Vol 23 No 1 February 2011

TAX INFORMATION Bulletin

CONTENTS

1 In summary

4 Binding rulings

Public rulings BR Pub 10/01 – 10/05: Australian Limited Partnerships

Public ruling BR Pub 10/21: Interest repayments required as a result of the early repayment of a financial arrangement – deductibility

27 New legislation

Taxation (GST and Remedial Matters) Act 2010

Orders in Council

Use-of-money interest rates change

Minimum family tax credit income amount increased

101 Standard practice statements

Industry-specific balance date for kiwifruit orchardists

102 Legislation and determinations

Special Determination S17: Utilisation of a profit emerging basis for purchased debt ledgers by a certain New Zealand Company Limited

Determination DEP 76: Tax depreciation rates general determination number 76

107 Legal decisions – case notes

Who is liable for GST, the receiver or the partnership?

Supreme Court denies leave to appeal

Taxpayer entitled to discontinue a test case

As a general rule, insolvent companies should be liquidated

113 Questions we've been asked

QB 10/06: Elections for qualifying company status

116 Items of interest

Review of Public Information Bulletins

Inland Revenue
Te Tari Taake

ISSN 0114–7161 (Print)
ISSN 1177–620X (Online)

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 6140

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

Note: The first paragraph on page 48 is incorrect. A correction has been published at **www.ird.govt.nz** (keywords: TIB corrections).

IN SUMMARY

Binding rulings

Public rulings BR Pub 10/01 – 10/05: Australian Limited Partnerships 4

These five public rulings deal with the ability of a New Zealand resident partner of an Australian limited partnership to claim foreign tax credits in respect of two forms of Australian tax, including Australian company tax, paid on income earned by an Australian limited partnership. They do not consider any other situations involving foreign income foreign tax paid. The rulings were signed and released to the public and published on the Inland Revenue website in March 2010. However, due to an oversight, they were not published in the *Tax Information Bulletin* at that time. Inland Revenue apologises for any inconvenience this may have caused.

Public ruling BR Pub 10/21: Interest repayments required as a result of the early repayment of a financial arrangement – deductibility 15

This item considers the situation when a term deposit arrangement is broken early and a reduced rate of interest is applied from the date of deposit as a consequence of the break. This results in the overpayment of interest to the depositor under the term deposit. The depositor is required to repay the overpaid interest. This item considers the deductibility of the interest repaid and the treatment of the interest repaid under the financial arrangements rules.

New legislation

Taxation (GST and Remedial Matters) Act 2010 27

Changes to the GST rules

Changes to the qualifying company rules and introduction of look-through company rules

Working for Families tax credits: definition of "family scheme income"

Clarifying that certain building fit-out is depreciable property

Depreciation loading grandparenting

Remedial items 73

KiwiSaver

Overseas donee status

Cap on shortfall penalties

Joint bank accounts

Independent earner tax credit and residual income tax

Amendments to the GST transitional rules

Non-resident seasonal workers

FBT "on premises" exemption

Section DB 2 – reverse charge rules

Section 17 – special returns

Approved issuer levy: technical changes

Consequential R&D amendments

PIE credit impairment provisions

Other amendments to the PIE rules

Emissions trading scheme amendments – income tax

Emissions trading scheme amendments – GST

Auckland Council restructuring amendment

Treatment of superannuation schemes administered by the National Provident Fund

Extending the redundancy tax credit

Further remedial changes to the taxation rules for life business

Taxation of general insurance business

Consequential changes to the Māori authority tax rate

Rewrite remedial items

Orders in Council

Use-of-money interest rates change 100

The use-of-money interest rates on underpayments and overpayments of taxes and duties have been changed in line with current market interest rates.

Minimum family tax credit income amount increased 100

The Income Tax (Minimum Family Tax Credit) Order 2010, made on 15 November 2010, increases the net income level guaranteed by the minimum family tax credit. The net income level will rise from $21,008 to $22,204 a year from 1 April 2011.

Standard practice statements

Industry-specific balance date for kiwifruit orchardists 101

The Commissioner has agreed to a change of the recognised industry-specific non-standard balance date from 31 January to 31 March for kiwifruit orchardists.

Legislation and determinations

Special Determination S17: Utilisation of a profit emerging basis for purchased debt ledgers by a certain New Zealand Company Limited 102

This determination relates to the ability of a certain New Zealand company to utilise a profit emerging basis for returning income and expenditure arising from the acquisition and collection of a portfolio of distressed debts acquired at a deep discount.

Determination DEP 76: Tax depreciation rates general determination number 76 105

This determination introduces Motorhomes as a new asset class description. The Commissioner considers that Motorhomes have previously been included within the Campervan asset class description.

Legal decisions – case notes

Who is liable for GST: the receiver or the partnership? 107

The sale of a forest by a partnership (each party of which was in receivership) created a goods and services tax (GST) liability of $127 million. The receivers paid the GST to the Commissioner and sought a Court order to return the funds. The Commissioner was unsuccessful in having the claim struck out.

Supreme Court denies leave to appeal 109

No significant error by the Court of Appeal, nor substantial principle sufficient to meet the requirements for leave was shown.

Taxpayer entitled to discontinue a test case 109

The taxpayer's challenge in respect of its 2003–05 tax years was designated as a test case by the Commissioner. Shortly before trial the taxpayer discontinued its challenge, and then commenced new challenge proceedings in respect of later tax years (albeit in respect of the same alleged tax avoidance arrangement). The Commissioner applied to have the discontinuance of the first challenge set aside on the grounds that it was an abuse of process. The Court dismissed the Commissioner's application, holding that the taxpayer was entitled to take the steps they did.

As a general rule, insolvent companies should be liquidated 110

Notwithstanding certain steps taken to satisfy outstanding debts, the Court was satisfied that the companies were insolvent and should be liquidated.

Questions we've been asked

QB 10/06: Elections for qualifying company status 113

This question we've been asked clarifies the Commissioner's position on who should sign shareholders' elections for qualifying company status where nominees or bare trustees are involved. The question also briefly considers elections for look-through company status where nominees or bare trustees are involved.

Items of interest

Review of Public Information Bulletins 116

Inland Revenue has commenced a review of *Public Information Bulletins* and *Tax Information Bulletins* published prior to 31 December 1995. Until these are reviewed these items should be referenced with some care, and they should not necessarily be taken as the Commissioner's current view of the law or operational practice.

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**

PUBLIC RULINGS BR PUB 10/01 – 10/05: AUSTRALIAN LIMITED PARTNERSHIPS

These five public rulings were signed and released to the public and published on the Inland Revenue website in March 2010. However, due to an oversight, they were not published in the *Tax Information Bulletin* at that time. Inland Revenue apologises for any inconvenience this may have caused.

Note (not part of rulings): These five public rulings, BR Pub 10/01 to BR Pub 10/05, deal with the ability of a New Zealand resident partner of an Australian limited partnership to claim foreign tax credits in respect of two forms of Australian tax, including Australian company tax, paid on income earned by an Australian limited partnership. It does not consider any other situations involving foreign income and foreign tax paid. The particular focus is on Australian limited partnerships that are corporate limited partnerships for Australian tax purposes and are treated under Australian tax law as companies, while in New Zealand they retain partnership and flow-through tax treatment.

A foreign tax credit will be available to the New Zealand partners when the tax paid is equivalent to New Zealand income tax or non-resident withholding tax and it is paid in respect of foreign income that is assessable in New Zealand.

The differing ways in which the income can be earned, and tax can be paid, by an Australian limited partnership mean it is appropriate to issue five rulings covering various situations. However, a single commentary applies to all five rulings.

The Income Tax Assessment Act 1936, Income Tax Assessment Act 1997 and Income Tax Rates Act 1986 are all Australian legislation.

PUBLIC RULING BR PUB 10/01: AUSTRALIAN SOURCE INCOME EARNED BY AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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

Taxation Laws

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

This ruling applies in respect of sections HG 2 and LJ 1.

Definitions

For the purpose of this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under section YA 1 and under Division 5A of the Income Tax Assessment Act 1936 (Aust) is defined as a corporate limited partnership and treated as a company for Australian income tax purposes.
- **New Zealand partner** means a partner that is resident under section YD 1 (residence of natural persons) or section YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means tax paid to the Australian Government that meets the definition of income tax in section YA 2(5).
- **Australian company tax** means tax levied under section 23(2) of the Income Tax Rates Act 1986 (Aust).
- **Partnership share** is defined in section YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in respect of it.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- Australian source income is earned by an Australian limited partnership that is income to the New Zealand partners under section HG 2 and CB 35.
- Australian income tax, in the form of Australian company tax, is paid on that income.

For the avoidance of doubt the Arrangement does not include arrangements where subpart BG of the Act applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit under sections LJ 1 and HG 2 for the Australian income tax paid, in proportion to their partnership share of the income earned by the partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2009–10 income year to the last day of the 2012–13 income year.

This ruling is signed by me on the 25th day of March 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/02: DISTRIBUTIONS MADE BY AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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

Taxation Laws

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

This ruling applies in respect of sections HG 2 and LJ 1.

Definitions

For the purpose of this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under section YA 1 and under Division 5A of the Income Tax Assessment Act 1936 (Aust) is defined as a corporate limited partnership and treated as a company for Australian income tax purposes.
- **New Zealand partner** means a partner that is resident under section YD 1 (residence of natural persons) or section YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means tax paid to the Australian Government that meets the definition of income tax in section YA 2(5).
- **Dividend withholding tax** means the amount withheld from a dividend to discharge the liability to pay tax in respect of dividends under section 128B of the Income Tax Assessment Act 1936 (Aust).
- **Partnership share** is defined in section YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in respect of it.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership makes a distribution to its partners in respect of which the New Zealand partners are not liable for New Zealand income tax on their partnership share of that distribution.
- Australian income tax in the form of dividend withholding tax is deducted from the payments made to the New Zealand resident partners.

For the avoidance of doubt the Arrangement does not include arrangements where subpart BG of the Act applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are not allowed a foreign tax credit under sections LJ 1 and HG 2, for the Australian income tax paid, in relation to the distribution made by the limited partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2009–10 income year to the last day of the 2012–13 income year.

This ruling is signed by me on the 25th day of March 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/03: DISTRIBUTIONS MADE BY AUSTRALIAN UNIT TRUST TO AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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

Taxation Laws

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

This ruling applies in respect of sections HG 2 and LJ 1.

Definitions

For the purpose of this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under section YA 1 and under Division 5A of the Income Tax Assessment Act 1936 (Aust) is defined as a corporate limited partnership and treated as a company for Australian income tax purposes.
- **New Zealand partner** means a partner that is resident under section YD 1 (residence of natural persons) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means tax paid to the Australian Government that meets the definition of income tax in section YA 2(5).
- **Australian company tax** means tax levied under section 23(2) of the Income Tax Rates Act 1986 (Aust).
- **Partnership share** is defined in section YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in respect of it.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- A distribution, which is a dividend under section CD 1, is made by a unit trust to an Australian limited partnership.
- The limited partnership pays Australian income tax, in the form of Australian company tax on that distribution.

For the avoidance of doubt the Arrangement does not include arrangements where subpart BG of the Act applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit under section LJ 1 and HG 2, for the Australian income tax paid, in proportion to their partnership share of the dividend income received by the limited partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2009–10 income year to the last day of the 2012–13 income year.

This ruling is signed by me on the 25th day of March 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/04: FRANKED DIVIDEND RECEIVED BY AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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

Taxation Laws

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

This ruling applies in respect of sections HG 2 and LJ 1.

Definitions

For the purpose of this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under section YA 1 and under Division 5A of the Income Tax Assessment Act 1936 (Aust) is defined as a corporate limited partnership and treated as a company for Australian income tax purposes.
- **New Zealand partner** means a partner that is resident under section YD 1 (residence of natural persons) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means tax paid to the Australian Government that meets the definition of income tax in section YA 2(5).
- **Franking credit** for Australian tax purposes is defined in section 205-15 of the Income Tax Assessment Act 1997 (Aust).

- **Partnership share** is defined in section YA 1 of the Act as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in respect of it.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership receives a dividend that has a franking credit attached.
- The New Zealand partners are liable to tax on their partnership share of the dividend received by the limited partnership under sections HG 2 and CD 1.

For the avoidance of doubt the Arrangement does not include arrangements where subpart BG of the Act applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand resident partners in the limited partnership are not allowed a foreign tax credit under sections LJ 1 or HG 2, in relation to the franking credit attached to the dividend received by the limited partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2009–10 income year to the last day of the 2012–13 income year.

This ruling is signed by me on the 25th day of March 2010.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 10/05: TAX PAID BY AN AUSTRALIAN LIMITED PARTNERSHIP AS A "HEAD COMPANY" AND FOREIGN TAX CREDITS

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

Taxation Laws

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

This ruling applies in respect of sections HG 2 and LJ 1.

Definitions

For the purpose of this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under section YA 1 and under Division 5A of the Income Tax Assessment Act 1936 (Aust) is defined as a corporate limited partnership and treated as a company for Australian income tax purposes.
- **New Zealand partner** means a partner that is resident under either section YD 1 (residence of natural persons) or section YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means tax paid to the Australian Government that meets the definition of income tax in section YA 2(5).
- **Australian company tax** means tax levied under section 23(2) of the Income Tax Rates Act 1986 (Aust).
- **Partnership share** is defined in section YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in respect of it.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership is a head company under section 703-15(2) of the Income Tax Assessment Act 1997 (Aust).
- The limited partnership pays income tax, in the form of Australian company tax, in Australia on all the taxable income of the consolidated group.
- The taxable income of the consolidated group in Australia includes income, such as business income earned by Australian subsidiary companies, which does not form part of the New Zealand partners' partnership share of the partnership income under sections HG 2 and CB 35.

For the avoidance of doubt the Arrangement does not include arrangements where subpart BG of the Act applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit under sections LJ 1 and HG 2 for the Australian income tax paid by the limited partnership to the extent that the Australian income tax is paid in relation to their partnership share of the income earned by the partnership under sections HG 2 and CB 35.

- New Zealand partners in the limited partnership are not allowed a foreign tax credit under sections LJ 1 and HG 2 for the Australian income tax paid by the limited partnership to the extent that the Australian income tax is not paid in relation to their partnership share of the income earned by the partnership under sections HG 2 and CB 35.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2009–10 income year to the last day of the 2012–13 income year.

This ruling is signed by me on the 25th day of March 2010.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULINGS BR 10/01 – BR 10/05

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in the five public rulings BR Pub 10/01 to BR 10/05.

Summary

Foreign tax credits for Australian tax paid by Australian limited partnerships are available to New Zealand resident partners, in proportion to their partnership share, when all the following are met:

- the Australian limited partnership is treated as a company for Australian income tax purposes but not for New Zealand tax purposes;
- the Australian tax paid, by or on behalf of the Australian limited partnership, is the equivalent of income tax or non-resident withholding tax;
- the income on which the tax was paid is assessable in New Zealand; and
- the Australian tax paid was paid on the income that is assessable in New Zealand.

Background

The question being considered is whether a foreign tax credit is available to New Zealand residents that earn Australian source income through a limited partnership registered in a state of Australia (that is an Australian limited partnership). The Australian limited partnerships that are under consideration are ones that are treated as corporate limited partnerships for Australian income tax purposes, under section 94D of the Income Tax Assessment Act 1936 (Aust), but do not meet the definition of "company" in section YA 1 of the Income Tax Act 2007. Before looking at the relevant foreign tax credit legislation in New Zealand law, the underlying Australian law surrounding limited partnerships registered in Australia, as well as their tax treatment in Australia, needs to be considered.

Australian partnerships

Three forms of Australian partnerships exist:

- (ordinary) partnerships[1];
- limited partnerships; and
- incorporated limited partnerships.

(Ordinary) partnerships

The regulation of partnerships in Australia falls under State law which includes the:

- Partnership Act 1958 (Victoria)
- Partnership Act 1892 (New South Wales)
- Partnership Act 1891 (Queensland)
- Partnership Act 1963 (Australian Capital Territory)
- Partnership Act 1891 (South Australia)
- Partnership Act 1891 (Tasmania)
- Partnership Act 1997 (Northern Territory)
- Partnership Act 1895 (Western Australia).

These Acts provide that an ordinary partnership is one where the partners are jointly and severally liable for the legal actions and debts of the partnership, have management control, share the profits of the firm in predefined proportions, and have apparent authority as agents of the firm to bind all the other partners in contracts with third parties. An ordinary partnership is not a separate legal entity.

Limited partnerships

Limited partnerships in Australia can be formed and registered only under:

- Part 3, sections 49–79, Partnership Act 1958 (Victoria)
- Part 3, sections 50A–81A, Partnership Act 1892 (New South Wales)
- Chapter 3, sections 48–69, Partnership Act 1891 (Queensland)
- Part 3, sections 47–84, Partnership Act 1891 (South Australia)
- Limited Partnership Act 1908 (Tasmania)
- Limited Partnership Act 1909 (Western Australia).

[1] Referred to as "partnerships" in Australian state legislation.

Neither the partnership laws of the Australian Capital Territory nor the Northern Territory have provision for limited partnerships although the Australian Capital Territory and the Northern Territory have provision for incorporated limited partnerships, as do New South Wales, Queensland, Victoria and South Australia mentioned below.

The provisions, listed above, provide that a limited partnership is one where there are both general partners and limited partners. The general partners have the rights and obligations as in an ordinary partnership. The limited partners are not jointly and severally liable for the debts of the partnership and their exposure is limited to their partnership investments, and a corresponding share of the profits. They also cannot participate in the management of the company or act as agents for the partnership. Despite the limited liability of the limited partners the limited partnership, which is not also an incorporated limited partnership, does not have a separate legal identity.

Incorporated limited partnerships

An incorporated limited partnership is a partnership which must have at least one general partner and one limited partner and the partnership is a separate legal entity with the powers and capacity of a natural person subject to the limitations in the partnership agreement.

Australian tax treatment of Australian limited partnerships

A "limited partnership" is defined in section 995-1 of the Income Tax Assessment Act 1997 (Aust)[2] as:

> (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of those persons is limited; or
>
> (b) an association of persons (other than one referred to in paragraph (a)) with legal personality separate from those persons that was formed solely for the purpose of becoming a VCLP, an ESVCLP, an AFOF or a VCMP and to carry on activities that are carried on by a body of that kind.[3]

Corporate limited partnerships

Section 94D of Division 5A of the Income Tax Assessment Act 1936 (Aust), Income of Certain Limited Partnerships, provides that a limited partnership is a corporate limited partnership if it is an association of persons (other than a company) carrying on business as partners or in receipt of ordinary or statutory income jointly where the liability of at least one of the associated persons is limited and:

- the relevant year of income is 1995-96 year of income or a later year of income or
- the partnership was formed on or after 19 August 1992 or
- if the partnership was formed before 19 August 1992 either it does not pass the continuity of business test set out in Division 5A at s 94E or there has been a change in composition of the partnership after 19 August 1992 and no election has been made by the partners under section 94F that the partnership not be treated as a corporate limited partnership and
- the limited partnership is not a foreign hybrid limited partnership in relation to the particular year of income, a VCLP, an ESVCLP, an AFOF or a venture capital management partnership.

These rulings apply only to limited partnerships that are also corporate limited partnerships under section 94D of the Income Tax Assessment Act 1936 (Aust) and do not have identities separate from their members. That is, they will not apply to limited partnerships which are also a foreign hybrid limited partnership, VCLPs, ESVCLPs, AFOFs or venture management partnerships.

Nothing in Division 5A of the Income Tax Assessment Act 1936 (Aust) overrides the state partnership laws by recharacterising limited partnerships as companies. Division 5A simply treats a limited partnership that also meets the test for a corporate limited partnership as a company for Australian income tax purposes only. In particular, subdivision C of Division A provides that a:

- company includes a reference to a corporate limited partnership; section 94J
- partnership does not include a reference to a corporate limited partnership; section 94K
- dividend includes a reference to a distribution made by a corporate limited partnership; section 94L.

This is discussed in the explanatory memorandum to the Taxation Laws Amendment Act (No. 6) 1992 that accompanied the introduction of subdivision C Division 5A:

> Under the existing law, limited partnerships are treated as partnerships for taxation purposes. However, the structure of a limited partnership is comparable to that of a limited liability company in that there are "limited partners" who are similar to shareholders in a company; they do not take part in the management of the business, and their liability generally is limited to the extent of their investment.
>
> Limited partners are not at risk beyond the limit of their liability. Generally, their liability is limited to their investment. They are not required to make good losses of

[2] The definition in the Income Tax Assessment Act 1936 is the same and referenced to that in the 1997 Act.

[3] A foreign hybrid limited partnership is formed outside Australia as defined ss830-(1) and (2) of ITAA97. A VCLP is a venture capital limited partnership and defined in section 118-405(2) of the 1997 Act; an ESVCLP is an early stage venture capital partnership and defined in section 118-407(4) of the 1997 Act; an AFOF is an Australian venture capital fund of funds defined in section 118-410(3) of the 1997 Act and a venture capital management partnership is defined in section 118-405(2). In all cases these types of limited partnership must have been registered under Part 2 of the Venture Capital Act 2002.

> their partnership, nor are they liable to meet the obligations of the partnership. If limited partners are treated in the same way as partners in any other partnership, however, they may benefit from distributions of losses that exceed their limited liability. Those losses could be used to reduce taxable income, and so tax paid, even though the loss is not one that exposes the partner to any risk of having to meet obligations or make good losses.
>
> State legislation enabling the formation of limited partnerships currently exists in New South Wales, Victoria, Western Australia, Queensland and Tasmania.
>
> **Explanation of proposed amendments**
>
> The Bill will amend the Principal Act to introduce taxation arrangements in new Division 5A of Part III of the Act for taxing limited partnerships … **The object of this new Division is to ensure that limited partnerships will be treated as companies for taxation purposes. This is not confined to the payment of income tax by limited partnerships, but includes all other purposes under income tax law, including the payment of tax by partners in limited partnerships; for instance, imputation and the taxation of dividends to shareholders** …
>
> [Emphasis added]

Australian tax consolidated groups

The concept that limited partnerships that are corporate limited partnerships are to be treated as companies for the purpose of the Australian income tax law was reinforced with the introduction of Australia's consolidation rules. The explanatory memorandum to the New Business Tax System (Consolidation) Act (No. 1) 2002 (Aust) makes it clear that corporate limited partnerships can also be head companies within that regime because they are sufficiently equivalent to a company for Australian income tax purposes.

> 3.29 To qualify as a head company, an entity must be a company as defined in section 995-1 of the ITAA 1997.
>
> 3.30 A corporate limited partnership will also satisfy this requirement. This is consistent with the objective of ensuring consolidated groups generally receive a tax treatment like ordinary companies because these partnerships are effectively treated as companies for income tax purposes.

The effect of becoming a head company in an Australian consolidated group is that all the income of the group is deemed to have been earned by the head company and not by the individual companies in the group: section 701 of the Income Tax Assessment Act 1997 (Aust).

Australian limited partnerships under New Zealand income tax law

Legislation

As these rulings focus on the ability of New Zealand partners to claim foreign tax credits for tax paid or deducted by an Australian limited partnership the key provisions in the Act are:

- the definitions of "company", "partnership", and "limited partnership" in section YA 1;
- section HG 2 which sets out that partnerships are transparent;
- section CB 35 which sets out that income arising from subpart HG is assessable income to the partner; and
- subpart LJ which sets out the rules for the allowance of credits for foreign tax paid.

These provisions are discussed below.

Limited partnerships

In terms of entity definitions in the Act, section YA 1 sets out the definition of a company:

> Company—
>
> (a) means a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere:
>
> (ab) does not include a partnership:
>
> (ac) includes a listed limited partnership:
>
> (ad) includes a foreign corporate limited partnership:
>
> (b) includes a unit trust:
>
> …

A listed limited partnership and a foreign corporate limited partnership are also defined in section YA 1. In essence, they are defined respectively as a New Zealand or foreign limited partnership that is listed on a recognised exchange and a foreign limited partnership that is treated as a separate entity under the non-tax laws of the country concerned.

Therefore, unless an Australian limited partnership is listed on a recognised exchange or the underlying state partnership laws give it a separate legal personality, it will not meet the definition of company in New Zealand. This is irrespective of whether or not it is treated as a corporate limited partnership for Australian income tax purposes.

Therefore Australian limited partnerships, which are not treated as companies, will be treated as partnerships for New Zealand income tax purposes. This arises from the interface between section YA 1 and section 4 of the Limited Partnerships Act 2008.

Section YA 1 defines:

- "partnership" in paragraph (d) as meaning a limited partnership; and
- "limited partnership" as including an overseas limited partnership as defined in section 4 of the Limited Partnerships Act 2008 but excluding a listed limited partnership or a foreign corporate partnership.

Section 4 of the Limited Partnerships Act 2008 defines an overseas limited partnership as:

> a partnership formed or incorporated outside New Zealand with:
>
> (a) 1 or more general partners who are liable for all of the debts and liabilities of the partnership; and
>
> (b) 1 or more limited partners who have only limited liability for the debts and liabilities of the partnership

That is, an Australian limited partnership that meets the definition of an "overseas limited partnership" under section 4 of the Limited Partnerships Act 2008; is not listed on a recognised exchange; and is not treated as a separate entity in Australia will be treated as a partnership under New Zealand tax law.

Partners in limited partnerships

For partners in Australian limited partnerships that meet the definition of "partnership" in section YA 1 because they are not listed on a recognised exchange or have a separate legal personality, the tax treatment is set out in section HG 2(2):

> … for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership income.

"Partnership share" is defined in section YA 1 as meaning:

> for a particular right, obligation, or other property, status or thing, the share that a partner has in respect of it.

The effect of section HG 2(2) and the definition of "'partnership share" is that for partners in a partnership, their assessable income includes their "partnership share" of the partnership income. Section CB 35 also confirms that this is assessable income of the partner:

> A person who is a partner has an amount of income to the extent to which an amount of income results from the application of subpart HG (Joint venturers, partners, and partnerships) to them and their partnership.

Section HG 2(2) also makes reference to tax credits, which would include foreign tax credits, being in proportion to the partner's partnership share. This then flows into sections LJ 1 to LJ 4 (Tax credits for foreign income tax).

Foreign tax credits

The key sections relating to foreign tax credits with respect to these rulings are sections LJ 1 to LJ 4. Sections LJ 1(1), LJ 1(2)(a), and LJ 2(1) state:

> **LJ 1 What this subpart does**
>
> *When tax credits allowed*
>
> (1) This subpart provides the rules for dividing assessable income from foreign sourced amounts into segments and allows a tax credit for **foreign income tax paid in relation to a segment** of that income.
>
> *Limited application of rules*
>
> (2) The rules in this subpart apply only when—
>
> (a) *a person resident in New Zealand derives assessable income* that is not derived from New Zealand; and
>
> …
>
> **LJ 2 Tax credits for foreign income tax**
>
> *Amount of credit*
>
> (1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of **foreign income tax paid on a segment of foreign-sourced income**, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.
>
> [Emphasis added]

Therefore the key terms, in determining whether a foreign tax credit is available, are "foreign income tax" and "segment of foreign-sourced income". "Foreign income tax" is defined in section LJ 3 and reinforced by section YA 2(5) and "segment of foreign-sourced income" is defined in section LJ 4.

Section LJ 3 states that "foreign income tax" is:

> an amount that, if paid, would satisfy a person's obligations in a foreign country in relation to amounts that have the same nature as income tax.

Section YA 2(5) states that "income tax" when used in relation to foreign tax:

> (a) means a tax of substantially the same nature as income tax imposed under section BB 1 (Imposition of income tax); and
>
> (b) includes a tax, imposed as a collection mechanism for the foreign tax, that is of substantially the same nature as … non-resident withholding tax (NRWT).

The Australian tax considered in these rulings is company tax and dividend withholding tax. In Australia, taxable income of a company is calculated under section 4-15 of the Income Tax Assessment Act 1997 (Aust), the Australian core provisions, which is comparable to section BB 1 in New Zealand. Dividend withholding tax that is deducted under section 128B of the Income Tax Assessment Act 1936 (Aust) is deducted from the gross amount of dividend and is otherwise excluded from the non-resident's

assessable income. This is comparable to the deduction of non-resident withholding tax from dividends in New Zealand under subpart RF of the Act.

A "segment of foreign-sourced income" is defined in section LJ 4 as:

> an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

Therefore for a New Zealand resident partner of an Australian limited partnership to be allowed a foreign tax credit under sections LJ 1 and HG 2, three key elements must be satisfied once income has been allocated to the partner under section HG 2:

1. A person resident in New Zealand must derive assessable income from a foreign source.
2. Foreign income tax must be paid.
3. The foreign income tax paid must be in respect of that assessable income from a foreign source.

It follows that a foreign tax credit is not available where a person has not actually paid foreign income tax; the foreign income tax has been paid but it is not in respect of income that is assessable in New Zealand; or there is no assessable income calculated under New Zealand tax law. The foreign income tax could be Australian company tax or dividend withholding tax as appropriate.

Double tax agreement with Australia

In the arrangements covered by the five rulings, the application of the treaty that came into force on 19 March 2010 or the previous treaty does not result in any relief that is different from the foreign tax credits granted under domestic law, as discussed above.

Examples

This section of the commentary discusses the specific factual scenarios related to each of the five public rulings. In all cases they involve Australian tax being paid at some level, but the issue is whether or not the Australian tax will be available to the New Zealand partners as a foreign tax credit.

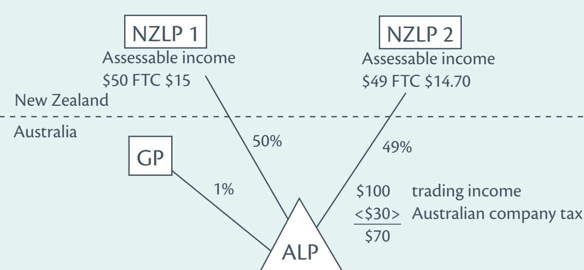
In all five examples the Australian limited partnership ("ALP") has three partners:

- one general partner ("GP") based in Australia having a 1% partnership share; and
- two New Zealand resident limited partners ("NZLP 1" and "NZLP 2") with 50% and 49% partnership shares respectively (the 50% and 49% partners). In examples 1, 2 and 5, "NZLP 1" and "NZLP 2" are either a company or a natural person but are only a natural person in examples 3 and 4.

The Australian limited partnership is treated as a corporate limited partnership for Australian income tax law but is treated as a partnership for New Zealand income tax law.

To avoid currency exchange issues, the reference to "$" is not a reference to any particular currency; it is used simply for illustrative purposes.

Example 1: Australian source income



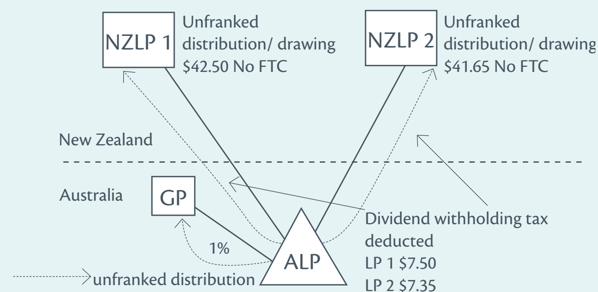
ALP earns trading income in Australia of $100 and pays Australian company tax of $30 on it.

The trading income is partnership income to the partners, so they must include their partnership share in their taxable income. The Australian company tax is allowed as a foreign tax credit ("FTC") in the same proportion as the partner's partnership share. This is because the three key elements are met:

1. The partnership income is assessable to the partners under sections HG 2 and CB 35.
2. The Australian company tax was paid to the Australian Government by the ALP.
3. The Australian company tax was paid because the ALP earned trading income.

In the specific example, the 50% partner (NZLP 1) has assessable income of $50 and a foreign tax credit of $15 and the 49% partner (NZLP 2) has assessable income of $49 and a foreign tax credit of $14.70. This is their respective partnership share of the trading income and the Australian company tax paid.

Example 2: Distribution made by Australian limited partnership

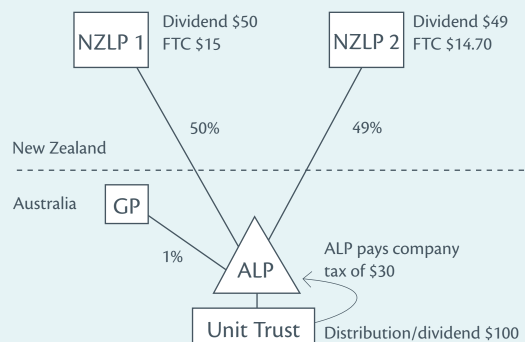


The ALP makes an unfranked distribution to the partners of $100. For Australian income tax purposes, this distribution is treated as a dividend and Australian dividend withholding tax of 15% is deducted. The net amount distributed is then $85 in total.

In this situation only the second of the three elements has been met. While the income tax (dividend withholding tax of 15%) has been paid to the Australian Government, it has not been paid in respect of New Zealand assessable income. This is because for New Zealand income tax purposes, the distribution from a partnership would have the nature of drawings and not be subject to New Zealand income tax.

Therefore, no foreign tax credit is available to the New Zealand partners.

Example 3: Distribution made from subsidiary unit trust



The ALP owns a subsidiary unit trust and the New Zealand partners are natural persons. As seen previously, a unit trust is included in the definition of "company" for New Zealand income tax purposes. The unit trust distributes income of $100 to the ALP and the ALP pays company income tax on the income from the unit trust of $30.

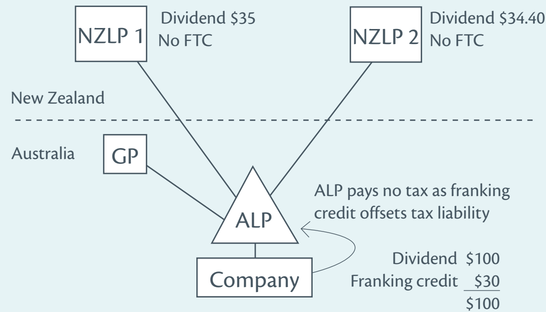
Under New Zealand income tax law the distribution from a unit trust is a dividend under section CD 1.

In this case all three elements are met:

1. The dividend will be assessable income to the partners under sections CD 1 and HG 2.
2. The income tax on that dividend has been paid to the Australian Government.
3. The Australian company tax was paid because the ALP received that distribution/dividend.

Therefore a foreign tax credit will be allowed in proportion to the partner's partnership share of partnership income. This means that the 50% partner (NZLP 1) has dividend income of $50 and a foreign tax credit of $15 while the 49% partner (NZLP 2) has dividend income of $49 and a foreign tax credit of $14.70.

Example 4: Franked dividend received by Australian limited partnership



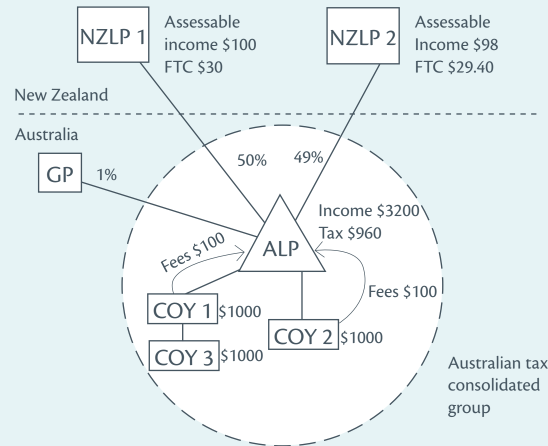
The ALP owns a subsidiary company that pays a $70 franked dividend to it and the New Zealand partners are natural persons. The underlying basis of the franking credit was company tax the subsidiary company had paid previously on its trading income. While the dividends received by the ALP are subject to tax in Australia, the attached franking credit means that the ALP does not pay tax on that income as the franking credit offsets any tax liability on the dividend.

In this case only the first and the second of the three elements are met:

1. The dividend will be assessable income to the partners under sections CD 1 and HG 2(2).
2. Income tax was paid to the Australian Government by the subsidiary company on its trading profits.
3. However, this income tax was not paid because the ALP received a dividend and so the franking credit is not available as a foreign tax credit for the New Zealand partners, as is the general case with franking credits attached to Australian dividends. Therefore, no foreign tax credit is available to the New Zealand partners.

In terms of New Zealand assessable income, however, there is dividend income of $35 and $34.30 to the 50% partner and 49% partner respectively.

Example 5: Tax paid by Australian limited partnership as "head company" of an Australian tax consolidated group



The ALP as the head company for a consolidated group of companies (COY 1, COY 2 and COY 3) pays tax on all the taxable income of the consolidated group in Australia. The taxable income of the consolidated group is $3,200 and the company tax paid is $960. This includes income from subsidiary companies that is not earned by the ALP of $3,000 which is calculated after allowing for the fees paid to the ALP. The New Zealand partners' partnership share of the partnership income does not include any part of the income that is not earned by the ALP and includes only their partnership share of the $200 earned directly by the ALP. That is, $100 and $98 for the 50% partner and 49% partner respectively.

In this case, the three elements are met and a foreign tax credit will be available to the partners of the ALP but only to the extent that the tax paid relates to income that is subject to tax in New Zealand.

A foreign tax credit potentially will be available only for the Australian company tax paid on the income earned directly by the ALP; that is $60 being the company tax on $200. In this case the foreign tax credit of $30 will be allowed to the 50% partner (NZLP 1) and $29.40 to the 49% partner (NZLP 2).

PUBLIC RULING BR PUB 10/21: INTEREST REPAYMENTS REQUIRED AS A RESULT OF THE EARLY REPAYMENT OF A FINANCIAL ARRANGEMENT – DEDUCTIBILITY

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

Taxation Laws

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

This ruling applies in respect of ss DA 1, DB 6, DB 7, DB 11 and EW 31.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- A person places an amount of money on term deposit.
- The term deposit is a financial arrangement subject to the financial arrangements rules.
- The term deposit contract provides that the rate of interest payable will be reduced in the event of the withdrawal, in part or in full, of the principal sum before the contractual maturity date.
- The depositor withdraws the whole or part of the term deposit before the contractual maturity date.
- The application of the reduced rate of interest requires the repayment of interest already derived by the depositor or the set-off of interest owed against the principal sum ultimately repaid to the depositor.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the arrangement as follows.

Full withdrawal of the term deposit

Where the depositor withdraws the full amount of the term deposit before the contractual maturity date the following applies:

- A base price adjustment is required.
- The amount of repaid interest is included in the "consideration" element of the base price adjustment.
- If the base price adjustment gives rise to a negative amount, that amount is expenditure incurred under the financial arrangements rules.
- Expenditure incurred under the financial arrangement rules is deemed to be interest.
- A deduction may be available under s DB 6 (*Interest: not capital expenditure*) or s DB 7 (*Interest: most companies need no nexus with income*).
- An automatic deduction is allowed under s DB 11 to the extent the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.

Partial withdrawal of the term deposit

Where the depositor withdraws part of the amount of the term deposit before the contractual maturity date the following applies:

- A base price adjustment is not required.
- Depositors who are not cash basis persons, and cash basis persons who have elected to adopt a spreading method, must apply Determination G25: *Variations in the terms of a financial arrangement* when the term deposit is varied by the partial withdrawal. The repaid interest is included in the calculation under the determination and an adjustment is made in the year of variation.

Cash basis persons

- Depositors who are cash basis persons may deduct the repaid interest at the time it is incurred only if the general permission is satisfied. To satisfy the general permission there must be a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers the relationship between the repayment and the interest income earned under the term deposit is insufficient to satisfy s DA 1(1)(a). However, the Commissioner considers that a deduction for the repayment may be available under the general permission, if it can be shown that the expenditure was incurred in the course of carrying on a business for the purposes set out in s DA 1(1)(b).
- If the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with on maturity of the deposit through the base price adjustment.
- The amount of repaid interest is included in both the "consideration" and "expenditure" elements of the base price adjustment.
- If the base price adjustment gives rise to a positive amount, that amount is income derived. However, it is not income to the extent to which it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied.

- Therefore, a positive base price adjustment amount in the final year of the term deposit will be reduced by the amount of interest repaid in the year of partial withdrawal.

The period or income year for which this Ruling applies

This ruling will apply for a three year period beginning on 16 December 2010 and ending on 16 December 2013.

This ruling is signed by me on 16 December 2010.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULING BR PUB 10/21

This commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 10/21 ("the Ruling"). The commentary is not a legally binding statement.

This Ruling is a reissue of BR Pub 97/9, which expired on 31 March 2001. The expired ruling took the view that if a partial withdrawal of a term deposit was to pay a business expense or to apply the amount to derive other assessable income, then the amount of repaid interest was deductible under the general permission at the time of the repayment.

After reconsidering this reissue, the Commissioner takes the view that there is not a sufficient relationship between the repayment of interest and any income to allow a deduction under s DA 1(1)(a) of the Income Tax Act 2007 at the time of the repayment. However, it is accepted that in some cases it may be deductible under s DA 1(1)(b).

Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

Summary

1. A depositor who withdraws funds early may have to repay a portion of the interest previously derived under the term deposit. The issue this ruling and commentary deal with is whether and when the repaid amount is deductible.
2. The fact a depositor may have to repay interest if they withdraw a deposit early does not mean interest they receive during the course of the deposit is not derived by the depositor. At the time of receipt or crediting of interest, the depositor has earned that interest and it is theirs to deal with as they wish. The fact a liability to repay some of that interest may arise later, if certain events occur, does not alter the fact derivation has occurred. Therefore, it is necessary to consider the taxation consequences of the repayment of the interest on the full or partial withdrawal of the term deposit amount.
3. The full withdrawal of a term deposit amount before the contractual maturity date will trigger a base price adjustment (BPA). Where the depositor is required to repay interest previously derived, the amount of repaid interest will be included in the "consideration" element of the BPA. This will generally give rise to a negative BPA amount. A negative BPA amount is expenditure incurred under the financial arrangements rules. Expenditure incurred under the financial arrangements rules is deemed to be interest under s YA 1. A deduction may be available under s DB 6 (*Interest: not capital expenditure*) or s DB 7 (*Interest: most companies need no nexus with income*). An automatic deduction is allowed under s DB 11 to the extent the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.
4. If a depositor partially withdraws the deposit, there is no maturity of the financial arrangement. Therefore, no BPA is performed. In these circumstances, the deductibility of the repaid interest depends on whether the depositor is a cash basis person.
5. A depositor who is not a cash basis person, or is a cash basis person who has elected to adopt a spreading method, needs to apply Determination G25: *Variations in the terms of a financial arrangement* when the term deposit is varied by the partial withdrawal. The repaid interest will be brought into the Determination G25 calculation and an adjustment made in the year of variation. A BPA is done when the term deposit finally matures.
6. Where a cash basis person does not adopt a spreading method, expenditure incurred during the term of a financial arrangement will be deductible at the time it is incurred only if the general permission is satisfied. To satisfy the general permission there must be a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers the relationship between the repayment and the interest income earned under the term deposit is insufficient to satisfy s DA 1(1)(a). As the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with through the BPA on maturity of the deposit. However, the Commissioner considers that where the expenditure has been incurred in carrying on a business, a deduction may be available under s DA 1(1)(b). Whether the repayment of interest satisfies the nexus

test for a business will depend upon the facts of each case.

7. The amount of the repaid interest will be included in both the "consideration" and "expenditure" elements of the BPA calculation. The application of the BPA at maturity will generally result in a positive amount, which reflects the receipt of interest income in the final year of the term deposit.
8. A positive BPA amount is income, except to the extent to which it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied. Thus, the amount of interest income derived in the final year of the term deposit will be reduced by the amount of interest repaid in an earlier year. However, an amount of repaid interest for which a deduction was available will not reduce the amount of interest income derived in the final year of the term deposit. This ensures the depositor returns the correct amount of interest income over the full term of the deposit.

Introduction

9. A term deposit contract will often include a clause that early withdrawal of the principal sum, in whole or in part, will result in a reduced rate of interest, calculated from the date of the initial deposit. In some cases, this means a depositor who withdraws funds early may have to repay a portion of the interest previously derived under the term deposit.
10. For example, assume that on 1 October 2010 a person invests $10,000 for 12 months at 7%, interest to be credited to the person's bank account six-monthly. Interest of $350 is paid to the person on 31 March 2011. However, on 1 May 2011 the person decides to withdraw $5,000 from the term deposit.
11. The term deposit contract states that the rate of interest on the $5,000 to be withdrawn is reduced to 5% from the date of deposit, 1 October 2010. Therefore, the amount of interest the person should have received in relation to the $5,000 withdrawn is $146 (seven months interest at 5%). The person has already been credited with $175 in respect of that $5,000. Therefore, the person owes the bank $29.
12. This ruling considers the tax consequences of the depositor's repayment of the interest to the bank.
13. Note that, in practical terms, it is unlikely the depositor would physically repay the interest previously derived to the bank. The more common scenario would be for the bank to deduct the amount of interest owed to it from the amount of the principal to be repaid by it. For example, in the above example the person would receive $4,971 from the bank on early withdrawal (the $5,000 principal withdrawn less the $29 interest to be repaid). Whether such a set-off occurs or not, the transaction is treated for tax purposes as the repayment of the interest owed by the depositor and the return by the bank of the full amount of the principal withdrawn early.

Application of the legislation

14. The tax consequences of the arrangement depend upon whether there is a full or partial withdrawal of the deposit early and whether the depositor repaying the interest is a cash basis person. These scenarios are considered below. However, before turning to these scenarios, it is necessary to consider the preliminary issue of whether the interest under the term deposit is fully derived when received or is only conditionally derived to the extent of the amount liable to repayment.

Derivation of interest subject to repayment on early withdrawal

15. The fact a depositor may have to repay interest if the deposit is withdrawn early does not mean interest received during the course of the deposit is not derived by the depositor. At the time of receipt or crediting of interest, the depositor has earned that interest and it is theirs to deal with as they wish. The fact a liability to repay some of that interest may arise later, if certain events occur, does not alter the fact derivation has occurred.
16. *Bowcock v CIR* (1981) 5 NZTC 61,062 supports this conclusion. Mr Bowcock was an employee who went on study leave but continued to receive his full salary. The terms of the employment bond provided that if he left his employment within four years of the end of his study leave, he would have to repay some of the amount he had received. He did leave within that time, so was required to repay salary in respect of two income years. He tried to deduct these sums from his income tax returns for the two years. In the High Court Mr Bowcock claimed he had never derived the amounts because they were contingent receipts not absolute receipts.
17. Vautier J rejected Mr Bowcock's argument. He said (at page 61,069):

> Upon a consideration of the terms of the bond and the course pursued in this case, I am quite unable to come to the conclusion that the moneys which were paid to the objector during the two years in question can be said to have been received by him conditionally in the sense referred to in the judgments in the High Court in [*Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314]. Those moneys clearly in my view became the absolute property of the objector when they were paid. No conditions or stipulations were attached to those payments

BINDING RULINGS

> themselves. They were clearly received and accepted as of right. Whether or not any liability arose in the future to repay any part of those moneys depended entirely on the course which the objector chose to take.

18. The *Bowcock* principle supports the view that if a taxpayer is liable to repay an amount previously received (for example, for breaching a bond or for the early withdrawal of funds), the repayment of the amount does not change the nature of the original derivation of the funds from absolute to conditional.
19. Vautier J distinguished the decision in *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 in *Bowcock*. *Arthur Murray* concerned whether income had been derived in the first instance, not the situation where income has been derived but may have to be repaid. It is the latter situation that was covered in *Bowcock*, where the court found that the possibility of repayment did not affect the derivation of the income.
20. In the present arrangement, the depositor has an absolute entitlement to the interest under the term deposit at the time it is received. If the depositor later chooses to withdraw funds before the contracted maturity date, the fact an obligation to repay some of the interest received may arise does not affect that entitlement. The interest has been derived and the nature of the derivation of the funds is not changed from absolute to conditional as a result of the repayment.
21. As the interest income is absolutely derived by the depositor, it is now necessary to consider the taxation consequences of the repayment of interest on the full or partial withdrawal of the term deposit amount.

Full withdrawal of the term deposit amount

22. A term deposit is a financial arrangement under s EW 3. Therefore, the financial arrangements rules apply. When a term deposit is withdrawn in full, the financial arrangement has matured and a BPA is required under s EW 29.
23. Although many depositors are likely to be cash basis persons under the financial arrangements rules and not required to use a spreading method, they are still subject to the financial arrangements rules and must do a BPA if they withdraw the term deposit in full.
24. The formula for calculating a BPA is in s EW 31(5). The formula is:

    consideration − income + expenditure + amount remitted

    where:

    consideration is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. Non-contingent and non-integral fees are ignored.

    income is income derived by the person under the financial arrangement in earlier income years.

    expenditure is expenditure incurred by the person under the financial arrangement in earlier income years.

    amount remitted is an amount that is not included in the consideration paid or payable to the person because it has been remitted by the person or by law.

25. Where a depositor withdraws a term deposit in full before the contracted maturity date and the depositor is required to repay interest derived in a previous income year, the repaid interest will be included in the "consideration" element of the BPA. The result of the BPA calculation will depend on matters such as the time of receipt of the interest payments, the differential in interest rates and the time of the withdrawal of the term deposit amount.
26. Where the BPA calculation gives rise to a negative amount, s EW 31(4) provides that a negative BPA amount is expenditure incurred by a person in the year the calculation is made. Expenditure incurred under the financial arrangements rules is deemed to be interest.
27. A deduction may be available under s DB 6 (*Interest: not capital expenditure*) or s DB 7 (*Interest: most companies need no nexus with income*). Section DB 6 overrides the capital limitation and allows a deduction for interest where the general permission is satisfied. Where the requirements of s DB 7 are satisfied, a company is allowed a deduction for interest expenditure incurred whether or not the expenditure satisfies the general permission. Section DB 7 also overrides the capital limitation, the exempt income limitation and the withholding tax limitation.
28. Section DB 11 supplements the general permission and overrides all the general limitations. An automatic deduction is allowed for the negative BPA amount under s DB 11 to the extent that the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.
29. Where the BPA calculation gives rise to a positive amount, s EW 31(3) provides that the amount is income derived by the person. A positive BPA amount may occur where the depositor derives interest income in the same year as the year in which the withdrawal and repayment of interest occurs. In these circumstances, the BPA calculation ensures that the positive BPA amount is reduced by the amount of the repaid interest.

30. Examples 1 and 2 illustrate the above points.

Example 1

On 1 October 2010 Mary (a cash basis person) invests $10,000 for 12 months at 7%, with interest to be credited to her bank account six-monthly. Interest of $350 is paid to Mary on 31 March 2011. However, on 1 May 2011 Mary decides to withdraw the full amount of the term deposit.

On the early withdrawal of the $10,000, the term deposit contract states that the rate of interest is reduced to 5% from the date of deposit, 1 October 2010. Therefore, the amount of interest Mary should have received in relation to the term deposit is $292 (seven months interest at 5%). As Mary has already been credited with $350 interest (for the first six months), she owes the bank $58. The bank sets off the amount of interest owed against the amount of the principal to be repaid and Mary receives $9,942.

Mary will have to apply the BPA formula to the term deposit in the 2012 income year as follows:

consideration – income + expenditure
+ amount remitted

The consideration Mary received is the repayment of the principal amount of $10,000 and the interest received of $350. The consideration Mary paid is the original deposit of $10,000 and the repayment of interest of $58.

The amount of income Mary derived in earlier income years is $350.

There is no expenditure from earlier years.

No amount is remitted.

Therefore, the BPA is:

($10,350 – $10,058) – $350 + $0 + $0

= $292 – $350

= –$58

The negative BPA amount is expenditure incurred under the financial arrangements rules. Mary has derived income under the financial arrangement in previous income years ($350) and therefore the negative BPA amount of –$58 will be deductible to Mary in the income year ending 31 March 2012.

Example 2

On 1 November 2010 Sally invests $10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. Interest of $350 is paid to Sally on 30 April 2011, 30 October 2011 and 30 April 2012. However, on 30 June 2012 Sally decides to withdraw the full amount of the term deposit. Sally has a standard balance date.

On the early withdrawal of the $10,000, the term deposit contract states that the rate of interest is reduced to 5% from the date of deposit, 1 November 2010. Therefore, the amount of interest Sally should have received in relation to the term deposit is $833 (20 months interest at 5%). Sally has already been credited with $1,050 interest, so she owes the bank $217. The bank sets off the amount of interest owed against the amount of the principal to be repaid and Sally receives $9,783.

Sally will have to apply the BPA formula to the term deposit in the 2013 income year as follows:

consideration – income + expenditure
+ amount remitted

The consideration Sally received is the repayment of the principal amount of $10,000 and the interest received of $1,050. The consideration Sally paid is the original deposit of $10,000 and the repayment of interest of $217.

The amount of income Sally derived in earlier income years is $700.

There is no expenditure from earlier years.

No amount is remitted.

Therefore, the BPA is:

($11,050 – $10,217) – $700 + $0 + $0

= $833 – $700

= $133

The positive BPA amount is income derived for Sally. The $133 for the 2013 income year reflects the receipt by Sally of interest income of $350 on 30 April 2012 and the repayment of interest of $217.

Partial withdrawal of term deposit amount

31. If a depositor only partially withdraws the deposit, there is no maturity of the financial arrangement. Therefore, no BPA is performed. In these circumstances, the deductibility of the repaid interest depends on whether the depositor is a cash basis person.

32. Note that this situation assumes the contract between the parties provides that the partial withdrawal of the deposit does not terminate the contract. If

the withdrawal results in the existing term deposit contract being terminated and a new term deposit being entered into, a BPA will be required as discussed in paragraph 22 above.

Non-cash basis person

33. A depositor who is a non-cash basis person needs to apply Determination G25: *Variations in the terms of a financial arrangement* when the term deposit is varied by the partial withdrawal.

34. The formula in Determination G25 is:

    a – b – c + d

    where:

    a is the sum of all amounts that would have been income derived by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued

    b is the sum of all amounts that would have been expenditure incurred by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued

    c is the sum of all amounts treated as income derived of the person in respect of the financial arrangement since it was acquired or issued to the end of the previous income year

    d is the sum of all amounts treated as expenditure incurred of the person in respect of the financial arrangement since it was acquired or issued to the end of the previous income year.

35. The repaid interest will be brought into the Determination G25 calculation and an adjustment made in the year of variation. When the formula in Determination G25 is calculated, a positive amount is deemed to be income, and a negative amount is deemed to be expenditure incurred. A BPA is done when the term deposit finally matures.

36. Example 3 illustrates this situation.

Example 3

On 1 October 2010 Penny invests $10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. She receives an interest payment of $350 on 31 March 2011. However, on 1 May 2011 Penny decides to withdraw $5,000 from the term deposit.

The term deposit contract states that on an early withdrawal the rate of interest is reduced to 5% on the amount of principal withdrawn. The reduced rate applies from the date of the original deposit; in this case, 1 October 2010. Therefore, the amount of interest Penny should have received in relation to the $5,000 withdrawn is $146 (seven months interest at 5%). Penny has already been credited with $175 interest in relation to the $5,000, so she owes the bank $29. The bank sets off the amount of interest owed against the amount of the principal to be repaid, and Penny receives $4,971 on 1 May 2011.

The balance of the principal remains in the term deposit and Penny receives interest payments of $175 on 30 September 2011 and 31 March 2012. On 30 September 2012, Penny receives $5,175, being the repayment of the remaining principal and the last interest payment.

Penny is not a cash basis person and has a standard balance date. If she has adopted the straight-line method, the results are as follows:

For the income year ending 31 March 2011, Penny has returned $350 of income.

For the income year ending 31 March 2012, Penny must apply the formula in Determination G25:

a – b – c + d

Item *a* is $671. This amount is made up of $525 in respect of the $5,000 not withdrawn (being $5,000 at 7% per annum for the 18 month period from 1 October 2010 to 31 March 2012) and $146 in respect of the $5,000 withdrawn (being $5,000 at 5% per annum for the seven months from 1 October 2010 to 1 May 2011).

Item *b* is nil, because if the changes had been known about at the start of the financial arrangement there would have been no expenditure. There would simply have been less income, which is taken into account in item a.

Item *c* is $350.

Item *d* is nil.

Therefore, applying the Determination G25 formula, the adjustment in the 2012 income year is:

$671 – $0 – $350 + $0 = $321

As the amount is positive, it is deemed to be income Penny derived for the year ending 31 March 2012. Essentially, the formula takes the $29 of repaid interest and deducts it from the income derived in the 2012 income year.

For the income year ending 31 March 2013, Penny will have to perform a BPA by applying the following formula:

consideration – income + expenditure + amount remitted

The consideration Penny received is the $10,000 principal repaid and the interest payments of $875 (being $350 on 31 March 2011 and $175 on 30 September 2011, 31 March 2012 and 30 September 2012). The consideration Penny paid is the $10,000 principal invested and the $29 repaid interest.

The amount of income Penny derived in earlier income years is $671 (being $350 in the 2011 income year and $321 in the 2012 income year).

There is no expenditure incurred in earlier income years.

No amount is remitted.

Therefore, the BPA is:

($10,875 – $10,029) – $671 + $0 + $0

= $846 – $671

= $175

As the BPA is positive, it is income derived by Penny. This equates with the interest income received by Penny in the 2013 income year. There is no adjustment for the repaid interest, because it was taken into account in the Determination G25 calculation in the previous income year.

Cash basis person

37. A person is a cash basis person if either:
    - the income and expenditure under all the person's financial arrangements for the income year does not exceed $100,000, or
    - the value of all the person's financial arrangements on every day of the income year does not exceed $1 million,

    and
    - the difference between the accrual treatment and the cash treatment of all the person's financial arrangements does not exceed $40,000 for the income year.

38. A cash basis person is not required to adopt a spreading method, although they may choose to do so.

39. If a depositor is a cash basis person and adopts a spreading method, they need to apply Determination G25 when the term deposit is varied by the partial withdrawal. This is the same as for a non-cash basis person and is covered in paragraphs 33 to 35 above.

40. Where a cash basis person does not adopt a spreading method, expenditure incurred during the term of a financial arrangement will be deductible when it is incurred if the general permission is satisfied. In the present case, this means the repaid interest on a partial withdrawal would be deductible at the time of the withdrawal, rather than taken into account in the BPA on the eventual maturity of the term deposit.

41. However, to be deductible at the time of the withdrawal, the repaid interest must satisfy the general permission and none of the general limitations must apply.

42. The general permission in s DA 1 provides that a person is allowed a deduction for an amount of expenditure or loss to the extent to which the expenditure or loss is incurred by the person:
    - in deriving their assessable income or excluded income or both, or
    - in the course of carrying on a business for the purposes of deriving their assessable income or excluded income or both.

43. The leading New Zealand cases on the deductibility of expenditure are the Court of Appeal decisions in *CIR v Banks* (1978) 3 NZTC 61,236 and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271. These cases establish that there must be a sufficient nexus between the expenditure incurred and the income earning process in order for the expenditure to be deductible.

44. In delivering the judgment of the court in *Banks*, Richardson J made the following comments (at pages 61,241 and 61,242):

    > For reasons such as these it seems clear that the application of the first limb must involve an amalgam of considerations. In the Australian cases … there has been considerable stress on the character of an outgoing in the sense of its being incidental and relevant to the gaining or producing of the assessable income. Statements to that effect emphasise the relationship that must exist between the advantage gained or sought to be gained by the expenditure and the income earning process. They do not, and cannot, specify in concrete terms the kind and degree of connection between the expenditure and the gaining or producing of assessable income required in individual cases for the expenditure to qualify for deduction …
    >
    > Putting it positively, Dixon J. said in *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295, at p. 309 and we respectfully agree:
    >
    > 'The expression "in gaining or producing" has the force of "in the course of gaining or producing" and looks rather to the scope of the operations or activities and the relevance thereto of the expenditure than to purpose in itself.'
    >
    > It then becomes a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and what it provided, or
    >
    > sought to provide, on the one hand, and the income earning process, on the other, to fall within the words of the section.

45. In *Buckley & Young*, Richardson J stated (at page 61,274):

    > It is not necessary for the purpose of this case to refer in

> any detail to the principles of deductibility under those provisions. There are two features of sec. 111 [of the *Land and Income Tax Act 1954*] which are of particular importance in this case. The first is that a deduction is available only where the expenditure has the necessary relationship both with the taxpayer concerned and with the gaining or producing of his assessable income or with the carrying on of a business for that purpose. The heart of the inquiry is the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the income earning process. That in turn requires determining the true character of the payment. It then becomes a matter of degree and so a question of fact to determine whether there is a sufficient relationship between the expenditure and what it provided or sought to provide on the one hand, and the income earning process on the other, to fall within the words of the section (*C of IR v Banks* (1978) 3 NZTC 61,236, 61,242). The second feature of sec. 111 is that the statutory language contained in the phrase 'to the extent to which' expressly contemplates apportionment.

46. In relation to the deductibility of expenditure incurred in carrying on a business, in *Cox v CIR* (1992) 14 NZTC 9,164, Williams J in the High Court stated (at p 9,168):

> While in jurisdictional terms para (b) is the narrower of the two limbs, it is generally recognised that for business taxpayers it facilitates deductibility in circumstances where a deduction might otherwise not be available under the first limb. This is so because it has been acknowledged in the authorities that the conduct of a business may require expenditures to be made which cannot be directly linked to the derivation of assessable income in some positive way, but which are made to, say, keep the enterprise on foot or to reduce expenditure: see *Europa Oil* (supra) at pp 61,196 and 61,197.
>
> The inclusion of the word "necessarily" in para (b) might mean that the paragraph is intended to be read in a restrictive sense, for example, disallowing deductions unless they are unavoidable or logically necessary for a business. However, the authorities have taken a more pragmatic and commercially realistic approach to business expenditures. Thus it is established by the cases that when compared to the older test laid down in s 111 of the Land and Income Tax Act 1954, s 104 has set a much wider and more commercially realistic test of deductibility of expenditure: *de Pelichet McLeod & Co Ltd v CIR* (1981) 5 NZTC 61,216, 61,219; (1982) 5 TRNZ 622, 626. Moreover, whether an expenditure can be said to be necessarily incurred in the course of carrying on a business must be decided in each case on the facts and by way of a judgment based on common sense and business realities: *Europa Oil (NZ) Ltd* (supra) at p 61,196 and at p 61,197.

47. The Commissioner considers these decisions remain relevant to the interpretation of s DA 1(1). Earlier provisions that correspond to s DA 1(1)(b) referred to "expenditure necessarily incurred in carrying on a business". Section DA 1 preserves that requirement for nexus, notwithstanding that it has removed the word "necessarily". It is the Commissioner's considered view that the word "necessarily" did no more than indicate a requirement that there be a sufficient degree of connection between the expenditure and the business.

48. Applying the principles from these cases requires asking whether there is a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers there is not a sufficient relationship between the repayment and the interest income earned under the term deposit under s DA 1(1)(a). The interest income is earned as a result of lending money. The advantage gained by the repayment is the ability to withdraw early from the term deposit contract, and therefore to cease earning the interest income. The repayment is not a cost of deriving the interest income; it is a cost of ceasing to derive the income. The repayment is a cost to the depositor of not fulfilling the terms of the contract between the bank and the depositor.

49. The repayment of the interest arises because of the depositor's decision to withdraw a portion of their funds before the maturity date. It is incurred solely because the depositor chooses to make a partial withdrawal; it is not incidental or relevant to the deriving of the earlier income.

50. The decision of the Commonwealth Taxation Board of Review in *Case 50* ((1958) 8 C.T.B.R. (N.S.) 250) supports this approach. In *Case 50* the taxpayer was granted leave from his employment to attend university lectures, but he continued to receive his salary for the times he was absent from work, subject to certain conditions. The taxpayer breached those conditions when he later resigned to accept a higher-paid position, so he had to repay some of the salary he had received. The taxpayer claimed a deduction for the amount of salary repaid.

51. The Board of Review denied the deduction. The Board concluded:

> 7. The liability on the taxpayer to repay the £412 arose directly from his failure to observe the conditions he had agreed to under which he had been paid salary in respect of periods of leave of absence granted to him for the purpose of attending lectures and examinations set down for the course of study undertaken by him. The outgoing was not incurred by the taxpayer in the course of gaining or producing his assessable income … The outgoing was not incidental or relevant to the gaining or producing of his assessable income but was incurred solely because of his failure to observe the conditions laid down when the leave was granted to him.

52. Where the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with through the BPA on maturity of the deposit.

53. However, the Commissioner considers that a deduction

may be available where the repayment of the interest was incurred in the course of carrying on a business for the purpose of deriving assessable income, or excluded income or a combination of both assessable and excluded income: s DA 1(1)(b). The courts take a pragmatic and commercially realistic approach to business expenditure. Whether there is a sufficient nexus under s DA 1(1)(b) will depend upon the facts of each case. In this situation, s EW 31(3) and the BPA formula ensure that no double deduction can occur.

54. The amount of the repaid interest will be included in both the "consideration" and "expenditure" elements of the BPA calculation. Where a depositor partially withdraws a term deposit early and is required to repay interest derived in a previous income year, the application of the BPA at maturity will generally result in a positive amount. This reflects the receipt of interest income in the final year of the term deposit. Section EW 31(3) provides that a positive BPA amount is income derived by a person in the year the calculation is made. However, it is not income to the extent to which it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied. Thus, the amount of interest income derived in the final year of the term deposit will be reduced by the amount of interest repaid in an earlier year. However, an amount of repaid interest for which a deduction was available (under s DA 1(1)(b)) will not reduce the amount of interest income derived in the final year of the term deposit. This ensures the depositor returns the correct amount of interest income over the full term of the deposit.

55. Example 4 illustrates this for a non-business cash basis holder.

Example 4

On 1 October 2010 Penny invests $10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. She receives an interest payment of $350 on 31 March 2011. However, on 1 May 2011 Penny decides to withdraw $5,000 from the term deposit.

The term deposit contract states that on an early withdrawal the rate of interest is reduced to 5% on the amount of principal withdrawn. The reduced rate applies from the date of the original deposit; in this case, 1 October 2010. Therefore, the amount of interest Penny should have received in relation to the $5,000 withdrawn is $146 (seven months interest at 5%). Penny has already been credited with $175 interest in relation to the $5,000, so she owes the bank $29. The bank sets off the amount of interest owed against the amount of the principal to be repaid, and Penny receives $4,971 on 1 May 2011.

The balance of the principal remains in the term deposit and Penny receives interest payments of $175 on 30 September 2011 and 31 March 2012. On 30 September 2012, Penny receives $5,175, being the repayment of the remaining principal and the last interest payment.

These are the same facts as in Example 3 above, except that in the current example Penny is a cash basis person who chooses not to adopt a spreading method. Therefore, in this example, the results are as follows:

For the income year ending 31 March 2011, Penny will have returned income of $350.

For the income year ending 31 March 2012, Penny will have returned income of $350 (being the interest payments of $175 on 30 September 2011 and 31 March 2012). She will not be able to claim a deduction for the $29 repaid interest on 1 May 2011.

For the income year ending 31 March 2013, Penny will have to perform a BPA by applying the following formula:

consideration – income + expenditure
+ amount remitted

The consideration Penny received is the $10,000 principal repaid and the interest payments of $875 (being $350 on 31 March 2011, and $175 on 30 September 2011, 31 March 2012 and 30 September 2012). The consideration Penny paid is the $10,000 principal invested and the $29 repaid interest.

The amount of income derived in earlier income years is $700 (being $350 in each of the 2011 and 2012 income years).

The expenditure incurred in earlier income years is $29, being the amount of repaid interest.

There is no amount remitted.

Therefore, the BPA is:

($10,875 – $10,029) – $700 + $29 + $0

= $846 – $700 + $29

= $175

As the BPA is positive, it is income Penny derived. However, it is not income to the extent to which it arises from expenditure incurred in earlier years and for which a deduction was denied. A deduction was denied for the $29 repaid interest in the 2012 income year, so the positive BPA is reduced by that amount. Therefore, in the 2013 income year, Penny derives income of $146. This amount equates to the interest payment of $175 received on 30 September 2012, reduced by the interest repaid on 1 May 2011.

APPENDIX – LEGISLATION

56. Section DA 1(1) and (2) reads:

Nexus with income

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

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

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

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

(i) their assessable income; or

(ii) their excluded income; or

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

General permission

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

57. Section DA 2(1) reads:

Capital limitation

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

58. Section DB 6(1) and (4) reads:

DB 6 Interest: Not capital expenditure

Deduction

(1) A person is allowed a deduction for interest incurred.

…

Link with subpart DA

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

59. Section DB 7(1), (2) and (8) reads:

DB 7 Interest: Most companies need no nexus with income

Deduction

(1) A company is allowed a deduction for interest incurred.

Exclusion: Qualifying company

(2) Subsection (1) does not apply to a qualifying company.

…

Link with subpart DA

(8) This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.

60. Section DB 11 reads:

DB 11 Negative base price adjustment

Deduction

(1) A person who has a negative base price adjustment under section EW 31(4) (Base price adjustment formula) is allowed a deduction for the expenditure to the extent to which it arises from assessable income, under section CC 3 (Financial arrangements), derived by the person under the financial arrangement in earlier income years.

Link with subpart DA

(2) This section supplements the general permission and overrides all the general limitations.

61. Section EW 3(2) and (3) reads:

Money received for money provided

(2) A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—

(a) at a future time; or

(b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

Examples of money received for money provided

(3) Without limiting subsection (2), each of the following is a financial arrangement—

(a) a debt, including a debt that arises by law:

(b) a debt instrument:

(c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement:

(d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

62. Section EW 29(3) reads:

Maturity

(3) A party to a financial arrangement must calculate a base price adjustment as at the date on which the arrangement matures.

63. Section EW 31 contains the base price adjustment formula and states:

EW 31 Base price adjustment formula

Calculation of base price adjustment

(1) A person calculates a base price adjustment using the formula in subsection (5).

When formula applies

(2) The person calculates the base price adjustment for the income year in which section EW 29 applies to them.

Positive base price adjustment

(3) A base price adjustment, if positive, is income, under section CC 3 (Financial arrangements), derived by the person in the income year for which the calculation is made. However, it is not income to the extent to which it arises from expenditure incurred by the person under the financial arrangement in earlier income years and for which a deduction was denied in those income years.

Negative base price adjustment

(4) A base price adjustment, if negative, is expenditure incurred by the person in the income year for which the calculation is made. The person is allowed a deduction for the expenditure under section DB 11 (Negative base price adjustment).

Formula

(5) The formula is—

consideration − income + expenditure + amount remitted

Definition of items in formula

(6) The items in the formula are defined in subsections (7) to (11).

Consideration

(7) **Consideration** is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. For the purposes of this subsection, the following are ignored:

(a) non-contingent fees, if the relevant method is not the IFRS financial reporting method in section EW 15D:

(b) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D.

Consideration in particular cases

(8) If any of sections EW 32 to EW 48 applies, the consideration referred to in subsection (7) is adjusted under the relevant section.

Income

(9) **Income** is—

(a) income derived by the person under the financial arrangement in earlier income years; and

(b) dividends derived by the person from the release of the obligation to repay the amount lent; and

(c) income derived under section CF 2(2) and (3) (Remission of specified suspensory loans).

Expenditure

(10) **Expenditure** is expenditure incurred by the person under the financial arrangement in earlier income years.

Amount remitted

(11) **Amount remitted** is an amount that is not included in the consideration paid or payable to the person because it has been remitted—

(a) by the person; or

(b) by law.

64. Section EW 54 reads:

EW 54 Meaning of cash basis person

Who is cash basis person

(1) A person is a ***cash basis person*** for an income year if—

(a) 1 of the following applies in the person's case for the income year:

(i) section EW 57(1); or

(ii) section EW 57(2); and

(b) section EW 57(3) applies in the person's case for the income year.

Persons excluded by Commissioner

(2) A person may be excluded under section EW 59 from being a cash basis person for a class of financial arrangements.

65. Section EW 55 reads:

EW 55 Effect of being cash basis person

Use of spreading method

(1) A cash basis person is not required to apply any of the spreading methods to any of their financial arrangements, but may choose to do so under section EW 61.

Calculation of base price adjustment

(2) The fact that a cash basis person does not use any of the spreading methods for the financial arrangement does not excuse them from the requirement to calculate a base price adjustment when any of section EW 29(1) to (12) applies to them.

66. Section EW 57 reads:

EW 57 Thresholds

Income and expenditure threshold

(1) For the purposes of section EW 54(1)(a)(i), this subsection applies if the absolute value of the person's income and expenditure in the income year under all financial arrangements to which the person is a party is $100,000 or less.

Absolute value threshold

(2) For the purposes of section EW 54(1)(a)(ii), this subsection applies if, on every day in the income year, the absolute value of all financial arrangements to which the person is a party added together is $1,000,000 or less. The value of each arrangement is,—

(a) for a fixed principal financial arrangement, its face value:

(b) for a variable principal debt instrument, the amount owing by or to the person under the financial arrangement:

(c) for a financial arrangement to which the old financial arrangements rules apply, the value determined under those rules.

Deferral threshold

(3) For the purposes of section EW 54(1)(b), this subsection applies if the result of applying the formula in subsection (4) to each financial arrangement to which the person is a party at the end of the income year and adding the outcomes together is $40,000 or less.

Formula

(4) The formula is—

(accrual income – cash basis income) + (cash basis expenditure – accrual expenditure)

Definition of items in formula

(5) The items in the formula are defined in subsections (6) to (9).

Accrual income

(6) **Accrual income** is the amount that would have been income derived by the person under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:

(a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(c) an alternative method approved by the Commissioner.

Cash basis income

(7) **Cash basis income** is the amount that would have been income derived by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Cash basis expenditure

(8) **Cash basis expenditure** is the amount that would have been expenditure incurred by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Accrual expenditure

(9) **Accrual expenditure** is the amount that would have been expenditure incurred under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:

(a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(c) an alternative method approved by the Commissioner.

Increase in specified sums

(10) The Governor-General may make an Order in Council increasing a sum specified in any of subsections (1) to (3).

67. In s YA 1, the definitions of "interest", "maturity", "non-contingent fee", and "non-integral fee" read:

interest,—

…

(c) in sections DB 6 (Interest: not capital expenditure), DB 7 (Interest: most companies need no nexus with income), and DB 8 (Interest: money borrowed to acquire shares in group companies),—

(i) includes expenditure incurred under the financial arrangements rules or the old financial arrangements rules

…

maturity,—

(a) in the financial arrangements rules, means,—

(i) for an agreement for the sale and purchase of property or services or an option, the date on which the agreement or option ends:

(ii) for any other financial arrangement, the date on which the last payment contingent on the financial arrangement is made:

…

non-contingent fee means a fee that—

(a) is for services provided for a person becoming a party to a financial arrangement; and

(b) is payable whether or not the financial arrangement proceeds

non-integral fee means a fee or transaction cost that, for the purposes of financial reporting under IFRSs, is not an integral part of the effective interest rate of a financial arrangement

NEW LEGISLATION

TAXATION (GST AND REMEDIAL MATTERS) ACT 2010

The Taxation (GST and Remedial Matters) Bill was introduced into Parliament on 5 August 2010. It received its first reading on 19 August, its second reading on 24 November and the third reading on 9 December.

The new legislation brings into effect changes to the GST rules to prevent "phoenix" fraud schemes, and clarifies the change-in-use rules and the GST boundary between residential and commercial accommodation.

Substantial additions to the bill were made by Supplementary Order Paper No. 187 after the bill's introduction. These measures, which were foreshadowed as part of the Government's Budget 2010 tax package, included measures to improve the integrity of social assistance programmes, reform the qualifying companies rules and clarify the depreciation rules for buildings.

The resulting Act received Royal assent on 20 December 2010.

The new Act amends the Goods and Services Tax Act 1985, Income Tax Act 2007, Tax Administration Act 1994, Income Tax Act 2004, KiwiSaver Act 2006, Stamp and Cheque Duties Act 1971, Income Tax Act 1994, Gaming Duties Act 1971, Local Government (Auckland Transitional Provisions) Act 2010, and certain regulations.

CHANGES TO THE GST RULES

Sections 2(1), 3A, 3A(3B), 3A(3C), 5(15), 5(22), 5(23), 5(24), 8(4B), 9(2), 9(6), 10(7B), 11(1)(mb), 11(8B), 11(8C), 17(1B), 19D(2B), 20(2), 20(3), 20(3C–3K), 20(4), 20(4B), 21(1)–(4), 21A–H, 24(7B), 25, 43(1B), 43(1C), 51B(4)–(6), 60B, 75(3B), and 78F of the Goods and Services Tax Act 1985

Budget 2010 foreshadowed amendments to the GST rules as part of a package of changes aimed at improving the integrity and fairness of the tax rules generally.

The Taxation (GST and Remedial Matters) Act 2010 principally strengthens the GST rules by preventing so-called "phoenix" schemes.

The new legislation also makes some useful changes to the GST rules more generally, to make it easier for taxpayers to understand their GST obligations. These include simplifying the change-in-use rules and providing greater clarity over when GST applies to residential and commercial accommodation.

ZERO-RATING LAND TRANSACTIONS

Background

In November 2009, the Government released the discussion document, *GST: Accounting for land and other high-value assets*, which proposed a number of changes to the GST Act to deal with certain GST base risks and improve the operation of the GST system more generally. The main risk to the tax base identified was "phoenix" fraud schemes, typically between associated entities, that involve Inland Revenue refunding GST to one party with no corresponding payment being made by the vendor because the vendor deliberately winds up their business before making payment.

The discussion document recommended a domestic reverse charge as a possible solution to the problem. However, most submitters expressed a preference for zero-rating as it would give rise to fewer compliance costs. This option has been adopted in the new legislation since, under this mechanism, the accounting obligations of the parties would in most situations remain virtually unchanged from the previous legislation.

Key features

GST-registered vendors will be required to charge GST at the rate of 0% on any supply to a registered person involving land, or in which land is a component, if at the time of settlement:

- the recipient intends to use the goods for making taxable supplies; and
- the supply is not a supply of land intended to be used as the principal place of residence of the recipient or a relative of the recipient.

Other features of the new rules include:

- a definition of "land" which largely follows the definition used for income tax purposes but which excludes most commercial leases;
- an obligation for the purchaser to advise of their registration status and intentions in respect of the land; and
- special rules to deal with situations when a supply is either incorrectly zero-rated or incorrectly standard-rated.

Application date

The new rules will apply to goods supplied on or after 1 April 2011.

For transactions entered into before 1 April 2011 but for which the time of supply is on or after that date, the supplier has the option of treating the transaction as being governed by either the current GST rules or the new rules (section 11(8C)).

Detailed analysis

Determining zero-rating

New section 11(1)(mb) provides that a GST-registered person must zero-rate a supply if the supply wholly or partly consists of land, and:

- is made to another registered person; and
- the recipient acquires the goods with the intention of using them for making taxable supplies; and
- the supply is not a supply of land intended to be used as a principal place of residence of the recipient of the supply or a person associated with them under section 2A(1)(c) (that is, their relative).

To be a zero-rated supply, the above conditions for zero-rating must be satisfied at the time of settlement of the transaction (new section 11(8B)). If any of these conditions are not satisfied at the time of settlement, the supply should be taxed at 15%.

If land is supplied as part of a larger supply, the whole supply is zero-rated. For example, if land is supplied as part of a business being sold as a going concern, under the new rules the supply of the going concern is zero-rated in its entirety. To ensure that the zero-rating rules apply to

services supplied as part of a transaction that includes land, new section 5(24) treats these services as a supply of goods.

The requirement that the recipient must intend to use the goods for making taxable supplies may be satisfied even if the recipient does not intend to use the goods wholly for making taxable supplies. Thus, the supply may be zero-rated in its entirety even if the recipient intends to use the goods partly for making non-taxable supplies. It should be noted, however, that in these circumstances the purchaser will be liable to account for the output tax on the non-taxable use of the goods under new section 20(3J). (See the section on the new apportionment rules in this TIB item for more details.)

The zero-rating rules do not apply to supplies of land intended to be used as a principal place of residence of the recipient of the supply or a relative of the recipient (section 11(1)(mb)(ii)). If a "principal place of residence" is included in a larger supply of real property, amended section 5(15) requires the supplier to treat the supply of the residence as separate from the supply of any other real property included in the supply. These provisions clarify that a supply of the principal place of residence is not subject to the zero-rating rules. This should prevent registered persons, such as sole traders, from using their GST-registered status to zero-rate the purchase of their family home.

Meaning of "land"

A supply will only be zero-rated under section 11(1)(mb) if it is a supply of land. A new definition of "land" in section 2(1) of the GST Act includes an estate or interest in land, a right that gives rise to an interest in land, and an option to acquire land or an estate or interest in land.

"Land" includes the ground within the territory of New Zealand, whether below or above the water, and things of a permanent nature situated on the ground, such as buildings or any other structures that become a fixture and thus part of the land. "Land" does not simply mean the physical ground, but the nature of the right involved in the ownership of land.

In common law, all land is held by the Crown and rights in respect of land held by subjects are derived directly or indirectly from the Crown. The bundle of rights held by subjects in respect of land is described as "an estate in land". The largest estate possible is an estate in fee simple but any number of smaller estates may exist at the same time as an estate in fee simple, and each of those estates may be sold or otherwise dealt with.

Estates may be freehold or less than freehold, for example, leasehold. For the purposes of the new rules, leases are excluded from the definition provided that they are leases of dwellings or they are commercial leases for which:

- the supply is made periodically; and
- 25% or less of the total consideration specified in the agreement, in addition to any regular payments, is paid or payable under the agreement in advance of or contemporaneously with the supply being made.

The exclusion will ensure that commercial leases that do not require high one-off payments and which are unlikely to be used for phoenix fraud purposes are not caught by the new rules. The definition also expressly excludes mortgages.

Although a person who has an estate will often have a right of immediate possession of the land, it is not a necessary component of having an estate in land. For example, an estate may exist if it gives a person a right of possession at some future time or is contingent on an event that may or may not take place.

An "interest" in land includes both legal and equitable estates. By including equitable estates in land, the definition includes interests in land that are recognised and enforceable under the rules of equity, for example, equitable easements or restrictions on the use of land.

One of the rights that may be granted by a person with a legal interest in land is a "profit à prendre", that is, a right to enter another person's land and take some profit from the soil. Common examples of profit à prendre include the right to mine for minerals or the right to harvest timber.

"Land" also includes a right or an option to acquire land or an estate or interest in land.

Finally, the new definition includes a share in the share capital of a flat-owning or office-owning company, as defined in section 121A of the Land Transfer Act 1952. This aims to prevent such structures being used for fraudulent purposes.

Disclosure requirements

A supply that wholly or partly consists of land is a zero-rated supply if, at the date of settlement, the recipient is a registered person, acquires the goods with the intention of using them for making taxable supplies, and the supply is not a supply of land intended to be used as a principal place of residence of the recipient or their relative.

New section 78F seeks to help the supplier identify this information so they can apply the correct GST treatment. Thus, if a supply wholly or partly consists of land, section 78F(2) requires the purchaser to provide, at or before settlement, a written statement to the supplier whether at the date of settlement:

- they are, or expect to be, a registered person; and
- they are acquiring the goods with the intention of using them for making taxable supplies; and
- they do not intend to use the land as a principal place of residence for them or a person associated with them under section 2A(1)(c) (their relative).

This information must be provided to the supplier in writing. It is expected that the requirements of this section will be incorporated into standard sale and purchase agreements. In that case, the written statement could simply be by way of ticking (or not) the relevant criteria.

Since the tests in section 11(1)(mb) must be satisfied on settlement for the zero-rating rules to apply, the information provided by the purchaser may be provided on a prospective basis, that is, on the basis of the best prediction of the recipient's circumstances at the time of settlement. For example, if a purchaser is not registered for GST but intends to register before settlement, they may indicate on their statement that they expect to be registered for GST. Furthermore, if the purchaser who contracts with the supplier does not intend to receive the land themselves but nominates or intends to nominate a third party to receive the supply, the purchaser may make representations on behalf of the nominated person (section 78F(5)).

If a supply of land is made by a lender to whom section 5(2) applies, the purchaser must provide the information required by section 78F to the lender rather than the borrower, for example, the mortgagee under a mortgagee sale.

Supplier's obligations

Having received a written statement from a purchaser, the supplier may rely on the statement to either standard-rate or zero-rate the supply (section 78F(3)). If the statement indicates that the conditions in section 11(1)(mb) are or will be met, the supplier may zero-rate the supply. If the statement indicates otherwise the supplier may standard-rate the supply.

In some circumstances, the vendor may believe that the information provided by the purchaser is not accurate. In these situations, the legislation provides flexibility for the vendor to adopt the GST treatment that they consider to be correct. For example, if, in contrast to the purchaser's claims the vendor is aware that the purchaser will use the property in question as their principal place of residence, they may but are not obliged to choose to standard-rate the supply. In a commercial transaction it is reasonable to assume that the vendor is unlikely to unilaterally adopt a GST treatment different from the one indicated by the purchaser's representation without first consulting the purchaser.

Once a written statement is provided, the supplier is not required to make any further enquiries regarding the purchaser's circumstances.

If the purchaser either refuses or for any other reason has not provided a written statement regarding their GST registration status and intentions in respect of land, the supplier should standard-rate the transaction.

Record-keeping requirements

If a supply is zero-rated under section 11(1)(mb), new section 75(3B) requires the supplier to maintain sufficient records to enable the following particulars in relation to the supply to be ascertained:

- the name and address of the recipient; and
- the registration number of the recipient; and
- a description of the land; and
- the consideration for the supply.

Consequences of incorrect GST treatment

In some situations, the GST treatment of the transaction elected by the supplier may be found to be incorrect. The consequences of this will depend on whether the mistake is discovered before or after settlement.

Correction of GST treatment before settlement

For a supply to be zero-rated, the conditions for zero-rating in section 11(1)(mb) must be satisfied at the time of settlement. Since the time of supply may occur before a transaction is settled, the supplier will need to determine whether the supply should be standard-rated or zero-rated at that earlier time. As discussed earlier, this determination will usually be made on the basis of the written statement provided by the purchaser.

Before settlement the parties may become aware that the GST treatment applied to the transaction thus far is not correct.

For example, on signing the sale and purchase agreement the purchaser may have informed the supplier that they will be registered at the time of settlement. The supplier zero rates the transaction as a result. Before settlement, the purchaser may decide to nominate a third person to settle the transaction. The nominated person indicates that they will not be registered at the time of settlement.

Conversely, the parties may become aware of circumstances that indicate that a transaction should be zero-rated rather than standard-rated.

In both cases, since the crystallisation of the correct GST treatment in respect of the supply occurs at the time of settlement, the new zero-rating rules do not impose any obligations on the parties to change the initial GST treatment of the supply before settlement. Nevertheless, the parties may voluntarily agree to correct the GST treatment to avoid the consequence of being incorrect, as outlined below.

If GST has already been accounted for to Inland Revenue by the supplier, the correction may be done under section 25 of the GST Act, which allows the supplier to issue a credit note to adjust the tax payable by the supplier. Thus, if a supply was standard-rated when it should have been zero-rated, the supplier will be able to deduct the GST already paid to Inland Revenue and the purchaser will be required to account for the amount of any deduction incorrectly claimed in respect of the supply. Alternatively, if a supply was zero-rated when it should have been standard-rated, the supplier would be required to account for the GST. Generally the purchaser will not be able to claim a deduction in respect of the supply since if they are registered for GST and intend to use the goods in making taxable supplies (requirements for obtaining a deduction), standard-rating is unlikely to be the correct treatment.

Section 25 has been amended by the Taxation (GST and Remedial Matters) Act 2010 to explicitly allow suppliers to issue debit and credit notes in the context of the zero-rating rules.

Example 1

Max, a registered vendor, agrees to sell land to Geoff for $500,000 plus GST, if any. Geoff informs Max that he does not expect to be registered for GST at the time of settlement and does not have any intention to use the land for taxable purposes.

Before settlement, Max issues a tax invoice on the basis that the GST of $75,000 is chargeable in respect of the supply. The tax invoice triggers the time of supply and Max accounts for the amount of GST to Inland Revenue.

Following the time of supply but before settlement, Geoff tells Max that he has decided to nominate Paul to settle the transaction. Paul informs Max that he will be registered for GST at the time of settlement, will use the land for making taxable supplies and will not use it as his or his relative's principal place of residence.

The parties want to ensure that the correct GST is achieved before settlement. Therefore, Max issues a credit note under section 25 and deducts the amount of GST already paid to Inland Revenue ($75,000).

Example 2

Robert, a GST-registered property developer, agrees to sell land to Graeme, who is not registered for GST, for $1 million plus GST, if any. In the sale and purchase agreement Graeme specified that on settlement he will be registered for GST, will acquire the property with the intention of using it for making taxable supplies and will not use it as his or his relative's principal place of residence. As a result, the parties treat the supply as zero-rated under section 11(1)(mb).

Before the date of settlement, Robert issues a tax invoice, thereby triggering the time of supply. Since Robert treats the transaction as zero-rated, he does not account for any GST to Inland Revenue.

Following the time of supply but before settlement, Graeme informs Robert that his circumstances have changed and that he will not be registered for GST at the date of settlement. As a result, the correct GST treatment of the transaction would be to standard-rate the supply.

The parties want to ensure that the correct amount of GST is accounted for before settlement. Robert issues a debit note under section 25 and accounts it to Inland Revenue for the GST amount of $150,000. Since Graeme is not registered for GST, he is not able to claim any input tax deduction.

Correction of GST treatment after settlement

In some situations the correct GST treatment may be unknown until after the transaction has been settled. The consequences of incorrectly standard-rating or incorrectly zero-rating the supply are set out below.

Supply incorrectly standard-rated

When a supply that should have been zero-rated is incorrectly standard-rated and the GST has been accounted for to Inland Revenue, the supplier will be required to use the credit note mechanism in section 25 to deduct the GST paid in respect of the supply. The purchaser would then be required to account for output tax in relation to any amount of input tax that they have incorrectly claimed in respect of the supply.

Example 3

Sarah, a registered vendor, agrees to sell land to Brent for $200,000 plus GST, if any. Brent informs Sarah that he does not expect to be registered for GST at the time of settlement and does not have any intention to use the land for taxable purposes.

Before settlement, Sarah issues a tax invoice on the basis that GST of $30,000 is chargeable in respect of the supply. The tax invoice triggers the time of supply and Sarah accounts for the amount of GST to Inland Revenue.

Before settlement, owing to changes in Brent's circumstances, he registers for GST. He also intends to use the land for making taxable supplies and does not intend to use it as his principal place of residence.

The parties settle the transaction. Since at the time of settlement all conditions in section 11(1)(mb) for zero-rating were satisfied, the supply should have been zero-rated rather than standard-rated.

Following settlement, Sarah issues a credit note under section 25 and deducts the amount of GST already paid to Inland Revenue ($30,000). Since Brent has not claimed an input tax deduction, he is not required to account for output tax in relation to the credit note adjustment.

Supply incorrectly zero-rated

When at any time after a transaction is settled it is found that the supply should have been standard-rated rather than zero-rated, new section 5(23) will treat the purchaser, at the date of settlement, as making a supply of the goods in question at the standard rate. The value of the supply under section 5(23) will be equal to the amount of the consideration for the original supply. Since the supply is treated as being made at the date of settlement of the underlying supply, the purchaser may be subject to use-of-money interest with any applicable penalties calculated from that date.

If the purchaser who is required to account for tax under section 5(23) is not registered for GST, they will be treated as registered from the date of the supply under section 5(23) and must apply to be GST-registered (new section 51B(4)). If the purchaser fails to apply for registration, the Commissioner of Inland Revenue will be able to force their registration.

New section 20(4B) denies a deduction to the person who is treated under section 5(23) as a supplier of goods. However, the person may be able to claim a deduction for the supply at a later date if they register for GST and use the relevant goods for making taxable supplies.

Once GST is accounted for, the purchaser may request that the Commissioner cancel their registration (new section 51B(5)). Under section 5(3) a person cancelling their registration must ordinarily account for the output tax on any goods and services forming part of the assets of a taxable activity carried on by the person. This rule could result in unfair and unintended consequences if it applied to deregistration of a person who was required to register under section 51B(4). Therefore, new section 51B(6) renders section 5(3) inapplicable if:

- the person seeks cancellation of their registration by the end of the taxable period in which they have accounted for the output tax under section 5(23); or
- the Commissioner agrees that section 5(3) should not apply.

Example 4

Isla agrees to acquire land for $1 million plus GST, if any. In a written statement provided to the supplier, Isla indicates that she is registered for GST, intends to use the land for making taxable supplies and will not use it as her or her relatives' principal place of residence. On the basis of these representations, the supplier zero-rates the transaction.

The transaction is settled on 1 July 2011. At the time of the settlement Isla is not registered for GST.

Following settlement, Isla is treated as making a supply of the land on 1 July 2011 and has to account for the GST at the standard rate. Since Isla is not registered for GST, she must apply to be registered.

Once registered, Isla must account for the GST under section 5(23) on the value equal to the consideration for the original supply:

$1m × 15% = $150,000

Isla will not be able to claim an input tax deduction on the payment made under section 5(23) as this is denied under section 20(4B).

In the same taxable period in which she accounts for the output tax under section 5(23), Isla asks the Commissioner to cancel her registration. The Commissioner confirms the deregistration. By application of section 51B(6)(a), Isla is relieved from the requirement to pay any additional tax under section 5(3) on deregistration.

Transactions involving associated persons

An amendment has been made to section 3A (meaning of "input tax") to limit input tax deductions for second-hand goods in relation to land acquired as part of an arrangement involving more than two associated parties and more than one supply (new subsection (3B)). If the section applies, the amount of input tax for the supply is limited to the amount accounted for as output tax for all supplies that are part of the arrangement. This section is necessary to ensure that the zero-rating rules are not circumvented by arrangements involving second-hand goods deductions.

NEW APPORTIONMENT RULES

For GST purposes, the amount of an input tax deduction that can be claimed by a GST-registered purchaser for acquired goods and services should relate to the taxable use of the goods and services.

This is achieved by allowing GST-registered persons to claim a full input tax deduction for GST paid on goods and services acquired for the principal purpose of making taxable supplies.

If the goods and services acquired for the principal purpose of making taxable supplies are used partly or entirely for another purpose, for example, for private and exempt purposes (non-taxable purposes), the GST Act treats the non-taxable use of goods and services as a taxable supply by the registered person, and output tax is charged accordingly.

Conversely, goods and services acquired principally for a non-taxable purpose (for which the GST-registered person is not entitled to an input tax deduction) could be partly or entirely used to make taxable supplies. In these circumstances, the GST Act allows a deduction to reflect that taxable use.

This approach of taxing the "self supply" of goods and services ignores the original input tax deduction claimed by the GST-registered person as the change-in-use adjustments do not relate to the amount of the deduction claimed on acquisition. This is because the use of goods and services for a non-principal purpose is deemed to be a supply which is separate from the purchase transaction.

Another aspect of the GST rules is that there is no statutory limit on the maximum number of adjustments that have to be made, so the number of adjustments required can be excessive relative to the amounts involved. In addition, since change-in-use adjustments do not relate to the amount of the initial input tax deduction, the value of adjustments that a person is required to make can potentially amount to more than the original GST paid on the purchase. Conversely the value of the deduction received by means of change-in-use adjustments can sometimes exceed the amount of GST originally paid.

Because of the detachment between the initial input tax claimed on acquisition and the subsequent change-in-use adjustments, the rules for imposing GST on mixed use assets have not been sufficiently clear for many taxpayers.

Other issues concerning the current approach were raised by the Court of Appeal decision in *Lundy* (2005) 22 NZTC 19 at 637, which involved land being used concurrently for taxable (advertised for sale) and non-taxable (generating rental income) purposes.

Proposals to reform the change-in-use adjustments rules were initially outlined in an officials' issues paper, *Options for strengthening GST neutrality in business-to-business transactions*, released in June 2008. In the 2009 discussion document, *GST: Accounting for land and other high-value assets*, the Government proposed to replace the change-in-use adjustment approach with one that would apportion input tax deductions in line with the actual use of the goods and services. The new apportionment rules contained in the Taxation (GST and Remedial Matters) Act 2010 have therefore been the subject of extensive consultation and incorporate various amendments that arose during the policy development process.

Overall, the new rules are intended to reduce compliance costs for businesses by being simpler and requiring fewer adjustments.

Key features

The new rules replace the current adjustment approach with an approach that apportions input tax deductions in line with the actual use of the goods and services. In summary, the rules operate as follows:

- On acquisition, unless an exclusion applies, the portion of a deduction that a registered person can claim must correspond with the portion of the asset's use that is intended for taxable purposes.
- In subsequent years, a person may be required to adjust the deduction claimed if the extent to which the asset is used for taxable purposes is different from the intended taxable use of the asset. A number of exemptions have been introduced to relieve a person from the requirement to make an adjustment if the amount of tax involved in the adjustment is low.
- The maximum number of adjustments that a person may be required to make varies according to the asset's value or estimated useful life.
- Special "wash-up" rules apply when goods and services that have been subject to the apportionment rules are sold or the person deregisters.

- Special rules also apply to assets used concurrently for taxable and non-taxable purposes.

Application dates

The new rules will apply to goods and services acquired after 1 April 2011.

For goods and services acquired before 1 April 2011, registered persons will be required to continue making change-in-use adjustments under the current rules. The obligation to make adjustments will, however, be limited by new section 21H for all supplies other than those that wholly or partly consist of land:

- For goods or services whose market value or book value on 1 April 2011 is $5,000 or less, no adjustment under the old rules may be made after 1 April 2011.
- For goods or services whose market value or book value on 1 April 2011 is more than $5,000 but not more than $10,000, no adjustment under the old rules may be made after 1 April 2013.
- For goods or services whose market value or book value on 1 April 2011 is more than $10,000, no adjustment under the old rules may be made after 1 April 2016.

Once the time limit for an asset is reached, the person must stop making any adjustments for change-in-use in respect of that asset.

Detailed analysis

Apportionment of input tax on acquisition

Acquisition of standard-rated goods and services

Under new section 20(3C), a purchaser can deduct input tax on the acquisition of goods and services to the extent to which the goods or services are used for, or are available for use in, making taxable supplies.

In determining the extent to which goods or services are used for making taxable supplies, a person must estimate on acquisition how they intend to use the goods or services, and choose a determination method that provides a fair and reasonable result (new section 20(3G)). The estimate could be made on the basis of any records that are available, previous experience, business plans or other suitable methods. The method of working out the extent of intended taxable use will largely depend on the nature of the goods and services in question. For example, if the asset is a car which is intended to replace an existing car used in the business, the logbook for the previous car could be a reasonable method of stipulating the intended use of the purchased car provided patterns of use were largely unchanged.

The estimated intended taxable use of the goods or services will determine the proportion of the input tax that can be deducted (new section 20(3H)).

New section 20(3D) is a *de minimis* provision to relieve recipients from the obligation to apportion input tax on the acquisition of goods or services in certain circumstances. In a similar way to the current rules, recipients will not be required to apportion input tax if they make both taxable and exempt supplies and have reasonable grounds to believe that the total value of their exempt supplies in the first adjustment period will be no more than the lesser of $90,000 or 5% of the total consideration for all taxable and exempt supplies.[1]

Example 1

John acquires a car for $23,000 (including GST of $3,000) to replace his existing car. The car will be used both in John's business as a sole trader and for private purposes.

The logbook kept by John for his old car shows that in the previous year he used the car 70% of the time for business purposes. Since John does not expect this ratio to substantially change in the future, he estimates that he will use the new car 70% for taxable purposes. Consequently, on acquisition John claims 70% of the available input tax using the formula in section 20(3H):

$3,000 × 70% = $2,100

Example 2

Safe Life Ltd (SL) is an insurance company that provides mostly life insurance policies (exempt supplies), but also provides a range of other insurance covers (taxable supplies). SL purchases 100 computers for a total consideration of $240,000 (including GST of $31,304).

On acquisition, SL may only claim the portion of the input tax that corresponds with the intended taxable use of the computers. SL estimates that in the 12 months prior to the purchase, 70% of all its supplies were exempt supplies of life insurance policies and 30% of its supplies were taxable supplies of other insurance covers. As a result, SL determines that the computers will be used 30% of the time for the purpose of making taxable supplies and claims 30% of the input tax paid in respect of the computers:

$31,304 × 30% = $9.391

[1] "First adjustment period" is defined in section 21G(2)(a) as a period that starts on the date of acquisition and ends on the date as the person chooses that either corresponds to the person's first balance date that falls after the date of acquisition or to the person's first balance date that falls at least 12 months after the date of acquisition. See more on "adjustment periods" later in this report.

Example 3

A corner dairy spends $6,000 (exclusive of GST) on renovations.

The major part of the dairy's business involves making taxable supplies. However, the dairy also runs a debtors' account and charges interest on any late payments (exempt supplies). Since the total value of the interest charged (exempt supplies) in the first adjustment period is expected to be no more than the lesser of $90,000 or 5% of the total consideration for all taxable and exempt supplies made by the dairy, the dairy is not required to apportion the input tax in relation to the renovations.

Acquisition of zero-rated goods and services

The Taxation (GST and Remedial Matters) Act 2010 introduces new rules that require suppliers of land, or supplies that include land, to charge GST on the supply at the rate of zero percent in certain circumstances.

New section 20(3J) provides special rules that will allow recipients of zero-rated supplies to determine the GST component of a zero-rated acquisition and account for any non-taxable use of the goods. In the absence of the special rule, any non-taxable use of the land would remain unaccounted for.

Thus, on the acquisition of a zero-rated asset, the purchaser will be required to perform the following steps:

Identify the nominal amount of tax

First, the purchaser must identify the nominal amount of tax (the "nominal GST component") that would be chargeable on the value of the supply if the zero-rating rules did not apply and the supply was subject to the standard rate of GST.

Determine the intended use of the supply

The purchaser must then determine as a percentage the extent to which they intend to use the goods for making taxable supplies.

Account for output tax, if any

If the person estimates that they will not use the asset solely for making taxable supplies, the person must account as output tax for the proportion of the nominal GST component that is attributable to the non-taxable use of the goods.

Example 4

Safe Life Ltd (SL) from Example 2 acquires new headquarters for $30 million. There was no GST included in the supply as it is subject to the new zero-rating rules.

On acquisition, SL has to apply the rules in section 20(3J) as follows:

1. Identify the amount of tax that would be chargeable on the value of the supply if the supply was subject to the standard rate of GST (the nominal GST component):

   ($30m × 15% = $4,500,000)

2. Determine the extent to which they intend to use the headquarters for making taxable supplies.

SL estimates that 30% of its activity involves making taxable supplies.

3. Account for the proportion of the nominal GST component that is attributable to the non-taxable use of the goods as an output tax:

   $4,500,000 × 70% = $3,150,000

SL has to account for output tax of $3,150,000 on acquisition of the new headquarters.

Example 5

Eric purchases a building for $3 million. The supply to Eric is zero-rated.

Eric intends to rent the ground floor of the building to commercial tenants, and the upper floors of the building to residential tenants.

On acquisition, Eric has to apply the rules in section 20(3J):

1. Identify the amount of tax that would be chargeable on the value of the supply if the supply was subject to the standard rate of GST (the nominal GST component):

   $3m × 15% = $450,000

2. Determine the extent to which he intends to use the building for making taxable supplies.

Eric determines that he intends to use the building 60% in making taxable supplies (rent to commercial tenants) and 40% in making exempt supplies (rent to residential tenants).

3. Account for the proportion of the nominal GST component that is attributable to the non-taxable use of the goods as output tax:

   $450,000 × 40% = $180,000

Eric has to account for output tax of $180,000 on acquisition of the building.

Subsequent adjustments for change-in-use

The new rules seek to achieve as much "first instance" accuracy as possible by requiring taxpayers to make fair and reasonable estimates on the intended taxable and non-taxable uses of acquired goods and services. In an "adjustment period" following the initial input tax

deduction claim, taxpayers may, however, be required to make further adjustments if the *actual* taxable use of an asset is different from its *intended* taxable use.

"Adjustment period"

An "adjustment period" (described in new section 21G(2)) is a period at the end of which a person is required to estimate whether an adjustment for a subsequent change-in-use is required. The first adjustment period is a period that starts on the date of acquisition and ends on the date as the person chooses that either corresponds to the person's first balance date that falls after the date of acquisition or to the person's first balance date that falls at least 12 months after the date of acquisition. All subsequent adjustment periods will be annual periods that start on the day after the end of the earlier adjustment period and end on the last day of the equivalent taxable period in which the first adjustment period ended.

Example 6

Mary purchases a car on 1 February 2012. Mary's balance date falls on 31 March.

The first adjustment period in respect of the car is, at Mary's option, either:

1. the period from 1 February 2012 to 31 March 2012; or
2. the period from 1 February 2012 to 31 March 2013.

If Mary has chosen option 1 as her first adjustment period, the second adjustment period will run from 1 April 2012 to 31 March 2013.

If Mary has chosen option 2 as her first adjustment period, the second adjustment period will run from 1 April 2013 to 31 March 2014.

Number of adjustment periods

There will be a maximum number of adjustment periods for which adjustments will be required to be made. The default method for identifying the maximum number of adjustment periods is in new section 21G(4)(a) and requires the taxpayer to apply the following GST-exclusive bands of goods and services:

- $5,001 to $10,000 – two adjustments
- $10,001 to $500,000 – five adjustments
- $500,001 or more – ten adjustments.

Alternatively, taxpayers will be able to select the maximum number of adjustments by reference to the estimated useful life of the asset as specified in the Tax Depreciation Rates Determinations set by the Commissioner under section 91AAF of the Tax Administration Act 1994 (new section 21G(4)(b)).

There will be no limit to adjustment periods in relation to land (new section 21G(5)).

Exclusions from the obligation to make adjustments in an adjustment period

No subsequent change-in-use adjustment will be required for goods and services acquired for the GST-exclusive value of $5,000 or less (new section 21(2)(b)).

Example 7

Sherry, a graphic designer, purchases a computer for $3,999 (including GST of $522) to use both for business and private purposes. She estimates that she will use the computer 80% for taxable purposes and claims a deduction of $418 (80% of $522).

Since the GST-exclusive value of the computer is less than $5,000, Sherry will not be required to make any adjustments for change-in-use in any of the subsequent adjustment periods.

For assets with a value of more than $5,000, no adjustment will be required in the relevant adjustment period if the recipient makes both taxable and exempt supplies and the total value of their exempt supplies in the adjustment period to which the adjustment relates is no more than the lesser of $90,000 or 5% of the total consideration for all taxable and exempt supplies for that adjustment period (new sections 21(2)(a) and 20(3D)).

Identifying whether there is substantial change in the use of the goods and services

If the above exclusions do not apply, new sections 21, 21A and 21B provide that, at the end of an adjustment period, a person must compare the percentage actual use of goods or services with:

- the percentage intended use of the goods or services (if no previous adjustment has been made); or
- the previous actual use (if the goods or services have been subject to a previous adjustment).

The "percentage actual use" is defined in section 21G(1)(a) as the extent to which the goods or services are *actually* used by the person for making taxable supplies. It is calculated from the date of acquisition to the end of the relevant adjustment period. The estimate must be expressed as a percentage.

The "percentage intended use" is defined in section 21G(1)(b) as the extent to which the goods or services are *intended* to be used by the person for making taxable supplies, estimated at the time of acquisition. The estimate must be expressed as a percentage.

The "previous actual use" is defined in section 21C(b)(i) as the percentage actual use in an earlier period that is the most recent period in which an adjustment has been made.

If the percentage intended use or previous actual use of

goods or services is equal to the percentage actual use, the person will not be required to make an adjustment in the relevant adjustment period.

If the percentage actual use of goods or services differs from the percentage intended use or previous actual use, the person will be required to make an adjustment in an adjustment period only if the difference between the amounts is 10 percentage points or more, or the monetary value of the adjustment is more than $1,000 (new section 21(2)(c) and (d)).

Calculating adjustments

If none of the exclusions mentioned above apply, the person will need to account for a change in use.

New section 21D sets out how to calculate the amount of a change-in-use adjustment for the adjustment period. This will be done by applying the formula:

> full input tax deduction × percentage difference

The "full input tax deduction" is the total amount of input tax on the supply. In situations where goods were acquired subject to the zero-rating rules, "full input tax deduction" will include any nominal GST component as calculated under section 20(3J).

The "percentage difference" is defined in section 21G(1)(c) as the difference between the percentage actual use and either the percentage intended use or the previous actual use if the person has already made an adjustment in respect of the asset in an earlier adjustment period.

Example 8: Identifying percentage actual use and percentage intended/previous actual use

Peter acquires a luxury boat for $800,000 plus GST. On acquisition, Peter estimated that the boat would be used 100% for chartering—a taxable purpose—and claimed the full input tax deduction. However, in later periods Peter uses the boat partly for private purposes.

Based on the value of the boat, Peter determines that there will be five adjustment periods. In those adjustment periods, Peter uses the boat as follows:

- in the first adjustment period – 100% for taxable purposes;
- in the second adjustment period – 80% for taxable purposes;
- in the third adjustment period – 83% for taxable purposes;
- in the fourth adjustment period – 50% for taxable purposes; and
- in the fifth adjustment period – 90% for taxable purposes.

The first adjustment period is a period of six months. All subsequent adjustment periods are periods of 12 months.

None of the exclusions apply to this situation. The question is: what are the use percentages that Peter has to compare at the end of each adjustment period?

First adjustment period

Percentage intended use – 100%

Percentage actual use – 100%

Second adjustment period

Previous actual use – 100%

Percentage actual use – 86.6%

> (100% × 6/18) + (80% × 12/18)
>
> = 33.3 + 53.33 = 86.6%

In the above calculations, figures "6" and "12" represent, respectively, the length of the first and second adjustment periods expressed in months. The figure "18" represents the total number of months since the acquisition of the boat.

Third adjustment period

Previous actual use – 86.6%

Percentage actual use – 85.2%

> (100% × 6/30) + (80% × 12/30) + (83% × 12/30)
>
> = 20% + 32% + 33.2% = 85.2%

Fourth adjustment period

Previous actual use – 86.6%

Percentage actual use – 75.2%

> (100% × 6/42) + (80% × 12/42) + (83% × 12/42) + (50% × 12/42)
>
> = 14.3% + 22.9 + 23.7% + 14.3% = 75.2%

Fifth adjustment period

Previous actual use – 75.2%

Percentage actual use – 78.4%

> (100% × 6/54) + (80% × 12/54) + (83% × 12/54) + (50% × 12/54) + (90% × 12/54)
>
> = 11.1% + 17.8% + 18.4% + 11.1% + 20%
>
> = 78.4%

It should be noted that Peter will be required to account for adjustments to Inland Revenue in the second, third, fourth and fifth adjustment periods as in each of those periods either the percentage difference is more than 10 percentage points or the monetary value of the adjustments is more than $1,000. Hence, Peter may not rely on the exclusion in section 21(2)(d).

Imported services

The reverse charge rules for imported services, in section 8(4B), have been amended. This amendment ties the use of imported services to the defined terms "percentage intended use" and "percentage actual use" to ensure that appropriate apportionment of imported services takes place following the introduction of the new rules. A new time of supply rule has been added to clarify that the supply is deemed to be made in the adjustment period in which the reverse charge rules first apply to the supply.

It is not anticipated that these changes will have a great impact on the primary users of the reverse charge rules. While the rules have changed from a test that looks at the overall business to one that focuses on individual supplies, the application of the revised rules should produce the same overall result as the change-in-use rules.

Special rule for concurrent use of land

Under the new apportionment approach, the portion of a deduction that a person should be entitled to must correspond with the extent to which the asset is used for taxable purposes. In most situations, an asset may only be used for either taxable or non-taxable purposes at one point in time. For example, at any given time a motor vehicle may be used by a person for making deliveries of goods and services or for taking the person's children to school—but usually not both at the same time.

In some circumstances, however, an asset may be used for taxable and non-taxable purposes at the same point in time, for example, a property developer may supply a house as a dwelling for a few months while advertising the house for sale. Thus, for the duration of the rental period, the asset is not only fully committed to the taxable activity (the sale), but is also simultaneously fully committed to the exempt activity (residential rental income).

Section 21E provides a formula that will assist taxpayers in apportioning between concurrent uses of land. It also allows taxpayers to apply to the Commissioner for an alternative approach should the formula not be workable in their circumstances.

Section 21E(3) requires a registered person to calculate the extent to which the land is used for making taxable supplies by using the formula:

$$\frac{\text{consideration for taxable supply}}{\text{total consideration for supply}} \times 100\%$$

The "consideration for taxable supply" is defined in section 21E(4)(a) as either the amount derived on a disposal of the land or, if the land has not been disposed of, the market value of the land at the time of the adjustment.

The "total consideration for supply" is defined in section 21E(4)(b) as the sum of the amount of the "consideration for the taxable supply" described above and:

- the amount of all rental income derived from the supply of a dwelling since the land was acquired; and
- if no rental income is paid or payable in relation to the non-taxable use of land, the market value of rental income that would have been derived from the time of acquisition of the land if rental had been charged.

New section 21E(5) specifies that the market value must be used in determining "consideration for the taxable supply" and/or "total consideration for supply" if amounts derived under those definitions are by associated persons or are not arm's-length amounts.

New section 21E(6) provides that if the market value of the land or rental income is not readily identifiable, the person may use another method to provide a fair and reasonable estimate of the market value.

Example 9

Sandy, a property developer, constructed two similar residential houses, House A and House B, next to each other. The construction cost of each house is $230,000 (including GST of $30,000). Sandy intends to sell both properties on completion (a taxable use) and therefore claims a full deduction on the GST incurred on construction.

Sandy is unable to sell the property immediately on completion. Therefore, while still advertising the houses for sale, she:

- rents out House A and receives rental income of $26,000 in the first adjustment period; and
- moves into House B and lives there rent-free.

At the end of the first adjustment period, Sandy sells House B for $360,000.

Adjustment at the end of the first adjustment period—House A

Since Sandy used the house concurrently for taxable (advertising for sale) and exempt (supplying a residential dwelling) purposes, she uses the formula in section 21E(3) to identify the actual taxable use of the property in the first adjustment period.

The "consideration for taxable supply" is either the amount derived on a disposal of the land or, if the land has not been disposed of, the market value of the land at the time of the adjustment. Sandy has not disposed of House A, but ascertains that the market value of

the house is approximately the same as for House B—$360,000.

The "total consideration for supply" is the amount of the "consideration for the taxable supply" ($360,000) and the amount of all rental income ($26,000) derived from the supply of the dwelling since the land was acquired—$386,000.

Therefore, Sandy's taxable use of the house is:

$$\frac{\$360{,}000}{\$386{,}000} \times 100 = 93\%$$

Sandy has therefore deducted 7% more input tax than she should have and has to account for this to Inland Revenue:

$30,000 × 7% = $2,100

Adjustment at the end of the first adjustment period—House B

Since Sandy used the house concurrently for taxable (advertising for sale) and private (residential) purposes, she has to use the formula in section 21E(3) to identify the actual taxable use of the property in the first adjustment period.

The "consideration for taxable supply" is the amount derived on a disposal of the house—$360,000.

Since Sandy did not rent out House B, but still used it for non-taxable purposes, the "total consideration for supply" is the amount of the "consideration for the taxable supply" ($360,000) and the market value of the rental income that she would have derived if she had rented out the property. Sandy estimates that she would have received $26,000 of rental income.

Therefore, Sandy's taxable use of the house is:

$$\frac{\$360{,}000}{\$386{,}000} \times 100 = 93\%$$

Sandy has therefore deducted 7% more input tax than she should have and has to account for this amount to Inland Revenue:

$30,000 × 7% = $2,100

In both cases it should be noted that Sandy may be able to recover some or all of the unclaimed input tax if she later disposes of the houses in the course of her taxable activity. (See the section below "Adjustment on disposal".)

An additional formula (section 21E(7)) estimates the extent of taxable use of the land if the land has, at any time, been used solely for making non-taxable supplies. The formula is:

$$\frac{\text{months}}{\text{total months}} \times \text{result*}$$

* as calculated under the formula in section 21E(3)

"Months" is defined in section 21E(8)(a) as the number of months since acquisition in which all or part of the land is used to some extent for making taxable supplies.

"Total months" is defined in section 21E(8)(b)as the total number of months since acquisition.

By taking into account the solely non-taxable use of the land, the formula will reduce the extent of the taxable use of the land calculated under the formula in section 21E(3).

Example 10

The facts are the same as in Example 9. Assume that the length of the first adjustment period was 12 months.

In the second adjustment period, Sandy continues both letting out and advertising for sale House A. However, six months after the start of the second adjustment period, Sandy stops advertising House A for sale as she decides to permanently rent it out.

In the second adjustment period, she receives rental income of $30,000. The market value of House A at the time of the adjustment is still $360,000.

At the end of the second adjustment period, Sandy uses the formula in section 21E to identify the taxable use of the house. For the purposes of the second adjustment period, the "total consideration for supply" is the sum of the market value of the house and all rental income received since the land was acquired:

$$\frac{\$360{,}000}{\$416{,}000} \times 100 = 86.5\%$$

However, because the house has been used for six months solely for making non-taxable supplies, she has to apply the formula in section 21E(6):

$$\frac{18}{24} \times 86.5\% = 64.8\%$$

Sandy's percentage actual use of House A in the second adjustment period is 64.8%. The percentage actual use must be compared with the "previous actual use", that is with the percentage actual use as determined in the most recent period in which an adjustment has been made. For Sandy, the previous actual use will be 93%. Sandy has therefore deducted 28.2% more input tax than she should have and has to account for this to Inland Revenue:

$30,000 × 28.2% = $8,460

Adjustment on disposal

When a registered person disposes of, or is treated as disposing of, goods or services in the course of a taxable activity and has not claimed a full input tax deduction, new section 21F allows them to claim an additional amount of input tax.

The amount of deduction available on disposal of goods or services will be calculated under the formula:

$$\text{tax fraction} \times \text{consideration} \times \left(1 - \frac{\text{actual deduction}}{\text{full input tax deduction}}\right)$$

For the purposes of the formula, section 21F(3) provides that:

- "Tax fraction" has the meaning given in section 2(1). For the purposes of the 15% GST rate, the tax fraction is 3/23.
- "Consideration" is the amount of consideration received, or treated as received, for the supply.
- "Actual deduction" is the amount of deduction already claimed, taking into account adjustments made up to the date of disposal.

The amount calculated under the formula, when added to any deduction already claimed, must not be more than the total amount of the input tax on the supply (or the nominal GST component, if the supply was zero-rated).

Example 11: Appreciating asset

Same facts as in Example 10.

The total input tax on the construction costs that relate to House A is $30,000. Sandy claimed 64.8% of the total input tax—$19,440.

At the beginning of the third adjustment period, Sandy sold the house to Nigel for $320,000 inclusive of GST.

Since Sandy has not claimed the full input tax in respect of the construction cost incurred in respect of the property, she may use section 21F to make a final adjustment of the input tax:

$$\frac{3}{23} \times \$320{,}000 \times \left(1 - \frac{\$19{,}440}{\$30{,}000}\right) = \$14{,}692$$

The resulting amount of $14,692, when added to the deduction already claimed ($19,440), is more than the total amount of the input tax on the supply ($30,000). Therefore, the amount of the adjustment that may be claimed by Sandy will be limited to $10,560.

Example 12: Depreciating asset

Charles acquired a car for $46,000 (inclusive of GST of $6,000) and claimed 70% of the input tax ($4,200). Having used the car for the intended purpose for three years, Charles sells it for $30,000 inclusive of GST.

Since Charles has not claimed the full input tax in respect of the car and the car was sold in the course of the taxable activity, he may use section 21F to make a final adjustment of the input tax:

$$\frac{3}{23} \times \$30{,}000 \times \left(1 - \frac{\$4{,}200}{\$6{,}000}\right) = \$1{,}174$$

The amount of the adjustment to be claimed in respect of the taxable disposal of the vehicle is $1,174.

Example 13: Master example

John, the sole trader in Example 1, acquired a vehicle for $20,000 plus $3,000 GST. On acquisition, John claimed 70% of the input tax—$2,100.

Since the GST-exclusive value of the car falls between $10,001 to $500,000, he has to monitor the use of the car for five adjustment periods.

In the first adjustment period (a period of 12 months), the entries in the logbook kept by John indicate that he used the car 55% in his business (taxable use).

In the second adjustment period (also a period of 12 months), John used the car 65% in his business.

In the third adjustment period (a period of 12 months), John withdrew the car from use in the business and used it solely for private purposes.

In the fourth adjustment period, John sold the car for $10,000 inclusive of GST.

First adjustment period

At the end of the first adjustment period, John has to determine whether he may rely on the exclusions in either section 21(2)(a) (minimal exempt supplies) or section 21(2)(b) (the value of the supply) to avoid any change-in-use adjustments. John determines that the exclusion does not apply.

John therefore has to determine whether the use of the car in the first adjustment period corresponds with the intended taxable use of the car as estimated on acquisition. To do this he must compare the percentage actual use of the car with the percentage intended use of the car.

The logbook kept by John in respect of the car indicated that the taxable use of the car accounted for 55% of its total use. On acquisition, John predicted that he would use the car 70% for taxable purposes. Since the difference between the intended taxable use and the actual taxable use is more that 10%, John may not rely on the exclusion in section 21(2)(c) and has to make an adjustment for change-in-use.

Using the formula in section 21D, John calculates the amount of the deduction that he has to return to Inland Revenue as output tax:

$3,000 × 15% = $450

Second adjustment period

For the purposes of the adjustment in the second adjustment period, the percentage actual use must be calculated from the date of acquisition to the end of the relevant adjustment period. John used the car for taxable purposes 55% in the first adjustment period of 12 months and 65% in the second adjustment period of 12 months. Overall, over two years, John used the car 60% for taxable purposes:

(55% × 12/24) + (65% × 12/24) = 60%

The percentage actual use must be compared with the "previous actual use", that is, with the percentage actual use as determined in the most recent period in which an adjustment has been made. For John, the previous actual use will be 55%, as this was the actual use of the car at the end of the first adjustment period.

Since the difference between the percentage actual use (60%) and the previous actual use (55%) of the car is less than 10 percentage points, John will not be required to account for the amount of the adjustment if the monetary value of the adjustment is less than $1,000.

John calculates that the value of the adjustment is less that $1,000 using the formula in section 21D:

$3,000 × 5% = $150

Third adjustment period

John calculates the percentage actual use of the car after three adjustment periods:

(55% × 12/36) + (65% × 12/36) + (0% × 12/36)

= 18.3% + 21.7% + 0 = 40%

The percentage actual use is 40%. This percentage has to be compared with the previous actual use. Since John did not make an adjustment in the previous (second) adjustment period, the "previous actual use" will be the percentage actual use in a period that is the most recent period in which an adjustment has been made. John made an adjustment in the first adjustment period when his percentage actual use was 55%. This percentage will therefore become John's previous actual use for the purposes of the adjustment in the third adjustment period.

Since the difference between the percentage actual use (40%) and the previous actual use (55%) of the car is more than 10 percentage points, John has to account to Inland Revenue for the over-claimed amount of the deduction. The amount of the output tax to be accounted for is:

$3,000 × 15% = $450

Fourth adjustment period

In the fourth adjustment period, John sold the car in the course of his taxable activity for $10,000. As John has not claimed the full deduction in respect of the car, he may claim an additional amount of the adjustment on disposal under section 21F calculated as follows:

$$\frac{3}{23} \times \$10{,}000 \times \left(1 - \frac{\$1{,}200}{\$3{,}000}\right) = \$783$$

John may claim a deduction of $783 in respect of the taxable disposal of the car.

Entitlement to input tax deduction for goods and services acquired before registration

New rules have also been introduced that may allow a registered person to claim input tax deductions for goods and services purchased by them before registration.

These will apply in the following circumstances:

- before becoming a registered person, the person acquired goods or services that were chargeable with GST at the standard rate; and
- at the time of the registration or at a later time, the person used the goods or services for making taxable supplies; and
- the original cost of the goods or services, excluding GST, was $5,000 or less.

If these conditions are met, a registered person will be able to claim a deduction for the goods and services purchased by them before registration if they hold a tax invoice in relation to the supply as required by section 20(2) or have adequate records that enable the identification of the particulars of an invoice as required by section 24(3).

To claim a deduction, the registered person must make an adjustment for change-in-use under sections 21 and 21A. The ordinary rules for apportionment of input tax would, however, be modified to treat the first adjustment period as the period that starts on the date of the acquisition of the goods or services and ends on the first balance date that falls after the person becomes registered for GST and uses the goods or services for making taxable supplies.

Following the determination of the length of the first adjustment period, the person must identify the percentage actual use of the goods or services in that period, using a method that provides a fair and reasonable result. This percentage actual use would then be compared with the percentage intended use (which will be 0% as the person will not have claimed any deduction on the acquisition). The resulting "percentage difference" will be used to claim an adjusted amount of the deduction under section 21D.

This rule allows goods and services acquired by a person before their registration to enter the apportionment regime. As a consequence, the asset will become subject to the same apportionment rules as any other asset purchased by the registered person.

Example 14

On 1 January 2012, Craig, an unregistered person, acquires a car for $23,000 (including GST of $3,000). For the next two years Craig uses the car solely for private purposes.

On 1 January 2014, Craig registers for GST and starts using the car solely for business purposes. Craig's next balance date is 31 March 2014.

Craig has retained the tax invoice received on the purchase of the car. Since the value of the car on the acquisition was more that $5,000, Craig may claim a deduction for the car under section 21B.

Craig's first adjustment period in respect of the car will be treated as the period that starts on the date of the acquisition of the goods or services and ends on the first balance date that falls after the person becomes registered for GST and uses the goods or services for making taxable supplies, that is, from 1 January 2012 to 31 March 2014.

During that period (a total of 27 months), Craig used the car 0% for taxable purposes for 24 months (1 January 2012 to 31 December 2013) and 100% for taxable purposes for three months (1 January 2014 to 31 March 2014). Therefore, his total taxable use in the first adjustment period will be:

$$(0\% \times 24/27) + (100\% \times 3/27) = 11\%$$

At the end of the first adjustment period, Craig can claim $330 (11% of the initial input tax of $3,000).

Subsequent adjustment periods

The maximum number of adjustments that have to be made for goods and services of value between $10,000 and $500,000 is five.

Therefore, if Craig continues owning the car he may be required to make four additional adjustments. If he sells the car in the course of his taxable activity, he may be entitled to an additional deduction under the wash-up mechanism in section 21F.

Application to acquisitions from associated persons

New section 3A(3C) amends the application of section 21B for goods or services acquired from an associated person. In these situations, the amount of input tax on goods or services that may be claimed by the person must not be more than the amount accounted for as output tax by the associated supplier of the goods or services.

TRANSACTIONS INVOLVING NOMINATIONS

Nominee transactions ordinarily involve a purchaser nominating another person (a nominee) to receive goods and services and/or settle the transaction.

The new rules are intended to provide greater certainty for transactions involving nominees by adopting an "economic substance" approach. These rules are not intended to apply to transactions that involve other structures, such as assignments, novations, or agency arrangements.

Key features

New section 60B clarifies the GST treatment of transactions involving nominations—when a contractual purchaser nominates another person (a nominee) to receive the goods or services from the contractual vendor.

In these circumstances, the GST treatment will depend on which party provides payment for the supply of goods or services. In respect of transactions involving land, however, the supply will always be treated as being made by the supplier to the nominee.

Application date

The new rules will apply to supplies made on or after 1 April 2011.

Detailed analysis

Effect of nomination on a supply

New section 60B applies when a person (person A) enters into a contract to supply goods and services to another

person (person B) and person B directs person A to provide the goods and services to a nominated person (person C) who is not party to the contract.

The section does not apply to situations involving supplies made to or by agents, as these situations are governed by section 60 of the GST Act. Also, the new rule does not apply to assignments or novations.

The GST treatment of a supply will depend on the exact circumstances of the transaction.

Contractual purchaser and nominated person have the same registration status

If a contractual purchaser (person B) and the nominated person (person C) are both registered or both not registered for GST, the treatment of the supply will depend on which party provides consideration for the supply:

- If person B pays the full consideration for the supply, the supply is treated as a supply from the supplier (person A) to person B and the existence of person C is ignored (section 60B(2)).
- If person C pays the full consideration for the supply, the supply is treated as a supply from person A to person C and the existence of person B is ignored (section 60B(3)).
- If person B and person C each pay part of the consideration for the supply, the supply is treated as a supply from person A to person B. However, person B and person C may agree in writing that the supply is to be treated as a supply made to person C. No such agreement can be made if person B has claimed an input tax deduction in relation to the supply (section 60B(4)).

Contractual purchaser and nominated person have different registration status

If the registration status of a contractual purchaser differs from the registration status of the nominated person (that is, one party is registered for GST and another party is not registered for GST), the supply is always treated as a supply from the supplier to the nominated person.

Nominee transactions that involve land

If a supply wholly or partly consists of land, the supply is always treated as made by the supplier to the nominated person. This is intended to provide consistency with the fact that the zero-rating rules apply at the time of settlement.

Record-keeping requirements

The nomination rules in section 60B affect the tax invoice requirements. In normal circumstances, a taxpayer must have a tax invoice to claim an input tax deduction. In transactions involving nominations, a nominee may not have the requisite tax invoice as it may have been issued to the purchaser. In these circumstances, new section 24(7B) requires a nominee to maintain records that would allow the name and address of the supplier, the date of payment for the supply, a description of the goods and services supplied, and the consideration for the supply to be ascertained.

New section 20(2)(e) further specifies that a nominee may use the records kept in accordance with section 24(7B) as documentation to claim a deduction of input tax.

SUPPLIES OF ACCOMMODATION

Accommodation provided by GST-registered persons is generally taxable unless it is expressly treated as an exempt supply. The GST Act exempts the supply of accommodation in a "dwelling", but not accommodation that is in a "commercial dwelling". The main reason for exempting the supply of accommodation in a dwelling from GST, as described in the 1985 *White Paper on Goods and Services Tax*, was to ensure that those in rental accommodation were not disadvantaged compared with owner-occupiers. For this reason, the definition was intended to apply to situations when there was a reasonable level of substitutability between renting and owning a home. This goal was arguably not being achieved because of the potentially wide interpretation of the definition of "dwelling".

In addition, the boundary between the definitions of "dwelling" and "commercial dwelling" could have resulted in different suppliers of essentially the same type of accommodation having their supplies treated differently for GST purposes, depending on whether particular aspects of the definitions were satisfied.

The Taxation (GST and Remedial Matters) Act 2010 amends the definitions of "dwelling" and "commercial dwelling" to provide a clearer boundary between the definitions.

Key features

The amendments narrow the definition of "dwelling" and update the list of accommodation that is treated as being in a "commercial dwelling".

For accommodation to be in a "dwelling" the relevant premises must be occupied by the recipient as their principal place of residence or it must be reasonably foreseeable that this will be the case. The recipient must also be entitled to quiet enjoyment of the property. Accommodation supplied to boarders will also be treated as a supply of accommodation in a "dwelling".

The current definition of "commercial dwelling" has been amended by expanding the list of types of accommodation that are to be treated as such to include homestays,

farmstays, bed-and-breakfast accommodation and certain serviced apartments.

Application date

The new definitions apply for supplies of accommodation made on or after 1 April 2011.

Detailed analysis

Definition of "dwelling"

The definition of "dwelling" in section 2(1) of the GST Act has been amended to include premises that the person occupies, or that it can reasonably be foreseen that the person will occupy, as their principal place of residence (paragraph (a)(i)), and of which the person has "quiet enjoyment" (paragraph (a)(ii)).

The term "premises" is defined by reference to section 2 of the Residential Tenancies Act 1986, and therefore includes:

- any part of any premises; and
- any land and appurtenances, other than facilities; and
- any mobile home, caravan, or other means of shelter placed or erected upon any land and intended for occupation on that land.

A definition of a "principal place of residence" is included in the GST Act and means a place that a person occupies as their main residence for the period to which the agreement for the supply of accommodation relates. For example, if accommodation is supplied for six months, to be considered as being in a "dwelling", the accommodation must be the recipient's principal place of residence, or be reasonably foreseen as being so, for that period.

For a supply to be a supply of accommodation in a "dwelling", the person must also have "quiet enjoyment" of the premises as the term is used in section 38 of the Residential Tenancies Act 1986. This means the person must be entitled to enjoyment of the premises without interruption by the landlord or any person claiming by, through, or under the landlord or having superior title to that of the landlord. Moreover, the landlord must not cause or permit any interference with the reasonable peace, comfort, or privacy of the tenant in their use of the premises.

Paragraph (b) of the definition of "dwelling" extends the definition to include accommodation provided to a person who is occupying the same premises, or part of the same premises, as the supplier of the accommodation and who occupies the premises as their principal place of residence. The intention of this paragraph is to include supplies of accommodation to boarders who reside in the same premises as their landlords and who may not meet the "quiet enjoyment" test.

Finally, a supply will not be a supply of accommodation in a "dwelling" if it is a supply of accommodation in a "commercial dwelling".

Definition of "commercial dwelling"

The definition of "commercial dwelling" in the GST Act provides a list of types of accommodation covered. The amended list adds supplies of the following types of accommodation:

- homestays;
- farmstays;
- bed and breakfast establishments; and
- a serviced apartment managed or operated by a third party for which services, in addition to the supply of accommodation, are provided and in relation to which a resident does not have quiet enjoyment.

The last inclusion ensures that all managed serviced apartments are treated in the same manner, irrespective of the structure adopted to provide the accommodation. This position was previously uncertain.

APPLICATION OF SECTION 19D TO NON-PROFIT BODIES

Differences in the accounting practices for GST can result in timing advantages being deliberately created when a registered person who accounts for GST on a payments basis makes a supply to another registered person who accounts on an invoice basis. In these situations, the payments-basis supplier accounts for GST when payment is received, while the purchaser may claim an input tax deduction following receipt of the tax invoice.

The aim of section 19D is to limit taxpayers' choices of accounting bases when the application of GST accounting principles could give rise to tax-base risks. Specifically, section 19D requires GST-registered suppliers accounting for GST using the payments basis to use the invoice basis when the amount payable for a supply of goods and services is $225,000 or more (including GST) and payment by the customer is deferred.

Under the rules before the amendment in the Taxation (GST and Remedial Matters) Act 2010, section 19D applied to all taxpayers. The universal application of section 19D could have an unintended detrimental effect on some non-profit bodies. Thus, a non-profit body could agree to supply an asset, such as a house, to an individual in need. Often the agreement would stipulate that the recipient of

the asset will make a number of payments over a period of time and will receive the title in the asset when the asset has been paid for in full.

These types of arrangements could trigger section 19D, and require the non-profit body to account for GST on an invoice basis. This would result in the non-profit body having to account for the GST on the entire purchase price at the outset, creating a significant cost to the non-profit body. Consequently, the rule may have discouraged non-profit bodies from providing goods and services over a certain value.

Key features

The Taxation (GST and Remedial Matters) Act 2010 amended section 19D to exclude non-profit bodies from the application of section 19D when the risk of tax avoidance is low, therefore allowing them to operate without the additional cost of having to fund the full cost of GST upfront.

Application date

The amendment applies from 21 December 2010.

Detailed analysis

New section 19D(2B) excludes supplies made by a non-profit body from the application of section 19D(1) in the following circumstances:

- when the recipient is not GST-registered; and
- when the recipient is either not intending to use the goods and services for the purposes of carrying on a taxable activity or intending to use the goods and services for the purposes of carrying on a taxable activity, only after the full payment for the supply is paid to the supplier.

CHANGES TO THE QUALIFYING COMPANY RULES AND INTRODUCTION OF LOOK-THROUGH COMPANY RULES

Subparts HA and HB, and sections CB 32B, 32C, CX 63, DV 21 to DV 24, GB 25B, GB 29, HZ 4B to HZ 4D and YA 1 of the Income Tax Act 2007

Changes to the qualifying company rules and the introduction of look-through company rules were added to the Taxation (GST and Remedial Matters) Bill by Supplementary Order Paper No. 187. The changes are part of Government announcements made in Budget 2010 aimed at improving the integrity of the tax system by preventing people from claiming losses against their personal income.

Specifically, the changes:

- provide transparent income tax treatment for electing closely held companies, which will be known as look-through companies (LTCs);
- allow existing qualifying companies (QCs) and loss-attributing qualifying companies (LAQCs) to continue to use the current QC rules without the ability to attribute losses, pending a review of the dividend rules for closely held companies; and
- allow existing QCs and LAQCs to transition into the new LTC rules or change to another business vehicle such as a partnership, without a tax cost during the period 1 April 2011 to 31 March 2013.

Background

As part of tax integrity measures introduced in Budget 2010, the Government announced reforms to the tax rules for qualifying companies. Feedback on the proposals was sought in the officials' issues paper, *Qualifying companies: implementation of flow-through tax treatment* published the day after the Budget announcement.

Based on this feedback, new rules providing an elective look-through income tax treatment for closely held companies apply from 1 April 2011.

Under the look-through rules, the company's tax treatment is integrated with the tax treatment of the owners, on the basis that entities are agents for their owners. It ensures that shareholders who use a company's losses also pay tax on any company profit at their marginal tax rate. This removes the tax disincentive faced by the owners of closely held businesses who wish to operate through a company. They can attain the benefits of limited liability afforded by a familiar corporate form, as well as the ability to be taxed at the level of the owner.

In addition, in response to feedback from small businesses, the Government decided to allow existing QCs and LAQCs to continue to use the current qualifying company rules, but without the ability to attribute losses, while a review of the tax rules for dividends from closely held companies is carried out.

As a result of the changes to the qualifying company rules, a special set of transitional rules have been developed, to allow existing QCs and LAQCs to transition into the new LTC rules or change to another business vehicle such as a partnership or sole trader, without a tax cost.

An early draft of this legislation was made available for public comment on 15 October 2010, accompanied by an explanatory note. The final legislation is different from the earlier draft, reflecting feedback received during consultation. Some of these changes are fairly substantial while others are more technical in nature. The earlier draft legislation and explanatory note have therefore been superseded by the enacted rules and should not be relied upon.

Key features

Look-through company rules

The new LTC rules are available for income years starting on or after 1 April 2011. The rules apply only to companies which are resident in New Zealand.

The main features of the new LTC rules are:

- An LTC must have five or fewer owners (the ownership interests of relatives are combined).
- All owners must elect for the LTC rules to apply initially. LTC elections are to be made prospectively.
- Once a company becomes an LTC it will remain so unless one of the owners decides to revoke the LTC election, or the company ceases to be eligible.
- Only a natural person, trustee or another LTC may hold shares in an LTC. All the company's shares must be of the same class and provide the same rights and obligations to each shareholder.
- An LTC's income, expenses, tax credits, rebates, gains and losses are passed on to its owners. These items will generally be allocated to owners in proportion to the number of shares they have in the LTC. Owners are also able to deduct expenditure incurred by the LTC before they became a member, subject to the other deductibility tests in the Act.

- Any profit is taxed at the owner's marginal tax rate. The owner can use any losses against their other income, subject to the loss limitation rule.
- The loss limitation rule ensures that the losses claimed reflect the level of an owner's economic loss in the LTC. An anti-avoidance rule also prevents an artificially high basis around the year-end being used to increase any loss flow-through. Owners' excess losses are carried forward to future income years, subject to the application of the loss limitation rule in those years. There are certain rules about the use of these losses if the LTC ceases to be an LTC, or if the owner sells their shares.
- When owners sell their shares they are treated as disposing of their share of the underlying LTC property. Owners may have to pay any tax associated with the deemed disposal of this property. Exiting owners are generally required to account for tax on disposing of their shares in the LTC only if the amount of the disposal proceeds derived from their LTC interest exceeds the total net tax book value of their share of LTC property by more than $50,000.
- Even if this $50,000 threshold is exceeded, exiting owners will not have to account for tax on things such as trading stock in certain circumstances. When exiting owners account for tax on their share, incoming owners must take on a cost basis in the LTC's assets and liabilities that is equal to the deemed disposal under the disposal provisions.
- The disposal thresholds do not apply if the company is liquidated, or ceases to use the LTC rules but otherwise continues in business. In these situations, the owner is deemed to have disposed of their shares at market value on the date of exit.
- Look-through treatment applies for income tax purposes only. An LTC retains its corporate obligations and benefits, such as limited liability, under general company law.
- An LTC is still recognised separately from its shareholders for certain other tax purposes, including GST, PAYE and certain administrative or other withholding tax purposes under the Income Tax Act 2007.

Qualifying company rules

The changes effectively "grandparent" the QC rules for existing QCs and LAQCs only. The revised QC rules will continue to apply to existing QCs and LAQCs unless they choose to revoke their QC election, and/or use one of the transition options.

The main effect of the changes is to:

- remove the ability of an LAQC to attribute losses. This means that existing LAQCs will effectively be taxed in the same way as ordinary QCs; and
- prevent companies that are not already QCs from entering the QC rules for income years starting on or after 1 April 2011.

Transitional rules for existing QCs and LAQCs

Special transitional rules allow existing QCs and LAQCs to transition into the new LTC rules or change to another business vehicle, without a tax cost.

If an existing QC or LAQC chooses not to transition they will remain in the QC rules, but cannot attribute losses to shareholders.

The transitional rules provide for the following:

- Transition can take place in either one of the first two income years starting on or after 1 April 2011; the year chosen for transition is called the "transitional year".
- QCs and LAQCs have six months from the start of their transitional year to advise Inland Revenue of their transition.
- If transitioning to a new business structure, the partnership or sole tradership must consist of the same person(s) who owned the QC or LAQC. The transition into the new business form must be completed by the end of the transitional year.
- The appropriate tax treatment (LTC, partnership or sole trader) will apply from the start of the transitional year.
- All of the QCs assets, liabilities, tax balances and other obligations will automatically transfer to the new LTC, partnership or sole trader with no tax cost.
- Any carried forward loss balances of a QC or an LAQC can be used in future but are effectively ring-fenced for owners of the LTC, or partners in the partnership, to use against future income from that LTC or that partnership.

Application dates

The application date for both the new LTC rules and the qualifying company reforms is the income year starting on or after 1 April 2011. The LTC election filing rules apply from 21 December 2010.

Companies with an early balance date, for example, a company with a balance date of 31 December, can start using the LTC rules from their income year from 1 January 2012 to 31 December 2012.

LAQCs choosing not to transition but to use the QC rules will have loss attribution for their income year ended 31 December 2012 but will no longer be able to attribute losses for their income year starting on 1 January 2013.

Companies with a late balance date, for example, a company with a balance date of 31 May, can start using the LTC rules from their income year from 1 June 2011 to 31 May 2012.

To use the grandparented QC regime, QCs and LAQCs must have used the QC regime for their income year immediately before the income year starting on or after 1 April 2011. If transitioning in the second of the possible transitional years, they must also have met the QC criteria for the whole of the first possible transitional year.

Detailed analysis

Look-through company rules

New subpart HB of the Income Tax Act 2007 contains the main LTC rules. It introduces the principle that LTCs are transparent for income tax purposes, and contains the LTC election requirements and rules on the tax treatment following an owner's disposal of interests in an LTC.

Section YA 1 introduces several defined terms, including "LTC", "owner's interest", "look-through interest" and "working owner".

Amendments have been made to income and deduction provisions and, in particular, to sections CB 32B and 32C, CX 63, DV 22 and GB 25B, as well consequential changes to the Tax Administration Act 1994 and the KiwiSaver Act 2006.

Definition of "look-through company"

Sections HB 1(1), HB 13(4) and YA 1

A company that elects to use the LTC rules must be a company (that is a body corporate or entity with a legal existence separate from that of its members) that is resident in New Zealand under domestic law and under any relevant double tax agreement. The company residence rules in section YD 2 apply for these purposes; in other words, it is the residence of the company and not its shareholders that is determinative.

A company using the LTC rules must have only one class of shares. All the shares must have the same rights to vote concerning company distributions, the company constitution, capital variation and director appointments, and to receive distributions of profits and net assets. This requirement prevents streaming of income or deductions under the LTC rules.

The shareholders of a company using the LTC rules must be either natural persons or trustees (including corporate trustees). An ordinary company cannot hold shares in an LTC. An LTC may be the "parent" of another LTC. The sub-LTC's income and expenses will ultimately be attributed to the owners of the parent LTC, and it is these owners who are included in the look-through counted owner test.

An LTC must have five or fewer "look-through counted owners".

To become an LTC, a company must meet all the eligibility criteria and must continue to meet it for the whole of the income year. If an LTC breaches the eligibility criteria its LTC status is lost from the first day of the income year in which the breach occurs. It cannot then use the LTC rules in the year in which the breach occurs or either of the following two income years.

A company that has elected to use the LTC rules is thereafter excluded from the definition of "company" in the Income Tax Act. This means that most of the rules that apply to companies, such as the requirement to keep memorandum accounts and the rules governing payments of dividends, do not apply to LTCs. However, for the following provisions there is no look-through treatment and the company, rather than its owners, is the relevant entity:

- PAYE
- FBT
- RWT
- NRWT
- ESCT
- RSCT
- Subpart FO (Amalgamation of companies).

The "look-through counted owners" test

Section YA 1

An LTC must have five or fewer "look-through counted owners". This term applies for this count test only, and although related to shareholdings it is not always transposable with the term "owner" or "shareholder", such as when an LTC is the parent company of another LTC.

For many LTCs it will be clear that they meet the count test, for example, if the company has only three individual shareholders it clearly has fewer than five shareholders and so fewer than five "look-through counted owners". However, for companies that have more than five individual shareholders, or shareholders that include trustees, the look-through counted owner test needs to be considered.

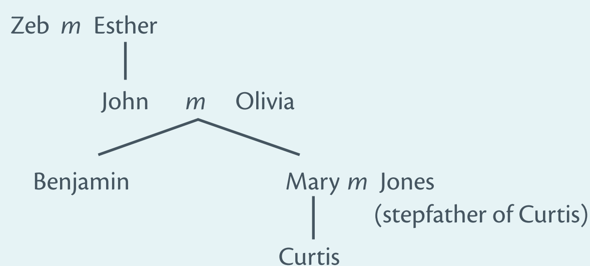
The look-through counted owner test determines the number of look-through owners the company has for the

purposes of the LTC rules by identifying the relationships between individual shareholders. Shareholders related by blood relationships (second degree), marriage, civil union or de facto relationship, or adoption are counted as a single "owner" for the purposes of this test.

The relationship between a step-parent and a step-child is a second-degree relationship.

Death or dissolution of marriage between the shareholders does not break the two-degree test, provided the company was an LTC and the shareholders were counted as "one" before the event.

Example 1: Natural person shareholders



In the example above, if Zeb, Esther, Benjamin, Mary, Jones and Curtis all held shares in a company they would be counted as a single look-through counted owner because they are related to each other (via Mary) within two degrees.

If only Jones, Esther and Curtis held shares they would be counted as two look-through counted owners because although Jones, as his stepfather, is related to Curtis within two degrees, neither of them are related to Esther within two degrees, as she is Curtis's great grandmother and Jones's grandmother-in-law.

The look-through counted owner test must also be applied if a trustee holds shares in an LTC. Here the test will "look through" to the natural person beneficiaries of the trust (which includes looking through any corporate beneficiaries to its natural person shareholders), if those beneficiaries are allocated income from the LTC as beneficiary income in that income year, or in any of the three preceding income years.

The trustees of a trust are counted as one look-through counted owner for an income year if any income the trust was allocated from the LTC in that income year, and in each of the preceding three income years, was retained by the trust and not paid out as beneficiary income.

Example 2: Trustee shareholder

All the shares in Mountain Design Ltd, an LTC, are held by Walton Trust.

Walton Trust is managed by a corporate trustee. It distributes all of the income from Mountain Design Ltd to the following beneficiaries:

20X1, 20X2 and 20X3	Cora and Emily
20X4	Elizabeth, Emily and Mamie (Emily's sister)
20X5	Rosemary, Erin and Aimee (Cora's daughter)

In 20X1, 20X2 and 20X3 there are two look through counted owners as between them Cora and Emily derived all of the LTC's income as beneficiary income.

In 20X4 there are three look-through counted owners, Cora, Elizabeth and Emily/Mamie. Because Mamie is Emily's sister (a two-degree blood relative) they are counted as one owner.

In 20X5 there are five look-through counted owners, because the test considers who received beneficiary income in the current income year (20X5), and any of the three preceding income years (20X2, 20X3 and 20X4). The look-through counted owners are:

- Cora/Aimee (counted as one)
- Elizabeth
- Mamie/Emily (counted as one)
- Rosemary
- Erin.

If a company (including a qualifying company) is the beneficiary of a trust and has received income from the LTC as beneficiary income in that income year, or in any of the three preceding income years, then the company itself is not regarded as a look-through counted owner. Instead the test counts all natural persons who have a voting interest in relation to that company, whether directly or otherwise.

Look-through company elections

Sections HB 1 and HB 13

The LTC regime is elective. A company can only use the LTC rules if it continuously meets all the eligibility criteria, and has filed a valid election with Inland Revenue.

Making an election

All owners must sign an LTC election in order for a company to first become an LTC. A guardian or legal representative must sign for owners aged under 18, or any other owner without legal capacity. The director or other authorised company agent should send the election form to Inland Revenue, and confirm that all the owners have signed it.

An LTC election may also be signed by a person holding shares as a nominee or as a bare trustee for the beneficial owner, acting on instructions and on behalf of the beneficial owner under section YB 21.

The LTC election must be received by Inland Revenue before the start of the income year in which the company wishes to be an LTC. Elections relate to the income year of the company electing to become an LTC; so the due date for the election depends upon its balance date.

Newly incorporated or non-active companies must file the LTC election by the date for filing their first income tax return.

If an LTC election is received after the start of the year to which it was intended to apply, or if it is discovered to be invalid because, for example, not all the shareholders signed the election, it may still be accepted as a valid election. However, the Commissioner's discretion will be exercised only if exceptional circumstances, such as a severe illness, caused the omission or lateness, and if any omission in the election is rectified in that income year.

A company will remain an LTC without any further LTC election. It will cease to be an LTC only if it breaches the eligibility criteria, or the LTC election is revoked.

Revoking an election

Any owner may revoke the LTC election. It does not matter whether they were one of the initial owners who signed the election or not. The revocation notice must be received by Inland Revenue before the start of the income year to which it applies. A copy should be sent to the director of the LTC, to ensure that all owners are aware of the change in status.

If a revocation notice is received after the start of the income year to which it relates, the Commissioner may still accept it, if it was late due to exceptional circumstances.

A revocation may be ignored if the owner issuing the revocation notice disposes of all their interests in the LTC, and the person(s) who acquire these interests advise Inland Revenue before the start of the relevant income year that the previous owner's revocation notice is to be reversed.

To protect the integrity of the new rules, if an owner revokes the LTC election the company cannot use the LTC rules in the year for which the revocation is made, or in either of the following two income years.

Becoming a look-through company

Sections CB 32C and HB 3

Any loss balance of a company from income years before becoming an LTC is cancelled when it becomes an LTC.

If a company becomes an LTC after its first year of trading, its reserves are regarded as held by the owners in proportion to their look-through interest. So when a company first becomes an LTC, each owner will be deemed to have an amount of income arising on the first day of the income year the company becomes an LTC. This is necessary because under the LTC rules these reserves may be distributed or drawn down upon without the owners being subject to tax upon distribution; this treatment is not intended to apply to previously accumulated company reserves.

Similar rules apply if a company that is not an LTC amalgamates with an LTC.

The amount of each owner's income is equal to their proportion (based on look-through counted interests) of the amount of the company's reserves that would be taxable if the company was liquidated and assets distributed to shareholders. The formula to determine the amount of these reserves, which applied to the company immediately before it became an LTC, is:

$$\left(a + c - b - \frac{c}{d}\right) - e$$

Where:

a is the amount that would be taxable dividends of the company on distribution following a deemed winding up.

b is the assessable income, less allowable deductions, that would be derived by the company on a deemed winding up. This includes items such as depreciation recovered, bad debts and loss on sale of assets.

c is balances on the company's ICA and FDP account immediately before becoming an LTC, plus any unpaid income tax for earlier years, less any income tax refunds due from these earlier years.

d is the company tax rate in the income year before the income year in which the company becomes an LTC.

e is the exit dividends that, if the company had previously been an LTC and is now re-entering the LTC rules, would be

attributed to any retained reserves from the previous LTC period that have not since been distributed.

Each owner is subject to tax on their proportion of these reserves, which are regarded as an income amount to them. This income amount is deemed to arise to owners in the income year the company becomes an LTC, and each owner pays income tax on the amount at their personal tax rate.

Slightly different rules apply to existing QCs or LAQCs who choose to transition to the LTC rules in either the first or second income year that starts on or after 1 April 2011.

Ceasing to be a look-through company

Sections CD 43 and CX 63

If a company ceases to be an LTC but continues in existence, it will be taxed as an ordinary company. Any retained revenue profits held by the company would have been previously allocated to owners who would have been subject to tax on this income in the year the income was derived.

To prevent any double taxation of this income, dividends paid by the company in income years after it ceases to be an LTC will be regarded as paid firstly from this retained revenue profit until an amount of dividends equal to the amount of retained profit has been paid. This applies whether the dividends are paid to the same shareholders that held shares while the company was an LTC or to new shareholders.

Dividends regarded as paid from this retained revenue profit are excluded income in the hands of the shareholder recipients.

The available subscribed capital formula is adjusted to reflect capital distributions made while the company is an LTC, taking into account both equity subscriptions and returns on that equity.

A look-through company is transparent

Sections CB 32B, DV 22, GB 23(2), GB 25B, GB 29, HB 1(4) to (5) and HB 2

With some exceptions, for the purposes of the Income Tax Act, owners are generally treated as carrying on activities and having the status, intention and purpose of the LTC. While the LTC is treated as not carrying on these activities or having such an intention or purpose. The exceptions to look-through are for the purposes of the PAYE rules, the FBT rules, the RWT and NRWT rules, the ESCT rules, the RSCT rules and subpart FO (which deals with the amalgamation of companies).

Generally though, LTCs are transparent for income tax purposes. Owners are treated as holding property in proportion to their effective look-through interest, and as parties to an arrangement, and doing or being entitled to a thing, through their capacity as owner, unless the context requires otherwise.

An owner's effective look-through interest in an LTC is measured by the percentage of decision-making rights carried by their shares in the company in relation to dividends or other distributions, the company constitution, variation of the company's capital and director appointments or elections.

Methods for allocation of income and deductions

Income, expenses, tax credits, rebates, gains and losses are passed through to owners. These items are generally allocated in accordance with an owner's effective look-through interest in the company, and will usually be allocated according to their average yearly interests, as if each item occurred uniformly throughout the year.

If the voting interest or market value interest varies during the year, owners may use the weighted average basis to determine their effective look-through interest, as shown in Example 3a.

If the company has a market value circumstance in the year, the owner's effective look-through interest is calculated as the average of their voting interest and the market value interest in the company for the income year.

Example 3a: Income and deduction allocation – average yearly interests

Walnut Ltd is an LTC with a standard balance date.

For the first nine months of the year Charles holds 60% of the shares, and his wife Caroline holds 40%. On 31 December Caroline sells all her shares to Laura.

Caroline and Laura have been shareholders for nine months (275 days) and three months (90 days) respectively.

Walnut Ltd's income statement for the year shows:

	$
Trading income	500,000
Allowable expenses	(300,000)
	200,000
Gross interest	10,000
RWT (28%)	(2,800)

NEW LEGISLATION

The income and deductions are regarded as accruing evenly throughout the year, and are allocated to each shareholder based on their yearly average as follows:

Charles's allocation is determined as:

		$
Trading income	0.6 × 500,000	300,000
Allowable expenses	0.6 × 300,000	(180,000)
		120,000
Gross interest	0.6 × 10,000	6,000
RWT (28%)		(1,680)

Caroline's allocation is determined as:

		$
Trading income	(275/365) × 0.4 × 500,000	150,000
Allowable expenses	(275/365) × 0.4 × 300,000	(90,000)
		60,000
Gross interest	(275/365) × 0.4 × 10,000	3,000
RWT (28%)		(840)

Laura's allocation is determined as:

		$
Trading income	(90/365) × 0.4 × 500,000	50,000
Allowable expenses	(90/365) × 0.4 × 300,000	(30,000)
		20,000
Gross interest	(90/365) × 0.4 × 10,000	1,000
RWT (28%)		(280)

Alternatively, if the voting interest or market value interest varies during the year owners can use their actual look-through interest in each period during the income year. This is applied to the income, expenses and other flow-through items from each period, and then added together. This requires accurate accrual accounts to be prepared for each period of ownership within the income year.

Example 3b: Income and deduction allocation – accounts method

If, in Example 3a, Walnut Ltd had drawn up a full accounts and a profit and loss statement for the period before and after Caroline disposed of her shares it would have shown:

	1 Apr to 31 Dec	**1 Jan to 31 Mar**	**Annual**
	$	$	$
Trading income	100,000	400,000	500,000
Allowable expenses	(100,000)	(200,000)	(300,000)
	Nil	200,000	200,000
Gross interest	7,500	2,500	10,000

Charles's allocation for the year is the same as in Example 3a.

Caroline's allocation for the 1 April to 31 December period is determined as:

		$
Trading income	0.4 × 100,000	40,000
Allowable expenses	0.4 × 100,000	(40,000)
		Nil
Gross interest	0.4 × 7,500	3,000
RWT (28%)		(840)

Laura's allocation for the 1 January to 31 March period is determined as:

		$
Trading income	0.4 × 400,000	160,000
Allowable expenses	0.4 × 200,000	(80,000)
		80,000
Gross interest	0.4 × 2,500	1,000
RWT (28%)		(280)

The Commissioner may require the LTC to use this accounts method if its taxable income in a 12-month period is $3 million or more, and if the Commissioner considers that the accounts method would result in a more equitable and reasonable measure of effective look-through interest in an income year.

Excessive effective look-through interests

The Commissioner may adjust the effective look-through interests of owners and consequently the income and deduction allocation if he considers that the current application provides excessive income allocations to an owner aged under 20.

This is an anti-avoidance provision, and aims to prevent income being unduly diverted to owners under the age of 20. It applies when two or more owners of an LTC are relatives, and one of them is under 20 years. In reallocating income and deductions for an income year, the Commissioner will consider the value of the contributions by way of service or capital rendered by the owner aged under 20, together with any other relevant matters.

Excessive remuneration to relatives

Section GB 25B

The Commissioner may adjust the allocation of income and deductions from the LTC to its owners if the LTC employs a relative of the owner, and the Commissioner considers that the remuneration paid to the relative for their services is excessive.

This is an anti-avoidance provision, to prevent income being unduly diverted to an owner's relatives. In reallocating income and deductions for an income year, the Commissioner will consider the nature and extent of services rendered by the relative, and any other relevant matters.

This provision does not apply if the relative is aged over 20 at the date of entering into a written contact of employment with the LTC, providing they have real control over the income paid to them under the contract.

Income from personal services

Section GB 29

For the purposes of applying the attribution rule for income from personal services (section GB 27), an LTC is treated as the associated entity, and is not treated as transparent.

ACC levies

For the purposes of ACC levies for natural person owners, a working owner is regarded as an employee and will pay the employee's levy while the LTC will pay the employer's levy. Other owners may receive a deduction for that expense.

An owner who is not a "working owner" but who personally exerts themselves in the LTCs income generating activities will be regarded as self-employed for ACC purposes and will pay the ACC levies as a self-employed person.

An owner who plays no active part in the LTC's business is regarded as a passive investor for ACC purposes, and is not subject to ACC levies on income attributed to them from the LTC. This includes any LTC income attributed to a natural person as beneficiary income via a trustee owner.

Each owner is responsible for assessing if their income from the LTC's business activities is of an active or passive nature, and declaring it accordingly in their individual income tax return.

Tax Information Bulletin Vol 13, No 3 (March 2001) has detailed information on the classification of ACC levies in partnerships. The same principles apply to LTCs and owners. For further details, please refer to that article, taking references to partners and partnerships as references to owners and LTCs as necessary.

Loss limitation

Sections HB 11 and HB 12

New section HB 11 ensures that owners' deductions are restricted if the amount of their deductions exceeds the adjusted tax book value of their investment in the LTC (the "owner's basis"). In that event, the deductions an owner can claim are limited to an amount equal to their owner's basis.

This is an anti-avoidance provision and will generally only apply if a company's tax losses are not matched by the owner's contributions. The rule aims to ensure that owners can offset tax losses only to the extent these reflect their economic losses. This reflects the fact that owners of a company enjoy limited liability under the corporate veil.

The owner's basis is calculated for each owner using the following formula:

investments – distributions + income – deductions – disallowed amounts

Where:

investments is the sum of the equity, goods or assets introduced or services provided to the LTC, or any amounts paid by the owner on behalf of the LTC. This includes any loans, including shareholder current account credit balances, made by the owner to the LTC and their share of any LTC debt which they, or their associate, have guaranteed (or provided indemnities for).

distributions is anything paid out to the owner by the LTC, including dividends and loans, including shareholder current account debit balances. It does not include any salary or wages received by a working owner.

income is the owner's share of the LTC's income (including exempt and excluded income) and capital gains from the current and any preceding tax years (in which the company was an LTC).

deductions is the owner's share of the LTC's deductions and capital losses in the preceding tax years (in which the company was an LTC).

disallowed amount is the amount of investments made by an owner within 60 days of the last day of the LTC's income year if these are distributed or reduced within 60 days after the last day of the income year. This is to prevent the creation of an artificially high basis around the end of the year. To allow for normal operational cashflow, if the reduction of investments within 60 days of the balance sheet date is less than $10,000, it may be ignored.

Example 4: Loss limitation

Oleson Ltd, an LTC, starts to operate a plant hire business in 20X1. It has three owners, Eleanor, William and Harriet, with shareholdings of 20%, 30% and 50% respectively.

Oleson Ltd is given a non-repayable business grant by a local entrepreneurial fund of $50,000. Its owners contribute a further $100,000, each contributing in proportion to their shareholding. Oleson Ltd also has a $100,000 interest-only loan from the bank, which Harriet has personally secured by guarantee against her residential property.

	$
Plant	250,000
Shareholder capital	100,000
Entrepreneur grant	50,000
Bank loan	100,000

The plant is depreciable at 20% pa = $50,000
Repair and maintenance costs = $20,000 pa
Interest costs = $10,000 pa (10% interest rate pa)

The plant produces hire income of $60,000 a year. Oleson Ltd pays total dividends of $30,000 each year. For the first five years of trading Oleson Ltd's accounts will show:

	$
Income	60,000
Repairs	(20,000)
Interest	(10,000)
Depreciation	(50,000)
Net loss	(20,000)

The owner's basis (there are no disallowed amounts in this example) determines the amount of their share of the $80,000 deductions that each owner can claim as follows:

$	Investment	Distribution	Income	Prior year deduction	Owner's basis	Current year deductions allowed	Restriced deductions c/f
20X1							
Eleanor	20,000	6,000	12,000	0	26,000	16,000	0
William	30,000	9,000	18,000	0	39,000	24,000	0
Harriet	150,000	15,000	30,000	0	165,000	40,000	0
20X2							
Eleanor	20,000	12,000	24,000	16,000	16,000	16,000	0
William	30,000	18,000	36,000	24,000	24,000	24,000	0
Harriet	150,000	30,000	60,000	40,000	140,000	40,000	0
20X3							
Eleanor	20,000	18,000	36,000	32,000	6,000	6,000	10,000
William	30,000	27,000	54,000	48,000	9,000	9,000	15,000
Harriet	150,000	45,000	90,000	80,000	115,000	40,000	0
20X4							
Eleanor	20,000	24,000	48,000	38,000	6,000	6,000	20,000
William	30,000	36,000	72,000	57,000	9,000	9,000	30,000
Harriet	150,000	60,000	120,000	120,000	90,000	40,000	0
20X5							
Eleanor	20,000	30,000	60,000	44,000	6,000	6,000	30,000
William	30,000	45,000	90,000	66,000	9,000	9,000	45,000
Harriet	150,000	75,000	150,000	160,000	65,000	40,000	0

Any deductions that an owner does not claim in an income year due to the operation of the loss limitation rule are carried forward and may be claimed in future years, subject to the application of the loss limitation rule in those years.

If the company ceases to be an LTC but continues in business as an ordinary company, the owner may use any "restricted deductions" against any future dividends he or she receives from the company.

If the owner ceases to hold shares in the company and so ceases to have an effective look-through interest in the LTC, the "restricted deductions" cannot be used unless the owner later reacquires shares in the same company.

Disposal of look-through interests

Sections FB 1(3), FB 10B, FC 1(2) and HB 4 to HB 10

Disposal of shares is disposal of underlying LTC property

The owners of an LTC are treated as holding LTC property directly, in proportion to their effective look-through interest. When owners sell their shares in the LTC they are treated as disposing of their share in the underlying LTC property, and will bear any tax consequences associated with the disposal.

However, sections HB 5 to HB 10 remove the requirement for the owner selling the shares (the exiting owner) to account for tax on this disposal of underlying property when the tax adjustment that would otherwise be required is below certain thresholds.

When a look-through interest is transferred as part of a settlement of relationship property, and the rules in subpart FB apply, there is no disposal of shares under the LTC rules. Instead, the transferee is treated as having acquired the look-through interests on the date they were acquired by the transferor, and will take on the transferor's cost basis. This only applies in relation to the disposal provisions. For the purposes of allocating an LTC's income or deductions in the year of transfer, the weighted average basis or the accounts method will apply to the transferor and transferee's periods of actual ownership in the year.

Deemed disposal of underlying LTC property

If the company ceases to use the LTC rules, but otherwise continues, the owner is deemed to have disposed of the underlying property at market value on the date of exit. The company is deemed to have immediately reacquired the property at the same market value.

For the purposes of the land provisions in subpart CB, the associated person rule in section CB 15 applies. This means that the "date" on which the company is regarded as acquiring land is the same date on which the "owners"

(via the LTC) acquired the land. The owners are effectively regarded collectively as the transferor, and the company as the transferee.

If an owner ceases to hold interests in the LTC because it permanently ceases to exist as a company, for example, through liquidation or Court order, there is a deemed disposal of the shares, at market value.

An owner's interest may also be reduced by cancellation or repurchase of their shares by the LTC. This is a deemed disposal of the shares for their market value, unless it is part of a pro-rata cancellation applied to all owners, and so does not actually alter each owner's effective look-through interest.

In the case of permanent cessation or share repurchase, any actual consideration received by the owner is ignored and the disposal is deemed to occur at market value.

The disposal threshold provisions in sections HB 5 to HB 10 do not apply in these deemed disposal circumstances.

Disposals thresholds

Sections HB 5 to HB 10 remove the requirement for the owner selling the shares (the "exiting owner") to account for tax on the disposal of underlying property when the tax adjustment that would otherwise be required is below certain thresholds.

When these provisions apply, the new owner (the "entering owner") is treated as acquiring their interests in the LTC's underlying property for the same cost that the exiting owner had acquired them.

The thresholds are:

- $50,000 threshold—

  Exiting owners are required to account for tax on sale of shares only if the amount of the disposal proceeds exceeds the total net tax book value of the owner's share of the LTC property (less any liabilities under generally accepted accounting practice) by more than $50,000. When shares in the same LTC have been sold within a 12-month period, all sales are taken into account for the purposes of the threshold.

- Trading stock—

  Exiting owners do not have to perform a revenue account adjustment for trading stock if the LTC's total annual turnover is $3 million or less.

- Depreciable tangible property—

  Exiting owners do not have to account for depreciation recovery or loss on their share of any depreciable tangible asset if the historical cost of the asset is $200,000 or less.

- Financial arrangements—

  Exiting owners are not required to perform a base price adjustment for their interest in a financial arrangement if:

  - the LTC is not in the business of deriving income from financial arrangements; and
  - the financial arrangement has been entered into as a necessary and incidental purpose of the LTC's business.

  Exiting owners do not have to account for tax on financial arrangements and excepted financial arrangements described in section EW 5(10).

- Short-term sale and purchase agreements—

  When exiting owners dispose of some or all of their look-through interests in a short term sale and purchase agreement, the consideration received is excluded income.

- Livestock—

  If the LTC property consists of livestock that includes female breeding livestock that is valued using the national standard cost scheme (section EC 22) or the cost price method (section EC 25), the entering owner may furnish a return of income choosing to apply section EC 26B. The entering owner is treated as if they had originally purchased and held the livestock, not the exiting owner. This is designed to reduce compliance costs for the LTC.

Working owners

Sections DC 3B, HB 11(6), RD 5(3) and YA 1 of the Income Tax Act 2007; section 14(1) of the KiwiSaver Act 2006

A working owner is an owner who is employed by the LTC under a written contract of employment and who personally and actively performs the duties of their employment for the LTC under that contract. This does not apply if the LTC is wholly or mainly engaged in investing money or in holding or dealing in shares, securities, investments, estates or interests in land.

An LTC's payments to a working owner are included in that owner's salary or wages, and the PAYE rules will apply. When computing their owner's basis, these wages or salaries are excluded from the distributions element of the formula.

An expense deduction is available to all owners of an LTC for wage and salary payments made to working owners.

The rules for automatic enrolment of employees into KiwiSaver do not apply to an owner in receipt of salary or wages only because they are a working owner in an LTC.

Interests in livestock

Section EC 12(4)

For the purposes of making a valuation election for specified livestock, a person's interests in an LTC that owns livestock is treated separately from any other interest that person may have in livestock. Separate elections are needed for each set of livestock, and different valuation methods may be applied to each.

Excepted financial arrangements

Section EW 5(11B)

A look-through interest for an LTC is an excepted financial arrangement.

Associated persons

Section YB 13

The LTC and an owner who is an employee or a director of the LTC are associated.

The LTC and an owner who has effective look-through interests of 25% or more are associated.

The look-through interests of owners associated under sections YB 2 to YB 11 and YB 14 are aggregated. A slightly modified aggregation rule applies for the purposes of land provisions.

Tax administration

Sections 42B, 89C(ka), 89D(1), 89DA, 138B and 141B(8) of the Tax Administration Act 1994

An LTC must file a return of income, ignoring the look-through requirements. The return must specify the amount of income and deductions allocated to each owner.

Only the LTC may propose adjustments to the tax position taken in its return, which the Commissioner may reject by written notice. The LTC may also reject any adjustments proposed by the Commissioner. An owner is entitled to challenge any assessment in relation to their interests in the look-through company by commencing proceedings in a hearing authority only after the disputes process in Part 4A is completed.

The Commissioner may issue an assessment to an owner on their tax position in relation to their look-through interests without issuing a notice of proposed adjustment if the LTC and the Commissioner have completed the disputes process for the return of income and that tax position.

For the purposes of applying shortfall penalties, and for determining a tax shortfall amount, the amounts returned on the tax return of the LTC are treated as if they were the amounts returned by each owner.

Changes to the qualifying company rules

Grandparented qualifying company rules

Sections HA 5, HA 7B

Existing QCs and LAQCs may continue to use the qualifying company rules in subpart HA, without the ability to attribute losses. This will be the default option for all existing QCs and LAQCs for income years starting on or after 1 April 2011.

The definition of an LAQC and the various provisions in subpart HA which provided for an LAQC to attribute losses to its shareholders have been repealed.

The grandparenting rules apply only to companies that are QCs or LAQCs in the income year immediately before the income year starting on or after 1 April 2011; this is called the "grandparenting income year".

Existing QCs and LAQCs include companies already registered with Inland Revenue as QCs or LAQCs, and companies such as newly incorporated companies, for whom the grandparenting income year is the first year for which they are required to submit a return of income, and who send their valid election to Inland Revenue within the timeframe allowed in section HA 30(3).

Transitional rules for existing QCs and LAQCs

Section HZ 4B to section HZ 4D

The transitional rules apply only to companies that are QCs or LAQCs in the income year immediately before the income year starting on or after 1 April 2011. If they are transitioning in the second of the possible "transitional" years they must also have met the QC criteria for the whole of the first possible transitional year.

Transition can take place in either one of the first two income years starting on or after 1 April 2011. The year chosen for transition is called the "transitional year".

The transitional rules are designed to provide a smooth transition for existing QCs and LAQCs to leave the QC rules and start using the LTC rules if they wish to do so.

They also provide an option for existing QCs and LAQCs to transition their business structure into a partnership, limited partnership or sole trader, with no tax cost. This transition will require the setting up of the alternative business structure, and the transfer of assets, liabilities, legal titles and so forth from the QC to the chosen structure. These changes will be completed under the relevant general law. They are not dealt with in the transitional rules, which are concerned solely with tax matters arising from, during or after the transfer.

The transitional rules are deliberately outcome focused. The exact process each QC will need to complete in order to transition will vary according to its existing structures and governance. Any interim measures necessary to transition will generally be ignored for tax purposes, as long as the new business structure is in place by the end of the chosen transitional year.

All of the necessary transfers of assets and liabilities, plus all other legal documentation necessary in the new business structure must be completed by that date. However the tax treatment of the new business structure (that is a partnership or sole tradership) will be applied from the start of the transitional year. This effectively provides a QC or LAQC with up to 12 months to reconstitute its business structure.

Transitioning to the LTC rules

All the shareholders of the existing QC or LAQC must complete the LTC election within six months of the start of the transitional income year. Making the LTC election revokes the previous QC and LAQC elections with effect for, and from the beginning of, that transitional income year.

When an existing company becomes an LTC its owners are usually treated as having an amount of taxable income equal to their proportion of the amount of the company's reserves that would be taxable if the company were to be liquidated and its assets distributed. However, under the transitional provision no income amount will arise, and so no tax will be paid by owners when an existing QC or LAQC transitions to become an LTC.

The carried forward loss balance of a QC, and any controlled foreign company (CFC) or foreign investment fund (FIF) losses carried forward by an LAQC, may be used by the owners of the LTC in future years against their share of net income from that LTC. For CFC or FIF losses carried forward, the normal country ring-fencing rules in subpart IQ will apply too.

The LTC loss limitation rules do not affect an owner's claim to these brought-forward losses.

For the purposes of the LTC loss limitation rules, there are two options for determining an owner's basis:

- the market value or the accounting book value of the amounts used to determine a owner's basis for the loss limitation rules. These values should be taken at the last day of the transitional year; and
- the historic basis, as if the LTC rules had always applied and the LTC had always existed.

If the application of the loss limitation rules calculates an owner's basis at less than zero, the owner's basis is treated as zero.

Transition to a partnership or limited partnership

Existing QCs and LAQCs may transition to become a partnership or a limited partnership during their transitional year under the "QCP transitional process".

This means that during the transitional year, the QC or LAQC must notify Inland Revenue that it intends to become a partnership or limited partnership under the QCP transitional process. Notification should be made within six months of the start of the transitional year. This notification will revoke its QC status from the start of that transitional year.

The partners of the partnership that emerges following the transition should be the same as the shareholders of the QC. One exception to this is a limited partnership, when a company may be used as the general partner with the shareholders of the QC being the limited partners.

Each partner should have the same relative interests in the partnership as in the QC. If several QCs transition into one partnership it is the net position of the partners following transition that should be compared.

Example: Transition into partnership

Mr A and Mr B each own 50% of AB Ltd, an LAQC with net assets of $3,000.

Mr X and Mr Y each own 50% of XY Ltd, a QC with net assets of $12,000.

They form a new limited partnership which has partnership net assets of $15,000. Each individual is a limited partner and Alphabet Ltd is incorporated to become the general partner.

Mr A and Mr B will each hold a 10% partnership share ($1,500 of the partnership's assets).

Mr X and Mr Y will each hold a 40% partnership share ($6,000 of the partnership's assets).

Alphabet Ltd is the general partner, but holds no partnership share.

The carried forward loss balance of a QC, and any CFC or FIF losses carried forward by a LAQC, may be used by the partners of the partnership in future years, against their share of net income from that partnership. In the case of CFC or FIF losses carried forward, the normal country ring-fencing rules in subpart IQ will also apply.

The limited partnership loss limitation rules do not affect a limited partner's claim to these brought-forward losses.

For the purposes of the limited partnership loss limitation rules, there are two options for determining the partners' basis of a limited partnership:

- the market value or the accounting book value of the amounts used to determine a member's basis for the loss limitation rules. The values are taken at the last day of the transitional year; and
- the historic basis, as if the limited partnership rules had always applied and the limited partnership had always existed.

If the application of the loss limitation rules calculates a partner's basis as less than zero, the partner's basis is treated as zero.

Transition to sole trader

Existing QCs and LAQCs with only one natural person shareholder may transition to become a sole tradership during their transitional year under the "QCST transitional process".

This means that during the transitional year, the owner of the QC or LAQC must notify the Commissioner that he or she intends to operate as a sole trader, and transition the business under the QCST transitional process. Notification should be made within six months of the start of the transitional year. This notification will also revoke the company's QC status from the start of that transitional year.

The carried forward loss balance of a QC, and any CFC or FIF losses carried forward by an LAQC, may be used by the sole trader in future years. In the case of CFC or FIF losses carried forward, the normal country ring-fencing rules in subpart IQ will apply.

Tax outcomes of completing the QCP or QCST transitional process

As long as the QCP or QCST transitional process is completed by the end of the chosen transitional year any income and expenses during the transitional year will be treated as arising to the partnership or the sole trader from the start of the transitional year, even if, as a matter of fact, they actually arose during a part of the transitional year when the business was still in a corporate form. For example, a written contract of service for a working partner may be "deemed" to be in place from the start of the transitional year, and the partnership and working partner taxed accordingly, even though in reality that contract will not have been in place until mid-way through the year, after the partnership had been established.

Other adjustments to accommodate tax paid by the QC or LAQC during the early part of a transitional year may also be necessary, and any reallocations or repayments should be discussed with Inland Revenue when the transition has been completed. Partners or sole traders will also need to consider any implications for their own tax position, including the need to complete personal tax returns or make provisional tax payments on their own account.

If the QCP or QCST transitional process is not completed by the end of the transitional year the company will be taxed as an ordinary company for that year, as its QC status will have been revoked. There may also be tax consequences from the parts of the incomplete transition that have already been carried out.

Under the QCP and QCST transitional process there is no tax cost arising from the transfer of assets, liabilities and any relevant rights and obligations from the QC to the partnership or sole trader. The historical tax position of the QC instead transfers to the partnership or sole trader. This means any future adjustments to income or deductions relating to the QC period will be dealt with through the partnership or the sole trader.

The memorandum account balances and other related tax accounts (such as ASC) for a company that was a QC or LAQC before the transition are extinguished. The company effectively becomes a "shell" company, and may be liquidated or removed from the New Zealand Companies Office Register.

WORKING FOR FAMILIES TAX CREDITS: DEFINITION OF "FAMILY SCHEME INCOME"

Sections MB 1, MB 7 to MB 13, YA 1, schedule 38 of the Income Tax Act 2007; sections 31C and 57B of the Tax Administration Act 1994

The definition of "family scheme income" in the Income Tax Act 2007, which is used for determining entitlements to Working for Families (WFF) tax credits, has been broadened. The amendments are intended to improve the fairness and integrity of WFF by, for example, countering arrangements that have the effect of inflating entitlements beyond what people's true economic circumstances justify, and filling in gaps in the definition of "family scheme income".

This broader definition of "family scheme income" will also apply to people with dependent children who apply for the community services card. The Government has also announced that the broader definition will be used in the parental income test for student allowances.

Background

In Budget 2010, the Government announced that the integrity of certain social assistance programmes, namely WFF, student allowances and the community services card, would be improved.

As a first step to addressing integrity concerns around these social assistance programmes, the Government excluded investment losses such as rental losses for the purpose of determining WFF tax credits. This was included in the Taxation (Budget Measures) Act 2010.

The current definition of "family scheme income" is based on "net income" for income tax purposes, with certain adjustments. The legislation broadens the definition of "family scheme income" in the Income Tax Act 2007 to more closely reflect the income available for the family's day-to-day living needs. This ensures the rules support the original intention of targeting assistance to people in genuine need.

Proposals to broaden the definition of family scheme income were set out in an officials' issue paper *Social assistance integrity: defining family income* in August 2010.

The new legislation was added to the Taxation (GST and Remedial Matters) Bill by Supplementary Order Paper No. 187.

Key features

The definition of "family scheme income" in the Income Tax Act 2007 has been amended to include the following additional types of income:

- trust income (including attributed income from trust-controlled companies) that is attributed to a person who is a settlor of the trust;
- fringe benefits that are attributable fringe benefits if received by a company employee who, with their associates, controls the company;
- passive income such as interest and dividends over $500 derived by dependent children;
- income from a portfolio investment entity (PIE) that is not sufficiently locked in until retirement;
- foreign-sourced income of non-resident spouses;
- tax-exempt salary and wages;
- main income equalisation scheme deposits;
- 50% of non-taxable private pensions and annuities; and
- other payments (besides those already included in the definition of family scheme income) used to replace income or to meet a family's living expenses if the total exceeds $5,000 a year per family.

The broader definition of family scheme income applies when determining entitlements for WFF tax credits. This change automatically flows through to people with dependent children who apply for the community services card because the definition of family scheme income also applies for this purpose. The broader definition will also be used in the parental income test for student allowances.

Application dates

The broader definition of "family scheme income" applies for WFF tax credits and community services cards for those with dependent children from 1 April 2011.

For the parental income test for student allowances, an application date will be set separately by Order in Council.

Detailed analysis

"Net income" as defined in the Income Tax Act 2007 is used as the basis for calculating "family scheme income". Family scheme income, which is used to determine entitlements for WFF tax credits, is defined to include a number of adjustments to a person's net income.

Details of the additional types of income that will be included in family scheme income are discussed below.

Trust income (section MB 7)

Trustee income distributed to beneficiaries of the trust tax-free is not included in the taxable income of beneficiaries. Consequently, under the previous rules, the amount of distributed trustee income was not included in family scheme income even though it could have been available to meet a family's living expenses. This had the effect of increasing their WFF tax credit entitlements.

The new rule includes the net income of a trust (less beneficiary income) in a person's family scheme income if they are a settlor of the trust. Beneficiary income received by the person is already included in their family scheme income. The new rule also includes the net income of trust-controlled companies.

Scope of attribution rule

The rule attributes the net income of a trust to a person who is a settlor of the trust.

A person is treated as a settlor if they meet the definition of "settlor" in sections HC 27 and HC 28. This means that the term "settlor" has a wide meaning and is defined broadly as a person who transfers value to a trust. For example, the extended definition of settlor in section HC 28 provides that:

- 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; and
- 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 them (or a nominee) as a beneficiary of the trust, the person is treated as a settlor of that trust.

The definition of settlor, in conjunction with the nominee look-through rule in section YB 21, does not include professional advisors 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 main focus of the definition is on persons who provide the trust property. It is therefore the client of the professional advisor, or the person the friend or family member is acting for, who would be treated as the settlor.

Section MB 7 also excludes persons who provide personal services for free in relation to a trust's administration or the maintenance of the trust's property from the definition of settlor. For example, if a person undertakes general repairs and maintenance work on the trust's assets for free, such as repainting a dwelling owned by the trust, these services will not be treated as a settlement for the purposes of these rules.

If there is more than one settlor for a trust, the trust income is attributed to the settlors of the trust proportionally based on the number of settlors. However, if a settlor arranges for friends or relatives to be settlors to artificially dilute the attribution rule, the original settlor is treated as the sole settlor of the trust. This is a result of the existing settlor definition (including the nominee look-through rule) and the anti-avoidance rule.

The focus of the attribution rule is on closely held situations where integrity concerns can arise. The following trusts have therefore been excluded from the trust income rule:

- charitable trusts that are registered as a charitable entity under the Charities Act 2005;
- trust settlements for the benefit only of local authorities;
- funeral trusts under section CW 45;
- trustees for registered superannuation schemes; and
- trusts where neither the settlor nor any member of the settlor's family can be a beneficiary without a Court order.

Calculation of amount attributed

Under the rule, the amount of trust income included in family scheme income is calculated according to the following formula:

$$\frac{\text{trustee} + \text{company} - \text{dividends}}{\text{settlor number}}$$

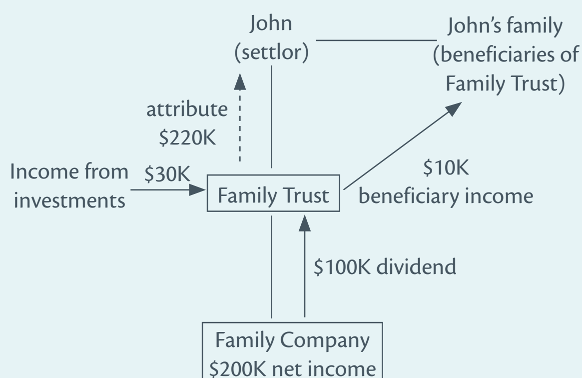
"Trustee" in the formula represents the net income of the trust less income distributed as beneficiary income. This amount cannot be less than zero. This income includes income of a trust earned directly by the trust carrying on a business or receiving investment income such as dividends or interest.

"Company" in the formula represents the net income of a trust-controlled company. A trust-controlled company is defined as a company in which the trustees and their associates hold 50% or more of the voting interests or market value interests (if there is a market value circumstance). The amount of income of the trust-controlled company that is attributed is calculated by multiplying the company's net income for the income year by the trust's voting interests (or market value interests) in the company.

The attribution of a company's net income is restricted to trust-controlled companies only. For example, if a trust is a shareholder in a widely held company, only the dividends from that company are included in trust income.

"Dividends" in the formula represents the total amount of dividends that are derived by the trust from a trust-controlled company. This amount cannot be greater than the net income of the company. Dividends are subtracted in the formula because they are already included as a part of the trust income.

Example: Application of attribution rule to single company



In this example, John is the sole settlor of Family Trust. Family Company is wholly owned by Family Trust. Family Company's net income is $200,000 and it pays an imputed dividend of $100,000 to Family Trust. Family Trust also earns income of $30,000 from investments. Family Trust distributes $10,000 as beneficiary income to John's family.

John's family scheme income for the income year is calculated as follows:

Trustee	$100,000 dividend + $30,000 debt investment income less $10,000 beneficiary income = $120,000
Company	$200,000 net income
Dividend	$100,000

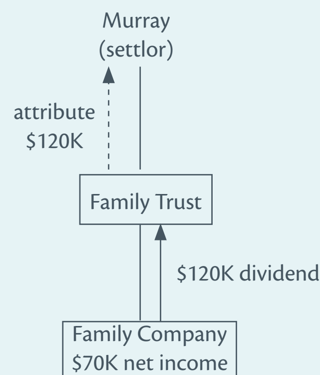
$$\frac{\text{trustee} + \text{company} - \text{dividends}}{\text{settlor number}}$$

$$= \frac{\$120{,}000 + \$200{,}000 - \$100{,}000}{1}$$

Total = $220,000

Therefore, $220,000 is included in John's family scheme income for the income year.

Example: Application of attribution rule when dividend exceeds net income



In this example, Murray is a sole settlor of the Family Trust. Family Company is wholly owned by Family Trust.

Family Company has $70,000 net income and it pays an imputed dividend of $120,000 to Family Trust. Murray's family scheme income for the income year is calculated as follows:

Trustee	$120,000 dividend
Company	$70,000 net income
Dividend	$70,000 (capped)

$$\frac{\text{trustee} + \text{company} - \text{dividends}}{\text{settlor number}}$$

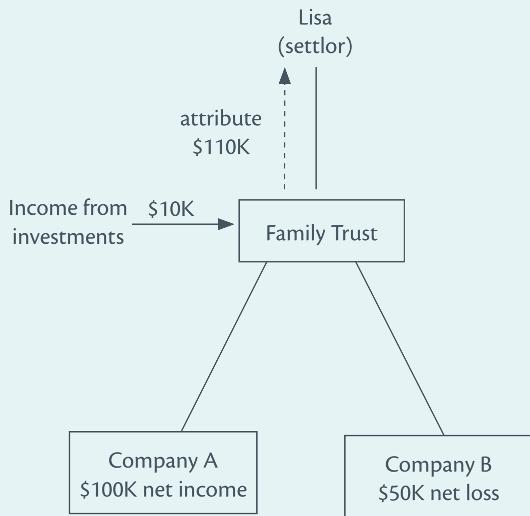
$$= \frac{\$120{,}000 + \$70{,}000 - \$70{,}000}{1}$$

Total = $120,000

Therefore, $120,000 is included in Murray's family scheme income for the income year.

If there is more than one trust-controlled company, the "net income" of each company is calculated separately and then added together. This means that if one of the trust-controlled companies has a "net loss", the amount cannot be offset against the net income of another company (section BC 4(3) provides that if a person has a net loss, their net income for the year is zero).

Example: Application of attribution rule to multiple companies



In this example, Lisa is a sole settlor of the Family Trust. Company A and B are wholly owned by Family Trust.

Company A has $100,000 net income; it pays no dividend to Family Trust. Company B has a $50,000 net loss. Family Trust also earns income of $10,000 from investments. Lisa's family scheme income for the income year is calculated as shown below:

Trustee	$10,000 debt investment income
Company	$100,000 (Company A's net income) + $0 (B's net loss)
Dividend	$0 (Company A) + $0 (Company B)

$$\frac{\text{trustee + company – dividends}}{\text{settlor number}}$$

$$= \frac{\$10{,}000 + \$100{,}000 - 0}{1}$$

Total = $110,000

Therefore, $110,000 is included in Lisa's family scheme income for the income year.

Fringe benefits (section MB 8)

Under the previous rules, fringe benefits were not included in family scheme income because they are taxed to the employer rather than included in the employee's taxable income.

New section MB 8 includes fringe benefits in a person's family scheme income if it is received by a shareholder-employee of a company. A person is treated as a shareholder-employee of a company if they and their associates hold 50% or more of the voting interests or market value interests (if a market value circumstance exists) in the company. The inclusion of interests held by associates means this rule applies to an individual who settles a family trust which owns a company of which the individual is an employee. The reason for limiting this rule to shareholder-employees as defined is because they can influence the nature of fringe benefits they receive as part of their employment.

The rule is also limited to include only attributable fringe benefits in a person's family scheme income. Attributable fringe benefits are significant fringe benefits, many of which are easily substitutable for cash. Such benefits are attributable to individual employees for the purposes of the fringe benefit tax rules. Section RD 47 provides a list of attributable fringe benefits which are:

- motor vehicles;
- low-interest employee loans;
- subsidised transport (when the employer is in the business of transporting the public) above a threshold of $1,000 per annum;
- contributions to sickness, accident or death funds (and funeral trusts) above a threshold of $1,000 per annum;
- payments to insurance schemes above a threshold of $1,000 per annum;
- employer contributions to superannuation schemes as defined in the Income Tax Act 2007 above a threshold of $1,000 per annum (this excludes superannuation schemes registered under the Superannuation Schemes Act 1989 and the KiwiSaver Act 2006); and
- undefined benefits above a threshold of $2,000 per employee per annum.

The rule also provides that the amount of the fringe benefit to be included in a person's family scheme income is equivalent to the gross cash value of the fringe benefit, comprising:

- the taxable value of the fringe benefit that the company must attribute to the person under sections RD 47 to RD 49 for the income year; and
- the company's fringe benefit liability in relation to the person's fringe benefit under section RD 50 (employer's liability for attributed benefits) for the income year.

Example

Chris is an employee of a company controlled by a trust which he settled. Chris is married and has three children under 13 years of age. His partner is not in paid employment. Chris receives a salary of $70,000 and is provided with a motor vehicle (with a cost price of $60,000 including GST) which is available at all times for private use.

Under the previous definition of family scheme income, Chris's situation would have been as follows:

Cash salary	$70,000
WFF income	$70,000
WFF tax credits	$7,427 ($143 per week)

Under the new rule, his situation becomes:

Cash salary	$70,000
Attributed income from fringe benefit (motor vehicle)	$17,909
WFF income	$87,909
WFF tax credits	$3,846 ($74 per week)

From 1 April 2011, Chris's entitlement to WFF tax credits decreases by $3,581 for the year.

Passive income derived by dependent children (section MB 11)

New section MB 11 includes passive income over $500 per child in a person's family scheme income. Parents are able to allocate income directly to their children through family trusts and companies or place their investments directly under their children's names. This income can then be used to meet the family's living expenses.

The rule includes in a person's family scheme income amounts derived by a dependent child which consists of:

- resident passive income (such as interest, dividends, and taxable Māori authority distributions);
- a royalty;
- rent;
- certain beneficiary income;
- attributed income from a portfolio investment entity that is not a superannuation fund or retirement savings scheme; and
- a distribution from a listed portfolio investment entity.

Beneficiary income of dependent children is counted even though the beneficiary income of a person who is under 16 years old is taxed as trustee income. However, beneficiary income that is an amount referred to in section HC 35(4)(b)(i), (ii) and (v) is not counted. These exceptions relate to trusts such as testamentary trusts, or trusts established by a Court order or for child disability.

A minimum threshold of $500 has been introduced to exclude modest amounts of passive income earned by children, and which is unlikely to be put towards the family's living expenses.

Income from unlocked portfolio investment entities (section MB 1(5))

New section MB 1(5) includes income from unlocked portfolio investment entities (PIEs) in a person's family scheme income. Unlocked PIEs include all PIEs other than superannuation schemes that are registered with the Government Actuary, such as KiwiSaver schemes or retirement savings schemes. These schemes are excluded on the basis that the income is sufficiently locked-in until a person's retirement.

The rationale for including unlocked PIE income is because this income can be accessed by investors at any time and is readily available to meet a family's living expenses. Examples of unlocked PIEs include cash PIEs, which are similar to on-call bank accounts, and listed PIEs.

Consequential to this change, sections 31C and 57B of the Tax Administration Act 1994 have been amended to bring forward the notification and return requirement dates for unlocked PIEs by one month from 30 June to 31 May.

Non-residents' foreign-sourced income (section MB 12)

New section MB 12 includes the foreign-sourced income of a person's non-resident spouse, civil union partner, or de facto partner in the person's family scheme income.

Under the previous rules, only the New Zealand-sourced income of a non-resident was included in family scheme income. This is despite the offshore income being available and often used to support the children resident in New Zealand.

This rule means that a non-resident parent's income is included in family scheme income. It is intended to ensure equitable treatment with families where both spouses live in New Zealand where both New Zealand and overseas income is taken into account.

Section MB 1(2) already includes any maintenance payments made by a non-resident parent to the resident parent in family scheme income if the parents are separated.

Exempt income—salary or wages (section MB 1(2)(b) and schedule 38)

Section MB 1(2) has been amended to include an amount of salary or wages that is exempt from income tax under specific international agreements in a person's family

scheme income. Previously, this income was not included in family scheme income as it was exempt from income tax, even though it is available to meet the family's living expenses. An example of these types of income is salaries received by employees of international organisations such as the United Nations or the Organisation for Economic Co-operation and Development.

New schedule 38 lists Acts that exempt salary or wages under specific international agreements. They are:

- the Arbitration (International Investment Disputes) Act 1979;
- the Consular Privileges and Immunities Act 1971;
- the Diplomatic Privileges and Immunities Act 1968;
- the International Finance Agreements Act 1961; and
- the Pitcairn Trials Act 2002.

Salary or wages that are exempt from income tax under these Acts, or under a regulation or Order in Council made under these Acts, are included in a person's family scheme income.

Main income equalisation scheme deposits (sections MB 1(5D) and MB 9)

New section MB 9 includes the amount of deposits to main income equalisation accounts in a person's family scheme income.

The main income equalisation scheme is intended to allow persons carrying on an agricultural, fishing or forestry business to smooth their incomes when there are large fluctuations of income over several years. Currently, section DQ 1 allows a deduction for a deposit made to a main income equalisation account for income tax purposes. Under the previous rules, the reduction in a person's net income resulting from deposits in these schemes could also reduce their family scheme income.

The rule includes deposits to these schemes made on or after 1 April 2011 in a person's family scheme income if the deposit was for a business of:

- the person;
- a company that meets the requirements of section MB 4;
- a trustee of a trust that meets the requirements of section MB 7; or
- a company controlled by a trust referred to above.

Regardless of who makes the deposits to these schemes, the amount of deposit is included in a person's family scheme income.

To prevent double counting, new section MB 1(5D) excludes refunds (excluding interest payable under section EH 6) from main income equalisation accounts (under sections EH 8 to EH 26) from a person's family scheme income.

This amendment does not apply to deposits made to the adverse event income equalisation scheme and the thinning operations income equalisation scheme.

Pensions and annuities (section MB 10)

New section MB 10 includes 50% of distributed non-taxable private pensions and annuities in a person's family scheme income. This would cover a pension from a superannuation fund that is a defined benefit scheme such as the Government Superannuation Fund or an annuity from a New Zealand-resident life insurer. It would not cover a lump-sum payment from a defined contribution scheme, such as KiwiSaver. Only 50% of pensions and annuities is included to reflect that some portion of these payments represents the return of the original capital investment rather than income.

Other payments (section MB 13)

New section MB 13 includes certain other payments that a person may receive (other than those already included or specifically excluded) in a person's family scheme income.

Under the previous rules, section MB 1(6) stated that the Commissioner must have regard to income from all sources known to the Commissioner in calculating family scheme income. There was some uncertainty over what section MB 1(6) actually captured. New section MB 13 clarifies this.

"Other payments" include the value of payments paid or provided to the person from any source and used by the person to:

- meet usual living expenses of the person or the person's family; or
- replace lost or diminished income of the person or the person's family.

What constitutes "usual living expenses" will depend on the particular circumstances of the person or the person's family.

Examples of other payments include:

- distributions of trust income from a trust where the person is not the settlor of the trust;
- regular cash payments from family members to supplement income;
- soft loans which are non-commercial loans with a discounted interest rate and/or lenient options for repayment; they are usually between related parties such as family members or family-controlled entities;

- payments from an income-related insurance policy, other than life insurance, to cover loss of employment income;
- payments received to meet living costs such as rent, servicing a mortgage, food, power and clothing or to pay hire purchase accounts, or insurance payments; or
- payments of expenses by a third person, such as paying utility bills directly.

Any payments with specific purposes other than usual living expense purposes, or any capital payments are excluded. New section MB 13(2) specifically excludes the following types of payments and benefits:

- a loan under ordinary commercial terms and conditions;
- an amount that is proceeds of the disposal of property and not assessable income of the person disposing of the property;
- a payment on behalf of the person by a local authority or public authority;
- a forgiveness of debt by a public authority;
- a charitable distribution from a charitable entity registered under the Charities Act 2005;
- an educational scholarship;
- a student loan under the Student Loan Scheme Act 1992;
- a grant for the payment of expenses relating to medical treatment or a funeral;
- a payment under an insurance contract, other than a payment for a loss of income;
- compensation for a loss other than a loss of income;
- lump sum compensation under the Accident Compensation Act 2001;
- a monetary benefit under the Social Security Act 1964 that is exempt income;
- a pension or allowance under the War Pensions Act 1954 that is exempt income;
- a payment that is exempt income under section CW 33(1)(c), (e), or (f) (allowances and benefits);
- an amount that is declared not to be income for the purposes of the Social Security Act 1964 by a regulation under section 132 of that Act;
- an amount included in the family scheme income of the person under another section; and
- an amount expressly excluded from the family scheme income of the person under another section.

Given there are separate rules including company income in closely held situations in family scheme income, company drawings are not counted under this category.

A threshold of $5,000 year has been introduced to exclude small payments received in a year. If the value of payments exceeds $5,000 for the income year, the whole amount is included in a person's family scheme income.

CLARIFYING THAT CERTAIN BUILDING FIT-OUT IS DEPRECIABLE PROPERTY

Sections DB 65, EE 47(2) and YA 1 of the Income Tax Act 2007

Changes have been made to the Income Tax Act 2007 to clarify that fit-out of commercial and industrial buildings remains depreciable. The changes also clarify the meaning of "plant" and "building" for the purposes of the tax depreciation rules. A transitional rule has been included, allowing certain building owners to claim a deduction for an amount of building fit-out embedded in the tax book value of their building.

A key goal of the tax system, including the depreciation rules, is to tax different forms of investment as neutrally as possible to avoid distorting investment decisions. There are strong grounds, therefore, for depreciation rates to mirror economic depreciation (how assets fall in market value through time) as closely as possible. In this context, a distinction between the tax treatment of residential and non-residential building fit-out is justified on the grounds that building fit-out is likely to constitute a greater portion of the value of non-residential buildings than it is for residential buildings. Generally, non-residential fit-out is also less permanent than residential fit-out because of tenant-specific requirements and changes of use.

The new rules ensure that the fit-out of a non-residential premises remains depreciable property. The fit-out of residential premises remains generally non-depreciable. This is in line with the Commissioner's recently released interpretation statement, IS 10/01 "Residential rental properties – depreciation of items of depreciable property".

The depreciation treatment of fit-out in a building that has both residential and non-residential premises is determined by the dominant purpose of the building. If the dominant purpose of the building is non-residential, items that are shared for both purposes will be depreciable as commercial fit-out. If the dominant purpose of the building is one of providing private residential accommodation, the items of shared fit-out generally will be non-depreciable.

A consequential change has been made to clarify that the change-of-use rules are triggered when the dominant purpose of a building or premises changes between residential and non-residential purposes.

A transitional rule has also been introduced to enable certain building owners to claim a deduction for building fit-out that is embedded in the value of their building and when the building depreciation rate has been set at 0% as a consequence of Budget 2010.

Background

Following changes to the tax treatment of buildings in Budget 2010, it was considered timely for a review of the depreciation rules around fit-outs of commercial and industrial buildings.

The review was intended to bring greater clarity on the distinction between a building and building fit-out in the depreciation rules, given:

- The release of interpretation statement, IS 10/01, "Residential rental properties – depreciation of items of depreciable property", that discusses items that are part of a residential building. While the statement only applies to residential buildings, many of the principles are also likely to apply to commercial and industrial buildings.
- It may be uncertain when taxpayers can choose to apply depreciation rates that differ from the rate that applies to a non-residential building, particularly when in the residential context the Commissioner's view is that many of these items will be part of the building.

Application date

The changes apply from the 2011–12 and later income years.

Detailed analysis

Definition of "building"

The definition of "building", in subpart YA 1, has been amended for the purpose of the tax depreciation rules. The change is intended to ensure that the value of items of commercial fit-out do not form part of the value of a building for the purposes of the tax depreciation rules. The amended definition of building means that a building does not include commercial fit-out for the purposes of subparts EE and EZ.

Definition of "commercial fit-out"

A definition of "commercial fit-out" has been introduced in subpart YA 1. The definition clarifies that plant attached to a commercial building is generally an item of commercial fit-out and therefore can be depreciated separately from the building. An exception is when the item of plant is used inside a dwelling within the commercial building. The intention is for plant to be depreciable unless the item is used in residential premises.

The second limb of the definition of commercial fit-out is intended to exclude items holding up the building or used to weather-proof the building ("building core") from being a commercial fit-out. This makes the building core of certain buildings non-depreciable. For a building with an estimated life of 50 years or more, the non-depreciable building core includes foundations, the building frame, floors, external walls, cladding, windows, external doors, internal stairways, the roof and load-bearing structures associated with the building such as pillars and load-bearing internal walls. Further, under the new definition of commercial fit-out, items attached to the building used within residential premises are not commercial fit-out. However, attached items used in relation to a residential dwelling are commercial fit-out if the building is a commercial building.

Definition of "commercial building"

A definition of "commercial building" has been inserted in section YA 1. The definition is important to the definition of "commercial fit-out". A commercial building is one where the main use is for non-residential premises and any residential premises within the building are of a secondary and minor use. In most instances it will be obvious whether the main use of a building is to provide residential premises. However, if it is not clear what the main use of a building is, taxpayers will need to take a position based on their particular circumstances. One method for determining the building's main use could be to compare the area of the building that is used or set aside exclusively for residential accommodation with the remaining area of the building. In making this assessment, the taxpayer would need to consider how to allocate the shared areas (for example, lobbies, hallways and entranceways that commercial and residential tenants can normally access). If commercial and residential tenants have equal access to shared areas, one approach would be to count the shared areas as appurtenant to the residential accommodation and again as part of the rest of the building. However, in working out the most appropriate apportionment approach the particular circumstances of each building will be important.

The definition of "commercial building" helps to define the boundary for the tax treatment of items of fit-out that are used for both commercial and residential purposes ("shared fit-out"). The dominant purpose of the building determines the tax treatment of items of shared fit-out, as illustrated by the following examples.

Example 1

If the dominant or main purpose of a building is commercial, items of shared fit-out will be depreciable as commercial fit-out. For example, most of the floor area of a building is occupied by commercial tenants but the top floor has a residential apartment. The shared items of fit-out, such as electrical cabling, fire protection equipment, sewerage and water reticulation, and the fit-out of lobbies that are not part of the residential premises are depreciable. However, the fit-out within the apartment is generally not depreciable property, as per the Commissioner's interpretation statement IS10/01.

Example 2

Most of the floor area of a building is used for residential purposes. The remainder is used for commercial purposes. Items of fit-out in the building that are used as a café and residential purposes will be mainly non-depreciable—as in the Commissioner's interpretation statement IS10/01. However, the fit-out of the café within the building will be depreciable as commercial fit-out because it is not used in relation to, and is not part of, a dwelling.

Definition of "plant"

Plant does not include an item that is structural in relation to a building. This definition has been introduced in section YA 1 to clarify that if an item, or part of an item, of plant is integrated into the structure of a building then the item or part of the item will be non-depreciable if the building has an estimated useful life of 50 years or more. Without this definition, it would be possible to argue that parts of a building's structure are also within the meaning of "commercial fit-out", as they are items of plant, and therefore depreciable.

Items holding up the building or used to weather-proof the building are non-depreciable if the building has an estimated useful life of 50 years or more. In certain buildings some of these items may be specially constructed or strengthened to support, for instance, an item of plant. The definition of "plant" ensures for example, that a lift shaft is not treated as being part of the lift, as lifts are depreciable property and have an estimated useful life of 25 years. The definition of plant makes it clear that the estimated useful life of a lift shaft is not 25 years, but is the estimated useful life of the associated building or structure.

Change of use

In the unlikely event that a building changes its dominant use, section EE 47 has been amended to clarify that the normal depreciation change-of-use rules apply to the items of shared fit-out. Thus, if the dominant purpose of a building changes from commercial to residential, the items of shared fit-out will be deemed to have been disposed of at their market value. The reverse applies when the dominant purpose of a building changes from residential to commercial. That is, the items of shared fit-out will be deemed to have been acquired for their market value. In these instances the normal depreciation recovery or loss-on-disposal rules apply to the items of shared fit-out. In this instance the change of use is treated as occurring on the first day of the next income year. Therefore, taxpayers need to have a view on the dominant use of their building throughout the income year.

Definition of "dwelling"

A definition of "dwelling" has been added to section YA 1 to help set the boundary between commercial and residential premises. The first limb of the definition is very broad and means any place used predominantly as a place of residence or abode. However, paragraph (b) of the definition excludes certain premises and types of activities that are more commercial in nature and the fit-out of these premises is more likely to depreciate when used in an income earning process. The new rules recognise that there are commercial buildings that provide residential-type accommodation by excluding a number of these types of buildings from the meaning of "dwelling". This ensures that fit-outs associated with these buildings will continue to be depreciable. The types of buildings that are specifically excluded from the meaning of "dwelling" are:

- hospitals;
- hotels, motels, inns, hostels, or boarding houses;
- certain serviced apartments, where additional services are provided and where the resident does not have quiet enjoyment;
- convalescent homes, nursing homes, or hospices;
- rest homes or retirement villages, except places that are characterised as places of residence for independent living; and
- camping grounds.

Definition of "independent living"

A definition of "independent living" has also been included in section YA 1. In relation to rest homes and retirement villages a distinction has been drawn between serviced apartments and premises that provide residents with independent living arrangements. Fit-out associated with rest homes, hospitals, community centres and serviced apartments will generally continue to be depreciable whereas fit-out associated with premises that provide for independent living will generally be non-depreciable. Serviced apartments are generally distinguishable from premises providing for independent living because the occupancy arrangements typically require the resident to purchase a bundle of care services (such as medical supplies, nursing care, meals, cleaning, provision of linen and laundry) in addition to a right of occupancy in order to be entitled to occupy the premises. In this situation, the fit-out of the serviced apartment will continue to be depreciable property. However, if the only compulsory services supplied to the resident are merely incidental to the occupancy (such as gardening, maintenance, management and security services) the fit-out of the serviced apartment will not be depreciable.

Transitional rule

A transitional rule, new section DB 65, allows a deduction for building fit-out that is embedded in the tax book value of certain buildings. The transitional rule applies to building owners that acquired a commercial building in the 2010–11 or earlier income years and who have not itemised the items of commercial building fit-out, acquired at the same time as the building, separately from the building in their tax asset register. Any subsequent commercial fit-out acquired and separately depreciated after the date that the building was acquired reduces the amount of the deduction allowed under section DB 65.

The amount of the deduction is the lesser of 2% of the starting pool value or the residual value of the pool—taking into account all previous deductions taken under this provision. The opening value of the pool is 15% of the building's adjusted tax book at the end of the 2010–11 income year less the adjusted tax book value, at the end of the 2010–11 income year, of any fit-out associated with the building that has been separately depreciated for income tax purposes.

Example

Company ABC acquired a warehouse on 1 April 1999 for $1 million. Items of commercial fit-out within the building were not separately identified and depreciated at the time the building was acquired. Twelve months later a refurbishment of the warehouse was completed. The refurbishment was itemised and depreciation was applied to the various items of commercial fit-out.

At the end of the 2010–11 income year the adjusted tax book value of the warehouse is $640,000 and the adjusted tax book value of the associated commercial fit-out is $64,000.

The starting pool value is:

(15% × 640,000) – 64,000 = $32,000

The annual deduction, assuming that the building is held for the 2011–12 income year is:

$32,000 × 2% × 12/12 = $640

To reduce complexity and compliance costs there are no loss or recovery rules applying to the value of the pool when the relevant building or fit-out is disposed of. In the above example, the taxpayer is entitled to a deduction of up to $640 a year provided they own the commercial building. However, if the dominant purpose of a building changes from commercial to residential, no deduction is allowed under section DB 65, as subsection (1)(a) no longer applies to the building. However, the deductions would begin again if the building subsequently reverts to being a commercial building—provided the building ownership has been maintained.

DEPRECIATION LOADING GRANDPARENTING

Sections EE 31 and EE 37 of the Income Tax Act 2007

Depreciation loading was removed on a prospective basis as part of Budget 2010. The policy intention was that an item for which there was a commitment for its purchase or construction in place on or before 20 May 2010 would continue to be eligible for loading. However, while the legislation that gave effect to this grandparenting worked in most situations, its result could be unclear or inconsistent with the policy intention in other instances.

Accordingly, the grandparenting provision has been amended to clarify the rule and ensure it works as intended.

Key features

- An item of depreciable property is eligible for loading if its owner either acquired it or was committed to its purchase or construction on or before 20 May 2010 (Budget day).
- For the purpose of the rule, "commitment" can be demonstrated by an item's owner either having entered into a binding contract for it or alternatively, after deciding to purchase the item, the owner incurred some expense in relation to it.

Detailed analysis

New rule for depreciation loading grandparenting

Section EE 31 has been amended to clarify when depreciation loading should be grandparented. Under the amended rule, there are two circumstances in which an item of depreciable property continues to be eligible for depreciation loading after 20 May 2010.

The first circumstance is when the item was acquired on or before 20 May 2010. The second is when the item's owner had decided to purchase or construct the item and, on or before 20 May 2010, either entered into a binding contract for it or incurred expenditure in relation to it after making the decision to acquire it.

One example of the second circumstance is when a person began building an item themselves before 20 May 2010 but had not finished it as at 20 May. Another example is when a person who was in the process of acquiring an asset comprising multiple components, but had only entered into contracts to purchase some of those components as at 20 May. In both cases the finished asset is eligible for depreciation loading.

It is important to note that the amended grandparenting rule only confers potential eligibility for depreciation loading. The item must still meet the other relevant criteria, for example, it cannot be a building or an imported second-hand car and cannot have been used previously in New Zealand.

Meaning of "in relation to"

An item may be eligible for depreciation loading if expenditure is incurred "in relation to" that item, and certain other criteria are met. Expenditure should be "in relation to" an item if the expenditure is on:

- the item itself (for example, if it is under construction);
- services relating directly to the item, such as having a contract for purchase drawn up;
- component pieces of the item (the item is a single depreciable asset that is made up of multiple components); or
- another item, if that item has a reasonable connection with the item in question. An item has a reasonable connection with another item if it would not function effectively or work as intended without the other item. For example, a piece of machinery and a shed designed to house it would have a reasonable connection with each other.

It is not necessarily the case when a decision is made to acquire multiple items as part of the same decision-making process that all of those items will have a reasonable connection with each other. While this suggests that there may be such a connection, it is not sufficient.

The requirement for a decision to purchase or build the item in question must also be met. If no decision had been made, the asset itself is not eligible for loading.

Administrative requirements

The Act introduces new subsection EE 31(4), which must be met for the amended grandparenting rule to apply. This requires a person to have either documenting evidence that they had, on or before 20 May 2010, decided to purchase or construct an item, or they must send to the Commissioner of Inland Revenue a statutory declaration that states the same.

In some situations, a project may have been approved involving multiple items but there may not be evidence for specific items. For the administrative requirement to be satisfied for the item, it must be clear that the item was contemplated as part of the project approved on or before 20 May 2010.

Whether a set of documents provides sufficient evidence that a person had decided to purchase or construct an item

on or before 20 May is a question of fact and circumstance. However, generally the documents would need to show that the business's standard purchasing process had been followed for the type of acquisition being made and approved in accordance with delegated authority levels. For example, if a purchase would usually only require a purchase order signed by the relevant manager, that would be sufficient evidence. If more detailed documentation was usually required, this would be needed to satisfy the administrative requirements.

If a person does not have the necessary documented evidence, the administrative requirements can be satisfied by providing to the Commissioner a statutory declaration that states the date when the person decided to acquire the item. This should cover smaller businesses that may not have formal purchasing processes that involve creating various documents.

These requirements are necessary but not sufficient conditions for an item to be eligible for depreciation loading. Regardless of whether they are met, the Commissioner can challenge whether a person had in fact decided on or before 20 May 2010 to purchase or construct at item.

Treatment of improvements

The Act makes a consequential amendment to section EE 37(3) to reflect the new grandparenting rule. This section provides that, if a person makes an improvement to an asset to which loading still applies, that improvement (being treated as a separate item) is eligible for loading if it meets the criteria of the amended grandparenting rule. If it does not meet the requirements, the improvement will not qualify for loading.

Example 1

In 2007 Electric Co embarked on a large-scale project to build a new hydro-electric dam which was due to be completed in January 2011. The project involves the construction and purchasing of many different components that, once complete, will form a single item of depreciable property (the dam). As at 20 May 2010, $60 million in costs had been incurred out of a total budget of $75 million but contracts had not yet been entered into for all of the remaining work.

In this case, the dam is eligible for depreciation loading. While as at 20 May 2010 Electric Co had not entered into contracts for all of the remaining work, it is clear that there was a firm decision to build the dam and that Electric Co had incurred expenditure in relation to it.

Example 2

Widget Co uses highly specialised production lines to produce its widgets. They build the construction lines themselves as they cannot be sourced externally. On 15 February 2010, Widget Co's board decided that a new production line should be made. Work started on the new line on 25 February and was expected to finish mid-July. As the line was being built internally no contracts were entered into for its construction.

As at 20 May 2010 the line was not complete and Widget Co's staff continued to work on it and purchase additional supplies as required.

The production line is eligible for depreciation loading in this situation. It is clear that Widget Co had decided on or before 20 May that it would build that production line and that expenditure had been incurred on producing the line. The board minutes should satisfy the administrative requirements and the invoices for the various components would be evidence that expenditure had been incurred on or before 20 May 2010.

Example 3

In 2008 Company A embarked on a project to completely redesign and build its computer systems. The project was split into four work streams; the first three were non-discretionary while the fourth depended on the outcome of the other three. Accordingly, Company A's board decided in 2008 that the first three streams would continue and that a decision would be made regarding the fourth in mid-2010.

Work began immediately on the first three streams. On 1 July 2010, Company A's board met and confirmed that the fourth work stream would proceed.

In this situation depreciation loading would apply to the first three work streams but not to the fourth. This is because Company A did not decide that the fourth stream would proceed until after 20 May 2010.

On the other hand, if the board had decided to proceed with the fourth stream on or before 20 May 2010 but work did not begin until after 20 May, it may be eligible for loading. This would depend on how closely related the streams are. For example, if they all relate to the same software package it is likely the expenditure on the first three streams would be "in relation to" the fourth stream and it would be eligible for loading. However, if they were for completely different software packages then it is unlikely that the expenditure on one stream would be "in relation to" another.

Example 4

When Company A's board originally decided to upgrade its computer systems, it was informed that the new software would not run on the company's current servers. The board therefore decided to upgrade its servers and allocated funds in the project's budget for this to occur, but due to the long timeframes for the software's development, contracts for the servers were not entered into until after 20 May 2010.

The servers would be eligible for depreciation loading in this situation because the expenditure on the software is in relation to the hardware. The software would not operate effectively without the server upgrade and the decision to upgrade was made on or before 20 May 2010.

Application date

The amendments apply from 20 May 2010.

REMEDIAL ITEMS

KIWISAVER

REFINEMENTS TO SCHEME WINDUP PROVISIONS

Sections 50(4), 51, 57, 59 and 173 of the KiwiSaver Act 2006

Changes have been made to the KiwiSaver Act 2006 to refine the scheme windup provisions.

The amendments clarify the date on which a member will be allocated to a new scheme, require scheme providers to supply a tax file number for transferring members, and stop the reissuing of KiwiSaver introductory information packs to existing members.

Background

If a KiwiSaver scheme provider winds up its operation and the scheme ceases to exist, Inland Revenue manages the transfer of members to a new scheme.

Under the previous rules, Inland Revenue was required to reallocate a member to a new default scheme on the day it received notice of their current scheme's windup. The member was provisionally allocated to a new scheme for three months before final allocation. The intention was to ensure that members were transferred smoothly to a new scheme upon closure of their current scheme. However in practice the process meant that members could be transferred too early, if the actual date of windup was more than three months after the date the Commissioner received notification of the windup. The early transfers impinged on trustees' completion of their fiduciary obligations under their scheme trust deeds.

In addition the requirement for Inland Revenue to make a default reallocation applied even when the trustees of the winding-up scheme had members' approval to transfer them to a chosen scheme upon windup. The default allocation was unnecessary in these situations, as the member had already chosen to join a particular scheme.

Key features

Sections 50(4), 51(1) and 57 (1) of the KiwiSaver Act have been amended to allow a winding-up scheme to retain its members and their contributions until its date of closure. There is no longer a requirement to have a three-month provisional period. Instead, a final allocation will occur, to either a default scheme or the member's chosen scheme(s) on the later of the date on which:

- notification of windup is received by the Commissioner; or
- the scheme's winding up takes effect.

To ensure correct identification of members throughout the transfer process, section 173 (1)(b) of the KiwiSaver Act has been amended to require schemes that are winding up to supply members' tax file numbers to Inland Revenue.

Finally, a minor amendment to section 59(a) of the KiwiSaver Act removes the obligation on Inland Revenue to issue an introductory KiwiSaver information pack to existing members who are being transferred to a new scheme following a winding up of their old scheme. Instead Inland Revenue will continue to send a tailored letter to affected members advising them of the windup and any required actions.

Application date

The new rules apply from 21 December 2010.

SHARING OF INFORMATION ABOUT KIWISAVER MEMBERS

Section 220B of the KiwiSaver Act 2006 and section 81(4)(t) of the Income Tax Act 2007

Changes have been made to allow information to be shared between Inland Revenue and the member's KiwiSaver provider. This will improve the accuracy of information held, particularly when a member's personal details, such as an address change.

Background

If a member updates their contact information they should tell both their scheme provider and Inland Revenue. Often members do not realise they have to tell both, or assume that telling one is sufficient.

Key features

Section 220B allows key data about a KiwiSaver member's address, date of birth, and tax file number to be shared by Inland Revenue and the member's scheme provider on an ongoing basis.

This will improve the accuracy of contact details held by Inland Revenue and scheme providers, and so better facilitate communication of vital KiwiSaver information, such as investment statements, annual reports and contribution holiday letters.

Application date

The new rules apply from 21 December 2010.

TRANSFER FROM COMPLYING SUPERANNUATION FUND TO KIWISAVER SCHEME

Section 226 of the KiwiSaver Act 2006

A change has been made to the KiwiSaver Act to clarify that a person who is over the New Zealand Superannuation age and who transfers from a complying superannuation fund to a KiwiSaver scheme will not receive the initial Crown contribution. This $1,000 kick-start contribution is designed to encourage new savers to KiwiSaver and is inappropriate for those who are transferring from another scheme.

Background

A person aged over the New Zealand superannuation age cannot join KiwiSaver under the automatic enrolment rules, or by direct contract.

However existing members of a complying superannuation fund may transfer to a KiwiSaver scheme, either by choice or as a result of an involuntarily transfer if their existing fund ceases, even if they are over the New Zealand superannuation age.

Key features

Section 226 of the KiwiSaver Act 2006 has been amended to clarify that when a person over the New Zealand superannuation age transfers from a complying superannuation fund into KiwiSaver for the first time they are not entitled to the kick-start Crown contribution upon transfer.

Application date

The new rules apply from 21 December 2010.

LEASEHOLD ESTATE FOR FIRST HOME WITHDRAWAL

Clause 8, schedule 1 of the KiwiSaver Act 2006

Changes have been made to correct an inadvertent alteration to the KiwiSaver first home facility.

Background

The Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 altered the eligibility criteria for the KiwiSaver first home withdrawal provision, by removing "leasehold estate" from the definition of the word "estate" in clause 8(6), schedule 1 of the KiwiSaver Act 2006.

As explained in the November 2010 issue of the Tax Information Bulletin, the change was intended to allow a KiwiSaver member who had previously been party to a leasehold residential tenancy to meet the eligibility criteria for the first home withdrawal facility. However the amendment as drafted precludes a member who is purchasing a leasehold estate from accessing the first home withdrawal facility; this effect was not intended.

Key features

Clause 8, schedule 1 of the KiwiSaver Act 2006 has been further amended to ensure that a member who is purchasing a leasehold estate may access the KiwiSaver first home withdrawal facility.

Application date

The new rules apply from 1 July 2010, being the date of enactment of the previous amendment.

OVERSEAS DONEE STATUS

Schedule 32 of the Income Tax Act 2007

The following organisations have been granted overseas donee status from the 2011–12 tax year:

- The Branch Foundation
- The Mutima Charitable Trust
- The Bougainville Library Trust.

Schedule 32 has also been amended to reflect the name change of the Volunteer Service Abroad (Incorporated) to Te Tuao Tawahi: Volunteer Service Abroad Incorporated.

Background

Charities that apply some or all of their funds outside New Zealand must be approved for charitable donee status by Parliament. These organisations are listed in schedule 32 of the Income Tax Act 2007.

Donations to listed organisations entitle individual taxpayers to a tax credit of $33^{1}/_{3}$% of the amount donated up to the level of their taxable income, and companies and Māori authorities to a deduction for donations up to the level of their net income.

Application date

The Branch Foundation has been granted donee status from the 2011–12 and later tax years.

The Mutima Charitable Trust has been granted donee status from the 2011–12 tax year until the end of the 2016–17 tax year.

The Bougainville Library Trust has been granted donee status from the 2011–12 tax year until the end of the 2018–19 tax year.

The amendment relating to Te Tuao Tawahi: Volunteer Service Abroad Incorporated applies from 21 December 2010.

CAP ON SHORTFALL PENALTIES

Section 141JAA of the Tax Administration Act 1994

Section 141JAA of the Tax Administration Act 1994, which caps some shortfall penalties, has been clarified so it does not apply if the taxpayer makes a disclosure at the time the tax position is taken (that is, a disclosure under section 141H of the Tax Administration Act 1994).

Background

Shortfall penalties can be reduced for different reasons. Under section 141G of the Tax Administration Act 1994 a shortfall penalty is reduced by between 40% and 100% if it is voluntarily disclosed before the beginning of an audit. Under section 141H of the Tax Administration Act 1994 a shortfall penalty for an unacceptable tax position or an abusive tax position is reduced by 75% if the taxpayer makes adequate disclosure of their tax position at the time they take their tax position.

Under section 141JAA of the Tax Administration Act 1994 a shortfall penalty for not taking reasonable care or for taking an unacceptable tax position can be limited to $50,000 if the taxpayer voluntarily discloses their tax position or the Commissioner determines the shortfall, no later than the date that is the later of:

a) the date that is 3 months after the due date of the return to which the shortfall relates; and

b) the date that follows the due date of the return to which the shortfall relates by the lesser of—

 (i) 1 return period; and

 (ii) 6 months.

It was not clear under the previous rules that the limit in section 141JAA was intended to apply only to voluntary disclosures under section 141G and not to disclosures made under section 141H. It was never intended that section 141JAA apply to disclosures made at the time the tax position is taken (under section 141H), because if it applied to these disclosures taxpayers could take tax positions that did not meet the standard of being "about as likely as not to be correct" knowing the maximum penalty they would face would be a penalty of $50,000.

Application date

The amendment applies from 21 December 2010.

JOINT BANK ACCOUNTS

Section 157 of the Tax Administration Act 1994, section 43 of the Goods and Services Tax Act 1985 and section 12L of the Gaming Duties Act 1971

The provisions in some Inland Revenue Acts which allow deductions of tax from amounts payable to a defaulting taxpayer have been amended to allow the Commissioner of Inland Revenue to require a bank to deduct and pay to Inland Revenue funds from joint bank accounts. The amendments allow deductions from a joint bank account if the defaulting taxpayer can make withdrawals from that account without the signature or other authorisation of the other person. The changes ensure consistency of treatment for deductions from joint bank accounts.

Background

When a taxpayer fails to pay any tax, interest or civil penalty the Commissioner may issue a written notice to any third party, for example, a bank, requiring the third party to deduct and pay to the Commissioner funds from any amounts payable to the defaulting taxpayer. The deductions may be in the form of a lump sum or instalments.

Before the amendment, section 157 of the Tax Administration Act 1994 did not refer to joint bank accounts. The courts had held that the Commissioner could not issue a deduction notice to obtain funds from a joint account for an income tax debt owed by one of the joint bank account holders, because there was no authority to do so under section 157.[1] The High Court noted that the Social Security Act 1964 and the Child Support Act 1991 both contain deduction provisions that expressly refer to money held in joint bank accounts, whereas the Tax Administration Act 1994 did not. This raised an inference that a tax deduction provision like section 157 needed to contain an express reference to joint bank accounts for it to apply to such accounts.

The Child Support Act 1991 allows the Commissioner to require deductions from money payable to a liable parent to meet a child support debt. This deduction power extends to money held in joint bank accounts in the name of the liable parent and one or more other persons when the liable parent can draw from that account without the signature of the other person.

Key features

Section 157 of the Tax Administration Act 1994, section 43 of the Goods and Services Tax Act 1985 and section 12L of the Gaming Duties Act 1971 have been amended to allow the Commissioner to require a bank to deduct and pay to Inland Revenue funds from a joint bank account if the defaulting taxpayer can make withdrawals from that account without the signature or other authorisation of the other person.

The amendments do not apply to the joint bank account of a partnership that files a return of income under section 33(1) of the Tax Administration Act 1994.

Application date

The amendments apply from 21 December 2010.

[1] *ANZ Banking Group (New Zealand) Limited v CIR* (1998) 18 NZTC 13,643

INDEPENDENT EARNER TAX CREDIT AND RESIDUAL INCOME TAX

Section YA 1 of the Income Tax Act 2007

An amendment has been made to add the independent earner tax credit (IETC) to the list of tax credits under the definition of "residual income tax" in section YA 1 of the Income Tax Act 2007.

Background

Under the tax rules, a person's provisional tax liability is calculated by reference to their residual income tax (RIT). This is essentially the person's income tax liability less certain specified tax credits (generally based on the previous year). However, the IETC was not included within the legislative definition of RIT as one of the credits that reduces a person's income tax liability, at the time that it was introduced in 2009.

The IETC is aimed at individuals who are New Zealand residents and who do not receive an income-tested benefit, New Zealand superannuation or Working for Families assistance. For employees who qualify for the IETC, it effectively reduces the amount of PAYE deduction from their salary or wages. Self-employed, other non-salary and wage earners and salary or wage earners who do not use an ME tax code who qualify are able to claim the IETC at the end of the year by filing a tax return or requesting a personal tax summary from Inland Revenue. The IETC is available for people with net incomes of $24,000 or over per year, with the IETC abating once the $44,000 per year net income mark is reached. The IETC is fully abated away once a person's income reaches $48,000 per year. The maximum yearly amount of the credit is $520.

Key features

The IETC has been added to the list of tax credits under the definition of "residual income tax" in section YA 1 of the Income Tax Act 2007. The change ensures that the legislation reflects the original policy intent that the IETC should be one of the tax credits which reduces a person's income tax liability for the purposes of determining RIT under the provisional tax rules.

Application date

The amendment applies from 1 April 2009, being the date the IETC was introduced.

AMENDMENTS TO THE GST TRANSITIONAL RULES

Sections 78(3) and 78AA of the Goods and Services Tax Act 1985 and section 139B of the Tax Administration Act 1994

Minor amendments have been made to the transitional rules in the Goods and Services Tax Act 1985 and the Tax Administration Act 1994 to accommodate the GST rate change that became effective from 1 October 2010.

Background

As part of changes to the tax system announced by the Government in Budget 2010, the rate of GST increased from 12.5% to 15% from 1 October 2010. To help businesses transition to the new rate, further changes to the Goods and Services Tax Act 1985 (GST Act) and the Tax Administration Act 1994 were introduced in the Budget night legislation, and as part of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 to supplement the transitional rules already provided in the GST Act.

Key features

Effect of the rate increase on prescribed fees and charges

Section 78(3) of the GST Act allows prescribed government fees and charges to automatically increase to cover the additional increase to the tax. This removes the legal and administrative costs of government agencies having to amend the relevant Acts and regulations to accommodate changes to the GST rate. The section contains a proviso to ensure that government benefits are not automatically adjusted to reflect changes to the rate. As previously drafted, this proviso had the effect of possibly exempting public authorities from paying the automatic increase in GST on a government fee or charge unless the prescribed Act or regulation (which set the fee or charge) was specifically amended to reflect the new GST rate. The proviso was not intended to have this effect and therefore has been amended to ensure that public authorities, required to pay a fee or charge set under an Act or regulation, are not exempt from paying the increase in GST.

Corrections to legislative provisions

Two drafting omissions in the transitional provisions, enacted as part of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010, have been corrected. Section 78AA(5) has been amended to correct an error in the description of the supplies to which the finance lease provisions apply. Section 78AA(12) has also been amended to insert a missing cross-reference.

The notification requirement in the finance lease transitional rules (section 78AA(4)(g)) has not been changed to align with the change made to section 78AA(5). A change to this section was considered undesirable, given the 30-day notification period had elapsed and the finance lease rules operate prospectively in respect of the 1 October 2010 rate change. Such a change could have had the effect of invalidating notices that had already been issued.

Reinstatement of late payment grace period

Section 139B of the Tax Administration Act was amended by the Taxation (Budget Measures) Act 2010 to enable a taxpayer's late payment grace period to be reinstated if the cause of the late payment was due to the GST rate change. The Budget night amendments, however, had the effect of only allowing reinstatement if penalties were remitted. Section 139B has, therefore, been further amended to ensure that remissions of interest attributable to the rate change can also be taken into account when reinstating a taxpayer's late payment grace period.

Application dates

The amendments to sections 78(3) of the GST Act and 139B of the Tax Administration Act apply from 1 October 2010, the date of the GST rate change.

The amendments to section 78AA of the GST Act apply from 7 September 2010, the date those transitional rules were enacted.

NON-RESIDENT SEASONAL WORKERS

Section YA 1, and schedule 2, part A, clause 8 of the Income Tax Act 2007; section 33A of the Tax Administration Act 1994

As a result of recent changes to personal tax rates, the tax rate that applies to non-resident seasonal workers has been reduced from 15% to 10.5%. In addition, a number of changes have been made to the tax legislation to clarify that non-resident seasonal workers are not required to file a tax return at the end of the year but may do so if they choose to. The measures were introduced by Supplementary Order Paper No. 187 during the passage of the Taxation (GST and Remedial Matters) Bill.

Background

The Recognised Seasonal Employer (RSE) scheme was introduced in April 2007. The RSE scheme allows for the temporary entry of overseas workers to work in the horticulture and viticulture industries in New Zealand. The tax legislation was amended in 2009 and now defines a worker under the RSE scheme to be a "non-resident seasonal worker". The rate of tax that previously applied to non-resident seasonal workers that elected the NSW (non-resident seasonal worker) tax code was a flat rate of 15%. The need to review the rate of tax arose as a result of the recent changes to the personal tax rates, particularly from Budget 2010.

Key features

The changes that have been made to the tax rules for workers under the RSE scheme are:

- a change to the flat rate of withholding tax that applies to workers under the RSE scheme;
- changes to correct the current filing requirements for workers under the RSE scheme; and
- a change to the commencement date of the definition of "non-resident seasonal worker".

Detailed analysis

Change of rate

After analysing data from the relevant industry a policy decision has been made for the rate of tax that applies to non-resident seasonal workers that elect the NSW tax code to be reduced from 15% to 10.5%.

From 1 October 2010, the personal tax rate for workers earning up to $14,000 per annum was reduced to 10.5%. The large majority of non-resident seasonal workers have an annual New Zealand income of less than $14,000, therefore a withholding rate of 10.5% is appropriate. It would be more accurate for the new rate to apply from 1 October 2010 (the date that the personal tax rates changed) however, due to compliance costs and the small numbers of workers and wages involved, it was decided that the best date for the new rate to apply from would be 1 April 2011.

Filing requirements

There has been no change in policy regarding the filing requirements for non-resident seasonal workers. These workers may still file a return at the end of the year but are not required to. Changes have been made to section 33A of the Tax Administration Act 1994 to clarify this policy intent.

As the rate that applies to non-resident seasonal workers is now equal to the lowest personal tax rate, from the 2011–12 tax year there will no longer be any benefit to the workers in filing a tax return. That is, due to them having tax withheld at the lowest rate, it will no longer be possible for them to have tax over-withheld during the year. It should be noted that workers may face a tax liability if they choose to file a tax return at the end of the year and have annual New Zealand income of more than $14,001.

"Non-resident seasonal worker" definition

The commencement date of the definition of non-resident seasonal worker has been changed from 6 October 2009 to 1 April 2008. This change ensures the definition is in force at the earliest date the tax provisions applying to non-resident seasonal workers and the RSE scheme apply from.

Application dates

There are various application dates for the above changes. The new 10.5% rate of tax will apply from 1 April 2011. The changes correcting the filing requirements apply from the date that they were originally intended to apply from.

FBT "ON PREMISES" EXEMPTION

Section CX 23 of the Income Tax Act 2007

The amendment clarifies the scope of the exemption from fringe benefit tax (FBT) for benefits that are provided on the premises of the employer, contained in section CX 23 of the Income Tax Act 2007.

Background

The wording used in the rewritten Income Tax Acts 2004 and 2007 for the FBT "on premises" exemption has been interpreted by some taxpayers as being broader than the wording used in the Income Tax Act 1994. There was no intention to widen the exemption beyond its original scope, as set out in the 1994 Act, which provided that benefits were exempt when they were "enjoyed" on an employer's premises.

The ambiguity arose through the use of the words "received or used" in the rewritten Acts. A 2006 amendment, unrelated to those particular words, meant that the wording of the exemption was no longer covered by the savings provision of the 2004 and 2007 Income Tax Acts (which effectively requires the rewritten Acts to be interpreted in the same way as the previous Act unless a deliberate policy shift has been indicated). Some taxpayers had used the enactment of this subsequent amendment to argue that the scope of the exemption had been deliberately widened.

The new amendment corrects any ambiguity by substituting the words "used or consumed" for "received or used" in section CX 23. It is considered that "used or consumed" more closely reflects the concept of "enjoyment" in the original exemption.

Key features

Under the new rules, fringe benefits (other than free, discounted or subsidised travel, accommodation or clothing) provided by an employer or company in the same group as the employer will not be subject to FBT if the benefit is "used or consumed" by the employee on the premises of the employer or relevant group company. This replaces the previous test which required the benefit to be "received or used" on the premises.

Application date

The change applies from 5 August 2010, being the date that the Taxation (GST and Remedial Matters) Bill was introduced to Parliament. This application date allows existing disputes with taxpayers to continue, but prevents other taxpayers taking advantage of any ambiguity for the period between the date of introduction of the bill and its enactment on 20 December 2010.

SECTION DB 2 – REVERSE CHARGE RULES

Section DB 2 of the Income Tax Act 2007

Generally, expenditure incurred in deriving assessable income is available as a deduction. Sometimes GST paid can be a real cost to business, even if they are GST-registered. The amendment clarifies that irrecoverable output tax incurred on reverse charge supplies since the introduction of the reverse charge rules is able to be deducted for income tax purposes.

Key features

Section DB 2 of the Income Tax Act 2007 (and equivalent provisions in the Income Tax Acts 2004 and 1994) has been amended to ensure that GST output tax on services that are subject to the reverse charge rules for imported services is available as a deduction for income tax purposes, provided the underlying services were also deductible.

Background

Currently, section DB 2(1) of the Income Tax Act denies an income tax deduction for both input tax and GST paid by the taxpayer to the Commissioner. Although this provision generally produces the desired result, it does not work when a GST-registered person is deemed to supply goods or services to themselves. Until recently, the only example of this enforced "self-supply" was the change-in-use adjustments made when a taxpayer who acquired goods or services for the principal purpose of making taxable supplies uses the goods or service for non-taxable purposes. To recognise that the output tax on these supplies is a real cost to the taxpayer (that is, it cannot be offset by input tax), section DB 2(2) of the Income Tax Act specifically allows it as a deduction.

Since 1 January 2005, when certain services are imported into New Zealand, the GST Act requires the New Zealand resident to treat itself as the supplier of those services (as well as being the recipient) and account for GST accordingly. This is another example of "self-supply" and is conceptually identical to the change-in-use adjustments. However, unlike the change-in-use rules, there is no specific provision in the Income Tax Act to allow any irrecoverable output tax incurred on the self-supply to be allowed as an income tax deduction. As a result, arguably, the general rule in section DB 2(1) applies and the taxpayer is denied a deduction, despite the fact that the expenditure is "real" in an economic sense. This anomaly potentially creates a discrepancy in income tax treatment between services that are sourced in New Zealand (and therefore not subject to the reverse charge) and those that are sourced offshore.

The amendment clarifies that irrecoverable output tax incurred on reverse charge supplies since the introduction of those rules is able to be deducted for income tax purposes.

Application date

The change applies from 1 January 2005, the date the reverse charge rules were introduced. This provides certainty going forward and provides taxpayers with comfort that Inland Revenue will not adopt a strict interpretation of section DB 2 for the intervening periods.

SECTION 17 – SPECIAL RETURNS

Section 17(1B) of the Goods and Services Tax Act 1985

The amendment clarifies the due date for payment of tax when a special return is filed and corrects an ambiguity that arose from a previous change made in 2007.

Key features

Section 17(1B) of the GST Act has been amended to clarify that the due date for the payment of tax when a "special return" is filed is not later than the due date for the return itself.

Background

Section 17 of the GST Act requires a person selling any goods that are being sold in satisfaction of a debt under section 5(2) – for example, a mortgagee sale – to file a special return in relation to that supply. Prior to an amendment in 2007, section 17 provided that this return was to be filed, and the relevant tax paid, on or before the 28th of the month following the month in which the sale took place. The 2007 amendment was introduced to confirm that the filing date for these special returns was the "standard" filing date for GST returns (which is not always the 28th of the following month). A consequence of this amendment was that the payment date for the relevant tax was removed.

The proposed amendment confirms that the person responsible for filing the special return must complete all of the obligations imposed on them under section 17(1)(a) to (c) on or before the due date for filing the special return. This includes the obligation to pay the amount of tax charged on the supply.

Application date

The change applies from 30 November 2007, the date when the 2007 amendment that created the existing ambiguity took effect. This effective date reinforces the underlying policy for the period between 2007 and the date of enactment of the current Act.

APPROVED ISSUER LEVY: TECHNICAL CHANGES

Sections 86I and 86L of the Stamp and Cheque Duties Act 1971 and section 32M of the Tax Administration Act 1994

Some technical changes have been made to the rules for the approved issuer levy in the Stamp and Cheque Duties Act 1971 and the Tax Administration Act 1994. The purpose of the amendments is to clarify the relationship between domestic law and treaty law for interest derived from New Zealand by foreign banks. The intention is to make the law more transparent rather than to substantively alter its effect.

Background

The approved issuer levy (AIL) is a domestic-law mechanism that can provide relief from non-resident withholding tax (NRWT) on interest paid to non-residents. NRWT on interest paid to an unrelated foreign lender can be reduced to nil if the borrower agrees to pay a 2% levy. Borrowers may agree to do this if the lender would simply demand more interest to cover the NRWT.

Provisions recently included in some of New Zealand's double tax agreements provide an exemption from source-country tax for interest derived by banks. For interest derived from New Zealand, the availability of the exemption depends on the borrower paying AIL, unless the borrower is not eligible to elect to pay the levy, or there is no such levy, or the rate of the levy exceeds 2% of gross payments. (See the Interest Articles of New Zealand's double tax agreements with Australia and the United States.)

Key features

The Stamp and Cheque Duties Act 1971 and the Tax Administration Act 1994 have been amended to clarify the circumstances in which a person is eligible to elect to pay AIL. The question of whether a person is eligible to elect to pay AIL under domestic law may now be relevant to a double tax agreement.

As amended, section 32M(1) of the Tax Administration Act 1994 provides that a borrower is eligible to elect to pay AIL for the purposes of an exemption under a double tax agreement, as well as for the purposes of the NRWT rules. This makes it clear that a borrower can pay AIL to qualify the interest for a treaty exemption, even if paying the levy makes no difference to the way a transaction is dealt with under domestic law. Similar changes have been made to Part 6B of the Stamp and Cheque Duties Act 1971.

Section 32M(2) of the Tax Administration Act 1994, together with Part 6B of the Stamp and Cheque Duties Act 1971, now set out the process by which a person elects to pay AIL. Essentially, this process is the same as before but is now clearer that the process of taking the necessary steps constitutes an election and that a person chooses to have approved issuer status rather than applying for it. This ensures consistency with terminology used in the relevant treaty provisions.

The main purpose of these changes is to address uncertainty around the treatment of interest paid to foreign banks operating through a branch in New Zealand. That uncertainty arose from the interaction between domestic law and the new treaty provisions mentioned above. Interest derived by a foreign bank with a New Zealand branch is taxed on a net basis, along with branch income, rather than being subject to NRWT. This means that the AIL mechanism is not relevant domestically. However, the new treaty provisions could still apply to such interest if the loan was made from offshore instead of through the New Zealand branch. It is therefore appropriate to make clear that the borrower can elect to pay AIL for the purposes of a treaty exemption.

It is considered that borrowers were eligible to elect to pay AIL for the purposes of a treaty exemption under the law as it stood before these amendments, including in relation to interest outside the scope of the domestic NRWT rules. The amendments make this transparent. There should be no risk for a taxpayer that relied on this interpretation of the law before the amendments took effect. Where it applies, the relevant treaty exemption requires that, if a borrower is eligible to pay AIL, the levy must be paid for the exemption to apply. This is not the same as the exemption being contingent on the borrower's eligibility to pay AIL. As long as the borrower has paid AIL and the other requirements for the exemption are satisfied, the exemption should apply.

Application date

The changes come into force on 1 August 2010.

CONSEQUENTIAL R&D AMENDMENTS

Sections CX 47 and DF 1 of the Income Tax Act 2007

Technology Development Grants and Technology Transfer Vouchers were two new R&D incentives announced in Budget 2010. Several consequential amendments have been made to the special income tax rules for grants to make the tax treatment of these incentives clear and to deal with a compliance issue.

Part of the payment under a Technology Development Grant may be paid after the end of the income year in which a relevant deduction is incurred. Dealing with the deduction and the payment under the special grant rules where the deduction arises in one year and the grant is received in a subsequent year can result in disproportionate compliance costs. This problem is addressed by these amendments.

Technology Transfer Vouchers deliver R&D support in a way which does not fall clearly within the normal grant rules. These rules have been amended to make the tax treatment of Technology Transfer Vouchers straightforward.

Background

As part of Budget 2010, the Government announced two new research and development (R&D) initiatives:

- Technology Development Grants to be made to businesses. The amount claimed by the business under a grant will be paid out in instalments over the course of its R&D programme. However, a proportion of the grant amount will be withheld until the grant administrator is satisfied that the grant claims which have been made meet the eligible expenditure criteria that are a condition of the award of a grant. The grant administrator will initially be the Foundation for Research, Science and Technology and, from 1 February 2011, the Ministry of Science and Innovation (MSI).
- Technology Transfer Vouchers. Under this initiative, the Government will pay 50% of the costs of R&D work which a business contracts out to a third party research provider.

The Technology Development Grant initiative takes effect from 1 October 2010 and the Technology Transfer Vouchers from 1 November 2010.

Tax legislation contains special rules which deal with grants. In short, grants are treated as excluded income, but the expenditure to which the grants relate is not deductible (or not depreciable, if the grants relate to expenditure on the acquisition of depreciable property).

Key features

The changes will:

- provide the facility for businesses to "opt out" of the special grant rules when a payment is received in an income year later than the year in which the relevant expense was incurred; and
- make the application of the special grant rules to Technology Transfer Voucher transactions clear.

Application date

The amendments apply from 1 October 2010.

Detailed analysis

Section CX 47 of the Income Tax Act essentially provides that, when a business receives a grant, and that grant relates to either deductible expenditure or expenditure on a capital asset which is depreciable, that grant is excluded income.

Two amendments have been made to section CX 47. Section CX 47(1) is replaced. Paragraph (b) has been amended to make it clear that section CX 47 cannot apply to a research provider who receives an amount from the Crown under a Technology Transfer Voucher arrangement. Paragraph (d) is amended to make the application to Technology Transfer Vouchers clear, and in the case of subparagraph (ii), to make it consistent with subparagraph (i).

The second amendment to section CX 47 is to insert a new subsection (4). Under this subsection, a person who receives a grant payment as a Technology Development Grant or under a Technology Transfer Voucher which has been withheld until the conditions of the grant are satisfied, and when the payment is received in a year subsequent to the year the expenditure was incurred can elect that section CX 47 not apply. If the person makes this election, the grant payment will be income of the person, and not excluded income.

Section DF 1 essentially provides that, if a person incurs expenditure which is either deductible or on an asset which is depreciable, and the person receives a grant which relates to that expenditure which is excluded income under section CX 47, that expenditure is not deductible, and no depreciation loss can be claimed in relation to it.

New subsection (1) excludes from the denial of deduction circumstances where a person has made an election under section CX 47(4). The section has generally been restructured, with subsection (1) providing a single point of entry into the section. This is the reason for the new subsection (1B), and the simplification of subsection (3).

Example 1: Receipt of a Technology Development Grant

AB Ltd has a 31 March year end. AB Ltd has been awarded a Technology Development Grant to support its R&D programme. The business's R&D programme will involve some of AB's staff, and they will design, build and test modifications to one of AB's production chains. Eligible R&D expenditure for the programme during the 2011–12 year totals $500,000, so the 2011–12 grant amount of 20% is $100,000.

The grant will support the business's R&D programme from August 2011, and claims for grant payments are submitted quarterly – at the end of September and December 2011 ($50,000 each quarter). The grant payments were made shortly after the claims were received, but 10% of the claim amounts were withheld, pending the satisfaction of MSI that the grant claims already made meet the eligible expenditure criteria that are a condition of the grant (in the case of AB Ltd, this involves submitting audited accounts to MSI; other businesses may need to send it externally certified accounts of R&D expenditure). AB Ltd therefore received two payments of $45,000.

AB Ltd will apply sections CX 47 and DF 1 to the payments received during the income year of $90,000. The amount of $90,000 will be treated as excluded income. To the extent to which the $90,000 represented staff wages, it will not be deductible, and to the extent to which the grant represented payment for the modifications made to the production chain, those costs will not be depreciable.

AB Ltd submits its audited accounts to MSI in May 2012, and receives the withheld amount of $10,000 in June 2012.

At this point AB Ltd has a choice.

It could adopt the "ordinary rules basis" and treat the final instalment of $10,000 as exempt income under section CX 47 in 2012–13, the year of receipt. This would mean that section DF 1 will apply to deny any claims for deductions or depreciation for the underlying expenditure in 2011–12. If AB Ltd has already filed its tax return for 2011–12, it may need to amend that return. If AB Ltd has not yet filed its return, it may be straightforward to deal with the denial of deduction and reduction in the depreciation amount.

Alternatively, it could elect to apply new section CX 47(4), which would mean it is required to treat the $10,000 proportion of the grant as ordinary income, but it can claim the deductions or depreciation amount which relate to the $10,000.

Example 2: Technology Transfer Voucher

DEF Ltd is a small company which is developing a non-toxic form of timber preservative suitable for use in children's playground equipment and marine farms. It does not have the ability to carry out the relevant R&D in-house, and has been awarded a Technology Transfer Voucher for the R&D to be performed by a third part research provider. Under the voucher arrangements, MSI will pay 50% of the costs of the R&D directly to the research provider. DEF Ltd will pay the other 50% of the costs directly to the research provider. For the purposes of this example, it is assumed that the R&D meets the deductibility tests in section DF 34.

Payments to the research provider by both MSI and DEF Ltd are ordinary income to the research provider.

There are two possible ways that DEF Ltd might treat the payments from MSI to the research provider:

- It may treat the payments as income. If this is the case, section CX 47 will apply and treat the amount as income (potentially subject to an election under new section CX 47(4)). A deduction will be denied for the book entry which DEF Ltd will record as the notional "on-payment" of the grant from itself to the research provider.
- It may not treat the payments as income (that is, effectively ignore them). If this is the case, section CX 47 cannot apply, and there will be no deduction for section DF 1 to apply to.

PIE CREDIT IMPAIRMENT PROVISIONS

Section HL 19B of the Income Tax Act 2004; sections HL 19B and HM 35B of the Income Tax Act 2007

Amendments have been made to the portfolio investment entity (PIE) rules to ensure that multi-rate PIEs are able to claim deductions for credit impairment provisions. The amendments will also ensure that multi-rate PIEs have sufficient authority to claim deductions for expenses and pay tax for income when these are reflected in the PIE's unit price or in its financial statements. The changes are intended to clarify uncertainty in the timing rules over when deductions can be made or income declared.

Key features

New section HM 35B clarifies that multi-rate PIEs are able to claim deductions for expenses and pay tax for income at the point when they are reflected in the PIE's unit price or its financial statements, even if this is before the PIE has legally incurred or derived the expenditure or income. The purpose of this timing rule is to maintain investor equity over time by ensuring that investors exiting a PIE are attributed their correct share of the PIE's tax.

Under this new rule, any future change in an expense or income that has already been deducted or taxed will also be picked up for tax purposes at the point when the change is reflected in the PIE's unit price or financial accounts.

Section HM 35B also ensures that multi-rate PIEs are able to claim deductions for credit impairment provisions when they are reflected in the PIE's unit price or its financial statements. Credit impairment provisions are created to reflect the decline in a financial asset's value due to past events.

A PIE can only claim deductions for credit impairment provisions if it has objective evidence of a loss in an asset's value because of events that have already occurred. Specifically, the criteria set out in NZ IAS 39 will need to be met for the PIE to make such a deduction.

The amendments apply retrospectively from 1 October 2007. Corresponding new sections HL 19B of the Income Tax Act 2004 and HL 19B of the Income Tax Act 2007 have therefore also been inserted with appropriate application dates. However, transitional measures have been included to confirm the tax positions already taken by multi-rate PIEs on the timing of income and expenses, as well as credit impairment provisions. These transitional measures prevent PIEs from making retrospective adjustments to their tax returns following these clarifications.

Application date

The amendments apply from 1 October 2007.

OTHER AMENDMENTS TO THE PIE RULES

Section HL 9 of the Income Tax Act 2004; sections HL 9, HM 21, HM 22(1), HM 37(3) and schedule 29 of the Income Tax Act 2007

A number of amendments have been made to the tax rules for portfolio investment entities (PIEs). These amendments are to ensure the PIE rules operate effectively and as intended.

Key features

Delay in the repeal of section HM 37(3)

The repeal of section HM 37(3), which sets out how a PIE should treat fund withdrawal tax (FWT), has been delayed until 1 April 2013. The FWT rules are generally being repealed on 1 April 2011; however, it was necessary to delay the repeal of this specific provision as, in certain circumstances, a PIE may need to rely on the provision up until 31 March 2013.

Investor interest requirement for listed PIEs

Section HM 21 has been amended to provide that an investor in a listed PIE that is itself widely held is able to hold up to 100% of the PIE. Corresponding amendments have also been made to sections HL 9 of the Income Tax Act 2004 and HL 9 of the Income Tax Act 2007. This matches the treatment afforded to multi-rate PIEs. The entities that are considered widely held for the purposes of this rule are listed in schedule 29.

The amendments apply from the beginning of the PIE rules, 1 October 2007.

Change to schedule 29

The reference to "Auckland Regional Holdings" in schedule 29 has been replaced with "Auckland Council". This reflects changes made during Auckland's council restructuring when Auckland Regional Holdings was disestablished and its investment assets transferred to Auckland Council. The change ensures that these investment assets continue to be exempt from the requirements of sections HM 14(1) and HM 15 despite the restructure.

The amendment applies from 1 November 2010, the date the Auckland Council restructure took place.

Amendment to section HM 22

Section HM 22 has been amended to clarify that, for the purposes of determining whether an entity is a foreign PIE equivalent or an entity that qualifies for PIE status, the exemptions provided by section HM 22(1) can be taken into account.

The amendment applies from 1 April 2010.

EMISSIONS TRADING SCHEME AMENDMENTS – INCOME TAX

Section ED 1B of the Income Tax Act 2007

Amendments have been made to the income tax treatment of the allocation of emissions units to businesses in those sectors which qualify for allocation under the New Zealand Emissions Trading Scheme (NZETS) (see the description of Industrial Allocation at **www.climatechange.govt.nz/emissions-trading-scheme/participating/industry/allocation/eligible-activities**). The new provisions align the recognition of income to the business's entitlement to receive emissions units under amendments made to climate change legislation in 2009.

Background

The Government introduced the NZETS by way of amendment to the Climate Change Response Act 2002. Under that Act:

- businesses in certain sectors are required to surrender emissions units to the Government based on greenhouse gas emissions they either produce themselves or which products they sell will ultimately produce; and
- the Government allocates emissions units to businesses carrying out specific activities under the Industrial Allocation rules to reduce the economic impact the emissions trading scheme would otherwise have. These activities have met the eligibility criteria of being emissions intensive and trade exposed.

A further important component of the NZETS is trading in emissions units taking place between business vendors and purchasers, such as businesses which have been allocated emissions units selling them in private transactions to businesses which have an obligation to surrender units. For more information on the emissions trading scheme see **www.climatechange.govt.nz**.

The majority of transactions in emissions units are on revenue account, and so give rise to taxable income or deductible expenditure as appropriate. Ordinary principles are supplemented by express statutory rules to achieve this outcome.

The basis of allocation of emissions units for Industrial Allocation was changed in 2009. Under those changes, businesses carrying out an eligible activity will receive allocations calculated by reference to:

- the level of assistance which applies to businesses carrying out each specific kind of activity in the relevant emissions year; and
- the business's production output for the emissions year.

Emissions years are always calendar years. Allocation to businesses under the Industrial Allocation rules (other than those in the agricultural sector) will be made on the following basis:

- The business will receive a provisional allocation of emissions units in the first half of the relevant emissions year. That interim allocation will be based on the business's production in the previous emissions year.
- In the first half of the following year, a "square-up" will take place, by reference to the business's actual production in the previous emissions year. If the business has received too many emissions units (production was lower than the previous year) it will be required to either transfer the excess units back to the Government, or offset them against a future allocation. If the business received too few emissions units (production increased compared to the previous year) then it will receive additional emissions units.

These allocations begin from 1 July 2010 (note that the explanation above applies for full years beginning 1 January 2011 and following; different timing applies to the initial six-month period). The allocation mechanism for the agricultural sector is simpler—a single allocation will be made, after the end of the emissions year, based on final production figures. The agricultural sector enters the emissions trading scheme from 1 January 2015.

Key features

Section ED 1B provides the rule which values units allocated by the Government and which are held at the end of the year (zero-value units). Under the new rules, income arises from valuing an appropriate number of zero-value units at market value. The appropriate number of zero-value units to value at market value is determined by applying the formula set out in the Climate Change Response Act 2002 to the business's production for the income year.

Application date

The income tax amendments apply from 1 July 2010.

Detailed analysis

The new rules conceptually need to do two things:

- determine an amount of income to be recognised in the year arising from the entitlement of the business to be allocated emissions units; and
- ascribe values to those units which are actually received by the business during the course of the income year to enable rules dealing with transactions like sales and surrenders to work on a sensible basis.

The new legislation deals with these two issues simultaneously.

Ordinary concepts of accrual accounting are used to determine the business's income (defined as "unit entitlement" in section ED 1B(7)). Sections 83 and 85 of the Climate Change Response Act 2002 provide a statutory formula by which the business's ultimate entitlement to units for the income year can be determined. The formula multiplies some known factors (the prescribed level of assistance, and the "allocative baseline" for the specific eligible activity) by the business's production output for the year to determine the business's ultimate entitlement to an allocation of units. If the business's income year does not end on the same 31 December date as an emissions year, two calculations are likely to be required, because the prescribed level of assistance changes from one emissions year to the next. These income calculations are likely to be the same as those used for financial reporting purposes. The output of these calculations is a number of emissions units which, when multiplied by the market value of emissions units, is an amount of income.

It is likely that the business will have received some emissions units from the Crown during the course of the income year, and may still hold some or all of them. Because of the two-step method of allocation, it is unlikely that the business will hold precisely the same number of emissions units as its allocation as described in the previous paragraph.

In the simplest scenario, if the business has not carried forward from a previous year a unit shortfall, subsections (6) and (8) will assign year-end market value to the number of zero-value units held as equal to the unit entitlement determined under subsection (7). If the business holds more zero-value units than the unit entitlement, the excess units are assigned a value of zero (subsection (8)(b)) to be carried forward into the next income year. (See Example 1.)

If the business holds fewer zero-value units than the unit entitlement (unit shortfall), subsections (9) and (11) effectively create an additional amount of unit value (unit shortfall value), which the business is required to recognise as income by virtue of its addition to the value of emissions units held under subsection (11). (See Example 2.)

The consequences of a unit shortfall in a previous year are dealt with by subsections (3), (4) and (10). Zero-value units received in a year subsequent to a unit shortfall year are first applied to the unit shortfall, by being valued at the market value which applied at the end of the unit shortfall year. (See Example 2)

These income recognition rules also apply to emissions units transferred to Negotiated Greenhouse Agreement participants to compensate them for the increased cost of their inputs.

Example 1: Falling production – excess emissions units allocated

A Ltd has a 31 December year-end. In March the Government transfers 150 emissions units to A Ltd. However, because of falling production, its final allocation for the year is only 100 units. It values 100 units at market value at year-end, and continues to hold the remaining 50 at nil value. These units will either be transferred back to the Government or offset against a future allocation.

Example 2: Rising production – insufficient emissions units allocated

B Ltd has a 31 December year-end. In March the Government transfers 100 emissions units to B Ltd. However, because of increasing production, its final allocation for the year is 150 units. It values all 100 units at market value, and records an additional amount of income equal to 50 units x market value.

In March of the next year, B Ltd receives an additional 50 units, representing the shortfall for the previous year. These 50 units will be assigned a market value equal to the market value of a unit at the end of the previous income year. (The legislation operates to ensure that no double-counting of income occurs because the unit shortfall value is reduced by subsection (10) and so no longer forms part of the subsection (11) adjustment.)

EMISSIONS TRADING SCHEME AMENDMENTS – GST

Sections 11(1)(o) and 11A(1)(u) of the Goods and Services Tax Act 1985

Amendments have been made to the rules under which certain transactions which include a supply of emissions units are zero-rated for GST purposes. These amendments correct an earlier error which inadvertently zero-rated transactions which were intended to be standard-rated.

Background

A general background to the emissions trading scheme is set out earlier in this *Tax Information Bulletin*, under the heading "Emissions Trading Scheme Amendments – Income Tax".

Almost all transactions in emissions units are zero-rated for GST purposes (see *Tax Information Bulletin* Vol 21, No 8). The policy intention is for a limited number of supplies made in exchange for a supply of emissions units also to be zero-rated. This is intended to be limited to circumstances when the transaction is between the Crown and a private party.

Key features

An error made in the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver and Remedial Matters) Act 2010, which inadvertently zero-rated all supplies made in exchange for the supply of emissions units, has been corrected. The amended legislation makes it clear that only certain supplies made in exchange for a supply of emissions units, when one of the parties is the Crown, are to be zero-rated.

Application date

The amendments apply from 1 July 2010.

Detailed analysis

A detailed explanation of the issue is set out on the Policy Advice Division website at **http://taxpolicy.ird.govt.nz/news/2010-10-01-gst-zero-rating-emissions-units-transactions**.

Section 11A(1)(s) and (t) of the GST Act zero-rates almost all supplies of emissions units.

Some of those supplies of emissions units will be made by the Crown to businesses under the Climate Change Response Act 2002 either as compensation to those businesses for the impact of the emissions trading scheme on their competitiveness, or in recognition of the capture of carbon by their business operation (mostly foresters). Businesses that receive emissions units in this way are likely to have made either an actual supply to the Crown, or a deemed supply in accordance with section 5(6D).

If a business has an obligation for emissions under the Climate Change Response Act 2002, it may meet that obligation by transferring emissions units to the Crown (known as surrendering). In this instance, the Crown may make a supply back to the business.

When these contra supplies are in the form of services, they are zero-rated by new section 11A(1)(u). When the contra supplies are in the form of goods, they are zero-rated by new section 11(1)(o).

Zero-rating of contra supplies does not extend to a supply made by one business to another in exchange for a supply of emissions units.

AUCKLAND COUNCIL RESTRUCTURING AMENDMENT

Section 83 of the Local Government (Auckland Transitional Provisions) Act 2010

Section 186 of the Amendment Act amends section 83 of the Local Government (Auckland Transitional Provisions) Act 2010, which provides transitional tax relief on the amalgamation of Auckland local authorities into one Council. It provides that for the purposes of the financial arrangement rules in the Income Tax Act 2007, when the new Auckland Council enters into an acknowledgement of debt with a council-controlled organisation (CCO) without paying the principal to the CCO, the Auckland Council is deemed to have advanced the amount of the principal to the CCO.

Background

On 1 November 2010, a new Auckland Council was established to replace the former Auckland local authorities. As part of this restructuring, certain assets owned by the former local authorities were vested in CCOs owned by the new Auckland Council. For commercial reasons, the debt relating to those assets was not transferred to the CCOs but was assumed by the Auckland Council. In turn, the CCOs entered into an acknowledgement of debt to the Council for the amount of the debt attributable to the assets.

Under the transfer process, there were no funds or other consideration actually flowing from the Auckland Council to the CCO in relation to the acknowledgement of debt. The absence of consideration flowing from the Auckland Council to the CCO in relation to the acknowledgement of debt created a problem under the financial arrangement rules in the Income Tax Act 2007.

The general definition of "financial arrangement" in section EW 3(2) does not apply to the acknowledgement of debt because there is no consideration paid by the Council to the CCO. However, the debt is a financial arrangement because section EW 3(3)(a) applies. This provision captures all debts, regardless of whether the borrower receives consideration.

Under the financial arrangement provisions, the difference between the amount received and the amount paid under a debt (generally the interest component) is deductible to the borrower and assessable income to the lender. Because there is no flow of funds from the Auckland Council to the CCO under the acknowledgment of debt, the CCO will have a tax deduction for all amounts (interest and principal) paid under the debt and the Auckland Council will have assessable income of the same amount.

Key features

Section 186 of the Amendment Act:

- ensures that only interest (and not the principal) is deductible to the CCO and assessable to Auckland Council;
- provides that Auckland Council will be deemed to have advanced the amount of the principal to the CCO; and
- applies for the purposes of the financial arrangement rules in the Income Tax Act 2007.

Application date

The amendment applies from 31 October 2010.

TREATMENT OF SUPERANNUATION SCHEMES ADMINISTERED BY THE NATIONAL PROVIDENT FUND

Section EY 11 of the Income Tax Act 2007

The application of the taxation rules for life insurance business has been clarified in connection with superannuation schemes administered by the Board of Trustees of the National Provident Fund. The change ensures that the schemes administered by the Board and constituted under the various National Provident Fund Acts are not subject to the life insurance rules in the Income Tax Act 2007.

Key features

Section EY 11(5) now ensures that superannuation schemes administered by the Board and constituted under various National Provident Fund Acts are not subject to the taxation rules for life insurance.

Application date

The change applies from 1 April 2010.

EXTENDING THE REDUNDANCY TAX CREDIT

Section ML 2(1) of the Income Tax Act 2007

The redundancy tax credit ceased for redundancy payments made on or after 1 October 2010. This was as a result of the income tax rate changes in Budget 2010 and, in particular, the introduction of the 33% tax rate.

However, because this rate does not become fully effective until 1 April 2011, section ML 2 has been amended so that the cessation date is payments made on or after 1 April 2011.

The amendment applies from 21 December 2010.

FURTHER REMEDIAL CHANGES TO THE TAXATION RULES FOR LIFE BUSINESS

Sections EY 24, EY 30 and YA 1 of the Income Tax Act 2007

Technical changes have been made to the recently enacted reforms for taxing life insurance business.

Background

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 significantly changed the taxation rules applicable to life insurance business. The new rules changed the basis of taxing life insurance business and contained a comprehensive set of transitional provisions that preserved the previous income tax treatment of life insurance policies sold before the application date.

Since the enactment of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, subsequent taxation bills have amended aspects of the transitional rules to remove uncertainties and deal with practical problems identified by life insurers.

In response to submissions received on the Taxation (GST and Remedial Matters) Bill, the Finance and Expenditure Committee recommended a number of technical amendments to the life insurance taxation rules.

Key features

The changes include:

- Section EY 30(3)(e) has been amended and simplifies the application of the transitional rule for life reinsurance contracts sold before the start of the new taxation rules. Transitional relief should apply to life reinsurance contracts in place before the start date of the new life insurance rules to the extent that any life insurance policy covered by the life reinsurance contract is:
  - also grandparented (this assumes the life reinsurer is able to use the information provided to it by the cedant life insurer about the underlying life policy); or
  - would be grandparented but for the seller of the life policy not being a "life insurer" for income tax purposes – for example, this can occur if the seller of the life policy fully reinsures.

  The revision to section EY 30(3)(e) allows life reinsurers to grandparent existing reinsurance contracts to the extent that the underlying life policy is also grandparented and there are no material changes in the terms of the life reinsurance contract.
- Section EY 30(8) has been amended and removes references to the Outstanding Claims Reserve and the Capital Guarantee Reserve from the transitional relief formula in section EY 30(7). The change ensures that the formula produces an amount which effectively taxes grandparented life insurance policies on a basis similar to the one that existed under the old life insurance taxation rules.
- Section EY 24(2)(a)(ii) clarifies the method for calculating the opening balance of the Outstanding Claims Reserve for the first income year that the new life insurance rules have application. The change recognises that historically individual life insurers have for tax purposes used different accounting methods when calculating the opening balance of the Outstanding Claims Reserve for their mortality profit calculations. The example used in the section is for illustrative purposes and uses the acronym "IBNR" (which is commonly used by insurers for claims incurred but not reported) instead of the defined terms in section EY 24 for outstanding claims reserve.
- Section YA 1 has been amended by narrowing the definition of "profit participation policy" to ensure that life reinsurance policies, multiple life policies, and workplace group policies are taxed as non-participating life insurance policies. Life reinsurance and group policies share the characteristics of pure risk policies and should not be treated as traditional profit participation policies when they contain no savings element.

Application date

The changes apply from 1 July 2010. Life insurers have the option to apply the rules from the beginning of their income year, if that year includes 1 July 2010.

TAXATION OF GENERAL INSURANCE BUSINESS

Section YA 1 of the Income Tax Act 2007 and section OB 1 of the Income Tax Act 2004

Changes have been made to the definition of "outstanding claims reserve" (OCR) to clarify that that the amount calculated should be net of amounts receivable for reinsurance or non-reinsurance recoveries. The change ensures that amounts calculated for financial reporting purposes can be used for taxation purposes.

Background

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 clarified that movements in a general insurer's OCR, as determined by applying International Financial Reporting Standard (IFRS) 4, are deductible. The rules allow a deduction for claims paid in an income year and for the movement in the OCR between the beginning and the end of the year.

The OCR is the amount an insurance company sets aside which, when invested, will provide sufficient funds to cover the liabilities for outstanding claims in the future. The value of these claims is estimated, as they generally have either been reported but not been paid at balance date, or an insured event has occurred but the insurer has not been notified about the claim by its balance date. The amount of expected future payments is discounted to reflect present value.

Estimates relating to expected reinsurance recoveries and non-reinsurance recoveries affect the amounts used to calculate movements in the OCR. For financial reporting purposes these amounts are treated as income and are discounted. For taxation purposes, however, the law was silent about how these expected recovery amounts should be treated.

The rules in the Income Tax Act 2007 which allow a deduction for movements in a general insurer's OCR have been clarified and now recognise, on a discounted basis, recoveries that insurers expect to receive from third parties, by way of reinsurance or directly from those parties.

Key features

The definition of "outstanding claims reserve" in section YA 1 of the Income Tax Act 2007 includes reference to amounts an insurer expects to receive by way of recoveries.

A corresponding change has been made to section OB 1 of the Income Tax Act 2004.

Application dates

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.

CONSEQUENTIAL CHANGES TO THE MĀORI AUTHORITY TAX RATE

Sections OZ 7B and RZ 5D and schedule 1 of the Income Tax Act 2007

As a consequence of the changes to personal tax rates arising from Budget 2010, the Māori authority tax rate has been lowered from 19.5% to 17.5%, to align it with the individual statutory rate of the majority of Māori authority members.

Background

Māori authorities are taxed as a proxy for their members. The 19.5% tax rate represented the statutory tax rate that applied to the majority of Māori authority members when the rules for Māori Authorities were introduced in 2004.

As part of Budget 2010, individual tax rates were lowered. Having a Māori authority tax rate that was not the statutory rate for individual members would have meant the Māori authority rate was no longer an effective proxy for these members. If left to continue, this situation would have increased compliance costs for these members because their taxable Māori authority distributions would not have been imputed to the correct ratio—making end-of-year corrections more common.

Key features

- The Māori authority tax rate has been reduced from 19.5% to 17.5%, as has the resident withholding tax rate for taxable Māori authority distributions. Both of these rates are contained in schedule 1.
- New section OZ 7B allows Māori authorities to continue to attach Māori authority credits at the previous 19.5/80.5 credit-to-distribution ratio until 31 March 2013.
- New section RZ 5D allows Māori authorities that pay provisional tax using the standard method or the GST ratio method to have immediate access to the tax cut.

Application date

The rate reduction applies for the 2011–12 and subsequent income years, which is the same effective date as the company tax rate decrease.

Detailed analysis

As part of the Budget 2010 package, which lowered the company tax rate, targeted provisions were introduced to assist the transition to the new company tax rate. As Māori authorities are taxed on a model based on the company imputation system, two of those transitional measures have also been introduced for the Māori authority tax rate transition.

"Grandparenting" imputation ratios – new section OZ 7B

The new maximum Māori authority credit ratio is 17.5/82.5. This ratio change can result in effective double taxation, as earnings taxed at the rate of 19.5% (prior to the rate change) may carry a maximum imputation ratio of 17.5% if distributed after the rate change. The result is that pre-rate change credits can be "trapped" in the Māori authority.

A "grandparenting" period of two years has been introduced to allow Māori authorities an opportunity to review their credit accounts and make distributions of pre-rate change profits if necessary. This two-year window is the same period afforded to companies as a consequence of their rate reduction. Therefore, the new section OZ 7B applies the company transitional measures in sections OZ 8 to OZ 11 and section OZ 13 to Māori authorities, with appropriate terminology changes and deletions to make them applicable to the Māori authority context.

Provisional tax adjustments – new section RZ 5D

An adjustment has been made to the provisional tax rules so that the rate decrease can be immediately reflected in the tax paid by provisional taxpayers. This change recognises the fact that, all other things being equal, the tax paid by a Māori authority is expected to be less in the year of the decrease.

This provision applies to taxpayers that base their provisional tax on an earlier year's tax obligations, that is, taxpayers that use the standard or the GST ratio method of calculation. The reduction is achieved by amending the uplift factor used to calculate the current year liability.

The change to the uplift factor is slightly different from that enacted for companies, reflecting the fact that the 2% rate reduction for Māori authorities is larger in real terms than the corresponding 2% company rate reduction. As with the imputation ratio change mentioned above, new section RZ 5D implements these measures by deeming the relevant company transition provisions in sections RZ 3 to RZ 5 to apply to Māori authorities with appropriate terminology changes. Māori authorities that actually estimate their liability would be unaffected by these changes, as they would factor the lower rate into their estimates.

REWRITE REMEDIAL ITEMS

Remedial changes have been made to the Income Tax Act 2007 and the Income Tax Act 2004 on the recommendation of the Rewrite Advisory Panel. The Panel lists submissions received on matters relating to the rewrite of the Income Tax Act and their recommendations on its website.

This remedial Act also amends a number of minor drafting matters that have been brought to the attention of the Rewrite Advisory Panel. In general, these amendments are corrections of cross-references, spelling, punctuation, terminology, and consistency of drafting. The Rewrite Advisory Panel publishes lists of these maintenance items on its website **www.rewriteadvisory.govt.nz**.

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 tax specialists review any submission that rewritten income legislation contains an unintended policy change.

An unintended policy change is one that gives rise to a different outcome from the corresponding provision in the previous Income Tax Act. The Rewrite Advisory Panel performs this review function. The process for making a submission to the Panel is set out in its statements, *RAP 001* and *RAP 002* which are published on the Panel's website.

In general, the Panel recommends that a provision is:

- amended to counter the effect of an unintended change; or
- identified as an intended change in the schedule of intended changes in the 2004 or 2007 Acts; 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 situations 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*, December 2008) and SPS 05/02, issued in relation to the 2004 Act (published in the *Tax Information Bulletin*, June–July 2005).

ACCOMMODATION BENEFITS

Sections 30 and 164 of the Taxation (GST and Remedial Matters) Act 2010

Key features

The Rewrite advisory Panel has agreed with a submission that, in the 2004 and 2007 Acts, section CE 1 incorrectly:

- includes the full value of accommodation in the income of an employee; and
- omits to refer to accommodation allowances.

In addition, the Panel noted that the corresponding provisions of the 1994 Act limit the application of this rule to a benefit provided in respect of an office or position.

Detailed analysis

The amendments correct section CE 1(1)(d), (g), and (2) in both the 2007 and 2004 Acts to clarify that the market value of the benefit of accommodation is income of a person if the accommodation benefit arises in relation to an office or a position.

In addition, the amount of income for the provision of accommodation is measured by the market value of the benefit of the accommodation provided, or if an allowance is provided in substitution for the provision of accommodation, the market value of the benefit arising from that allowance.

These amendments restore the outcome given by the corresponding provisions of the Income Tax Act 1994 in the definition of "monetary remuneration".

Application dates

The amendment to the 2004 Act applies from the beginning of the 2005–06 income year.

The amendment to the 2007 Act applies from the beginning of the 2008–09 income year.

THRESHOLD FOR APPLICATION OF INTEREST APPORTIONMENT RULES

Section 65 of the Taxation (GST and Remedial Matters) Act 2010

The Rewrite Advisory Panel considered this provision contains an unintended change in outcome. The unintended change in outcome is that section FF 4(1)(a) of the 2007 Act incorrectly provides that a conduit tax relief company is required to perform a "thin-cap" interest allocation (deductible/non-deductible interest) if its conduit tax credits exceed $50,000, even if the relevant debt percentage in the foreign group is less than or equal to 66%.

Under the corresponding provision in the 2004 Act, the conduit tax relief company was only required to perform this allocation if its conduit tax credits amount was at least $50,000 and its relevant debt percentage was less than or equal to 66%.

Key features

The amendment ensures that a conduit tax relief company is not required to make this "thin-cap" interest allocation if the company's debt percentage in the foreign group is less than or equal to 66% and its conduit tax relief credits are at least $50,000

Application date

The amendment applies from the beginning of the 2008–09 income year.

WHEN AMALGAMATING COMPANIES ARE A PARTY TO A FINANCIAL ARRANGEMENT

Section 66 of the Taxation (GST and Remedial Matters) Act 2010

The Rewrite Advisory Panel concluded that section FO 18 of the 2007 Act contains an unintended change in outcome. The unintended change is that an insolvent amalgamating company is treated as providing the market value of the financial arrangement when it is deemed to discharge its financial arrangements on any amalgamation.

Under the 2004 Act, in the same circumstances, the amalgamating company was treated as having provided the accrued value as consideration for a financial arrangement deemed to be discharged under the amalgamation.

Key features

The amendment ensures that, if an insolvent amalgamating company is likely able to meet its financial obligations (for example, because property of the company fully secures the debt), the accrued value of a financial arrangement deemed to be discharged under the amalgamation is treated as being the amount of consideration given by the amalgamating company immediately prior to the amalgamation.

Application date

The amendment applies from the beginning of the 2008–09 income year.

FDP CREDITS DERIVED BY PERSON RECEIVING EXEMPT DIVIDEND

Section 108 of the Taxation (GST and Remedial Matters) Act 2010

The Rewrite Advisory Panel has concluded that section LF 8(1) does not permit a person who derives dividends as exempt income to obtain a refund of a foreign dividend payment (FDP) credit. The corresponding provision in the 2004 Act permitted a person deriving dividends as exempt income to obtain a refund of FDP paid on the exempt dividend.

Key features

The amendment ensures that FDP credits attached to dividends that are exempt income of the shareholder are refundable to that shareholder.

Application date

The amendment applies from the beginning of the 2008–09 income year.

REMITTANCE OF PAYE TO COMMISSIONER

Section 125 of the Taxation (GST and Remedial Matters) Act 2010

The Rewrite Advisory Panel agreed that section RD 4(2) contained an unintended change in outcome. The change in outcome is that an employee could be liable to account for PAYE on their own salary if the employer withholds PAYE from salary or wages, but had not paid the PAYE to the Commissioner.

Under the corresponding provisions of the 2004 Act, an employee was liable to account for PAYE on their own salary or wages only if the employer did not withhold PAYE, but not if the employer had withheld the PAYE but not remitted the PAYE to the Commissioner.

Key features

The amendment ensures that an employee is liable to account for PAYE only if the employer does not withhold PAYE (in full or in part) at the time of paying a PAYE income payment.

Application date

The amendment applies from the beginning of the 2008–09 income year.

LAND INVESTMENT COMPANY

Section 132(22) of the Taxation (GST and Remedial Matters) Act 2010

The definition of "land investment company" in section YA 1 is the rewritten definition of portfolio land company. A land investment company is defined in a way to ensure it is a PIE that owns predominantly assets consisting of real property.

Key features

The rewritten definition has been amended to ensure that it correctly reflects its pre-rewrite meaning, as follows:

- Paragraphs (a) and (b) have been amended to be conjunctive (as per paragraphs (a) and (b) of the definition of "portfolio land company").
- In paragraph (b), the $100,000 market value threshold has been amended to ensure the threshold is "more than or equal to" $100,000 (as per paragraph (b) of the definition of "portfolio land company").
- In paragraph (b)(ii), the amendment ensures the 90% relates to the market value of the property (as per paragraph (b)(ii) of the definition of "portfolio land company").
- The amendment also ensures that a company (Company A) will not be a land investment company if it invests in another land investment company which in turn invests back into Company A (as per paragraph (b)(i) of the definition of "portfolio land company").

Application date

The amendments apply from the beginning of the 2008–09 income year.

LOW OR NIL INTEREST LOANS PROVIDED TO A SHAREHOLDER OR AN EMPLOYEE

Sections 141 and 170 of the Taxation (GST and Remedial Matters) Act 2010

The Rewrite Advisory Panel considered that sections CD 28(9)(b) and NE 1E(2) of the 2004 Act contain an unintended change in law. The unintended change identified is that the provisions permit fully imputed dividends and exempt dividends to be offset against the balance of low or nil interest loans provided to a shareholder of a company or an employee, if the dividend was an exempt dividend paid to a shareholder of a qualifying company or if the dividend was a fully imputed dividend.

Those drafting changes were re-enacted in the 2007 Act as sections CD 39(9)(b) and RD 36(2) respectively.

Under the corresponding provisions of the Income Tax Act 1994, a shareholder-employee of a company could offset dividends derived from the company against the balance of a low or nil-interest loan if the dividend was assessable income but was not resident withholding income.

However, the Panel recommended that the Government consider retaining these drafting changes, on the basis that the outcomes are consistent with the policy for low or nil interest loans.

Key features

This amendment to the schedules setting out intended changes in legislation (schedule 51 of the 2007 Act and schedule 22A of the 2004 Act) confirm that sections CD 28(9)(b) and NE 1E(2) of the 2004 Act and sections CD 39(9)(b)(c) and RD 36(2) of the 2007 Act contain intended changes in outcomes.

Application dates

The amendment to the 2004 Act applies from the beginning of the 2005–06 income year.

The amendment to the 2007 Act applies from the beginning of the 2008–09 income year.

REWRITE MAINTENANCE ITEMS

The following provisions, most of which come into force on 1 April 2008, have been amended as follows:

- Cross-references
- Grammar
- Spelling
- Punctuation
- Terminology and definitions
- Drafting consistency, including readers' aids – for example, the defined terms lists
- Some defined terms.

Section in Taxation (GST and Remedial Matters) Act 2010	Section in principal Act	Description
Section 28	Section CD 24(2)(a)(i) (2007 Act)	Cross-reference corrected.
Sections 32, 33, 55, 60, 64, 80, 103, 107, 109, 129, 130, 132(10), (18), (29)	Sections CR 3(1), CV 17(2), EG 1(10), EY 48(2), FE 1(1), HD 29(2)(c), HZ 2(2), LC 12(1)(b), LJ 1(2)(a), RE 2(5)(f), RF 2(1), YA 1 "derived from New Zealand", "foreign non-dividend income", "non-filing taxpayer" (2007 Act)	Consequential amendments on adopting the term "source in New Zealand", to replace the term "derived from Zealand".
Sections 37(1) and 165	Section DB 2(2) (2007 Act and 2004 Act)	Cross-reference corrected.
Section 38	DB 46 (2007 Act)	Cross-reference corrected.
Section 41	Section DE 10 (2007 Act)	Correction of terminology.
Sections 43, 44, 85, 86(2), 89, 92. 93, 94(2), 97, 98, 99, 100, 101, and 110	DV 2, DV 5, HM 3, HM 5, HM 15, HM 23, HM 31, HM 35(2), HM 43, HM 47, HM 48, HM 61, HM 62 and LS 4 (2007 Act)	Clarifies the circumstances in which the term "interests" is a reference to the defined term "investor interest".
Section 85	Section HM 3(e) (2007 Act)	Clarifies the circumstances under which a foreign investment vehicle is treated as PIE.
Section 86(1)	Section HM 5(4)(a) (2007 Act)	The amendment clarifies that both paragraphs (a) and (b) must be satisfied before an investor is entitled to the relief under this provision.
Section 87	Section HM 6(2)(b) (2007 Act)	Clarifies that a PIE is not liable for income tax in relation to a zero-rated investor.
Section 88	Section HM 9(d) (2007 Act)	Clarifies that trustees of a group investment fund can elect to be a multi-rate PIE in relation to category B income.
Section 94(1)	Section HM 35(3)(a) (2007 Act)	Clarifies that the amount "assessable income" in the formula in M 35(2) includes tax credits received by the PIE for the income.
Section 105	Section IC 3(1) (2007 Act)	The term "portfolio tax rate entity" is updated to refer to "multi-rate pie".
Section 106	Section LC 4(1)(c) (2007 Act)	Corrects a cross-reference.
Section 113	Section ME 1(2) (2007 Act)	The placement of the brackets is corrected.
Sections 117 and 188	Sections OB 41(3) and OC 24(3) (2007 Act)	The amendment clarifies the circumstances in which section OB 41 applies to a qualifying company.
Section 119	Sections OZ 7 to OZ 17 (2007 Act)	The compare notes to 2004 Act provisions are omitted as the 2004 Act provisions did not commence.

NEW LEGISLATION

Section in Taxation (GST and Remedial Matters) Act 2010	Section in principal Act	Description
Section 127	Section RD 22 (2007 Act)	The amendment clarifies that an employer remitting PAYE on a monthly basis need only provide the Employer Monthly Schedule once per month.
Section 128	Section RD 36(2) (2007 Act)	Ensures consistency with the drafting of section CD 39(9) (low interest loans to shareholders.)
Section 132(43), (46)	Section YA 1 "source in New Zealand", "transfer of value" (2007 Act)	Correction of cross-references.
Section 133	Section YA 2(5) (2007 Act)	Definition amended to refer to taxes imposed by state and local governments.
Section 143(3)	Section 3(1), Tax Administration Act "tax payable"	Ensures definition of "tax payable" is in alphabetical order within section 3.
Section 147	Section 39(5), Tax Administration Act 1994	A drafting error formula is corrected.
Section 151	Section 85F(3) "company"	Update of terminology relating to certain film grants.
Section 168	Section ND 1E(2) (2004 Act)	Ensures consistency with the drafting of section CD 28(9) (low interest loans to shareholders).
Section 188	Health Entitlement Cards Regulations 1993, regulation 2, "net income "	Correction of a cross-reference.

ORDERS IN COUNCIL

USE-OF-MONEY INTEREST RATES CHANGE

The use-of-money interest rates on underpayments and overpayments of taxes and duties have been changed in line with current market interest rates. The new rates are:

- underpayment rate: 8.89% (previously 8.91%)
- overpayment rate: 2.18% (previously 1.82%).

The new rates apply from 16 January 2011, the starting date for interest applying to the second provisional tax instalment for standard balance date taxpayers.

The rates are reviewed regularly to ensure they are in line with market interest rates. The new rates are consistent with the Reserve Bank floating first mortgage new customer housing rate and the 90-day bank bill rate.

The rates were changed by Order in Council on 22 November 2010.

Taxation (Use of Money Interest Rates) Amendment Regulations 2010 (2010/433)

MINIMUM FAMILY TAX CREDIT INCOME AMOUNT INCREASED

The Income Tax (Minimum Family Tax Credit) Order 2010, made on 15 November 2010, increases the net income level guaranteed by the minimum family tax credit. The net income level will rise from $21,008 to $22,204 a year from 1 April 2011.

The order increases to $22,204 the prescribed amount in the definition in the formula for calculating the minimum family tax credit, in section ME 1(3)(a) of the Income Tax Act 2007.

The increase applies for the 2011–12 and later tax years.

The order replaces the prescribed amount in the Income Tax Act 2007 as amended by the Taxation (Budget Measures) Act 2010. The order also revokes the Income Tax (Minimum Family Tax Credit) Order 2009.

Income Tax (Minimum Family Tax Credit) Order 2010 (SR 2010/418)

STANDARD PRACTICE STATEMENTS

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

INDUSTRY-SPECIFIC BALANCE DATE FOR KIWIFRUIT ORCHARDISTS

Standard Practice Statement SPS 08/04, signed 22 December 2008, sets out Inland Revenue's practice for considering applications for the Commissioner's consent to change a balance date for income tax purposes. The SPS was published in the *Tax Information Bulletin* Vol 21, No 1 (February 2009) and can also be viewed on Inland Revenue's website at **www.ird.govt.nz** (keywords: SPS 08/04).

The Commissioner recognises a number of industry-specific non-standard balance dates and these are listed in Appendix A of SPS 08/04.

In response to a submission on behalf of the kiwifruit industry that the previous March to June balance date is no longer appropriate due to improved growing techniques and early kiwifruit cultivars producing earlier crops, the Commissioner agreed to a change of the recognised industry-specific non-standard balance date from 31 January to 31 March for kiwifruit orchardists.

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.

SPECIAL DETERMINATION S17: UTILISATION OF A PROFIT EMERGING BASIS FOR PURCHASED DEBT LEDGERS BY A CERTAIN NEW ZEALAND COMPANY LIMITED

This determination may be cited as Special Determination S17: *Utilisation of a profit emerging basis for acquired bad debts by a certain New Zealand Company Limited*.

1. Explanation (which does not form part of the determination)

1) This determination relates to the ability of New Zealand Company Limited (NZC) to utilise a profit emerging basis for returning income and expenditure arising from the acquisition and collection of a portfolio of distressed debts acquired at a deep discount.

2) NZC acquires for valuable consideration pools of unpaid loans and receivables, which may consist of a few hundred to a few thousand individual debts (ABDs).

3) NZC acquires the ABDs at a deep discount to their face value. NZC subsequently seeks to recover the overdue balances from debtors through various means.

4) The acquisition of an individual ABD is done on the expectation that its recoveries will be in excess of the purchase price and the cost incurred in attempting collection. Some debts may not achieve any recovery and become uncollectable, and others may be partially collected. The volatility of cash collections may be attributed to such things as the nature of the underlying debt, its age and type, as well as external economic conditions and the effort applied.

5) NZC previously applied IAS 39 to ABDs for financial reporting purposes. From (and including) the financial year ended 30 June 2010, NZC will apply AASB 9 to ABDs for financial reporting purposes.

6) This determination provides that NZC's tax liability for an income year will be based on actual collections reduced by the proportion of purchase cost allocated to that income year.

2. Reference

This determination is made under s 90AC(1)(bb) of the Tax Administration Act 1994.

3. Scope of determination

1) This determination applies to the tax treatment of ABDs acquired by NZC.

2) ABDs are pools of unpaid loans and receivables. These pools may consist of a few hundred to a few thousand individual debts.

3) NZC acquires the ABDs at a deep discount to their face value on the expectation that its recoveries will be in excess of the purchase price and the cost incurred in attempting collection.

4) NZC previously applied IAS 39 to ABDs for financial reporting purposes. From (and including) the financial year ended 30 June 2010, NZC will apply AASB 9 to ABDs for financial reporting purposes.

5) NZC will apply the spreading method adjustment formula in s EW 27 of the Income Tax Act 2007 to any financial arrangements (forming part of an ABD) to which it was a party at the end of the financial year ended 30 June 2009.

6) This determination is made subject to the following conditions:

   i) NZC is satisfied on the basis of objective criteria that five years is the appropriate period over which cashflows from an ABD are to be forecast; and

   ii) NZC will not take a deduction for the acquisition cost of an ABD (or any part thereof) except as set out in this determination; and

   iii) NZC continues to treat all underlying debts to which it becomes a party on the acquisition of an ABD (which would otherwise be excepted financial arrangements) as financial arrangements under s EW 8 of the Income Tax Act 2007.

4. Principle

1) All underlying debts to which NZC becomes a party on the acquisition of an ABD are either financial arrangements as defined in s EW 3 of the Income Tax Act 2007, or are treated as financial arrangements by NZC under s EW 8 of the Income Tax Act 2007.
2) This determination specifies that income and expenditure from an ABD for an income year is recognised using a profit emerging method. This method takes into account actual cash flows less an apportionment of the cost of purchase.
3) The apportionment of the purchase cost of an ABD is based on the original forecasted recoveries for the income year as a proportion of the total original forecasted recoveries from the ABD over a five year period.
4) Any cash collections will be returned as income in the income year in which they are received.

5. Interpretation

In this determination (and the Explanation), unless the context otherwise requires:

- Words and expressions used (which have not been defined elsewhere within the determination) have the same meaning as in s YA 1 of the Income Tax Act 2007.
- "IAS 39" means International Accounting Standard 39 (Financial instruments: recognition and measurement), issued by the International Accounting Standards Board.
- "AASB 9" means Australian Accounting Standard AASB 9 (Financial instruments), issued by the Australian Accounting Standards Board.

6. Method

The profit emerging method is illustrated in the following formula:

$$AI = AC - \frac{(PC \times OF)}{TECC}$$

Where:

AI = assessable income of an ABD for an income year
AC = actual cash collected from the ABD during the income year
PC = purchase costs of ABD
OF = original forecast cash to be collected during the income year
TECC = total expected cash to be collected over five years, forecast at date of purchase

Once the cost of the ABD is fully amortised, cash collected after the five year period will be treated as derived in the income year in which it is received.

7. Example

This example illustrates the application of the method (set out in this determination) for determining the income and expenditure attributable to an ABD in each income year.

This example proceeds on the following parameters:

Purchase date	1 July 2006
ABD purchase cost (PC)	1,000,000
Forecast cash collection (OF)	
Year 1	1,068,000
Year 2	582,000
Year 3	274,000
Year 4	58,000
Year 5	18,000
Total expected cash collected over five years (TECC)	2,000,000
Actual cash collection (AC)	
Year 1	1,106,000
Year 2	600,000
Year 3	293,000
Year 4	88,000
Year 5	20,800
Year 6	6,800
Year 7	500

LEGISLATION AND DETERMINATIONS

Taxable income	2007	2008	2009	2010	2011	2012	2013	Total
Original forecast cash (OF)	1,068,000	582,000	274,000	58,000	18,000	0	0	2,000,000
Actual cash (AC)	1,106,000	600,000	293,000	88,000	20,800	6,800	500	2,115,100
Actual cash (AC)	1,106,000	600,000	293,000	88,000	20,800	6,800	500	2,115,100
Less (PC × OF/TECC)	534,000	291,000	137,000	29,000	9,000	0	0	1,000,000
Equals assessable income (AI)	572,000	309,000	156,000	59,000	11,800	6,800	500	1,115,100

This determination is signed by me on the 17th day of December 2010.

Howard Davis
Director (Taxpayer Rulings)

DETERMINATION DEP 76: TAX DEPRECIATION RATES GENERAL DETERMINATION NUMBER 76

Note to determination DEP 76: This determination applies to the 2010–11 income year and subsequent income years and is issued pursuant to section 91AAF of the Tax Administration Act 1994.

This determination introduces Motorhomes as a new asset class description. The Commissioner considers that Motorhomes have previously been included within the Campervan asset class description. Motorhomes acquired before the 2010–11 income year should continue to be depreciated using the appropriate depreciation rate for Campervans.

For Campervans and Motorhomes that are exclusively available for hire for periods longer than 1 month, the rates in section EE 29 of the Income Tax Act 2007 apply (30% DV or 21% SL).

For Campervans and Motorhomes that are not available exclusively for hire for periods longer than 1 month, there are three different depreciation rates that may apply depending on when the Campervan or Motorhome was acquired. The different rates apply to the following:

- Campervans and Motorhomes acquired in the 2010–11 and later income year;
- Campervans and Motorhomes acquired after 1 April 2005, but prior to the 2010–11 income year; and
- Campervans and Motorhomes acquired prior to 1 April 2005.

For Campervans and Motorhomes acquired in the 2010–11 and later income years, the depreciation rates are set under section EE 30 of the Income Tax Act 2007 (Economic rate for plant, equipment, or building, with high residual value). These are new depreciation rates.

For Campervans and Motorhomes acquired prior to the 2010–11 income year, the depreciation rates are set under sections EZ 23 and EE 27 respectively. These rates remain unchanged. The asset class descriptions have been updated to take into account the new depreciation rates and to make it clear the Campervan asset class included Motorhomes.

This determination may be cited as Determination DEP 76: *Tax depreciation rates determination number 76.*

1. Application

This determination applies to taxpayers who own items of depreciable property of the kind listed in the table below that have been acquired during the 2010–11 and later income years.

2. Determination

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

- Adding into the "Leisure" industry category and the "Hire Equipment" and "Transportation" asset categories, the general asset classes, estimated useful lives, and diminishing value and straight-line depreciation rates listed in the table below:

General asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Campervans* acquired during or after the 2010–11 income year	8	18	12.5
Motorhomes* acquired during or after the 2010–11 income year	8	18	12.5

* Under section EE 30 (Economic rate for plant, equipment, or building, with high residual value) residual value estimated at 20%.

3. Consequential changes

As a consequence of this determination, the existing general asset classes for "Campervans" in the "Leisure" industry category and the "Transportation" asset category are amended as follows:

General asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Campervans (including Motorhomes) acquired before 1 April 2005	10	18	12.5
Campervans (including Motorhomes) acquired on or after 1 April 2005 but prior to the 2010–11 income year	10	20	13.5

The above change does not represent a change of depreciation rates. The only change is that the asset class description has been clarified.

4. Interpretation

In this determination, unless the context otherwise requires, words and terms have the same meaning as in the Income Tax Act 2007 and the Tax Administration Act 1994.

This determination is signed on the 23rd day of December 2010.

Rob Wells
LTS Manager, Technical Standards

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.

WHO IS LIABLE FOR GST: THE RECEIVER OR THE PARTNERSHIP?

Case	Stiassny and ORS v Commissioner of Inland Revenue
Decision date	4 November 2010
Act(s)	Goods and Services Tax Act 1985, Personal Property Securities Act 1999
Keywords	Partnership, receiver, personal property, GST, liability

Summary

The sale of a forest by a partnership (each party of which was in receivership) created a goods and services tax (GST) liability of $127 million. The receivers paid the GST to the Commissioner and sought a Court order to return the funds. The Commissioner was unsuccessful in having the claim struck out.

Impact of decision

This decision has limited tax-technical implications, but is of interest for its analysis of section 95 of the Personal Property Securities Act 1999 (PPSA) and of the law regarding mistaken payments. The decision is being appealed by the Commissioner.

Facts

The plaintiffs in this case are:

- two companies, and the receivers of those companies, which were the partners in the Central North Island Forestry Partnership (CNIFP)
- the secured creditors of the CNIFP.

The partner companies were each placed in receivership by a secured creditor. The CNIFP itself was not in receivership.

The CNIFP sold a forest for US$621 million, plus GST of approximately NZ$127 million. There were insufficient funds to repay secured lenders as well as the GST on the sale, which resulted in a dispute as to the priority of the GST amount. The receivers paid the GST to the Commissioner and commenced proceedings to claim the funds back. The plaintiffs sought:

- an order that the receivers were not liable to pay the GST
- the return of the funds as money paid under a mistake of law (a restitutionary claim).

The Commissioner applied to strike out the claim, on the grounds that the:

- receivers were liable to pay the GST amount
- Commissioner is nevertheless entitled to retain the funds under section 95 of the PPSA
- Commissioner provided good consideration for the funds
- companies and the receivers did not have standing to bring the proceedings.

Decision

The receivers were not liable to pay the GST; the liability was that of the partnership [32]–[48].

- The sale of the assets was not a taxable activity of the partners; it was part of the taxable activity of the partnership. The partners (in being members of the partnership) were not conducting any taxable activity:

  > … Section 58(1A) imposes upon a specified person liability only in respect of the taxable activities of the incapacitated person concerned [ie the partner companies], and not in respect of the taxable activities of some other person registered in respect of those activities [ie the partnership] [41].

- His Honour held at [42] that while the partners were jointly and severally liable for the GST liability of the partnership under section 57(3), that liability:

  > is not dependent upon or related to the carrying on by partners of their own taxable activity. The subsection simply imposes statutory liability for the GST responsibilities of another (registered) entity.

- The receivers of companies that are partners in a partnership are not members of the partnership:

> Although the definition of "member" in section 2(1) is not a closed definition, the Court would not, in my view, be justified in extending it to a receiver, given that the legislature has seen fit to specify four categories of legal person who come within that definition [44].

Section 95 of the PPSA applied, but did not operate to prevent in personam claims such as a claim for money had and received [49]–[73].

- The payment was a debtor-initiated payment, notwithstanding it was paid under compulsion or pressure as a result of exposure to interest and penalties:

> … There is nothing in the language or purpose of s 95 which requires that a gloss be placed on the meaning of the term "debtor-initiated payment". There can be no question here but that the payment was initiated by or on behalf of the debtor in the sense that a conscious decision was taken by the receivers to forward a cheque to the Commissioner for the amount of the GST liability. The fact that they did so because they believed that they were or might be personally liable for the amount of the GST concerned could not justify the conclusion that the payment was other than debtor-initiated. Although the payment was made for motives associated with the sanctions for late payment imposed by the relevant statutory regime, it could not be said that the payment thereby lost its debtor-initiated status [72].

- Section 95 of the PPSA did not prevent the plaintiffs claiming restitution on the ground of mistaken payment. His Honour noted at [60] that nothing in the section or Act shows a legislative intention to exclude overarching legal principles, and went on to state at [64]:

> While I accept that section 95 protects a creditor from a proprietary claim to a negotiable instrument falling within the section, as against the holder of a relevant security interest, a claim *in personam* does not conflict with the creditor's rights in a negotiable instrument.

At [107]–[122]:

- While the liability was the CNIFPs, and the CNIFP made the payment, the CNIFP understood the receivers to be liable for the debt and made the payment to avoid that liability. The payment would not have been made but for that mistaken belief [103]–[104], [117], [120]–[122].

- There may have been some doubt on behalf of the receivers as to the correct position (as opposed to a fully fledged mistaken belief). His Honour noted there is authority that says mere doubt does not amount to a mistake, but there is also authority holding that doubt is not necessarily sufficient to rule out an argument based on mistake. His Honour stated at [119]:

> I do think that the fact that the plaintiffs had doubts as to whether the receivers were personally liable for the GST payment is determinative of the question of whether they are acting under a mistake.

The Commissioner provided good consideration, but may not have acted in good faith. His Honour decided that, due to the novel nature of the fact scenario, and that this is a developing area of the law, that this question should only be addressed after hearing fuller evidence and submissions, and it was not appropriate to determine it at the strike-out stage [123]–[140].

- His Honour found on the facts that the CNIFP made the payment to discharge its GST liability, and that the discharge of the liability constituted good consideration by the Commissioner [125].

- His Honour noted that the receivers had little choice but to take the course that they did, in paying the disputed amount and then commencing proceedings. His Honour stated at [137]:

> … Although the Commissioner did not acknowledge any mistake, he was on notice by the time of receipt that the plaintiffs challenged the validity of the payment. There is an argument to make that in those circumstances, the Commissioner did not receive the payment bona fide for the purposes of the provision.

- His Honour went on to note at [138]:

> The law relating to recovery of payments made under a mistake (and particularly under a mistake of law) is still evolving. Goff and Jones observe that questions about the scope of the defence of good consideration have not been definitively answered. Those questions include the good faith requirement. I recognise that questions of law will ordinarily be determined on a strike-out application even where difficult and troublesome but in my opinion, this unusual combination of factual and legal issues is best resolved at trial and not on the present application.

The circumstances are not sufficiently clear to say that the plaintiffs do not have standing to bring the proceedings [141]–[144].

SUPREME COURT DENIES LEAVE TO APPEAL

Case	Chesterfields et al v Commissioner of Inland Revenue
Decision date	16 December 2010
Acts	Supreme Court Act 2003, Judicature Amendment Act 1972
Keywords	Leave, appeal, Supreme Court, judicial review

Summary

No significant error by the Court of Appeal, nor substantial principle sufficient to meet the requirements for leave was shown.

Impact of decision

Given the "extremely very fact specific" nature of the case and that it "has practically no precedential value" [7] there are limited implications of this judgment.

Facts

The parties have been involved in a long-running judicial review. The taxpayers are one individual (Mr Hampton) together with two partnerships involving him and two companies of which Mr Hampton is the director.

Following partial success on appeal by the Commissioner at the Court of Appeal ([2009] NZCA253), Mr Hampton on behalf of the taxpayers sought to appeal to the Supreme Court, on the basis that the interpretation the Court of appeal had used in approaching the High Court judgments was incorrect. There was no direct appeal of the judgment of the Court of Appeal.

Decision

Leave to appeal to the Supreme Court was declined.

The Supreme Court considered the Court of Appeal's "guidance" on the High Court's judgment was sufficiently prescriptive in the present context to amount to directions under the Judicature Amendment Act and thus to justify considering the application for leave to appeal on its merits [6].

The application did not raise any substantial issue of principle nor show there was an error of law in the lower appellate court such as to give raise to a miscarriage of justice [8].

While proportionality was addressed this was fact specific and therefore not a general requirement in relation to additional taxes. Nor was there any basis to address alleged late discovery of documents [9]–[11].

TAXPAYER ENTITLED TO DISCONTINUE A TEST CASE

Case	Commissioner of Inland Revenue v Telstra NZ Holdings Limited
Decision date	3 December 2010
Acts	Tax Administration Act 1994
Keywords	Test case, discontinuance, increased or indemnity costs

Summary

The taxpayer's challenge in respect of its 2003–05 tax years was designated as a test case by the Commissioner. Shortly before trial the taxpayer discontinued its challenge, and then commenced new challenge proceedings in respect of later tax years (albeit in respect of the same alleged tax avoidance arrangement). The Commissioner applied to have the discontinuance of the first challenge set aside on the grounds that it was an abuse of process. The Court dismissed the Commissioner's application, holding that the taxpayer was entitled to take the steps they did.

Impact of decision

The decision confirms that challenges designated as test cases are able to be discontinued and that challenges in respect of latter years are not determined by a decision in respect of earlier years.

Facts

This is an interlocutory decision relating to Telstra's part in the Optional Convertible Notes (OCN) litigation. The OCN litigation involves challenges to assessments issued by the Commissioner on the grounds that OCN arrangements entered into by a number of taxpayers constituted tax avoidance.

Telstra's challenge of the assessments to its 2003–05 years was designated as a test case in the OCN litigation along with another OCN case. Other OCN challenges were stayed pending the outcome of the test cases.

Telstra's challenge was due to be heard by the High Court in Auckland from 26 October 2010. The proceedings were well advanced, and almost ready for trial, when Telstra discontinued its challenge proceedings on 3 September 2010.

On 5 October 2010 Telstra filed a second challenge to its OCN assessments, this time in respect of the 2006–08 years.

The Commissioner applied to set aside Telstra's discontinuance of the first challenge on the grounds that it was an abuse of process in circumstances where:

a) Telstra's first challenge was a test case for other litigants, and Telstra had not objected to it being designated as such

b) the proceedings were substantially ready for trial, and briefs of evidence had been exchanged

c) Telstra continues to litigate the later years of the same arrangement in its second challenge.

The Commissioner also sought, in the alternative, an order for increased or indemnity costs, on the grounds that Telstra's conduct in discontinuing at the last minute had put the Commissioner to unnecessary expense.

Decision

Discontinuance

His Honour found on the facts that there was no abuse of process by Telstra in this instance; its decision to discontinue was a commercial decision to not incur the costs of trial. There was nothing in the evidence to suggest that Telstra discontinued in order to gain an improper advantage in the OCN litigation.

Further, the Commissioner was not prejudiced by the discontinuance. The Commissioner saved the costs of a trial, and will be able to use a substantial part of the evidence in defending the next OCN challenge.

His Honour noted that the discontinuance had inconvenienced the Commissioner, but said this was not sufficient to set aside the discontinuance, and that the test case regime "does not abrogate the right of a designated taxpayer to discontinue its tax challenge proceedings". His Honour went on to note that, while the second challenge raised exactly the same questions of fact and law as the first, the second challenge is a separate challenge in respect of different income years and "[a] previous decision, relating to a different year of income, does not determine the tax liability of a taxpayer in respect of later years of income".

Costs

His Honour held that Telstra is not liable for increased or indemnity costs as its discontinuance was not unreasonable.

AS A GENERAL RULE, INSOLVENT COMPANIES SHOULD BE LIQUIDATED

Case	Commissioner of Inland Revenue v Atlas Food & Beverage Ltd et al
Decision date	26 October 2010
Acts	Companies Act 1993
Keywords	Insolvency, creditor, liquidation, discretion

Summary

Notwithstanding certain steps taken to satisfy outstanding debts, the Court was satisfied that the companies were insolvent and should be liquidated.

Impact of decision

The case provides a useful precedent on the Court's discretion not to make a liquidation order.

Facts

The Commissioner applied to liquidate Atlas Food and Beverage Ltd (Atlas), Char Char Ltd (CCL), Yellow Cross Brewing Company Ltd (YCB) and Edward J Schwartz Entertainment Inc Ltd (EJS). The four companies were part of a group.

Atlas

By the time of the hearing, Atlas had paid its tax debt that was not disputable under the disputes regime. It had also issued a Notice of Proposed Adjustment (NOPA) in respect of the remaining PAYE debt of approximately $110,000.

CCL

CCL was trading at the time of the hearing. It had a tax debt of around $63,000. CCL had made a payment proposal which had been rejected by the time of the hearing.

YCB and EJS

These companies were in receivership. YCB has substantial PAYE and GST arrears. EJS had a significant GST debt.

Decision

Atlas

It was argued for Atlas that as all the undisputed tax had been paid, the Commissioner was no longer a creditor, and alternatively the Court should exercise its discretion against making a liquidation order.

The Court held that the Commissioner was a creditor. As well, the case was a plain one and not one that warranted

departure of the general policy that insolvent companies should be liquidated. However, the liquidation order in respect of this company was stayed pending an appeal to the Court of Appeal.

CCL

It was argued for the company that a provisional liquidation order should be made which could only come into effect if payment in full was not made within 14 days. The Court held that in the circumstances, it was not appropriate to allow the company an indulgence of a 14-day period to pay its outstanding tax and a liquidation order was granted.

YCB and EJS

It was argued for the companies (by the director exercising residual powers) that as the Commissioner's tax debt (PAYE and GST) was preferential, the receivers should have paid the debt out of the proceeds of the inventory.

The Commissioner expressed doubt as to the validity of the above argument and argued that a liquidator could evaluate the merits of any such argument. The Court was satisfied that the Commissioner's position was a reasonable one and was not prepared to exercise its discretion not to grant a liquidation order.

QUESTIONS WE'VE BEEN ASKED

QB 10/06: ELECTIONS FOR QUALIFYING COMPANY STATUS

All legislative references are to the Income Tax Act 2007.

Question

If a nominee or bare trustee holds shares in a company for another person, should the nominee or bare trustee shareholder, or the beneficial owner of the shares sign the notice of shareholder election for qualifying company status?

Answer

A notice of shareholder election for qualifying company ("QC") status for that shareholding will be effective if signed by any one of:

- the beneficial owner of the shares
- a person holding shares as a nominee for the beneficial owner of the shares, or
- a person holding shares as a bare trustee for the beneficial owner of the shares.

The legislation requires that the beneficial owner make the shareholder election. The beneficial owner can satisfy this requirement by personally making the election. However, the legislative requirements will also be satisfied if the election is made by a nominee or bare trustee acting on instructions and on behalf of the beneficial owner.

The act of a nominee is "looked through". The nominee's act is treated as done by the person on whose behalf the nominee is acting (see s YB 21(1)). Therefore, where a nominee shareholder signs a notice of shareholder election for QC status, the election will be treated as having been made by the beneficial owner of the shares.

A bare trustee is treated as a nominee (see s YB 21(2)). Therefore, when a bare trustee signs a notice of shareholder election for QC status, the election will similarly be treated as having been made by the beneficial owner of the shares.

This item clarifies the Commissioner's statement on who is required to sign a notice of shareholder election for QC status, where nominees or bare trustees are involved (*Tax Information Bulletin* (TIB) Vol 3, No 7 (April 1992)). That statement is withdrawn with immediate effect to the extent of the following bolded text in relation to "Shareholder elections – Section 393D":

> In determining who has to make the election it is important to note that the look through rules only apply for the count test and not for the election requirements. Where a chain of qualifying companies exists, only the shareholder qualifying company must complete a shareholder election and assume liability. **Similarly, in the case of a nominee interest it is the nominee who elects.**

The Commissioner considers that the same conclusions apply in relation to the newly enacted look-through company regime.

Explanation

Purpose of this item

This item explains who should sign a notice of shareholder election for QC status where a nominee shareholder or bare trustee shareholder is involved. In these situations, the possible signatories are the person holding shares as the nominee or bare trustee for the beneficial owner or the beneficial owner of the shares. The item concludes that an effective shareholder election will be made when a notice of shareholder election is signed by any one of these signatories.

This item does not impact on the rules of general agency where a person could validly instruct an agent to sign an election on their behalf.

Who is required to make a shareholder election?

Section HA 1(5) states in relation to entering the QC regime:

> For a company to be a qualifying company or a loss-attributing qualifying company, all the directors of the company, and **every shareholder in the company with legal capacity, must sign an election referred to in section HA 5**. An exception applies for a minority shareholder in the situation described in section HA 29.
>
> [Emphasis added]

For a company to become a QC, every shareholder in the company with legal capacity must sign an election. Section HA 1(6) then states:

> A shareholder who makes an election referred to in subsection (5) must agree to take personal liability to the extent described in section HA 8.

By electing QC status, the shareholders:

- elect to enter the QC regime, and
- elect to be liable for a share of the company's income tax liability, proportional to the shareholder's effective interest in the company.

Elections to become a qualifying company

Section HA 5(1) states that:

> A company that meets the requirements of sections HA 6 to HA 9 may be a qualifying company or an LAQC only if all the directors of the company and every shareholder in the company with legal capacity, choose that the company is to become a qualifying company. Every director and every shareholder with legal capacity must sign a notice of election and give it to the Commissioner.

To make the election to be a QC, every shareholder with legal capacity must:

- choose that the company is to become a QC
- sign a notice of election, and
- give that notice to the Commissioner.

When these legislative requirements are considered in detail along with the discernible policy intent of the QC and LAQC regimes, the "shareholder" referred to in these sections is the beneficial owner of the shares. It is the beneficial owner who must make a shareholder election. Given that the beneficial owner must make the shareholder election, the issue is whether the beneficial owner must do this personally or whether a nominee or bare trustee could do so on behalf of the beneficial owner.

Can nominees or bare trustees elect on behalf of beneficial owners?

Definition of nominees

"Nominee" is defined in s YB 21:

> **Treatment of nominee**
>
> (1) In this Act, unless the context otherwise requires, if a person holds something or does something as a nominee for another person, the other person holds or does that thing and the nominee is ignored.
>
> **Who is a nominee?**
>
> (2) A person holds or does something as a nominee for another person if the person acts on the other person's behalf. However, a trustee is a nominee only if the trustee is a bare trustee.

For the purposes of the Act, a nominee is a person who holds something or does something for another person on that other person's behalf. Usually a nominee will be directly instructed to take a particular action. A nominee acts within the limits allowed by the person on whose behalf and as whose representative the nominee is acting.

The nominee can only act as directed by the beneficial owner. Therefore, the nominee's action is implicitly or explicitly approved by the person for whom they are acting.

Unless the context requires otherwise, if a nominee holds or does something for another person, the nominee is ignored. The person, on whose behalf the nominee was acting, is treated as having taken the action. The nominee is looked through.

A nominee shareholder

Where a person uses a nominee to hold shares in a company, the nominee is the shareholder on the company's share register. However, the nominee holds the shares for the other person (the beneficial owner of the shares).

If the nominee shareholder does something on behalf of the beneficial owner of the shares and as instructed by the beneficial owner, that action is treated as the action of the beneficial owner of the shares.

Example 1

Adam holds shares in a company, as Bella's nominee. Adam is the shareholder on the company's share register. Adam, as Bella's nominee shareholder, signs an election for QC status in relation to that shareholding as directed by Bella. Adam has acted on behalf of Bella and as Bella's representative. For the purposes of the QC regime, Adam is ignored. Bella, the beneficial owner of the shares, is treated as having made the shareholder election. .

In summary, where a nominee shareholder acts on behalf of the beneficial owner of the shares in relation to those shares and as instructed by the beneficial owner, the nominee is ignored and the action is treated as that of the beneficial owner of the shares.

A bare trustee shareholder

Section YB 21(2) states that "a trustee is a nominee only if the trustee is a bare trustee". As such, a bare trustee is a "nominee" under the Act.

Therefore, if a bare trustee holds shares in a company, the bare trustee holds those shares for and on behalf of the beneficial owner of the shares. Where the bare trustee shareholder acts on behalf of and as instructed by the beneficial owner of the shares, the bare trustee (then acting as a nominee) is ignored. The action is treated as that of the beneficial owner of the shares.

Example 2

Alice is the shareholder of a company. She holds the shares in the company as a bare trustee for Ben. Ben is the beneficial owner of the shares. Ben instructs Alice to sign the form to elect QC status in relation to those shares. Alice, as shareholder, signs a shareholder election form for QC status. Alice has acted on behalf of Ben and as instructed by Ben. For the purposes of the QC regime and by the application of section YB 21, Alice is ignored. Ben, the beneficial owner of the shares, is treated as having made the shareholder election.

Look-through companies

The Commissioner considers that the same result is reached in relation to the newly enacted look-through company ("LTC") regime. Section HB 13 states in relation to electing to become an LTC:

> **HB 13 LTC elections**
>
> (1) For the purposes of section HB 1, an LTC election (the election) is a notice that—
>
> (a) is signed and dated by a director of the company that becomes a look-through company (the LTC) or other agent with appropriate authority; and
>
> (b) is in the form prescribed by the Commissioner; and
>
> (c) specifies an income year beginning on or after 1 April 2011 for which it may first operate; and
>
> (d) has attached to it notices—
>
> (i) signed and dated by all persons who, on the date of signing the election, own look-through interests in the LTC; and
>
> (ii) evidence unanimous agreement of the owners in choosing to apply section HB 1.

The QC and LAQC regime requires notices of shareholder elections. Under the LTC regime, s HB 13(1)(d)(i) requires all persons who own "look-through interests" in an LTC to make an election. A "look-through interest" is defined as meaning a person's shares in an entity or look-through company (subject to the requirements of that definition). For the same reasons as for the QC and LAQC regimes, the election required under s HB 13(1)(d)(i) must be made by the beneficial owner of the shares. The beneficial owner can satisfy this requirement by personally making the election. However, the legislative requirements will also be satisfied if the election is made by a nominee or bare trustee acting on instructions and on behalf of the beneficial owner under s YB 21.

Therefore, a notice of election for LTC status made by the owner of a look-through interest will be effective if signed by any one of:

- the beneficial owner of the shares
- a person holding shares as a nominee for the beneficial owner of the shares, or
- a person holding shares as a bare trustee for the beneficial owner of the shares.

Example 3

Arthur is the shareholder of a company. He holds the shares in the company as a nominee for Brenda. Brenda is the beneficial owner of the shares. Brenda instructs Arthur to sign the form to elect LTC status in relation to those shares. Arthur, as Brenda's nominee shareholder, signs a shareholder election form for LTC status. Arthur has acted on behalf of Brenda and as instructed by Brenda. For the purposes of the LTC regime and by the application of s YB 21, Arthur is ignored. Brenda, the beneficial owner of the shares, is treated as having made the election for LTC status.

ITEMS OF INTEREST

REVIEW OF PUBLIC INFORMATION BULLETINS

To assist taxpayer certainty and compliance Inland Revenue has commenced a review of *Public Information Bulletins* (PIBs) and *Tax Information Bulletins* (TIBs) published prior to 31 December 1995.

PIBs were published regularly by Inland Revenue between September 1963 and July 1989. As tax advisors and some taxpayers will be aware PIBs are dated and often refer to legislation that has been repealed or amended. They also often refer to information that is very general in nature with limited analysis or reasoning to support the views expressed. In addition, the Commissioner's views or reasoning may well have developed or changed significantly since that time. Inland Revenue ceased publishing PIBs from July 1989, and then commenced publication of TIBs. Similar concerns apply to TIBs published between 1989 and December 1995 before a more robust process, including routine external consultation, was introduced. These TIBs will also be part of the review.

Process

The PIBs and TIBs will be systematically reviewed in date order, starting with the oldest publications and working forward to December 1995.

Notification that an item has been reviewed will be made on the Inland Revenue website. However, where an item is still relevant and correct, it will be updated to reflect current legislation (if necessary) and reissued on the Inland Revenue website and in a current TIB.

Any historical legislative commentary contained in PIBs and the identified TIBs will be made publicly accessible as an electronic archive.

During the course of the review, Inland Revenue will consult with the New Zealand Institute of Chartered Accountants and the New Zealand Law Society. We will also consult with other affected parties as issues arise.

Information on the progress of the review will be available on the Inland Revenue website.

Until the PIB and identified TIB items are reviewed these items should be referenced with some care, and they should not necessarily be taken as the Commissioner's current view of the law or operational practice. Where there is doubt professional advice should be sought.

Any queries regarding this review please contact Craig Robertson, **craig.robertson@ird.govt.nz**, 09 985 7189.

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 public 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.

GET YOUR TIB SOONER ON THE INTERNET

This *Tax Information Bulletin* (*TIB*) is also available on the internet in PDF at **www.ird.govt.nz**

The *TIB* index is also available online at **www.ird.govt.nz/aboutir/newsletters/tib/** (scroll down to the bottom of the page). The website has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you would prefer to get the *TIB* from our website, please email us at **tibdatabase@ird.govt.nz** and we will take you off our mailing list.

You can also email us to advise a change of address or to request a paper copy of the *TIB*.