of the same group of companies as one of these Crown-related entities (section YB 2(6)). It also provides that in the international tax rules (defined in section YA 1) two companies are not associated if one, but not both, is a non-resident (section YB 2(7)).

Additionally, for the purposes of the land provisions, two companies are not associated persons if one is a portfolio investment entity (PIE) or an entity that qualifies for PIE status (section YB 2(8)). This exception ensures that a widely held managed fund is not adversely affected because of the personal land dealings of the directors of the fund.

Company and person other than a company test (section YB 3)

Section YB 3 contains the test for associating a company and a person other than a company.

A company and a person other than a company are associated if:

- the person has a voting interest in the company of 25% or more. The concept of voting interests is defined in subpart YC; or
- a market value circumstance exists for the company and the person has a market value interest in the company of 25% or more. A "market value circumstance" is defined in section YA 1, and a "market value interest" is defined in subpart YC. Under the measurement of company ownership rules in subpart YC, a person's interest in a company is generally measured by reference to the person's voting interests in the company. If these voting

interests in certain circumstances – coming within the definition of "market value circumstance" in section YA 1 – do not reflect accurately the person's economic interest in a company then the person's interests are also measured by reference to the person's market value interests in the company.

Aggregation rule

The test associating a company and person other than a company test contains a general aggregation rule, which applies for the purposes of the whole Act except the land provisions (section YB 3(3)). Accordingly, for the purposes of determining whether a company and a person other than a company are associated, a person is treated as holding anything held by persons associated with the person under sections YB 4 to YB 14. This aggregation rule is designed to prevent the test associating a company and a person other than a company being circumvented by the fragmentation of interests among associated persons, resulting in the interest threshold of 25% not being reached.

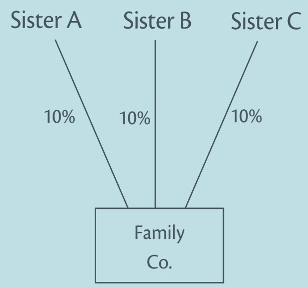
The test associating a company and a person other than a company contains a separate rule which aggregates the interests of associates for the purposes of the land provisions (section YB 3(4)). Under this rule, a person is treated as holding anything held by persons associated with the person under the limited relatives definition in sections YB 4 (namely, spouses, civil union partners, de facto partners, and infant children) and under the tests in sections YB 7, YB 8, and YB 10 to YB 14. This modification ensures that for the purposes of the land provisions, the general relatives test and the beneficiary-related trust tests do not apply in the aggregation rule for the test associating a company and person other than a company.

When applying the rule aggregating the interests of associates, the rule is applied afresh to each person being tested for association with a company and it is irrelevant that a person does not directly hold shares in a company before the application of the aggregation rule.

The aggregation rules are an element of both of the company-based tests in sections YB 2 and YB 3. As noted above, the aggregation rules are designed to prevent these tests being circumvented by the fragmentation of interests among associated persons, resulting in the interest thresholds in these tests not being met. As such, the aggregation rules do not act as separate associated persons tests.

Example

Application of the general aggregation rule in the company and person other than a company test

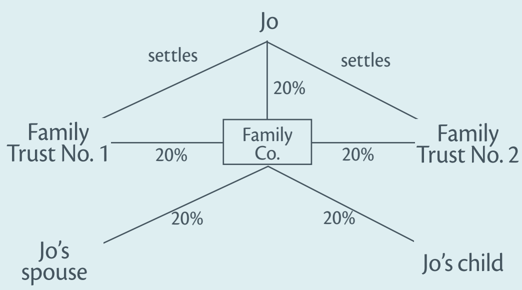


Without an aggregation rule, neither Sister A, B nor C would be associated with Family Co. under the company and person other than a company test because their respective interests do not meet the required 25% threshold. However, under the aggregation rule in section YB 3(3), each sister would be associated with the company. This is because for the purposes of determining whether Sister A is associated with Family Co. under section YB 3(1), she is treated as holding her sisters' 20% voting interests in the company (10% each from Sister B and Sister C). This 20%, when aggregated with her own 10% voting interest, means that Sister A is treated as holding a 30% interest and, therefore, is associated with the company.

The aggregation rule applies afresh to each person – so similarly, Sister B and Sister C are each treated as holding the other two sisters' aggregate 20% voting interests in the company. Therefore, when aggregated with the 10% interest they each own in the company, Sister B and Sister C are each associated with Family Co.

Example

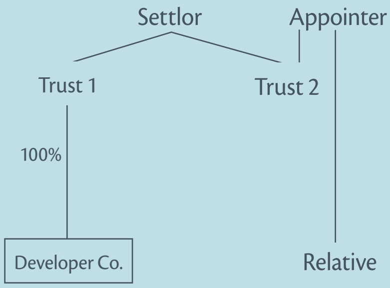
Application of the general aggregation rule in the company and person other than a company test



Jo settles Family Trusts No. 1 and No. 2 and arranges for each of them to hold 20% of the shares in Family Co. Jo also arranges for his spouse and child to hold 20% each in Family Co. Jo directly holds only 20%. Under the aggregation rule in section YB 3(3), Jo is treated as holding the shares in Family Co. held by the family trusts and relatives because they are his associates. Accordingly, Jo is associated with Family Co. Without the rule aggregating the interests held by associated persons Jo would not be associated with Family Co. despite the close community of interests.

Example

Application of aggregation rule in the company and person other than a company test in the context of the land provisions



The question in this case is whether the appointer of the trustee in Trust 2 is associated with Developer Co. under the test in section YB 3 associating a company and a person other than a company. The appointer is associated with Developer Co. under this test because of the application of the aggregation rule for land provisions in section YB 3(4) which treats a person as holding anything held by their associates. The appointer is associated with Trust 1 under the tripartite test in section YB 14. Specifically, the appointer is associated with Trust 2 under the test in section YB 11 associating a trustee and their appointer, and Trust 2 is associated with Trust 1 under the test in section YB 7 associating two trustees with a common settlor. Therefore, under the aggregation rule for land provisions in section YB 3(4) the appointer is treated as holding Trust 1's shares in Developer Co. Accordingly, the appointer and Developer Co. are associated under section YB 3.

Note, however, that the relative of the appointer would not be associated with Developer Co. In particular, the tripartite test does not associate Trust 1 and the relative and therefore the relative is not treated as holding Trust 1's shares in Developer Co. The aggregation rule is applied afresh to the relative, and not to the appointer, for the purposes of determining whether the relative is associated with Developer Co. Therefore, the fact that the appointer is treated under the aggregation rule as holding Trust 1's shares when testing for association between the appointer and Developer Co. is disregarded when testing for association between the relative and Developer Co.

Corporate trustees

In section YB 3, "a person other than a company" includes a company acting in its capacity as a trustee of a trust (section YB 3(5)). This amendment is of a clarifying nature only and is consistent with long-standing policy (*Tax Information Bulletin*, Vol. 3, No. 7, April 1992 at page 23).

The company look-through rules in subpart YC applying to voting and market value interests do not apply to a corporate trustee; therefore, the voting interests or market value interests held by a corporate trustee are not traced through to the shareholders of that corporate trustee. This treatment is a result of the separate capacity that a trustee (whether a company or natural person) has under the Income Tax Act 2007, and is recognised in the definition of "trustee" in section YA 1 which refers to a trustee "only in the capacity of trustee of the trust". This separate trustee capacity feature of the income tax law has been maintained in the new associated persons definitions.

Therefore the shareholders of a corporate trustee are not relevant when testing for association between that trustee and other persons. This is consistent with the general position under the Income Tax Act, which is that a company acting in its capacity as trustee is treated as a trustee rather than a company. This means that the relevant test for determining association between a corporate trustee and a company in which the corporate trustee is a shareholder is section YB 3.

Relatives test (section YB 4)

There are three limbs to the general relatives test in the new associated persons definitions:

- The first limb associates two persons who are within two degrees of blood relationship (section YB 4(1)(a)). Previously the general relatives test extended to the fourth degree of blood relationship. This means that the blood relationships limb of the general relatives test extends to grandparents and siblings but not to nephews and nieces (third degree) and cousins (fourth degree) as the previous test did.
- The second limb associates two persons who are married, in a civil union, or in a de facto relationship (section YB 4(1)(b)).
- The third limb associates two persons if one person is within two degrees of blood relationship to the other person's spouse, civil union partner or de facto partner (section YB 4(1)(c)). This limb associates persons with their in-laws and step-children.

For the purposes of the relatives associated persons test, a child by adoption is treated as a natural child of the adoptive parents and not as a natural child of the birth parents (section YB 4(3)).

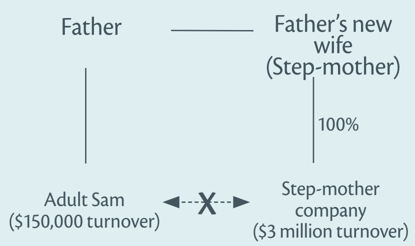
A new provision (section YB 4(4)) has been added to the test associating two relatives to ensure that a person is not associated with another person if the person cannot reasonably be expected to know that the other person exists or that they are within two degrees of blood relationship to the other person. This exclusion is designed to deal with a small minority of situations such as when siblings are separated at a very young age and do not know of each other's existence.

Narrower application of relatives test in certain cases (section YB 4(2))

The first and third limbs (section YB 4(1)(a) and (c)) of the general relatives test of association do not apply for the purposes of the land provisions (defined in section YA 1) or two compliance-cost saving provisions in the Income Tax Act – namely, the low turnover trader provision in section EB 13, and the provision relating to the adverse event livestock transfers in section EC 5. In these circumstances, persons are associated because of a blood relationship only if one is the infant child of the other. An "infant child" is defined in the Age of Majority Act 1970 as a person under 20 years of age.

Example

Application of narrow relatives test in section YB 4(2)



Under the trading stock provisions in the Income Tax Act 2007, there are special low-compliance cost rules which apply to a "low-turnover trader". For a person to be a low-turnover trader, the turnover of that person's business, when aggregated with the turnover of associated persons, must be no more than $3 million.

In this example, because a narrow relatives test applies for the purposes of the low-turnover trader rules, Adult Sam and Step-mother company are not associated and therefore Sam is entitled to use the low-turnover trader rules for his business. In particular, because Adult Sam is not treated under the relatives test in section YB 4 as being associated with his step-mother, the aggregation rule in the test in section YB 3 associating a company and a person other than a company does not apply to treat Adult Sam as holding his step-mother's shares in her company. If the ordinary relatives associated persons test had applied to the low-turnover trader rules Sam would be treated as being associated with Step-mother company under section YB 3 and therefore would not have been entitled to use the low-turnover trader rules.

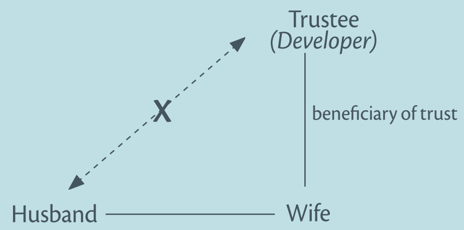
Trustee for relative test (section YB 5)

A person (first person) and a trustee of a trust under which a relative (as defined in section YB 4) of the first person has benefited or is eligible to benefit are associated persons under new section YB 5. For example, a husband and a trustee of a trust under which the husband's wife is a beneficiary would be associated under this test.

The trustee for relative test does not apply for the purposes of the land provisions. This is consistent with the land provision exclusions in the other beneficiary-related tests in section YB 6 (trustee and beneficiary) and YB 9 (settlor and beneficiary).

Example

Person and trustee for relative: exception for the purposes of the land provisions



Because the trustee for relative test does not apply for the purposes of the land provisions, the husband would not be associated with the trustee of the trust under which his wife is a beneficiary. Under the previous trustee for relative test in former section YB 12, the husband would have been associated with the trustee for the purposes of the land provisions.

Additionally, as further discussed below, this test does not apply to lines trusts established under the Energy Companies Act 1992 (energy consumer trusts) or the unit trust administering bonus bonds (section YB 16).

Trustee and beneficiary test (section YB 6)

A trustee of a trust and a person who has benefited or is eligible to benefit under the trust are associated persons under new section YB 6. This provision does not apply for the purposes of the land provisions.

Persons have benefited under a trust if they have received a distribution under the trust.

Inland Revenue's long-standing policy on when a person is eligible to benefit under a trust will continue (Tax Information Bulletin, Vol. 7, No. 9, February 1996 at page 25). In particular, a person is "eligible to benefit" when the person is either:

- named by the trustee as a potential beneficiary; or
- designated as a member of a class of potential beneficiaries, for example, "the children of ...".

When trustees have a general power of appointment, persons not already appointed as beneficiaries under the power are not treated as being eligible to benefit.

Therefore, a person who is eligible to benefit under a trust (as described above) does not need to have actually received a distribution (as defined in section HC 14 of the Income Tax Act 2007) under the trust to qualify as a beneficiary.

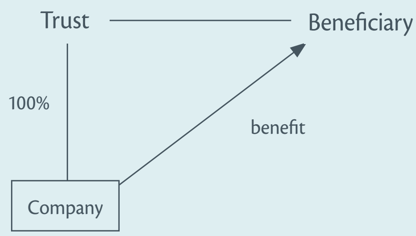
An exception to the trustee and beneficiary test for certain employee trusts is contained in section YB 15. Additionally, as with section YB 5, this test does not apply to energy consumer trusts or the unit trust administering bonus bonds (section YB 16).

The trustee and beneficiary test (and other trustee-related tests) are not relevant to unit trust investment vehicles. This is because such unit trusts are treated as companies for all income tax purposes. This means that it is the company-related tests – in particular, section YB 3 – that are the relevant associated persons tests. The 25% threshold in section YB 3 would ensure that retail investors would not be associated with widely held public unit trusts.

The trustee and beneficiary test (and other beneficiary-related tests) are not relevant to purpose trusts such as charitable trusts and community trusts referred to in the Community Trusts Act 1999 (these trusts were established to hold the shares in the successor companies to the former trustee banks). This is because purpose trusts do not at law have beneficiaries.

The previous general definition of associated persons did not contain a trustee and beneficiary test. This constituted a significant omission in test coverage and transactions were often structured to take advantage of the loophole. Without a trustee and beneficiary test in the associated persons definitions, many of the operative rules in the Income Tax Act using the general associated persons definition could be readily circumvented by simply interposing a discretionary trust.

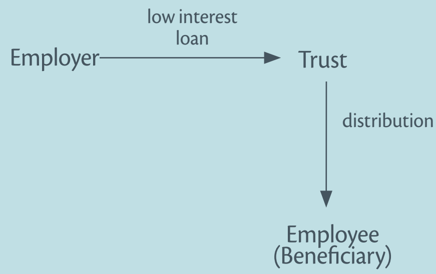
Example



In this example, the company provides a benefit to a beneficiary of its trustee shareholder. The company provides the benefit because the trustee is its sole shareholder. Section CD 6(1)(a)(ii) in the dividend rules treats payments to associated persons of shareholders as dividends. However, without a trustee and beneficiary test, this simple arrangement would avoid the dividend rules.

Under the new trustee and beneficiary test, because the company is providing a benefit to an associated person (Beneficiary) of a shareholder in the company (Trust), the company has made a dividend to the beneficiary under section CD 6(1)(a)(ii).

Example



In this example, an employer provides a low interest loan to a trust under which an employee is a beneficiary. Under section CX 18, fringe benefit tax applies to fringe benefits provided to associated persons of employees. Without the trustee and beneficiary test in section YB 6, this simple arrangement avoids this rule. However, because of the new trustee and beneficiary test, the employer would be providing a fringe benefit (the low interest loan) to an associated person of the employee (the Trust) and would therefore be subject to fringe benefit tax.

Two trustees with common settlor test (section YB 7)

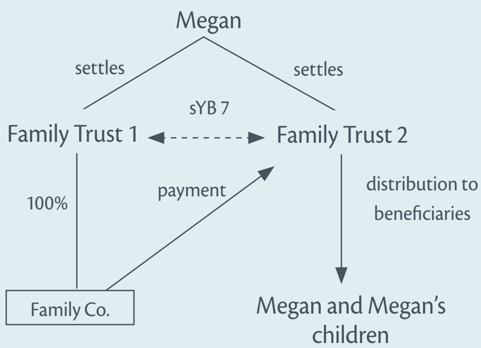
Under new section YB 7, a trustee of a trust and a trustee of another trust are associated persons if the same person is a settlor of both trusts.

New section YB 10 provides that for the purposes of the new section YB 7, "settlor" has the meaning set out in section HC 27 of the Income Tax Act 2007, but does not include a person who provides services to a trust for less than market value.

An exception to the two trustees with common settlor test for certain employee trusts is contained in section YB 15.

Without a test associating two trustees with a common settlor many of the operative rules in the Income Tax Act which use the associated persons definition, such as the dividend rules, could be circumvented by structures such as the following example.

Example



In this example, Megan settles Family Trust 1, a trust that owns all of the shares in Family Co. Megan also settles Family Trust 2 whose discretionary beneficiaries include Megan's children and Megan herself. Family Co. makes a payment to Family Trust 2.

Under the dividend rules in sections CD 3 to CD 6 of the Income Tax Act, any payment made by a company to an associated person of a shareholder of the company is treated as a dividend if that payment would have been a dividend if it had been made to the shareholder.

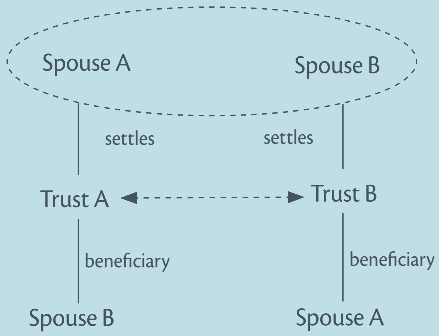
In the absence of a two trustees with common settlor test, Family Co. has not made a payment to an associated person of its shareholder (Family Trust 1), in terms of section CD 6(1)(a)(ii). Therefore, the payment from Family Co. to Family Trust 2 would not be treated as a dividend.

Under the new two trustees with common settlor test in section YB 7, Family Trust 1 and Family Trust 2 are associated persons as they have a common settlor (Megan). Therefore, the payment from Family Co. to Family Trust 2 (an associated person of Family Co's shareholder, Family Trust 1) is treated as a dividend.

For the purposes of the two trustees with a common settlor test in section YB 7, two persons who are married, in a civil union, or in a de facto relationship are treated as the same single person. This is relevant to identifying a common settlor of two trusts, and prevents the new associated persons definition being circumvented by the use of "mirror trusts". This is illustrated in the following example.

Example

Two trustees with common settlor: mirror trusts



In this example spouse A settles a family trust (Trust A) for the benefit of spouse B and spouse B settles another family trust (Trust B) for the benefit of spouse A. Without the provision in the two trustees with common settlor test treating two persons who are married, in a civil union, or in a de facto relationship as the same single person, the trustees of Trust A and Trust B would not be associated despite the close community of interests.

The trustees of Trust A and Trust B are associated under new section YB 7 because Spouse A and Spouse B are treated as the same single person and therefore the trustees of Trust A and Trust B have a common settlor.

Trustee and settlor test (section YB 8)

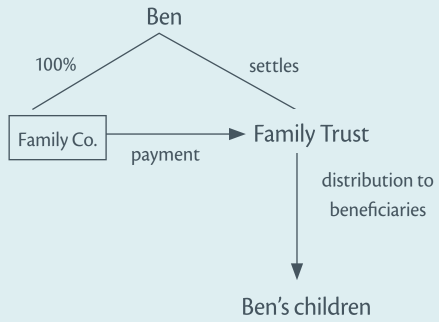
A trustee of a trust and a settlor of the trust are associated persons under new section YB 8.

New section YB 10 provides that for the purposes of new section YB 8, "settlor" has the meaning set out in section HC 27, with the modification that a settlor does not include a person who provides services to a trust for less than market value.

An exception to the trustee and settlor test for certain employee trusts is contained in section YB 15.

As with the other trustee-related tests, the trustee and settlor test is an important element of the new associated persons definition. Without this test in the associated persons definitions, schemes could be developed to exploit such a loophole. This is illustrated by the following examples.

Example

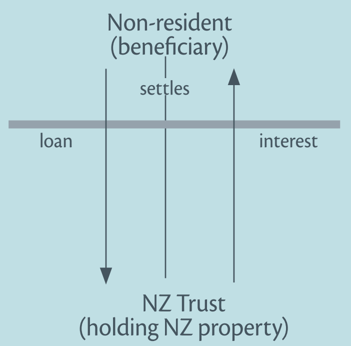


In this example, Family Co. makes a payment to Family Trust. Ben is the sole shareholder of Family Co. and the settlor of Family Trust.

Without a trustee and settlor test in the associated persons definition the payment from Family Co. to Family Trust is not caught as a dividend despite the close community of interests. This is because Family Trust would not be associated with Ben who is the sole shareholder of Family Co.

Under the new trustee and settlor test in section YB 8, Ben and Family Trust are associated persons as Ben is the settlor of Family Trust. The payment from Family Co. to the Family Trust is accordingly treated as a dividend because Family Co. has made a payment to an associated person (Family Trust) of its shareholder (Ben) in terms of section CD 6(1)(a)(ii).

Example



In this example, a non-resident settles a New Zealand trust (with a New Zealand-incorporated company as trustee) which owns New Zealand land and buildings. This investment by the trustee is funded by a loan from the non-resident settlor. If the non-resident is not associated with the New Zealand trustee, then the interest paid on this loan qualifies for the approved issuer levy (AIL) of 2% instead of being subject to the higher non-resident withholding tax (NRWT) rate.

The previous associated persons definition used in the AIL rules was generally deficient in relation to arrangements involving trusts. In this example in particular, without a trustee and settlor test of association, the interest would qualify for AIL treatment despite the in-substance association between the two parties.

The new trustee and settlor test in section YB 8 would associate the non-resident with the New Zealand trustee. Accordingly, the interest derived by the non-resident from New Zealand would be subject to a higher rate of NRWT instead of AIL at 2%, which is the appropriate treatment.

Settlor and beneficiary test (section YB 9)

A settlor of a trust and a person who has benefited or is eligible to benefit under the trust are associated persons under section YB 9. This test does not apply for the purposes of the land provisions (as defined in section YA 1).

The settlor and beneficiary test is the third test of association (the others being the trustees with a common settlor and trustee and settlor tests) that is based on the settlor of a trust. This focus on the settlor is consistent with the settlor-based focus of the trust taxation rules.

Given that there is a sufficient connection between a trustee and a beneficiary, as well as between a trustee and a settlor to justify treating them as associated persons, there is equally a sufficient connection between a settlor and a beneficiary to justify treating them as associated persons as well.

An exception to the settlor and beneficiary test for certain employee trusts is also contained in section YB 15.

Definition of settlor (section YB 10)

As mentioned above, for the purposes of the settlor-based tests in sections YB 7 to YB 9, settlor has the meaning set out in section HC 27, with the modification that a settlor does not include a person who provides services to a trust for less than market value. This modification prevents a professional advisor who provides services to a trust at no charge being treated as a settlor of the trust.

The term "settlor" has a wide meaning under the section HC 27 definition of that term. A settlor of a trust is defined to mean broadly a person who transfers value to a trust. The definition of settlor is further extended by the provisions of section HC 28, the most significant of which are:

- When a company makes a settlement, any shareholder with an interest of 10% or more in that company is treated as a settlor in relation to that settlement as well as the company itself.

- When a trustee of a trust (the first trust) settles another trust (the second trust), the settlor of the second trust is treated as including any person who is a settlor of the first trust.
- When a person has any rights or powers in relation to a trustee or settlor of a trust which enables the person to require the trustee to treat the person (or any nominee) as a beneficiary of the trust, the person is treated as a settlor of that trust.

The definition of "settlor" is used extensively in the Income Tax Act and its wide meaning is consistent with the settlor-based focus of the trust taxation rules in the Income Tax Act.

The definition of "settlor", in conjunction with the nominee look-through rule in section YB 21, does not include professional advisers acting on behalf of clients and other persons such as friends and family members who simply allow their name to be listed as the settlor on a trust deed. The definition of "settlor" that is being used is essentially the same as that originally enacted in 1988 as part of a reform of the trust rules (with the exception that the provision of services at less than market value are excluded). The main focus of this definition is on persons who provide the trust property, and therefore does not include persons who merely allow their name to go on the trust deed as the named settlor.

It is therefore the client of the professional adviser, or the person that the friend or family member is acting for, who is treated as the settlor under the settlor-based tests in sections YB 7 to YB 9.

This position is consistent with Inland Revenue's long-standing policy. *Tax Information Bulletin* of November 1989 on the trust rules at paragraph 6.93 states:

> "Often professional advisers or relatives will assist in establishing a trust by settling a nominal sum on trust on behalf of another person. In these circumstances it is not appropriate to expose the professional adviser or relative to a potential tax liability. The professional adviser or relative is not the real settlor of the trust but is in effect only an intermediary or facilitator. The real settlor is the person on whose behalf the professional adviser or relative acted in making the settlement. Thus, s.226(3) [now section YB 21 of the Income Tax Act 2007] treats the person for whom the nominee or the nominal settlor acted as the settlor rather than the nominee or nominal settlor."

Trustee and person with power of appointment or removal test (section YB 11)

A trustee of a trust and person who has a power of appointment or removal of the trustee are associated persons under section YB 11. This test is intended to complement the test associating a trustee and settlor in section YB 8. In many cases, a settlor of a trust, as the author of the instrument creating and governing the administration of the trust, retains the power to appoint or remove trustees. However, this power could be reposed in a separate person.

There is sufficient connection between a trustee of a trust and the person who has the power to appoint or remove the trustee to justify treating them as associated persons.

The situations considered to be caught by the test in section YB 11 associating a trustee and a person with the power of appointment or removal of the trustee include:

- a person who holds a power to appoint or remove trustees jointly with another person; and
- a person who holds a power to appoint or remove trustees only with the consent of another person (often referred to as the "protector").

However, the following situations are not considered to be caught by the test in section YB 11:

- a person who holds a power to appoint or remove trustees only on the happening of certain events in the future (for example, the incapacity of another person) are not treated as currently holding a power of appointment or removal; and
- a person (often referred to as the protector) who holds the power to veto the appointments or removal of a trustee (because they do not hold any positive power).

The requirement in the tripartite test in section YB 14 that two persons must be associated with the same third person under different associated persons tests should obviate any concerns about whether otherwise unrelated trustees are associated under that test merely because a professional advisor acting in their capacity as such has been granted the power to appoint or remove trustees by their clients.

An exception to the test associating a trustee and a person with a power of appointment or removal of the trustee for certain employee trusts is contained in section YB 15.

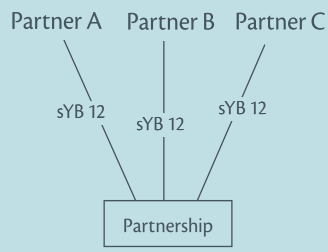
Partnership and partner test (section YB 12)

A partnership and a partner in the partnership are associated persons under section YB 12(1).

The tripartite test in section YB 14 – which associates two persons if they are each associated with the same third person under different associated persons tests – will not apply to associate the partners themselves with each other. This is because partners in a partnership would be associated with the same third person (the partnership) under the same associated persons test, namely section YB 12.

Example

Partnership and partner

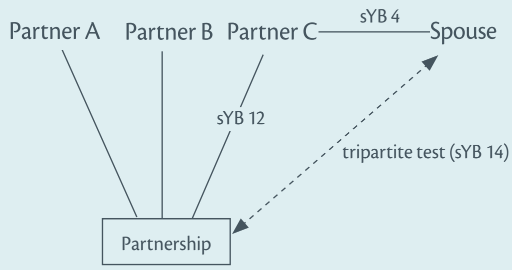


A, B and C are individuals who are partners in a partnership. Under the partnership and partner test in section YB 12, Partners A, B, and C are each associated with the partnership. However, they are not associated with each other under the tripartite test in section YB 14 through their association with the partnership. The partners may still be associated with each other under a different associated persons test. For example, if partners B and C were married they would be associated with each other under the relatives test in section YB 4.

The test associating a partnership and an associate of a partner in former section YB 17 has been subsumed by the new tripartite test in section YB 14, which associates two persons if they are each associated with the same third person under different associated persons tests. This means that an associate of a partner, such as a spouse of a partner, would still be associated with the partnership itself, as illustrated in the following example.

Example

Partnership and associate of a partner: association through tripartite test



In this example, the spouse of Partner C is associated with Partner C under the relatives test in section YB 4, and Partner C and Partnership are associated under the partnership and partner test in section YB 12. Therefore, applying the tripartite test, Spouse and Partnership are associated persons as they are each associated with the same third person (Partner C) under different associated persons tests.

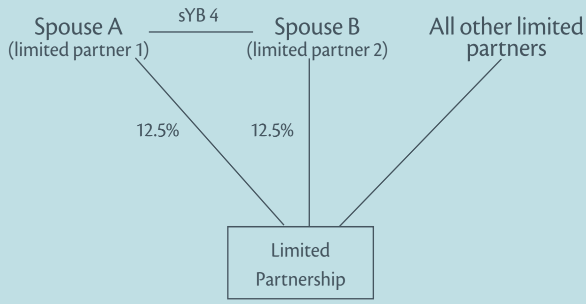
Limited partnerships

There is a separate test for determining if a limited partnership and a limited partner are associated. A limited partnership (as defined in section YA 1 of the Income Tax Act 2007) and a limited partner are associated only if the limited partner has a partnership share of 25% or more in the limited partnership (section YB 12(2)). This treatment is appropriate because a limited partner cannot be involved in the management of the partnership (unlike in a general partnership). It should be noted that section YB 12(2) is limited to the limited partners and not the general partner in a limited partnership. A general partner in a limited partnership will be associated with the limited partnership under section YB 12(1).

Section YB 12(3) and (4) contain aggregation rules for limited partnerships, similar to the aggregation rules in the company and person other than a company test in section YB 3 (the aggregation rule in section YB 12(3) applies for the purposes of the whole Act except the land provisions, and the more limited aggregation rule in section YB 12(4) applies for the purposes of the land provisions). This is appropriate given that a limited partner is more akin to a shareholder in a company and the interest threshold for associating a limited partner in a limited partnership – 25% – is the same as the threshold in section YB 3.

Example

Aggregation rule for limited partnership



In this example, in the absence of an aggregation rule, Spouse A and Spouse B would not be associated with Limited Partnership, as their respective shares in the partnership do not meet the required 25% threshold. However, applying the aggregation rule for limited partnerships in section YB 12(3), both Spouse A and Spouse B would be associated with Limited Partnership. This is because for the purposes of determining whether Spouse A is associated with Limited Partnership under section YB 12(2), Spouse A is treated as holding anything held by associates – in this case, Spouse A is associated with Spouse B under the relatives test in section YB 4. When Spouse A's 12.5% share in Limited Partnership is aggregated with his associate's (Spouse B) 12.5% share, the required 25% threshold is met and Spouse A is therefore associated with Limited Partnership under section YB 12(2).

Once again, the aggregation rule is applied afresh to each person. As a result, the aggregation rule is also applied in this case to associate Spouse B with Limited Partnership. This is consistent with the application of the aggregation rule in the company-related tests.

Tripartite test (section YB 14)

The tripartite test in section YB 14 associates two persons if they are each associated with the same third person under different associated persons tests.

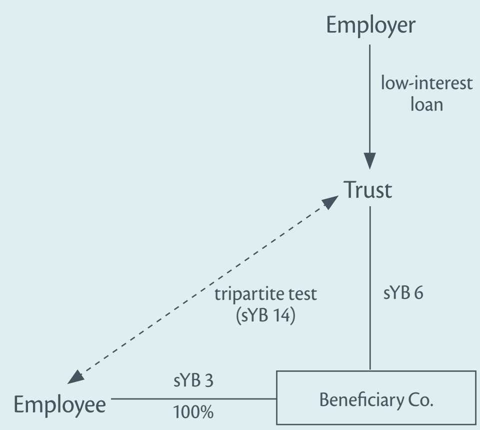
The tripartite test acts as an important buttress to the other associated persons tests and makes the associated persons definition as a whole more difficult to circumvent.

For the tripartite test to associate two persons, each of these persons must be associated with the same third person under different associated persons tests, not including the tripartite test itself. The requirement that the two persons cannot be associated with the same third person under the tripartite test itself is necessary to prevent the tripartite test operating in a reiterative manner. The requirement that the two persons have to be associated with the same third person under different associated persons tests ensures that the tripartite test does not apply more widely than is necessary to protect the tax base.

The examples below illustrate the important role of the tripartite test in preventing the other associated persons tests being circumvented by arrangements involving the interposition of relatives, companies and trusts which are under the influence or control of the main protagonists.

Example

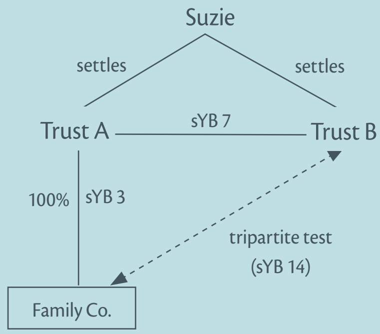
Application of the tripartite test



In this example, the employer makes a low-interest loan to Trust which in turn makes a distribution to Beneficiary Co. which is wholly owned by an employee of the employer. The tripartite test in section YB 14 associates Trust with the employee because they are both associated with Beneficiary Co. In particular, Trust is associated with Beneficiary Co, under the trustee-beneficiary test in section YB 6 and the employee is associated with Beneficiary Co. under the test in section YB 3 associating a company and a person other than a company. As a result, because the employer has provided a fringe benefit (the low-interest loan) to an associate of an employee, the employer would have to account for FBT on the low-interest loan.

Example

Application of the tripartite test

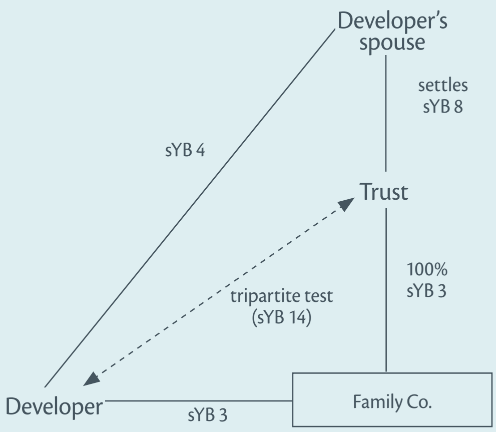


In the above example, Suzie settles two family trusts: Trust A and Trust B. Trust A in turn owns all the shares in Family Co. The issue is whether Family Co. is associated with Trust B.

Without a tripartite test, Family Co. and Trust B would not be associated, despite the close community of interests between them. However, under the tripartite test in section YB 14, Family Co. and Trust B are associated. In particular, Family Co. is associated with Trust A under the company and person other than a company test in section YB 3, and Trust A is associated with Trust B under the two trustees with a common settlor test in section YB 7. Therefore, under the tripartite test, Family Co. and Trust B are associated persons.

Example

Application of the tripartite test and the aggregation rule



In this example, Developer's spouse settles Trust, which in turn owns all the shares in Family Co. The issue is whether Developer is associated with Family Co. under the test associating a company and a person other than a company in section YB 3.

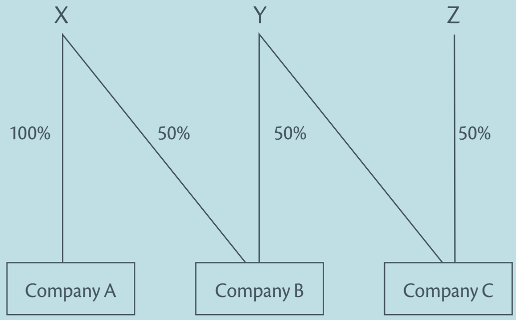
Developer would be associated with Family Co. under the company and person other than a company test because of the application of the aggregation rule in that test, in conjunction with the tripartite test. In particular, Developer would be treated for the purposes of the company and person other than a company test as holding all the shares held by Trust in Family Co. This is because Trust is associated with Developer under the tripartite test: Developer is associated with his spouse under the relatives test (section YB 4) and Developer's spouse is associated with Trust under the trustee and settlor test (section YB 8), which means that Developer is associated with Trust under the tripartite test.

Without the tripartite test in section YB 14 and the rule in the company and person other than a company test aggregating interests held by associated persons, Developer would not be associated with Family Co. even though there is a large community of interest between them.

Different associated persons requirement

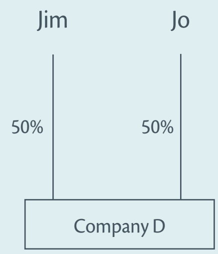
The requirement in the tripartite test in section YB 14 that the two persons have to be associated with the same third person under different associated person tests is designed to prevent the tripartite test applying more widely than is necessary to protect the tax base. This requirement is illustrated by the following examples.

Example



In this example, individuals X, Y and Z, who are not associated with each other, own all the shares in Company A, Company B and Company C. Without the different associated persons tests requirement, Company A and Company C would be associated under the tripartite test in section YB 14, despite not having any common shareholders. However, because Company A and Company C are each associated with Company B under the same two companies test in section YB 2, they are not associated under the tripartite test.

Example



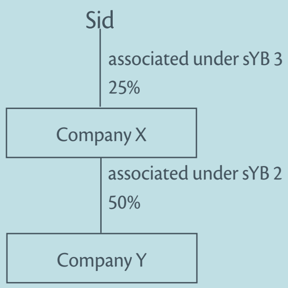
In this example, Jim and Jo, who are not separately associated with each other, each hold 50% of the voting interests in Company D and are therefore each associated with Company D under the test in section YB 3 associating a company and a person other than a company. Without the different associated persons tests requirement, Jim and Jo would be associated under the tripartite test. However, because Jim and Jo are each associated with Company D (the common third person) under the same test (section YB 3), they are not associated under the tripartite test in section YB 14.

Exception for companies tests (section YB 14(2))

As well as not applying to associate two persons if they are each associated with the same third person under the same associated persons test, the tripartite test will not associate two persons if they are each associated with the same third person under the company-related tests in sections YB 2 and YB 3.

Example

Tripartite test: Companies tests exception



In this example, Sid is associated with Company X under the company and person other than a company test in section YB 3, and Company X and Company Y are associated under the two companies test in section YB 2.

Without the companies tests exception in section YB 14(2), the tripartite test would apply to associate Sid and Company Y (Company X being the common third person). This would be the case even though Sid only has a 12.5% interest in Company Y – the product of multiplying Sid's 25% interest in Company X by Company X's 50% interest in Company Y – which is below the 25% threshold in the company and person other than a company test in section YB 3. The companies test exception in section YB 14(2) ensures that Sid is not associated with Company Y under the tripartite test.

Exceptions for certain trusts and charitable organisations (sections YB 16 and YB 8(2))

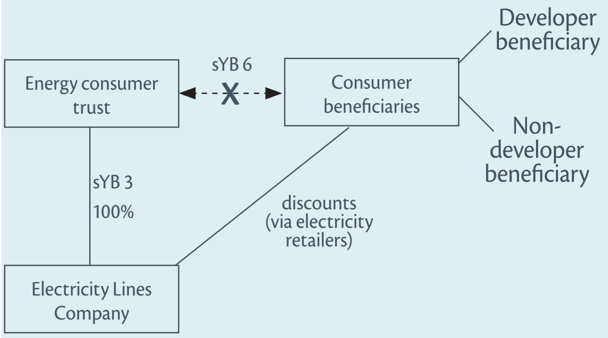
Energy consumer trusts and bonus bonds unit trust

Under section YB 16(1), a lines trust established under the Energy Companies Act 1992, commonly referred to as an energy consumer trust, is excluded from the trustee for relative test (section YB 5) and the test associating trustees and beneficiaries (section YB 6). This is because such trusts are public in nature and do not pose a risk to the tax base. Such large public trusts are different in nature from private trusts which are intended to be subject to the associated persons tests.

Excluding energy consumer trusts from the tests in sections YB 5 and YB 6, ensures that discounts to consumers from electricity lines companies owned by consumer trusts are not treated as dividends, as illustrated in the following example.

Example

Exception for energy consumer trusts



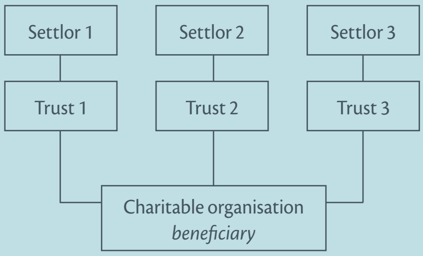
The exception for energy consumer trusts also prevents consumer beneficiaries from being associated with one another. Even without this exception, the scope of the tripartite test is such that it would not apply to treat consumer beneficiaries as associated persons. Using the above example, this means that the developer beneficiary and the non-developer beneficiary will not be associated persons. This is because they are both associated with the same third person (Energy consumer trust) under the same associated persons test, namely the trustee and beneficiary test in section YB 6, which means that the tripartite test does not apply.

Additionally, section YB 16(1) also excludes the unit trust that administers bonus bonds from the associated persons tests in section YB 5 and YB 6 because of its public nature. This unit trust is excluded from the unit trust definition in section YA 1 of the Income Tax Act 2007, and therefore is not treated as a company, which means that the trust-related associated persons tests could potentially apply to it.

Charitable organisations

Under section YB 16(2), "charitable organisations" (as defined in section YA 1 of the Income Tax Act 2007) are not treated as beneficiaries for the purposes of tests associating trustees and beneficiaries (section YB 6) and settlors and beneficiaries (section YB 9).

Example



Without the exception for charitable organisations in section YB 16(2), the beneficiary-related tests could have unintended consequences. For example, if the beneficiary of several unrelated trusts is the same charity, the trustee and settlor of each such trust could end up being associated with the trustees and settlors of the other trusts without being aware of the fact. This exception therefore ensures that trustees and settlors of trusts in this situation are not treated as associated persons simply because the same charity is a beneficiary under their trusts.

Charitable trusts

The trustee and settlor test in section YB 8 does not apply if the trust is a charitable trust. This exception – section YB 8(2) – prevents donors to a charitable trust being associated with each other. A charitable trust under the Income Tax Act 2007 is required to be registered as a charitable entity under the Charities Act 2005 and is therefore subject to any regulatory requirements of that Act. Such charities do not pose a risk to the tax base and therefore it is not necessary to include them in the trustee and settlor associated persons test.

Rationalising associated persons references in operative provisions

A number of operative provisions in the Income Tax Act 2007 previously contained modifications or additional wording in their associated persons references. These modifications were a result of different combinations of the associated persons tests in former subpart YB applying, in particular, the tests that applied for the purposes of the whole Act (excluding the 1973, 1988 and 1990 version provisions) or the 1988 version provisions (corresponding to the associated persons definitions in sections OD 7 and OD 8(3) of the Income Tax Act 2004). An example of such a provision was section EX 21(15).

These modifications to the associated person references in the operative provisions of the Income Tax Act 2007 have been generally omitted because they have been effectively subsumed by the various reforms to the associated persons tests in new subpart YB. The wording of these operative provisions therefore has been significantly simplified because they will simply refer to persons being associated without more (for example, without various references to the 1973, 1988 or 1990 version provisions). As a result, the wording of the associated person references in the operative provisions of the Income Tax Act 2007 are now streamlined and easier to understand.

For example, the wording of section GB 28(2) was:

> "A person is treated as being associated with another person if a person would be treated as being associated under the parts of subpart YB (associated persons and nominees) that apply for the purposes of the whole Act (excluding the 1973, 1988, and 1990 version provisions), or the 1988 version provisions, at the time the services are personally performed by the working person."

This wording has been replaced by:

> "A person is treated as being associated with another person if they are associated at the time the services are personally performed by the working person."

The definitions of the 1973, 1988 and 1990 version provisions and previous section YB 20 have been repealed because they are largely subsumed by the various reforms to the associated persons tests in subpart YB. These definitions equate to the lists of operative provisions to which the former specific associated persons definitions in sections OD 8(4), OD 8(3) and OD 8(1) of the Income Tax Act 2004 applied. However, because of the various modifications that apply in the associated persons tests in relation to the land transaction provisions, previously defined as the "1973 version provisions", this definition has been re-enacted in section YA 1 and called "land provisions".

The new associated persons definition in the Income Tax Act 2007 also applies in the Tax Administration Act 1994 because of section 3(2) of the Tax Administration Act 1994.

A number of the specific modifications or additional wording in the associated persons references in the operative provisions in the Income Tax Act 2007 were incorrect. These references have been corrected applicable from the commencement of the Income Tax Act 2007 on 1 April 2008, even though these references themselves have been omitted as part of these reforms of the associated persons definitions. It is necessary to correct these references from the commencement of the Income Tax Act 2007 on 1 April 2008 because the current associated person reforms do not apply generally until the 2010–11 income year.

Section CD 6(1)(a)(iii) repealed

A transfer of value from a company to a person is a dividend if the cause of the transfer is a shareholding in the company as described in section CD 6 of the Income Tax Act 2007.

Section CD 6(1)(a)(iii) contained an extension which treated as a dividend any distribution made by a company to a trust under which a shareholder of the company, or spouse, civil union or de facto partner of the shareholder, was a beneficiary. This trust extension rule has been repealed because its function is performed by the new associated persons definition – in particular, the trustee-beneficiary test in new section YB 6.

Section CD 22(9) amendment

The definition of "fifteen percent interest reduction" in section CD 22(9), which relates to the share buy-back exclusion from the dividend definition, refers to "counted associate", which is defined inter alia as "a trustee of a trust under which a spouse, civil union partner or de facto partner, or minor child of the shareholder is a beneficiary". This wording has been amended so that it is consistent with other references in the associated persons definitions which describe discretionary beneficiaries. The provision now refers to a person who has benefited or is eligible to benefit under a trust (instead of referring to a beneficiary).

Section DB 42(2) amendment

Section DB 42(1) allows a taxpayer a deduction for any loss arising through misappropriation by an employee. Former section DB 42(2) stated that this deduction was not available if the taxpayer and the defalcating employee were associated in certain ways.

The new associated persons definition is comprehensive enough to cover all the relationships described in former section DB 42(2). Therefore the specific associated persons tests in this provision have been replaced by a standard associated persons reference. New section DB 42(2) simply provides that the section does not apply when a person who misappropriates property is associated with the person who carries on the business.

Omitted tests

Several associated persons tests contained in the previous subpart YB of the Income Tax Act 2007 have been omitted for simplification and rationalisation purposes. These omitted tests were:

- The test associating two persons if they habitually act together (former section YB 18).
- The test associating a person and a charity, friendly society, or non-profit body controlled by that person or a relative of that person (former section YB 19).
- The tests associating two companies and a company and a person other than a company, which were based on income interests (former sections YB 3 and YB 7). These tests were redundant given the equivalent comprehensive tests based on voting interests. The existence of these tests can be explained historically by the fact that they were originally enacted in 1988 before the voting interest concept was enacted in 1992.
- The test associating a partnership and an associate of a partner (former section YB 17). This test has been subsumed by the new tripartite test in section YB 14. Under the tripartite test two persons are associated if they are each associated with the same third person under different associated persons tests. This means that an associate of a partner, such as a spouse of a partner, would still be associated with the partnership under the tripartite test.

Rationalisation of other income tax provisions

A number of provisions in the Income Tax Act 2007 embodying a related person concept, similar to that in the associated persons definitions, have been rationalised. It is desirable, from a simplification perspective, that similar concepts in the Act be addressed similarly.

Replacing company control definition with associated persons definition

Section YC 1 of the Income Tax Act, which defined when a company was treated as being under the control of any persons, has been repealed. Its function is now performed by the new associated persons definition.

The definition of company control in section YC 1 and the definitions of associated persons in subpart YB are conceptually similar in that they define related parties for the purposes of operative provisions in the Income Tax Act 2007. The separate use of the section YC 1 company control definition rather than the associated persons definitions was probably a legacy of the company control definition being developed in the Income Tax Act before the associated persons definitions. The company control definition in the Act was first implemented in 1939, whereas the first associated persons definition in the Act was not enacted until 1968.

Allowing section YC 1 to be subsumed by the new associated persons definition is a desirable simplification measure.

The provisions in the Income Tax Act 2007 which previously employed the section YC 1 definition of company control, have been amended to use the new associated persons definition. They are:

- section GC 5 (leases for inadequate rent);
- section RF 11 (dividends paid to companies under control of non-residents); and
- paragraph (a) of the definition of "holding company" in section YA 1.

Replacing related person definition with associated person definition

Former section CD 44(15) to (17) of the Income Tax Act 2007 contained a definition of "related person" which was used in section CD 44(11) and (12) to determine the amount of the capital gain exclusion from a dividend arising from the realisation of a capital asset in the course of a company's liquidation. As part of the amendments to rationalise the Income Tax Act provisions which embody an associated persons concept, the function of the former related person definition in section CD 44 will be performed by the new associated person definition.

Section CD 44(11) and (12) have been replaced by section CD 44(10A) and (10B) with associated persons references replacing related persons references. The new provisions apply for capital gain amounts derived or losses incurred after 31 March 2010, therefore ensuring that the changes have prospective application only.

For capital gain amounts derived or capital loss amounts incurred between 1 April 1988 to 31 March 2010, the previous law which used the related person definition continues to apply. This law contained in former section CD 44(11), (12) and (15) to (17), is now contained in section CZ 9B of the Income Tax Act 2007.

The references to related persons in the dividend definition in section YA 1 have also been replaced with references to associated persons.

Definition of "relative"

The definition of "relative" in section YA 1 of the Income Tax Act 2007 has been simplified so that it extends only to the second degree of blood relationship. Previously the definition also extended for the purposes of some provisions to the fourth degree of blood relationship. The new definition of relative includes a trustee of a trust under which a relative has benefited or is eligible to benefit – this continues the effect of paragraph (c)(v) of the old relative definition.

Application of changes to other Acts

A number of provisions in other Acts, which utilise the associated persons definitions in the Income Tax Act 2007, have been consequently amended as a result of these reforms. The provisions in these other Acts are:

- Fisheries Act 1996, section 59(10)(c) and (d);
- Misuse of Drugs Amendment Act 2005, section 31;
- Privacy Act 1993, section 6;
- Radiocommunications Act 1989, sections 153(2) and 161(2); and
- Smoke-free Environments Act 1990, section 2(1).

A number of provisions in other Acts also utilised former section YC 1 of the Income Tax Act 2007, which defined when a company was treated as being under the control of any persons. These references to section YC 1 have been replaced with references to the new associated persons definition in the Income Tax Act 2007. The provisions in these other Acts are:

- Insolvency Act 2006, section 182(1);
- Public Service Investment Society Management Act (No.2) 1979, section 2(2);
- Trustee Companies Management Act 1975, section 2(2); and
- Unit Trusts Act 1960, section 3(4).

OTHER POLICY MATTERS

TAX TREATMENT OF TRANSACTIONS IN EMISSIONS UNITS

Sections CB 36, CX 51B, DB 60, DB 61, EB 2, ED 1, ED 1B, EW 5, GC 1 and YA 1 of the Income Tax Act 2007; sections 2 and 11A of the Goods and Services Tax Act 1985

The legislation deals with the income tax treatment of transactions in emissions units outside the forestry sector. The amendments ensure that the tax treatment of emissions units is clear, that income and expenditure are recognised appropriately, and that unintended distortions do not arise.

Emissions units are treated as excepted financial arrangements which are revenue account property. Emissions units purchased will generally be deductible on acquisition, but added back at cost at year-end to the extent they are still on hand. Income from the receipt of emissions units from government is assessable on an accruals basis.

The amendments to the GST legislation ensure that emissions acquisitions and disposals of emissions units can take place across international electronic markets. The supply of emissions units is almost always zero-rated for GST purposes. Supplies made by businesses to government for the receipt of emissions units under the Permanent Forest Sink Initiative (PFSI) are now also zero rated.

These changes ensure that the tax treatment of transactions in emissions units is clear, and consistent with both the government's objectives in introducing an emissions trading scheme and coherent tax policy.

Background

The government introduced an emissions trading scheme in the Climate Change Response (Emissions Trading) Amendment Act 2008. That Act inserts provisions into the Climate Change Response Act 2002, under which:

- businesses in certain sectors will be required to surrender emission units based on their emissions; and
- the government may allocate "free" emission units to businesses in certain sectors.

For more information on the emissions trading scheme see **www.climatechange.govt.nz/emissions-trading-scheme**.

Previously, the taxation treatment of transactions in emissions units was sometimes unclear, and inconsistent with the government's climate change objectives or coherent tax policy.

Proposals for the tax treatment of transactions in emissions units were set out in the government discussion document, *Emissions Trading Tax Issues*, released in September 2007 **(www.taxpolicy.ird.govt.nz/publications/files/emissions.pdf)**.

Some amendments to the tax legislation were made by the Climate Change Response (Emissions Trading) Amendment Act 2008. The Act amended tax legislation to:

- provide for the income tax treatment of forestry businesses which participated in the emissions trading scheme; and
- generally GST zero-rate transactions in emissions units.

An explanation of these amendments can be found in *Tax Information Bulletin*, Volume 20, No. 9 (November 2008) – see **www.ird.govt.nz/technical-tax/tib/vol-20/issue-09**.

The new rules follow on from the amendments above, and deal with the income tax treatment of businesses outside the forestry sector. They also make some further GST amendments.

In the interests of simplicity and coherency, the earlier income tax amendments have been rewritten and incorporated into the new rules.

Key features

New provisions in the Income Tax Act 2007 provide for the tax treatment of emissions trading units.

The amendments address transactions which arise under the emissions trading scheme, and other transactions in emissions units – such as the sale of emissions units by one business to another. Certain amendments also apply to "voluntary" emissions units – units which are not used in the emissions trading scheme.

Most costs of emissions trading will be tax deductible, and the government subsidy (the award of "free" emission units by government) of emissions costs will generally be taxable. The specific taxation treatment varies depending on the emissions type, of which there are four:

- non-forestry – generally dealt with on an accruals basis;
- post-1989 forestry – dealt with on a cash basis;
- pre-1990 forestry where the land is held on capital account – outside the tax system; and
- pre-1990 forestry where the land is held on revenue account – special rules apply.

There are special rules for the surrender of emission units to government.

The government subsidy is recognised on an accruals basis, by reference to the accruing costs or liability for which the subsidy is intended to compensate.

Emissions units are treated as excepted financial arrangements that are revenue account property. Emissions units are generally deductible upon acquisition, but added back at cost at year-end to the extent they are still on hand.

Application date

The amendments to the Income Tax Act apply from 1 January 2009.

Amendments to the GST Act relating to Kyoto-compliant and other "official" emissions units apply from the date of Royal assent, being 6 October 2009. GST amendments for "unofficial" or voluntary units take effect from 1 April 2010.

DETAILED ANALYSIS

The underlying objective of the income tax amendments for the non-forestry sector is to treat transactions in emissions units as revenue account transactions. Emissions units are excepted financial arrangements, so are generally valued at cost with no annual revaluation and consequent gains and losses. Income and expenditure arising under the emissions trading scheme is recognised on an accruals basis, consistent with ordinary tax and accounting practice.

Except where otherwise indicated, the commentary below applies only to New Zealand units, Kyoto and other "official" units – defined in section YA 1 as "emissions units".

At the end of this section there is a comprehensive example of the income tax treatment of a non-forestry business.

Underlying basis of taxation

Emissions units are defined as trading stock in section EB 2, and as excepted financial arrangements in section EW 5. Section ED 1 contains new provisions which require businesses which hold emissions units received from more than one source (for example, units awards for carbon capture in a post-1989 forest, and units purchased on the open market) to be kept in separate "pools" for valuation purposes. This is to ensure that the correct tax treatment can be applied to each different type of unit when selling, surrendering, or valuing at the end of the year.

Certain "unofficial" units are also treated as revenue account property and excepted financial arrangements. These are emissions units which are issued by reference to greenhouse gases and which are verified to an internationally recognised standard. (See the definition in section YA 1 of "non-Kyoto greenhouse gas unit".)

Disposal of emissions units

New section CB 36 deals with the disposal, including by way of surrender, of emissions units. In general, an amount received on the disposal of an emissions unit is treated as income.

If the emissions unit is surrendered to meet an obligation relating to post-1989 forestry land or pre-1990 forestry land held on revenue account, the unit is treated as being sold for zero.

If the emissions unit is a post-1989 forest land emissions unit but is surrendered to meet a liability which does not relate to post-1989 forest land, or it is a unit granted by government outside the forestry context and which has not yet been brought into account for tax purposes, it is treated as being sold for market value.

In all other circumstances, surrender is treated as a sale for cost. This is because the business will have already received the deduction for the liability to surrender units on an accruals basis.

Separate provision has been made in section CX 51B for the disposal of emissions units awarded by the government in relation to pre-1990 forestry land which is not held on revenue account. Because the award of these units is to compensate for the fall in value of the land – a capital transaction – the disposal of these units gives rise to excluded income. The classification as excluded rather than exempt income is to ensure that there is no impediment to claiming interest deductions relating to this forestry land.

Deduction for emissions liabilities outside the forestry sector

There are no specific provisions providing deductions for emissions liabilities outside the forestry sector. This is because ordinary principles are sufficient to provide a deduction on an accruals basis. The year-end deduction for each business will be determined by:

- calculating the business's liability to surrender units under the emissions trading scheme which is attributable to the income year, in accordance with the methodology prescribed under the Climate Change Act (almost certainly the same calculation as will be made for financial reporting purposes);

- to the extent that the business has purchased and still holds at the end of the income year any emissions units, the cost of those units (limited to the income year liability); and
- to the extent the business holds fewer units than the income year liability, that shortfall multiplied by the market value of a New Zealand unit at the end of the income year (or, if a proposed price cap is implemented and applicable, the amount of the price cap).

Emissions units awarded without payment by the government are not netted off in this calculation – they are brought in as income separately under express statutory provisions.

The application of ordinary principles to post-1989 forestry land and pre-1990 forestry land held on revenue account is expressly denied by section DB 61. This is because forestry businesses obtain their deduction by way of the rule which states that emissions units surrendered for liabilities arising from this type of land are treated as being sold for zero.

Recognition of income when subsidy units are allocated by government (non-forestry)

Certain non-forestry businesses will be allocated units without payment under the emissions trading scheme. These are some of the businesses which face increased costs as a result of the introduction of the emissions trading scheme, either in the form of a new liability to surrender emissions units, or increased costs, such as higher electricity prices.

The principle behind these amendments is that income arises from the free allocation of these units, but that income should be recognised on an accruals basis. Income from the award of units is matched to the expenses for which the award compensates. The section is primarily required to deal with the fact that allocations of units will relate to an emissions year, which is a year ending 31 December, whereas many businesses do not have income years ending 31 December. Income recognition is triggered by assigning the units a market value – in the absence of a market value being assigned, the units will have a zero value.

Section ED 1B applies when emissions units have been allocated to the business by government, the emissions units do not relate to forestry, and the section has not previously valued the units at market value.

When first allocated, these units have a value of zero – see section ED 1(7B)(a).

If the emissions year to which the units relate has not started at the end of the income year, the emissions units continue to have a value of zero. If the emissions year finishes during or at the end of the income year, the emissions units have a value of the market value of those emissions units at the end of the income year.

If the emissions year has started at the end of the income year, but has not yet finished, section ED 1B applies to value some of the units received at market value, and the remainder at nil.

A simple pro-rating calculation is applied to determine the number of units which are to be given a market value.

The primary basis for the pro-rating calculation is by reference to the business's emissions. So, if the business expects to have a total emissions liability of 1,000 units for the emissions year, and at the end of the income year emissions total 200 units, then 200/1000, or 20%, of whatever number of units have been allocated for the year are assigned a market value, with the remainder having a nil value. The remaining units will probably be assigned a market value at the end of the next income year, under the rule that all emissions units which relate to an emissions year which has finished are assigned a market value.

If the business cannot estimate its emissions liability for the emissions year or the accrued liability at the end of the income year, a pro-rating by reference to the number of days of the emission year which have elapsed in the income year can be used.

There are two important variations to the rules described above.

First, some businesses which receive subsidy emissions units will be facing indirect cost increases (such as a higher electricity price) rather than a direct liability to surrender emissions units. These businesses should use the relevant cost (such as expenditure on electricity), if they can determine it, in the pro-rating formula in place of emissions.

Secondly, some businesses might sell emissions units received before the end of the income year. The sale proceeds are brought into account under other provisions. This other income recognition is taken into account in the pro-rating formula – so if, in the scenario discussed above, the business had already sold 20% or more of its free allocation of units, no further units would be assigned a market value. If it had sold less than 20%, the difference between 20% and the number of units already sold would be assigned a market value.

Anti-avoidance rules

Because emissions units are trading stock, the anti-avoidance rule in section GC 1 applies. Transactions at less than market value are deemed to take place at market value. However, the surrender of emissions units is expressly excluded from section GC 1.

Example: Income tax calculations for a non-forestry business

On 1 January 2015, AB Co begins manufacturing product Z for export. Carbon dioxide is emitted as part of manufacturing product Z, and the provisions of the Climate Change Act require AB Co to surrender the commensurate number of emission units following the end of each emissions year.

The government issues an allocation plan under the provisions of the Climate Change Act under which businesses that make product Z for export are entitled to receive "free" emission units.

AB Co is issued 100 free units for the emissions year which runs from 1 January to 31 December 2015. AB Co's expected emissions liability for the emissions year is 800 units. AB Co has a 30 June balance date. On 30 April 2015, AB Co buys a further 150 emissions units for $8 each. On 30 June 2015, emission units are trading at $10 each.

The following calculations are required for AB Co's 2014–15 tax return.

Under existing law, AB Co will be entitled to a deduction on an emerging basis for its emissions obligations. AB Co produces the same amount of product Z every month in the same way, so management knows that emissions are exactly the same level every month. At the end of the 2014–15 income year, the proportion of the emissions liability to be recognised is 6/12 x 800 units = 400 units. The fraction 6/12 is simply the number of months in the 2015 emissions year which have elapsed at the end of the 2014–15 income year.

The 2014–15 income year deduction for the accrued liability to surrender 400 units will be calculated as follows:

- 150 units x $8 = $1,200. This is the portion of the liability matched to the 150 units which have been purchased, valued at the cost price of those units.
- 250 units x $10 = $2,500, which is the remaining portion of the liability, valued at the market value of those units at balance date. Any variance between the year-end market value and the eventual actual cost of the 250 units required will be brought to account in the following income year.

The 100 free units are not relevant to calculation of the deduction.

The total deduction for the liability accrued in 2014–15 to surrender 400 units is therefore $1,200 + $2,500 = $3,700.

The approach taken to recognition of the income from the 100 free units is similar. Income from the 100 allocated units will be recognised over the period to which the allocation applies, on a basis which matches the allocated units to the costs for which they are intended to compensate.

AB Co will therefore recognise as income the value of 400/800 x 100 units = 50 units at the end of its 2014–15 income year. The fraction 400/800 is the number of units of emissions actually emitted in the 2015 emissions year at the end of the 2014–15 income year, divided by the number of units of emissions expected for the entire 2015 emissions year. This is the same pro-rating formula used to determine the deduction above.

The balance date market value of the units is used to calculate the income, so this is 50 units x $10 = $500.

However, if the 100 units were sold immediately upon receipt for $8 each (and this might occur if the business does not have a direct emissions obligation, but rather is downstream from a business with emission obligations), then the sale proceeds of $800 would be income. The units sold would have no cost base.

The increase in the market value of the 150 emissions units held from $8 to $10 each is not brought into account.

GST amendments – background

As noted earlier, transactions in emissions units were generally zero-rated by amendments introduced in the Climate Change Act.

Technical amendments have been made to reflect the original policy intention of the provisions introduced in the Climate Change Act, particularly in relation to emissions units which are transferred by the government under schemes outside the Climate Change Act.

Amendments have also been made to extend zero-rating to emissions units which are not New Zealand units, Kyoto-compliant emissions units or approved overseas units (sometimes called "voluntary" or "unofficial" units).

A table showing the GST position of different transactions at different times is set out at the end of this TIB item.

GST treatment of Permanent Forest Sink Initiative transactions in units

The Permanent Forest Sink Initiative (PFSI) is a government scheme under which landowners can establish permanent forest sinks on land that was not forested on 31 December 1989, and receive emissions units reflecting the amount of carbon sequestered in their forests. For more information, see **www.maf.govt.nz/forestry/pfsi**.

The zero-rating of the transfer of emissions units by the government under PFSI has been added to paragraph (s).

This change has the consequential effect of zero-rating the supply of services made by the forester in exchange for the emissions units (whether it is an actual supply or a deemed supply under section 5(6D)).

The change applies from the date of Royal assent, being 6 October 2009.

GST treatment of other transfers of emissions units by government

Section 11A(1)(v) was introduced by the Climate Change Act. It was intended to zero-rate transactions in emissions units in the private sector, and the sale of emissions units by the government. It was not intended to apply when the government transfers emissions units without payment. The section has been amended to make this clear. Accordingly, the transfer of emissions units by government under schemes such as the Project to Reduce Emissions (PRE) and Negotiated Greenhouse Agreements (NGAs) revert to being standard-rated, although any subsequent transfers of these units by recipients will be zero-rated under paragraph (v).

The change applies from the date of Royal assent, being 6 October 2009.

Zero-rating of transfers of other types of emissions units

The provisions referred to above apply to transactions in New Zealand units, Kyoto-compliant units and approved overseas units.

New provisions also zero-rate certain other emissions units which do not fall within this description – sometimes called “grey market” or “voluntary” units.

The new provisions apply to units which are:

- issued by reference to the sequestration, or avoidance of emission, of human-induced greenhouse gases; and
- verified to an internationally recognised standard.

Examples of the type of units which will qualify for zero-rating under the new rules are Voluntary Carbon Standard units (**www.v-c-s.org**) and Gold Standard units (**www.cdmgoldstandard.org**).

The change applies from 1 April 2010.

Table: Summary of GST treatments

The following table sets out the GST treatment of different emissions units transactions.

Transaction	From / to	GST treatment	Legislative reference
Common transactions – New Zealand units, Kyoto-compliant units and approved overseas units			
All supplies of emissions units.	before 1 January 2009	standard-rated	ordinary provisions
All supplies of services (deemed or actual) made in exchange for emissions units.	before 1 January 2009	standard-rated	ordinary provisions
Transfer of emissions units by government under s64 or part 4, subpart 2, of the Climate Change Response Act 2002.	1 January 2009 onwards	zero-rated	GST Act s11A(1)(s)
All supplies of services (deemed or actual) made in exchange for emissions units transferred by government under s64 or part 4, subpart 2, of the Climate Change Response Act 2002.	1 January 2009 onwards	zero-rated	GST Act s11A(1)(u)
Surrender of emissions units under s63 of the Climate Change Response Act 2002.	1 January 2009 onwards	zero-rated	GST Act s11A(1)(t)
Supply of New Zealand units and Kyoto-compliant emissions units not involving the government.	1 January 2009 onwards	zero-rated	GST Act s11A(1)(v)
Voluntary units			
All supplies of voluntary units.	before 1 April 2010	standard-rated	ordinary provisions
All supplies of services (deemed or actual) made in exchange for voluntary units.	at all times	standard-rated	ordinary provisions
All supplies of voluntary units.	1 April 2010 onwards	zero-rated	GST Act s11A(1)(w)
Transactions involving the government outside the Emissions Trading Scheme			
Transfer of emissions units by government other than under s64 or part 4, subpart 2, of the Climate Change Response Act 2002 (eg, PFSI, PRE and NGA).	1 January 2009 to 6 October 2009	zero-rated	GST Act s11A(1)(v) before amendment by this Act
Supplies of services (deemed or actual) made in exchange for emissions units transferred by government other than under s64 or part 4, subpart 2, of the Climate Change Response Act 2002 (eg, PFSI, PRE and NGA).	1 January 2009 to 6 October 2009	standard-rated	ordinary provisions
Transfer of emissions units by government under PFSI.	6 October 2009 onwards	zero-rated	GST Act s11A(1)(s)(iii)
Supply of services (deemed or actual) made in exchange for emissions units transferred by the government under PFSI.	6 October 2009 onwards	zero-rated	GST Act s11A(1)(u)
Transfer of emissions units by government other than under s64 or part 4, subpart 2, of the Climate Change Response Act 2002 or PFSI (eg, PRE).	6 October 2009 onwards	standard-rated	ordinary provisions

STAPLED STOCK

Sections CD 22(9), DB 10B, DP 8(3), EX 5(5)(c), EX 9(6)(c), EX 30(6)(c), FA 2(4)(b), FA 2(5)(c), FA 2B, FE 15(1) and (2), FE 21(4B), HD 14(2)(a), and YA 1 of the Income Tax Act 2007; sections CD 14(9), DB 8B, DP 7(3), EX 5(5)(c), EX 9(6)(c), EX 31(6)(c), FC 1(4), FC 2(4B), FC 2B, FG 4(2)(b), FG 8G(1), HK 13(1), LF 2(3), and OB 1 of the Income Tax Act 2004

Under the new rules, certain debt securities stapled to shares are to be treated as shares for most tax purposes.

Background

The amendments are intended to bring tax rules up-to-date with developments in financial markets and prevent a potentially serious loss to the revenue base. Previously, using stapled stock instruments with debt components, companies could pay tax-deductible interest to shareholders as a substitute for dividends. The issue becomes particularly acute if the instruments are issued to foreign investors in New Zealand companies. The amendments ensure that when a debt instrument that would normally give rise to tax deductions is stapled to a share it will be treated as equity for tax purposes.

The amendment was added to the bill post-introduction through Supplementary Order Paper No. 224.

Key features

- Debt securities "stapled" to ordinary shares will generally be treated as shares rather than debt for most tax purposes.
- The debt security component of the stapled stock instrument continues to be treated as debt under the thin capitalisation rules unless it is stapled in proportion to the available subscribed capital of all participating shares.
- Key exclusions include debt securities stapled to the share before 25 February 2008, debts stapled only to fixed-rate shares, and debts of a non-widely held company stapled under a shareholders' agreement.

Application date

The new rule applies if the debt security was stapled to the share on or after 25 February 2008.

Detailed analysis

Debt securities stapled to shares are treated as shares for most tax purposes (sections FA 2B and DB 10B of the Income Tax Act 2007 and sections FC 2B and DB 8B of the Income Tax Act 2004)

New section FA 2B of the Income Tax Act 2007 (new section FC 2B of the Income Tax Act 2004) applies to a debt security stapled to a share, if the share is not a fixed-rate share. This debt security is treated as a share for most tax purposes. For example, interest payments will be treated as dividends under the Act.

For the purposes of the rule, a debt security is defined as a financial arrangement that:

- provides funds to the company;
- would give rise to a deduction but for the new rule; and
- does not arise only from a movement in a currency exchange rate or a non-contingent fee.

As a result of this limited definition, debt securities issued by a non-resident are not caught by the new rule unless the issuer has New Zealand income against which it could deduct the interest on the security.

What is "stapled"?

Under the new rule, a debt security is "stapled" to a share if it can, or ordinarily can, be disposed of only together with the share. Arrangements to which neither the company that issued the debt security nor the company that issued the share is a party are excluded.

The rule is also designed to exclude conventional "shareholder agreements" that limit separate trading of debt and shares in companies with small numbers of shareholders. A shareholder agreement is defined as an arrangement between shareholders of a company that is not a widely held company. The arrangement cannot be the company's constitution, the terms of a debt security, or the terms of the company's shares.

What type of shares?

The rule is only intended to apply to debt securities that are stapled to participating or ordinary shares. This is achieved by excluding debts stapled to a share that is a "fixed-rate". A new definition of "fixed-rate share" is provided for this purpose.

Debt security and share aggregated for certain purposes

Under current rules, in certain situations, such as a share repurchase, a taxpayer is required to consider whether a share is a *non-participating redeemable share*, *fixed-rate share*, or *fixed-rate foreign equity*. When considering whether the stapled stock instrument meets one of these definitions, taxpayers are required to consider the stapled stock instrument as a whole. The two parts, when considered as one instrument, usually have the characteristics of an ordinary participating share, and so will not meet the definitions.

The debt security under the thin capitalisation rules

The debt security component of the stapled instrument will continue to be treated as debt under the thin capitalisation rules, except when it is stapled to shares in a *proportional-stapling company* or issued to a non-resident. This is to prevent taxpayers using the new rule to circumvent the thin capitalisation rules.

A proportional-stapling company is defined as one in which:

- each *participating share* is stapled to a debt security; and
- the available subscribed capital of each participating share and the amount payable for the issue of the debt security are in the same proportion for every participating share.

Effects of "stapling" and "de-stapling"

The available subscribed capital of a company needs to be adjusted appropriately for debt securities treated as shares under the new rule. The "stapling" of a debt security to a share is equivalent to issuing a share and the "de-stapling" of a stapled debt security is equivalent to cancelling a share. The definitions of "cancellation" and "consideration" have been amended to ensure that the same tax effects occur.

Relationship to rules treating certain debentures as shares

The new rule is similar to existing sections relating to "profit-related" and "substituting" debentures. An arrangement could, in theory, meet the conditions for both the new rule and one of the older rules. The older sections have been amended to clarify that only the new rule applies in such cases.

FILM AND GOVERNMENT FUNDING

Sections CW 37, CX 47, CX 48C, DF 1(6), DF 5, DS 2, EJ 4, EJ 5, EJ 7 and EJ 8 of the Income Tax Act 2007; sections 81, 85F and 87 of the Tax Administration Act 1994

SCREEN PRODUCTION INCENTIVE FUND

The amendments change the tax treatment of the net cost of films that receive grants from the new Screen Production Incentive Fund (SPIF). Because the grant receives standard grant tax treatment, the net of the grant cost of the film is deductible. The amendments provide that the deduction is over the standard two-year period, instead of being immediately available. Consequential amendments have also been made in relation to SPIF grant co-funding by government agencies and on secrecy matters.

Background

As a part of Budget 2008, the government announced a new film grant – the SPIF grant. Under the terms of the grant, "New Zealand" feature films are eligible for a 40% grant and other New Zealand screen formats are eligible for a 20% grant. The Film Commission has overall responsibility for administering and paying the grant, but Inland Revenue is responsible for verifying the cost of the production to enable the grant to be quantified.

Key features

Sections CX 47, DS 2(4), EJ 4, EJ 5, EJ 7 and EJ 8 contain the definition of "Government Screen Production Payment" which is now used to cover both large budget screen production grants (LBSPG) and SPIF grants. These sections also specify that films receiving the SPIF grant are deductible over the usual two-year period, rather than qualify for the immediate deduction incentive.

The inclusion of sections CX 48C and DF 5 means that standard grant treatment explicitly applies to any funding from government funding organisations that is in addition to funding received via SPIF grants. This further reduces the allowable deductible expenditure of the production by the value of the additional funding from government funding organisations. Any payments to these funding bodies are, however, deductible.

Sections 81, 85F and 87 of the Tax Administration Act 1994 have been amended so that tax auditing and secrecy obligations for the LBSPG also apply to SPIF grants.

Application dates

The SPIF measures apply from 1 January 2010.

The information sharing and secrecy measures apply from the date of Royal assent, being 6 October 2009.

LARGE BUDGET SCREEN PRODUCTION GRANT

Amendments have been made to the tax treatment of the Large Budget Screen Production Fund (LBSPF) to give the grant standard treatment, the same tax treatment as the new SPIF grant.

Background

When the LBSPG was introduced, the standard grant treatment was turned off. Instead, a deduction was allowed for the full cost of the film. This resulted in artificial tax losses being created and there was concern these might become more generally usable. Any incentive allowed for the screen industries should be explicit so accordingly, the ability for producers to use artificial tax losses has been removed. The tax treatment of the LBSPG has therefore been amended to provide the standard grant tax treatment.

Key feature

The repeal of sections CW 37 and DF 1(6) ensures the LBSPG is also given the standard grant treatment – meaning that the cost of the film will be reduced by the amount of the grant.

Application dates

Changes to the LBSPG apply when the final application for the grant is made from 1 October 2009, except when the project incurred at least $3 million in film-related expenditure by 1 July 2008.

GENERAL INSURANCE RISK MARGINS

Sections CR 4, DW 4 and YA 1 of the Income Tax Act 2007; sections CR 3 and DW 3 of the Income Tax Act 2004

Movements in a general insurer's outstanding claims reserve (OCR), as determined by applying International Financial Reporting Standard (IFRS) 4, can now be claimed as a deduction for income tax. The amendment responds to uncertainty about the tax treatment of the OCR following the adoption of IFRS 4.

Background

Under IFRS 4, the OCR of a general insurer has two components: a "central estimate", which is the average present value of expected future payments, and a risk margin, which is a prudential addition to reflect uncertainty connected with the central estimate.

IFRS 4 does not prescribe how the separate components should be calculated and reliance is placed on actuarial standards and practice.

For tax purposes, the law was not clear on the extent that deductions could be claimed for movements in the OCR connected with the risk margin. New sections CR 4 and DW 4 confirm that amounts calculated for both the central estimate and risk margin are income or deductible.

Key features

An insurer who uses IFRS 4 for accounting for its general insurance contracts may claim as a tax deduction (section DW 4) (or return as income (section CR 3)) the movement between the opening and closing OCR for the income year. Direct and indirect claim settlement costs are therefore deductible under section DW 4 to the extent they are included in the OCR.

Taxpayers applying sections CR 4 or DW 4 for the first time should use the closing outstanding claims reserve that existed before the insurer adopts IFRS 4.

The term "OCR" is defined in section YA 1 to mean an amount relating to an insurer's outstanding claims liability for general insurance contracts, as measured by Appendix D, paragraphs 5.1 to 5.2.12 of IFRS 4.

Corresponding changes (new sections CR 3 and DW 3) have been made for income years affected by the Income Tax Act 2004.

Application date

The changes apply from the 2009–10 income year. For taxpayers that elect, the change can be applied earlier – beginning from the first income year IFRS is adopted for financial reporting purposes.

CHANGES TO THE TAX TREATMENT OF PETROLEUM MINING

Sections DT 1A, DT 2, DT 5, DT 9, EJ 12, EJ 12B, EJ 13, EJ 13B, EJ 13C, EJ 19, EJ 20 of the Income Tax Act 2007; sections DT 1A, DT 2, DT 5, DT 9, EJ 11, EJ 11B, EJ 12, EJ 12B, EJ 12C, EJ 13, EJ 17 and EJ 18 of the Income Tax Act 2004

There have been a number of changes made to the petroleum mining tax rules. Deductions for expenditure on petroleum mining undertaken through a branch in another country will only be allowed to be allocated against income from petroleum mining operations outside of New Zealand. The petroleum mining rules have also been updated to address a number of issues that apply to investment in oil and gas exploration and development in New Zealand. Lastly, a remedial amendment ensures that a petroleum mining anti-avoidance provision does not apply more broadly than intended.

Background

In November 2007, tax policy officials consulted on possible changes to the tax treatment of expenditure incurred on petroleum mining. The suggested changes were designed to remove the uncertainty and disincentives that currently exist with the current rules.

On 4 March 2008, the government announced that it would amend legislation to prevent New Zealand missing out on significant tax revenue from the petroleum mining industry. Tax legislation would be changed to ensure that expenditure on petroleum mining operations undertaken through a foreign branch cannot be offset against petroleum mining income from New Zealand.

Application dates

The application dates for the three sets of amendments to the petroleum mining rules are:

- Petroleum mining expenditure incurred through a branch in another country applies to expenditure incurred on or after 4 March 2008.
- The changes updating the petroleum mining rules apply to expenditure incurred on or after 1 April 2008.
- The remedial amendment to the petroleum mining anti-avoidance provision applies from 1 December 2007.

Key features

- Expenditure incurred on petroleum mining operations undertaken through a branch in another country cannot be deducted from income earned in New Zealand.
- Changes to the petroleum mining tax rules remove disincentives that may affect investment in oil and gas exploration and development in New Zealand.
- A change to the legislation ensures that the petroleum mining anti-avoidance rule does not apply more broadly than intended.

Detailed analysis

Expenditure on petroleum mining operations undertaken by a branch in another country

Section DT 1A of the Income Tax Act 2007 and the Income Tax 2004 provides that expenditure incurred on petroleum mining operations undertaken through a branch in another country cannot be deducted from income earned in New Zealand.

Petroleum mining expenditure not allocated in a current year is carried forward and is available for allocation in future income years. The amount that can be allocated in future years is capped to the amount of income that a petroleum miner earns from petroleum mining operations outside of New Zealand.

For example, if a petroleum miner incurs exploration expenditure through its branch operation in India, section DT 1A means that this expenditure cannot be offset against income from any petroleum mining in New Zealand. However, if the petroleum miner has income from the sale of oil or gas condensate from operations in Switzerland it will be able to offset this income against the exploration expenditure incurred in India.

Addressing existing impediments

A number of changes have been made to the petroleum mining tax rules to remove disincentives that may affect investment in oil and gas exploration and development in New Zealand.

Removing the onshore/offshore boundary

Section EJ 19 has been amended to remove the distinction between onshore and offshore petroleum mining development. Section EJ 12 has been changed so that a petroleum miner can start amortising development expenditure in the year that the expenditure is incurred, rather than having to work out whether the expenditure relates to an onshore or offshore development. Development expenditure incurred on or after 1 April 2008 can begin to be amortised during the income year in which it is incurred.

Reserve depletion method

New section DT 5 provides two methods for allocating deductions to an income year. A petroleum miner can elect to amortise development expenditure under either the current straight-line method (the default allocation rule) or the reserve depletion method. Section EJ 12 contains the default allocation rule. Section EJ 12B is the new reserve depletion method. This section allows petroleum development costs to be amortised in a manner that better reflects the allocation of development costs over the life of the field. The election to amortise development expenditure under the reserve depletion method must be made in the year that commercial production first begins. Once the election has been made, it applies to future development expenditure incurred in that permit area. The reserve depletion method is available for development expenditure incurred on or after 1 April 2008. Development expenditure incurred before this date must be amortised under the seven-year straight-line method.

Changes to probable reserves are counted in the year directly following the year that the estimate occurs. The following example illustrates the process:

Example

In December 2007, Slick Oil Ltd incurs $35 million on petroleum expenditure on an offshore development in New Zealand. Slick Oil incurs similar amounts of development expenditure in June 2008 and in December 2008. Commercial production begins in January 2009.

The first $35 million of development expenditure (incurred in December 2007) is amortised over seven years on a straight-line basis. A deduction of $5 million is allocated to each year until the expenditure is completely amortised at the end of 2014.

The remaining $70 million is allocated on a straight-line basis until commercial production begins in January 2009. Slick Oil then elects to allocate the remaining development expenditure under the reserve depletion method. As at January 2009, the balance of unamortised development expenditure incurred on or after 1 April 2008 is $67.5 million.

Applying section EJ 12B, the balance of reserve expenditure is $67.5 million. With probable reserves estimated at 100 million barrels and first-year production totalling 40 million barrels, a $27 million deduction for development expenditure is allocated to the 2009 income year.

At the end of 2009, the amount of probable reserves is revised down by 20 million barrels to 40 million barrels. The balance of reserve expenditure less previous expenditure is $40.5 million. Total production during 2010 is 20 million barrels. The deduction for development expenditure for 2010 is therefore $20.250 million.

Deduction for expenditure on a dry well

Section EJ 13B allows a deduction for the cost of a dry production well, if the cost of the well is incurred on or after 1 April 2008. A dry production well is a well that will never produce petroleum in commercial quantities, as opposed to a well that ceases to produce petroleum in commercial quantities. A deduction for the balance of the unamortised cost of the well is allowed in the year that drilling stops and the well is abandoned.

Well ceasing to produce petroleum in commercial quantities

Section EJ 13C provides a deduction for expenditure on a well if the well ceases producing petroleum in commercial quantities and is abandoned, and the petroleum miner is amortising development expenditure on the reserve depletion basis. Subject to these requirements, a deduction for the unamortised balance of the expenditure on the well is allowed in the income year that the well is abandoned. This rule applies to expenditure incurred on or after 1 April 2008.

Remedial amendment to petroleum mining anti-avoidance provision

Section DT 2 of the Income Tax Act 2004 and the Income Tax Act 2007 has been amended to ensure that the petroleum mining anti-avoidance rule does not apply more broadly than intended. The purpose of section DT 2 is to prevent double deductions for the same amount of expenditure. However, in some cases it could give the inappropriate result of reducing a taxpayer's deductions from a single deduction to no deduction at all. As amended, section DT 2 prevents this result by excluding from the provision transactions involving the disposal of foreign petroleum mining assets. The amendment applies from 1 December 2007.

NIUE DEVELOPMENT

Section IC 13 of the Income Tax Act 2007

New section IC 13 allows the 66% common ownership threshold for loss grouping to be varied by Order in Council in relation to Niue development projects. This power has been introduced with a view to assisting in the development of the Niuean economy.

Background

Under section IC 3, losses incurred by one company can be offset against the profits of another company only if there is at least 66% common ownership of the two companies. This is intended to allow the ultimate shareholders of a group of companies to obtain immediate relief for a loss, while ensuring, as far as practicable, that the people who enjoy the relief are those who actually bore the economic loss in the first place.

Key features

New section IC 13 allows the percentage thresholds in sections IC 2(2), IC 3 and IC 5(1)(a) to be varied by Order in Council in relation to Niue development companies.

An order may be made if the Governor General is satisfied that a company:

- is carrying on a business that has been or is carried on wholly or mainly for the development of Niue and/or has been or is important to the development of Niue; and
- has incurred expenditure wholly or mainly in deriving income from Niue or in the course of carrying on a business or enterprise in Niue for the purpose of deriving income.

The order must name the company or companies with a tax loss to which the varied threshold should apply (referred to as company A in subpart IC). The relaxation of the common ownership threshold would be effected by substituting a lower figure for the percentage figure specified in paragraphs (a) and (b) of section IC 3(1).

Section IC 6(1) provides that the common ownership requirement applies for the commonality period. This is the period beginning from the start of the income year in which company A incurs the loss and ending at the end of the income year in which company B (the company to which the loss is made available) uses that loss. An order under section IC 13 may specify a period or periods for which it applies. If no period is specified, the order applies for the whole commonality period.

Application date

The amendment comes into force on 1 April 2008.

PROVISIONAL TAX POOLING

Sections OB 33(1), RP 17, RP 17B, RP 18(2)(c), RP 18(2B) and RP 19 of the Income Tax Act 2007; sections 15N to S, 120C(1), 120OE(1) and 173M of the Tax Administration Act 1994

A number of amendments have been made to the provisional tax pooling rules to ensure:

- the legislation reflects the original policy intent of the rules;
- to extend tax pooling to reassessments (including voluntary disclosure and resolution of dispute) of most taxes; and
- to enable pooling funds to be transferred between intermediaries.

Background

The tax pooling rules were introduced in April 2003 and allow compliant taxpayers to reduce their exposure to use-of-money interest on under-payments as a result of uncertainty about their provisional tax payments by purchasing funds from, or depositing funds with, a tax pooling intermediary.

Tax pooling generally involves a taxpayer depositing money with a tax pooling intermediary. The deposit earns interest. The intermediary deposits that money in his or her pooling account with Inland Revenue. The taxpayer may use the funds (deposit) in the future to pay his or her outstanding tax liabilities or sell the funds to other taxpayers who are clients of that tax pooling intermediary. If the taxpayer sells the funds, the intermediary will facilitate the sale, for a fee. On payment of the fee, the intermediary transfers the funds to the other taxpayer's income tax account as at the date that the money was originally deposited with the intermediary. Tax pooling allows provisional taxpayers to access money at lower interest rates than if they failed to pay provisional tax on the due date and were subject to use-of-money interest. It also enables taxpayers who have overpaid their tax to get a higher return, from selling the funds, than they would receive from Inland Revenue.

Key features

The major change to the tax pooling rules are as follows:

- ensuring the legislation reflects the original policy intent that the only regular tax payments that tax pooling funds can be used for is provisional tax and terminal tax. Pooling funds cannot be used for regular payments of non-income tax obligations such as PAYE, FBT or GST;
- extending the tax pooling rules to reassessments of most taxes, including voluntary disclosures and resolution of disputes;
- enabling pooling funds to be transferred between tax pooling intermediaries to foster competition among intermediaries and ensure the integrity of the rules are maintained;
- requiring pooling funds for payment of provisional or terminal tax liabilities to be accessed within 60 days of the terminal tax date; and
- enabling all taxpayers to deposit money into a tax pooling account. Previously only provisional taxpayers could deposit money into tax pooling accounts.

Application date

The changes apply from the date of Royal assent, being 6 October 2009.

Detailed analysis

Transferring funds between pooling intermediaries

Pooling funds held with one intermediary can now be transferred to another intermediary while retaining the original deposit date. The transfer must be at the taxpayer's request (made via their intermediary) and will apply to both existing deposits and future deposits. This will foster competition between intermediaries and also assist intermediaries entering or exiting the pooling rules. Amendments have been made to sections RP 18(2) and RP 18(2B) of the Income Tax Act.

An amendment has been made to section RP 19(1) of the Income Tax Act to enable a tax pooling intermediary to transfer funds from his or her tax pooling account either to the taxpayer or to another intermediary. Previously, a tax pooling intermediary could not transfer funds to another intermediary and retain the original deposit date.

Transfers to be made within 60 days of terminal tax date

The tax pooling legislation has also been amended (by introducing a new section RP 17B(4) and amending section RP 19(3) of the Income Tax Act) to ensure that taxpayers who want to access funds held by a tax pooling intermediary to meet their provisional tax and/or terminal tax liabilities have 60 days from their terminal tax date to access such funds. This was the original intent of the legislation.

Transfers made after more than 60 days of terminal tax date

Changes have been made to the way tax pooling funds are treated if a taxpayer accesses funds after the 60-day timeframe. A new section has been introduced (section RP 19(1B) so that pooling funds will first be applied to pay any interest that the taxpayer is liable for and then any remainder is applied to meet the person's core tax liability. Transfer requests made more than 60 days after the terminal tax date will not be able to be made using backdated effective dates.

Restricting tax pooling for regular tax payments

The fundamental principle on which tax pooling is based is the reduction of interest in situations when the taxpayer is uncertain of the amount he or she is required to pay on the due date. If there is certainty of liability on the due date, the taxpayer is required to pay that amount and tax pooling is not available.

To reflect this intent, the tax pooling rules have been amended (sections RP 17 and new section RP 17B to ensure that the only regular tax payments that tax pooling funds can be used for are provisional tax and terminal tax. Pooling funds cannot be used for regular payments of non-income tax revenues such as GST, FBT or PAYE, as the amount due is known on the due date.

Extending tax pooling to reassessments (including reassessments resulting from voluntary disclosures and disputes)

There are other instances, apart from provisional tax, when a taxpayer can be uncertain of their tax liability, namely additional tax payable as a result of a reassessment, including reassessments resulting from a voluntary disclosure or a dispute with Inland Revenue. Changes have been introduced which extend the tax pooling rules to additional tax payable as a result of a reassessment (including from voluntary disclosures and the resolution of a dispute) for most tax types.

New section RP 17B has been introduced to extend the tax pooling rules to include reassessments of most taxes, including reassessments from voluntary disclosures and resolution of disputes.

The provision requires an assessment to be issued before tax pooling can be used. This enables an increased amount of tax, the taxpayer's original liability, to be identified. There are instances where an original assessment is not issued, such as for PAYE and FBT. The Commissioner is still considering how the legislation will be applied for voluntary disclosures of PAYE, RWT and FBT where an assessment has not been made. Clarification will be provided in an upcoming operational statement.

It is difficult to provide for all possible reassessment scenarios in legislation. Instead, the legislation provides that tax pooling will be available for the increased amount of tax, being the difference between the taxpayer's previously assessed liability and the amount that results from:

- the Commissioner amending an assessment under section 113 (Commissioner may at any time amend assessments) of the Tax Administration Act.
- the Commissioner making a determination under section 119 (Commissioner may determine amount of provisional tax) of the Tax Administration Act.
- the assessment being made because the person or the Commissioner is deemed under section 89H as having accepted a proposed adjustment; or
- the person is making a voluntary disclosure.

Taxpayers can use tax pooling funds provided they are requested within 60 days of:

- the date the amended assessment is issued;
- for disputes, the date of the resolution of the dispute; or
- for disputes before the courts, the date on which the court proceedings are finally determined.

The Commissioner considers that tax pooling would be available for the difference between the amount of tax owing at the time the NOPA is issued resulting in the current proceedings and the final assessment. Where a dispute is before the courts, Inland Revenue considers that court proceedings are finally determined by either withdrawing from proceedings as well as a court judgment.

To provide some clarity on the legislation, Inland Revenue considers that tax pooling will be available in the following circumstances. These examples are not exhaustive and Inland Revenue will also be publishing comprehensive operational guidelines on how tax pooling will be determined, which will expand on these examples.

Examples of reassessments that do not involve court action

Example A

In 2010 the taxpayer files an income tax return for the 2009–10 income year and determines their tax liability to be $100,000. Inland Revenue reassesses the taxpayer for $150,000 under section 89C of the Tax Administration Act. This reassessed amount is disputed by the taxpayer and, following the disputes process, the parties agree on a reassessed amount of $140,000. Tax pooling funds would be available for $40,000, being the difference between the original assessed amount of $100,000 and the final reassessed amount of $140,000. The intervening reassessment is ignored.

Example B

In 2012 the taxpayer is reassessed again for their return for the 2009–10 income year under section 89C of the Tax Administration Act. Inland Revenue issues a reassessment increasing the last reassessed amount paid in 2010 of $140,000 to $160,000. Again the taxpayer disputes the reassessment and at the end of the disputes process the assessed amount is increased to $170,000. Tax pooling will be available for $30,000, being the difference between the $140,000 assessed in 2010 and the final reassessed amount of $170,000.

Examples of reassessments when the disputes is considered by the courts

A company's 2009 residual income tax is $90,000. On 25 August 2010, following a NOPA, NOR, conference and the exchange of SOPs, Inland Revenue issues a Notice of Assessment increasing the company's 2009 tax liability to $150,000. The company accepts a tax liability for $115,000, but disputes the remaining $35,000 and challenges the assessment by issuing a statement of claim.

On 24 October 2010 (60 days after the issue of the Notice of Assessment), the company's tax pooling intermediary asks Inland Revenue to transfer $25,000 to the company's 2009 income tax account in order to avoid the imposition of UOMI and late payment penalties on the amount of tax the company accepts is owing.

One of the following outcomes to the dispute occurs:

Example C

On 15 November 2010, the company discontinues the court proceedings by filing a notice with the court.

The company's tax pooling intermediary has until 14 January 2011 (60 days after the discontinuance) to ask Inland Revenue to transfer up to $35,000 (the deferrable tax) to the company's 2009 income tax account and backdate it.

Example D

On 15 November 2010, Inland Revenue and the company sign a settlement agreement. The company's 2009 tax liability is agreed at $125,000. On 17 November 2010, the company discontinues the court proceedings by filing a notice with the court. On 8 December 2010, Inland Revenue issues a Notice of Assessment for $125,000.

The company's tax pooling intermediary has until 16 January 2011 (60 days after the discontinuance) to ask Inland Revenue to transfer up to $10,000 (the deferrable tax) to the company's 2009 income tax account and backdate it.

The company could also choose to have its tax pooling intermediary ask Inland Revenue to transfer the above amount by 6 February 2010 (60 days after the issue of the Notice of Assessment). Because 6 February is a Sunday, the intermediary has until the next working day (Monday 7 February) to ask Inland Revenue to transfer the funds.

The Commissioner considers that the increased amount of tax referred to in section RP 17B(3)(a) is the difference between the amount accepted by the company of $115,000 and the amount subsequently agreed by the parties of $125,000.

Example E

On 23 October 2011, the High Court determines the dispute in favour of the Commissioner, and the company's 2009 tax liability is $150,000. There is no appeal, and Inland Revenue does not issue a new Notice of Assessment.

The company's tax pooling intermediary has until 23 December 2011 (60 days after the court determines the proceedings) to ask Inland Revenue to transfer up to $35,000 (the deferrable tax) to the company's 2009 income tax account and backdate it.

Example F

On 24 October 2011, the High Court determines the dispute in favour of the Commissioner, and the company's 2009 tax liability is $150,000. There is no appeal. The company subsequently finds a further error in its 2009 tax return. It makes a voluntary disclosure and on 18 November 2011, by agreement with the company, Inland Revenue issues a Notice of Assessment for $190,000.

The company's tax pooling intermediary has until 17 January 2012 (60 days after the Commissioner issues the Notice of Assessment for an increased amount of tax) to ask Inland Revenue to transfer up to $40,000 (the second increase in the amount of tax) to the company's 2009 income tax account and backdate it.

Example G

On 24 October 2011, the court determines the company's 2009 tax liability to be $120,000, which is not appealed. On 17 November 2011, Inland Revenue issues a Notice of Assessment for $120,000.

The company's tax pooling intermediary has until 16 January 2012 (60 days after the Commissioner issues the Notice of Assessment for an increased amount of tax) to ask Inland Revenue to transfer up to $5,000 (the deferrable tax) to the company's 2009 income tax account and backdate it.

The Commissioner considers that the increased amount of tax referred to in section RP 17B(3)(a) is the difference between the amount accepted by the company of $115,000 and the amount subsequently determined by the court of $120,000.

These examples illustrate the general principles that the Commissioner will consider in administering section RP 17B of the Income Tax Act. Other relevant factors will need to be taken into account in determining whether pooling funds will be available. Inland Revenue will be issuing operational instructions that will elaborate on these examples.

One taxpayer sourcing tax pooling funds for multiple taxpayers no longer allowed

As a result of the legislative changes to the tax pooling rules, a practice that Inland Revenue has accepted in the past will change. The practice relates to the transfer of tax pooling funds for multiple taxpayers into one taxpayer's income tax account and a subsequent request is then made to on-transfer those funds to the "associated" taxpayers at backdated effective dates.

This practice was allowed where the taxpayers were all "associated" and could all have sourced the tax pooling funds individually. In these cases Inland Revenue would process the on-transfer request.

This practice will no longer be allowed as the tax pooling rules only allow taxpayers to use tax pooling to meet their own tax obligations.

Inland Revenue will decline tax pooling transfers if these are sourced by one taxpayer for other taxpayers, or reverse these if this is determined after the funds have been transferred. This may result in the "associated" taxpayer not being able to use tax pooling at backdated effective dates if a tax pooling intermediary cannot request a transfer in the correct taxpayer's name within the 60-day timeframe allowed.

Other amendments to the Income Tax Act

There has been some uncertainty over how the term "tax paid" should be interpreted. Section 120C(1) of the Tax Administration Act has also been amended to clarify that "tax paid" means the amount transferred to a taxpayer's account or a tax pooling account by the original due date for the tax.

For income tax this means the terminal tax date, and for non-income tax revenues this means the original due date for the payment of the tax.

Funds that cannot be sourced on or before the terminal tax date or original due date, as applicable, will first be applied to any interest owing at the effective date of the transfer of those funds and any balance will be applied to the tax owing.

This means taxpayers who cannot source the full amount of increased tax obligations at the terminal tax date or original due date, as applicable, will not be able to source more funds to meet any interest or penalties that they may also be required to pay. This includes the situation where some or all of the funds sourced from a tax pooling account may be applied against interest and penalty obligations.

Examples of how penalties and interest apply where tax pooling funds used to meet obligations

Example H

In 2010 the taxpayer files an income tax return for the 2009–10 income year and determines their tax liability to be $120,000. On 20 June 2012 Inland Revenue reassesses the taxpayer's liability at $180,000. The taxpayer sources $20,000 tax pooling funds on each of the 2nd and 3rd provisional tax instalment dates to mitigate interest on their increased income tax obligations. Because no intermediary has funds available at the 1st provisional tax instalment date, the taxpayer sources the remaining $20,000 on the 2nd provisional tax instalment date.

The $20,000 sourced on the 2nd and 3rd instalment dates will be fully applied to the $20,000 owing on each date for the purposes of calculating interest. The other $20,000 also sourced on the 2nd instalment date will be fully applied to the remaining $20,000 provisional tax owing. However interest will have accrued from the day after the 1st provisional tax instalment date to the 2nd provisional tax instalment date.

The taxpayer will not be able to use tax pooling funds at backdated effective dates to meet the interest obligation. The taxpayer will be required to pay the interest and if the funds are sourced from a tax pooling account they cannot be backdated.

Example I

A taxpayer files a GST return for the period ended 30 November 2006 and pays the resulting GST of $50,000 on 15 January 2007. On 21 June 2010 the taxpayer's GST return is reassessed at $80,000 and a Notice of Assessment is issued. A new due date of 21 August 2012 is set to pay the $30,000 increase in GST.

The taxpayer sources $30,000 tax pooling funds with an effective date of 31 January 2007, because no intermediary has funds available at an earlier date. This will mitigate most of the interest that will accrue from the day after the original due date (15 January 2007) and the date of the reassessment (21 June 2010).

The $30,000 will firstly be applied to the interest of $172.01 that has accrued between 16 January and 31 January 2007 ($30,000 x 13.08% / 365 x 16 days). The remaining $29,827.99 will be applied against the $30,000 tax owing. This leaves a balance of $172.01 tax owing, which will accrue further interest until fully paid.

The taxpayer cannot use tax pooling funds at backdated effective dates to pay interest (or penalty) obligations that arise from reassessments. This applies equally to income tax and non-income tax reassessments.

Imputation credit account implications

When a company deposits money in a tax pooling account, a credit is made to the company's imputation account at that time. However, if the money in the tax pool is subsequently transferred to pay a reassessed amount of tax that is not income tax, the amendment to section OB 33(1) of the Income Tax Act provides that the imputation account is debited by the amount of the transfer at the time the funds are transferred.

Similarly, when a company taxpayer sells money that it has previously deposited in a tax pooling account, the imputation account is debited by the amount of the funds sold, as this is treated as a refund. The debit to the imputation account arises at the date of sale.

When a company taxpayer's tax pooling funds are transferred to another pooling intermediary, there are no impacts on the company's imputation account solely because of such a transfer.

Imputation credit account implications – company purchases funds

Where a company taxpayer purchases tax pooling funds to meet an income tax obligation, including from a reassessment, the company's imputation account is credited by the amount of the funds purchased. The credit to the imputation account arises at the effective date of the transfer.

Commissioner's notification

The current legislation requires the tax pooling intermediary to provide the Commissioner with details relating to deposits made with the intermediary. On receipt of this information, the Commissioner provides this information back to the intermediary. In practice, the Commissioner does not currently provide the details back to the intermediary. To do so would increase both compliance and administration costs, with no real gain.

Section RP 18(4) has been amended to require simply that the Commissioner confirms receipt of details provided by the pooling intermediary, rather than provide the details back to the intermediary.

Who can deposit money into a tax pooling account

Currently only provisional taxpayers can deposit money into a tax pooling account. With the extension of the tax pooling rules to reassessments of most taxes, the rules now allow all taxpayers to deposit money into a tax pool as they could be subject to a reassessment of taxes. This should provide a source of funds for tax pooling intermediaries.

Other amendments to the Tax Administration Act

Interest paid on deposits in tax pooling accounts

Section 120OE(1) has been amended to ensure that interest is paid by the Commissioner on money deposited in a tax pooling account from the date of deposit until such time as the amount is refunded or transferred.

Renumbering of provisions

Existing sections 15Q to 15V have been renumbered and are now contained in sections 15N to 15S.

Transfer of excess tax to another taxpayer

The transfer rules have been amended to enable taxpayers to transfer excess tax to a tax pooling intermediary (section 173M(2)(fb)).

Also, this amendment clarifies that transfers can be made from any tax type to a tax pooling account. The effective date of the transfer will be the date of the request or a later date (not a backdated date).

TAX TREATMENT OF NON-RESIDENT SEASONAL WORKERS

Sections RD 12, YA (1), YD (1) and schedule 2, part A of the Income Tax Act 2007; sections 24B(3), 24F(5) and 33A of the Tax Administration Act 1994

The bill contains several remedial amendments to the legislation to ensure the correct amount of tax is deducted from migrant non-resident seasonal workers during the year. It also removes the requirement for these workers to file end-of-year tax returns. The changes will reduce the compliance costs incurred by non-resident seasonal workers, who come to New Zealand to work under the recognised seasonal employer policy, in complying with their tax obligations.

Background

Non-resident seasonal workers come to New Zealand under the Recognised Seasonal Employer Work Scheme for between 7 and 9 months before going home. Under the previous rules, if they were here more than 183 days they were considered to be resident for tax purposes. Also, as they worked for only part of the year, the PAYE tax deduction system over-deducted tax, requiring migrant workers to file an end-of-year return to receive their refund. The new rules resolve these difficulties.

Key features

The changes will:

- tax non-resident seasonal workers at a flat tax rate of 15 cents in the dollar;
- deem non-resident seasonal workers to be non-resident for tax purposes; and
- remove the requirement for these workers to file income tax returns.

Application date

The amendment to section 33A of the Tax Administration Act 1994 to remove the requirement to file income tax returns applies from the 2008–09 income year onwards. All other amendments apply from the 2009–10 and later income years.

Detailed analysis

Section RD 12 of the Income Tax Act which treats multiple payments received by an employee in a week as one payment has been amended so this section does not apply to non-resident seasonal workers.

Changes have been made to reduce the tax compliance costs faced by non-resident seasonal workers and deduct the correct tax from these workers. The definitions of "non-resident seasonal worker" and "recognised seasonal employment scheme" have been inserted in the definition sections – section YA 1. A non-resident seasonal worker is defined as a non-resident person employed under a recognised seasonal employment scheme. A recognised seasonal employment scheme is defined as a recognised seasonal employer policy published by the Department of Labour under section 13A of the Immigration Act 1987.

The rules that deal with the residency of natural persons (section YD 1(11) have been amended to deem these non-resident seasonal workers, who would otherwise be treated as residents and taxable in New Zealand on their worldwide income, to be non-residents.

Also, a new tax deduction code, "NSW", has been introduced for non-resident seasonal workers. The tax code requires tax to be deducted as a full and final flat tax rate of 15 cents in the dollar. Amendments are made to schedule 2, part A of the Income Tax Act and to section 24B(3) of the Tax Administration Act 1994 to give effect to this new tax deduction code and rate.

As non-resident seasonal workers are taxed at a flat tax rate which is full and final, a new section 24F(5) of the Tax Administration Act 1994 has been inserted to preclude non-resident seasonal workers from being issued with a special tax code.

The return filing requirements of section 33A of the Tax Administration Act 1994 have been amended to remove the requirement for non-resident seasonal workers to file an income tax return or personal tax summary.

PENALTIES

The Taxation (Business Taxation and Remedial Matters) Act 2007 introduced a number of changes to the penalty rules in the Tax Administration Act. The following amendments clarify the practice and policy intent of the earlier amendments.

GRACE PERIODS

Sections 3(1), 139B(5B) and (5C) of the Tax Administration Act 1994

Two amendments have been made to the late payment penalty grace period:

- The grace period will apply to the first default identified by Inland Revenue.
- If the taxpayer enters a pre-emptive instalment arrangement, the grace period will not apply.

Background

The Taxation (Business Taxation and Remedial Matters) Act 2007 amended the late payment penalty to provide a grace period under which Inland Revenue notifies a taxpayer the first time a 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.

The rule 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 was disproportionately high compared with the severity of the breach. The effect of the rule is to give consideration to the taxpayer's previous record of compliance before imposing the late payment penalty.

Key features

Application to the first default identified

It is possible for Inland Revenue to apply a grace period and then determine that the grace period should have been applied to an earlier period. For example, when a return is filed late, and a grace period has already been applied to a subsequent return when it should have been applied to the late return. To ensure that the taxpayer benefits from the grace period, the amendment ensures the grace period will be applied to the first default identified by Inland Revenue.

Pre-emptive instalment arrangements

To encourage taxpayers to contact Inland Revenue as soon as possible, the second stage of the initial late payment penalty is not imposed if a taxpayer enters an instalment arrangement before the due date for payment of tax (this is known as a pre-emptive instalment arrangement).

To provide a further incentive for taxpayers to contact Inland Revenue as soon as possible, the amendment ensures the grace period will not apply for the period when a pre-emptive instalment arrangement is entered into but will apply at a later date if the taxpayer inadvertently misses a payment. The amendment also reinforces the policy of the grace period – to ensure that taxpayers who inadvertently miss a payment are not penalised.

Application date

The amendments apply to late payments of tax that are due on or after 1 April 2008.

NOT PAYING EMPLOYER MONTHLY SCHEDULE (EMS) AMOUNT PENALTY

Sections 141ED(3)(ab), (5B) and (5C) of the Tax Administration Act 1994

A number of minor amendments have been made to the EMS penalty to ensure that the rules reflect the policy intent. The changes are:

- A late payment penalty is no longer imposed on the EMS penalty.
- Employers wishing to enter an instalment arrangement will not be subject to the EMS penalty when they are negotiating an arrangement.
- If the amount on the EMS changes, the EMS penalty is calculated using the lesser of the corrected figure and the unpaid amount.
- The legislation now sets out a rule for the application of a payment when an EMS penalty has been imposed.
- The EMS penalty is not assessed in the same way as the tax to which it relates and the Commissioner does not have to give a notice of assessment to the taxpayer.

Background

An EMS penalty is imposed when an employer files an employer monthly schedule but does not pay some or all of the tax it should. The penalty was introduced in 2008 and is aimed at encouraging employers to comply by providing an incentive for them to pay tax associated with employer monthly schedules on time. It is imposed each month if the tax is not paid or the employer has not entered an instalment arrangement.

Key features

Imposition of the late payment penalty on the EMS penalty

A late payment penalty is imposed when taxpayers do not pay their tax, and any previous penalties imposed, on time. It too is imposed each month the amount remains unpaid. Before the amendment, the EMS penalty was also subject to the late payment penalty.

To ensure that penalties do not accumulate too quickly, and are not disproportionate to the non-payment amount, the EMS penalty is no longer subject to the late payment penalty.

The amount of tax not paid will still be subject to late payment penalties as well as use-of-money interest.

Negotiation periods

Currently, an employer who files an employer monthly schedule but does not pay the tax may be liable to an EMS penalty. Before the penalty is imposed taxpayers are warned that if they do not pay or enter an instalment arrangement a penalty will be imposed in the following month.

To encourage employers to enter instalment arrangements, under the new amendment the EMS penalty will not be imposed when an employer is negotiating an instalment arrangement. If an instalment arrangement is not entered into or payment is not made, the employer will be warned and the EMS penalty will then be imposed.

Corrected amounts

The EMS penalty was previously imposed on the lesser of the unpaid amount and the amount shown on the EMS when it is filed. Following the amendment, if the employer corrects the schedule, the penalty will be calculated on the lesser of the corrected amount and the unpaid amount.

Ordering rule for payment

Under the new rule, if an EMS penalty has been imposed and a payment is then made, the payment is first applied to the EMS penalty and then to the core tax owing. If the payment were not applied to the penalty first, there would be an incentive for taxpayers to pay the core tax and allow the penalty to remain outstanding with the risk of the penalty never being paid.

Similar rules apply for late payment penalties and use-of-money interest.

Assessment of the EMS penalty

Under section 94A(2), a shortfall penalty is assessed in the same way as the tax to which it relates, and under section 111, the Commissioner must give a notice of assessment to the taxpayer. The EMS penalty is a shortfall penalty. However, unlike other shortfall penalties it is imposed each month that an EMS amount is not paid and is therefore more like a late payment penalty.

Before an EMS penalty is applied, the employer is warned. When the penalty is applied, the employer receives another letter and a statement setting out the penalty and the core tax. Therefore it is not necessary to send a separate notice of assessment. Section 94A has been amended to provide that the EMS penalty is not assessed in the same way as the tax to which it relates and the Commissioner does not give a notice of assessment to the taxpayer. This means that the EMS penalty and the late payment penalty are imposed in the same way.

Application date

The amendments apply to tax positions taken on or after 1 April 2008.

IMPOSITION OF PENALTIES AND INTEREST ON AMOUNTS OF $100 OR LESS

Section 183F of the Tax Administration Act 1994

Under section 183F, small amounts of penalties and interest are not charged. The section has been amended to apply on a tax-type basis rather than to the total amount outstanding.

Background

The provision has been amended to apply on a tax-type basis rather than on the total amount outstanding. This reflects the intention of the provision, which is that small amounts of penalties and interest are not charged.

The EMS penalty was not imposed if the unpaid amount was less than $100. The legislation has been amended so that the penalty is not charged on amounts of $100 or less, ensuring it is consistent with the other provisions.

Application date

The amendment applies from the date of Royal assent, being 6 October 2009.

REMOVING TAX AGENT STATUS NO LONGER A DISPUTABLE DECISION

Section 138E(1)(e)(iv) of the Tax Administration Act 1994

The decision to remove a tax agent from the list of tax agents or not to list a person as a tax agent is no longer a disputable decision.

Background

Following an amendment in the Taxation (Business Taxation and Remedial Matters) Act 2007, Inland Revenue must keep a list of tax agents. Inland Revenue has the ability to remove a person from the list or not list a person, if it is concerned that continuing to list the person as a tax agent would adversely affect the integrity of the tax system.

Operational guidelines set out the circumstances in which the discretion might be exercised. Before making a decision not to list or remove a person from the list, 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 or a longer period if it is appropriate in the circumstances) in which to resolve the matters raised in the notice of intended revocation.

Because sufficient time is allowed for the affected agent to comment and for those comments to be taken into account, the decision of the Commissioner is no longer a disputable decision.

Application date

The amendment applies from the date of Royal assent, being 6 October 2009.

NO NEW DUE DATE FOR DEFAULT ASSESSMENTS

Section 142A of the Tax Administration Act 1994

The requirement to set a new due date has been amended so that it does not apply when the Commissioner makes a default assessment.

Background

The Taxation (Business Taxation and Remedial Matters) Act 2007 amended section 142A to allow a new due date to be set by the Commissioner, regardless of whether a return has been filed. The amendment ensures that late payment penalties and shortfall penalties are not both imposed if the taxpayer has not filed a return. For example, before the amendment to section 142A, if a return had not been filed and some time later Inland Revenue determined that there was income and a return was necessary, late payment penalties would apply from the original due date for payment with a possible shortfall penalty also imposed.

The amendment also applied if the Commissioner made a default assessment. A default assessment is an estimation of tax liability and remains in place until the taxpayer files a return. A default assessment is likely to present a slightly larger debt than a self-assessment, and thereby encourage taxpayers to file returns.

Given that a default assessment is made when there is a concern about non-compliance and a taxpayer has not filed a return, and that the assessment is reversed when the return is filed, a new due date is no longer set when a default assessment is made. When the return is filed, a new due date will be set.

Application date

The amendment applies from the date of Royal assent, being 6 October 2009.

ORGANISATIONS APPROVED FOR CHARITABLE DONEE STATUS

Schedule 32 of the Income Tax Act 2007

The following organisations have been granted charitable donee status from the 2008–09 tax year.

- Educational Aid for International Development Trust Board;
- Ingwavuma Orphan Trust Fund of New Zealand;
- Kyrgyzstan New Zealand Rural Trust;
- L Women of Africa Fund;
- Partners Relief and Development NZ;
- Tender Trust;
- The Band Aid Box;
- The Destitute Children's Home, Pokhara, Charitable Trust;
- The Palestine Children's Relief Fund Charitable Trust;
- Triyog Himalaya Trust; and
- UNHCR (United Nations High Commissioner for Refugees).

Donee status entitles individual donors to a tax credit of 33⅓% of the amount donated to these organisations. Companies and Māori authorities may claim a deduction from their net income for amounts donated. The maximum amount that may be claimed for donations to any qualifying organisation is set out on page 98 of *Tax Information Bulletin*: Vol 20, No 3 (April 2008).

A change has also been made to reflect that the Bright Hope International Trust, which already has donee status, has changed its name to Global Hope.

Application date

The amendment applies from the 2008–09 and later income years.

NON-DISCLOSURE RIGHT

Sections 3(1) and 20B to 20G of the Tax Administration Act 1994

An amendment has been made to the Tax Administration Act 1994 to allow the right of non-disclosure to apply to discovery and similar processes that occur during litigation.

Background

In 2005, the government introduced a right of non-disclosure relating to certain tax advice documents provided between tax advisors who are not lawyers and their clients so there is greater parity between lawyers (who are able to claim legal professional privilege) and other tax advisors. The ability to not disclose such documents applies at the investigation and disputes phases entered into by, or with, Inland Revenue. However, the right did not extend to preventing disclosure of these documents by the Commissioner of Inland Revenue during litigation. In contrast, legal privilege extends throughout both court and administrative proceedings.

Key features

The right of non-disclosure in sections 20B to 20G of the Tax Administration Act 1994 has been amended to allow the right to apply to documents that the Commissioner has sought to be disclosed during litigation. The amendment allows the Commissioner to have access to the facts (the tax contextual information), but not to the tax advisor's view of the facts.

Previously, the ability of the Commissioner or taxpayer to challenge the claim that a book or document is a "tax advice document" subject to the non-disclosure right was determined by a District Court Judge. This may have created difficulties if the matter was being heard in another court. A further amendment has been made to allow the determination to be made by the court hearing the matter.

Application date

When the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill was introduced, the amendment was to apply to challenges begun on or after the date of enactment.

Some submissions on the bill at the Committee stage considered that the application date should be retrospective. However, it became clear that any application date that had any element of retrospectivity would be problematic. In some cases parties may have already disclosed documents as part of the discovery proceedings. As with legal privilege, this could be treated as a waiver of their non-disclosure right or could mean that the discovery process would need to be revisited. Other parties who have not yet disclosed information could (subject to the weight judges give to proposed legislation) be protected by an early application date, resulting in inconsistent treatment among taxpayers. Such a change would compound uncertainty and add complexity to proceedings.

The New Zealand Institute of Chartered Accountants suggested that the measure should apply if the Commissioner has made a request for information after 1 April 2009. However, the same issues that arise in respect of a retrospective application date would have applied to this option.

The Institute suggested in the alternative that the earliest practical time from which the right of non-disclosure could apply was in relation to discovery orders requested on or after the date of Royal assent of the bill. This application date was also problematic in that there may be several requests for information and/or discovery in a case. The provision would therefore have been difficult to define. It could also have resulted in application of the non-disclosure right to some but not all such requests in the same case and consequent confusion about which documents were or were not able to be used in litigation.

The policy intent of the non-disclosure right was, however, to provide a level of parity of treatment between tax advice provided by lawyers and that provided by other tax advisors.

Therefore the application provision was amended. Under the amended legislation the right of non-disclosure at the discovery phase applies to future disputes and current disputes which have not advanced to the first conference required under the High Court rules or the Taxation Review Authority regulations as at 6 October 2009. Discovery action is frequently the first agreed step after the initial conference and therefore this application provision will in many cases be equivalent to one based on discovery, but is more certain.

A concern about current cases which raise substantially similar issues to later cases was also taken into account in the application provision. The concern was that if the earlier case has not had the protection of the non-disclosure right but the later cases did have this protection, taxpayers may decide to proceed with the later cases given that they have the benefit of the non-disclosure right and could possibly result in a more favourable decision. This could incur significant costs of litigation for both parties. Therefore there is an exception to the application provision for future cases if a substantially similar issue is currently being considered by the courts – the amendment does not apply to the future case if the challenge was begun before the date of Royal assent, being 6 October 2009.

ACC — PERSONAL SERVICE REHABILITATION PAYMENTS

Sections MD 9(2), RD 3(1) and YA 1 of the Income Tax Act 2007

The following minor changes have been made to ensure that amendments made in the Taxation (Business Taxation and Remedial Matters) Act 2007 work as intended:

- a drafting error that meant that, technically, ACC was not required to deduct tax and claimants who pay their carers directly were, has been corrected;
- the full-time earner requirement for the in-work tax credit has been amended to ensure that personal service rehabilitation payments count as a "PAYE income payment" for the purposes of this tax credit; and
- any doubt that the current provisions apply to personal service rehabilitation payments entitlements arising under enactments before the Injury Prevention, Rehabilitations, and Compensation Act 2001 has been removed.

Details of the changes made in 2007 are set out on pages 102 and 103 of *Tax Information Bulletin*: Vol 20, No 3 (April 2008).

Application date

The amendment applies from 1 July 2008.

TAX RECOVERY ARRANGEMENTS

Section 173D of the Tax Administration Act 1994

Section 173D of the Tax Administration Act 1994 has been amended, by the inclusion of a new subsection (2), to clarify that charges associated with foreign unpaid tax may be collected under New Zealand's tax recovery arrangements.

Background

New Zealand has in recent years begun entering into bilateral tax recovery arrangements with a selected number of its tax treaty partners – to date, with Australia, the Netherlands, Poland and the United Kingdom. (In the case of Australia, Poland and the United Kingdom the arrangements have been included in our double tax agreements with those countries, but in the case of the Netherlands they constitute a stand-alone Tax Recovery Convention).

Part 10A of the Tax Administration Act 1994 provides a framework for the type of tax recovery assistance that New Zealand can provide to other countries. Tax treaties generally override domestic law, but part 10A has been deliberately framed so that it cannot be overridden by a tax treaty.

Part 10A is silent on the matter of charges associated with the foreign unpaid tax (such as penalties, interest and costs) that New Zealand may be asked to collect for other countries under such arrangements. However, concerns have arisen that an argument could be constructed that the way "tax" is defined for the purposes of the Act results in part 10A preventing New Zealand from collecting such charges. This would run counter to the original policy intention that associated charges could be collected. It would also conflict with the provisions of our tax recovery arrangements that explicitly require New Zealand to collect associated charges.

To prevent the possibility of such an argument being raised, Part 10A has been amended to include clarification that charges such as interest, administrative penalties and costs may be collected under New Zealand's tax recovery arrangements.

The clarifying amendment will apply from at least 1 April 2008, which is the earliest date from which New Zealand has potentially been able to receive and respond to requests for tax recovery assistance.

Key features

Subsection (2) of section 173D of the Tax Administration Act 1994 clarifies that assistance in the recovery of taxes includes assistance in the recovery of charges associated with the taxes, whether interest, administrative penalties, costs of collection or conservancy, or any other related amount.

Questions we've been asked

Q: What are "costs of conservancy"?

A: A state that is not yet able to ask for assistance in the collection of unpaid tax (because, for example, a final judgement has not yet been issued) may, in certain circumstances, request that measures of conservancy be taken to safeguard its collection rights. This might include, for example, seizure or freezing of assets, to ensure that those assets will still be available when collection can subsequently take place. Costs of conservancy are costs that relate to the taking of any such measures of conservancy.

Application date(s)

The amendment will apply in relation to events and periods occurring before or after 1 April 2008.

New Zealand has potentially been able to receive and respond to requests for tax recovery assistance since 1 April 2008. The amendment has therefore been drafted so it is clear that it has application in relation to any requests received from that date. As such requests may apply to unpaid taxes owing from earlier tax periods, the drafting contemplates the possibility that it may further predate 1 April 2008.

VENTURE CAPITAL EXEMPTION

Section CW 12 of the Income Tax Act 2007

A remedial amendment has been made to section CW 12 of the Income Tax Act 2007 to ensure consistency with changes previously made to the equivalent section in the predecessor Act, the Income Tax Act 2004.

Background

The predecessor to section CW 12, section CW 11B of the Income Tax Act 2004, was introduced, with effect from 1 October 2005, to facilitate increased offshore venture capital investment into New Zealand. It was to have achieved this by removing a potentially significant tax obstacle to in-bound venture capital investment – the 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 was that the investor must be from a jurisdiction approved by the Governor-General by Order in Council. Broadly, a jurisdiction would be approved only if effective exchange of information arrangements were in place with New Zealand. Section CW 11B was amended in 2008 to ensure that it would operate as intended regardless of whether the exchange of information arrangements were established by means of a double tax agreement or a tax information exchange agreement.

At the same time as the amendment was being made, a replacement Act, the Income Tax Act 2007, entered into force. The amendments made to section CW 11B of the Income Tax Act 2004 were not correctly reflected in the equivalent section of the Income Tax Act 2007, section CW 12. A remedial amendment has therefore been made to ensure that the amendments made to section CW 11B are now also reflected in section CW 12.

Key features

The definitions of "foreign exempt entity", "foreign exempt partnership" and "foreign exempt person" in section CW 12(4) of the Income Tax Act 2007 have been updated for consistency with changes previously made to its equivalent predecessor section, section CW 11B of the Income Tax Act 2004.

Application date

The amendments apply from 1 April 2008.

TAX TREATMENT OF REIMBURSEMENTS AND HONORARIA PAID TO VOLUNTEERS

Sections CO 1 and CW 62B of the Income Tax Act 2007

The Income Tax Act 2007 has been amended to provide an exemption from income tax for reimbursement payments to volunteers. The rules also clarify the tax treatment of honoraria paid to volunteers.

Background

Before this amendment it was unclear how reimbursement payments made to volunteers should be taxed, particularly if they were made as combined payments with honoraria.

Key features

New section CO 1 of the Income Tax Act 2007 provides a general rule treating amounts derived in undertaking voluntary activities as income of the person receiving them.

Section CO 1 is overridden by new section CW 62B, which provides that:

- Reimbursement payments that are based on actual expenses incurred by volunteers in undertaking voluntary activities will be treated as exempt income to the volunteer.
- If a paying organisation puts in place a process for making a reasonable estimate of the amount of expenditure likely to be incurred by a volunteer for whom reimbursement is payable, payments based on that estimate will also be treated as exempt income. This will provide flexibility, such as when it is not practical for organisations to reimburse their volunteers on the basis of actual costs incurred.
- Organisations will still be able to make combined payments as long as they:
  - clearly identify which portion of the payment is reimbursement;
  - correctly withhold tax from the honorarium portion; and
  - return the honorarium as a schedular payment in their employer monthly schedule.

The exempt income treatment includes reimbursements in non-cash form, such as petrol vouchers. It also includes reimbursement of transport costs incurred in getting to and from the place of volunteering, as well as those incurred in the course of volunteering.

Volunteers are defined as "people who freely undertake activity in New Zealand that has been chosen either by them or a group of which they are a member". The activity must provide a benefit to a community or another person. Although it is possible that the paying organisation could carry on a business for profit, there must be no purpose or intention of private pecuniary gain for the volunteer.

The term "honorarium" is defined for the purposes of both new section CW 62B and schedule 4, part B (Rates of tax for schedular payments).

The new tax treatment applies regardless of whether reimbursements are paid progressively through the year or in a lump sum.

Application date

The exemption for reimbursements and rules for the treatment of mixed payments of honoraria and reimbursements apply retrospectively to all reimbursement payments made on or after 1 April 2009.

Example

Miriama is a voluntary regional coordinator for a national sports organisation, SportCo. Some travel to local centres, as well as attendance at tournaments is involved. Miriama uses her own car.

SportCo pays Miriama an honorarium of $50 per month for six months of the year.

SportCo estimates that Miriama travels an average of 250 kilometres per month in the course of her voluntary activities, including her travel to and from her home.

SportCo decides to reimburse Miriama's travel expenses by paying her a travel allowance of 70 cents per kilometre.

The honorarium and travel allowance are paid together.

SportCo also gives Miriama meal vouchers to buy meals on the days that she has to attend tournaments.

Miriama receives a total payment of $225 in each of the six months of the year.

SportCo will deduct tax of $16.50 from the monthly payment of $225.

The $50 honorarium is subject to withholding tax at the 0.33 rate, and the $50 is included as a schedular payment in the employer monthly schedule.

SportCo will pay the $16.50 tax deduction to Inland Revenue.

The $175 travel allowance is treated as exempt income.

The meal vouchers fall within the scope of the exempt income treatment.

GST AND LOYALTY POINTS

Sections 2(1), 9(9), 9(10), and 11C of the Goods and Services Act 1985

Changes have been made to the Goods and Services Tax Act 1985 to allow certain loyalty programme operators to defer the imposition of GST until the redemption of loyalty points to ensure that GST is being paid at the correct rate.

Background

GST is charged on goods and services consumed in New Zealand. Since exported goods and services are consumed outside of New Zealand, as a general rule, exports of goods and services are zero-rated. Zero-rating allows a supplier of goods and services not to charge GST, but to still be able to claim input tax deductions.

Before the current amendment to the GST Act, because of the involvement of an intermediary, supplies of what are normally considered zero-rated goods or services could be subject to GST at the standard rate. For example, a loyalty programme operator (such as an airline) could enter into a transaction with a purchaser whereby the purchaser paid consideration to the loyalty programme operator for crediting loyalty points to a customer. The customer would later redeem the loyalty points for a zero-rated reward supplied by the loyalty programme operator. By imposing GST on the loyalty points at the time they were issued, GST was in effect imposed on what would normally be a zero-rated supply. This anomaly would not exist if the supply was acquired directly from the operator for a monetary consideration instead of through the use of loyalty points.

The amendment to the GST Act allows certain loyalty programme operators to defer the imposition of GST until such time as the nature of the reward and the normally applicable GST rate is known.

Key features

New section 9(9) of the GST Act allows certain loyalty programme operators to defer the imposition of GST on a sale of loyalty points to another person until such time that the loyalty points are redeemed.

New section 11C specifies the requirements which have to be satisfied before a loyalty points operator can defer the imposition of GST under section 9(9). A loyalty programme operator is able to use the rules if it makes supplies for consideration under an arrangement with another person to provide loyalty points to a third person and the following conditions are satisfied:

- 25% or more of the loyalty programme operator's or its associated person's business involves the provision of zero-rated goods or services.
- The operator or its associated person has a business activity outside the activity of operating a loyalty programme (the main business activity) and the loyalty points are able to be redeemed for rewards supplied by the operator or associate as part of the main business activity.
- The loyalty programme operator is able to identify, at the time of the redemption of loyalty points, whether GST was imposed on the points in question when they were issued or whether the GST liability was deferred until the redemption of points under proposed section 9(9).

A new section 11C(6) states that the second requirement will still be satisfied if, in addition to being redeemable for rewards supplied by the operator's or associated person's main business activity, the loyalty points are able to be redeemed for a reward supplied by an operator's partner under an associated loyalty programme.

New section 9(10) states that when the GST "reverse charge" provisions in the GST Act treat the New Zealand-resident purchaser of the loyalty points as supplying the loyalty points, the purchaser is able to choose whether to defer the payment of the GST until those points are redeemed. If the purchaser chooses to defer the imposition of the GST, they must be able to meet the requirement of being able to identify whether GST has been paid and deferred.

The legislation also introduces a definition of the term "loyalty programme" in section 2, and makes a consequential amendment to the meaning of the term "supply" in section 5(14).

Application date

The amendments apply from the day of Royal assent, being 6 October 2009.

GST AND EXPORTED SECOND-HAND GOODS

Sections 10(4), 11(3B), 11(3C) and 11(3D) of the Goods and Services Tax Act 1985

Changes have been made to the Goods and Services Tax Act 1985 to allow, in certain circumstances, exported second-hand goods to be zero-rated when a registered person has claimed a second-hand goods input tax deduction. The changes ensure that exported second-hand goods that are not brought back into New Zealand are treated in the same way as exported new goods.

Background

Under section 11(3)(a) of the GST Act, exports of second-hand goods are subject to GST at the standard rate of 12.5% if the exporter, or an associate of the exporter, has claimed a second-hand goods input tax deduction. The specific application of this section was considered by the Taxation Review Authority in *Case N66*.[1]

The imposition of GST in these circumstances is designed to prevent revenue losses from exporting second-hand goods that have never been subject to GST but gave rise to an input tax deduction when acquired. A further tax base risk arises if the goods are subsequently brought back to New Zealand without GST applying on importation and again sold to the exporter or an associate of the exporter to create another second-hand goods deduction. GST therefore applies to remove the incentive for second-hand goods to be repeatedly imported to and exported from New Zealand to take advantage of the resulting input tax deductions.

The problem with charging GST on exported second-hand goods is that if the goods do not return to New Zealand, they will have been taxed differently from exported new goods.

The changes are consistent with the objective that:

- The GST Act does not distort the tax treatment of second-hand goods that are consumed outside New Zealand.
- The GST base is not exposed to "leakage" arising from transactions that repeatedly seek to claim the deduction available on the purchase of second-hand goods.

Under the amended rules, the supply of second-hand goods in situations – when there is limited prospect of the goods being brought back to New Zealand in substantially the same condition as when they were exported – will be zero-rated.

Key features

The zero-rating rules that apply to exported goods have been changed by inserting three new subsections into section 11 of the GST Act.

New section 11(3B) permits registered persons to zero-rate certain exported second-hand goods for which a second-hand goods input tax deduction has been claimed, if:

- the goods are entered for export under the Customs and Excise Act 1996; and
- the goods leave New Zealand within 28 days of the goods being supplied (as determined by the earlier event of the recipient paying for the goods or the supplier issuing an invoice).

New section 11(3B) will apply if the recipient provides the registered person, at or before the time of supply, a written undertaking that the goods will not be brought back to New Zealand by the recipient, or a person associated with the recipient, in a condition that is substantially the same as the condition in which they were exported.

New section 11(3C) is an anti-avoidance provision that requires GST to be charged if all of the following events have taken place:

- the exported goods were previously zero-rated;
- the goods are subsequently imported into New Zealand;
- the goods are reacquired by the registered person in a condition that is substantially the same as when the goods were zero-rated; and
- the registered person had claimed a second-hand goods input tax deduction in connection with the original export of the goods.

New section 11(3D) provides that section 11(3C) applies at the time the goods are reacquired unless GST is levied when the goods are subsequently imported into New Zealand. This change is designed to remove the possibility of double taxation under section 11(3C) and section 12.

A consequential change has been made to section 10(4), which determines the taxable value of the exported goods if section 11(3C) applies.

[1] (1991) 13 NZTC 3,495. The case concerned an exporter of second-hand motorcycles to Japan. The taxpayer acquired the motorcycles from a number of sources, both GST-registered and unregistered. The Taxation Review Authority held that the motorcycles acquired from unregistered persons could not be zero-rated if the second-hand goods input tax deduction had been claimed.

Example: Exported scrap metal

Company A Ltd pays $630 for scrap metal (2,000 kg of light gauge grade steel and 1,500 kg of oversized grade steel) acquired from the demolition of a haybarn on private property. The owner of the haybarn is not registered for GST, and Company A claims a second-hand goods deduction of $70 ($630 ÷ 9) on the purchase of the scrap metal. Company A cleans and sorts the steel and cuts any oversized components to light gauge specification. The steel is baled and stored with similar gauged steel which is held as trading stock.

Company A receives an order for 6,000 kg of steel from an Indonesian firm.

Supplying the order involves Company A using a mixture of scrap metal that has been acquired from unregistered and registered suppliers (including all of the steel that was formerly part of the haybarn).

The entire export can be zero-rated if the Indonesian firm provides a declaration (for example, a clause in the sale and purchase agreement) that it or a person associated with the firm will not cause the goods to be brought back into New Zealand in substantially the same condition in which they were exported.

"In a condition that is substantially the same"

Section 11(3B) uses the phrase "in a condition that is substantially the same" for the export and re-importation of second-hand goods. The phrase is not defined and is intended to be given its ordinary meaning.

The purpose of the phrase is to ensure, in the event that the goods return to New Zealand (and tax is not levied on the importation), that GST will apply unless any of the following apply:

- the nature of the goods has been fundamentally varied;
- the goods are in a form that is unrecognisable contrasted to the goods when they were exported; or
- the goods have been subsumed into other goods so that they are no longer identifiable from the goods as a whole.

For example, if the scrap metal in the example above returned to New Zealand in the form of metal window frames, the goods would not be considered to be in a condition that is substantially the same. A similar outcome would result if the scrap metal in example 1 returned to New Zealand in the form of an artistic metal sculpture.

Application date

The change applies from the date of Royal assent, being 6 October 2009.

GST AND PUBLIC AUTHORITIES

Sections 2(1) of the Goods and Services Act 1985

Changes have been made to the Goods and Services Tax Act 1985 to confirm that the Office of the Clerk of the House of Representatives and the Parliamentary Service have an obligation to charge GST on the activities they undertake.

Background

The GST Act currently treats public authorities as carrying on a taxable activity and requires GST to be charged on appropriations received from Parliament. This outcome is achieved by deeming public authorities, including instruments of government and certain offices of Parliament, to be carrying on a taxable activity and making supplies of goods and services in return for appropriations from Parliament. This is consistent with the comprehensiveness of the GST base.

A question was raised whether the Office of the Clerk of the House of Representatives and the Parliamentary Service fall within the definition of "public authority" for the purposes of the GST Act.

Key features

Section 2, the interpretation section of the GST Act, has been amended to include the Office of the Clerk of the House of Representatives and the Parliamentary Service in the definition of "public authority".

Application date

In relation to the Parliamentary Service, the amendment applies from 1 October 1986, the date GST started. The amendment applies to the Office of Clerk of the House of Representatives from 1 August 1988, the date the Office of the Clerk of the House of Representatives was established.

CORPORATE REORGANISATIONS NOT AFFECTING ECONOMIC OWNERSHIP

Section YC 18B

Section YC 18B ensures that shareholder continuity is preserved for certain restructuring arrangements that result in no change of economic ownership in a group of companies. The preservation of shareholder continuity will ensure that no unintended consequences of the continuity rules will arise in respect of imputation credits and losses as a result of the restructuring. The new section was required as the existing concessionary continuity rules do not readily apply to the type of restructuring arrangements contemplated by the new section YC 18B.

Background

Some Australian banking groups with significant New Zealand operations are considering restructuring to separate their banking business from their other businesses. The restructuring results in the Australian bank replacing its initial parent company with a new company as the listed banking group parent company. This potential restructuring is a direct response to Australian regulatory standards and has the full support of the regulators and the Australian government.

The Income Tax Act 2007 provides general rules to determine the shareholder interests in a company. There are a number of concessionary rules that deal with situations where it is impractical to apply the more detailed general rules. However, this particular type of restructuring falls outside of the requirements of those concessions. This means that the initial parent company and its subsidiaries will not easily be able to carry forward any tax losses and imputation credits they had before restructuring under the existing concessionary rules.

Key features

Section YC 18B ensures that continuity is preserved for certain restructuring arrangements that result in no change in the economic ownership of a group of companies. The type of restructuring arrangement contemplated by the section is where the initial parent company of the group is replaced by a new parent company but results in no change to the economic ownership of the group of companies as a whole.

The preservation of shareholder continuity will ensure that there are no adverse consequences to the group of companies' imputation credits, losses and other tax balances which depend on shareholder continuity, as a result of the restructuring.

Detailed analysis

Section YC 18B ensures that shareholder continuity is preserved for restructuring arrangements that do not result in an economic change of ownership within a group of companies. Shareholder continuity will be preserved for the initial parent, new parent and any interests deemed to be held by the initial parent before the restructuring.

The main criteria for the concession will be that the restructuring will result in no significant change to the ultimate economic ownership of the initial parent and all of its subsidiaries.

Section YC 18B(2) sets out the criteria for the concession:

- Except for a nominal amount of shares issued to facilitate the restructuring, or where securities law requirements make it impracticable or impossible, the shareholders of the initial parent company will at the start of the restructuring and immediately at the completion of the restructuring, own the same interests in the same proportions in the new parent.
- The market value of any nominal amount of shares issued to facilitate the restructuring expressed as a percentage of the market value of all the shares in the new parent company is such that it is reasonable to treat the exchanging shareholders as owning all the shares.
- The restructuring does not result in any return to the shareholders (ignoring any nominal amount of shares issued to facilitate the transaction, and shares in respect of which securities law requirements make it impracticable or impossible), apart from the exchange of shares in the initial parent company for shares in the new parent company.
- The initial parent company before the restructuring and the new parent company after implementation of the restructuring are limited attribution companies. If the initial parent ceases to be a limited attribution company before the new parent company becomes a limited attribution company this will be ignored.

If the criteria are met, the new parent company effectively steps into the shoes of the initial parent company for the purposes of the shareholder continuity rules. This results in no breach of the shareholder continuity rules as a consequence of the restructuring. As such, the group of companies involved in the restructuring will maintain its ability to use or carry forward any imputation credits, losses or other tax balances which depend on shareholder continuity which it had before the restructuring.

Note that certain "excluded preference shares" are ignored when determining the economic ownership of a group of companies for the purposes of this section. That is, shares that fall within the definition of "excluded preference shares" in subsection YC 18B(5)(b) are ignored when applying the criteria set out in section YC 18B(2).

Application date

Section YC 18B applies from 1 April 2008.

FURTHER IFRS AMENDMENTS TO THE FINANCIAL ARRANGEMENTS RULES

Sections EW 14, EW 15B, EW 15D to EW 15I, EW 21 to EW 23, EW 25B, EW 26, EW 29, EW 31, EZ 52BB and YA 1 of the Income Tax Act 2007; sections EW 15C to EW 15E, EW 21 to EW 23, EW 26, EW 29, EW 31 and OB 1 of the Income Tax Act 2004

The Taxation (Business Taxation and Remedial Matters) Act 2007 introduced changes to the taxation of income and expenditure on financial arrangements (the accrual rules) for taxpayers who have adopted new international financial reporting standards (IFRSs). It was anticipated that further changes to those rules would be required once the full consequences of the new IFRS were better understood. The amendments to the Income Tax Act 2004 and the Income Tax Act 2007 were largely introduced by Supplementary Order Paper. The first four bullet points below were included in the original bill. The amendments mostly reflect changes anticipated following introduction of the original IFRS tax rules.

Key features

The amendments:

- make IFRS GAAP (generally accepted accounting principles) operating leases which are financial arrangements for tax purposes subject to the compulsory yield to maturity (YTM) treatment for tax purposes;
- amend the anti-arbitrage provisions regarding the use of the Determination, expected value and modified fair value methods where IFRS hedging involving two financial arrangements occurs and the (IFRS financial reporting) fair value method is used for one of the financial arrangements in the hedging relationship;
- ensure that IFRS taxpayers who prepare financial statements in a functional currency other than New Zealand dollars are required to use New Zealand dollars for the four IFRS methods available for financial arrangements when filing the tax return;
- for Determinations G27 and G29, replace the use of Determination G9A with Determination G9C, both changes applying from the 2009–10 income year;
- introduce an option to allow the use of Determination G3 from the 2009–10 income year for New Zealand currency non-derivative financial arrangements;
- allow the retrospective use of Determination G3 from the 2008–09 income year for financial arrangements of entities which are subject to a creditor workout. This change implements the policy change announced by the Ministers of Finance and Revenue on 15 December 2008;
- allow IFRS early adopters who used the (IFRS financial reporting) fair value method in the 2005–06 income year to change to another method in either the 2006–07 or 2007–08 income years, with a base price adjustment being performed in the year of change;
- clarify the deductibility of interest capitalised in terms of NZ IAS 23 so that, unless it was otherwise dealt with in a return filed by 30 June 2009, the interest is deducted for tax purposes as it is incurred;
- reinstate on a retrospective basis the use of the pre-IFRS financial reporting method for those taxpayers who did not have to adopt IFRS GAAP;
- clarify that the use of the IFRS financial reporting method is based on the IFRS GAAP rules used in the taxpayer's financial statements;
- allow taxpayers who use the (IFRS financial reporting) fair value method for financial arrangements which are held for the business of dealing in such arrangements not to adjust for impaired credit adjustments included in the IFRS GAAP financial reporting values;
- change the consistency requirements for group companies in respect of the expected value and modified fair value methods so that they do not apply to financial arrangements of group companies that do not have a business of a substantially similar nature to a business of another group company, unless the financial arrangement is with other members of the group. These provisions have also been amended to make it clear that there is both an election and a notification requirement to fulfil;
- correct an error for use of the base price adjustment in respect of non-integral fees and consideration; and
- provide for the use of the modified fair value method for taxpayers within an IFRS GAAP consolidated group in some circumstances, based on the hedge accounting adopted in the consolidated financial statements.

Application date

Except where otherwise stated, the amendments set out above all apply from the application date of the original legislation, being 1 April 2007 for the Income Tax Act 2004 and 1 April 2008 for the Income Tax Act 2007.

Detailed analysis

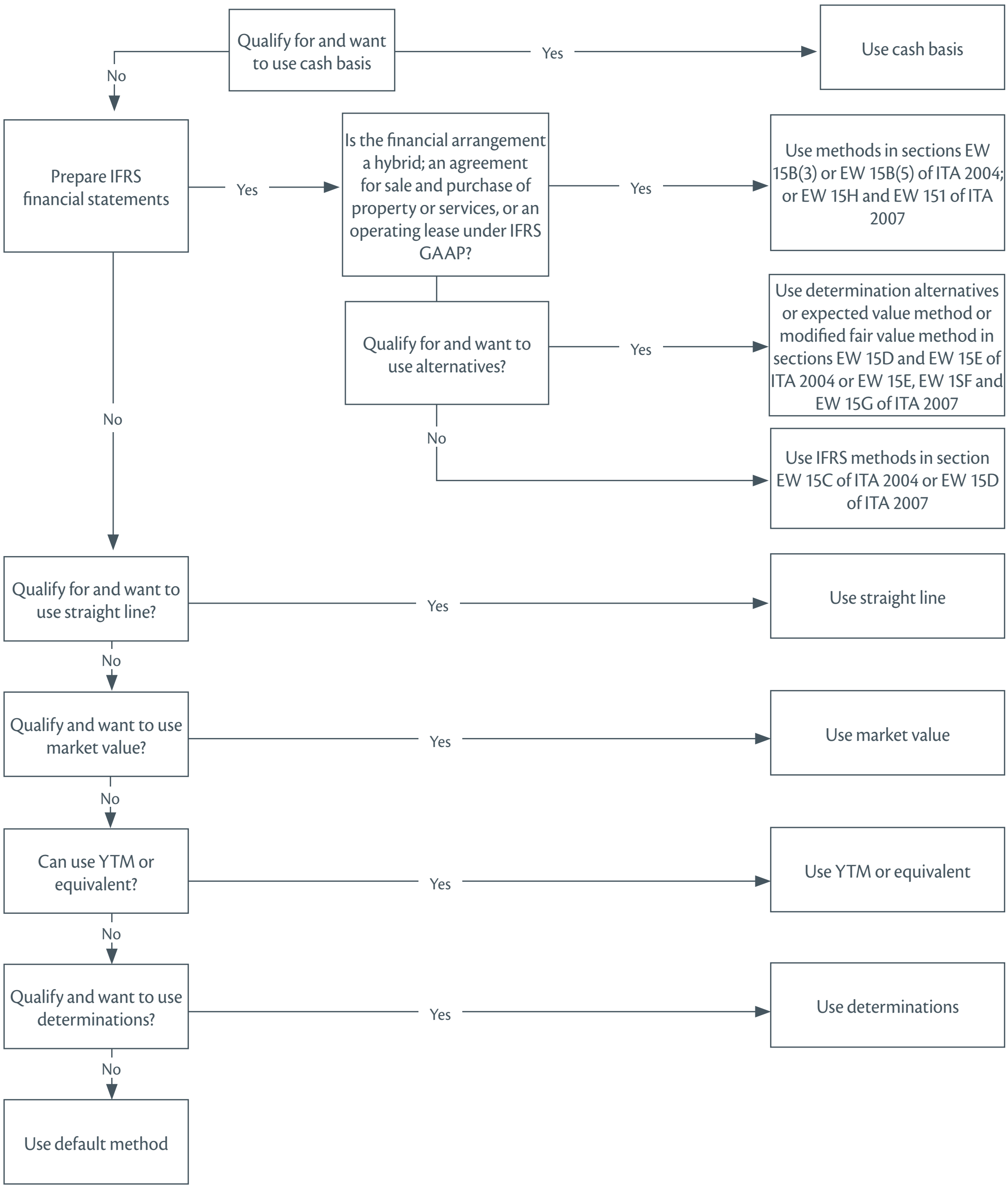
The amendments in this Act primarily clarify or amend provisions in the original legislation, based on further submissions and discussions with taxpayers and advisors. There are also some new general initiatives in the Act, being:

- the use of the modified fair value method for taxpayers within an IFRS GAAP consolidated group in some circumstances, based on the hedge accounting adopted in the consolidated financial statements;
- introduction of the general use of Determination G3 from the 2009–10 income year for New Zealand currency non-derivative financial arrangements;
- changes to the consistency requirements for group companies in respect of the expected value and modified fair value methods, so that they do not apply to financial arrangements of group companies that do not have a business of a substantially similar nature to a business of another group company, unless the financial arrangement/s is/are with other members of the group; and
- making IFRS GAAP operating leases which are financial arrangements for tax purposes subject to the compulsory YTM treatment for tax purposes.

These are discussed, along with all the other changes mentioned above, in the following commentary.

A summary of the spreading methods available to taxpayers under the amended financial arrangement rules is presented in Figure 1. An earlier version of this flowchart was included in TIB Volume 20 No. 3 April 2008.

Figure 1: New financial arrangement spreading rules



IFRS GAAP operating leases which are financial arrangements for tax

Under the original legislation some financial arrangements for tax purposes were being classified as operating leases in IFRS GAAP financial statements. However, the IFRS tax methods available for such financial arrangements were not appropriate and, after consultation with taxpayers and advisors, these types of financial arrangements have been included in the compulsory use of the YTM method in section EW 15B of the Income Tax Act 2004 and section EW 15I of the Income Tax Act 2007.

Determination methods: inclusion of Determination G3 from the 2009–10 income year

The use of Determination G3 has been included in section EW 15E of the Income Tax Act 2007 for New Zealand currency non-derivative financial arrangements. Originally, it was considered that the IFRS financial reporting method would be the only method necessary for New Zealand currency non-derivative financial arrangements. However, after consideration and consultation, it is now considered that an alternative YTM method should be available for these financial arrangements.

Taxpayers will be able to use this method from 2009–10 by performing a base price adjustment or change of spreading method adjustment as appropriate. Section EZ 52B of the Income Tax Act 2007 provides a one-off opportunity for taxpayers to change to Determination G3 in the 2009–10 income year to further allow the reduction of volatility. The tenor of Determination G26 can be used in conjunction with Determination G3 where appropriate (see the discussion below relating to creditor workouts).

It should be noted that Determination G30 was withdrawn from use on 1 October 2009. This determination was introduced as an interim measure for use with certain New Zealand currency financial arrangements which were either held or issued by IFRS taxpayers who were in the business of lending money. It is understood that only a few taxpayers applied Determination G30 to eliminate volatility on applicable financial arrangements following the introduction of the original legislation. The revised rules available from the 2009–10 income year mean that this determination was no longer required.

Creditor workouts: use of Determination G3 from the 2008–09 income year

A "creditor workout" has been defined in section YA 1 of the Income Tax Act 2007. The use of Determination G3 is permitted in the 2008–09 and subsequent income years in section EZ 52B for financial arrangements which are subject to a creditor workout. These changes give effect to the policy change announced by the Ministers of Finance and Revenue on 15 December 2008.

It is intended that the legislation will apply to creditor workouts which are legally binding on the parties to the relevant financial arrangements, including those which are legally binding on the parties to the financial arrangements as a result of a workout effected through changes to a trust deed and a trustee.

For financial arrangements affected by these changes, changing the tax method to the use of Determinations G3 will be accomplished by performing a change of spreading method adjustment in the income year in which the method is changed. Determination G25 is also relevant here.

Further developments

Inland Revenue has been made aware that the definition of "creditor workout" may not include some of the workouts which have been entered into and would qualify in terms of the policy objective announced by the Ministers in December 2008. Officials will discuss the situation with affected parties and any amending legislation necessary will be separately enacted on a retrospective basis.

It is also aware that some creditor workouts may involve a fixed-rate financial arrangement being rearranged as a floating rate financial arrangement. If the rearrangement causes a one-off fair value accounting gain for IFRS GAAP purposes, that amount can be spread on a YTM basis as per Determination G3, while the ongoing floating rate payments from that time in accordance with the tenor of Determination G26 will also form part of the YTM income/expenditure for those financial arrangements. Again, any amending legislation necessary will be separately enacted on a retrospective basis.

Anti-arbitrage provisions in the Determinations, expected value and modified fair value methods

The policy intent for the use of these three methods is that they cannot be used for a financial arrangement which is either a hedge of another financial arrangement or being hedged by another financial arrangement under IFRS GAAP if the other financial arrangement is using the fair value method (included in the IFRS method and the IFRS financial reporting method in the Income Tax Act 2004 and the Income Tax Act 2007 respectively).

This policy is to prevent tax arbitrage where there is IFRS GAAP hedging occurring. This was considered necessary because, as a result of many submissions on the original legislation, the three methods were introduced to allow taxpayers to elect out of volatility for tax purposes which may have resulted from the use of the IFRS method and the IFRS financial reporting methods in the respective acts.

Otherwise, the three methods can be used for financial arrangements that are not in an IFRS GAAP hedging situation, or when both financial arrangements in an IFRS GAAP hedging situation use any of the three methods or the IFRS financial reporting method which is not the fair value method.

It proved difficult to draft the appropriate clause in sections EW 15D and EW 15E of the Income Tax Act 2004, and sections EW 15E to EW 15G of the Income Tax Act 2007 and taxpayers and the Inland Revenue became aware that the clauses inserted in the bill did not achieve the desired policy intent. There have been subsequent discussions with many taxpayers and advisors on the application of these sections and it has been Inland Revenue's position that the clauses were to be amended to achieve the intended outcome as set out in the first paragraph of this item.

A table summarising the use of the various tax methods for financial arrangements (FAs) where IFRS GAAP hedging applies and does not apply is set out below.

Table: Anti-arbitrage – tax methods for financial arrangements and IFRS GAAP

IFRS GAAP Hedging	FA 1 Tax Method	FA 2 Tax Method	Comments
	(IFRS financial reporting) fair value method.	(IFRS financial reporting) fair value method.	Both must use (IFRS financial reporting) fair value method.
	(IFRS financial reporting) **not** fair value, Determination, expected value or modified fair value methods.	(IFRS financial reporting) **not** fair value, Determination, expected value or modified fair value methods.	Both have to use a method that is **not** the (IFRS financial reporting) fair value method.
Non-IFRS GAAP Hedging	Any applicable method.	Any applicable method.	A full choice of tax methods is available for these FAs.

During the course of the drafting process it became obvious that, for the anti-arbitrage provisions to work properly, it was also necessary to insert a new subclause in sections EW 15C of the Income Tax Act 2004 and section EW 15D of the Income Tax Act 2007 for the use of the IFRS financial reporting fair value method, in addition to amending the clauses relating to the anti-arbitrage provisions for the three methods above.

It has also been considered appropriate, as a result of submissions during the consultation stage of the bill, to include in the definition of "fair value method" in section OB 1 of the Income Tax Act 2004 and section YA 1 of the Income Tax Act 2007 reference to sections EW 15C and EW 15D respectively. This reference is not intended to change the meaning of the definition but merely to reinforce that the fair value method is a method included in those two sections, being the IFRS taxpayer method and the IFRS financial reporting method respectively.

It should also reinforce that the IFRS method/financial reporting fair value method does not include the modified fair value method, which is a separate method.

FRS early adopters who used the (IFRS method) fair value method in the 2005–06 income year

IFRS early adopters who filed their 2005–06 income year tax returns on the basis of using the (IFRS method) fair value method for financial arrangements have the choice of changing to another applicable method for those financial arrangements in either the 2006–07 or 2007–08 income years. They can make the change by performing a base price adjustment in the year they elect to change methods.

This transitional measure has been provided on the basis that the original legislation was not enacted until after early adopters were required to file their 2005–06 income year returns and were not fully aware of the final shape of the legislation. It is likely that very few taxpayers would be affected by this change.

Interest capitalised for IFRS GAAP

The policy on capitalised interest and other borrowing costs is that it is deductible when incurred for tax purposes. However, enactment of the 2007 tax legislation for IFRS created some doubt on this matter. There was no intention to change the longstanding policy as a result of the enactment of the original IFRS tax legislation.

Accordingly, section EW 15C of the Income Tax Act 2004 and section EW 15D of the Income tax Act 2007 have been amended so that interest that has been capitalised in the IFRS GAAP financial statements is deducted for tax when it is incurred, which will be the same income year as it is capitalised for IFRS GAAP. However, if a taxpayer has taken the position of not deducting interest which has been capitalised for IFRS GAAP in a tax return filed before 30 June 2009, that position will be grandparented.

Pre-IFRS GAAP financial reporting method

The original 2007 IFRS legislation repealed the section allowing the use of pre-IFRS GAAP financial reporting methods as a method available for tax. For taxpayers who had adopted IFRS financial reporting, the repeal was understandable as the new IFRS tax rules specifically include methods based on IFRS financial reporting. However, its wider repeal failed to recognise that IFRS is not compulsory for all preparers of GAAP financial statements.

Sections EW 21 of the Income Tax Act 2004 and the Income Tax Act 2007 have therefore both been reinstated as they were previously, including consequential amendments to other relevant sections. These sections apply from the dates of the original IFRS legislation and are available to non-IFRS GAAP adopters for any income year since those application dates.

IFRS financial reporting method – clarification

Section EW 15B of the Income Tax Act 2004 and section EW15B of the Income Tax Act 2007 did not specify whether the allocation of an amount for tax must be the amount shown in a taxpayer's financial statements or whether an allocation can be made by applying an accounting methodology available under IFRS but not used by the taxpayer.

The policy intent is that the taxpayer must be actually using the allocation method in its financial statements for it to be able to use it for tax purposes. It is not intended for a taxpayer to use any allocation method which IFRS accounting may generally permit without actually using the method for its own financial statements. It should be noted that the policy is based on considerations such as simplicity, ease of compliance and that the financial statements are almost certainly audited.

The sections have been amended to provide greater clarity.

Impaired credit adjustments for financial arrangements using the IFRS financial reporting fair value method – dealers

Section EW 15C of the Income Tax Act 2004 and section EW 15D of the Income tax Act 2007 required taxpayers using the (IFRS financial reporting) fair value method to identify and adjust for credit impairments to financial arrangements accounted for at fair value.

Before the original IFRS legislation, dealers were permitted to use the mark to market value method with no adjustment for credit impairments.

It was subsequently submitted that the IFRS tax legislation changed the previous policy for dealers who now use the (IFRS financial reporting) fair value method, by making them identify and adjust for credit impairments to non-derivative financial arrangements.

This change restores the earlier position that existed for dealers before the original IFRS tax legislation, with retrospective effect.

Financial arrangements held by non-New Zealand functional currency taxpayers

An IFRS GAAP taxpayer can apply any relevant method of the four IFRS methods available under the IFRS tax legislation to financial arrangements denominated in a functional currency other than New Zealand dollars.

It was submitted at the consultation stage of the bill that there should be a rule requiring non-New Zealand dollar functional currency entities that apply IFRS GAAP to use New Zealand dollars, regardless of which of the four methods specified in section EW 15C(1) is adopted.

Section EW15B of the Income tax Act 2004 and section EW 15B of the Income Tax Act 2007 have both been amended to ensure that, when a taxpayer is using a non-New Zealand dollars functional currency for IFRS GAAP, the four IFRS tax methods are applied using New Zealand dollars.

Methodology for calculating taxable income on swaps: Determination G9A

Direct use of Determination G9A was denied in the original IFRS legislation. However, it was overlooked that Determination G27 included use of Determination G9A in some circumstances, and amendments eliminate that use via Determination G27 to ensure consistency with the original policy.

The original policy intent is considered to be still valid, to reduce volatility caused by the use of spot exchange rates unless the taxpayer is using the IFRS financial reporting method which accounts for volatility.

It is also considered that the other methods available in the legislation will allow taxpayers sufficient choice to reduce volatility for tax purposes in hedge situations.

However, it was agreed that the application dates as proposed were not equitable and that affected taxpayers should be given the choice of applying them from the next income year. As originally proposed, they would have been retrospective to the 2006 tax year if an IFRS early adopter taxpayer chose to use the new IFRS tax rules from 2006.

Officials also noted that Determination G29 allows the use of Determination G9A in some situations and that for IFRS taxpayers this is also inappropriate in terms of the original policy. This alternative has also been removed for IFRS taxpayers.

Sections EW 14E and EW 15H of the Income Tax Act 2007 have been amended to effect these changes, with application from the 2009–10 income year. A change of spreading method adjustment may be necessary in that year.

Consistency requirements for groups of companies: expected value and modified fair value methods

The original IFRS legislation for these two methods included a consistency requirement which could have been interpreted as an election requirement. Section EW 15E of the Income Tax Act 2004 and sections EW 15F and EW 15G of the Income Tax Act 2007 have been amended to ensure that it is both an election condition and a consistency requirement, as originally intended.

Also, submissions were received about the general application of the consistency requirements for groups of companies' using these two methods for financial arrangements.

As a result, the application of the consistency requirements for groups of companies and those two methods has been relaxed, and sections EW 15E of the Income Tax Act 2004 and sections EW 15F and EW 15G of the Income Tax Act 2007 have been amended.

The resulting changes mean that the consistency requirements for the two methods do not apply to a company in a group of companies which does not have a business of a substantially similar nature to another company in the group, and the relevant financial arrangements are not with associated persons. However, if the arrangements are with associated persons, the two methods can be used by a company in a group of companies if the associated persons also use the same method for those arrangements (following the requirements in the legislation prescribing the use of those methods). This is illustrated in the following example.

Example

Company A in a group is the importer and distributor of electronic equipment, while Company B in the same group manages/operates computer systems for companies not associated with the group. Company A enters into FX contracts with a non-associated person for the purchase price of its imported electronic equipment, and Company B enters into FX contracts with non-associated persons for revenue it receives from overseas people it manages computer systems for. Company A and Company B, while being part of the same group, would not be regarded as having businesses of a substantially similar nature. Therefore, Company A could use either of the above two methods for its FX contracts if they are available in terms of the legislation, irrespective of the method chosen by Company B for its FX contracts. This applies because both companies' FX contracts are with non-associated persons.

However, if either company's FX contracts are with associated persons, the two methods cannot be used for the FX contracts for the relevant company unless the associated person also used the same method for its FX contracts.

It is noted that there is no intention to change the consistency requirements applying to a taxpayer in a group of companies for either the use of tax methods for the same/similar financial arrangements or for financial arrangements over time (i.e. from year to year) by the changes regarding group companies described above.

Base price adjustment: non-integral fees

The definition of "consideration" was changed by the original IFRS legislation in respect of "non-integral fees" for IFRS GAAP. The change was made for non-integral fees paid by a taxpayer but it should also have been made for non-integral fees paid to a taxpayer. This has been corrected by changes to sections EW 31 of the Income Tax Act 2004 and the Income Tax Act 2007.

Modified fair value method: IFRS GAAP hedging achieved only in the consolidated financial statements

The original IFRS legislation did not provide an acceptable method for eliminating volatility of income/expenditure for financial arrangements in an individual company's tax return where IFRS GAAP cashflow hedge accounting cannot be applied at an individual company level but is applied at an IFRS GAAP consolidated level. The hedge accounting in this situation therefore does not appear in the IFRS GAAP financial statements of any individual group company.

In practice the situation will arise where one company in a wholly owned group has a financial arrangement with a non-associated person which is hedged by a financial arrangement entered into by another group company, again with a non-associated person. These financial arrangements would be "related" for purposes of the legislation.

Where this occurs one of the individual companies in the group will have fair value amounts for financial arrangements in its profit and loss account which will produce volatility and may be unacceptable for tax purposes. However, when these amounts are offset for IFRS GAAP accounting by hedging entries at the consolidated level, an acceptable accounting result is achieved. This is achieved by removing the IFRS GAAP volatility in the individual company's profit and loss account to equity reserve accounts at the consolidated level.

It must be emphasised that, in these limited situations, the affected taxpayers only want to achieve a position where volatility at the individual company level is removed for tax purposes, as it is for IFRS GAAP at the consolidated level. It should also be noted that, without an amendment, the issue is still relevant when individual companies file as part of a tax "consolidated" group in terms of tax legislation.

Where a taxpayer in a wholly owned group uses the modified fair value method in this manner, all members of the wholly owned group must use the modified fair value method for financial arrangements which have amounts allocated to equity reserves either in the taxpayer's accounts or at the consolidated level.

Section EW 15G of the Income Tax Act 2007 has therefore been amended to achieve this outcome of removing the volatility in an individual company's tax return which is otherwise removed for IFRS GAAP only at the consolidated level with application from the 2008–09 income year.

REGISTERED BANKS AND RESIDENTIAL MORTGAGE-BACKED SECURITIES SPECIAL PURPOSE VEHICLES

Sections HR 9, HR 10 and YA 1 of the Income Tax Act 2007

The residential mortgage-backed securities (RMBS) scheme established by the Reserve Bank of New Zealand (RBNZ) in 2008 requires registered banks to set up a bankruptcy remote third party (SPV), which can be either a company or a trust. All the major banks have set up RMBS structures, and some may have drawn down RBNZ monies.

Broadly, the RBNZ will provide additional liquidity support for a bank provided the bank offers collateral securitised AAA rated residential mortgages as securities. As part of the security arrangements for this funding, the RBNZ requires these mortgages be held by a SPV.

There are potential tax consequences arising from establishing and using the RMBS as collateral to secure a medium-term finance facility from the RBNZ.

The government has determined that taxation consequences should not impact adversely on the RBNZ measures designed to ensure the stability of the financial system.

Consequently, new sections HR 9 and HR 10 have been inserted into the Income Tax Act 2007 by Supplementary Order paper to the bill to produce a tax outcome for the banks and the SPVs which achieves the government's objective.

Key features

The amendments:

- insert a new definition of a residential mortgage-backed securities special purpose vehicle (RMBS SPV);
- set out the tax consequences following the establishment of an RMBS SPV;
- set out the tax consequences of an RMBS SPV ceasing to qualify, other than on an unwind; and
- set out the tax consequences of the unwind of an RMBS SPV.

Application date

The RMBS amendments apply for the 2008–09 and later income years.

Detailed analysis

A RMBS SPV is defined in section YA 1 of the Income Tax Act 2007 as.

- a company or a trust that derives no exempt income;
- which holds interests in New Zealand residential mortgages or loans secured by such mortgages that are treated for financial reporting as being held by the registered bank;
- has all its funding from the RMBS it issues, apart from incidental funding amounts; and
- the RMBS it has issued must be either held by the registered bank with the intention of participating in the RBNZ's domestic liquidity operations; held by RBNZ and accepted into its domestic liquidity operations; or transferred by RBNZ, after being accepted into its domestic liquidity operations, to a person resident in New Zealand or a person not resident in New Zealand but unassociated with the registered bank.

Tax consequences where RMBS SPV exists

Once the existence of a RMBS SPV has been established as set out above, the following tax consequences apply:

- The registered bank is treated as carrying on the activities that the SPV carries on, and having a status, intention and purpose of the SPV, and the SPV is treated as not carrying those activities, and not having that status, intention and purpose.
- The registered bank is treated as holding all property that the SPV holds, and the SPV is treated as not holding it.
- The registered bank is treated as being party to any arrangement which the SPV is party to, and the SPV is treated as not being party to that arrangement.
- The registered bank is treated as doing a thing and being entitled to a thing that the SPV does or is entitled to do, and the SPV is treated as not doing that thing or being entitled to that thing.

The tax effect of these provisions is that the registered bank is treated as doing everything that the SPV does while it remains a qualifying SPV, and the SPV is treated as not doing those things while it is a qualifying SPV.

Practically, this will mean that transactions between the registered bank and the SPV will have no tax consequences for either party while the SPV remains a qualifying SPV. Also, all transactions with third parties by the registered bank and the SPV will be included in the registered bank's tax return while the SPV remains a qualifying SPV.

It also means the RMBS SPV will not be required to obtain an IRD number or file income tax and GST returns while it continues to qualify.

Tax consequences when RMBS SPVS cease to qualify

When a RMBS SPV ceases to qualify in terms of the definition above and other than being unwound (as defined below), the following consequences apply:

- The registered bank is treated as having disposed of the property it was treated as holding as above. It is treated as disposing of the property immediately before the SPV ceases to qualify.
- The RMBS trust/company is treated as acquiring the property referred to in the preceding bullet point immediately after it fails to qualify as a SPV.
- The registered bank is treated as not being a party to an arrangement it was treated as being a party to in relation to the SPV immediately before the SPV ceases to qualify.
- The vehicle is treated as being a party to the arrangement immediately after the SPV ceases to qualify.

Where property or an arrangement is disposed of/acquired for tax purposes in terms of the above deeming provisions it is done so at market value.

Unwind of RMBS SPV

The unwind of a RMBS SPV for tax purposes is defined as being the process of:

- cancellation of the RMBS issued by the SPV and held by the registered bank or the RBNZ;
- transfer of the interests in residential mortgages and loans secured by residential mortgages held by the SPV to the registered bank; and
- termination of the company or trust, by liquidation or otherwise.

Further developments

The definition of a RMBS SPV includes the requirement that the mortgages and loans secured by mortgages held by the SPV are treated for financial reporting purposes by the registered bank as being held by the registered bank.

The strict reading of this requirement is that the relevant financial arrangements are reported in the legal entity financial statements of the registered bank. It has been brought to officials' attention that, while this applies in some cases, there are other cases when the relevant financial arrangements are treated as held by the registered bank only in the consolidated financial statements prepared by the registered bank.

The policy intent is that the amendments apply in the latter case, when the relevant financial arrangements are treated as held by the registered bank in the consolidated financial statements prepared by the registered bank where they are not also included in the legal entity financial statements of the registered bank.

It seems likely that further amendments will be recommended.

REMISSION OF USE-OF-MONEY INTEREST

Sections CX 48, EW 46, RC 7(7), RC 36 and YA 1 of the Income Tax Act 2007; sections 177D(3) and 183ABA of the Tax Administration Act 1994

Amendments have been made to update the provisions relating to disasters. The amendments were part of a Supplementary Order Paper, which, among other measures, extended and simplified the range of circumstances under which Inland Revenue can offer relief from use-of-money interest when taxpayers are physically impeded by a disaster or similar event, from paying their tax on time.

Background

Under previous legislation, Inland Revenue could relieve use-of-money interest when a taxpayer was significantly affected by a "qualifying event". A qualifying event was a naturally occurring event for which a civil defence emergency was declared and an Order in Council made. Amendments to section YA 1 of the Income Tax Act 2007 and section 183ABA of the Tax Administration Act 1994 extend the range of events for which Inland Revenue can remit use-of-money interest. This has been achieved by removing the requirements for the event to be "naturally occurring", and for a civil defence emergency to be declared. The term "qualifying event" has been replaced by the term "emergency event".

Key features

- Section 183ABA of the Tax Administration Act 1994 clarifies that "significantly affected" means that the person's physical ability to pay tax has been significantly affected by the emergency event.
- Consequential amendments have been made to replace the term "qualifying event" with the term "emergency event" in sections CX 48 and EW 46 of the Income Tax Act 2007 and section 177D(3) of the Tax Administration Act 1994.
- Sections RC 7(7) and RC 36 of the Income Tax Act 2007 have been repealed. These provisions allowed taxpayers to make a late re-estimation of provisional tax. As a result of amendments contained in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006, it is no longer necessary to have a specific provision allowing taxpayers to make a late re-estimation of provisional tax.
- An amendment has been made to the list of defined terms in section GC 1, to correct a minor drafting error.

Application date

The amendments apply from the date of Royal assent, being 6 October 2009.

REMEDIAL MATTERS

TAX CREDIT FOR REDUNDANCY PAYMENTS

Sections ML 2 and YA 1 of the Income Tax Act 2007; section 41B of the Tax Administration Act 1994

Remedial amendments have been made to the Income Tax Act 2007 and the Tax Administration Act 1994 to ensure that the policy intention reflected in the Income Tax Act 2004 is reflected in the 2007 Act and that terminology changes in the 2007 Act are reflected in the Tax Administration Act 1994.

The amendments relate to the definition of "redundancy payment", clarification relating to the availability of a tax credit for redundancy payments and terminology consistency between the 2007 Act and the Tax Administration Act 1994.

Key features

Definition of redundancy payment

The definition of "redundancy payment" in section YA 1 of the 2007 Act has been amended to ensure it reflects the intent of the 2004 Act and terminology changes from the 2004 Act to the 2007 Act. The amended definition in section YA 1 is:

"redundancy payment means a PAYE income payment paid –

(a) to a person whose employment in a position is terminated because the position has become superfluous to the requirements of the employer; and

(b) in compensation for the loss of the person's employment"

Clarification relating to provision of tax credit for redundancy payment

Minor amendments have been made to section ML 2 of the 2007 Act to clarify that a redundancy payment tax credit is available per redundancy, regardless of the redundancy payment arrangements (as a lump sum or instalments) or the number of times a person may be made in any period.

Terminology changes

Section 41B of the TAA has been amended to reflect the change in terminology from "rebate" in the 2004 Act to "tax credit" in the 2007 Act.

Application date

The amendments apply from the date the Income Tax Act 2007 came into force – 1 April 2008.

AMENDMENTS TO THE PORTFOLIO INVESTMENT ENTITY RULES

Sections CX 55, CX 56, DV 2, DV 4(B), DV 5, DV 7, HL 4(1), HL 4(2), HL 5B(1), HL 6, HL 7, HL 9, HL 10(2), HL 12(1), HL 13, HL 29(7), IC 3, LA 6(1), LE 1, LS 1, LS 2, OB 9B and YA 1 of the Income Tax Act 2007; sections HL 4(1), HL 4(2), HL 10(2), HL 11B(1), HL 12, HL 27(7), ME 4(1) and OB 1 of the Income Tax Act 2004; sections 31B(1), 57B(3B), 57B(6) and 61(1C) of the Tax Administration Act 1994

A number of remedial amendments have been made to the tax rules for portfolio investment entities (PIEs). These amendments ensure that the rules achieve their intended policy effect.

Background

New tax rules for collective investment vehicles that meet the definition of a "portfolio investment entity" (PIE) were enacted by the Taxation (Savings Investment and Miscellaneous Provisions) Act in December 2006.

The PIE rules were designed to alleviate a number of long-standing problems with the taxation of collective investment vehicles. The rules treat investment through PIEs largely in the same way as direct investment by individuals, thus removing long-standing disadvantages of saving through collective investment vehicles, such as superannuation funds being taxed at a rate higher than investors in those funds with a lower marginal tax rate. These reforms were particularly important given the implementation of KiwiSaver in 2007.

PIEs are not taxable on realised share gains made on investments in New Zealand and certain Australian companies. They pay tax on investment income for their individual investors at a rate of 19.5% or 30%, depending on the investor's income in the previous two years. Income earned through a PIE generally does not affect investors' entitlements to family assistance, their student loan repayments or child support obligations.

Key features

The amendments in this Act are of a remedial nature and address technical problems that have been identified with the rules or amend the rules to cater for different circumstances. The amendments are consistent with the policy intent of the tax rules for portfolio investment entities.

The Act also rewrites the PIE rules to ensure they are consistent with the plain language drafting approach adopted more generally across other pats of the Income Tax Act. In particular, the entire subpart HL is rewritten as subpart HM.

Application dates

There are various application dates for the changes to the PIE rules. The amendments to the PIE rules in the Income Tax Act 2007 apply from 1 April 2008. The amendments to the PIE rules in the Income Tax Act 2004 are effective from 1 October 2007. The relevant amendments to the Tax Administration Act 1994 are effective from 1 October 2007. The changes to the rules related to the rewrite apply from 1 April 2010 to prevent them having any retrospective application.

Detailed analysis

Australasian share gains exclusion

Section CX 55 of the Income Tax Act 2007, which provides that proceeds from disposals of certain Australasian shares by PIEs are excluded income, has been amended to reinstate the previous Australian Stock Exchange listing and franking account requirements. These requirements were contained in the former section CX 55(1)(a)(ii) and (iii) and were inadvertently omitted when an amendment was made to this provision by the Taxation (Business Taxation and Remedial Matters) Act 2007.

Transfer of expenditure to portfolio investment entities (PIEs)

The PIE tax rules allow a superannuation fund or a unit trust (a member fund) that has not elected to be a PIE but that has invested in a PIE to transfer deductible expenditure to the PIE. A member fund may want to transfer expenditure to a PIE in this way as it may not have sufficient income against which to offset the expenditure. The member fund gains the tax benefit of the expenditure it transfers because the PIE offsets the transferred expenditure against the income that it earns for the member fund.

A number of remedial amendments to the expenditure transfer rules in subpart DV of the Income Tax Act 2007 have been made to ensure that they apply appropriately for PIEs that are portfolio tax rate entities.

Section DV 2(6) has been amended to ensure that the transferred expenditure is deductible to the portfolio tax rate entity in the income year the expenditure is transferred by the member fund.

Sections DV 2 and DV 5 of the Income Tax Act 2007 have been amended to provide that a portfolio tax rate entities deduction is limited to the member fund's share of the portfolio tax rate entities taxable income for the income year in which the expenditure is transferred (sections DV 2(8B) and DV 5(7B)).

REMEDIAL MATTERS

Sections DV 4(B) and DV 7(1) provide that excess expenditure that cannot be transferred in a year can be carried forward by the member fund and transferred in a later income year.

Entity type eligibility requirement

Section HL 4(1)(a) of the Income Tax Act 2007 and Income Tax Act 2004 has been amended to provide that an entity ceases to be a PIE if the entity fails to meet the entity type requirements in section HL 2(2). For example, the key entity type requirement for a portfolio tax rate entity is that the entity must be a company, superannuation fund or a group investment fund.

Effect of failure to meet eligibility requirements

Section HL 4(2)(a) of the Income Tax Act 2007 and the Income Tax Act 2004, concerning breaches of certain eligibility requirements, has been restructured to clarify that some requirements are on a class basis while others are on an entity basis. An entity ceases to be eligible to be a PIE if a portfolio investor class of the entity fails to meet a requirement of section HL 6 (Investor membership requirement) or section HL 9 (Investor interest size requirement) within the prescribed timeframes. New section HL 4(2)(ab) on the other hand, provides that an entity ceases to be eligible to be a PIE if the entity fails to meet a requirement of section HL 10 (Requirements relating to PIE investments) within the prescribed timeframes.

Portfolio investor proxy

Section HL 5B(1)(d) of the Income Tax Act 2007 has been repealed so that, for an investment in a PIE held through a portfolio investor proxy (PIP), the ultimate investor rather than the PIP is treated as the investor. This is relevant when PIEs are considering whether the investor membership requirement in section HL 6 or the investor interest size requirement in section HL 9 have been satisfied.

Public unit trusts

Section HL 6 of the Income Tax Act 2007 has been amended so that it is clear that there is no investor membership requirement for a portfolio investor class if the class itself is a public unit trust (that satisfies paragraphs (a) and (c) to (e) of the definition) or an investor in the class is a public unit trust. Similar amendments have been made to the investor interest size requirement in section HL 9.

Investor interest adjustment

Portfolio tax rate entities must make an adjustment to reflect the effect of the portfolio investor rate of an investor, within certain time periods. An amendment has been made to section HL 7 of the Income Tax Act 2007 to allow the Commissioner to extend the time limit for which an adjustment must be made if it is reasonable in the circumstances. This is to ensure that the PIE status of an entity is not automatically lost when the investor return adjustment requirement is not satisfied within the required time period.

Application of fund withdrawal tax rules to superannuation funds that have elected to be portfolio tax rate entities

An amendment has been made to section HL 7 of the Income Tax Act 2007 to ensure that the income that a PIE (that no longer files an income tax return) derives under the fund withdrawal tax rules should be treated as income to which no investor has an entitlement. This change effectively results in the PIE accounting for the fund withdrawal tax along with its other PIE tax obligations.

Exemption for investor interest size

Section HL 9 of the Income Tax Act 2007 sets out the investor interest size requirement for PIEs. The general rule in section HL 9(1) is that an investor in a portfolio investor class of the PIE cannot hold more than 20% of the portfolio investor class. The list of exceptions to this requirement has been amended to add a portfolio investor class of fewer than 20 persons, provided certain criteria are met.

Exception for community trusts

Community trusts are established to manage public assets and, as such, are analogous to entities that have exemptions applying to them, such as the Earthquake Commission and Auckland Regional Holdings. An amendment has therefore been made to sections HL 6 and HL 9 of the Income Tax Act 2007 to add "community trusts" to the list of investors to which exemptions apply.

Land-owning companies

As well as holding shares and debt investments, PIEs can also directly own land because passive investments in land can be a major element of a diversified investment portfolio. However, weaknesses in the previous law allowed land-rich active businesses (for example, rest homes and airports) to use the ability of portfolio investment entities to own land directly to their advantage and restructure themselves as PIEs. This was contrary to the policy intent of the portfolio investment entity rules, which were designed to be used by widely held passive savings vehicles.

In particular, previously, the weakness in the law allowed a land-rich active business to be effectively split up into a land-owning company (the PIE), and an operating company, using a structure that ensured the operating company did not "taint" the land-owing company and prevent it from being a PIE. This could be done by:

- stapling shares in the land-owing company to shares in the operating company; or
- leasing the PIE's land and buildings to an associated operating company and ensuring the operating company does not represent a significant portion of the PIE's total investments.

The weaknesses have been addressed by amending the income type requirement in section HL 10(2)(b)(iii) of the Income Tax Act 2004 and the Income Tax Act 2007, which previously provided that income under a lease of land meet the income type requirement. The amendment provides that income under a lease of land derived by a PIE from an associated person (which includes a company whose shares are stapled to the shares in the PIE) does not count as qualifying income for the purposes of the income type eligibility requirement in section HL 10(2)(b)(iii).

Becoming a portfolio investment entity

Section HL 13 of the Income Tax Act 2007 and section HL 12 of the Income Tax Act 2004 contain rules dealing with consequences of an entity becoming a PIE. Section HL 13(1)(b) of the Income Tax Act 2007 and section HL 12(1)(b) of the Income Tax Act 2004 provide that an entity is considered never to have been a PIE if, within 12 months of the date of election to become a PIE, it fails to meet one or more of the eligibility criteria referred to in section HL 4.

These deeming provisions have been amended so they apply only if an entity fails to meet one or more of the eligibility requirements in section HL 6 (Investor membership requirement), HL 9 (Investor interest size requirement), or section HL 10.

Credits received by portfolio tax rate entities

The credit allocation rules for PIEs in section HL 29(7) of the Income Tax Act 2007 and section HL 27(7) of the Income Tax Act 2004 have been amended to ensure that an investor with a portfolio investor exit period (exiting investor) is not able to gain a double benefit for the allocated amount of credits.

An exiting investor in a quarterly portfolio tax rate entity should be treated as receiving a credit which has been allocated to the investor in the quarter in which the exit occurs. Previously, under the wording of these provisions, the exiting investor may have got the benefit of credits that were allocated in previous quarters twice – first by the portfolio tax rate entity reducing its portfolio entity tax liability, and secondly by the investor being able to use the allocated credit against other tax liabilities. Therefore a clarifying amendment has been made to section HL 29(7) of the Income Tax Act 2007 and section HL 27(7) of the Income Tax Act 2004 to ensure that the proper amount of credit is allocated to an exiting investor.

Consolidated tax group including portfolio tax rate entities

The policy intention of the grouping rules as they apply to portfolio tax rate entities is that the benefits of the wholly owned group rules apply when a portfolio tax rate entity parent owns 100% of the underlying companies and the underlying companies are portfolio tax rate entities or portfolio land companies. An amendment has been made to section IC 3 of the Income Tax Act 2007 to ensure this policy intent has been met.

Use of allocated imputation credits

A clarifying amendment has been made to section LE 1 of the Income Tax Act 2007 to ensure that persons are allowed a tax credit if imputation credits are allocated to them under section HL 29(7)(b). The relevant persons are zero-rated portfolio investors such as companies and trustees, and investors with portfolio investor exit periods. Section LE 1(1B) provides that an investor in a portfolio tax rate entity who is allocated an imputation credit under section HL 29(7)(b) has a tax credit for the tax year of an amount equal to the imputation credit.

The main imputation crediting provision in section LE 1(1) refers to a person whose assessable income for an income year includes an imputation credit. This inclusion is achieved by section CD 15, which provides that an amount of a dividend is increased by an imputation credit attached to the dividend. This provision, however, is not applicable to investors in portfolio tax rate entities who are allocated imputation credits under section HL 29(7)(b) separately from any dividend.

Section LE 1(4) has consequently been repealed.

Confirming refundability of certain tax credits for portfolio tax rate entities

A clarifying amendment has been made to ensure that tax credits under section LS 1 of the Income Tax Act 2007 are refundable to a portfolio tax rate entity (other than an entity that chooses to pay provisional tax). The relevant credits are credits (not being foreign tax credits) allocated to individual investors (other than investors with portfolio investor exit periods) under section HL 29 and credits arising under section HL 21(2).

The amendment confirming refundability of credits arising under section LS 1 involves including section LS 1 credits in the list of refundable credits in section LA 6(1). The section YA 1 definition of "refundable tax credit" has also been amended to include credits arising under section LS 1.

Imputation credit of ICA company passed on by portfolio tax rate entity

A change has been made to section ME 4(1) of the Income Tax Act 2004 to allow an imputation credit account (ICA) company an imputation credit for the amount of imputation credit allocated to it by a portfolio tax rate entity.

Recording allocated credits in company investor's imputation credit account

A new provision, section OB 9B, has been inserted in the Income Tax Act 2007 to ensure that a company investor in a portfolio tax rate entity can include imputation credits allocated to it under section HL 29(7)(b) in its imputation credit account. The imputation credit will be recorded in the company investor's imputation credit account on the date the credit is allocated by the portfolio tax rate entity to the investor.

Previously, section OB 9 allowed a company to include in its imputation credit account an imputation credit attached to a dividend derived by the company. This did not cater for a company investor in a portfolio tax rate entity which was allocated imputation credits under section HL 29(7)(b) separately from any distribution from the portfolio tax rate entity.

Selection of incorrect portfolio investor rate

An amendment has been made to the definition of "portfolio investor rate" in section YA 1 of the Income Tax Act 2007 to allow the Commissioner to override a rate incorrectly selected by an investor; the exercise of this discretion would result in the default portfolio investor rate of 30% applying.

Normally, the portfolio investor rate is the rate that an investor notifies to the portfolio tax rate entity as the investor's prescribed investor rate. The portfolio tax rate entity is entitled to rely on the rate notified to it by the investor. Under the amendment, the rate notified by the investor to the portfolio tax rate entity will continue to apply as the portfolio investor rate unless the Commissioner has notified the entity that the rate notified by the investor is to be disregarded, in which case the default rate of 30% under paragraph (a) of the portfolio investor rate definition applies.

Prescribed investor rates and trustees of charitable trusts

The definition of "prescribed investor rate" in section YA 1 of the Income Tax Act 2007 and section OB 1 of the Income Tax Act 2004 has been amended to prevent trustees of charitable trusts electing a 30% rate instead of being zero-rated portfolio investors. If charitable investors could elect a 30% rate they could access the benefit of refundable credits for portfolio investor allocated losses and excess imputation or other credits, something they could not get as zero-rated portfolio investors. This would be contrary to the policy intent of the portfolio investment entity rules.

Prescribed investor rate for trustees

An amendment has been made to section YA1 of the Income Tax Act 2007 to allow trustees to elect the 19.5% prescribed investor rate.

Section CX 56 has been amended so that portfolio investor allocated income allocated to a trustee that has had the 19.5% prescribed investor rate applied to that income, is not excluded income.

Section LS 2 has been amended to allow the trustee a tax credit for tax paid at the PIE level on the allocated income.

The changes will help trustees manage their provisional tax obligations.

Listed PIEs electing to be portfolio tax rate entities

To ensure there is consistency with the policy intent of the PIE rules, an amendment has been made to section YA 1 of the Income Tax Act 2007 that allows PIEs that are listed on a recognised exchange to elect to be portfolio tax rate entities.

Information provided by portfolio tax rate entities to investors

Section 31B(1) of the Tax Administration Act 1994, which contains the requirement for portfolio tax rate entities to provide information statements to zero-rated portfolio investors, has been repealed. This means that these investors are covered by the information statement rules in section 31B(3), which require portfolio tax rate entities to provide information statements to their investors by 30 June after the end of the tax year (or a later date if the entity has a late balance date).

Previously, portfolio tax rate entities were required under section 31B(2B) to provide information statements to their zero-rated portfolio investors within one month of the end of the relevant period, which in practice was an insufficient period to comply with. Also, quarterly portfolio tax rate entities were required to issue a statement each quarter to zero-rated portfolio investors rather than on an annual basis.

Returns by portfolio tax rate entities

Section 57B(6)(c) of the Tax Administration Act 1994 has been amended to provide an additional month for portfolio tax rate entities that are ceasing to file their final return. This means that such entities have three months rather than the previous two months to provide their final return.

A cross-referencing correction to section 57B has been made in section 61(1C). The amended section 61(1C) requires a portfolio tax rate entity (not being an entity that chooses under section HL 23 to pay provisional tax) to disclose its interests in foreign companies or foreign investment funds by the due date for the entity's return under section 57B(7).

The provision in section 57B, containing the deadlines by when portfolio tax rate entities must perform their responsibilities for investors with portfolio investor exit periods, has been re-enacted as subsection (3B) – the provision previously had incorrectly been located within section 57B(7).

Minor drafting corrections

A number of amendments have been made to correct minor drafting and cross-referencing errors. These include:

- Section HL 6(4)(a) and (b) of the Income Tax Act 2007 and the Income Tax Act 2004, relating to the investor membership requirement, have been amended to include a cross-reference to the paragraph that lists Auckland Regional Holdings.
- Section HL 9(6)(a) and (b) of the Income Tax Act 2007 and the Income Tax Act 2004, relating to the investor interest size requirement, have been amended to include a cross-reference to the paragraph that lists Auckland Regional Holdings.
- Section HL 12(1)(a) of the Income Tax Act 2007 and section HL 11B(1)(a) of the Income Tax Act 2004, relating to unlisted companies choosing to become portfolio listed companies, have been amended so that the reference to an unlisted company needing to have 100 shareholders has changed to an unlisted company needing to have at least 100 shareholders.

AMENDMENTS TO THE OFFSHORE PORTFOLIO SHARE INVESTMENT RULES

Sections CD 36, EX 31(2), EX 37, EX 46, EX 46(10)(cb), EX 47, EX 51, EX 52, EX 53, EX 56, EX 59, EX 59(2B), EX 62 and EX 66B of the Income Tax Act 2007; sections CD 26, EX 33(4), EX 40B, EX 44, EX 44C, EX 44D, EX 45B and EX 47 of the Income Tax Act 2004; sections 61, 91AAO and 183 of the Tax Administration Act 1994

A number of remedial amendments have been made to the 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 rules, which apply for income years beginning on or after 1 April 2007, generally apply to an investment by a New Zealand resident in a foreign company when the investor owns less than 10% 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 tax rules for offshore portfolio investment in shares mainly relate to the foreign investment fund (FIF) rules. The main changes were removal of the "grey list" exemption in the FIF rules and introduction of the new fair dividend rate method – which broadly taxes 5% of a person's offshore share portfolio's opening value each year.

Key features

The following amendments outlined in this TIB report are of a remedial nature and address technical problems that were identified with the new rules or amend the rules to cater for different circumstances. All the amendments are consistent with the policy intent of the new tax rules for offshore portfolio investment in shares.

Application dates

The amendments contained in the Income Tax Act 2007 are generally effective from 1 April 2008 (any variation from this date is noted in the following text). The smaller number of amendments to the Income Tax Act 2004 are effective from 1 April 2007.

Detailed analysis

Venture capital exemption

Several aspects of the exemption in the FIF rules for interests in grey list companies which own New Zealand venture capital companies – section EX 37 of the Income Tax Act 2007 and section EX 33(4) of the Income Tax Act 2004 – have been clarified. First, ownership of the New Zealand company has been defined as "holding more than 50% of the voting interests in the company". This amendment makes it clear when the 10-year limitation for the exemption ends. Secondly, an amendment has been made to clarify that the company that carries on business in New Zealand is a New Zealand-resident company.

Australian-resident listed company exemption

The exemption from the FIF rules for shares in Australian-resident companies listed on the Australian Stock Exchange has been amended to cater for companies which are the subject of court-approved reorganisations. In particular, the requirement in section EX 31(2) of the Income Tax Act 2007 that shares in the company be included in an approved Australian Stock Exchange index has been expanded. It now includes the situation when the shares are included in an approved index at the beginning of the final month of the preceding income year, if the shares are cancelled or transferred in the first month of an income year under a court-approved arrangement.

Comparative value method and currency conversion rules

A clarifying amendment has been made to the "opening value" definition in the comparative value method in the FIF rules (section EX 51 of the Income Tax Act 2007 and section EX 44 of the Income Tax Act 2004) to ensure that the correct exchange rate is used.

The opening value definition in the comparative value method refers to the market value of the person's interest at the end of the previous income year. If a person has chosen to use the average exchange rate (the average of the close of trading spot exchange rates for the 15th day of each month that falls in the year), it is the average exchange rate applying for that previous year which should be used to calculate the opening value for the current year. This approach is necessary to ensure that exchange rate gains and losses are reflected in FIF income or loss under the comparative value method over different income years.

Therefore the comparative value method provisions have been amended to ensure that it is the relevant exchange rate applying in the previous income year that is used to calculate the opening value for the current year.

Comparative value method loss restriction

The comparative value method in section EX 51 of the Income Tax Act 2007 has been amended so that the loss restriction rule under this method applies to foreign superannuation and foreign life insurance interests. Without this amendment investors would be able to claim a loss under the comparative value method for these interests but limit any gain to 5% under the fair dividend rate method.

This amendment applies for the 2009–10 and subsequent income years.

Criteria for using the fair dividend rate method – hedging requirement

The fair dividend rate method cannot be used for certain types of investments that are broadly the same as New Zealand dollar denominated debt investments. One of these exclusions is contained in section EX 46(10)(c) of the Income Tax Act 2007. The section provides that the fair dividend rate method cannot be used for an interest in a non-resident entity that holds, directly and indirectly, assets of which 80% or more by value consist of financial arrangements or fixed-rate shares that are denominated in New Zealand dollars or are hedged back to New Zealand currency with that hedging being at least 80% effective.

New section EX 46(10)(cb) clarifies that the instrument which hedges the investment to New Zealand currency can be held by the New Zealand investor as well as a non-resident entity. In determining whether the non-resident in which the interest is held holds directly or indirectly assets of which 80% or more by value consist of financial arrangements or fixed-rate shares, intra-group financial arrangements are ignored. Also, the new provision does not apply if the non-resident entity (in which the New Zealand resident invests) is listed on a recognised exchange and is not a foreign investment vehicle (ignoring section HL 10(4) which narrows the "foreign investment vehicle" definition). The purpose of these restrictions in new section EX 46(10)(cb) is to ensure that in-substance, equity investments are not caught.

Excluding managed funds from grey list exception in fair dividend rate method

The fair dividend rate rules were amended by the Taxation (Business Taxation and Remedial Matters) Act 2007 to provide that there is no FIF income for an interest if the interest is a 10% or more holding in a grey list company at the start of an income year. This ensures there is no FIF income if that holding falls below 10% during the year. This treatment is consistent with the general fair dividend rate treatment, which ignores purchases of shares during a year (other than quick sales).

However, this 2007 amendment should not generally apply to managed funds that hold shares in a foreign investment vehicle because the remaining grey list exemption for 10% or more interests does not apply to managed funds such as portfolio investment entities. Instead, the fair dividend rate method applies to these investments. Accordingly, an exclusion has been made to this amendment for managed funds (portfolio investment entities, entities eligible to be portfolio investment entities or life insurance companies) that hold interests in foreign investment vehicles (as defined in section YA 1 of the Income Tax Act 2007 and section OB 1 of the Income Tax Act 2004).

A managed fund is therefore able to use the fair dividend rate method for a 10% or more interest in a foreign investment vehicle that is resident in a grey list country (as it was previously able to for an interest in a foreign investment vehicle resident in a non-grey list country). This exclusion has been achieved by amendments to the fair dividend rate method provisions in the Income Tax Act 2007 (sections EX 52 and EX 53) and the Income Tax Act 2004 (sections EX 44C and EX 44D).

Related amendments have been made to sections EX 59 and CD 36 of the Income Tax Act 2007 and sections EX 47 and CD 26 of the Income Tax Act 2004 to ensure that the dividend exclusion continues to apply for a managed fund holding an interest in a foreign investment vehicle.

Cost method: transitional rule

The cost method in the FIF rules was amended by the Taxation (Business Taxation and Remedial Matters) Act 2007 to allow investors to use their actual cost for their opening value under that method, instead of having to obtain an independent valuation, for interests acquired in the 2005–06 or 2006–07 income year. This amendment was designed to reduce compliance costs for taxpayers using the cost method for the 2007–08 income year, the first income year that the cost method is used for.

An amendment has been made to the cost method in section EX 56 of the Income Tax Act 2007 and section EX 45B of the Income Tax Act 2004 to ensure that the opening value option is available only for the 2007–08 income year and not future income years. This is because the opening value does not include an uplift factor for the previous year's FIF income to act as a proxy for an increase in the value of the investment.

Cost method: effect of previous year's quick sale gains on opening values

The cost method in section EX 56 of the Income Tax Act 2007 has been amended so that the formulas for calculating the opening value do not include the previous year's quick sales gains. Quick sale gains from the previous year should not be included in calculating the opening value because this would overstate FIF income in the current year.

Management fee rebate received from an offshore fund

New section EX 59(2B) of the Income Tax Act 2007 ensures that management fee rebates received from an offshore fund manager in relation to a FIF interest are not excluded by section EX 59(2) from being treated as income of the New Zealand-resident investor if the investor was allowed a deduction for the fee.

This amendment applies for the 2009–10 and subsequent income years.

Change of method by taxpayer in the first year

An amendment to section EX 62 of the Income Tax Act 2007 allows individuals a one-off opportunity to change their FIF calculation method from the accounting profits or branch equivalent methods to the fair dividend rate method. The change must be made for the 2008–09 tax year if the person has not filed a return for that year before the date of Royal assent. If the person has filed a return for the 2008–09 tax year before the date of Royal assent, the change to the fair dividend rate method will be effective for the 2009–10 tax year.

Deemed disposal and re-acquisition when FIF becomes New Zealand-resident

An amendment has been made to deal with the situation where a non-resident entity becomes a New Zealand resident, thereby ceasing to be a FIF. New section EX 66B of the Income Tax Act 2007 treats individuals with an interest in the entity as having disposed of and reacquired their interest at market value.

This amendment applies for the 2009–10 and subsequent income years.

Drafting consistency amendment

To achieve consistency with other references to the comparative value method in sections EX 46(4)(a)(i) and EX 62(2)(c), section EX 47 of the Income Tax Act 2007 has been amended by replacing the reference to "start of the income year" with "end of the income year". Therefore, a person who is not allowed to use the fair dividend rate method for an attributing interest is required to use the comparative value method for that interest, or the deemed rate of return method if the comparative value method is not practical because the person cannot obtain the market value of the interest at the end of the income year. The same change has been made to the corresponding provision in section EX 40B of the Income Tax Act 2004.

Income Tax Act rewrite-related amendments

A number of remedial amendments have been made to the FIF rules in the Income Tax Act 2007 to ensure that there has been no inadvertent change to the rules as part of the Income Tax Act rewrite process. The significant rewrite-related amendments are:

- The fair dividend rate rules in sections EX 52 and EX 53 of the Income Tax Act 2007 have been amended to allow an investor to offset a net loss from one FIF interest against the net gain from another FIF interest. This reinstates the position that exists under the Income Tax Act 2004. The fair dividend rate rules in the Income Tax Act 2004 pooled the results for all attributing interests for which an investor used the fair dividend rate method. In contrast, the fair dividend rate rules in the Income Tax Act 2007 deal separately with each FIF in which an investor holds attributing interests. This approach prevents an investor offsetting, under the quick sale gains part of the fair dividend rate formula, a net loss from one FIF interest against a net gain from another FIF interest.
- The references to treating certain shares as debt have been removed from sections EX 46 and EX 47. This prevents the wording of a number of provisions in sections EX 46 and EX 47 of the Income Tax Act 2007 giving the incorrect impression that certain types of shares for which the fair dividend rate method may not be used are instead treated as debt for the purposes of the Income Tax Act 2007 (and therefore subject to the financial arrangement rules rather than the FIF rules). It is intended that these shares be taxed under the comparative value method in the FIF rules.
- 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 should be treated as being held by the share supplier and not the share user. This amendment was made by the Taxation (Business Taxation and Remedial Matters) Act 2007 to the fair dividend rate method provisions in the Income Tax Act 2004 but was inadvertently not made to the corresponding provisions in the Income Tax Act 2007. This omission has been rectified by amendments to sections EX 52 and EX 53 of the Income Tax Act 2007.

Disclosure of foreign interests

Section 61 of the Tax Administration Act 1994, containing the disclosure requirements for interests in foreign companies or FIFs, has been amended to facilitate electronic filing. One of the problems for electronic filing under the previous rules was the requirement that the disclosure must be "with that person's return of income". This has been replaced by a requirement that the disclosure be made within the time allowed for providing a person's return of income for the year.

The first reference to "tax year" in section 61(1) has also been replaced with "income year" to cater for persons with non-standard balance dates. This amendment is a correction since references to years in the international tax rules – which include section 61 of the Tax Administration Act 1994 – have always included non-standard accounting years since their inception in 1988. The amendment is effective from 1 April 2005.

Application date of fair dividend rate determinations

An amendment has been made to section 91AAO of the Tax Administration Act 1994 to allow portfolio investment entities that return their income on a quarterly basis to apply a fair dividend rate determination retrospectively for a quarter beginning before the date that the determination is made.

Suspending obligation to pay tax on foreign investment fund income

Section 183 of the Tax Administration Act 1994, which allowed the payment of tax on FIF income to be suspended in very limited circumstances, has been repealed as a tax simplification measure. This complicated provision was not used in practice and had also been superseded by exemptions enacted in 2006 for new migrants.

REMEDIAL AMENDMENTS TO THE RESEARCH AND DEVELOPMENT TAX CREDIT

Sections CX 48D, LH 1, LH 2, LH 3, LH 5(4), LH 14B, OB 4(3), OB 32(7), OB 33(5), OB 37, OC 16, OK 2(3)(cb), OK 12(7), OK 13(5), OK 14B, OP 7(3)(fb), OP 30(5), OP 31(5), OP 35, schedule 21 part A and part B of the Income Tax Act 2007; sections 3, 68D, 68E, 68F, 89AB, 89DA(3), 108(1B), 113D(2), 173L(3) and 177B(7) of the Tax Administration Act 1994

Remedial amendments have been made to the research and development tax credits for the 2008–09 income year. The amendments clarify the policy intention of the tax credit and make some technical changes to the administration of the tax credit.

Background

While the R&D tax credits have been repealed from the 2009–10 income year, the government signalled further work to align the tax credit legislation with the policy intention in a number of areas. The remedial amendments arising from that work relate to:

- eligibility of government agencies;
- company groups and the eligibility rules;
- • feedstock rules;
- eligibility of labour R&D costs; and
- technical changes to the administration of the tax credit.

Application date

The amendments are retrospective and will apply for the 2008–09 income tax year. The tax credit was repealed from the 2009–10 income year by the Taxation (Urgent Measures and Annual Rates) Act 2008.

Key features

Government agencies (section LH 1 of the Income Tax Act 2007)

The tax credit rules require a claimant to be in business or to be an industry research co-operative. Some Crown agencies are specifically excluded from eligibility.

Under the previous legislation, Crown agencies that could meet the business test and that were not specifically excluded were eligible for the tax credit. This is contrary to the policy intent of the tax credit, which aims to incentivise R&D carried out by private sector businesses.

A new paragraph has been added to section LH 1(2) to exclude Crown entities as that term is defined in the Crown Entities Act 2004.

A consequential amendment has been made to paragraphs LH 1(2)(b) and (c) which exclude associates of and those controlled by entities that are specifically excluded.

Company groups (sections LH 1 and LH 3 of the Income Tax Act 2007)

To qualify for the tax credit, among other requirements, a claimant must:

- be in business;
- control the R&D activity; and
- effectively own the results of the R&D activity.

This can be problematic for larger firms that separate aspects of their operation for commercial purposes. For example, a firm may locate its R&D division in one subsidiary but hold any resulting intellectual property in another subsidiary to manage risk.

Group companies, which are essentially one economic unit, would be eligible for the tax credit if they restructured their activities so that one member of the group carried out all the necessary functions. Requiring firms to amalgamate these functions, which were previously carried out in separate subsidiaries within the group, in order to be eligible for the tax credit is inefficient and would create unnecessary compliance costs.

Section LH 1 has been amended to enable a New Zealand-resident member of a group to meet the requirement to be in business in New Zealand if another New Zealand-resident member of the group would meet that requirement. A consequential amendment has been made to section LH 3(1)(a).

New subsection LH 3(6)(a) has been added to allow a New Zealand-resident member of a group to meet the requirement to control the research and development activities if another New Zealand member of the group would meet that requirement. Similarly, new subsection LH 3(6)(b) allows a New Zealand-resident member of a group to meet the requirements to effectively own the results of the research and development activities, if another New Zealand-resident member of the group, or another member that is controlled by a New Zealand-resident member, would meet that requirement.

Feedstock rules (schedule 21 part A and part B of the Income Tax Act 2007)

The feedstock rules apply when the R&D includes the testing of a production process. The objective of the feedstock rules is to limit the amount of the R&D credit which can be claimed when some valuable output is produced.

The feedstock rules have been rewritten to better reflect the intention of the original legislation. Paragraph 8, part A of schedule 21 makes it clear that, at first instance, expenditure or depreciation loss incurred in acquiring or producing things which are to be transformed as part of a production process is eligible for the credit. The limitation formerly in part A has been removed.

The limitation in part B has been rewritten to make it clear that:

- It only applies to things which are the input into the feedstock process.
- It does not apply when a trial model or preliminary version is the output of the process.

Example

A mountain bike manufacturer is developing a new coating for bike frames which will be more durable than paint. It applies several different trial formulations of the coating to batches of frames to see whether the colour is consistent. The resulting frames are of a good enough quality to be sold as factory specials.

Cost of inputs (value of bare steel frames and coating)	$2,000
Other production costs (labour, electricity etc)	$1,000
Total costs	**$3,000**
Value of coated frames	$2,500

The credit will not be available for the input cost of $2,000. The other production costs of $1,000 remain eligible for the credit.

Labour R&D costs (section LH 5(4)(c)(ii) of the Income Tax Act 2007)

The R&D credit is generally only available for expenditure which is deductible for income tax purposes. However, the credit is also available for capital expenditure where that expenditure is incurred in the intended development of depreciable property that is intangible property, or tangible property intended only for use in the R&D activities.

These rules mean that R&D expenditure on labour which is capitalised and is:

- incurred in relation to a tangible asset which is intended to be used in the business; or
- incurred on intangible property which is not depreciable–

will not be eligible for the R&D credit when the expenditure is incurred.

New section LH 5(4)(c)(ii) allows the credit for certain R&D labour costs. To be eligible for the credit, the costs must be:

- of the type which falls within clauses 1, 3 or 9 of part A of schedule 21. These clauses refer to labour costs, costs which relate to labour, and contracted-out expenditure respectively;
- incurred in scientific, investigative, and experimental activities referred to in section LH 7(1)(a), and not those which fall under the "support costs" limb in section LH 7(1)(b); and
- not incurred directly in the construction of tangible property.

Example

A business is developing a new production line to produce items in a way that has never been done before. Developing the new production line involves the following stages:

- The company's production scientists design the new production line. On the facts of this case, designing the production line qualifies as R&D. All of the uncertainties around the new production line are resolved by computer-aided modelling before the decision to construct the new production line is made.
- The company's engineers construct the new machinery which makes up the production line. They are supervised by the production scientists. Construction is entirely straightforward and conventional.

If the production line works satisfactorily, the business will use it in its normal business. The costs of the production scientists, the engineers, and the various materials used to construct the production line are capitalised as part of the costs of the new production line.

The work of the production scientists in designing the new production line is eligible for the R&D tax credit under new section LH 5(4)(c)(ii). So is any expenditure relating to those scientists falling under paragraph 3 of part A of schedule 21. The expenditure on the engineers who build the production line, and the production scientists in supervising them, is not eligible because it is incurred "directly in the construction of tangible property". The expenditure on materials does not qualify.

In this example, if the production line, once completed, is used in the R&D process – perhaps for testing – depreciation on the production line will not be eligible for the credit. This is because the requirement in schedule 21, part A, paragraph 2(b) that "all the activities involved in the construction of the property are research and development activities" is not met because the construction of the production line is neither a scientific, investigative or experimental activity, and the production line is not constructed mainly for the purpose of scientific, investigative and experimental activities. The main purpose of the production line is use in the business.

ADMINISTRATIVE AMENDMENTS

Sections CX 48D, LH 1(3), LH 2(7), LH 14B, OB 4(3)(eb), OB 32(7), OB 33(5), OB 37, OC 16, OK 2(3)(cb), OK 12(7), OK 13(5), OK 14B, OP 7(3)(fb), OP 30(5), OP 31(5) and OP 35 of the Income Tax Act 2007; sections 3, 68D, 68E, 68F, 89AB, 89D(2E), 89DA(3), 108(1B), 113D(2), 173L(2)(bb), 173L(3) and 177B(7) of the Tax Administration Act 1994

The amendments fine-tune the administration of the tax credit.

Filing on behalf of partners (sections 68D and 68E)

Partners are required to file individual detailed statements supporting an R&D tax credit claim including contributions to R&D performed on behalf of a partnership and R&D done on their own account. This amendment streamlines the filing process for R&D returns for situations when a partner is a member of more than one partnership doing R&D, and particularly when they are also in an internal software development group.

Switching off certain return requirements for the detailed statement (section 68F)

Some of the requirements and consequences of being a return are switched off for detailed statements – namely, the requirements to sign and retain a hardcopy transcript of the detailed statement for seven years. The amendments also make it clear that the position taken by claimants in the detailed statement do not amount to the claimant taking a tax position. This ensures that shortfall penalties do not apply from the calculations in the detailed statement. Shortfall penalties will continue to apply to R&D tax credits claimed in an income tax return.

Response periods for notices related to R&D tax credits (sections 3 and 89AB)

The core definition of "response period" has been moved from section 3(1) to a new section 89AB of the Tax Administration Act 1994. Time periods for filing notices of proposed adjustment (NOPAs) that relate solely to an amount of R&D tax credit have been amended so that they are consistent with other time limits for those credits. Claimants have two years from the final date for filing a tax return for an income year to file a NOPA that relates solely to an amount of R&D tax credit for that income year. There is no change to response periods in the case of notices that do not relate solely to an amount of R&D tax credit.

No dispute of an R&D amount until detailed statement provided (sections 89D(2E) and 89DA(3))

Claimants cannot dispute an assessment of an R&D amount until an R&D detailed statement (under sections 68D or 68E) has been provided for the tax year. This will ensure that Inland Revenue has the necessary information about a claimant's R&D activities before a dispute commences.

OTHER TECHNICAL AMENDMENTS

Sections CX 48D, LH 1(3), LH 2(7), LH 14(B), OB 4(3)(eb), OB 33(5), OB 37, OC 16, OK 2(3)(cb), OK 12(7), OK 13(5), OK 14B, OP 7(3)(fb), OP 30(5), OP 31(5), OP 35, OP 31(5) and OP 35 of the Income Tax Act 2007; sections 108(1B), 173L (2)(bb), 173L (3) and 177B(7) of the Tax Administration Act 1994

The amendments also confirm current policy in relation to the interaction between imputation rules and the R&D tax credit, refunds of the tax credit, effective dates of transfer of the credit, and clarifies that the R&D tax credit is excluded income of the taxpayer. Other amendments to the rules align final dates for filing an R&D tax credit claim, providing supporting information, and amending a tax credit claim, by making them relative to the due date for the initial claim.

KIWISAVER

Sections 13, 25, 89, 100, 101D, 101FB, 101FC, 101G, 226, and 229 of the KiwiSaver Act 2006; clause 9 of the KiwiSaver Scheme Rules; section YA 1 of the Income Tax Act 2007; section 68C of the Tax Administration Act 1994

A number of remedial amendments have been made to the KiwiSaver legislation. These amendments ensure that the KiwiSaver rules achieve their intended policy effect.

Key features

Withdrawal of funds on death

The accumulated funds in a member's KiwiSaver account, up to a maximum of $15,000, can be paid out on that member's death directly to a named person, in accordance with section 65 of the Administration Act 1969. The previous process required that probate or letters of administration be presented to the trustees of a KiwiSaver scheme before a deceased member's funds could be withdrawn. This new process is in addition to the probate or letters of administration procedures, and applies from 1 July 2007.

Liability to back-pay compulsory employer contributions

Employers who fail to comply with the automatic enrolment rules of the KiwiSaver Act by not making deductions from an employee's salary or wages when the employee begins new employment must back-pay any unpaid compulsory employer contributions once the non-compliance is detected. New section 101FB of the KiwiSaver Act limits an employer's liability to back-pay compulsory employer contributions to the lesser of the duration of the current employment relationship or the first year of current employment (provided the employee becomes a KiwiSaver member during either of those periods). The provision applies from 1 April 2008.

Repeal of section 13 (Employment in schools)

Under the previous rules, section 13 of the KiwiSaver Act provided that Ministry of Education employees who begin a new job at a state or state-integrated school were treated as starting new employment, despite remaining on the same payroll. Boards of Trustees, which are treated as the employer of school employees for KiwiSaver purposes, were exempt from automatic enrolment before 1 October 2008. This exemption ended when the State Sector Retirement Savings Scheme and the Teachers Retirement Savings Scheme were closed to new enrolments.

The end of the Boards of Trustees' exemption from automatic enrolment created compliance problems for the Boards and the Education Service Payroll, particularly when transferring employees across the education sector. Section 13 has been repealed so that employees who transfer between schools are not subject to automatic enrolment. The amendment applies from the date of Royal assent, being 6 October 2009.

Exempt employer provisions – sunset clause

Section 25 of the KiwiSaver Act limits the ability for employers who have established their own superannuation schemes to be eligible for exemption from the automatic enrolment rules. The provision does not restrict employers from setting up their own superannuation schemes. Instead, it prevents these employers from exempting themselves from the automatic enrolment rules unless the scheme is in existence at the date of Royal assent, being 6 October 2009.

Threshold for interest paid on refunds

Inland Revenue pays use-of-money interest on money to be refunded to KiwiSaver members and employers – for example, if a member opts out. An amendment to section 89 removes the minimum threshold of $5 for interest payments, so that interest is payable on all KiwiSaver refunds. The amendment applies from the date of Royal assent, being 6 October 2009.

Refund of employer contributions

Previously, a refund of KiwiSaver employer contributions could be used either to offset tax debt or be forwarded to the employer at the discretion of Inland Revenue. As employer contributions may form part of an employee's total remuneration package, section 100 of the KiwiSaver Act now requires that employer contributions are refunded back to the employer (for example, because an employee opts out of KiwiSaver), so those contributions are available to be refunded to the employee. The provision applies from 1 April 2008.

Extending "double dipping" provisions to existing defined contribution schemes

Section 101D of the KiwiSaver Act extends the legislation for preventing "double dipping" to existing defined superannuation schemes in which membership rights are portable. This means that members of a multi-employer scheme who change jobs to work for another employer who is part of the same scheme cannot continue to receive employer contributions for their existing scheme, as well as access compulsory employer contributions to KiwiSaver. The provision applies from 1 April 2008.

Hybrid scheme amounts and compulsory employer contributions

An employer who is contributing to an employee's existing superannuation scheme can offset the amount of those contributions against the amount of compulsory employer contributions to KiwiSaver. The amount that can be offset is the amount the employer is required to pay, including the amount of employer superannuation contribution tax that is payable on such contributions. The rules applying to hybrid scheme amounts did not refer to an employer's superannuation contribution. Section 101D of the KiwiSaver Act has been amended to provide that hybrid scheme amounts are inclusive of the amount of employer superannuation contribution tax payable. The provision applies from 1 April 2008.

Employer contributions for employees in two or more funds

New section 101FC of the KiwiSaver Act may exempt an employer from making a top-up contribution if an employee is a member of a KiwiSaver scheme and an existing employer superannuation fund. As long as the amount of the contributions to the existing employer fund is calculated using a rate equal to or greater than the compulsory employer contribution rate, there is no additional compulsory employer contribution payable to the employee's KiwiSaver account (even if the dollar amounts are uneven as a result of a different salary basis being used). The provision applies from 1 April 2008.

Complying funds – notice of eligibility to withdraw funds

Employers must make compulsory employer contributions into an employee's KiwiSaver account or complying superannuation fund if the employee is over 18 and is under the age of eligibility to withdraw (which is the later of the age of eligibility for New Zealand Superannuation or after five years of membership). Providers are required to notify Inland Revenue of the date when a member is eligible to withdraw his or her funds. The Commissioner may then notify the member's employer of the date so the employer can cease making compulsory employer contributions.

An amendment to section 101G of the KiwiSaver Act provides that, as complying superannuation fund providers have a direct relationship with employers, providers must inform employers directly (rather than via Inland Revenue) of the date upon which a member will be eligible to withdraw funds. The amendment applies from the date of Royal assent, being 6 October 2009.

Eligibility for kick-start payment

The KiwiSaver Act provided that when an individual ceased to be a member of a KiwiSaver scheme, and then rejoined, the person was not entitled to the kick-start payment even if the person had not previously received the payment. However, the policy intention was that each KiwiSaver member is eligible for one kick-start payment. Amendments to section 226 ensure that people who have not previously received a kick-start payment but subsequently become KiwiSaver members can receive the kick-start payment. The change applies from 1 July 2007.

Mortgage diversion – fixed dollar amount

Under the mortgage diversion facility, an amount diverted from a member's KiwiSaver scheme was required to be a fixed dollar amount. This requirement was considered by the superannuation industry to be administratively costly and complex. Section 229 of the KiwiSaver Act has been amended to remove this requirement, and applies from 1 July 2008.

Mortgage diversion – use of past contributions

The policy intent of the mortgage diversion facility is that only current or future contributions can be diverted to a member's mortgage. However, it was not clear whether the legislation achieved this intent. Consequently, there has been an amendment to section 229 of the KiwiSaver Act to ensure that a member can only divert contributions made after the person has joined the mortgage diversion facility, and cannot divert previous contributions as well. The provision applies from 1 July 2008.

First home withdrawal – contributions via Inland Revenue

The KiwiSaver Scheme Rules set out the requirements for withdrawing funds for the purpose of purchasing a first home. The previous wording of clause 8 specified that if a person joined KiwiSaver directly through a provider and contributed only via the provider, eligibility for first home withdrawal would be reset as soon as the person sent a contribution via Inland Revenue. Consequently, the three-year time period for eligibility to withdraw funds for a first home would restart from the date the contribution was received by Inland Revenue. An amendment to clause 8 corrects this, and ensures that a person who has not previously withdrawn funds for a first home can withdraw if at least three years have passed since the person joined a KiwiSaver scheme or made his or her first contribution. The amendment applies from the date of Royal assent, being 6 October 2009.

Commissioner discretion to back-date member tax credit

Non-compliance by employers with the automatic enrolment rules has implications for employees in terms of their entitlement to and accumulation of the member tax credit. If an employee was not automatically enrolled in KiwiSaver when they should have been, they will have a belated membership start date because their employer failed to begin deductions. This could result in these employees missing out on the member tax credit for periods of time against which their annual contributions could be pro-rated.

An amendment to the definition of "creditable membership" in the Income Tax Act 2007 gives the Commissioner a discretion to back-date a person's membership start-date when, because of circumstances outside the employee's control, deductions of KiwiSaver contributions did not begin at the correct time. The amendment applies from 1 April 2008.

Date for claiming member tax credit

Fund providers were required to claim a person's member tax credit for a member credit year on a date determined by the Commissioner. The reason for this was to ensure that each provider had the same opportunity to claim the credit and for the member tax credit payment to be pro-rated between providers for members who contribute to more than one scheme. However, the pro-rating of the credit was removed by the Taxation (KiwiSaver) Act 2007. Accordingly, the credit is paid to providers on a first-come, first-served basis, removing the need for a due date (other than after the end of the member tax credit year on 30 June). An amendment to section 68C of the Tax Administration Act 1994 repeals the requirement that the member tax credit must be claimed on a date determined by the Commissioner. The amendment applies from the date of Royal assent, being 6 October 2009.

CHANGES TO THE DEPRECIATION RULES

Sections EE 30, EE 31 and schedule 13 of the Income Tax Act 2007; sections 91AAF, 91AAG, 91AAG, 91AAH, 91AAH, 91AAK and 91AAM of the Tax Administration Act 1994; sections EE 25E, EE 26 and schedule 16 of the Income Tax Act 2004; sections EG 10 and schedule 16 of the Income Tax Act 1994; schedule 21 of the Income Tax Act 1976 and regulations 2, 3, 6 and 9 of the Income Tax (Depreciation Determinations) Regulations 1993

A number of technical changes to the tax depreciation provisions have been made to deal with administrative concerns and to clarify the law. The changes are consistent with the original policy intent of the tax depreciation rules.

Application dates

The new depreciation rules generally apply for the 2008–09 and later income years. However, a number of the changes apply from earlier income years, to address previous technical uncertainties or inconsistencies with the legislation.

Key features

Depreciation loading for assets with provisional or special rates

Section EE 31 of the Income Tax Act 2007 has been amended to clarify that depreciation loading is allowable, subject to the normal criteria, for assets if the depreciation rate is set by a provisional or a special rate determination. There had been a technical concern that the 20% depreciation loading may not have applied to assets that had a depreciation rate set under these types of determinations. This was because section EE 31 referred only to an "economic rate", which excludes "special rate" or "provisional rate". The same analysis also suggested that the rates set by provisional and special rate determinations are not economic rates. As such, taxpayers relying on such determinations may not have been entitled to depreciation deductions. Neither outcome was consistent with the original policy intent of the depreciation rules. For this reason, section EE 26 of the Income Tax Act 2004 has also been amended, with effect from the 2005–06 and later income years.

Section EE 30 has been amended by adding the words "of cost" to subsection (1) paragraph (b). Without the addition of these words, it was not clear what met the definition of a high residual value asset. The amendment removes any possible inconsistency or ambiguity and applies from the 2005–06 and later income years.

Revoking outdated determinations

Subsections 91AAF(6) and section 91AAG(7) of the Tax Administration Act 1994 have been amended to give the Commissioner of Inland Revenue the ability to revoke outdated provisional rate determinations and economic rate determinations. This will allow the Commissioner to regularly update the list of depreciable items to ensure that it does not include items that no longer exist. Subsections 91AAK and 91AAM have been amended to include revoking a determination as part of the notification process. A revocation of a determination takes effect the day after the date of publication of the Gazette that contains the notification of the revocation.

Provisional and special rate determinations based upon statutory formulas

Changes to sections 91AAG(3) and 91AAG(4) of the Tax Administration Act 1994 clarify that provisional rate determinations and special rate determinations must be based upon the statutory formulas. Previously, there was no reference to the formulas that the Commissioner must use to set the rate under either a provisional rate determination or a special rate determination. The new rules make it clear that provisional rate and special rate determinations will be based upon the appropriate statutory formulas.

Applying for provisional rate determination

Subsection 91AAG(1)(b) of the Tax Administration Act 1994 has been amended to ensure that taxpayers can apply for a provisional rate determination – even when there is an applicable rate available. This ensures that the Commissioner can issue a provisional determination when the default rate is not broadly correct.

Changes to subsection 91AAH(3)(a) allow the Commissioner to decline to issue a provisional rate when the most appropriate default rate is "about right" for that type of asset. This is designed to reduce compliance and administration costs. The Commissioner can also decline to issue a provisional rate determination when the most appropriate default rate is clearly not broadly correct for that type of asset. That is to say, the Commissioner can decline to issue a provisional depreciation rate where the depreciation rate is less than 50% of the amount that is the difference between the default rate and the next highest or lowest rate, as applicable, in schedule 12 of the Income Tax Act 2007.

Assets acquired before 1 April 2005

A reference to section EZ 23 has been added to section 91AAG(3) to ensure that a special rate determination for assets acquired before 1 April 2005 are calculated under the depreciation rules that existed before the changes of 2005. As a matter of principle, special rate applications for assets held before 1 April 2005 ought to be determined using the earlier rules.

Reliance on previous economic rate determinations

Section 91AAF(3) has been amended to ensure that taxpayers can rely on previous economic rate determinations. Under the previous rules, section 91AAF(3) is intended to provide taxpayers with certainty that the Commissioner could not retrospectively change depreciation rates for assets already owned or under contract to purchase. However, section 91AAF(4) overrode section 91AAF(3), resulting in a technical argument that the Commissioner had the power to issue a determination that had retrospective application. This result was inconsistent with the original policy intent. The amendment clarifies the rule so that taxpayers can rely on previous economic rate determinations.

Depreciable land improvements

The following categories of depreciable land improvements have been added to schedule 13 of the Income Tax Act 2007 and, where appropriate, to earlier Income Tax Acts:

- pipes; and
- purpose-built surfaces for outdoor sports facilities.

The changes apply to the 2008–09 and later income years.

Updating Income Tax (Depreciation Determination) Regulations 1993

As a result of the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004, some of the legislative references in the Income Tax (Depreciation Determination) Regulations 1993 were no longer correct. The regulations have been updated and references to sections 91AE and 91AJ have been amended to refer to sections 91AAG and 91AAL respectively.

TECHNICAL AMENDMENTS TO THE PARTNERSHIP RULES

Sections EB 26B, HG 3, HG 4, HG 5, HG 6(6), HG 7(6), HG 8(6), HG 9, HG 10 and HG 11(8) of the Income Tax Act 2007

Several remedial amendments have been made to the tax rules for partnerships to correct several technical problems with the general partnership legislation, particularly for primary sector partnerships.

Background

The Taxation (Limited Partnerships) Act 2008 came into force on 1 April 2008. The legislation updated the tax rules relating to general partnerships, as well as providing for flow-through tax treatment for the new "limited partnership" vehicle created by the Limited Partnerships Act 2008. The amendments were added at the Committee stage of the legislation and apply from the 2008–09 tax year.

Application date

One of the amendments applies for the 2008–09 and later income years. This amendment ensures that the death of one of the spouses in a husband and wife partnership where the other spouse inherits does not give rise to immediate tax consequences for the surviving spouse. This also applies when dissolution relates to the settlement of relationship property.

All other changes apply for the 2009–10 and later income years.

Detailed analysis

Tax consequences upon the death of a spouse or relationship property settlement

Section HG 4 has been amended for the 2008–09 and later income years to ensure that the death of one of the spouses in a husband and wife partnership does not give rise to immediate tax consequences when the surviving partner inherits from the deceased. In the absence of these rules, the partnership is treated as being dissolved where the partners are married, in a civil union or in a de facto relationship, and one partner dies leaving his or her interests to the other partner. Where the surviving partner inherits the deceased partner's partnership interests there is a tax base rollover in respect of the deceased's interests. However the partnership cessation rule treats the surviving partner as having disposed of and reacquired his or her partnership interests at market value for tax purposes. The amendment ensures that the rules that apply on the cessation of a partnership will not apply to a two-person partnership when the partners are married, in a civil union or in a de facto relationship, and one partner dies. A similar exemption has been provided in section HG 4 when the dissolution relates to the settlement of relationship property (for example, in the event of a divorce).

Disposal of partnership interests

Remedial amendments have been made to the general rollover relief formula. The definition of "gross tax value" in section HG 5(2)(c) has been amended by including assets whose sale or disposal does not have taxation consequences at their market value. Further, the treatment of assets, such as forestry, that have no carrying value for the purposes of the Income Tax Act 2007 has been clarified.

Section HG 3 has been amended to clarify the rules around the application of the $50,000 exemption in section HG 5 and its relationship with the exemptions in sections HG 6 to HG 10. Section HG 3 clarifies that when HG 5 applies, sections HG 6 to HG 10 cannot apply.

Section HG 4(2) and (3) has also been amended to remove the need to have all partnership disposals treated as being at market value.

Trading stock

Section HG 6(1) has been amended to clarify that "quantum of turnover" is measured for the immediately preceding partnership income year.

Livestock

Amended section HG 10 provides that an incoming partner may elect to spread any difference between the price he or she paid for specified livestock that the partnership is valuing at cost when the partnership has breeding livestock.

The details for this spread are contained in new section EB 26B, which times the incoming partner's valuation adjustment.

Section EB 26B provides that where an incoming partner has elected to spread the difference between the price he or she paid for the specified livestock and the partnership's cost base carrying value of that livestock, then the spread shall be calculated as follows:

At the end of the income year that the incoming partner acquired the livestock:

- The partnership will perform its specified livestock cost calculations as if the partnership had not changed.
- To the extent the partnership is using a cost basis, the incoming partner will also calculate the value of specified livestock based on the price he or she paid.
- At the end of the next x years, the incoming partner may amortise on a straight line basis the difference between

his or her calculation of the cost of livestock and share of the partnership calculation. (NB: x is 4 when the partnership change occurred before 2 July; x is 5 when the partnership change occurred on or after 2 July.)

- This applies only when the partnership continues to value the relevant specified livestock at cost.

Minor drafting and cross-referencing corrections

The reference to section HG 4 in section HG 4(4) has been replaced with section HG 5.

References to "small partnerships" in sections HG 5 to HG 9 have been deleted because sections HG 5 to HG 9 are elective under section HG 3(2).

References to "short-term agreements for the sale and purchase of property or services" in section HG 9 have been replaced by "short-term agreements for sale and purchase", to be consistent with the definition in section YA 1.

Sections CB 27B and DO 11B have been consequentially repealed.

Clarification of policy intent of aspects of the new partnership rules

Further clarification on the policy intent of aspects of the new partnership rules introduced by the Taxation (Limited Partnerships) Act 2008 are discussed below.

Variable profit sharing clauses

Some partnerships contain a "variable profit sharing clause". This allows one partner's proportionate entitlement to income from the partnership to be different to his or her share in the partnership's assets.

It is common in professional services firms such as accounting or law firms for each partner's rights to the profit from the partnership to fluctuate from year to year based on their individual performance, but for each partner's share of the partnership assets remains the same. For example, 10 partners in a firm each have a share of 10% in the assets of the firm. However, the partnership agreement may provide that their right to income from the partnership is partly dependent on an individual partner's performance during that year. Therefore, a partner who performs particularly well may be allocated 12% of the partnership's profits from that year and a partner who performs less well may be allocated 8% of the profits.

The intent of the partnership legislation is to allow a partner's share in the income to be different from the partner's share in the assets for tax purposes. The definition of "partnership share" in section YA 1 accordingly refers to the "relevant share that a partner has in the rights and obligations and other property…in a partnership".

Section HG 2(2) does not prevent this outcome. Rather, section HG 2(2) prevents streaming of income, tax credits, rebates, gains, expenditure or loss of the partnership to specific partners.

Non-resident partner's partnership income

A question has been raised regarding whether a non-resident partner deriving what would otherwise be treated as foreign-sourced income through a New Zealand partnership would be brought within the New Zealand tax net merely because:

- the partnership is a New Zealand limited partnership formed and registered in New Zealand; or
- the general partner is a New Zealand tax resident or has a fixed establishment in New Zealand.

Partnerships, including limited partnerships, are transparent for the purposes of the Income Tax Act by virtue of subpart HG. Therefore, as has always been the case for general partnerships, the relevant question under the residence rules (sections YD 1 to YD 3) for a person who is a partner in a partnership, is whether the individual is New Zealand-resident. Likewise, under the source rules (sections YD 4 to YD 8), the question (when it arises) is whether that person carries on business through a fixed establishment in New Zealand. The answer to either question would depend on the facts of the particular case.

Definition of a person – income equalisation schemes

A question has been raised regarding whether partnerships are included for the purposes of the income equalisation scheme in sections EH 3 and EH 37, as those sections refer to a "person".

Under section OB 1 of the Income Tax Act 1994, it was clear that a person includes an unincorporated body of persons (which includes a partnership). Given that section 29 of the Interpretation Act 1999 provides the rule that a reference to "person" in legislation includes an unincorporated body, this was removed from section OB 1 as part of the rewrite of the Income Tax Act.

REWRITE AMENDMENTS

The amending Act includes a number of remedial changes to the Income Tax Act 2007, at the recommendation of the Rewrite Advisory Panel. The Panel sets out submissions relating to these changes on its website **(www.rewriteadvisory.govt.nz)**. It also lists its conclusions and recommendations for each submission.

Rewrite remedial items also include:

- Minor drafting matters that have been brought to the attention of the Rewrite Advisory Panel. In general, these amendments consist of corrections of cross-references, spelling, punctuation, terminology, formulas, and consistency of drafting. The Rewrite Advisory Panel publishes lists of these maintenance items on its website.
- Consequential amendments arising from the amendments as recommended by the Rewrite Advisory Panel, and the minor drafting items referred to above.

Background

At the time of reporting back the Income Tax Bill 2002, the Finance and Expenditure Committee expressed concern that the new, rewritten, legislation could contain unintended policy changes.

To alleviate that concern, the committee recommended that a panel of taxation specialists review any submission that rewritten income legislation contains an unintended policy change. An unintended policy change is regarded as a change in the drafting of a provision that results in a different legislative outcome from its corresponding provision in earlier income tax legislation. For example, to determine the corresponding provision for a provision in the Income Tax Act 2007, it is necessary at times to trace the legislation back to the Income Tax Act 1976, by examining the history of the provision through the Income Tax Act 2004, The Income Tax Act 1994 and the Taxation (Core Provisions) Act 1996.

The Rewrite Advisory Panel performs this review function. The process for making a submission to the Panel is set out in its statement, RAP 001. This statement is published on the Panel's website.

In general, the Panel considers whether a change in outcome has occurred, and then recommends that a provision is:

- amended to counter the effect of an unintended change;
- identified in schedule 51 of the 2007 Act as an intended change; or
- contains no change in outcome when compared with its corresponding provision in the earlier Act.

The Finance and Expenditure Committee also noted in its commentary on the Income Tax Bill 2002 that there may be a situation in which:

> … the Government of the day decides to retain the rewritten law without retrospective amendment.

The Committee went on to say:

> Such a decision would be a change in policy, and the Inland Revenue Department would be obliged to require taxpayers to meet any increased tax. The department has advised us that it intends to inform taxpayers through an appropriate publication that, in such cases, where taxpayers rely on the transitional provisions, they will be required to meet the tax obligation but will not be subject to penalties, and any use-of-money interest incurred will be remitted. The taxpayer must have taken reasonable care and adopted a reasonable tax position under the old law. We agree with this approach.

Inland Revenue has published two standard practice statements setting out how it will apply the penalty and interest rules within the context of the comments of the Finance and Expenditure committee referred to above. Those two statements are SPS 08/03, issued in relation to the 2007 Act (published in the Tax Information Bulletin Vol. 20, No. 10, December 2008) and SPS 05/02, issued in relation to the 2004 Act (published in the Tax Information Bulletin Vol. 17, No. 5, July 2005).

Application dates

Unless otherwise stated, the following amendments apply from the beginning of the 2008–09 income year.

Detailed analysis

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 amends the following provisions of the Income Tax Act 2007, the Income Tax Act 2004, and the Tax Administration Act 1994.

2007 Act – recommendations of the Rewrite Advisory Panel

Section CC 8B

The Panel considered that the marginal notes for section CZ 6 of the 2007 Act could be read to suggest that the provision does not apply to commercial bills acquired after 31 July 1986. This amendment clarifies the marginal text, and relocates the provision to subpart CC.

The provision has been amended to clarify that the rule applies to non-residents owning commercial bills if the financial arrangement rules do not apply to the commercial bill, irrespective of the date of acquisition of the commercial bill

Section CD 5

Under the 1994 Act, amounts derived on the buy-back of shares or share reduction by a company were treated expressly as a dividend, unless the buy-back or share reduction came within one of the specified exclusions. The Panel considered this outcome is less clear in the 2007 Act and recommended that the dividend rules be clarified to assist the reader.

New subsection CD 5(2B) ensures that, in calculating the value given by shareholders to the company in a share buyback or share reduction or share cancellation, the market value for the surrender of shareholding interests is treated as zero. This ensures that payments to shareholders for a buy-back of shares or a share reduction comes within the meaning of transfer of value.

Section CD 25(4)

The Panel considered that section CD 17(4) of the 2004 Act (and subsequently section CD 25(4) of the 2007 Act) would result in the available subscribed capital (ASC) of a company being be reduced to zero in relation to a company's acquisition of treasury stock. The Panel concluded this was an unintended change in outcome and recommended the 1994 Act position be restored.

Section CD 25(4) has been amended to ensure that the ASC should only be reduced by the amount paid for shares that are held as treasury stock for more than 12 months or cancelled within 12 months (subject to the amount paid for the shares not exceeding the ASC per share calculated under the ordering rule).

Section CE 1, section YA 1 – definition of "accommodation"

In section CE 1 of the 2004 Act (and section CE 1 of the 2007 Act), it was unclear whether the provision included in a person's income, the value of accommodation provided by way of board or lodgings. The concept of "board or lodgings" in the 1994 Act was considered to include accommodation provided for employees on long-term projects, where the employee was required to live away from home.

Section CE 1 of the 2007 Act has been amended to clarify that the meaning of accommodation in this section covers a wide range of living arrangements provided by the employer, including the value of board or lodgings provided in connection with employment or the provision of services.

Section CW 9(1), (3)

In the 2004 Act, section CW 9 provided that dividends derived from a foreign company by a portfolio tax rate entity were excluded from the exempt income rule under section CW 9. That amendment was not correctly reflected in section CW 9 of the 2007 Act.

This amendment ensures that the 2007 Act provides that dividends derived by a portfolio tax rate entity from a foreign company are not exempt income.

Section CW 12(4)

The amendments insert the meaning of defined terms that are used in the section:

- "foreign exempt entity";
- "foreign exempt partnership"; and
- "foreign exempt person".

This amendment comes into force on 1 April 2008.

Section DB 3(4)

The amendment clarifies that section DB 3 overrides the capital limitation (section DA 2).

Section DC 13(5)

The Panel considered that section DC 12(5) of the 2004 Act (section DC 13(5) of the 2007 Act) contained a change in law, when compared with its corresponding provision of the 1994 Act (section DF 7(3)(h)(iii)). Under the rule as drafted, it prohibited employees from putting any dividends derived from a share purchase scheme towards the repayment of their share purchase loan.

The Panel recommended that the 2004 and 2007 Acts be amended to provide that the rule prohibited the trustee of a share purchase scheme from appropriating any dividends, derived under the share purchase scheme, for the repayment of the employee's share purchase loan rather than preventing the employee from putting dividends received towards repayment of the employee's share purchase loan.

Section DU 12(3)

The Panel considered a submission that section DU 12(3) in the 2004 and 2007 Acts contained a different outcome from that given by the corresponding provision in the 1994 Act (section DN 3(3)(b)). The Panel noted that section DU 12 of the 2004 Act had been re-enacted, unamended in the 2007 Act.

The Panel concluded that the 1994 Act provision provided that the amount of the deduction should be calculated by reference to the difference between:

- the prescribed proportion of the aggregate amount of exploration and development expenditure incurred by the mining company before the end of the income year in which the holding company's mining loan is written off; and

- the aggregate deductions allowed to the holding company under the section in all income years before the current income year.

The amendment restores to the 2007 Act the effect of the corresponding provisions from the 1994 Act.

Section EE 21

The Panel considered that section EE 21(7) and (8) of the 2004 Act contained an unintended legislative change, which has been carried over to the Income Tax Act 2007.

An amendment to section EE 21 ensures that the amount of depreciation loss for an income year in relation to a pool of assets is calculated by reference to the number of months the pool is used in the taxpayer's income year. That number of months of use may be more or less than 12 months if the taxpayer begins to use the pool in the income year.

Section EW 31(7), (9)(a)

The amendment clarifies that the base price adjustment for a cash-basis holder of a financial arrangement takes into account all income derived relating to the financial arrangement. This ensures that a cash basis holder will include cash-basis income (that income is usually determined outside the financial arrangement rules) in the base price adjustment calculation.

Section FA 2

Section FA 2 has been amended to clarify that a profit-related debenture includes debentures determined by a fixed relationship to banking interest rates, general commercial rates of interest or other published indices. This amendment also relocates the content of section FA 2(3) to section FA 2(4).

Section FA 2(5) restores the rule in the 2004 Act that the provision does not apply to a convertible note. In addition, the content of section FA 2(6) has been relocated to section FA 2(5) for drafting consistency.

The amendment comes into force on 1 April 2008.

Section FC 4

The amendment contains a rewrite amendment and a policy change (non-rewrite).

The rewrite amendment to section FC 4(1) restores the effect of section FI 5(1) of the 2004 Act so that section FC 4(1) applies to distributions made from a deceased person's estate to a charity, if section CW 43 applies to that charity.

The policy change limits the application of section FC 4(1) to distributions by the executors or the administrators or the trustees of a deceased person's estate to a "qualifying" beneficiary who is beneficially entitled to receive the property under the will or the rules governing intestacy. The change means that the transfer or transmission of the revenue base property to the executor or administrator of the deceased person's estate following the death of the taxpayer is treated, under section FC 2, as a disposal at market value for income tax purposes.

The provision comes into force on the date of Royal assent, being 6 October 2009. This has the effect that the notified change for section FC 4 in schedule 51 is effective, from the beginning of the 2008–09 income year, until the amendment comes into force.

Section FE 36(3)

The Panel concluded that section FE 36 of the 2007 Act provides that a resident entity could be included in a New Zealand banking group if:

- the entity was required to consolidate with the registered bank or the ultimate foreign parent of the bank for the purposes of generally accepted accounting practice (GAAP); and
- the entity was also part of the same group of companies as the registered bank.

The Panel concluded that this outcome was not the same as the outcome given by section FG 8C of the 2004 Act. Under the 2004 Act provision, a resident entity operating in New Zealand could be in a New Zealand banking group if:

- it was in the same group of companies as the registered bank; or
- it was required to consolidate with the registered bank or the ultimate foreign parent of the registered bank, for the purposes of generally accepted accounting practice (GAAP).

The amendment restores section FE 36 of the 2007 Act to give the same outcome as provided by its corresponding provision in the 2004 Act.

Section FM 31

The Panel concluded that section FM 31 resulted in a change in outcome, when compared with the corresponding provision in the 2004 Act (the definition of "eligible company" in section OB 1 of the 2004 Act).

The amendment restores the effect of the 2004 Act definition of "eligible company" in relation to a grandparented consolidated company, ensuring that the grandparented consolidated company is eligible to remain a member of a consolidated group of companies.

Section FN 8

Under section FDA 3(1) of the 2004 Act, New Zealand subsidiaries of a trans-Tasman imputation group were required to form a resident imputation subgroup.

The amendment restores the requirement that if a New Zealand company is a member of a trans-Tasman imputation group, the New Zealand company must form or become part of a resident imputation subgroup. The amendment also clarifies that a resident imputation subgroup continues even if only one company remains in the resident imputation subgroup.

Section FO 16

The Panel considered that section FO 10 in the 2007 Act was not clear that, under a resident's restricted amalgamation (formerly a "qualifying amalgamation"), an amalgamating company does not derive income, or have allowable deductions for the transfer of property in the course of the resident's restricted amalgamation.

The amendments to section FO 16 clarify that an amalgamating company will not derive income or have deductions from the disposal of depreciable property in the course of a resident's restricted amalgamation.

Section HA 11(5)

A submission to the Panel considered that section HA 11(5) does not require that the dividends be distributed as beneficiary income after a company attained qualifying company status, as was previously required under section OB 3(3A) of the Income Tax Act 2004. The Panel concluded that section HA 11(5) did not contain an unintended change, but recommended that the drafting be improved.

The amendment improves the drafting consistency and clarifies that section HA 11(5) applies because of the application of the general law to the trustee's obligations, in relation to distributions of dividends from the trust.

Sections HA 14, 15(1), (9), HA 16 and HA 19

The amendment restores the outcome in section HG 13 of the 2004 Act which stated that, to the extent imputation and FDP credits are available, they must be attached to a dividend paid by a qualifying company at the maximum permitted ratio. The rule applied irrespective of whether the shareholder was resident in New Zealand or not. The amendment also restores the rule that the portion of the dividend in excess of the fully-imputed amount is:

- exempt income of a resident shareholder; or
- non-resident withholding income of a non-resident shareholder.

The amendments to sections HA 14 and HA 16 remove an overlap, where sections HA 14 and HA 16 also provided for outcomes given by section HA 15.

The amendment to section HA 19 is consequential to the amendments to sections HA 14 to HA 16.

The amendment to section HA 19 comes into force on 1 April 2008.

Section HC 27(3)

The amendment clarifies that an employer is not a settlor in relation to settlements made to a trust that is established mainly to provide retirement benefits to natural persons, other than trusts that are foreign superannuation schemes or superannuation funds. The amendment ensures that section HC 27(3) has the same outcome as that given by section HH 1(10) of the 2004 Act.

Section HR 8

Amendments to section HR 8(1) clarify that:

- a transitional resident is taxed on the same basis as a non-resident for certain provisions, despite being a resident of New Zealand for income tax purposes; and
- the period referred to in section HR 8(3) begins on the day the person satisfies either:
  - the permanent place of abode test in YD 1(2); or
  - the day-count test in section YD 1(3); and
  - in relation to the permanent place of abode test and the day-count test, section YD 1(4) is ignored/not taken into account;
- a person who is not in receipt of tax credits for families is able to elect to be a transitional resident; and
- the effect of section FC 24(6)(b) of the 2004 Act is restored, to provide a time limit under which a person can give the Commissioner notice that they wish to cease being a transitional resident.

Section ID 3

The Panel considered that section ID 3 does not reflect the corresponding provisions of section IG 6(6) of the 2004 Act. The provision is concerned with the extent to which a loss company within a consolidated group may make its losses available to the group, to subtract from the consolidated group income in calculating the taxable income of the group.

The Panel concluded that section IG 6(6) of the 2004 Act permitted the loss company to make its losses available to the consolidated group, to the extent the loss company satisfies the commonality rules with every member company of the consolidated group throughout the continuity period.

The amendment restores the outcome given by section IG 6(6) of the 2004 Act.

Section IP 1(1)

The amendment to section IP clarifies that the part-year loss rules in subpart IP are to apply to a company entering or leaving a group of companies during the tax year, whether the entry or exit is caused by a breach of the continuity or commonality rules or otherwise. A typical example of a company entering a group of companies during an income year would be for a newly formed company that joins the group of companies.

Section IQ 2(3)

Section IQ 2 has been amended to clarify how section IQ 2(3) applies when a person is unable to use their maximum permitted amount of a carried forward attributed CFC net loss to subtract from the person's net income, because the person has insufficient net income.

The amendment clarifies that the unused portion of the "maximum permitted amount" is treated as an ordinary tax loss component from, and including, that income year. This ensures that the person is able to carry forward the unused amount in the person's loss balance, and not as a carried forward attributed CFC net loss.

Sections IQ 3(1), (3) and IQ 5(3)

Sections IQ 3 and IQ 5 have been amended to:

- set out the method for calculating the maximum permitted amount of brought-forward FIF net losses that persons are able to subtract from their net income (or a group company under section IQ 5 for the current income year). The rule ensures that the maximum amount available to subtract from net income is determined by reference to attributed CFC income or FIF income calculated using the branch equivalent method that arises in the same country as that in which the CFC or FIF is resident; and
- clarify that, if the taxpayer has insufficient net income to fully use the maximum permitted amount, the unused portion of the "maximum permitted amount" of a person's carried forward FIF net loss is treated as an ordinary tax loss component from and including that income year. This ensures that the person is able to carry forward that unused amount in the person's loss balance, and not as a carried-forward FIF net loss.

The amendment restores the effect of the rule in section IE 4(4) of the 2004 Act. The drafting approach reverts to the explicit wording set in sections IE 4(2), (3) and (6) of the 2004 Act, before their repeal in 2006.

Section LA 7(1)

Section LA 7 has been amended to clarify that the provision applies to the tax credit for both charitable and public benefit donations.

The amendment comes into force on 1 April 2008.

Section LB 1

Section LB 1 has been amended to clarify at what time a person's tax credit arises for tax withheld from wages and salaries, or other payments subject to the PAYE rules. Under this rule, the tax credit arises even if the employer has not paid PAYE to the Commissioner. However, the tax credit is available only if the amount withheld is correctly set out on the employer monthly schedule.

In addition, the provision clarifies that, for an employee that is an associated person of a close company, the tax credit is limited to the amount withheld (as shown on the employer monthly schedule) from the wages and salaries only if the amount withheld has been paid to the Commissioner. The rule also applies if the employee's spouse, civil union partner, or de facto partner is an associated person of the close company.

This amendment comes into force on 1 April 2008.

Sections LB 4 and MF 6 of the Income Tax Act 2007 and section 80 KLB of the Tax Administration Act 1994

Under the family scheme, the amount of a person's family scheme tax credit referred to in section LB 4 is determined under sections MD 1 and ME 1, and is refundable under section LA 7. Subpart MF permits the Working for Families (WFF) tax credit to be paid by instalment, with an end-of-year "wash-up" calculation required under section MD 1.

If the "wash-up" calculation indicates that the instalments of the tax credit paid to the person exceed the person's actual WFF tax credit, the excess amount is recoverable from the taxpayer in an end-of-year assessment (sections MF 5 and MF 6).

Section MD 1(3A) of the 2004 Act permitted the Commissioner to recover the overpayment of the previous year's overpaid instalments from the current year's instalments. This provision was omitted from the 2007 Act. This amendment restores the effect of section MD 1(3A) of the 2004 Act, and ensures that the amounts of prior year's overpaid instalments of the family tax credit that are recovered from the current year's instalments, are taken into account in the end-of-year assessment in:

- determining whether the current year's instalments of the family scheme credits are over- or underpaid; and
- determining the correct amount to be refunded if the

entitlement is underpaid (and instalments have been used to satisfy a previous year's recovery of overpaid instalments).

The amendment to sections MF 6 and 80KLB of the Tax Administration Act clarify how the Commissioner is to deal with over- or underpayments of instalments of family tax credits.

Sections LB 7 and LB 8

These two provisions clarify how the amount of a person's tax credit is determined in relation to personal services rehabilitation payments when the payer or provider has been supplied with a special tax rate certificate, or the no-declaration rate applies.

The amendments come into force on 1 July 2008, the commencement date for the rules relating to personal services rehabilitation payments.

Sections LJ 1(3) and LJ 2(2), (6) and (7)

Section LJ 2(2) has been amended to clarify that the amount allowed as a foreign tax credit relating to foreign tax paid on foreign-sourced income derived from a particular source is limited to the amount of New Zealand tax payable on that foreign-sourced income (as calculated under section LJ 5).

The content of section LJ 1(3) has been relocated to section LJ 3(6) and (7).

Section LJ 3

The definition of "foreign income tax" has been replaced. The amendment clarifies that the term refers to an amount that is treated as income tax in another country or territory (other than New Zealand).

Section LJ 5

The amendment to section LJ 5(4) clarifies that the denominator in the formula in subsection (4) refers to New Zealand tax payable on all sources or types of income, irrespective of whether the amount of income is derived from New Zealand or from foreign sources. The effect of the amendment is to ensure that any excess of expenditure over the related income types (segmental losses) are spread across all sources of income, both domestic and foreign sourced, and that the calculation of the New Zealand tax under section LJ 5(2) appropriately pro-rates these losses across all classes of income.

The amendment to section LJ 5(6)(b) corrects the meaning of "losses" to ensure that the term is defined by reference to the loss balance carried forward from the prior income year.

Section LJ 7

Section LJ 7 has been amended and replaced by new sections LJ 7 and LJ 8. The amendments:

- clarify to which year the payment for the foreign income tax relates; and
- to which year the amount of the refund, amount or benefit for the person relates; and
- restores to the 2007 Act, the effect of sections LC 1(3A)(b), LC 3(1)(c)(ii) and LC 3(2) of the 2004 Act.

These provisions provide for an adjustment to the calculation of the amount of FDP payable on receipt of a dividend from a foreign company, if the taxpayer has recovered excess foreign tax credits previously allowed to the taxpayer.

Section LK 1

Section LK 1 has been amended to clarify that the tax credit is in relation to income tax, (including foreign income tax) paid by a controlled foreign company and withholding taxes withheld from distributions made by the CFC. The amendment is to ensure that the provision more closely reflects the effect of its 2004 Act corresponding provision, section LC 4(1).

In addition, the effect of subsections LC 4(10) and (11) of the 2004 Act have been restored to the Act as subsection LC 4(5) to (9) of the 2007 Act.

Section LK 2(2)(b)

Section LK 2(2) has been amended to remove the words "in relation to the person's attributed CFC income". This amendment removes an ambiguity that potentially would double count the section EX 18 income interest in the formula in section LK 2(1).

Section LP 4(2)

The amendment addresses the Panel's recommendation that section LP 4(2) be amended to clarify that a market value circumstance must exist before a person is required to calculate a market value interest.

Section MB 4(1)

The amendment clarifies that a dividend from a close company is not taken into account in determining a person's family scheme income. The amendment reinstates the 2004 Act rule that ensured the calculation of family scheme income does not double count dividends that represent distributions of net income of a close company that has also been included in the determination of family scheme income.

Section MC 6(b)(ii), schedule 51

The amendment is a policy change to correct a drafting error in the 2004 Act. The amendment repeals subsection MC 6(b)(ii) to clarify that a person in receipt of the veteran's pension does not preclude a person from being entitled to the in-work tax credit, the parental tax credit or the minimum family tax credit.

This amendment applies from the beginning of the 2008–09 income year, and is listed in schedule 51 to confirm this is an intended policy change.

Section MD 9

The amendment clarifies that recipients of parental leave payments are not precluded from entitlement to the in-work tax credit if they meet the necessary full-time work test before receiving paid parental leave.

The amendment to section MD 9(2) ensures that the "qualifying" PAYE income payment test is satisfied if the income derived from a work activity is not of the types listed in section MD 9(3), and the person does not derive income of any type described in section MD 8. The amendment applies even if the person also derives income of the types listed in section MD 9(3) (after the amendment to section MD 9(3)).

Section ME 3(2), (3)

The amendment corrects the formula, that applies for partial periods in an income year, for determining the annualised amount of net income for the purposes of determining, under section MB 1, a person's family scheme income.

Section MZ 3

Section MZ 3 restores the effect of section KD 1(1)(e)(i), (vi) of the 2004 Act. The rule ensures that the determination of family scheme income is appropriately adjusted for withdrawals from the main income equalisation account or the adverse event equalisation account to the extent those withdrawals related to deposits made to those equalisation accounts in the 2002–03 income year, or an earlier income year.

Sections OB 1(1), (2)(a)(i) and (3) and OB 2(1)

The amendments relate to recommendations made by the Panel to clarify that:

- a non-resident company is required to maintain an imputation credit account (ICA) unless the company is also resident in another country and is treated as not being resident in New Zealand for the purposes of a double tax agreement; and
- an Australian ICA company is not required to be resident in New Zealand, consistent with the amendment to section ME 2(1A) of the 2004 Act by section 155(1) of the Taxation (Business Taxation and Remedial Provisions) Act 2007.

Section OB 34

The amendment corrects an unintended change in outcome relating to the timing of the debit to a company's ICA for a refund made to the company from a tax pooling account. The 2007 Act inadvertently drafted the timing rule as a single common rule for all companies. In contrast, the 2004 Act distinguished between the timing of the debit for qualifying companies and the timing of the debit for other companies.

For a company that is not a qualifying company, the amendment restores the effect of section ME 5(1)(ea), (2)(ea), (eb), to provide that a refund from a tax pooling account is debited to the company's ICA in the following order, until the amount of the refund is fully debited:

- firstly, to the tax year before the refund, to the extent the ICA has a credit balance; and then
- to the tax year of the refund; and then
- to the tax year before the refund.

Although the amendment applies from the beginning of the 2008–09 income year, a savings provision applies for taxpayers who relied on the drafting of section OB 34 in the 2007 Act to determine the date of the debit. The savings provision applies to refunds of income tax made before 2 July 2008 (the date that the Taxation (International Taxation, Life Insurance and Remedial Matters) Bill 2008 was introduced.

Section OB 71

Section OB 71 has been amended to ensure that it applies to a company ceasing to be part of a wholly owned group because of changes in the ultimate ownership of the company, irrespective of the balance in the company's ICA. This rule corresponds to section ME 9B(3), (4) of the 2004 Act.

The 2007 Act provision was drafted on the basis that it applied only if the company ceasing to be a group member had a debit balance in its ICA at the time it left the group. The Panel concluded that the 2004 Act did not require the leaving company to have a debit balance, and recommended the 2004 Act outcome be restored. The amendment corrects section OB 71 to ensure that it applies irrespective of whether the leaving company has a debit balance in its ICA.

Section OD 3

The amendments to section OD 3(1) and (2) address ambiguity in the provision by clarifying:

- the time by which the company must elect to become a CTR account; and
- that a company must maintain a conduit tax relief account on a continuous basis from the beginning of the tax year in which the election is made.

Section OP 6

As originally enacted in the 2007 Act, this provision did not permit a group company that did not have a credit balance in its imputation credit account to receive refunds of income tax to which it is entitled under section RM 2 of the Income Tax Act 2007.

Under the corresponding provisions of the 2004 Act (section ME 14), a company that is a member of an imputation group was able to receive a refund to which it was entitled, provided the imputation group (of which the refund company was a member) has a credit balance as at the end of the previous imputation year. The amendment corrects the 2007 Act to restore the effect of section ME 14 of the 2004 Act.

The amendment also ensures that the effect of sections 14(3B) to ME 14(6) of the 2004 Act are more clearly reflected in section OP 6.

Section OP 44(6) to (8)

The amendments to section OP 44 ensure that the content of sections ME 14(1A), (4) to (6) of the 2004 Act is appropriately reflected in section OP 44. These amendments clarify that a consolidated group of companies that has a non-standard balance date must transfer part of its credit balance (if any) from ICA to its PCA account to the extent necessary to satisfy provisional tax or foreign dividend payment (FDP) obligations.

Sections RA 5(2) and RA 6(4)

The amendments clarify that tax is to be withheld is at the time the related PAYE income payment is made.

Section RA 15(2)

The Panel concluded that in section RA 15(2)(c), it was unclear to which quarter the section referred. The Panel recommended that section RA 15 be amended retrospectively to clarify how the reference to "quarter" should apply for foreign dividend payments (FDP) and fringe benefit tax (FBT). The Panel also recommended that the retrospective amendment should not apply to those taxpayers who had adopted a tax position for payment of FDP or FBT for quarters ending before the remedial legislation was enacted.

The amendments to section RA 15 clarify that if an amount of tax or FDP is payable on a quarterly basis, the amount must be paid to Inland Revenue by the 20th of the following month. The amendments also clarify the circumstances when 31 May is the due date for payment, and that the due date of payment for FBT determined on an income-year basis is the terminal tax date of the taxpayer.

A savings provision applies to taxpayers who have relied on the original wording of section RA 15(2) in determining their due date for payments of tax or FDP to Inland Revenue before the date of assent of the amending Act.

Section RA 20

The amendment clarifies that, in a resident's amalgamation, the amalgamated company is treated as having paid the PAYE that was paid by the amalgamating company in the preceding income year. This ensures that an amalgamated company that is a close company takes into account the amalgamating company's circumstances in determining whether the amalgamated company qualifies for the monthly basis for paying PAYE and filing the employer monthly schedule.

Section RD 3(3) and (4)

The amendment corrects an unintended change in law.

The amendment restores the effect of section OB 2(2) of the Income Tax Act 2004, (PAYE income payments and shareholder-employees of close companies). This rule provided that, if a shareholder-employee of a close company meets the requirements of section RD 3(2), that employee is able to elect that all of the income from employment derived from the close company is not subject to PAYE. The amendment also restores the effect that, in electing to not have the PAYE rules apply to these wages and salaries, the employee's income derived from that close company is liable for provisional tax.

Section RD 11(3)

The amendment relates to the former rule in Regulation 6(3) of the Income Tax (Withholding Payments) Regulations 1979. Regulation 6(3) provided that the amount of withholding tax to be withheld from a schedular payment would be calculated by reference to the difference between:

- the gross amount of a class of income subject to the withholding payments rules; and
- the amount of expenditure that the Commissioner determined under the former Regulation 7 as relating to that income.

This amendment restores the effect of Regulation 6 in section RD 11(4).

Section RD 17(1)

The amendment ensures that the section cannot be read to include the amount of extra pay twice in determining

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the rate of tax to apply for the withholding of PAYE from an extra pay. The amendment reflects the Panel's recommendation for correcting the drafting in the provision.

Section RD 18(3)

The amendment corrects an unintended legislative change arising from rewriting section NC 7(2) of the 2004 Act. Section NC 7(2) applied when a person entitled to receive a withholding payment (now termed a schedular payment) did not provide to the payer a withholding declaration. That section provided for a no-declaration rate of 15% in addition to the rate of withholding required under the Income Tax (Withholding Payments) Regulations 1979.

The amendment to section RD 18(3) reinstates the no-declaration rate to be applied to the withholding from a schedular payment if the recipient of the schedular payment fails to provide the payer with the appropriate schedular tax code form (section 24L of the Tax Administration Act 1994). The no-declaration rate is 15%, in addition to the relevant rate of withholding set out in schedule 4.

Sections RD 19(2) and YA 1, Definitions of non-filing taxpayer and non-resident entertainer, schedule 4: part F

The amendment corrects an unintended change in law relating to non-resident entertainers. Under the 2004 Act, a person, whose only income derived from New Zealand was as a non-resident entertainer, could elect to be a non-filing taxpayer.

Section RD 19(2) and the definitions of non-filing taxpayer in section YA 1 have been amended to clarify that a person whose only New Zealand-sourced income is in the capacity of a non-resident entertainer may elect to be a non-filing taxpayer. The definition of "non-resident entertainer" has been amended to clarify the types of activities that are activities of a non-resident entertainer. This list of activities is relocated to new part F of schedule 4.

Section RD 22(3) and (3B)

Section RD 22 has been amended to clarify when the due date occurs for:

- the payment of PAYE withheld from PAYE income payments; and
- the filing of the employer's monthly schedule, which contains the details of PAYE income payments and withholdings made by the employer from PAYE income payments.

Section RD 65(1), (2), (3), (4), (7) and (11)

The definition of "employer's superannuation contribution" has been replaced by the term "employer's superannuation cash contribution". This amendment clarifies that the ESCT applies to superannuation contributions paid in cash, which better reflects the application of the 2004 Act SSCWT rules to a "specified superannuation contribution".

Section RE 2

The amendment corrects an unintended change in law and clarifies that the RWT rules apply to interest paid in New Zealand, including interest paid to a fixed establishment of a non-resident.

A savings provision applies to protect payers of resident passive income, who had not withheld RWT from those payments made from the commencement of the 2007 Act, until the date of assent of the amending Act, in reliance on the unamended wording of the original section RE 2.

Section RE 3

The amendment corrects an unintended change in law and clarifies that a person paying resident passive income to person who holds a Certificate of Exemption, is not required to withhold RWT.

Section RF 2(5)

The amendment corrects an unintended change in law and ensures that a royalty paid to a non-resident is subject to non-resident withholding tax (NRWT).

A savings provision applies to protect payers of royalties who had not withheld NRWT from non-resident passive income paid between the commencement of the 2007 Act and the enactment of the amending Act in reliance on the unamended wording of section RF 2.

Section RF 10

The amendment corrects an unintended change in law and ensures that, to the extent a non-cash dividend derived by a non-resident is fully imputed, a zero rate of NRWT is applied to the dividend.

Section RF 12

The amendment corrects an unintended change in law and ensures that a zero rate of NRWT applies to:

- interest, which is subject to the approved issuer levy, is derived by a non-resident provided that:
  - the non-resident is not an associated person of the payer; and
  - the non-resident does not derive the interest jointly with a New Zealand resident.
- Interest paid by a transitional resident in relation to money borrowed while the transitional resident was a non-resident of New Zealand, provided that:
  - the interest is not paid in relation to a business carried

on through a fixed establishment in New Zealand; and

- the person deriving the interest is not an associated person of the transitional resident, and the interest is not derived jointly with a New Zealand resident.

Section RF 12C

The amendment corrects an unintended change in law and ensures that a zero rate of NRWT applies to payments made by a New Zealand branch of a non-resident life insurer, if the life insurer has elected that the New Zealand branch is treated as a New Zealand resident company for income tax purposes.

Section YA 1 – definitions

Agricultural, horticultural, or viticultural company

The definition of "agricultural, horticultural or viticultural company" has been amended to ensure that withholding is required from payments to companies that carry out the agricultural, horticultural or viticultural work described in the definition of horticultural contract work in schedule 4, part C.

Employee, Employer

The amendment corrects an unintended change in law and clarifies that the definitions of "employee" and "employer" includes payments of a "schedular payment", ensuring that the FBT rules apply to a person who pays a "schedular payment".

Employer's superannuation cash contribution

The 2004 Act required a withholding of tax from "specified superannuation contributions" (employer superannuation contributions to superannuation funds made in cash). The distinction between "specified superannuation contributions" and "employer superannuation contributions" was not clearly separated in the 2007 Act.

The new term "employer's superannuation cash contribution" has been inserted and used throughout the Act to ensure that the effect of the 2004 Act is correctly reflected in the 2007 Act in relation to any provision that relates to the employer's superannuation contributions made in cash (specified superannuation contribution in the 2004 Act).

Income from employment

For the purpose of section DA 2(4), the definition of "income from employment" has been amended to ensure that no deduction is available to an employee for expenditure incurred in deriving excluded income derived from or in connection with employment. For example, income from employment includes fringe benefits that are excluded income of an employee (section CX 3).

This amendment comes into force on 1 April 2008.

Section YZ 2

Section YZ 2 re-enacts section YA 5B of the 2004 Act, which was inadvertently omitted from the 2007 Act. This amendment restores a savings provision relating to certain imputation credits arising under section 394L(4A) of the 1976.

Schedule 20

Schedule 20, part A, clause 1 has been amended to insert the word "preparation" after the phrase "unless clause 2 applies".

Clause 2 (regrassing and fertilising etc) has been amended to correct the amortisation rate in column 2 from 6% to 45%.

2007 Act – rewrite maintenance items

The following provisions, most of which come into force on 1 April 2008, have been amended to correct:

- cross-references;
- grammar;
- spelling;
- punctuation;
- terminology and definitions;
- drafting consistency, including readers' aids – for example, the defined terms lists;
- some defined terms; and
- subsequential amendments arising from substantive rewrite amendments. An example is the correction to the term "employer's superannuation contribution", which has been amended where appropriate to refer to an "employer's superannuation cash contribution".

Part B

Section BE 1((2)

Part C

Section CD 32(2); Section CD 53, list of defined terms; Section CF 1(2); The heading to subpart CR; Section CS 1; Section CS 2; Section CS 6(1)(d); Section CS 7(2)–(5); Section CW 15(1); Section CW 40, defined terms list; Section CW 42(5), (7), (8), and (9); Section CX 13(2); Section CX 28; Section CX 47(1)(d)(i); Section DB 53(1)(a), (b); Section DC 7(1), (1B), defined terms list

Part D

Section DC 7; Section DF 4(3)(b); Section DS 4(5); Section DT 2(1)(b), (c), list of defined terms

Part E

Section EE 55(1)(b); Section EF 2 and list of defined terms; Section EW 31(9); Section EX 15(1); Section EX 29(1)(b); Section EX 32(9)(d); Section EX 34(b); Section EX 38(g); Section EX 46(6)(d), (8)(a), (10); Section EX 47; Section EX 51(5); Section EX 52(1)(a), (2), (13)(a), (c); Section EX 53(1)(a), (2), 15(a), (c); Section EX 56(6), (9); Section EX 58(1); Section EX 65(5)(b); Section EY 11(7), (11); Section EZ 38(6)

Part F

Section FB 9; Section FC 2(2); Section FE 4, definition of reporting bank; Section FE 6(3)(a)

Section FE 13(1); Section FE 21(3)(d)(ii); Section FM 6(5); Section FN 2(i); Section FZ 1(3)

Part G

Section GB 28(2); Section GB 45(3); Section GB 48(1)(b)

Part H

Section HA 9(2); Section HC 7(2); Section HC 21(3); Section HC 32(2); Section HC 35(4)(a); Section HL 3(11); Sections HL 4(1)(a), HL 4(2)(b)(ii); Section HL 12(1)(a); Section HL 20(3); Section HL 29(6)(a)(ii), (11)(a)(i); Section HL 30(7)(c)

Part I

Section IA 7(5), (6); Section IA 8(1)(a)

Part L

Section LA 9; Section LC 4(4); Section LC 6(4); Heading for subpart LD; New heading before section LD 1; Section LD 1(5); Section LE 1(1); Section LP 3(5)

Part M

Section MA 7(2); Section MA 8; Section MC 1, compare note; Section MC 5(1); Section MC 6, compare note; Section MC 8(2); Section MC 10(4); Section MD 6(2); Section MD 7(1); Section MD 10(3)(d)(ii); Section ME 2, list of defined terms; Section MF 5(2); Section MK 1(1); Section MK 2(1)

Part O

Section OB 4(3)(e), (eb); Section OB 19(1); Section OB 32(7); Section OB 33(5); Section OB 35(4)(b); Section OB 37(1)(a), (b), 3(a), (b); Section OB 39(1); Section OB 61(7); Table O1, row 14; Table O2, row 9; Section OC 30, heading; Table O4, row 5; Section OD 1(2); Section OD 16(3)(b); Table O6, Row 2; Section OK 14B(1)(a), (b), (4)(a), (b); Table O18, row 6; Section OP 30(5); Section OP 31(4); Section OP 35(1)(a), (b), 3(a), (b); Section OP 78(1); Section OZ 10(2)

Part R

Section RA 5(1)(c); Section RA 10(1)(a); Section RA 21(4); Section RA 23(2); Section RB 1; Section RC 34(2)–(6); Section RD 5(1)(b)(ii), (c)(v) (6)(a), (c), (8), (9); Section RD 5(6)(a), (c); Section RD 6(1)(a), (b); Section RD 8(1)(b)(v); Section RD 13(1)(a); Section RD 51(3); RD 54, compare note; Section RD 60(1)(a), (3); Section RD 61(1)(a), (3); Section RD 67; Section RD 68; Section RD 69; Section RD 70; Section RD 71; Section RE 11(3); Section RE 12(3)(a); Section RF 2(2); Section RF 8, list of defined terms; Section RF 9(1); Section RF 12B, relocates the provisions of section RF 12(1) to (4); Section RG 5(2); Section RG 6(3)(a); Section RG 7(2)(b); Section RM 2; Section RB 5(1B); Section RM 10; Section RP 6; Section RP 7; Section RP 11; Section RP 13; Section RZ 3(3)

Part Y

Section YA 1

- Consolidated FDPA group
- Employee's superannuation accumulation
- Employer monthly schedule
- Employer sourced superannuation savings
- Employer's superannuation cash contribution
- Employer's superannuation contribution
- ESCT
- ESCT rate threshold amount
- Lease
- Member credit contribution
- Part F activity
- PAYE income payment form
- Schedular income
- Trading stock

Section YB 21; Section YC 4; Section YC 6(4); Section YD 3(4)(b); Section YD 4

Schedules

Schedule 5, clause 3(c); Schedule 20, clause 1; Schedule 25; Schedule 52

2004 Act – recommendations of the Rewrite Advisory Panel

Application dates

The amendments apply from the beginning of the 2005–06 income year.

Section CC 8B

The Rewrite Advisory Panel considered that the marginal notes for section CZ 6 of the 2007 Act may suggest that the provision does not apply to commercial bills acquired after 31 July 1986. This amendment clarifies the marginal text, and relocates the provision to Part C, as the provision continues to apply to non-resident taxpayers if the commercial bill is not subject to the financial arrangement rules.

The provision is amended to clarify that the rule applies to non-residents owning commercial bills if the financial arrangement rules do not apply to the commercial bill, irrespective of the date of acquisition of the commercial bill.

Section CD 4

Under the 1994 Act, amounts derived on the buy-back of shares or share reduction by a company was treated expressly as a dividend unless the buy-back or share reduction came within one of the specified exclusions. This outcome is less clear in the 2004 Act.

Section CD 4(2B) has been inserted to ensure that the market value for the surrender of shareholding interests is treated as zero for the purpose of calculating the value given by shareholders to the company in a share buy-back, share reduction or share cancellation. This ensures that payments to shareholders for a buy-back of shares or a share reduction comes within the meaning of transfer of value.

Section CD 17(4)

The Panel considered that section CD 17(4) of the 2004 Act (and section CD 25(4) of the 2007 Act), in relation to a company acquiring treasury stock, provided that when shares are held for more than 12 months or cancelled within 12 months of acquisition, the available subscribed capital (ASC) of the company would be reduced to zero. The Panel agreed this was an unintended change in outcome and recommended the 1994 Act position be restored.

Section CD 17(4) has been amended to ensure that the ASC should only be reduced by the amount paid for shares that are held as treasury stock for more than 12 months or cancelled within 12 months (subject to the amount paid for the shares not exceeding the ASC per share calculated under the ordering rule).

Section CE 1

In the rewritten section CE 1 of the 2004 Act, it was unclear whether the provision included in a person's income the benefit of accommodation provided by way of board or lodgings, such as provided for employees on long-term projects. Section CE 1 has been amended to clarify that the meaning of "accommodation" in this section includes the value of board or lodgings provided in connection with employment or the provision of services.

Section DB 3(4)

The amendment clarifies that section DB 3 overrides the capital limitation.

Section DC 12(5)

A submission to the Rewrite Advisory Panel considered that the requirement in section DC 12(5) of the 2004 Act (section DC 13(5) of the 2007 Act) for a share purchase scheme to prohibit the employee from putting any dividends towards the repayment of his or her share purchase loan is an unintended change in outcome.

The Panel agreed and recommended that the provision be amended to ensure it prevented the trustee from appropriating the dividend towards the repayment of the employee's share purchase loan rather than preventing the employee from putting dividends received towards repayment of the employee's share purchase loan.

Section DU 12(3)

The Panel considered a submission that section DU 12(3) in the 2004 Act (section DN 3(3)(b)) contained a different outcome from that given by the corresponding provision in the 1994 Act. Section DU 12 of the 2004 Act had been re-enacted, unamended, in the 2007 Act.

The Panel concluded that the 1994 Act provided that the amount of a deduction for an income year exploration and development expenditure incurred by the taxpayer to the end of the current year was the difference between:

- the prescribed proportion of the aggregate amount of exploration and development expenditure incurred by the mining company before the end of the income year in which the holding company's mining loan is written off; and
- aggregate deductions allowed to the holding company under the section in all income years before the current income year.

The Panel agreed the outcome under the 2004 and 2007 Acts was different from the outcome in of the 1994 Act, (less all deductions allowed by the section in all tax years before the current one).

This amendment restores the correct policy outcome, as set out in section DN 3(3)(b) of the 1994 Act.

Section EE 21

The Panel considered that section EE 21(7) and (8) of the 2004 Act contained an unintended legislative change.

The amendment to section EE 21 ensures that the amount of depreciation loss for an income year in relation to a pool of asset is calculated by reference to the number of months the pool is used in the taxpayer's income year. That number of months of uses may be more or less than 12 months if the taxpayer starts to use the pool in the income year.

2004 Act – rewrite maintenance items

The following provisions are amended to correct:

- cross-references;
- grammar;
- spelling;
- punctuation;
- terminology and definitions;
- drafting consistency, including readers aids, for example the defined terms lists;
- some defined terms; and
- subsequential amendments arising from substantive rewrite amendments. An example is the correction to the term "employer's superannuation contribution", which has been amended where appropriate to refer to an "employer's superannuation cash contribution".

Part C

Section CD 32, defined terms list; Section CF 1(2); Subpart CR, heading; Section CW 12(4); Section CW 33, defined terms list; Section CW 40, defined terms list; Section CW 42(5), (7), (8), and (9); Section CX 41(1)(d)(i)

Part E

Section EE 46; Section EW 15D(1)(d)(ii)

Part O

Section OB 1, "income interest", para (b); Section OB 2, "portfolio investor rate"; Section OB 1 – definitions

These amendments to the 2004 Act maintenance items come into force on 1 April 2005.

Tax Administration Act 1994 – rewrite maintenance items

Section 3; Subpart 2B reinserted; Section 4P; Section 32A; Section 32B; Section 36A(2); Section 68C(2); Section 85G(1)(c); Section 120KD; Section 138E(1)(e)(iv); Section 139AA(1)(a); Section 141B(8); Section 183F(1); Section 225A(2)(b)(iii), (iv)

MISCELLANEOUS TECHNICAL AMENDMENTS

THRESHOLD FOR ATTRIBUTION OF PERSONAL SERVICES INCOME

Section GB 27(2)(c) of the Income Tax Act 2007

Section GB 27 ensures that income from personal services is attributed to the person who performs the services, rather than an interposed entity, in certain circumstances. Previously, the personal services attribution rule applied if the net income of the person performing the services was more than $60,000.

The $60,000 income threshold in the personal services attribution rule has been raised to $70,000. This reflects the new personal tax rate structure enacted as part of the tax cuts in 2008.

The amendment applies from 1 April 2008.

REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding pulic rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the "Your opportunity to comment" section.

Policy Advice Division

The Policy Advice Division advises the government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as the Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

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