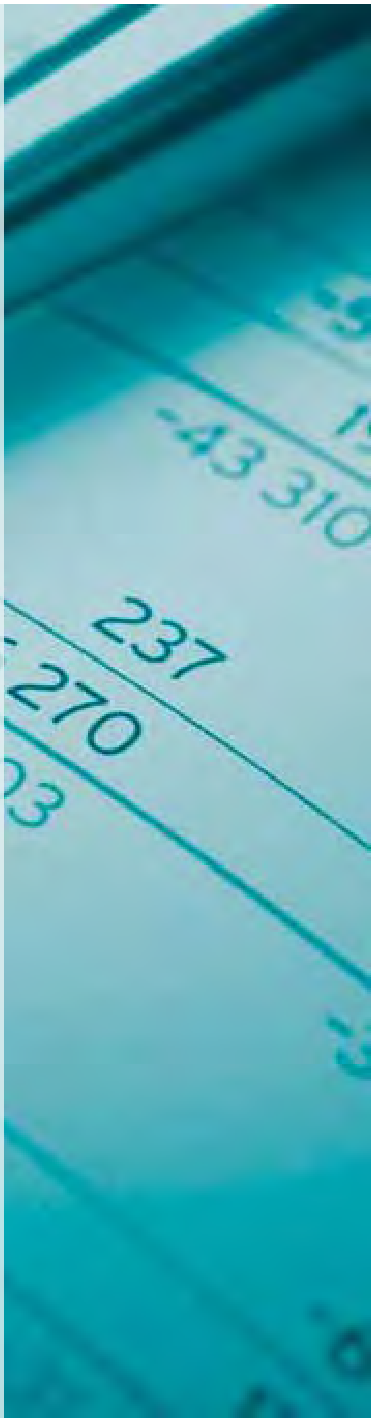
Vol 23 No 8 October 2011

TAX INFORMATION *Bulletin*



CONTENTS

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.

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

Ref	Draft type/title	Description/background information	Comment deadline
INS0033	Deductibility of company administration costs	This interpretation statement considers whether a range of expenditure incurred by companies is deductible under the Income Tax Act 2007. Please note the consultation period for this draft is shorter than normal; if you are intending to comment, please contact Public Consultation as soon as possible. The expenditure is of a type that is incurred by companies as a result of their inherent nature and the regulatory environment applicable to them. The costs considered include audit fees, annual/special meetings of shareholders, costs associated with paying dividends, registered exchange listing fees, share registry costs, costs of filing statutory returns, and associated legal and accounting costs.	
QWB0092	Income tax – look-through companies and interest deductibility	This item questions whether interest will still be deductible where a loss-attributing qualifying company becomes a look-through company. In particular, it examines the effect of the tax transparency provisions set out in section HB 1(4) of the Income Tax Act 2007. Please note the consultation period for this draft is shorter than normal; if you are intending to comment, please contact Public Consultation as soon as possible.	
ED0139	Draft standard practice statement: Application of discretion in section 81(1B) of the Tax Administration Act 1994 – the secrecy provisions	This draft standard practice statement sets out the factors that Inland Revenue must take into account, and the process that will be followed, when disclosing tax secret information to third parties.	28 October 2011
ED0140	Questions we've been asked – Depreciation of commercial fit-out	This draft QWBA clarifies that a taxpayer cannot re-characterise a part of a commercial building into components of commercial fit-out to claim depreciation when those items had not previously been identified as separate depreciable property.	18 November 2011

Clarification – to TIB Vol 23, No 1 (February 2011)

The definition of "deductions" in the loss limitation formula for the look-through company rules on page 53 has been clarified to include the current tax year for an owner's share of capital loss amounts in the formula. The definition on page 53 should be read as follows (emphasis added to show changes): *deductions* is the owner's share of the LTC's deductions **in the preceding tax years**, and capital losses in the **current and** preceding years (in which the company was an LTC).

IN SUMMARY

New legislation (continued)

Legislation and determinations

Legal decisions – case notes

REVENUE ALERT

Revenue alerts inform taxpayers and tax agents about significant and/or emerging tax planning issues or arrangements where Inland Revenue has concerns and is undertaking further risk assessment and investigative activities.

RA 11/02: DIVERTING PERSONAL SERVICES INCOME BY STRUCTURING REVENUE EARNING ACTIVITIES THROUGH AN ASSOCIATED ENTITY SUCH AS A TRADING TRUST OR A COMPANY – THE CIRCUMSTANCES WHEN INLAND REVENUE WILL CONSIDER THIS ARRANGEMENT IS TAX AVOIDANCE

Explanation

A Revenue Alert is issued by the Commissioner of Inland Revenue and provides information about a significant and/or emerging tax planning issue that is of concern to Inland Revenue. At the time an Alert is issued, risk assessments will already be underway to determine the level of risk and to consider appropriate responses.

A Revenue Alert will identify:

- the issue (which may be a scheme, arrangement, or particular transaction) which the Commissioner believes may be contrary to the law or is inconsistent with policy;
- the common features of the issue;
- our current view; and
- our current approach.

An Alert should not be interpreted as being Inland Revenue's final position. Rather, an Alert outlines the Commissioner's current view on how the law should be applied. For any Alert we issue it is likely that some investigatory work has already been carried out.

If people have entered into an arrangement similar to the one described or are thinking about it, they should talk to their tax advisor and/or to Inland Revenue for advice about tax implications.

Note: This Revenue Alert updates the Commissioner's view on this matter following the Supreme Court's decision in *Penny and Hooper v CIR* [2011] NZSC 95. It replaces Revenue Alerts RA 08/01 issued in March 2008 and RA 10/01 issued in June 2010.

Key issues

- The use of companies, trusts and other business structures does not of itself give rise to avoidance concerns;
- However, the use of those structures can provide the controllers of the business with an opportunity to divert income away from themselves;
- When the business involves the provision of services, whether that diversion is legitimate or not requires a focus on two issues:
  - *Is that individual controller appropriately compensated for his or her skill and exertion?* This requires an examination of the respective drivers of profit for the particular services provider and how the profits of the business are actually distributed.
  - *If not, are there any valid commercial reasons for the individual receiving a reduced level of remuneration?* Here the focus is on whether there are particular reasons why the individual is accepting an unreasonably low level of remuneration.
- We will be concerned with arrangements where the compensation received by the individual is artificially low while related entities benefit (or the individual ultimately benefits), and any commercial reasons for that transaction do not justify the low level of remuneration.

Introduction

Inland Revenue has always been concerned about arrangements involving taxpayers who arrange to effectively divert to an associated entity some or all of the income they earn (or could earn) from a business or activity of supplying personal services—where it has the effect of taking advantage of lower marginal income tax rates payable by that entity and/or by family members as beneficiaries or shareholders of that entity. Other tax-linked benefits (such as certain entitlements and obligations such as child support) may also arise under the arrangement.

There are legitimate reasons for using entities such as trusts or companies in many business situations. Therefore the mere use of alternative business structures will not, on its own, amount to a tax avoidance arrangement. Further, the profit generated by the business may not be wholly generated by the individual and there may also be good non-tax reasons as to why the controller of a business receives significantly less of the business's profits than would otherwise be the case.

However, where the business involves the provision of services, we are likely to examine closely any arrangement where the individual service provider (usually the real owner or owners or controllers of the business) is not receiving a significant portion of the profits derived from the business. This is particularly so where there is an absence of other business profit drivers and other non-tax reasons do not justify the level of remuneration received by the individual.

Inland Revenue's position in this regard has recently been confirmed by the Supreme Court's judgment in *Penny and Hooper v CIR*. That decision confirms that income substantially generated by the direct personal skills, experience or labour of an individual should generally be subject to tax in the hands of that individual. The individual's contribution to the business should be properly reflected in the income returned by that individual—either through an appropriate salary or other taxable distributions to the individual.

We consider that the Supreme Court's analysis endorses earlier cases decided in this area, and potentially applies to any type of services provided by an individual to third parties.

We will closely examine situations where an arrangement has the effect of diverting a substantial amount of that personal exertion income but the benefit of those diverted funds is still enjoyed, directly or indirectly, by the individual or their family or associates. We will generally focus on the most serious and artificial cases—where the arrangement results in a substantial proportion of the income generated by the business being diverted away from the individual service providers.

In many cases, taxpayers entering into these types of arrangements are also benefiting from reduced child support liabilities or student loan repayment obligations. In some cases taxpayers are structuring their remuneration at a level that will allow them access (or greater access) to other non-income-tax benefits that rely on income calculated for tax purposes.

Features

It is often a combination of factors, such as those listed below, that concern us. Where income is generated from the supply of services provided by individuals, a combination of some or all of the following factors may result in us looking more closely at a business structure:

1. The controllers of the business arrange for an entity, such as a trading trust or company, to operate and own the business. The operating entity engages or employs them (or contracts for their services);
2. Where the business has been transferred, the business operates substantially as it did before its transfer to the operating entity;
3. The business may not in substance be operated according to the terms of the arrangements entered into. This includes examining the agreements themselves, the manner in which they are actually implemented and also whether the overall arrangement is commercial having regard to a comparison with relevant standard business practices;
4. The degree to which the individual service providers or their family ultimately control the entity, its economic product and cash flows from the business;
5. Whether there is a redistribution of the underlying income from the entity to the person or to family members, usually via a trust but there are other mechanisms, for example, by way of employment of the family members perhaps at inflated salaries, or related party loans or the payment of management and other service fees to associates; and
6. The extent to which, as a consequence of the arrangement, significant tax benefits are obtained, eg, where the entity and/or any beneficiaries or shareholders pay lower marginal tax rates than would have been payable by the taxpayer, but for the arrangement.

In certain circumstances, notwithstanding that all or most of the above factors may be present, the arrangement will still not constitute tax avoidance. This is because there are legitimate reasons for adopting particular business structures (such as asset protection, limited liability and business continuity). Businesses can also legitimately make decisions about whether or not, or the extent to which, profits are to be retained or distributed, for example.

There is also nothing preventing individuals, or entities related to the individual service provider, from owning the business and receiving distributions of profit reflecting that ownership. Further, it may be appropriate in certain circumstances for family members or associated entities to receive funds from the business as:

- an employee or service provider; and/or
- an owner of capital equipment used by the business.

However, in those circumstances care needs to be taken that the relevant transactions can be commercially justified. We will be more concerned with arrangements that have non-arm's-length factors present, especially where the individual service providers are not adequately remunerated for their contribution to the business. We will look at the totality of the arrangements.

Businesses need to have a valid commercial basis for the way in which profits are distributed, especially in the form of remuneration paid to individuals they employ or contract to provide services. The profits of a service entity will generally be driven by a combination of the following:

- *The controllers of the business' personal skill, judgement and exertion:* The more specialised and marketable those attributes are, the greater the remuneration should be;
- *The use of capital assets:* Where the business and not the individual owns significant assets that are used to generate business income, the owners of the business are entitled to a appropriate return on those assets;
- *Services provided by other staff:* Similarly, where the business employs other skilled staff, some of the business income generated can be seen as contributing to the business' profits and not the individual business controllers. The greater the number of specialist staff employed in the business, the more influential this will be;
- *Intangible assets:* Sometimes the profits of a service business may also be improved through matters such as business know-how or other intellectual property owned by the business. As with capital assets, an appropriate return on such assets can be expected by the business; and
- *Return on business risks:* This may be influenced by factors such as who has legal liability for the business or its funding. For example, who carries the reputational risk for the business, who is liable to the industry body for any wrongdoing, what insurance policies are in place, and who guarantees any borrowings. Where the structure does little to remove those risks from the controller, the controller's overall remuneration should reflect those risks.

We recognise that it can sometimes be difficult to determine an appropriate remuneration for the individual. There is no exact science to weighing up the extent to which the individual is responsible for the business's profit (instead of other profit drivers). However, we consider that in most circumstances, the main profit driver of a service business is the personal skills and exertions of the controllers of the business—particularly where the business does not require a great deal of capital.

In those circumstances, we would expect the compensation received by those individuals (whether by way of salary, service fees, distributions of profits or any combination of them) to be significantly more than the return received by entities associated with the business. We will particularly weigh that against what happens to other forms of distribution from the business received by the associated entities (such as loans, dividends, salaries, service fees, trust distributions etc).

Given our focus on the more artificial arrangements, and the resources available to us, we are more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider are less than 80% of the total distributions received by the controller, his/her family and associated entities.

The department's approach focuses on the commercial reality of the business, and not on "market" salaries, or comparable industry averages.

For that reason, we agree with both the Court of Appeal and the Supreme Court on this point, that there may be particular reasons as to why the controllers of the business may not be adequately remunerated in a particular year. Examples of this include:

- Adverse business conditions mean that the business's profits are down but most of those profits are still paid out to the individual service providers;
- It is financially prudent to retain some profits in the business because it is anticipated that the business may experience financial difficulties in the near future;
- The profits are set aside to acquire business assets in the next financial year; or
- The business relates to a charity and the individual receives less to ensure the charity's return is maximised.

There may be other non-tax reasons why a business may pay the individual less than an arm's-length party would receive over the short term. However, in those circumstances, we would accordingly expect to see no significant distributions being made to entities associated with the individual.

Current view

Inland Revenue considers that arrangements that exhibit a combination of the above features may constitute an avoidance arrangement in terms of sections BG 1 or GB 44 of the Income Tax Act 2007. Such cases fall outside the contemplation of Parliament.

To determine whether or not there has been tax avoidance we will look at all aspects of these arrangements including all documentation, and the actual behaviours of the persons involved.

In summary, whether or not the arrangement under consideration is a tax avoidance arrangement in relation to the tax payable on the entity's distributed profits in any given income year will depend on an examination of:

- the reality of the service provider's business structure and how it operates commercially;
- whether and how the profits of the business have been distributed in substance—including whether the individual and their family continue to receive the benefit of all profit distributions from the business;
- whether the remuneration received by the individual service provider appropriately reflects the individual's contribution to the business's profit; and
- whether there are particular non-tax reasons justifying a departure from that standard.

Options available to Inland Revenue on reconstruction include deeming all of the income to have been derived by the individual (in extreme circumstances), or deeming that individual to have received some other amount of remuneration personally (eg, an amount that more properly reflects the individual's contribution to the business's profits).

Current status

Inland Revenue has investigated a number of these arrangements over recent years. Where we still consider, after initiating the tax disputes process, that the arrangement is tax avoidance, amended assessments will be issued which attribute some or all of the diverted income to the taxpayer, to counteract the tax benefit resulting from the use of this arrangement. Some of those investigations and disputes were deferred awaiting the Supreme Court's decision in *Penny and Hooper*.

We will also continue to investigate similar arrangements where there are significant tax benefits. Many other arrangements involving service providers share some features of the arrangements considered in *Penny and Hooper* but have their own particular characteristics. We will take those factors into account in any investigation but the Revenue Alert seeks to highlight the general issues we consider relevant to such arrangements. Where the tax avoidance rules apply, we will take steps to counteract the tax benefits obtained.

Late payment penalties and use of money interest may be applied to people entering into the type of arrangement described in this Revenue Alert.

Shortfall penalties may also apply, although these may be reduced where a voluntary disclosure is made.

If you consider that our concerns may apply to your situation, we recommend you discuss the matter with your tax advisor or with us, and consider making a voluntary disclosure.

This Revenue Alert is issued on 1 September 2011.

Graham Tubb

Group Tax Counsel, Legal & Technical Services

References to consider

The following related references will assist taxpayers with determining whether their arrangement is subject to the avoidance provisions in the Revenue Acts.

Subject	Tax avoidance
Acts	Income Tax Act 2004, sections BG 1, GB 1, GC 14B, GC 28 ITA Income Tax Act 2007, sections BG 1, GA 1, GB 27, GB 44
Standard practice statements	SPS 09/02: Voluntary disclosures
Forms and guides	*Voluntary disclosure (IR 281), Putting your tax returns right (IR 280)*
Revenue alerts	RA 08/01, RA 10/01
Case law	*Penny and Hooper v CIR* [2011] NZSC 95 *Krukzeiner v CIR (No. 3)* (2010) 24 NZTC 24,563 *Ben Nevis Forestry Ventures Limited v CIR* [2009] 2 NZLR 289 *Peate v FCT* (1962) 9 AITR 3 *CIR v Penny and Hooper* [2010] NZCA 231 *Hadlee & Sydney Bridge Nominees Ltd v CIR* (1993) 15 NZTC 10,106 *Case Z24* (2010) 24 NZTC 14,354 *Case W33* (2004) 23 NZTC 11,321 *Case Y1* (2007) NZTC 13,001 *Wells v CIR* (1973) 1 NZTC 61,094 *Halliwell v CIR* (1977) 3 NZTC 61,208 *Shine and Laird v CIR* (1981) 5 NZTC 61,058 *FCT v Gulland, Watson* (1985) 17 ATR 1

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 *Adjudication & Rulings: A guide to binding rulings (IR 715)* or pages 1–6 of the *TIB* Vol 6, No 12 (May 1995) or pages 1–3 of Vol 7, No 2 (August 1995). You can download these publications free from our website at **www.ird.govt.nz**

PRODUCT RULING BR PRD 11/02: PMP DISTRIBUTION LIMITED

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

Name of the person who applied for the Ruling

This Ruling has been applied for by PMP Distribution Limited.

Taxation Laws

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

This Ruling applies in respect of section(s):

- BD 2, DA 1, DA 2(4), RA 5, RD 1, RD 2, RD 3, RD 5, RD 6, RD 7, RD 8 and YA 1
- 6(3)(b) of the Goods and Services Tax Act 1985 ("GST Act").

The Arrangement to which this Ruling applies

The Arrangement is the engagement of deliverers by PMP Distribution pursuant to the Deliverers' Handbook and Contract ("the Contract") for the delivery of unaddressed newspapers, leaflets, brochures, catalogues, advertising material, samples and other similar items to households and other premises throughout New Zealand.

PMP Distribution carries on the business of distributing newspapers, leaflets, brochures, catalogues, advertising material, samples and other similar items to households and other premises throughout New Zealand.

PMP Distribution engages the deliverers pursuant to a standard form contract that includes a deliverers' handbook and conditions that the deliverers agree to abide by when entering the contract with PMP Distribution. Conditions include the requirement to deliver particular items, within a specified period, to each house, flat or other premises located within a designated area, by placing one of each item in each letterbox (or other specified location).

The deliverers are paid specified rates per item delivered, depending on the weight of the item.

The Contract is in the Appendix to this Ruling.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following condition:

a) The relationship between PMP Distribution and the deliverers is, and during the period of this Ruling will continue to be, entirely in accordance with the Contract and no other collateral contracts, agreements, terms or conditions, written or otherwise, relate to the engagement of the deliverers.

How the Taxation Laws apply to the Arrangement

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

- For the purposes of the PAYE rules, any payment PMP Distribution makes to a deliverer pursuant to the Contract will not be "salary or wages" or "extra pay" or a "schedular payment" within the meaning of those terms as defined in sections RD 5, RD 7 and RD 8 respectively.
- For the purposes of section DA 2(4), any payment PMP Distribution makes to a deliverer pursuant to the Contract will not be "income from employment".
- For the purposes of the PAYE rules, any payment made to a deliverer by PMP Distribution will not be a "schedular payment" (as defined in Schedule 4) to the extent that such payment does not relate to mail delivery for any item the carriage of which requires PMP Distribution to be registered as a postal operator under the Postal Services Act 1998 (ie, addressed mail).
- For the purposes of the GST Act, the provision of services by any deliverer, under the Contract, will not be excluded from the definition of "taxable activity" (as defined in section 6 of the GST Act) by section 6(3)(b) of the GST Act.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 July 2010 and ending on 30 June 2014.

This Ruling is signed by me on the 14th day of July 2011.

Tracey Lloyd
Investigations Manager

PRODUCT RULING BR PRD 11/03: BANK OF NEW ZEALAND

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

Name of the person who applied for the Ruling

This Ruling has been applied for by Bank of New Zealand.

Taxation Laws

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

This Ruling applies in respect of sections CA 1(2), CC 3, CC 4, CC 7, and HM 36.

The Arrangement to which this Ruling applies

The Arrangement is the offering by Bank of New Zealand (BNZ) of Fly Buys points to Fly Buys members who invest in either of two portfolio investment entity (PIE) funds promoted by BNZ (the BNZ Term PIE and the BNZ Cash PIE, collectively the Funds).

This Ruling does not apply to Fly Buys members who habitually redeem Fly Buys points for rewards and then sell the rewards, who redeem Fly Buys points for the purpose of selling rewards, or who receive the relevant Fly Buys points in the course of carrying on a business.

Further details of the Arrangement are set out in the paragraphs below.

Background

1. BNZ Investment Services Limited (the Manager), which is a wholly owned subsidiary of BNZ, is the Issuer and Manager of each Fund. Each Fund is a unit trust established under, and as defined in, the Unit Trusts Act 1960. A prospectus for the Funds has been registered with the Registrar of Companies. An investment statement for each Fund is available from any BNZ store. The respective investment statements set out the terms of the Funds.
2. Customers can invest in each Fund by filling out the relevant application form (provided in the respective investment statement) and depositing money into the account of a person (currently BNZ Investment Services Nominees Limited) nominated by the Trustee of the Funds (New Zealand Guardian Trust Company Limited). On acceptance of the application form, and clearance of the deposit made in the nominated account, the Manager will subsequently issue units to the investors in that Fund. Each Fund is a multi-rate PIE through which investors are taxed based on their prescribed investor rate (PIR).

Key features of the Funds

3. The relevant terms applying to both Funds include the following:
   - Each Fund invests solely in a New Zealand dollar interest bearing account with BNZ.
   - An investment made in the Funds does not represent a bank deposit or other liability of BNZ.
   - An investor does not have a direct interest in any particular deposit made by a Fund with BNZ.
   - For their investment, investors acquire units in the Funds. Each unit represents an undivided beneficial interest in the assets of the Fund as a whole and does not give the investor an interest in any particular property of the Fund.
   - An investor and their associated persons cannot hold more than 20% of the units in either Fund.
   - Payments can be made at any BNZ store or with any BNZ Partner.
   - Selling and transferring units in the Funds to another person is permitted only with the Manager's approval. In the Manager's opinion there is no established market for sales or transfers.
   - An investor's units in a Fund are recorded in the investor's name.
   - A unit of each Fund has a fixed price of $1.
4. Terms specific to the Term PIE include the following:
   - Investments are not term deposits but operate similarly.
   - Each unit is issued for an agreed term and for an agreed rate of return. At the time of investing an investor must select either a maturity date or term for the investment.
   - A minimum of $5,000 must be maintained in each investment (or other such amount as the Manager may prescribe from time to time).
   - Throughout the term of the investment, distribution dates will be calculated based on the frequency of returns selected on the application form.
   - Investors' returns are always made by the issue of further units in the Term PIE. Investors can elect that these units be redeemed with the proceeds being paid into a nominated account.
   - An investor cannot withdraw their investment before the maturity date except in exceptional circumstances and the Manager agrees at its discretion. A break fee will apply for early withdrawals.

5. Terms specific to the Cash PIE include the following:
   - The initial investment by an investor must be at least $1,000 (or other such amount as the Manager may prescribe from time to time). The investor may make further investments at any time provided that each further investment is at least $250 (or other such amount as the Manager may prescribe from time to time).
   - An investor can withdraw all or part of their investment at any time (subject to the minimum balance requirement of the Cash PIE noted below). If an investor withdraws part of their investment, the Manager may deem the investor to have requested to withdraw also the number of units (if any) required to be cancelled to reflect tax paid or payable by the Fund on income attributed to the investor at their notified PIR. No exit fees are currently payable. The minimum amount that an investor can withdraw from the Fund is $500 (or other such amount as the Manager may prescribe from time to time).
   - An investor must maintain at least $1,000 worth of units (or other such amount as the Manager may prescribe from time to time) unless the investor wishes to withdraw their entire investment. The Manager can require redemption of all remaining units should the investment fall below $1,000 (or other such amount as the Manager may prescribe from time to time).
   - Returns are distributed to investors on a monthly basis by the issue of further units in the Cash PIE.
   - The interest rate payable on the Cash PIE's deposits is the main factor that will affect investors' returns. As at the date of this Ruling, no fees are payable by investors in the Cash PIE.

Fly Buys

6. Fly Buys is New Zealand's largest loyalty programme. Fly Buys is administered by Loyalty New Zealand Limited (Loyalty NZ) which is jointly owned by BNZ, Foodstuffs Ventures (NZ) Limited, IAG New Zealand Limited, and Z Energy Limited, each company having a 25% shareholding. BNZ and Loyalty NZ are therefore not associated persons (as defined in section YB 2).
7. More than 70% of New Zealand households actively engage in the Fly Buys programme and it has high brand recognition with New Zealand consumers.
8. Membership of Fly Buys is free. Under the programme, Fly Buys points are recorded in a member's points record for qualifying purchases of goods and services from participating retailers. At the date of this Ruling, the programme has over 40 participating retailers.
9. Each participating retailer and Loyalty NZ agree on the level of Fly Buys points that may be awarded to members by Loyalty NZ. By way of example, as at the date of this Ruling, Z Energy Limited awards 1 point per 20 litres of fuel purchased, New World awards 1 point per $25 spent, and Contact Energy awards 1 point per $50 spent. Participating retailers may also offer bonus points from time to time.
10. From time to time, Loyalty NZ provides members with a points summary setting out the opening points balance, points recorded and deducted during the period, and the closing points balance.
11. A member who has sufficient points credited with the Fly Buys programme may request a reward from the then current reward schedule made available by Loyalty NZ. Requests must be made by the member personally, in a way specified by Loyalty NZ from time to time. The number of points required to claim a reward is subject to change without notice. In the reward schedule as at the date of this Ruling, a member requires a minimum of 80 points to claim a reward. All rewards are subject to availability. Kinds of reward include: accommodation, appliances, books, electronics, flights, food and drink, music, tools, and toys. At Loyalty NZ's option, rewards are posted or delivered to the address of the member, or made available for collection at a location notified to the member. The number of points for redemption of a reward claimed is deducted from the balance in the member's points record, with the oldest points being deducted first. Points that are awarded but not used by a member within 36 months expire, and are deducted from the balance in the member's points record.
12. Fly Buys points cannot be sold, transferred, or assigned for cash or other consideration under the Fly Buys Terms and Conditions. The Fly Buys Terms and Conditions do not, however, prohibit rewards received from being sold, transferred, or assigned for cash or other consideration. Fly Buys points cannot be redeemed for, or refunded in, cash.

Fly Buys and BNZ

13. As at the date of this Ruling, BNZ offers Fly Buys points on several of its products (the level of which may change from time to time) as follows:

Credit Cards	
Classic Visa or MasterCard	$50 spend on purchases = 1 point
Classic American Express	$25 spend on purchases = 1 point
Gold Visa or MasterCard	$40 spend on purchases = 1 point
Gold American Express	$20 spend on purchases = 1 point
All Blacks Master Card	$40 spend on purchases = 1 point
BNZ Platinum Visa	20 Platinum reward points = 1 point
Insurance	
Life insurance, travel insurance and general insurance	$20 spend on premiums = 1 point
Home Loans (annual average balance)	
Less than $50,000	108 points per year
$50,000–$149,999	408 points per year
More than $149,999	1008 points per year
Out of the Box Banking	50 points per banking combo selected
Foreign Exchange	NZ$100 = 1 point

Fly Buys and the Funds

14. Under the Arrangement, BNZ will offer Fly Buys points to Fly Buys members who invest in either Fund. Those Fly Buys points will be credited to the member's points record by Loyalty NZ at the direction of BNZ. Fly Buys points may be offered to investors in several ways (all, none, or some of which may be offered at any time). The ways of awarding Fly Buys points that form part of this Arrangement are by awarding:
    - points on opening a new investment in a Fund;
    - points on re-investing a maturing Term PIE investment into a new Term PIE investment;
    - points to investors who choose to receive their investment information online;
    - points on an annual basis assuming the minimum balance is maintained;
    - points on a points per unit held basis;
    - points annually based on the average balance for the year;
    - points on a monthly basis based on the average balance per month;
    - points when an investor reaches a certain saving hurdle in addition to any points awarded per dollar invested;
    - points based on the term of the investment;
    - points to investors who set up regular investment amounts by automatic payment or other regular contribution method.

15. From time to time, BNZ may also consider additional ways to award Fly Buys points in respect of each Fund. This Ruling does not consider or rule on the tax treatment of other ways of awarding Fly Buys points.

16. The Funds pay a market rate of return on amounts invested with them, independently of any Fly Buys points awarded. Investors in each Fund will be entitled to receive the same pre-tax rate of return on their units in the Fund, regardless of whether they hold a Fly Buys membership. Investors who are not Fly Buys members or members who do not provide their membership number to the Manager will not receive points, and will not receive any other reward from BNZ or Loyalty NZ in lieu of the points. A member cannot require BNZ or Loyalty NZ to pay a cash amount in substitution for points.

17. At present, the cost to BNZ of the Fly Buys points awarded to the investors in a Fund, does not impact on the rate of return BNZ pays to a Fund (and therefore the rate of return a Fund pays to individual investors). In any event, the cost to BNZ of awarding Fly Buys points will only ever be taken into account in determining the rate of return payable by BNZ to the Fund to the extent the total costs incurred by BNZ in relation to the Fund are taken into account in determining that rate and the costs associated with the award of Fly Buys points are included in those total costs.

18. An investment in each Fund is a separate contractual arrangement to a member's Fly Buys membership and each one can (and does) exist without the other. BNZ and Loyalty NZ reserve the right to withdraw or amend any points offer at any time, and this does not affect a member's return from their investment in each Fund or give them any contractual basis to terminate that investment. Members have no recourse against the Fund if the advertised points are not awarded because of the failure of Loyalty NZ.

How Fly Buys points will be awarded

19. Investors in each Fund who are Fly Buys members will be able to record their Fly Buys membership number on their application form. The Manager will pass this information on to BNZ. The Manager (and therefore each Fund and the underlying investors) does not have any additional costs associated with the award of points.
20. BNZ will send regular data to Loyalty NZ to enable the points to be awarded to each Fly Buys member for the relevant period. (This information will include Fly Buys points in relation to the Funds, and any other BNZ product offering Fly Buys points.) Loyalty NZ, through its relationship with the Fly Buys member, will credit the requisite number of points to the member's points record.
21. Points awarded by all participating retailers are recorded in a similar manner. The points awarded by BNZ to a Fly Buys member will accumulate alongside points awarded to that member from other participating retailers. At this point the points are homogenous. Fly Buys does, however, track when points are awarded to measure whether the points have expired.
22. BNZ will share with Loyalty NZ the revenue generated by investors purchasing units in each Fund, in consideration for Loyalty NZ promoting, and for the administration of, the Fly Buys programme.
23. It is possible that from time to time BNZ may promote a product with a bonus level of points (eg, on initial investment). The total volume of Fly Buys points awarded under the Arrangement to an investor in an income year and any reward those points may be redeemed for are not significant compared with the return to the investor from their investment in the Funds.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) Each Fund pays a market rate of return to investors.

b) The award of Fly Buys points will only ever be taken into account in determining the rate of return payable by BNZ to each Fund (and therefore the rate of return each Fund pays to its individual investors) to the extent the total costs incurred by BNZ in relation to the Fund's deposit with BNZ are taken into account in determining that rate and the costs associated with the award of Fly Buys points are included in those total costs.

How the Taxation Laws apply to the Arrangement

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

- No income arises to a Fly Buys member under section CA 1(2) when the member receives Fly Buys points.
- No income arises to a Fly Buys member under section CC 3(1) when the member receives Fly Buys points.
- No interest income arises to a Fly Buys member under section CC 4(1) when the member receives Fly Buys points.
- No deemed interest income arises to a Fly Buys member under section CC 7 when the member receives Fly Buys points.
- The award of Fly Buys points is not attributed PIE income for an investor under section HM 36.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 23 September 2011 and ending on 30 September 2014.

This Ruling is signed by me on the 22nd day of July 2011.

Fiona Heiford

Manager (Taxpayer Rulings)

PRODUCT RULING BR PRD 11/04: KIWIBANK LIMITED

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

Name of the person who applied for the Ruling

This Ruling has been applied for by Kiwibank Limited ("Kiwibank").

Taxation laws

This Ruling applies in respect of:

- sections BG 1, CC 7, EW 15, EW 31, GA 1, RE 1 to RE 10, RF 2, RF 3 and RF 4 of the Income Tax Act 2007
- sections 86F and 86I of the Stamp and Cheque Duties Act 1971
- the section 2 definition of "disposition of property" in the Estate and Gift Duty Act 1968.

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

The Arrangement to which this Ruling applies

The Arrangement is a product that Kiwibank intends to offer to its customers. The product is to be marketed as the Kiwibank Offset Mortgage. For the purposes of this application, the Kiwibank Offset Mortgage is referred to as "the product" or "the Arrangement".

The product allows a customer to elect that interest payable by the customer on a loan made by Kiwibank should be calculated by offsetting the balance of the loan against the aggregate credit balances of certain nominated transaction and savings and investments bank accounts (hereafter referred to as "credit accounts") held by either that customer or, certain other eligible persons. Interest is payable on the net notional balance of these combined accounts.

This Ruling does not consider the tax consequences of any arrangement under which a credit account holder agrees to offset his or her credit account balance against another person's home loan account balance in return for valuable consideration.

Further details of the Arrangement are set out below.

Background

1. The product is a new feature that Kiwibank is seeking to offer to new and existing customers. The product is intended to enhance Kiwibank's competitiveness and to give Kiwibank customers a new way to manage their money. The product can affect the way in which interest is calculated on home loans offered by Kiwibank that have an agreed fixed periodic repayment arrangement (also referred to as the "table portion" of a home loan).
2. Kiwibank also offers home loans with a revolving credit feature whereby amounts can be repaid or re-borrowed at any time provided the principal, interest, fees and costs on the home loans do not exceed the specified maximum credit limit (also referred to as the "revolving portion" of a home loan). The product does not apply to "revolving portion" home loans.
3. In overall commercial terms, the economic consequences for a customer of using the product, or using a revolving portion home loan product bearing a variable interest rate, are broadly the same.
4. Currently, customers of Kiwibank may elect for their table portion home loan to have one or more of three components: fixed, variable, and construction components.
5. The "fixed component" of the home loan is subject to a fixed interest rate for a fixed term. Customers may repay all or part of a fixed component at any time, although in certain circumstances they may be charged with a fixed rate break cost for making any repayment that exceeds an early repayment limit agreed with Kiwibank.
6. The "variable component" of the home loan is subject to a variable interest rate. Customers may repay all or part of a variable component of a home loan at any time without any break costs.
7. The "construction component" of the home loan is available where the home loan is obtained for the purpose of buying land and building a house on it or renovating a house on land the borrower already owns. The construction component of the home loan is subject to a variable interest rate and can be borrowed in stages (as opposed to a fixed or variable component which must be borrowed in a lump sum).
8. Kiwibank recognises that customers may have a range of accounts, including various deposit and loan accounts. Therefore, Kiwibank is introducing with the product a new component called an "offset variable component".
9. When a customer elects that all or part of a home loan is to have an offset variable component, interest accruing on that home loan, or that portion of the home loan, is to be calculated by reference to a notional balance. The notional balance is calculated by offsetting the debit balance of the offset variable component of the home loan against the total credit

balances of nominated everyday banking and savings and investments accounts (referred to as the "credit accounts"). This lowers the interest payable and the variable component of the home loan. Therefore, it results in a greater proportion of a customer's regular loan repayments being applied in reduction of the principal of the offset variable component of the home loan.

10. This new feature effectively treats a group of accounts in a collective or aggregated manner for the purposes of calculating interest accrued on the offset variable component of the home loan. This new feature is intended to make the Kiwibank overall banking relationship more attractive to current and potential customers.

11. Outlined in this section are the primary features of the product:
    - interest calculations
    - eligibility requirements
    - other features
    - terms and conditions
    - groups of account.

Interest calculations

Calculations of interest on an offset variable component of a home loan

12. Interest payable on an offset variable component of the nominated home loan is calculated by reference to a notional balance. This notional balance is determined, for the purposes of that calculation only, by reducing the balance of the offset variable component of the home loan by the aggregate of the credit balances of the nominated credit accounts.

13. The rate of interest applicable to the product is the "offset variable interest rate" that is specified from time to time to be applicable to the product. The offset variable interest rate is one of several different rates that Kiwibank uses under its Home Loan Terms and Conditions. The offset variable interest rate may be above or below Kiwibank's variable interest rate. Initially, the offset variable interest rate will be set below the variable interest rate to attract new customers.

14. Interest is *not* calculated separately in respect of each account and then offset. Instead, a net notional balance is calculated across all the relevant accounts. The notional balance equals the offset variable component of the home loan less (ie, "offset" against) the credit balances of up to eight nominated credit accounts. Interest is then payable on that net balance at the offset variable interest rate. This is the case as a matter of law (in terms of the terms of contractual relationship under the Home Loan Agreement and the terms and conditions applicable to home loans offered by Kiwibank) and as a matter of practice (in terms of Kiwibank's computer and accounting systems).

15. The offsetting is solely for the purpose of calculating the notional balance on which interest is calculated. There is no actual transfer of funds, no set-off or "netting" of funds together in an account, and no transfer of any interest in or entitlement to funds. Importantly, the customer has no legal entitlement to interest on credit balances. This is the case, even if the customer's total credit balances exceed the customer's home loan balance.

16. Interest is calculated on a daily basis and is debited to the home loan account on a regular basis. Loan repayments are credited periodically into the home loan accounts, which will pay the periodic interest and reduce the principal outstanding. Such payments are made from a Kiwibank account that the customer has selected. This account may be an account that the customer has nominated to participate in the product.

17. The offsetting aspect of the product essentially offers the same economic benefits to customers as a revolving portion home loan in terms of reduced interest costs (through a reduced balance on which interest is calculated) and consequently accelerated loan repayment. With a revolving portion home loan, funds that would otherwise be in a savings or cheque account are paid into the loan account (but are available to be redrawn).

No interest is payable on credit accounts

18. No interest is payable by Kiwibank on the credit balances of the credit accounts that customers have nominated to participate in the product. This is regardless of whether those credit balances exceed the debit balance of the home loan facility. This means that if the debit balance of a home loan facility is less than the aggregate of the credit balances of the nominated credit accounts, no interest is paid or payable by Kiwibank.

Eligibility requirements

19. The product is only available to:
    - an individual who holds a home loan with Kiwibank
    - two individuals who are married, in a civil union, or in a de facto relationship and who hold a home loan with Kiwibank.

20. Additional people who may elect to offset their Kiwibank credit account against the home loan of a customer are:
    - child or children of the customer (or one of the customers)
    - parent or parents of the customer (or one of the customers).
21. Children and parents of customers may have a registered address with Kiwibank that is different from that of the customers.
22. An offset variable component of a home loan may be offset by up to eight credit accounts of the customers or other eligible people.

Other features of an offset variable component

23. The offset variable component is not an independent product; it is a component of a home loan. The following features (amongst others) apply to the offset variable component along with the other components of a table portion home loan:
    - Interest is calculated on a daily basis, and is debited to the home loan account on each specific payment date.
    - Customers may repay all or part of an offset variable component of a home loan at any time without any break costs.
    - The interest and principal of an offset variable component are repayable by way of regular payment cycles over the term of the offset variable component, except in relation to any applicable interest-only period. Only interest payments are required to be made during an interest only period.
    - All amounts owing under the table portion (including any offset variable component and other components) must be repaid in full on the last day of the home loan term.
    - The offset variable interest rate can vary at any time. Kiwibank will give the customer notice before changing the rate:
        - If the offset variable interest rate increases, the customer's regular payments for the offset variable component will automatically increase if this is necessary to enable the customer to pay off the offset variable component over the agreed term.
        - If the offset variable interest rate decreases, the customer's regular payments for the offset variable component will remain the same, so the term of the home loan will shorten. However, the customer can elect to reduce the amount of the regular payment so that the offset variable component can be repaid over the same term.
    - The product will be offered to customers having an existing variable rate table portion home loan facility. If an existing customer elects to convert a part or all of an existing variable rate table portion home loan to have an offset variable component, the customer must agree that Kiwibank's applicable terms and conditions for the product will apply. All new customers will sign new terms and conditions applicable to all Kiwibank accounts, which will, by definition, include the terms and conditions applicable to the product.
    - A customer may have more than one loan account to which the terms and conditions of the product apply, but each such loan account is treated separately.
    - A transaction or deposit account (eg, everyday banking and savings and investments accounts) may be nominated to link to a single home loan account only under the product terms and conditions.
    - A monthly fee will be charged to the customer of the home loan account. The fee is charged against one of the customer's Kiwibank accounts other than the home loan account.

Terms and conditions for the product

24. Each Kiwibank home loan is documented under a collection of documents:
    - The Home Loan Terms and Conditions, which are contained in a booklet that Kiwibank issues (as amended and updated from time to time) and which set out the generic provisions applicable to all Kiwibank home loan facilities.
    - The Home Loan Agreement, which contains specific provisions about the home loan facility that is being made available to a specific customer, including the amount and timing of regular payments calculated on a basis that will repay the loan over the applicable term.
    - The General Terms and Conditions, which contains the terms that govern the general banking relationship between Kiwibank and its customers. The General Terms and Conditions may also contain specific terms and conditions that apply to particular accounts and services. If any part of the General Terms and Conditions and the Home Loan Terms and Conditions conflict, then the Home Loan Terms and Conditions will prevail.

Groups of accounts

25. The product is based on a group of participating accounts. The following rules explain the accounts that may be included in the group.
26. The accounts of an individual, or the individual and joint accounts of married, de facto, and civil union couples, any of their children, and any of their parents may be combined as part of one group.
27. To illustrate, Sarah and Peter have a home loan facility with Kiwibank. Sarah, Peter and their child Michael each have a savings account with Kiwibank. Sarah and Peter's home loan facility could be offset by any or all of the credit balances of the various accounts held by Sarah, Peter and Michael.
28. Borrowers of the home loan facility and owner of other transaction accounts nominated for the offset feature must be either:
    - all residents of New Zealand for tax purposes; or
    - all non-residents of New Zealand for tax purposes.
29. Companies, trusts and sole traders are ineligible to participate in this product.

Conditions stipulated by the Commissioner

The amount of interest payable under the product is determined by Kiwibank in accordance with arm's length market interest rates.

How the Taxation Laws apply to the Applicant and the Arrangement

Subject in all respects to any condition stated above, the Taxation Laws apply to the Applicant and the Arrangement as follows.

Financial arrangements rules

For the purposes of applying sections EW 15 and EW 31 in calculating income and expenditure arising under the operation of the "financial arrangements rules" (as defined in section EW 1(2)), no amount of consideration is paid or is payable by virtue of a debit balance of a home loan account being offset by a credit balance of a credit account under the Arrangement.

Section CC 7

No income arises under section CC 7 for Kiwibank or its customers in relation to the Arrangement.

Resident withholding tax, non-resident withholding tax, and approved issuer levy

For the purposes of the resident withholding tax rules (as defined in section RE 1(1)) and the non-resident withholding tax rules (as defined in section RF 1(1)), there is no payment of, or entitlement to, interest in relation to the credit accounts participating under the Arrangement that would give rise to an obligation to deduct resident withholding tax or non-resident withholding tax or to pay approved issuer levy.

Tax avoidance

Section BG 1 does not apply to the Arrangement.

Gift duty

Where the balance of a credit account owned by one person is offset against the balance of the offset variable component of a home loan account of another person, there is no "disposition of property" (as defined under section 2(2) of the Estate and Gift Duty Act 1968). Therefore, gift duty does not apply.

The period or income year for which this Ruling applies

The Ruling will apply for the period beginning on 27 May 2011 and ending on 31 May 2016.

This Ruling is signed by me on the 26th day of August 2011.

Fiona Heiford

Manager, Taxpayer Rulings

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

TAXATION (TAX ADMINISTRATION AND REMEDIAL MATTERS) ACT 2011

The Taxation (Tax Administration and Remedial Matters) Bill was introduced into Parliament on 23 November 2010. It received its first reading on 7 December 2010, its second reading on 14 July 2011 and the third reading on 16 August 2011.

The new legislation brings into effect improvements to the tax administration system, abolishes gift duty, makes improvements to the tax disputes process and clarifies the tax pooling rules. It also reduces tax for non-residents investing through New Zealand portfolio investment entities.

Several changes to the bill were made by Supplementary Order Papers Nos 220, 254 and 263 following the bill's introduction, mainly to deal with tax issues arising from the Canterbury earthquakes of 2010 and 2011.

The resulting Act received Royal assent on 29 August 2011.

The new Act amends the Income Tax Act 1994, Income Tax Act 2004, Income Tax Act 2007, Tax Administration Act 1994, Goods and Services Tax Act 1985, New Zealand Superannuation and Retirement Income Act 2001, KiwiSaver Act 2006, Taxation Review Authorities Act 1994, Taxation Review Authorities Regulations 1998, and the Estate and Gift Duties Act 1968.

GIFT DUTY ABOLITION

Sections 2(2) and 61 of the Estate and Gift Duties Act 1968

The new legislation abolishes gift duty for dispositions of property made on or after 1 October 2011. The change follows a review of gift duty, which revealed that the compliance costs far outweigh both the revenue it collects and the limited protections it has offered to prevent tax avoidance, social assistance targeting and defeat of creditors.

The definition of a "gift" in section 2 of the Estate and Gift Duties Act 1968 (EGDA) is amended so that the term refers only to dispositions of property before 1 October 2011. The Bill also amends section 61 of the EGDA to ensure that gift duty is payable only for gifts made from the Act's commencement until 1 October 2011.

Background

Gift duty has existed in New Zealand since 1885. Its original purpose was to protect the estate duty base (by discouraging the gifting of assets before death) and to raise revenue. When estate duty was abolished in 1992, the government of the day decided to retain gift duty to protect against income tax avoidance and social assistance targeting until alternative protection measures could be introduced.

Ministers and officials have received frequent requests for exemptions from gift duty and for a review of the gift duty thresholds over the past few years. The thresholds of $27,000 for non-dutiable gifts and $12,000 for the filing of gift statements were set in 1984 and have not been revised since. In addition, administration of gift duty has become antiquated, with no provision for the electronic filing of gift statements or any form of payment other than by cheque. Further, the valuation of annuities for the purposes of gifts under the EGDA is set according to life expectancy data that is more than 25 years out of date.

With this background, a review of gift duty was initiated. Options considered included:

- narrowing the scope of gift duty to apply only to gifts between individuals, trusts and closely held companies;
- raising the thresholds at which gift duty applies;
- removing the requirement to file gift statements for non-liable gifts;
- introducing electronic systems for the filing of gift statements and payment of gift duty; and
- updating life-expectancy tables for valuing annuities under the Estate and Gift Duties Act 1968.

As the review progressed, a strong case for outright abolition emerged. Some of the concerns which existed in 1992 have been addressed or reduced by the strengthening of existing legislative provisions. Remaining areas of concern were scrutinised in consultation with the Treasury, the Ministry of Economic Development, Ministry of Justice, Ministry of Health, New Zealand Police, the Ministry of Social Development, and Housing New Zealand Corporation. None of these agencies opposed gift duty abolition and several have said they will make administrative changes to support its abolition.

The review concluded that gift duty no longer raises any significant revenue and imposes a high level of compliance costs on the private sector. The protections offered by gift duty in the areas of income tax, creditors and social assistance have been incidental rather than intended policy goals. The analysis undertaken across government revealed that the protection gift duty offers is inefficient, limited and outweighed by the significant compliance costs that it imposes on the private sector. Therefore Ministers decided to abolish gift duty and an effective date of 1 October 2011 was chosen to provide certainty for the private sector.

The government agencies mentioned above will monitor the effects of gift duty abolition on their respective areas of responsibility. Inland Revenue will also co-ordinate, in due course, a post-implementation review to ensure there are no unintended consequences arising from the abolition of gift duty.

Key features

- Gift duty will not be payable for dispositions of property made on or after 1 October 2011.
- Gift statements will not need to be filed for dispositions of property made on or after 1 October 2011.
- Gift duty and gift statements will remain due for dispositions of property made prior to 1 October 2011.

Application date

The new legislation abolishes gift duty for dispositions of property made on or after 1 October 2011. The EGDA remains effective with respect to dispositions of property before this date.

Detailed analysis

Record keeping requirements

Gift statements will not be required for dispositions of property made on or after 1 October 2011. However, requirements to ensure the legal certainty of gifts, such as deeds of gift for trusts, are unchanged. Taxpayers may, therefore, still need to consult a lawyer when making a gift.

Income tax implications

The abolition of gift duty does not have any impact on income tax anti-avoidance rules. As has always been the case, a gift may be deemed to be part of a wider arrangement of tax avoidance under section BG 1 of the Income Tax Act 2007.

There is a range of provisions in the Income Tax Act 2007 designed to directly ensure integrity around arrangements involving gifts, in addition to the general anti-avoidance provisions. These include:

- section HC 35, the minor beneficiary income rule;
- section EW 38, which provides for the disposal of financial arrangements for less than fully adequate consideration;[1]
- section HD 15, which creates joint and several liability of company directors and controlling or interested shareholders where a company enters into an arrangement that results in an inability to meet its tax liability;
- sections CD 6, which deems there to be a dividend for transfers of value from a company to an individual;
- subpart CX, which treats certain gifts to employees as a fringe benefit;
- sections FC 1 and FC 2, which provides for the treatment of distributions from companies and trusts, gifts, and transfers of assets and liabilities upon death as disposals and acquisitions at market value; and
- section GC 1, which provides rules for disposal of trading stock for less than fully adequate consideration.

Additionally, the Goods and Services Tax Act 1985 provides rules for dealing with transactions when goods and services are supplied to final consumers at non-arm's length terms, refer section 10(3).

[1] Section EW 44 provides an exception to this rule where the creditor forgives the debtor's debt because of the natural love and affection the creditor has for the debtor.

DISPUTES PROCESS

REMOVING THE SMALL CLAIMS JURISDICTION OF THE TRA

Sections 3(1), 89E, 89N(1)(vii), 138N(2) and 138O of the Tax Administration Act 1994; sections 13A(b)(ii), 13B and 26A(2) of the Taxation Review Authorities Act 1994; regulations 2, 5, 7, 12(2), Part 3, 27(2), 28(b) and the schedule to the Taxation Review Authorities Regulations 1998

Key features

These provisions have been amended or repealed to reflect the fact that the right to have a dispute heard before the small claims jurisdiction of the Taxation Review Authority (TRA) has been removed.

Background

The small claims jurisdiction of the TRA was established in 1996 as part of the major overhaul of the tax disputes system that took place at that time. The aim of establishing the small claims jurisdiction was to provide taxpayers with a truncated process whereby simple disputes could be heard quickly.

The small claims jurisdiction was used less than 10 times between its establishment and the introduction of the Taxation (Tax Administration and Remedial Matters) Bill 2010. There may be numerous reasons why taxpayers did not elect to use this forum, including that the eligibility criteria were relatively restrictive and there was no appeal right against a decision of the TRA acting in its small claims capacity.

The removal of the small claims jurisdiction should not impede the access of smaller tax disputes to the judiciary. An Inland Revenue standard practice statement (SPS 10/04) sets out a number of criteria under which the Commissioner will agree to a truncated disputes process. From a small claims perspective, the key criterion is that a truncated process will be agreed to when the core tax in dispute is under $75,000. This practice will allow taxpayers to have a dispute heard by the TRA's general jurisdiction at around the same time as they would have been able to elect to the small claims jurisdiction under the repealed provisions. The Commissioner intends to release new standard practice statements on the disputes process that reflect these legislative changes. It is anticipated that, under these revised standard practice statements, the $75,000 threshold will be applicable to both taxpayer- and Commissioner-initiated disputes.

It is also important to note that the TRA acting in its general jurisdiction is not necessarily more formal than the TRA acting in its small claims jurisdiction. Taxpayers are able to represent themselves if they wish. As a Commission of Inquiry, the TRA has considerable flexibility in the procedures adopted, including the ability to ask questions to ensure that the "right" result is reached, irrespective of the tax or legal expertise of the presenting parties.

Application date

A taxpayer's right to elect for their dispute to be heard in the small claims jurisdiction was removed from 29 August 2011.

EVIDENCE EXCLUSION RULE

Section 138G of the Tax Administration Act 1994; sections 17(2A) and 17(2B) of the Taxation Review Authorities Act 1994

Key features

The evidence exclusion rule (EER) is contained in section 138G of the TAA. If a tax dispute reaches a hearing authority, the EER previously limited the parties to the issues, propositions of law, facts and evidence contained in their respective Statements of Position (SOP). This rule has been relaxed so that the parties are now only limited to the issues and propositions of law contained in their SOP.

Background

When a party to a tax dispute issues a SOP, section 89M of the TAA requires the SOP to contain:

- an outline of the facts on which they intend to rely;
- an outline of the evidence on which they intend to rely;
- an outline of the issues they consider will arise; and
- the propositions of law on which they intend to rely.

Section 138G reinforced these requirements by providing that, if SOPs have been issued and the dispute reached a hearing authority, the parties could only raise the facts, evidence, issues and propositions of law disclosed in their SOP (subject to some discretion afforded to the hearing authority).

The EER was designed to encourage an "all cards on the table" approach to tax disputes. If a party is prevented from using undisclosed material in court, they are effectively compelled to provide the other party with all the material they have that supports their contentions. Another way of looking at the issue is that the EER prevented "trial by ambush", where one party could choose to withhold key information until the dispute has reached the courts.

The policy underlying the EER remains relevant. However, the EER in its previous form had the unintended consequence of encouraging parties to a dispute to produce very lengthy SOPs. The party issuing the SOP may include every potentially relevant fact or piece of evidence in their SOP for fear of being denied the ability to raise information at the court stage. This in turn necessitates the other party having to respond to the relevant parts of the original SOP, as well as set out the differing interpretation and version of events. The result is that SOPs can be large unwieldy documents, a significant portion of which may be irrelevant to the ultimate resolution of the dispute.

The amendments therefore relax the EER so that parties will still be bound to the issues and propositions of law contained in their SOP, but not the facts and evidence. This should allow the parties to enter the challenge phase of a dispute knowing that the dispute has been adequately framed, by issues and propositions of law that cannot easily be amended. However, parties will have more flexibility to introduce new facts and evidence at the hearing authority stage. It is important to note that relaxing the EER does not alter the requirements of the SOP—meaning that the parties are still required to provide an outline of the facts and evidence on which they intend to rely. The difference is that whether new facts and evidence can be raised will be left to the discretion of the relevant hearing authority.

The changes do not affect disputes that reach a hearing authority for which SOPs have not been issued (that is, a truncated dispute). Such disputes remain outside the scope of the EER.

Application date

The EER is relaxed in respect of disputes when a disclosure notice was issued on or after 29 August 2011.

EXCEPTIONAL CIRCUMSTANCES

Sections 3(1), 89K, 89L, 108 and 108A of the Tax Administration Act 1994

Key features

The circumstances in which the Commissioner can accept documents filed out of time in the disputes process have been widened and rules put in place to make the Commissioner's refusal to accept late documents challengeable in the TRA.

The exceptional circumstances test for the Commissioner has also been amended to bring it more in line with the test that applies to taxpayers.

Background

The disputes process requires a taxpayer to produce certain documents within a statutory "response period". If documents are not received within the response period the taxpayer is treated as having accepted the position adopted by the Commissioner. This effectively results in the dispute coming to a close in the Commissioner's favour.

However, a taxpayer can file a document outside the response period when exceptional circumstances exist. Exceptional circumstances generally exist when an event outside the control of the taxpayer has prevented the timely filing of a document. An example of an exceptional circumstance is a natural disaster that affects the taxpayer's immediate environment. However, the courts have considered other instances to determine where the boundaries of exceptional circumstances lie, particularly in the context of the similarly worded test in section 138D of the TAA.[2]

The definition of "exceptional circumstances" in section 89K has not actually been amended. Instead the circumstances in which late documents can be accepted have been expanded to include situations where the Commissioner considers that the disputant has a demonstrable intention to enter into or continue the disputes process at the relevant time. It is anticipated that forthcoming revised standard practice statements on the disputes process will set out in more detail how the Commissioner intends to interpret this provision.

The revised rule applies to the three response periods that apply to a taxpayer engaged in the disputes process under Part IVA. These are the response periods for rejecting a Notice of Proposed Adjustment (NOPA) from the Commissioner, issuing a NOPA and issuing a Statement of Position (SOP). The expanded test does not apply to the response period for issuing a challenge under section 138, in particular, the exceptional circumstances test under section 138D(2) remains unchanged.

If the Commissioner does not exercise the discretion to accept a late document in favour of the taxpayer, the Commissioner must issue a refusal notice, advising the taxpayer of that decision, within one month of the taxpayer sending the relevant notice.[3] In the event that the Commissioner fails to issue a refusal notice within that one-month period, such a notice is treated as being provided at the expiry of that month.[4]

[2] See, for example, *TRA No 11/09* (2011) 25 NZTC 1-002 (in respect of section 89K) and *CIR v Fuji Xerox NZ Limited* (2002) 20 NZTC 17,470 (CA) (in respect of section 138D).

[3] Section 89K(4)

[4] Section 89K(5)

Receipt of an actual or deemed refusal notice allows the taxpayer the right to challenge the notice in the TRA (and the definition of "challenge" in section 3(1) has been updated to reflect this). The challenge must be filed with the TRA within two months of the refusal notice. Because section 89K(6) confers a direct challenge right, the taxpayer is not required to dispute the refusal notice through the issue of a NOPA. In other words, there is no need to start an entirely separate dispute in respect of the refusal notice—any disagreement over the notice can be challenged directly in the TRA.

To reflect the fact that the substantive dispute will effectively be "on hold" in the event that a refusal notice is challenged, the statutory time bars in sections 108 and 108A have been extended to include this period. The extension will be for the period between the date of the refusal notice and the date the subsequent challenge is judged successful by a court or, alternatively, the date the Commissioner concedes.

The exceptional circumstances test that applies to the Commissioner, in section 89L(3), has also been amended to remove reference to changes to a tax law, a new law or a court decision made during the response period.

Application date

The revised exceptional circumstances test applies from 29 August 2011.

CHALLENGE NOTICES

Sections 3(1), 89H, 89J, 89L, 89M, 89P and 138B(3) of the Tax Administration Act 1994

Key features

A statutory notice called a "challenge notice" has been introduced to mark the conclusion of a taxpayer-initiated dispute. These challenge notices will form the basis for any subsequent challenge in the courts. The Commissioner must issue a challenge notice within four years of a dispute being commenced.

Background

Under the previous rules, a taxpayer could effectively opt-out of a dispute they had initiated at any time following receipt of the Commissioner's Notice of Response (NOR). This created an asymmetry between disputes initiated by the Commissioner and those initiated by a taxpayer.

Under a Commissioner-initiated dispute (ie, a dispute where the NOPA is issued by the Commissioner), the combined effect of Part IVA was that the Commissioner could generally not issue an amended assessment until after the SOPs had been exchanged. By contrast, a taxpayer could technically initiate a dispute with a NOPA, wait for the Commissioner's NOR and then immediately challenge the assessment in the TRA.

This result created many difficulties. By definition, the Commissioner was generally not aware of an impending taxpayer-initiated dispute until the NOPA was received. The Commissioner therefore had only the two-month response period for the NOR to essentially reach a final view of the adjustment proposed. This runs counter to the "all cards on the table" philosophy underlying the disputes system—especially when it is considered that the Commissioner may wish to conduct an audit as well as issue the NOR within the two-month response period.

To ensure that the full disputes process is followed irrespective of which party commenced the process (other than in defined circumstances, such as when the parties agree to a truncated process), a "challenge notice" has been created to mark the conclusion of a taxpayer-initiated dispute.[5] A challenge notice must state that the Commissioner will not be issuing an amended assessment that includes or takes into account the adjustment proposed by the taxpayer and that a challenge may proceed.[6] The challenge notice is therefore equivalent to an amended assessment for taxpayer-initiated disputes and signals the end of the disputes process under Part IVA and the start of the challenge process under Part VIIIA.

Like an amended assessment, a challenge notice has a time period within which it must be issued. Given that an amended assessment must be issued within four years of the end of the tax year in which the relevant return is provided, section 89O imposes a similar four-year restriction on the challenge notice. The four-year period commences on the date the taxpayer issues their NOPA. If the Commissioner fails to issue a challenge notice within the four-year period, the taxpayer's proposed adjustment is deemed to be accepted.[7]

[5] "Challenge notice" is now a defined term in section 3(1)

[6] Section 89P(4)

[7] Sections 89H(4) and 89J(2)

Under section 89N(3), the Commissioner cannot issue an amended assessment until after the taxpayer's SOP has been considered, unless an exception listed in section 89N(1)(c) applies. To create a parallel for the issue of a challenge notice, section 89P(3) provides that a challenge notice cannot be issued until after the Commissioner has issued a SOP, with the exceptions in section 89N(1)(c) still being relevant. No challenge notice is necessary to the extent that a dispute has ended.[8]

If exceptional circumstances exist, the Commissioner can apply to the High Court for an extension of the four-year timeframe for issuing a challenge notice.[9]

To reflect the existence of the challenge notice, the challenge provisions in section 138B(3) have been amended. A taxpayer can now challenge an assessment when they have issued a NOPA only if the Commissioner has issued a challenge notice. This rule replaces the previous regime (discussed above) under which a taxpayer could opt-out of such disputes after receipt of any "written disputable decision" from the Commissioner rejecting a proposed adjustment.

Consistent with the policy of completing the full disputes process in appropriate cases, section 89M has also been amended to clarify that the Commissioner must issue a SOP in response to a taxpayer's SOP in a taxpayer-initiated dispute.

Application date

Because the challenge notice is only relevant for taxpayer-initiated disputes, these changes apply in respect of disputes for which a taxpayer's NOPA was issued after 29 August 2011.

REMEDIAL DISPUTES CHANGES

Definition of "disputable decision"

Section 3(1) of the Tax Administration Act 1994

The definition of "disputable decision" has been amended to avoid a duplication that previously existed and to confirm that most notices provided by the Commissioner as part of the disputes process are themselves not "disputable decisions". This is to avoid the possibility of, for example, a SOP being treated as a disputable decision, which can itself be the subject of a taxpayer NOPA. The Act already provides mechanisms to respond to disputes documents.

Application date

This change applies from 29 August 2011.

Extinguishing tax losses

Section 89C(1b) of the Tax Administration Act 1994

Section 89C lists a number of circumstances where the Commissioner is able to issue an amended assessment without having to first issue a NOPA. Subsection (1b) has been added to clarify that the Commissioner does not need to issue a NOPA when the Commissioner has made a decision to write-off tax debt under section 177C. This clarifies that write-off decisions are not intended to be subject to the dispute process.

Application date

This change applies from 29 August 2011.

TRA regulations

Regulations 4 and 11(2) of the Taxation Review Authorities Regulations 1998

Regulation 4 has been amended so that it refers to the District Court Rules currently in force, being the District Court Rules 2009. Regulation 11(2) has been amended so that the Commissioner must file and serve a notice of defence within 25 working days of service of a notice of claim (previously 40 working days). This aligns the TRA timeframes with those that operate for standard track proceedings in the High Court.

Application date

This change applies from 29 August 2011.

Shortened process for taxpayer initiated disputes in limited circumstances

Section 138B(4) of the Tax Administration Act 1994

Two of the situations in which the Commissioner can bypass the disputes process under section 89C are:

- when the relevant facts and law are identical to those for another assessment for the taxpayer in another period;
- when the assessment will correct a tax position taken by the taxpayer as a consequence of a tax position taken by another taxpayer.

The first of these covers circumstances where a taxpayer has adopted the same tax position in more than one tax period. The second relates to when one taxpayer's position is dependent on the position of another taxpayer, for example, when losses have been transferred between group companies and the denial of those losses will automatically mean they were unable to be transferred. The Commissioner being able to bypass the disputes process in these circumstances reflects that a second dispute may be unnecessary if the outcome is entirely contingent on the result of another dispute.

[8] Section 89P(2)

[9] Section 89L(1)

NEW LEGISLATION

The new section 138B(4) provides a mirror process for taxpayer-initiated disputes. Under section 138B(4), the taxpayer must notify the Commissioner in writing setting out the proposed adjustment and sufficient details to identify how the adjustment fits into one of the two categories for a fast-track procedure. The two categories are broadly identical to those available to the Commissioner under section 89C (discussed above):

- The adjustment is in relation to a matter for which the material facts and relevant law are identical to those for another assessment for the taxpayer for another period.
- The adjustment corrects a tax position taken by the taxpayer or an associated person as a consequence or result of an incorrect tax position taken by another taxpayer—
- in either case when the other position is the subject of, or was the subject of, court proceedings.

In appropriate cases, this process should allow these subsequent disputes to "catch up" to the main dispute so that the hearing authority can consolidate them if it sees fit.

Application date

Because these truncated proceedings are only relevant for taxpayer-initiated disputes, these changes apply in respect of disputes for which a taxpayer's NOPA was issued after 29 August 2011.

CHANGES TO THE SECRECY AND INFORMATION SHARING RULES

Section 81(1) and new section 81BA of the Tax Administration Act 1994

Amendments have been made to the Tax Administration Act 1994 to:

- relax the taxpayer secrecy rules for tax administration purposes; and
- facilitate the sharing of tax information between Inland Revenue and other government agencies.

Background

In June 2010, the discussion document *Making Tax Easier*, was released for consultation, alongside an online forum seeking feedback on a range of proposals aimed at making the tax system easier and more efficient for taxpayers to interact with. Included were proposals concerning the operation of Inland Revenue's tax secrecy rules.

Inland Revenue is subject to a strict obligation of secrecy in relation to the information it collects and holds. The general rule, contained in section 81 of the Tax Administration Act 1994, requires all employees of Inland Revenue to keep secret all matters that come to their knowledge relating to the Acts administered by Inland Revenue. This is subject to a number of exceptions, for purposes both related, and unrelated, to the administration of the tax system.

The operation of the New Zealand tax system is heavily reliant on taxpayers voluntarily complying with their obligations. For taxpayers to be willing to comply with their obligations, it is critical that they trust Inland Revenue. Appropriate treatment of taxpayer information is an important aspect of building and maintaining this trust.

However, Inland Revenue also needs to be able to disclose information to taxpayers and third parties in certain circumstances, in order to efficiently operate the tax system. There are also certain situations when disclosure, while not directly related to the operation of the tax system, has been considered important enough by Government that a specific exception to the secrecy rule has had to be enacted.

Therefore changes have been made to Inland Revenue's information disclosure rules. First, to relax the taxpayer secrecy rules, to extend the ability of the Commissioner to release taxpayer specific information for the purposes of administering the tax system, subject to certain criteria (section 81(1)) and secondly, in relation to Inland Revenue's ability to share information with other government agencies (new section 81BA).

Key features

Section 81(1) of the Tax Administration Act – Disclosures for tax administration purposes

The Act amends the secrecy rule contained in section 81 of the Tax Administration Act 1994 to give the Commissioner of Inland Revenue greater discretion to release taxpayer information for the purpose of administering the tax system more efficiently. The new rule only permits disclosures that are made in the course of the Commissioner's duties—that is, the disclosure must be for the purpose of executing or supporting the execution of a duty of the Commissioner.

In deciding whether to exercise the discretion to release information, the Commissioner must consider his obligation to use best endeavours to protect the integrity of the tax system, the importance of promoting compliance, especially voluntary compliance, the resources available to him, any personal or commercial impact of the communication, and the public availability of the information. Following consideration of these factors, the Commissioner may release information if the communication is considered reasonable, having regard to the purpose of the disclosure and these factors.

A draft standard practice statement has been released for comments, setting out how the new rules will be administered in different situations. (See inside front cover for link.) The statement outlines the process for disclosure and the level at which different types of disclosure are signed off. It also provides examples of situations where disclosure will and will not be permitted under the new rules.

Inland Revenue will in future include information regarding the use of the new secrecy rules in its annual report. This will constitute a brief summary of the use of the provision over the previous year in particular noting any issues or areas of complaints that have arisen.

New section 81BA of the Tax Administration Act – Sharing information with other Government agencies

The Act also introduces changes to facilitate the sharing of tax information between Inland Revenue and other government agencies. This will allow more efficient use of information collected by Inland Revenue and reduce the need for individuals to provide duplicated information to multiple government agencies. The Act allows an Order in Council to be made, authorising the sharing of Inland Revenue information with another government agency.

Inland Revenue can communicate the information if it is already available to Inland Revenue, it is reasonable and practicable for the Commissioner to do so and certain criteria are satisfied. The criteria are:

- the government agency seeking access to the information must have the ability and authority to collect the information in its own right;
- it is either inefficient for the agency seeking access to collect and/or verify the information itself, or there must be compliance benefits to individuals for the information to be shared rather than collected separately;
- an Order in Council is made to specify and authorise the nature, type or class of the information to be shared with another government agency; and
- the Commissioner and the government agency have entered into a memorandum that states the purpose of the communication of the information, the use that may be made of the information, and the arrangements that may be made of the information, and the arrangements for the control, security, subsequent disclosure, and accuracy of the information, including access to it by taxpayers, as well as providing for monitoring arrangements.

The final decision on whether information should be shared with another agency will be made by Cabinet. Before recommending a sharing arrangement to Cabinet the Minister must consult with the Privacy Commissioner, the agencies that may be affected by the proposed order, and any organisations considered by the Minister to represent the interests of those likely to be substantially affected by the proposed information sharing arrangement. Further, the Minister must determine that the information to be shared is not so sensitive that it will unduly inhibit individuals from providing accurate information in the future.

The changes seek to strike an appropriate balance between individuals' privacy rights and a more efficient and effective government service. Several privacy safeguards are built into the legislative framework, such as the requirement that information shared must be information that the requesting agency is authorised and able to collect in its own right. In addition, Inland Revenue and the agency seeking access to the information must enter into a memorandum of understanding, covering a range of specified matters, including safeguards for the information being shared.

The first information sharing arrangement is likely to be with the Ministry of Social Development. Inland Revenue currently has eight information-matching agreements with the Ministry under the current Privacy Act 1993.

In several of these matches Inland Revenue is unable to provide information until the Ministry has sent information to Inland Revenue on selected individuals and a match has been found. Inland Revenue is currently unable to, for example, advise the Ministry of cases of benefit overpayment it becomes aware of, unless an information matching request has been generated by the Ministry in respect of the individual concerned.

The Act includes provision for a review of the information sharing framework after five years of operation to consider any impact on the privacy of individuals, the impact on the tax system, and whether any further amendments to the law are necessary.

Application date

Section 81(1) and new section 81BA came into force on 29 August 2011.

FOREIGN INVESTMENT PIES

Sections CP 1, CX 56, CX 56B, DB 54B, HM 1, HM 2, HM 6, HM 6B, HM 7, HM 8, HM 11 to 13, HM 19B, HM 19C, HM 31 to 33, HM 35C, HM 41, HM 44, HM 44B, HM 47, HM 51, HM 53, HM 55C to 55H, HM 60, HM 61, HM 64, HM 65, HM 71B, HM 82, IC 3, LS 1, LS 2, YA 1 and schedule 6 of the Income Tax Act 2007; sections 28D, 31B and 31C of the Tax Administration Act 1994

These new rules for foreign investment PIEs aim to align the tax treatment of non-resident investors in PIEs with the tax treatment of direct investors. Resident investors in a foreign investment PIE will continue to be taxed as if they were in an ordinary PIE.

Background

When the portfolio investment entity (PIE) rules were originally developed in 2007, the focus was ensuring that the rules operated properly for resident investors in KiwiSaver funds. The rules were designed so the tax treatment of a resident investor in a PIE roughly matched that of direct investment into the PIE's underlying assets. This required reasonably complex rules in a number of areas. Given the complexity of the new rules and the systems changes for managed funds it was not practical at that time to also provide non-resident investors in a PIE a tax treatment similar to that of direct investors.

Non-resident investors are currently taxed at a flat 28 percent on their PIE income, regardless of the income's source and type. In many instances this rate is much higher than that which would apply had the investor invested directly into the PIE's underlying assets. For example, a non-resident investing in a foreign company would not be subject to New Zealand tax. This is because of the general principle underlying the tax system that non-residents should only be subject to tax on their New Zealand-sourced income. Despite this, such an investment through an ordinary PIE would be taxed at 28 percent.

The PIE rules have had time to bed down and the relevant legislation is now relatively settled. At the same time, various reports (most recently, the report of the International Funds Services Development Group) noted there is the potential for New Zealand to become a "financial hub", providing back-office services to international managed funds. To take advantage of such an opportunity, the over-taxation of non-resident investors in PIEs would need to be resolved. This is the objective of the new foreign investment PIE rules.

Key features

- The Act introduces two new categories of PIE: "foreign investment zero-rate PIE" (referred to as "zero-rate PIEs") and "foreign investment variable-rate PIE" (referred to as "variable-rate PIEs"). The rules for these PIEs aim to align the tax treatment of non-resident investors in the PIE with the tax treatment of direct non-resident investors. Resident investors in a foreign investment PIE will continue to be taxed as if they were in an ordinary PIE.
- The new rules are optional. PIEs do not need to elect to become one of the new types of PIE and can continue to apply the existing rules, where PIEs are taxed at 28 percent on the income attributable to non-residents.
- Zero-rate PIEs are generally only able to invest offshore. De minimis levels of New Zealand-sourced income are allowed, however. This allows such a PIE to finance its day-to-day operations with a New Zealand bank account, for example.
- Zero-rate PIEs are taxed at zero percent on all PIE income attributable to certain non-residents.
- Variable-rate PIEs can invest into both New Zealand and offshore assets.
- Variable-rate PIEs face a variety of different tax rates on income attributable to non-residents, depending on the type and source of the income.

Application date

The rules for zero-rate PIEs apply from the date of Royal Assent of the Act on 29 August 2011. The rules for variable-rate PIEs will apply from 1 April 2012.

Detailed analysis

Introductory provisions

Sections HM 2, HM 6 and YA 1

Section HM 2 has been amended to include the two types of foreign investment PIE in the list of PIE types. Additionally, section HM 6 has been amended to set out the intended effects for investors in foreign investment PIEs—namely:

- that for a "notified foreign investor" in a foreign investment PIE, the PIE has a tax liability that resembles that of the investor if they were to make the investment directly; and
- a notified foreign investor should have no tax liability on their PIE income unless they have been treated as a notified foreign investor when they do not in fact meet the relevant requirements.

NEW LEGISLATION

A "notified foreign investor" is essentially a non-resident who has elected for the new rules to apply to them and has supplied the required information to the PIE. This concept is described more fully below.

Definitions have been inserted in section YA 1 for "foreign investment PIE", "foreign investment variable-rate PIE", "foreign investment zero-rate PIE" and "notified foreign investor".

Notified foreign investors

Sections CX 56, HM 55D and YA 1

The new tax treatment of investors in a foreign investment PIE applies to those who elect to become a "notified foreign investor". The relevant criteria for this election are set out in section HM 55D.

The general rule is that a notified foreign investor must be a non-resident. Specifically, a person cannot be:

- resident in New Zealand;
- a controlled foreign company;
- a non-portfolio foreign investment fund; or
- a non-resident trustee of a trust other than a foreign trust.

To target what is a non-portfolio foreign investment fund (FIF), the legislated restriction is that the item "income interest" in section EX 50(4) cannot be 10% or more for an investor. In effect, this means that if a FIF has a New Zealand-resident investor entitled to 10% or more of its income, either directly or indirectly, that FIF cannot elect to be a notified foreign investor.

A non-resident trustee of trusts other than foreign trusts cannot be a notified foreign investor. Such trustees are not taxed in the same way as other non-residents, so it is not appropriate for them to be treated as notified foreign investors. Similarly, resident trustees of foreign trusts are not able to be notified foreign investors as such trustees are taxed as New Zealand residents on any New Zealand-sourced trustee income.

In addition to a person not being one of the types described above, in order to be treated as a notified foreign investor, a person must also provide the PIE with the information set out in section 28D(1) of the Tax Administration Act 1994. Examples of required information are the person's name, address, country, and their tax file number in their home country (if applicable).

If an investor in a foreign investment PIE meets these requirements, the investor can notify the foreign investment PIE that they wish to be treated as a notified foreign investor. If the person meets the relevant criteria, they then become a notified foreign investor. Special rules apply when a person transitions to or from being a notified foreign investor as set out in section HM 55E. See "Change in status of investors in foreign investment PIEs" later in this section for more detail.

PIE relying on notification

Investors must self-assess that they are a person who can be a notified foreign investor. Accordingly, a foreign investment PIE can rely on an investor's notification that they should be treated as a notified foreign investor.

The investor must provide the PIE with the information set out in section 28D(1) of the Tax Administration Act. If the investor does not, the PIE is unable to treat the investor as a notified foreign investor.

Ineligible investor treated as a notified foreign investor

If an investor has been treated as a notified foreign investor when they do not in fact meet the relevant requirements, the investor will generally be treated in the same way as a resident investor who notifies a PIE of a tax rate that is too low. That is, section CX 56 will not apply to the PIE income attributed to them, so the income will not be excluded. If this is the case the investor should include the attributed PIE income in their tax return and is able to claim a tax credit for any tax paid by the PIE on their behalf.

An exception to this general rule is if one of the transitional rules in section HM 55E apply. These are described in more detail below.

Commissioner can override notification

Although a PIE is able to rely on an investor's notification that they are eligible to be a notified foreign investor, section HM 55D(6) provides that the Commissioner of Inland Revenue is able to advise the PIE to disregard the investor's notification and treat them as an ordinary non-resident investing in a PIE, taxed at 28%. This notification must be on reasonable grounds.

Calculation of income and tax liability for notified foreign investors

Sections DB 54B, HM 35C, HM 47, HM 55F, HM 64, HM 65 and schedule 6

Foreign investment PIEs have special rules for calculating PIE income attributed to notified foreign investors and the associated tax liability.

Calculating income

The aim of the foreign investment PIE regime is to tax PIE income attributed to non-resident investors in a similar manner to a direct non-resident investor. To reflect this, expenses incurred in relation to notified foreign investors are non-deductible. This is provided by section DB 54B. Further, the calculation formulae in sections HM 35 to 47 are modified so any expenses cannot be subtracted from the income of a notified foreign investor. Carry-forward losses and land losses are similarly set to zero. It should be noted, however, that streaming is not allowed. Expenses and losses must still be attributed to notified foreign investors even though they cannot be utilised by them.

Section HM 35C(2) provides that, for the purpose of the calculations in sections HM 35 to 47, for each investor class, a foreign investment PIE must treat the notified foreign investors of that class as if they were in a separate notional investor class. The purpose of this rule is to split each investor class in two – one part containing investors to whom the normal PIE rules apply and one part containing notified foreign investors.

Importantly, it is not intended that a foreign investment PIE be forced to create a notional investor class for its notified foreign investors if there is a better way for the PIE to create the same result.

Example

In the current calculation period, ABC, a PIE, has derived $1000 in assessable income and incurred $100 of expenses deriving that income. In addition, ABC has $200 of formation losses that it can use in the period.

ABC has 2 investors, Rachael and Grant, who are each entitled to 50% of its distributions (for simplicity, assume that ABC does not need to meet the "investor in" requirements of the PIE rules). Rachael is a notified foreign investor and Grant is a resident investor with a 28% prescribed investor rate.

ABC must attribute Rachael's share of its expenses and formation losses; however, it cannot use these to reduce Rachael's net income. Her attributed PIE income is therefore equivalent to her share of the PIE's assessable income, ie $500.

As Grant is an ordinary resident investor he is able to benefit from ABC's expenses and formation losses. Grant will have attributed PIE income of $350, which is his share of ABC's income less his share of the expenses and formation losses.

The $50 of expenses and $100 of formation losses that ABC was not able to utilise (as they were attributed to a notified foreign investor) are exhausted. They cannot be used in a later period.

Correction of errors

PIEs, on occasion, erroneously attribute an amount of income to an investor. In some cases it is not possible to directly undo this error, for example due to the passage of time. In such cases a PIE will often attribute an investor, in the current period, an offsetting negative amount of income, which effectively undoes the earlier error.

It is not intended for such an adjustment to be affected by section HM 35C, which modifies section HM 35 so expenses cannot be subtracted from a notified foreign investor's income. Such adjustments are considered to be accounting entries designed to correct earlier errors, so do not form part of the legislated formulae.

Calculation of tax liability

Section HM 47 is amended to establish how a notified foreign investor's tax liability should be calculated. Subsection (2B) clarifies that, for a notified foreign investor, the calculation in subsection (3) must be done for each investment type and source. This requirement is only relevant for variable-rate PIEs, for which different tax rates apply for different investment types and sources.

Linking in with this is section HM 55F(2), which requires a variable-rate PIE to identify the source and type (if it is not a foreign-sourced amount) of all amounts attributed to notified foreign investors. The different tax rates for income of differing types and sources are set out in schedule 6, table 1B. The requirement to perform the calculation in subsection (3) for each investment type and source does not apply to a zero-rate PIE, as all its income attributed to a notified foreign investor is taxed at the same rate (0%).

There is no change in the tax liability calculation for investors other than for notified foreign investors in either type of foreign investment PIE.

Finally, if a notified foreign investor's tax liability is negative, new section HM 55F(6) provides that no tax credit arises.

Optional flow-through rule

Section HM 6B

PIEs often use a tiered investment structure, where retail PIEs invest through larger wholesale PIEs. New section HM 6B provides an optional flow-through rule to ensure this structure is compatible with foreign investment PIEs.

Full flow-through

Sections HM 6B(1) and (2) provide a rule ultimately designed to be used by variable-rate PIEs, however, the rule can be used by any type of PIE.

The flow-through rule allows a PIE (PIE A) to be treated as if it has derived another PIE's (PIE B's) income directly. If PIE A applies the flow-through rule, income from PIE B would not be "attributed PIE income" but would retain its character. This includes notional income, such as income under the fair dividend rate (FDR) regime, which is not paid to B but is deemed to be derived by it nonetheless.

The intention is that expenses charged to A by B will also be treated as incurred by A. This should be the case regardless of whether the charge is explicit (ie, an invoice sent to A) or implicit (ie, B takes out its charges from what it attributes to A). Nevertheless, these expenses will not be deductible if they are attributed to notified foreign investors or if there is no nexus with assessable income (for example, they were incurred in deriving untaxed amounts).

The flow-through rule is designed to look through multiple levels of PIE. For example, say PIE A invested into PIE B, which in turn invested into PIE C. B could use the flow-through rule for the income it derives from C, and in turn A could use the flow-through rule for the income it derives from B. In effect, A will be treated as if it has derived its share of C's income directly.

Applying the optional flow-through rule requires information about the gross receipts from each investment source and type to flow between PIEs each attribution period. The rule cannot be used unless this information is available. As such, if the information is not available, any attributed PIE income should be treated as such, and accordingly will have a New Zealand source.

Example

R is a retail PIE that invests solely into W, a wholesale PIE. R holds 20% of the units in W, so is entitled to 20% of W's income. R is a variable-rate PIE while W is an ordinary PIE.

In the latest calculation period, W has derived the following amounts of New Zealand-sourced income:

- $1,000 interest income;
- $2,000 fully imputed dividends;
- $5,000 from a foreign currency hedge.

W has also derived $10,000 in foreign-sourced amounts.

R is able to get this information from W, which is sufficient information to apply the flow-through rule, and chooses to apply the flow-through. Accordingly, R is treated as deriving its share of W's income. Specifically:

- $200 New Zealand-sourced interest income;
- $400 New Zealand-sourced fully imputed dividends;
- $1,000 New Zealand-sourced non-interest financial arrangement income; and
- $2,000 foreign-sourced income.

Variable-rate PIE treating amounts as foreign-sourced

Section HM 6B(3) provides a flow-through rule that allows it to treat income derived from a zero-rate PIE (or a PIE eligible to become a zero-rate PIE) as a foreign-sourced amount. This is on the basis that the ultimate investments will generally be offshore.

A similar rule operates for zero-rate PIEs, allowing such PIEs to derive income from a zero-rate PIE (or a PIE eligible to become a zero-rate PIE) although, on its face, the income will be New Zealand sourced. This is described in the section "Allowable amounts".

Modified residence rules

Sections HM 8(2) and HM 19B(2)

Section HM 19B(2) is designed to clarify that a zero-rate PIE will be treated as resident in New Zealand provided it is a unit trust to which the Unit Trust Act applies and has a New Zealand resident trustee. The clarification is necessary because unit trusts are not incorporated, so country of incorporation cannot be used to determine residence. No such clarification is necessary for PIEs that are companies, as place of incorporation is available to determine residence for companies.

The section is not intended to restrict the types of entity eligible to become a zero-rate PIE.

Investment types and sources

Sections HM 11, HM 12, HM 19B(1) and HM 19C

Sections HM 19B(1) and HM 19C set out the rules for the investment types and sources that zero-rate PIEs and variable-rate PIEs, respectively, are able to derive. It is important to note that the "investment-out" restrictions of HM 11 to HM 13 that apply to ordinary PIEs also generally apply to foreign investment PIEs.

A zero-rate is only able to derive a foreign sourced amount or an allowable amount (a concept defined by section HM 55G).

It is intended that the measurement of whether or not a zero-rate PIE's New Zealand-sourced income falls within the criteria of allowable amounts should only be done quarterly (as per section HM 55H). If a zero-rate PIE inadvertently breaches one of the allowable amount thresholds, the PIE will generally have a quarter to remedy the breach. That said, it is not intended that this rule should be used by a PIE to intentionally derive New Zealand sourced income in between the quarterly tests.

A variable-rate PIE is able to derive both foreign sourced amounts and New Zealand sourced amounts. However, variable-rate PIEs are not able to invest in New Zealand land (or rights or options in relation to land), nor are they able to derive income from New Zealand land. Non-residents can generally deduct expenses incurred in deriving income from land, so allowing such investment would greatly complicate the foreign investment PIE rules.

Both variable-rate and zero-rate PIEs are able to invest in land not situated in New Zealand. Variable-rate PIEs can also invest in New Zealand companies that own land, although there are limits on the percentage of ownership the PIE can have.

As with zero-rate PIEs, variable-rate PIEs are also generally given a "grace period", designed to allow corrections of any inadvertent breaches of these rules.

Modified investment-out test

Section HM 13

PIEs are generally only able to hold up to 20% of the voting rights in ordinary companies (or, for unit trusts, 20% of the interests in that trust). This restriction is extended for foreign investment PIEs so that it also applies to land investment companies and entities that qualify for PIE status. In effect, foreign investment PIEs can only exceed the 20% limit on investments in other PIEs (including foreign investment PIEs) and foreign PIE equivalents.

The reason for this broad 20% ownership restriction is to ensure the non-deductibility of expenses attributed to notified foreign investors. Allowing a foreign investment PIE to have controlling interests in subsidiary companies could provide opportunities for that PIE to shift non-deductible expenses to its subsidiary entities, where the expenses may be deductible. The same concern does not arise with controlling interests in subsidiary PIEs due to the operation of the flow-through rule. Thus, the ownership restriction does not apply to such investments.

Rules for the treatment of investors

Section HM 32(3)

Section HM 32(3) provides that, if a person notifies a PIE that they wish to be treated as a notified foreign investor, that person is treated as having notified the PIE of a tax rate for the purposes of section HM 32(1). The default rate therefore does not apply for the person.

Foreign investment PIEs and PIE proxies

Section HM 33

The rules for PIE proxies have been modified to cater for foreign investment PIEs. If a PIE proxy chooses to provide the benefits to its non-resident investors of the foreign investment PIE rules, it must:

- act as a proxy for a foreign investment PIE;
- obtain the PIE's income details in order to apply the appropriate tax rates to each type and source of income if acting for a variable-rate PIE; and
- collect any information from the investor required by the PIE (such as the investor's country of residence, which is required under section HM 55D(4)).

These new provisions only apply to proxies that choose to act for foreign investment PIEs. There is no change in the treatment of proxies that act only for ordinary PIEs.

No provisional tax option for foreign investment PIEs

Sections HM 41(3) and HM 44

Foreign investment PIEs are unable to use the provisional tax option for calculating their tax liability. The rationale for this restriction was that, given the nature of PIEs that pay provisional tax, it was considered they would be unable to comply with the new rules.

Ability to withhold NRWT

Sections HM 44 and CX 56B

Instead of paying tax on behalf of a notified foreign investor, a foreign investment PIE has the option of withholding non-resident withholding tax (NRWT) on distributions of unimputed dividends paid out to the investor. If the PIE received partially imputed dividends from a New Zealand company, it would be able to use this option to the extent the dividends were unimputed. For example, if it received a $100 dividend with $20 of imputation credits attached, and the PIE distributed the full $100, it could withhold NRWT on $48.57 of the distribution.

As NRWT is a withholding tax, this option can only be applied to amounts actually distributed. Note that, due to the fungibility of money, it is only required that the PIE distribute an amount equivalent to what it has in unimputed dividends. This distribution must be made on or before the date the PIE would otherwise be required to pay PIE tax on the amount.

For example, if the PIE were an "exit PIE" (ie, pays tax under section HM 42), it would generally have until 30 April after the end of the tax year to make a distribution and withhold NRWT. However, if a notified foreign investor reached an exit period, the PIE would generally need to make the distribution one month after the end of the month in which the exit period fell in order to be able to apply this NRWT option.

If a PIE elects to withhold NRWT on an amount on behalf of a notified foreign investor, that amount is not included in the investor's assessable income in section HM 35(3) or their income in section HM 36(3). As such, it does not constitute income that the PIE must pay tax on, nor is it included in the investor's attributed PIE income. Further, section CX 56, which normally deems distributions from a PIE to be excluded, does not apply. In all, this is to clarify that the NRWT is a tax borne by the investor, not the PIE.

Finally, section CX 56B does not apply to the extent a distribution has had NRWT withheld on it. This means the income is not excluded income of the investor. If the amount distributed exceeds the amount that has been subject to NRWT, the balance continues to be excluded.

Example

Z has elected to become a variable-rate foreign investment PIE. Z has derived $400 in income, constituting:

- $200 New Zealand-sourced partially imputed dividends ($200 cash dividend with $40 of imputation credits attached);
- $200 foreign-sourced amounts.

Z has decided it will distribute all of this income to its investors.

Z has two investors: Sarah, who has elected to be a notified foreign investor, and Frank, who is a resident investor with a 28% prescribed investor rate (for simplicity, assume that Z does not need to meet the "investor in" requirements of the PIE rules). Each investor holds 50% of the units in Z.

Since Sarah is a notified foreign investor, Z has decided to withhold NRWT on the payment to her. Sarah's share of Z's dividends is $100 and $20 of imputation credits, which is equivalent to $51.43 in fully imputed dividends and $48.57 in unimputed dividends. Z therefore withholds NRWT on $48.57 of its distribution, which is $7.29 (assuming the applicable NRWT rate is 15%).

The income that Z has withheld NRWT on ceases to be attributed PIE income of Sarah's—her attributed PIE income is now $151.43. Z must pay tax on this amount as usual; however, since it only consists of fully imputed dividends and foreign-sourced amounts, the applicable tax rate is 0%.

Net of tax, Sarah receives $192.71.

As Frank is a resident investor, Z must pay tax on income attributed to him as normal. Frank's share of Z's income is $200 (plus $20 of imputation credits) and Z must pay tax on this. Net of tax and after accounting for the imputation credits, Frank receives $158.40.

Use of tax credits by foreign investment PIEs

Sections LS 1, HM 51 and HM 53

The intention of the new rules is that notified foreign investors in foreign investment PIEs are unable to utilise foreign tax credits and imputation credits attributed to them. Other credits can be utilised by notified foreign investors, but we do not expect this to be a common occurrence. PIEs generally hold RWT exemption certificates so it would be unusual for a notified foreign investor to be attributed an RWT credit in relation to interest earned. Nevertheless, if this were to happen, the PIE would be able to utilise this credit on the investor's behalf. In turn, the investor would be taxed at the rate generally charged on interest paid to non-residents. Overall, the treatment should match that afforded to a non-resident investing directly.

It is important to note that a foreign investment PIE cannot stream its tax credits. It must still attribute its credits amongst investors as stipulated by section HM 50, despite the fact that credits attributed to notified foreign investors will generally not be able to be used.

Modified source rules

Section HM 55C

For foreign investment PIEs, certain source rules are overridden in some situations. Income attributed to a notified foreign investor is not deemed to have a New Zealand source merely because:

- a foreign investment PIE carries on a business in New Zealand; or
- the income is derived from a contract made or performed in New Zealand, provided the income from the contract relates to the PIE's offshore investments.

The restriction that a contract's income must relate to the PIE's offshore investment is designed to cover arrangements such as foreign currency hedges or derivatives to increase or decrease exposure to foreign share markets—even if that contract is entered into with a New Zealand counterparty. The restriction was put in place as otherwise the rule could be too far-reaching. Some contracts may only be given a New Zealand source by the operation of section YD 4(3) (contracts made or performed in New Zealand). Overriding it without qualification would therefore be risky.

Importantly, if there is some other reason for an amount to have a New Zealand source, the income will continue to be treated as having a New Zealand source under section YD 4(18).

Zero percent rate for transitional residents

Sections CX 56, HM 55D(8) and schedule 6, table 1

Transitional residents are generally not taxed on their non-New Zealand sourced investment income. Accordingly, transitional residents are able to invest in zero-rate PIEs and be taxed at a 0% tax rate. Similar rules that apply to notified foreign investors are intended to also apply to such transitional residents, for example, fees and expenses should not be deductible to such investors and credits should not be able to be utilised by them. Similar transitional rules to those that apply to notified foreign investors who become or cease to be non-residents in a tax year also apply.

It should be noted that transitional residents cannot be notified foreign investors; they are only able to elect a 0% tax rate in zero-rate PIEs. This is on the basis that, while transitional residents are generally not taxed on their foreign-sourced investment income, they are taxed as a New Zealand resident on any New Zealand-sourced income. Allowing transitional residents to elect to be a notified foreign investor would therefore be inappropriate.

Change in status of investors in foreign investment PIEs

Sections CX 56 and HM 55E

Transitional rules can apply when a person changes to or from being a notified foreign investor. These rules are designed to simplify when an investor transitions to and from being a New Zealand resident. The rules reflect that a person's change of residency can be retrospective by the operation of the "183-day rule" in section YD 1(3) and that not all PIEs will be able to apply an investor's new status immediately.

Section CX 56 applies to an investor if that investor has become or ceased to be a New Zealand-resident in the tax year. For such an investor, any attributed PIE income will be excluded income, even if the investor is treated as a notified foreign investor when they are resident.

Similarly, section HM 55E does not require a foreign investment PIE to change an investor's status as soon as they are notified. At the latest the change needs to be effected by the start of the next tax year, but must be as soon as is practicable by the PIE. If a PIE's systems are able to change an investor's status quickly, it cannot defer the change to the start of the next tax year. As described above, if there is a delay in changing an investor's status, there are no consequences for that investor.

Allowable amounts for foreign investment zero rate PIEs

Sections HM 19B, HM 55G and HM 55H

Zero-rate PIEs are generally only supposed to derive foreign-sourced amounts. However, it is acknowledged that such PIEs will, in some situations need to derive some New Zealand-sourced income. Accordingly, zero-rate PIEs are permitted to derive the following "allowable amounts".

Income from financial arrangements

Zero-rate PIEs are able to derive income from financial arrangements with a New Zealand-source in two situations. The first situation is if the arrangements do not pay interest and relate to the PIE's offshore investments. "Offshore investments" in this context is intended to have a similar meaning to that in the modified source rules, discussed above.

The second situation is if the arrangements pay only interest income and have a term of 90 days or less (or no term at all). This exemption only applies if the total value of the PIE's financial arrangements that have a term of 90 days or less (but not including any non-interest arrangements as described above), is less than 5% of the total value of the PIE's investments (including the value of any non-interest arrangements).

In both cases, "interest" is intended to have its defined meaning, that is, a payment made for money lent to any person.

The purpose of the first exemption is to allow zero-rate PIEs to enter into derivatives (such as foreign currency hedges) in New Zealand. The purpose of the second exemption is to allow these PIEs to have New Zealand bank accounts to fund day-to-day management costs.

Example

A variable rate PIE has the following New Zealand-sourced financial arrangements:

- $5,000 in a 30-day term deposit, paying interest at 5% p.a.;
- $10,000 in an on-call account, paying interest at 1.43% p.a.;
- a foreign-exchange hedge (which does not pay any interest), designed to remove the effect of currency fluctuations on its offshore investments, with a market value of $7500.

The total value of all of the PIE's other investments is currently $285,000 and the income from these investments does not have a New Zealand source.

The total value of the PIE's investments is $307,500. The PIE has $15000 in interest-bearing financial arrangements with a term of 90 days or less, or no term at all. As a percent of total investments this is 4.88%.

The PIE therefore meets the requirement of deriving only foreign-sourced amounts and "allowable amounts". The PIE's New Zealand-sourced financial arrangements that pay interest both have a term of 90 days or less and constitute less than 5% of the PIE's investment portfolio. The only other New Zealand-sourced income that the PIE could derive is from a non-interest bearing financial arrangement that relates to the PIE's offshore investments.

Income from dividends

Zero-rate PIEs are also able to derive income from New Zealand dividends if the total value of all shares held by the PIE in New Zealand-resident companies is less than 1% of its investments.

The purpose of this exemption is to allow PIEs that track a global share index to be zero-rate PIEs, even though they may have a small exposure to New Zealand equity.

Income from other foreign investment zero-rate PIEs

Income from other zero-rate PIEs (or PIEs that could be zero-rate PIEs if they elected to be one) also count as an "allowable amount". This is on the basis that the ultimate investments of the PIE will be offshore. This forms a similar flow-through rule provided to variable-rate PIEs by section HM 6B(3).

Breaches of the foreign investment PIE rules

Section HM 55H

Section HM 55H provides special breach rules for the additional requirements of foreign investment PIEs. The existing breach rules also apply to foreign investment PIEs where a requirement of being a normal PIE is not met.

As with the original PIE rules, it is intended that whether or not a foreign investment PIE meets the relevant rules is to be tested every quarter. This is because requiring more frequent testing would be excessively costly from a compliance perspective. However, there are certain requirements that, if breached, have immediate consequences.

Zero-rate PIEs

Zero-rate PIEs are only allowed to derive foreign-sourced and "allowable" amounts. As described above, certain thresholds apply to some of these allowable amounts, for example, there is a maximum of 1% of total assets in New Zealand shares. If one of these thresholds is exceeded, that breach must be remedied on the last day of the next quarter (when the PIE will again do its quarterly check). If the breach is not remedied, the foreign investment zero-rate PIE will become a foreign investment variable-rate PIE on the first day of the third quarter.

If, on the other hand, a zero-rate PIE derives an amount other than an allowable amount or a foreign sourced amount, the PIE will become a foreign investment variable-rate PIE immediately. The reason for this difference is that it was considered very unlikely that a PIE could inadvertently derive an amount other than a foreign-sourced or allowable amount, but it is feasible that a PIE could inadvertently breach a threshold for an allowable amount from time to time.

Foreign investment variable rate PIEs

Variable-rate PIEs are required to meet the requirements of sections HM 55F(3) and HM 19C. Among other things, these provisions require the PIE to identify the source and type of amounts of income derived. If one of these criteria is not met, then, similar to a foreign investment zero-rate PIE, the PIE will have until the last day of the next quarter to remedy the breach. If this is not done, the PIE will become an ordinary multi-rate PIE from the first day of the third quarter.

Transitional rule

The rules for foreign investment variable-rate PIEs do not come into force until 1 April 2012. Therefore, section HM 55H(5) provides that if a foreign investment zero-rate PIE breaches one of the rules and loses its status before 1 April 2012, it will become a multi-rate PIE.

Election to be a foreign investor PIE

Sections HM 71B and HM 72

Section HM 71B provides that an entity can elect to become a foreign investment PIE if it:

- is, or is eligible to be, a multi-rate PIE;
- has, or intends to have, non-resident investors; and
- does not use the provisional tax option of section HM 44 to pay its tax if the entity is a PIE.

The entity's election will have to include which type of foreign investment PIE it wishes to become. Finally, the existing rules providing when an entity's election to become a PIE take effect have been modified to also apply to entities becoming foreign investment PIEs.

Modified grouping rules

Section IC 3

New subsection IC 3(2D) provides that a foreign investment PIE cannot be part of a group of companies that includes a land investment company. In other words, a foreign investment PIE is only able to group with wholly-owned PIEs.

Yearly request of information

Section 31C of the Tax Administration Act 1994

Section 31C of the Tax Administration Act 1994 has been modified to provide that a foreign investment PIE must, at least once a year, ask its notified foreign investors to confirm that:

- they are still eligible to be a notified foreign investor; and
- the information the PIE is required to collect under section 28D(1) of the Tax Administration Act 1994 has not changed.

If the PIE receives no response, the PIE may continue to treat the investor as a notified foreign investor.

PROVISIONAL TAX POOLING

Sections RP 17, RP 17(2), RP 17B(3) & (4),RP 17B(4B), RP 17B(5) & (7) to (11), RP 19(3), RP 19B, RP (20) and DB 4B of the Income Tax Act 2007 and 157(10) of the Tax Administration Act 1994

A number of amendments have been made to the provisional tax pooling rules to ensure the legislation is simpler, fairer and is applied consistently across different tax types. A number of these changes either legislate operational concessions that previously applied to the tax pooling rules prior to amendments being made in 2009 or more correctly reflect the policy intent of the rules than they do currently.

Background

The tax pooling rules were introduced in April 2003 and allow compliant taxpayers to reduce their exposure to use-of-money interest on under-payments as a result of uncertainty about their provisional tax payments by purchasing funds from, or depositing funds with, a tax pooling intermediary.

Tax pooling generally involves a taxpayer depositing money with a tax pooling intermediary. The intermediary deposits that money in the intermediary's pooling account with Inland Revenue. The deposit earns interest. Tax payments deposited with an intermediary remain part of the tax pool until the taxpayer directs the intermediary to transfer the credit to the taxpayer's own account with the Commissioner. Alternatively, a taxpayer may sell their funds to another taxpayer, who is also a client of the same pooling intermediary. Or they may request a refund directly from the pooling intermediary.

Tax pooling allows provisional taxpayers to potentially access money at lower interest rates than if they failed to pay provisional tax on the due date and were subject to use-of-money interest. It also enables taxpayers who have overpaid their tax to get a higher return from selling the funds than they would receive from Inland Revenue.

A review of the legislation applying to tax pooling intermediaries was undertaken to ensure the rules were working as intended. As a result, a number of amendments were made to the tax pooling legislation in 2009, and some of Inland Revenue's administrative practices were also discontinued. However the amended tax pooling rules were perceived by some intermediaries and stakeholders as being less flexible than previously.

The amendments below aim to address this problem while still reflecting the original policy intent of the tax pooling rules.

Clarifications at the end of this item set out how the legislative changes affect the administration of the tax pooling rules. There are also clarifications on existing tax pooling policies and legislation.

Key features

The major changes to the tax pooling rules are:

- extending the time limit available to satisfy an obligation to pay provisional or terminal tax (a new 75-day time limit);
- the time limit for meeting provisional or terminal tax no longer applies to the use of own deposited funds, provided the return is filed on time;
- enabling taxpayers to use purchased funds in a tax pooling account towards the payment of a future provisional or terminal tax liability if certain criteria are met;
- allowing members in a group of companies to use pooling deposits made or purchased by any member of the same group in certain circumstances;
- extending the use of pooling funds to voluntary disclosures for certain non income tax revenues where there has been no previous assessment;
- correcting an omission that prevented tax pooling funds being used in cases where a return was filed but no assessment resulted, where the obligation quantified in the return was subsequently increased through an assessment;
- a discretion for the Commissioner to allow taxpayers to use tax pooling in certain cases of income tax or RWT voluntary disclosures where no return has previously been filed;
- removing the unintended ability to use tax pooling funds to eliminate imputation account debit closing balances;
- extending the definition of increased "amount of tax" to reflect the policy intent; and
- clarifying the effective date of tax pooling funds received when deduction notices are applied.

Application date

The changes apply from the date of Royal assent, being 29 August 2011.

NEW LEGISLATION

Detailed analysis

New time limit to meet provisional or terminal tax liabilities

Previously all taxpayers were required to access funds in pooling accounts within 60 days of their terminal tax date in order to apply the pooling deposits against a provisional tax or an income tax liability effective at the date the deposit was originally made.

Changes have been made to section RP 17B(4) to provide more time for taxpayers who use funds in a pooling account—at back-dated effective credit dates—held by a tax pooling intermediary to meet their provisional or terminal tax liabilities.

The changes are being made because for some taxpayers the previous time limit of 60 days meant that the last day to use tax credits from a tax pooling account fell before the date when the tax returns are due to be filed, and potentially before tax liabilities have been determined by the taxpayer. This was an issue for some early balance dates (mostly December balance dates).

New subsection RP 17B(4)(a) provides that all taxpayers using a provisional tax pooling intermediary will have 75 days from their terminal tax date for the tax year to access funds held by a tax pooling intermediary to meet their provisional or terminal tax liabilities at backdated effective dates.

There are exceptions to this rule explained below.

New subsection RP 17B(4)(b) extends the time limit to 76 days from terminal tax date for persons with an October, November and December balance date, where the terminal tax date falls in a tax year that is a leap year.

Example 1 – early balance dates

Alex, a self-employed Wellington taxpayer, has an approved balance date of 31 October and has an extension of time until 31 March 2012 to file her 2011 income tax return. Alex's 2011 terminal tax date is 7 November 2011.

If Alex chooses to use tax pooling funds to pay any of her 2011 provisional or terminal tax obligations, her tax pooling intermediary will have until 21 January 2012 to request Inland Revenue to transfer tax pooling funds to her tax account with the Commissioner. Since 21 January 2012 is a Saturday, a tax pooling intermediary will have until Monday 23 January 2012 to make the transfer request for Alex.

Note: 23 January 2012 is also Wellington Anniversary day. However Alex's tax pooling intermediary will not get an extra day to make her transfer request, unless the tax pooling intermediary's business operation was based in Wellington (in which case the extra day will apply to all clients of that intermediary whose 75th day following their terminal tax date falls on 23 January 2012).

Example 2 – early balance dates

A Wellington company has an approved 31 December balance date and an extension of time until 31 March 2012 to file its 2011 income tax return. The company's 2011 terminal tax date is 15 January 2012. Because this day is a Sunday the company has until Monday 16 January 2012 to pay its terminal tax.

If the company chooses to use tax pooling funds to pay any of its 2011 provisional or terminal tax obligations, its tax pooling intermediary will have until 31 March 2012 (ie, 76 days) to request Inland Revenue to transfer tax pooling funds to the company's tax account with the Commissioner. This is because the company's 2011 terminal tax date of 15 January 2012 falls in the 2012 tax year which is a leap year.

Since 31 March 2012 is a Saturday, a tax pooling intermediary will have until Monday 2 April 2012 to make the transfer request in respect of the company.

Note: The 75 days (76 days in a leap year) are counted from the day commencing after the terminal tax date, even if that day is not a working day.

Treatment of a taxpayer's deposits in a pooling account

Currently the time limit also applies to the use of a taxpayer's own deposited funds (the funds that a taxpayer deposits (as per section RP 18) into a pooling account themselves) as well as purchased funds[10]. New subsection RP 17B(4)(c) removes the time limit restriction where the amount that is to be transferred is a person's own deposited funds (under section RP 18) subject to a return being filed on time.

Therefore provided a person's return filing requirements have been met, there is no longer any time limit for transfer of these funds for meeting provisional and terminal tax liabilities. The return filing requirement applies only to the tax year for which the tax pooling funds are intended to be used.

[10] Except in the case of company amalgamations, purchased funds include any acquisition of tax pooling funds deposited by another person, including by way of sale, transfer, gifting, swapping, etc.

This amendment means that people who use amounts that they have deposited will be able to transfer the total amount of their deposit as long as they do so within 75 days of their terminal date if they have not filed their tax return, or at any time if they have filed their return.

New subsections RP 17(2) and RP 17B(4)(4B) provide for the use of amounts deposited by a person to pay provisional tax, terminal tax, an increase in an assessment of tax or other obligations as if it had itself deposited the funds. This applies if the person is a member of a group of companies at the time an amount is deposited; so that each company of a group is able to use those deposited funds.

The treatment of "own deposited funds" as provided for in new subsection RP 17B(4)(c) therefore extends to these group companies. This removes the time limit for the use of own funds where a person is a member of the same group of companies based on the membership of the group at the time of deposit or purchase, and use of the tax pooling funds—provided the return filing requirements have been met.

For imputation purposes if a member (company A) of a group of companies (which is not an imputation group) makes a deposit of own funds only company A receives an imputation credit at the time of the deposit. If company A uses any of these deposited funds to pay its own income tax or provisional tax obligations, no further imputation debits or credits arise as a result of the transfer of its own deposited funds from the tax pooling account to its income tax account.

However, if another member of the group (company B), who must have been a member of that group at the time the deposit was made by company A, uses the deposit to pay income tax or provisional tax, then an imputation credit will arise for company B when the deposit is transferred from the tax pooling account to company B's income tax account and an imputation debit will arise for company A. An imputation credit arises for company B on the effective date of the transfer and an imputation debit arises for Company A on the date the Commissioner processes the transfer request from the tax pooling account to company B's income tax account.

Company C, a member of the group, can use a deposit made by Company A to meet a non-income tax obligation (such as an increased GST obligation) by direct transfer of the deposit into their own GST account.

No imputation credit will arise for company C, but an imputation debit will still arise for company A on the date the Commissioner processes the transfer request from the tax pooling account to company C's GST account.

Company C can only use the deposit if they are a member of the group at the time the deposit was made.

The treatment of imputation credits and debits for members of the same group is intended to be similar to the way the imputation rules apply if company A transferred its own deposited funds to its income tax account and then requested transfers under the transfer rules to other members of the group, or to meet company A's obligations to pay other non income tax obligations.

The amendment also ensures that funds paid directly to a tax pool are treated similarly to those paid directly to the Commissioner. Once transferred from the tax pool to the taxpayer's tax account section 173L and 173M of the Tax Administration Act allows excess tax to be transferred within the taxpayer's account or to related parties at the date the tax was paid. There is no time limit on such transfers. There are no changes to transfers of "own funds" back into a tax pooling account (ie, the effective date of all such transfers will continue to be the date of request).

New subsection RP 17B(7) limits the amount a taxpayer may request an intermediary to transfer:

- Section RP 17B(7)(a) applies to purchased funds and limits these to the actual obligation owing (subject to section RP 19B, explained below).
- Section RP 17B(7)(b) ensures no limit applies to a taxpayer using their own deposited funds if they have complied with their return filing obligations for the applicable tax year.
- Section RP 17B(7)(c) and (d) limit the amount of all tax pooling transfers (whether own funds or purchased funds) to the increased amount of tax payable or the amount of deferred tax payable, as applicable.

In practice, the requirement to file a tax return in order for a taxpayer to access their own deposited funds will not necessarily prevent the taxpayer from using these funds if the return for the applicable tax year is not filed.

The purpose of the return filing requirement is, firstly, to ensure that taxpayers who use their own deposited funds comply with their other tax obligations and, secondly, to consider, on a case by case basis, if a request complies with other legislative provisions. Where taxpayer's use of their own deposited funds is found to be done in a manner that contravenes other legislative provisions and this becomes possible solely because they have not filed their tax return, the Commissioner may not allow the funds to be transferred, or if already processed will amend or reverse the transfer.

Example 3 – use of "own deposited funds"

Rokky Ltd has a 31 March balance date and did not file its 2011 income tax return by 7 July 2011 (the company does not have a tax agent or an individual extension of time). The company's 2011 terminal tax date is 7 February 2012.

If the company chooses to use its own deposit tax pooling funds to pay any of its 2011 provisional or terminal tax obligations, its tax pooling intermediary will have until 22 April 2012 to request Inland Revenue to transfer tax pooling funds to its tax account with the Commissioner. Since 22 April 2012 is a Sunday, a tax pooling intermediary will have until Monday 23 April 2012 to make the transfer request in respect of the company.

The company fails to ask its tax pooling intermediary to transfer its own deposited funds by 23 April 2012. On 24 April 2012 the company asks its tax pooling intermediary to transfer its own deposited funds with backdated effective dates towards its 2012 provisional tax obligations.

The company then requests the Commissioner (under the Transfer Rules in Part XB of the TAA) to transfer the funds from the company's 2012 tax year to its 2011 tax year retaining the backdated effective dates.

Example 4 – use of purchased funds

Julia paid $63,000 of 2011 provisional tax in three instalments. By 31 March 2011 Julia thought she might owe some terminal tax so she then purchased $9,000 of tax pooling funds (one third at each of her 2011 provisional tax instalment dates of 28 August 2010, 15 January and 7 May 2011) to mitigate the use-of-money interest otherwise payable.

Julia files her 2011 income tax return on 7 July 2011 showing terminal tax to pay of $6,000 due by 7 February 2012. Julia asks her tax pooling intermediary to request transfer of her $9,000 to her 2011 tax account at the backdated effective dates she purchased these funds. The tax pooling intermediary makes the transfer request on 17 February 2012.

The Commissioner will only allow Julia to receive a total of $6,000 at backdated effective dates into her 2011 tax account as that is the amount she owes for the 2011 tax year.

The remaining $3,000 (ie, $1,000 purchased at each of 28 August 2010, 15 January and 7 May 2011), if transferred into her 2011 income tax account, will have the effective dates changed to the date of request (ie, 17 February 2011).

Alternatively Julia could ask her tax pooling intermediary to transfer the $3,000 towards her 2012 provisional tax obligations and/or any expected terminal tax obligations. The effective dates Julia can use must be no earlier than the effective date the funds are available at and must not be any earlier than the first day of her 2012 tax year (ie, 1 April 2011).

Example 5a – "own deposited funds" used to meet an increased amount

Wendy has a 31 March balance date and deposited $30,000 into a tax pooling account on each of her 2011 provisional tax instalment dates to meet her provisional tax obligations of $90,000. Wendy's RIT turns out to be $87,000. On 30 April 2012 Wendy asks her tax pooling intermediary to transfer $29,000 of the $30,000 she deposited at each instalment date to meet her 2011 tax obligation of $87,000.

Wendy keeps the remaining deposits in the tax pool ($1,000 at each of 28 August 2010, 15 January and 7 May 2011).

On 24 April 2012 a GST audit revealed that Wendy has made an error in calculating the GST payable for the two month period ended 31 March 2011. Wendy is issued with an assessment for an additional $2,000 in GST due to the error.

Because Wendy's 31 March 2011 GST was due on 28 April 2011, she can use the remaining 28 August 2010 and 15 January 2011 deposits to pay her increased GST obligations and mitigate use-of-money interest that would otherwise be payable.

Example 5b – "own deposited funds" used to meet other obligations

Continuing with example 5a, Wendy made an adding error and short-paid her PAYE by $1,500 for the period ended 30 April 2012, which was due on 20 May 2012. Wendy realises her error when she receives her PAYE statement of account on 30 May 2012.

Because Wendy still has $1,000 of her own deposited funds in a tax pooling account with an effective date of 7 May 2012, she can ask her tax pooling intermediary to transfer this $1,000 to her 30 April 2012 PAYE period with an effective date of 20 May 2012.

Because Wendy has no other own deposited tax pooling funds she still owes the remaining $500 PAYE as well as late payment penalties and use-of-money interest on this amount.

Example 6 – group companies (own deposited funds and purchased funds)

Example 6a

Orange Ltd is the nominated member of a group of companies for making tax pooling deposits and purchasing tax pooling funds. Orange Ltd makes three deposits of $100,000 on 16 June 2010, 27 April 2011 and 31 August 2011 and on 22 June 2011 also purchased $200,000 from another member of the same tax pool it is a member of. When these deposits and the purchase were made the members of the group were Orange Ltd, Blue Ltd and Grey Ltd.

At the time of deposit only Orange Ltd received imputation credits.

Any of these members of the group can use any of the three tax pooling deposits as their own deposited funds. The funds purchased on 22 June 2011 are not "own deposited funds" for any of the companies.

Note: The exact imputation impacts for members of a group of companies will differ for "own deposited funds" and purchased funds, where these are applied to income tax accounts of the members. Additionally there will also be imputation impacts where "own deposited funds" and purchased funds are applied to meet other taxes. These impacts are explained in other parts of this item.

Example 6b

On 1 June 2011 Purple Ltd joined the Orange Ltd group of companies. Because Purple Ltd was not a member at the time the 16 June 2010 and 27 April 2011 deposits were made, it cannot use these funds as "own deposited funds". If Purple Ltd uses any of these two deposits they would be purchased funds (ie, acquired in some way from the Orange Ltd group).

The deposit made on 31 August 2011 is considered to be "own deposited funds" as Purple Ltd was a member of the group as at that date. The funds purchased on 22 June 2011 are not "own deposited funds" for Purple Ltd either.

There are no imputation impacts on any of the companies as a result of Purple Ltd joining the group.

Note: Group companies and tax pooling intermediaries are responsible between themselves for ensuring that full details of group membership of companies are maintained each time a deposit is made by a group member and each time when such funds are used as "own deposited funds".

Example 6c

Purple Ltd has its own tax pooling deposit of $50,000 it made on 22 October 2009. When Purple Ltd joined the Orange Ltd group this deposit had not been used and remains Purple Ltd's "own deposited funds".

However if Orange Ltd, Blue Ltd or Grey Ltd use any of the $50,000 deposit made by Purple Ltd they cannot use this as "own deposited funds".

Note: Companies joining or leaving a group and tax pooling intermediaries are also responsible between themselves for ensuring that full details of unused deposits the company made before joining a group are maintained as well as any use of those "own deposited funds" while they are a member of a group of companies.

Example 6d

On 30 September 2011 Grey Ltd leaves the Orange Ltd group. Grey Ltd retains the $100,000 deposited into the tax pool on 27 April 2011. Because Grey Ltd was a member of the Orange Ltd group when that deposit was made this becomes Grey Ltd's "own deposited funds".

From that time the $100,000 deposit made on 27 April 2011 is no longer a deposit of the Orange Ltd group.

On 30 September 2011 Grey Ltd would receive an imputation credit of $100,000 as at 27 April 2011 and Orange Ltd will receive an imputation debit as at 30 September 2011.

If Grey Ltd were to rejoin the Orange Ltd group at some point in future, this $100,000 deposit would only be "own deposited funds" for Grey Ltd. Orange Ltd and Blue Ltd cannot use this deposit as "own deposited funds" again. There would be no imputation impacts if Grey Ltd rejoined the group at the time of rejoining.

Note: If it was Purple Ltd that left the group, it could never have used the 27 April 2011 deposit as "own deposited funds" and therefore the $100,000 would be treated as purchased funds of Purple Ltd upon leaving the group. Orange Ltd will receive an imputation debit of $100,000 on 30 September 2011 (but the date the debit arises in its imputation account and in which imputation year(s) will depend on its 2011 imputation account closing balance and on its 2012 imputation account balance on 30 September 2011).

An imputation credit for Purple Ltd will only arise on the date the Commissioner transfers the $100,000 to its income tax account. The effective date of Purple Ltd's imputation credit will be the same effective date it uses the $100,000 at.

Example 6e

On 1 November 2011 Pink Ltd joined the Orange Ltd group. Because Pink Ltd was not a member at the time the 16 June 2010 and 31 August 2011 deposits were made, it cannot use these funds as "own deposited funds". Also Purple Ltd's deposit of 22 October 2009 cannot be used by Pink Ltd as "own deposited funds".

Pink Ltd has also made a deposit of its own of $100,000 on 14 January 2011 and retains this as "own deposited funds" when it joins the Orange Ltd group. Orange Ltd, Blue Ltd and Purple Ltd cannot use this deposit as "own deposited funds".

There are no imputation impacts on any of the companies as a result of Pink Ltd joining the group.

Example 6f

On 31 May 2012 Pink Ltd leaves the Orange Ltd group. Prior to leaving, Pink Ltd and Orange Ltd come to an arrangement to swap Pink Ltd's deposit of 14 January 2011 for $50,000 of the $100,000 deposit Orange Ltd's group made on 16 June 2010.

Both Pink Ltd and Orange Ltd group are deemed to have disposed of (ie, sold) their respective "own deposited funds" and acquired the other's $50,000. Pink Ltd now has purchased funds of $50,000 with an effective date of 16 June 2010 and Orange Ltd Group now has purchased funds of $50,000 with an effective date of 14 January 2011 and a remaining $50,000 of its "own deposited funds" with an effective date of 16 June 2010.

Note: Both Orange Ltd and Pink Ltd will receive an imputation debit of $50,000 on 31 May 2012. The dates these debits will arise in each of these companies imputation accounts and in which imputation years will depend on their respective 2012 imputation account closing balances and on their respective 2013 imputation account balances as at 31 May 2012.

Imputation credits for both Orange Ltd and Pink Ltd will only arise on the date the Commissioner transfers the $50,000 to their respective income tax accounts. The effective date of each company's imputation credit will be the same effective date it uses the $50,000 at (which is likely to be different for each company as the deposit dates are different).

Example 7 – imputation effects of use of "own deposited funds" for members of a group of companies

Example 7a

Ship Ltd, Boat Ltd and Dinghy Ltd are members of a group of companies. On 28 October 2011 Ship Ltd makes a deposit of $500,000 into a tax pooling account and an imputation credit of $500,000 arises on the same date.

On 26 April 2012 the Commissioner processes a transfer request from the group's tax pooling intermediary to transfer $200,000 of the $500,000 deposit to Boat Ltd's 2012 income tax account with an effective date of 28 October 2011.

An imputation credit of $200,000 arises for Boat Ltd on 28 October 2011. For Ship Ltd an imputation debit of $200,000 arises on 26 April 2012.

Example 7b

Dinghy Ltd has an increased GST obligation of $30,000 for its GST period ended 30 September 2011 following an amended assessment issued by the Commissioner on 13 June 2012.

On 27 June 2012 the Commissioner processes a transfer request from the group's tax pooling intermediary to transfer $30,000 of the remaining (ie, $300,000) deposit Ship Ltd made on 28 October 2011 to Dinghy Ltd's GST account, also with an effective date of 28 October 2011.

No imputation credit arises for Dinghy Ltd as the transfer is from the tax pooling account to its GST account. For Ship Ltd an imputation debit of $30,000 arises on 27 June 2012.

Note: If instead, Ship Ltd had the increased GST obligation, an imputation debit of $30,000 would still arise for Ship Ltd on 27 June 2012.

Transfers for certain expected tax liabilities

Currently taxpayers who purchase pooling funds and who filed their income tax return at the time Inland Revenue processes the transfer request are only able to transfer funds for actual tax obligations. There may be situations when taxpayers wish to purchase pooling funds and have them transferred to their income tax account before they file their income tax return (because they have an expected obligation that cannot be quantified at that time). New section RP 19B allows taxpayers to use purchased funds in a tax pooling account towards the payment of a future tax liability if certain criteria are met.

The section applies to a person who:

- expects to have an income tax or provisional tax liability for a tax year;
- has *acquired* funds in a tax pool (there are no limitations in relation to taxpayers using their own deposited funds); and

- has not yet filed a return of income in relation to the liability for the year (and therefore cannot quantify the actual obligation).

In order to use purchased funds for future tax liabilities according to this section, certain requirements must be met. Section RP 19B(3) provides that at the time of making the request the person must have met all of their return filing requirements for earlier tax years (for an income tax liability) and have met all their obligations under the provisional tax rules (for a provisional tax liability). This ensures that the Commissioner has all of the necessary information when a request for purchased pooling funds is received to determine what the taxpayer's provisional tax obligations are as these are generally based on prior year terminal tax obligations from tax returns.

Section RP 19B(4) provides that any backdated credit date for purchased funds is limited to the tax year in which the funds are used. This ensures that backdated tax pooling funds are not able to be used to meet other obligations that the tax pooling rules are not intended to apply to. Taxpayers will be able to choose any date within their tax year (or income year in the case of non-standard balance date taxpayers) to transfer tax pooling funds at. If no purchased funds are available at the dates required, funds with later effective dates can be used.

Section RP 19B(5) ensures that if excess tax results from the purchased pooling funds this can only be:

- transferred to a future tax year of the taxpayer to meet an obligation to pay their provisional or terminal tax; or
- transferred to another tax obligation of the taxpayer or another taxpayer with an effective date no earlier than the date the taxpayer requests a transfer of the excess tax (that is, no backdated effective date is possible); or
- refunded to the taxpayer.

Examples 8 & 9 – purchased funds to meet expected liability

Example 8a

Phil has a 31 December balance date and all his income tax returns are up to date. Phil has paid his 2011 provisional tax of $60,000 in three payments of $20,000 at each of the due dates (28 May 2010, 28 September 2010 and 28 January 2011).

Phil has an extension of time to 31 March 2012 to file his 2011 income tax return but an analysis of his financial data in March 2011 indicates Phil's 2011 RIT is likely to be $75,000.

Phil decides to purchase $5,000 at each of his 2011 provisional tax instalment dates and asks his tax pooling intermediary to transfer these amounts in April 2011. Phil's tax agent files Phil's 2011 tax return on 31 March 2012 showing RIT of $70,000.

Because Phil paid $60,000 and also purchased $15,000 of tax pooling funds towards an expected liability of $75,000, the first $15,000 of any excess tax in his 2011 income tax account would be subject to section RP 19B(5) if his RIT turned out to be less $75,000. Since Phil's RIT was $70,000 he has $5,000 excess tax he must now choose how to deal with.

On 30 April 2012 Phil asks the Commissioner to transfer $1,000 of the excess tax to his Child Support for the month of April 2012 due on 20 May 2012 and requests a refund of the balance of $4,000. The Commissioner transfers the $1,000 to Phil's Child Support on 7 May 2012 with an effective date of 30 April 2012 (or a later date that Phil chooses) and refunds the $4,000 together with the use-of-money interest accrued to 7 May 2012.

Note 1: The reason the Commissioner will allow Phil to transfer the purchased tax pooling funds that have become excess tax to meet his Child Support obligations is because the transfer is not being backdated and if the $1,000 was refunded along with the other $4,000 Phil will need to make a payment of $1,000 on or before 20 May 2012 to meet his Child Support obligations on time.

Note 2: If Phil also owed $1,000 Child Support for the month of March 2012, which was due on 20 April 2012, and had also requested a transfer on 30 April 2012, the earliest effective date Phil could choose for the transfer would be the date of request (ie, 30 April 2012). In this case Phil could request a transfer of the $1,000 and the late payment penalty of $100 to be transferred on 30 April 2012 to clear this Child Support debt for that month because there is no backdating of tax pooling funds.

Example 8b

Using the facts from example 8a except that Phil's RIT was $55,000 when his tax agent filed his 2011 tax return.

Phil purchased $15,000 which was not needed to meet his RIT and he also has $5,000 of excess tax from the provisional tax payments he made.

The first $15,000 of transfers will be subject to section RP 19B(5). If Phil wishes to transfer any of the $5,000 of overpaid provisional tax, he will firstly need to advise the Commissioner what he wants to do with the $15,000 of excess tax resulting from the tax pooling purchase.

Until the $15,000 of purchased tax pooling funds is dealt with pursuant to section RP 19B(5) the Commissioner will not process any transfer request in respect of the $5,000 of overpaid provisional tax.

Example 8c

Using the facts from example 8a except that Phil's RIT was $55,000 when his tax agent filed his 2011 tax return and Phil purchased tax pooling funds to meet his 2011 provisional tax obligations of $20,000 on each provisional tax due date.

Phil purchased $15,000 which was not needed to meet his RIT in addition to $5,000 of the $60,000 provisional tax payments he purchased.

Section RP 19B(5) will apply to all $20,000 of the purchased tax pooling funds that became excess tax when Phil's tax return was filed and his RIT and terminal tax was determined.

If Phil wishes to transfer any of the $20,000 of purchased tax pooling funds that have become excess tax, he will need to advise the Commissioner which option(s) under section RP 19B(5) he wishes to apply to the $20,000.

Example 9

Kath estimates her 2012 provisional tax on 26 August 2011 at $54,000 and purchases $18,000 of tax pooling funds to pay her first instalment due on 28 August 2011. Kath's tax pooling intermediary requests the Commissioner to transfer the $18,000 to Kath's 2012 income tax account. On 23 November 2011 Kath determines that her 2012 RIT will be much lower than her estimate and she files a revised estimate of $45,000.

Because Kath's second instalment is not due to be paid until 15 January 2012 she has excess tax of $3,000 (from the $18,000 tax pooling funds transferred to her account). On 13 December 2011 Kath asks the Commissioner to transfer the $3,000 excess tax to her husband's 2012 income tax account. The effective date of this transfer will be 13 December 2011 because the excess tax arose from purchased tax pooling funds she is transferring to another taxpayer (the concessions for transfers between associated persons under the transfer rules do not apply to transfers that are subject to section RP 19B). For Kath to retain the 28 August 2011 effective date she would have to be applying the excess tax pooling funds to her own income tax (the 2013 tax year but not an effective date earlier than the first day of that tax year, ie, 1 April 2012), an increased amount of tax she owes, or an obligation she has to pay deferred tax (in both these last two cases the original due dates of the tax must fall on or after 28 August 2011).

Extending the use of pooling funds to voluntary disclosures where there has been no previous assessment

In the past, tax pooling funds were limited to situations when there has been a previous assessment. In addition, the use of tax pooling funds did not extend to situations where a tax liability existed without the need for an assessment (because the amount due is an obligation, not assessed taxes such as for resident withholding tax and fringe benefit tax).

New section RP 17B(3)(ab) will allow pooling funds to be used to pay increased amounts arising from a voluntary disclosure when there has not been a previous assessment (because the amount due was an obligation, not assessed taxes), provided the relevant return has previously been filed for that return period.

Since not all adjustments will arise from a voluntary disclosure, new section RP 17B(3)(ac) will allow pooling funds to be used when the Commissioner makes an assessment or adjustment increasing an amount previously payable (because the amount due was an obligation, not assessed taxes), provided the relevant return has previously been filed for that year or return period.

The original amount of tax payable cannot be paid using tax pooling funds. Tax pooling funds can only be used for the adjustment resulting from the difference between the return filed and the increased amount owing. This is consistent with the treatment of additional amounts owing resulting from amended assessments. If second or subsequent adjustments are made that result in more tax to pay, this amendment will also allow tax pooling to be used, provided each subsequent adjustment results in an increased amount of tax to pay than the immediately preceding adjustment.

The timeframe for taxpayer's using tax pooling at backdated effective dates to meet increased amounts of tax remains at 60 days from the date the Commissioner issues an assessment, or other form of written notice where the increased amount of tax does not result from an assessment (for example a letter setting out the adjustments or a statement of account).

Example 10 – PAYE voluntary disclosure is made (return has previously been filed)

The Corner Company employs 5 staff and has 3 contractors and files its own PAYE schedules. For the month of August 2011 it had a payroll software problem that resulted in incorrect information being generated and the PAYE paid was $4,000 instead of $4,500. The company did not become aware of the problem until it was preparing its September 2011 PAYE schedule.

The company makes a voluntary disclosure to correct the error and once the Commissioner has made the adjustment the company sources tax pooling funds within 60 days of the date the Commissioner notifies the company of the adjustment to pay the increased amount of PAYE of $500 with an effective date equal to the original due date to mitigate the use-of-money interest that would otherwise be payable (even though a new due date was set to pay the $500).

Shortly after the Commissioner is approached by one of the company's contractors who considers that he should be an employee. Following a review of all of the contracts and other relevant documents, a meeting is held with the company and the contractor where agreement is reached that the contractor was in fact an employee and that PAYE of $400 should have been deducted for the month of August 2011.

The Commissioner makes a further adjustment increasing the PAYE for the month of August 2011 from $4,500 to $4,900. The Commissioner sets a new due date for the increased amount of tax of $400 and the company is able to use tax pooling funds within 60 days of the notification of the increase of $400 in the PAYE (which may be by way of a Notice of Assessment, a letter setting out the Commissioner's adjustment, or a Statement of Account showing the increased PAYE if the adjustment made does not result in an assessment).

Example 11 – FBT voluntary disclosure is made (return has previously been filed)

In December 2011 the Commissioner investigates Rentals 4 You Ltd, a company that hires out cars for special events. The Commissioner finds that the company did not include FBT on a limousine that was used privately by some of the employees of the company in its quarterly FBT returns filed covering the quarterly FBT periods between 1 July 2010 and 30 June 2011. Following the investigation assessments are made by the Commissioner increasing the FBT obligations of the company by $500 per quarter.

The company has 60 days from the date of the Notices of Assessment for each quarter to use tax pooling funds to meet the increased FBT payable. The company has $500 of its own funds in the tax pooling account that was left over from a deposit made on 7 May 2010 to pay its 2010 income tax that was not needed.

The company uses the $500 of its own funds to pay the increased FBT for the quarter ended 30 September 2010 as at the original due date of 20 October 2010 to mitigate the use-of-money interest that is otherwise payable.

The company also purchases $1,500 of tax pooling funds to pay the additional FBT of $500 due for each of the three quarters ended on 31 December 2010, 31 March 2011 and 30 June 2011 at the due dates these FBT returns were originally due (ie, 20 January 2011, 31 May 2011 and 20 July 2011, respectively).

A Commissioner discretion to use funds where no return is filed

New section RP 17B(9) stipulates that the Commissioner's discretion in new section RP 17B(10) is available in situations where a voluntary disclosure is made and a return has not previously been filed (ie, the return is provided at the time of making the voluntary disclosure). This discretion is limited to income tax and resident withholding tax (RWT).

New section RP 17B(10) provides the matters that the Commissioner will have regard to in considering whether or not to allow the use of tax pooling funds. This includes consideration of the compliance history over the previous two years (filing and paying) and other factual information available to the Commissioner at the time. That other factual information available must satisfy the Commissioner that the increased amount of tax has arisen as a result of an event or circumstance beyond the person's control and the person has a reasonable justification or excuse for not filing the return by the due date (for example, the person cannot reasonably have been expected to have known of their obligations). This ensures that in exercising discretion the Commissioner is satisfied that each occasion of non-compliance is not a deliberate act or a continuation of failures because of the taxpayer's inadequate or poorly applied internal controls.

The taxpayer is required to have the ability to use tax pooling funds confirmed to them in writing before backdated tax pooling funds are used under this provision. It is therefore advisable that taxpayers ask the Commissioner to exercise his discretion at the same time as making their voluntary disclosure of income tax or RWT and before committing themselves to acquiring tax pooling funds at backdated effective dates.

Requests to use this discretion need to be sent to The Manager, Legal and Technical Services, PO Box 1462, Wellington.

Examples 12 & 13 – voluntary disclosure is made (return is filed at same time)

Example 12

John immigrated to New Zealand 5 years ago to retire and sought the advice of a professional advisor to ensure that his New Zealand tax obligations would be met. John had extensive foreign investments but was incorrectly advised that because these were being taxed in the countries in which they were held in, he was not required to file New Zealand tax returns and return the income.

John considered himself to be a "non-filing taxpayer" as he had no other income. By chance John discovered that the advice he had received may have been incorrect. John engaged a tax agent who confirmed that the earlier advice had been wrong and he has always been a "filing taxpayer" and should have filed IR 3 returns for all of the tax years he has been resident in New Zealand declaring all his overseas income (and claim any overseas tax paid).

The tax agent makes a voluntary disclosure and files the last 5 years of returns for John together with an application under section RP 17B(10) of the Income Tax Act 2007 as he may qualify for being allowed to use backdated tax pooling funds to mitigate the use-of-money interest that will otherwise apply.

The Commissioner accepts the voluntary disclosure and after making suitable enquiries also accepts that John had done what any other reasonable person in similar circumstances could be expected to do. The Commissioner was satisfied from his enquiries that John could not have been expected to have known or suspect the advice he had been given was incorrect until his suspicions were aroused.

The Commissioner accepts that the increased amount of tax to pay (after allowing for overseas tax credits) was due to an event or circumstance that was beyond John's control because he should have been able to rely on a professional advisor to have given him correct advice. The Commissioner also took into consideration that John had a reasonable excuse for not filing his tax returns by their due dates and that he took immediate steps as soon as practicable after he discovered that he had failed to file his returns to make a voluntary disclosure and file them.

Because John had no other tax obligations to fulfil there was no other compliance history for the Commissioner to take into account and the absence of a compliance history will not count against John.

The Commissioner is able to issue John with a letter that he can provide to a tax pooling intermediary confirming that John may use backdated tax pooling funds to meet the income tax obligations arising for each of the previous 5 tax years as a result of his voluntary disclosure.

Note 1: John will be able to purchase tax pooling funds at effective dates that fall within each tax year to the extent of the tax owing in each year. If no tax pooling funds are available at an appropriate backdated effective date he will be able to purchase funds that have later effective dates. If John cannot source enough funds at backdated effective dates to mitigate all of the use-of-money interest, he will not be able to purchase backdated tax pooling funds to pay any use-of-money interest.

Note 2: John will need to arrange to purchase tax pooling funds and ensure his tax pooling intermediary requests the transfer within 60 days of the date the Commissioner confirms in writing that John's self assessments have been accepted (or if the Commissioner issues an assessment within 60 days of the date of the notice of assessment).

Example 13

Mary became a self-employed builder 3 years ago but did not file tax returns or GST returns. In Mary's first year of business she received $40,000 gross. In Mary's second year of business she received $100,000 gross. This level of income continued into the third year. In Mary's fourth year of business she was offered a big building contract. Mary realises that now she will need to issue GST invoices so she needs to sort out her tax affairs.

Mary engages a tax agent who subsequently makes a voluntary disclosure and files the last 3 years of income tax and two years of GST returns for Mary. He thinks Mary may qualify to use backdated tax pooling funds to mitigate the use-of-money interest that would apply for unpaid income tax. The agent also makes an application under section RP 17B(10) of the Income Tax Act 2007. The tax agent advised Mary that applications can't be made in respect of GST.

The Commissioner accepts the voluntary disclosure, accepts that Mary was not liable to be registered for GST until the commencement of her second year of business and investigates Mary's compliance history. The Commissioner determines that Mary knew when she became self-employed that she was required to file income tax returns, declaring her building income and that she could claim business related expenses, and was required to keep adequate records of both.

The Commissioner also determines that Mary was fully aware of GST and that she also knew that she should have registered from her second year in business as she had exceeded the GST registration threshold due to the large amount of taxable supplies she was making.

Mary could not provide adequate reasons for failing to file income tax and GST returns or for not engaging a tax agent to do her returns for her, other than she was always busy with work.

The Commissioner determines that the increased amount of tax arising from the tax position Mary took by not filing her income tax returns when they were due was not as a result of an event or circumstance beyond her control.

Mary did not have any reasonable justification or excuse for not filing her income tax returns by their respective due dates.

The Commissioner also takes into account that Mary should have registered for GST 2 years ago, but failed to do so and did not file her GST returns or pay any GST owing.

The Commissioner advises Mary's tax agent in writing that he is not satisfied she meets all of the criteria of section RP 17B(10) and declines her application to use backdated tax pooling funds to meet the increased amount of income tax resulting from the filing of her voluntary disclosure.

Note: A decision by the Commissioner to decline an application under section RP 17B(10) is a disputable decision and a taxpayer may challenge the decision by filing a Notice of Proposed Adjustment within the required response period from the date of issue of the Commissioner's written notification.

New section RP 17B(11) provides that the Commissioner's discretion be reviewed after one year, with specific regard to the impact of the discretion on voluntary compliance and the administration cost to Inland Revenue. The review will consider whether any amendments may be necessary or desirable and in particular whether the discretion is necessary. The Commissioner will report the findings and recommendations to the Minister of Revenue.

Correcting the use of tax pooling to eliminate imputation account debit closing balances

The provisional tax pooling rules currently include an unintended ability to use tax pooling funds to eliminate imputation account debit closing balances. This occurs when a taxpayer purchases or otherwise acquires tax pooling funds at an effective date that falls before the income tax year in which the tax pooling funds are to be used. This effectively allows a company to receive a backdated effective date for imputation purposes while paying a current provisional or terminal tax obligation. This circumvents the imputation rules, and does not reflect the original policy intent.

Section RP 19(3) has been amended so that the treatment of transfers from tax pooling accounts reflects the original policy intent. Taxpayers purchasing pooling funds must use an effective date that falls within the tax year (or income year in the case of non-standard balance date taxpayers) for which the funds are being used to meet a provisional tax or terminal tax obligation.

Generally taxpayers will purchase tax pooling funds on effective dates when provisional tax instalments are due, or (in cases where there is no liability for use-of-money interest) the terminal tax due date.

The Commissioner recognises that in some cases tax pooling funds may not be available at the exact effective date they are required by a taxpayer. Taxpayers will be able to purchase tax pooling funds to meet provisional or terminal tax obligations at any effective date within the tax year (or income year for non-standard balance dates) provided that this will not result in the misapplication of the tax pooling rules or any other provisions in the Revenue Acts. Where tax pooling funds are not available for purchase at any date within the tax year, taxpayers may purchase funds at later effective dates, including at the terminal tax date for a tax year.

Situations where the Commissioner will not allow taxpayers to use purchased backdated tax pooling funds include (but are not limited to):

- **Imputation** – tax pooling funds applied to meet an increased obligation for further income tax that are applied to a company's imputation account cannot be applied any earlier than the original due dates set out in section OB 65 of the ITA and section 140B of the TAA, as applicable.
- **Non-income-tax revenues** – tax pooling funds applied to meet an increased obligation for non-income-tax revenues cannot be applied any earlier than the original due date the obligation was due to be paid.
- **Income tax** – tax pooling funds applied to meet an "expected" obligation for terminal tax in excess of the provisional tax owing after 31 March of the relevant tax year and before the tax return for the tax year has been filed to mitigate an expected debit closing balance for the corresponding imputation year.

Such requests may be queried at the time the tax pooling intermediary submits a transfer schedule and in cases where the Commissioner is not satisfied that there will be an expected obligation for terminal tax the request will be held pending the filing of the tax return to confirm the funds are being purchased to meet income tax obligations, not imputation shortfalls.

Where such cases are identified after the income tax return for the year has been filed the Commissioner will alter the effective dates of any purchased funds that have been transferred to the taxpayer's account to the extent that these exceed the terminal tax owing and make consequential adjustments to the corresponding imputation return.

Example 14 – imputation

Crushed Rock Dust Supplies Ltd has a 31 March balance date and has a debit closing balance of $5,000 for its 2010 imputation year. Since the company's tax agent only prepared its 2010 income tax and imputation returns in March 2011 it is now too late to make a voluntary payment of income tax to mitigate the imputation shortfall as this needed to be done by 31 March 2010.

The company did not have any provisional tax obligations for the 2010 tax year and its 2010 terminal tax was nil. The company will not be able to purchase tax pooling funds for the 2010 tax year.

The company has estimated its 2011 provisional tax at $30,000 as it had secured a new contract and expected to make a profit in that tax year. Before the amendment to section RP 19(3) the company could have purchased $5,000 of tax pooling funds to meet its first instalment of 2011 provisional tax and chosen an effective date of 31 March 2010 and another $5,000 with an effective date of 28 August 2010, instead of purchasing the whole $10,000 as at 28 August 2010.

The amendment ensures that all taxpayers (not just companies) are required to nominate an effective date for all purchased pooling funds that falls within the tax year (or relevant income year for taxpayers who have non standard balance dates) or a later tax year if no funds are available at dates within the tax year.

In this example the company would have to nominate an effective date no earlier than 1 April 2010 for all purchased tax pooling funds that are applied to meet 2011 provisional tax (and any terminal tax obligations). The company will not be able to use backdated tax pooling funds to pay its 2010 further income tax, 10% imputation penalty tax, or any late payment penalties and use-of money interest payable as a result.

Examples 15 & 16 – non-income-tax revenue

Example 15

Crushed Rock Dust Supplies Ltd's GST return for the two month period ended 31 May 2011 showed GST to pay of $50,000 which was paid on the due date. Following an audit the company agrees that there is a discrepancy of $5,000 GST. A shortfall penalty of $500 also applies. On 30 September 2011 the company was issued with an amended assessment for the GST and an assessment for the shortfall penalty.

The company has 60 days from 30 September 2011 to purchase tax pooling funds to pay the increased GST obligation of $5,000 with an effective date of 28 June 2011, being the original due date of this return period (or a later date if it chooses). The company cannot purchase backdated tax pooling funds to meet the obligation to pay the shortfall penalty or any use-of-money interest that may arise in respect of the increased amount of $5,000 (if for example the only tax pooling funds available to purchase have effective dates after 28 June 2011).

Example 16

Cloud Cover Insurance Services Ltd's 2011 provisional tax obligations are $90,000 based on the standard option from its 2010 income tax return. The company has already paid the $90,000 into its 2011 tax account. In October 2011 the company's financials indicate its 2011 RIT will be approximately $120,000. The company also discovers that it will have an expected imputation account debit closing balance of $40,000 for the 2011 imputation year.

By purchasing the extra $30,000 to meet the expected income tax obligations from a tax pooling intermediary at effective dates prior to 31 March 2011 (for example $10,000 on each of its first two instalment dates of 28 August 2010 and 15 January 2011 and the last $10,000 on 31 March 2011), the company would also legitimately mitigate $30,000 of the $40,000 expected imputation debit closing balance by paying its income tax obligations for the corresponding tax year.

The company can purchase $30,000 on this basis on 19 October 2011 to meet a legitimate expectation that it will owe $120,000 income tax when it files its 2011 tax return by its extension of time date of 31 March 2012.

However, the company will not be able to purchase any more backdated tax pooling funds and will have to pay the remaining $10,000 of its expected $40,000 further income tax closing balance for 2011, 10% imputation penalty tax, and the late payment penalties and use-of money interest payable as from 21 June 2011.

Note 1: If the company's income tax obligations turned out to be $130,000 or more when it files its 2011 tax return it will have 75 days from its terminal tax date to purchase more tax pooling funds at backdated effective dates to meet the shortfall.

This will also have the effect of allowing an additional imputation credit on the same effective date as the tax pooling funds are purchased at (however this imputation credit does not arise until the day the Commissioner processes the transfer request from the company's tax pooling intermediary). If the effective date chosen for the terminal tax shortfall is on a date or dates that fall between 1 April 2010 and 31 March 2011 the imputation credits will arise in the 2011 imputation year.

Note 2: If the company's terminal tax turns out to be $80,000, the Commissioner will need to be satisfied that the $30,000 purchased in October 2011 was based on a legitimate expectation and how this changed after the funds were purchased and transferred into the company's 2011 tax account. If the purchase was based on a legitimate expectation, then the company will have one of the three options available in section RP 19B(5) in respect of the $30,000 excess.

If the Commissioner is not satisfied that there was a legitimate expectation that the company's 2011 RIT tax was going to be more than $90,000 then the Commissioner may alter the effective dates of the $30,000 of tax pooling funds to match the date of the transfer request (ie, 19 October 2011) and make a consequential adjustment to the 2011 imputation return to remove this credit (as it would arise in the 2012 imputation year).

Note 3: While imputation credits for $30,000 of purchased funds will have the same effective dates as the effective dates at which they are transferred into the company's tax account (in this case $10,000 on each of 28 August 2010, 15 January 2011 and 31 March 2011), the credits cannot be included in the 2011 imputation return until the Commissioner has actually transferred these amounts from the tax pooling account to the company's income tax account. In this example the imputation credits would arise on 19 October 2011 and be credited, respectively, on 28 August 2010, 15 January 2011 and 31 March 2011. Where an imputation return for an imputation year in which purchased tax pooling imputation credits arise was filed before the credits arose, the company will need to request the Commissioner to amend the imputation return when the funds are transferred from the tax pooling account to its income tax account.

Extending the definition of increased "amount of tax" to reflect the policy intent

In the past tax pooling could be used to pay an increased amount of tax only when there had been a prior assessment. It did not allow tax pooling to be used where an increase in the "amount of tax" did not arise from an increased assessment (for example a withholding tax obligation). Additionally, "amount of tax" is a defined term in section YA 1 of the Income Tax Act and this definition has unintentionally limited tax pooling to withholding taxes where amended assessments are issued.

New section RP 17B(8) aims to achieve two policy outcomes. First, to extend the revenue types that tax pooling can be used for, so it also includes income tax, FBT, GST, further income tax and imputation penalty tax payable under section 140B of the Tax Administration Act. Secondly, to bring the withholding taxes defined in "amount of tax" in the section YA 1 definition into the tax pooling rules. These measures better reflect the policy intent of which revenues and in what circumstances tax pooling can be used.

The 10% imputation penalty tax can also be met using tax pooling to the extent that this relates to an increased amount of further income tax payable following an assessment of further income tax by the Commissioner. This concession is a pragmatic way to deal with this unique penalty provision for imputation.

Examples 17–19 – increased amount of tax (non-income-tax revenues)

Example 17

We Clean Luxury Cars Ltd files its FBT return for the quarter ended 30 September 2011 and pays its FBT obligation by the due date. In December 2011 the company makes a voluntary disclosure showing that it owes an extra $1,000 in FBT for the quarter. The company purchases $1,000 tax pooling funds as at the original due date for the FBT return to mitigate the use-of-money interest that would otherwise be payable.

The Commissioner accepts that the underpaid FBT was $1,000 and issues an assessment for the FBT period including this amount. Following the issue of the assessment the $1,000 of tax pooling funds the company purchased can be transferred from the tax pool and applied to the company's increased FBT obligation for the 30 September 2011 FBT quarter.

Note: If the company was liable for a shortfall penalty on the FBT shortfall, this cannot be met by using backdated tax pooling funds.

Example 18a

We Clean Luxury Cars Ltd discovers in late March 2012 while preparing its 2012 imputation return that it made an error in its 2011 imputation return filed on 7 July 2011. As a result the company's 31 March 2011 imputation closing balance alters from a credit of $3,000 to a debit of $1,000. As a consequence the company also determines that its 31 March 2012 imputation return is now expected to result in a debit of $2,000 instead of a nil balance. The company makes a voluntary disclosure and purchases $1100 tax pooling funds as at 20 June 2011 to mitigate the use-of money interest payable.

The Commissioner accepts that the error will result in an imputation shortfall of $1,000 and issues an assessment for further income tax of $1,000 setting a new due date. The company is also liable to pay a 10% imputation penalty tax pursuant to section 140B of the Tax Administration Act and a new due date is also set for this. Following the issue of the assessment of further income tax the $1,100 of tax pooling funds the company purchased can be transferred from the tax pool and applied to the further income tax and imputation penalty tax for the company's 2011 imputation year.

Note 1: If, for the 2011 tax year, the company had at least $1,000 of unpaid provisional tax (or income tax due on its terminal tax date) it could instead purchase $1,000 as an income tax payment (with an effective date no earlier than 1 April 2010 and no later than 31 March 2011) as long as it does so within 75 days of its 2011 terminal tax date. This would give rise to an imputation credit that would eliminate the $1,000 imputation debit.

Note 2: If the company has already met its 2011 income tax obligations it cannot purchase tax pooling funds at backdated effective dates for the 2011 tax year to make voluntary payments of provisional tax or income tax for the purposes of mitigating the imputation debit closing balance for the 2011 imputation year.

Note 3: The company should also consider the impacts of the 2011 imputation adjustment on its 2012 imputation year and if necessary ensure it makes voluntary payments of income tax by 31 March 2012, if necessary.

Example 18b

We Clean Luxury Cars Ltd does not make a voluntary income tax payment by 31 March 2012 to mitigate any expected imputation debit for the 2012 imputation year as identified in the previous example because the company expects that its 2011 terminal tax will be approximately $10,000 more than the provisional tax obligations it has paid and it intends to purchase tax pooling funds in April 2012 to meet this terminal tax shortfall. This will allow the company to choose an effective date that falls on or before 31 March 2011 for at least $1,000 of its $10,000 tax pooling purchase to eliminate the 2011 imputation debit closing balance through paying its 2011 tax obligations.

Example 19

Old Cars Recyclers Ltd has a 31 March balance date and files its 2011 income tax and imputation returns on 15 January 2012. The imputation return showed a debit closing balance of $2,000. The company has no income tax to pay for 2011 due to a loss carried forward. The company pays its further income tax, imputation penalty tax, late payment penalties and use-of-money interest on 15 January 2012 to clear its imputation debt.

In March 2012 the company discovers an error in its 2011 imputation return which increases its debit closing balance from $2,000 to $3,500. The company makes a voluntary disclosure in April 2012 and purchases $1,650 tax pooling funds as at 20 June 2011 to mitigate the use-of money interest payable.

The Commissioner accepts that the error will result in an additional amount of further income tax of $1,500 and issues an assessment setting a new due date to pay this increased amount. The company is also liable to pay a further 10% imputation penalty tax of $150 pursuant to section 140B of the Tax Administration Act and a new due date is also set for this. Following the issue of the assessment for further income tax the $1,650 of tax pooling funds the company purchased can be transferred from the tax pool and applied to the further income tax and imputation penalty tax for the company's 2011 imputation year as at 20 June 2011.

Note: If the company had at least $1,500 of unpaid provisional tax or income tax for the 2011 tax year it could instead purchase $1,500 to apply to its 2011 income tax obligation (with an effective date no earlier than 1 April 2010 and no later than 31 March 2011) as long as it does so within 75 days of its 2011 terminal tax date. This would give rise to an imputation credit that would eliminate the $1,500 imputation debit.

Clarification of effective date of transfer where section 157 Tax Administration notice applied

Section 157 of the Tax Administration Act has been amended to clarify that when a taxpayer has made a deposit or purchased tax pooling funds and fails to instruct their tax pooling intermediary to transfer the funds to meet their tax obligations, the concessions available for using tax pooling funds voluntarily will not apply. The amendment confirms that when a deduction notice is applied to seize the funds the effective date is the date the tax pooling intermediary pays the seized funds to the Commissioner. Previously it could have been argued that the deposit date of the funds was retained as the effective date.

Examples 20 & 21 – applying a deduction notice to tax pooling funds

Example 20

Henry has a 31 March balance date and made three deposits of $10,000 on 27 August 2010, 14 January 2011 and 6 May 2011 into a tax pool to meet his 2011 provisional tax obligations of $30,000. On 31 March 2012 Henry's tax agent files Henry's 2011 income tax return showing Henry's residual income tax is $25,000. Henry does not ask his tax pooling intermediary to transfer his deposits to meet his 2011 tax obligations. Inland Revenue contacts Henry fruitlessly on a number of occasions over the following months.

On 14 August 2012 Inland Revenue advises Henry that unless he asks his tax pooling intermediary to transfer at least $25,000 of the funds in the tax pool to meet his 2011 tax obligations within the next 7 working days, a deduction notice will be issued to seize them. Henry promises to do so straight away, but fails to.

On 24 August 2012 a deduction notice is issued to Henry's tax pooling intermediary to seize all $30,000 of the funds Henry deposited (because with penalties and interest accruing since 29 August 2010 Henry owes more than $30,000). The Commissioner receives the $30,000 on 28 August 2012 and applies this to Henry's income tax account with an effective date of 28 August 2012.

Note: Before using a deduction notice Inland Revenue will make reasonable attempts to determine why a taxpayer has not instructed their tax pooling intermediary to transfer their own deposited funds within a reasonable period after their terminal tax date. The Commissioner will consider the 75 day timeframe for purchased funds as being the starting point from which enquires will be made with taxpayers as to why they are unable to instruct their tax pooling intermediary to transfer their deposited funds to meet their income tax obligations.

Example 21

Graeme has a 31 March balance date and when he filed his 2011 income tax return on 7 July 2011 he had terminal tax of $8,000 to pay by 7 February 2012.

Graeme purchases $8,000 on 7 February 2012 but does not instruct his tax pooling intermediary to transfer the funds at that time.

Graeme receives an arrears notice later in February 2012 and then a phone call from Inland Revenue on 28 March 2012. Graeme advises the debt officer that he has purchased tax pooling funds and will ask his intermediary to transfer these before 23 April 2012 (75 days after 7 February 2012 plus 1 day because the 75th day falls on a Sunday).

However Graeme fails to ask his tax pooling intermediary to transfer the tax pooling funds. On 25 April 2012 a deduction notice is issued to Graeme's tax pooling intermediary to seize all $8,000 of the funds Graeme purchased. The Commissioner receives the $8,000 on 27 April 2012 and applies this to Graeme's 2011 income tax account with an effective date of 27 April 2012.

Note 1: For purchased tax pooling funds, once the applicable timeframe has passed for the taxpayer's tax pooling intermediary to request a transfer to the taxpayer's account, the Commissioner can commence recovery actions in the same way as for any other overdue taxes.

Note 2: As the $8,000 seized will be applied to use-of-money interest owing first, Graeme will still owe some terminal tax and also late payment penalties which will not be able to be met with any further purchase of backdated tax pooling funds. Further use-of-money interest will accrue from 28 April 2012 on the remaining balance of terminal tax and late payment penalties.

Refusals to transfer amounts

Previously when taxpayers asked their intermediaries to process transfers that did not comply with the tax pooling rules Inland Revenue would decline to process the transfer or amend the transfer to comply with the tax pooling rules. But in cases when a tax pooling transfer is found to be incorrect after it has been processed, Inland Revenue would amend the transfer or reverse it. Section RP 20 has been amended to avoid any doubt that the Commissioner can decline to process, or amend, or reverse a tax pooling transfer if the request does not (or did not) comply with the tax pooling rules.

Example 22 – refusal to transfer

On 20 October 2011 Wilma purchases $25,000 of tax pooling funds with effective dates of 28 August 2010, 15 January 2011 and 7 May 2011 to meet her expected 2011 RIT of $75,000 (Wilma was not required to pay 2011 provisional tax as her 2010 RIT was less than $2,500). Wilma files her 2011 income tax return on 30 March 2012.

Prior to the amendment the Commissioner would not process the transfers until Wilma had filed her 2011 tax return. Furthermore, if the 2011 RIT was less than $75,000 the Commissioner would only allow transfers at the backdated effective dates these were purchased at to the extent of 1/3rd of the terminal tax. Any excess pooling funds purchased not used to meet Wilma's terminal tax obligations could only be transferred with an effective date of the date the tax pooling intermediary requested the transfer.

Wilma will no longer have her transfer request held if her tax return has not been filed. If Wilma's terminal tax turns out to be less than $75,000 after she files her tax return, the Commissioner will not revisit the transfers unless he considers that Wilma did not have a genuine reason to believe that she would owe $75,000 RIT at the time she purchased the tax pooling funds.

Note 1: However, if Wilma chose to wait until after she filed her 2011 tax return before asking her tax pooling intermediary to transfer her purchased funds, she will only be allowed to transfer the amount she owes at backdated effective dates. So if Wilma owed 2011 RIT of $70,000 and had made a payment of $1,000 on 28 August 2010 she would only be able to transfer $69,000 of the $75,000 she purchased at backdated effective dates.

This is because once a tax return has been filed the tax obligations for that tax year have been quantified and there is no longer any uncertainty of what is owed and what purchased funds are needed to satisfy the actual tax obligation for that tax year.

If Wilma would like the $6,000 which is not needed transferred into her 2011 income tax account, this cannot be with an effective date earlier than the date the Commissioner receives the tax pooling intermediary's request. If the tax pooling intermediary requested the $6,000 to be transferred on 1 April 2012 that would also be the earliest effective date that Wilma could choose.

Note 2: The same restrictions were also applied to taxpayers using their own deposited funds. Taxpayers transferring own deposited funds will not be subject to the "genuine reason" requirement or have a limit applied to the amount of own funds that can be transferred.

Deductibility of fees

New section DB 4B of the Income Tax Act provides that fees paid to a tax pooling intermediary to purchase an amount held in a tax pooling account to satisfy a liability for provisional tax, terminal tax, or an increase in an assessment are deducible to the taxpayer.

The deduction is allocated in the income year that the transfer is processed by the Commissioner into the taxpayers account to satisfy a tax liability.

Example 23 – deductibility of fees

On 22 June 2011 Joe purchases $30,000 of tax pooling funds to meet a shortfall in his 2011 provisional tax obligations. Joe has a 31 March balance date and paid $20,000 on each of his instalment dates but thinks his 2011 RIT will be $90,000. The fees Joe pays to the intermediary to purchase the $30,000 are incurred in the 2012 tax year (when he made the purchase) but will not be deductible until his intermediary has requested the transfer to be made and the Commissioner has processed this request.

Joe's tax agent files Joe's 2011 tax return on 31 March 2012 showing Joe's residual income tax is $96,000. Joe purchases another $6,000 on 10 April 2012 and asks his tax pooling intermediary to send a transfer request to the Commissioner for the total $36,000 he purchased to meet his 2011 tax obligations. The Commissioner receives the request from the intermediary on 16 April 2012 and processes Joe's transfers on 17 April 2012.

Both amounts of tax pooling funds were processed by the Commissioner in the 2013 tax year (on 17 April 2012) and Joe is able to claim a deduction for the fees paid to acquire both amounts of tax pooling funds in his 2013 tax year.

Administrative and other tax pooling matters

This section sets out required administrative changes resulting from the legislative amendments as well as some clarifications of how the Commissioner will apply the amended tax pooling rules.

Deposits into tax pooling accounts, due dates and non-working days

Inland Revenue will continue to ensure that deposits made into a tax pooling account to meet obligations that fall due on a non-working day are received in time as long as the deposit is received on the next working day (ie, the same day the due date is shifted to).

Deposits made by way of a request by a taxpayer to transfer excess tax from their tax account into a tax pooling account will be accepted as being received on the date the transfer request is received by Inland Revenue.

This is consistent with Standard Practice Statement SPS 07/01: *Tax payments – when received in time*.

Tax pooling schedules

All tax pooling intermediaries will need to ensure that their transfer schedules have two additional columns added. These need to be named "Own Funds" and "Purchased Funds", respectively. Alternatively, transfer schedules can have two "Amount" fields, one named "Own Funds" and the other named "Purchased Funds".

Tax pooling intermediaries will need to ensure that at the point in time they complete a transfer schedule they can readily identify whether each transfer amount for each taxpayer is the taxpayer's own deposited funds or purchased funds to be able to correctly show this on the transfer schedule.

Where it is not clearly identifiable whether a transfer is a taxpayer's own funds or purchased funds, the transfer will be held pending checks with the tax pooling intermediary.

Where transfers noted as "Own Funds" are found to be "Purchased Funds" the Commissioner will amend the effective date (including reversing or amending transfers identified after they have been processed to the taxpayer's account) if the funds would be applied (or have been applied) to the taxpayer's account in a way that was not possible for purchased funds.

Transfers of deposits between tax pooling intermediaries

Tax pooling intermediaries must ensure where any taxpayer funds are transferred to another tax pooling intermediary, the receiving pooling intermediary is advised whether the funds being transferred are the taxpayer's own funds or purchased funds.

Where a taxpayer's own deposit is transferred from one tax pooling intermediary to another the deposit retains its character as the taxpayer's own deposit. For imputation companies there are no imputation effects for transfers of the company's own deposits between tax pooling intermediaries.

Reversing tax pooling transfer requests

Occasionally Inland Revenue is asked to reverse a tax pooling transfer after it has been processed to the taxpayer's account or to alter the transfer request before it is processed. The Commissioner's ability to correct errors on transfer schedules that are received and before they are processed is very limited, and even more limited after the transfer has been processed.

The Commissioner will continue to consider any such request to amend errors on a case by case basis taking into account how the error arose, why it arose and whether the correction of the error is possible under the tax pooling rules.

Errors that the Commissioner can correct on a schedule include:

- where an incorrect taxpayer's IRD number was entered by mistake;
- the tax year or period was entered incorrectly;
- an amount was transposed or entered incorrectly.

Sufficient evidence will need to be provided by the taxpayer and/or tax pooling intermediary to satisfy the Commissioner that an error has occurred and that the Commissioner can correct this in line with the tax pooling rules.

Situations which are not considered to be errors include:

- a taxpayer advising the intermediary of the wrong effective date and/or amount of a transfer;
- a tax pooling intermediary making a tax pooling transfer request outside of the legislative timeframes (60, 75 or 76 days, as applicable);
- after submitting a transfer request and before Inland Revenue processes it the underlying commercial contract is altered (either by using different funds or altering the effective dates of the funds on the schedule);
- a taxpayer changing their mind as to any aspect of their tax pooling transfer after it has been received by Inland Revenue;
- a taxpayer choosing to use purchased tax pooling funds instead of their own deposited funds or vice versa.

Where a taxpayer incurs late payment penalties or use-of-money interest as a result of an error that cannot be corrected, the taxpayer can apply for a remission if they meet the criteria set out in Standard Practice Statement SPS 05/10: *Remission of penalties and interest.*

If the error results in a transfer not being able to be processed as requested, it can be withdrawn if the taxpayer and tax pooling intermediary agree (see next heading below). However any new transfer request received will be treated as a new request.

Withdrawing tax pooling transfer requests

Where a tax pooling transfer request cannot be processed as requested, the Commissioner can decline to process the request or alter the amounts and/or effective dates of the amounts requested to be transferred. This is usually done with the taxpayer or their agent directly and may also involve the pooling intermediary.

The Commissioner will continue to allow a taxpayer and their intermediary to agree between them to withdraw a transfer request that cannot be processed as requested.

This concession is only available before the Commissioner processes the transfer. Once processed a transfer cannot be withdrawn, except where it did not comply with the tax pooling rules at all.

Where a transfer does not comply in part, for example the amount and/or effective dates need to be altered, those are the only alterations that will be possible.

Deposit made to Inland Revenue but intended for a tax pooling account

If a taxpayer makes a payment of tax to Inland Revenue but intended for the payment to be made into a tax pool, the payment can be refunded to the taxpayer or transferred to the tax pooling intermediary's tax pool account only if it is excess tax (ie, has not been applied to meet an obligation to pay tax). If such payment is able to be transferred to a tax pooling account, the effective date will be the date of the request to transfer the payment (ie, no backdating of the transfer date is possible).

Taxpayer requests for transfers into a tax pooling account

Taxpayers can choose to transfer excess tax from their tax accounts to a tax pooling intermediary's tax account. The effective date of the transfer is the date the transfer request is received by the Commissioner (or a later date the taxpayer chooses).

Any transfers into a tax pooling account are own deposited funds with a deposit date equal to the effective date of the transfer into the tax pool.

The above restrictions on choosing effective dates when transferring excess tax into a tax pool will continue to apply to funds that were originally sourced from a tax pool which become excess tax, including if the funds were own deposited funds.

Transfers to meet increased amounts and/or deferrable tax

Transfer requests received before an assessment is made resulting in an increased amount of tax and/or where court proceedings have been finally determined but the required ledger actions have not occurred will continue to be held until the increased amount and/or deferrable tax transactions giving effect to the court proceedings have been updated in FIRST. This restriction only applies to purchased tax pooling funds.

Debt policing

Because the use of tax pooling funds allows income tax and provisional payments to be made after the terminal tax due date, debt policing processes may still occur between the terminal tax date and the date the tax pooling funds are transferred into a taxpayer's tax account.

This is because the Commissioner does not necessarily know that a particular taxpayer will use tax pooling funds to meet their income tax and/or provisional tax obligations until a transfer schedule is received from their tax pooling intermediary.

If taxpayers are contacted by Inland Revenue in respect of overdue income tax and/or provisional tax before their tax pooling funds have been transferred, a note can be added to the taxpayer's file recording that tax pooling funds will be used to meet the tax obligations and approximately when the funds are expected to be transferred.

This should ensure no further proactive contact will occur before the date the tax pooling funds are transferred. However some automated debt policing letters may still be issued. These can be ignored if tax pooling funds will be used to meet core tax owing in full as at the respective provisional and terminal tax due dates within the timeframes allowed to transfer tax pooling funds.

Company amalgamations

Where companies amalgamate and either form a new amalgamated company or one of the amalgamating companies continues on as the amalgamated company, any tax pooling funds the amalgamating companies had which vest in the amalgamated company will retain their character for the purposes of the tax pooling rules as follows:

- the amalgamating companies' own deposited funds in a tax pooling account will be own deposited funds of the amalgamated company; and
- the amalgamating companies' purchased funds in a tax pooling account will be purchased funds of the amalgamated company.

Struck-off companies

Inland Revenue cannot process tax pooling transfer requests where it is identified at the time the transfer request is made, that the company has been struck off the companies register.

Once a company has been struck off the companies register the Companies Act 1993 provides for a struck-off company's assets (which includes funds the company holds in a tax pooling account) to be vested in the Crown. A struck-off company cannot make deposits or purchase tax pooling funds, nor receive refunds of tax pooling funds from a tax pooling account.

A transfer request made to transfer tax pooling funds while a company is struck off has no legal status and will be invalid (ie, there is no authority for any person to act for, or on behalf of, a struck-off company to make the transfer request). The same applies to any requests for refunds from a tax pooling account.

A struck-off company would have to be restored to the companies register before Inland Revenue is able to process a tax pooling transfer request or a tax pooling intermediary can refund an amount held in the tax pooling account for the company. However, in respect of declined transfer requests, a new request would then have to be made once the company is restored to the companies register (and must be received by Inland Revenue within any applicable timeframe if a backdated effective date is requested).

Imputation credit accounts and tax pooling deposits, purchases, sales and refunds

Tax Information Bulletin Vol 16, No 1 (February 2004) explains how the imputation rules apply to tax pooling deposits, purchases, sales and refunds for consolidated imputation groups and all other companies that maintain imputation credit accounts under the Income Tax Act 1994. The following information updates the section references to the Income Tax Act 2007, but is not otherwise intended to alter the application of the imputation rules and the examples in the above TIB are still reflective of the current law.

(a) Consolidated imputation transfer within a tax pooling account

Where a consolidated imputation group has made deposits into a tax pooling account and decides to transfer this deposit (including by way of swap, exchange, etc) to another member of that tax pool a debit will arise in the consolidated group's imputation account, pursuant to section OP 33 of the Income Tax Act.

The imputation debit arises and is allocated:

- firstly, to the *previous* imputation year to the extent that there is a credit closing balance;
- secondly, if the debit is not fully allocated under the above bullet point, the balance is allocated to the imputation credit balance (if any) that exists *on the day* of the transfer; and
- any balance not allocated under previous bullet point is allocated to the *previous* imputation year.

Example 24

ABC Consolidated Group Ltd is a consolidated imputation group which made a deposit into a tax pooling account on 15 January 2009 of $100,000. It also received an imputation credit of $100,000 for the imputation year ended 31 March 2009.

For the imputation year ended 31 March 2010 the company's balance was a $30,000 credit. On 1 February 2011 the company's imputation credit account is $10,000 in credit.

On 1 February 2011 the company swapped its deposit with another taxpayer in the same tax pool. In return the company received a $100,000 deposit made by the other taxpayer with an effective deposit date of 27 August 2010.

On 1 February 2011 a $100,000 imputation debit arises and is firstly allocated to the 2010 imputation year to the extent of the $30,000 closing credit balance. Secondly the remaining $70,000 debit is allocated to the 2011 imputation account to the extent of the $10,000 credit balance on 1 February 2011 and thirdly the unallocated balance of $60,000 is applied to the 2010 imputation year.

This creates a debit closing balance of $60,000 further income tax which was due to be paid by 20 June 2010 and accrues imputation penalty tax of $6,000, use-of-money interest and late payment penalties.

Additionally the 2011 imputation year opening balance will alter from a credit of $30,000 to a debit of $60,000.

Note: The company will not receive an imputation credit for the $100,000 it received from the other taxpayer until it uses those funds to meet an income tax obligation (because these are purchased funds). Assuming the company can and does use the $100,000 it received with an effective date of 27 August 2010 to pay its 2011 income tax, it will receive an imputation credit of $100,000 in its 2011 imputation year as at 27 August 2010. However this credit will only arise when the Commissioner transfers the $100,000 to the taxpayer's 2011 income tax account following receipt of the tax pooling intermediary's transfer schedule.

Example 25

XYZ Consolidated Group Ltd is a consolidated imputation group which made a deposit into a tax pooling account on 9 June 2010 of $50,000. It also received an imputation credit of $50,000 for the imputation year ended 31 March 2011.

For the imputation year ended 31 March 2010 the company's balance was a $20,000 credit. On 1 February 2011 the company's imputation credit account is $10,000 in credit.

On 1 February 2011 the company sold its deposit to another taxpayer in the same tax pool. The purchasing taxpayer pays the amount into the tax pooling intermediary's trust account on 2 February 2011 to complete the sale.

XYZ Consolidated Group Ltd decides to deposit the funds it has received as a new tax pooling deposit, instead of having these paid out to it by the tax pooling intermediary and this deposit is received on 3 February 2011.

On 1 February 2011 a $50,000 imputation debit arises and is firstly allocated to the 2010 imputation year to the extent of the $20,000 closing credit balance, secondly the remaining $30,000 debit is allocated to the 2011 imputation account to the extent of the $10,000 credit balance on 1 February 2011 and thirdly the unallocated balance of $20,000 is applied to the 2010 imputation year.

This creates a debit closing balance of $20,000 further income tax which was due to be paid by 20 June 2010 and accrues imputation penalty tax of $2,000, use-of-money interest and late payment penalties.

Note: The company will receive an imputation credit for the $50,000 it received on 2 February 2011 in payment for selling its earlier deposit, but this credit will only arise on 3 February 2011 when this amount was deposited into the tax pooling account (ie, it will not stop the company from going into debit by $20,000 as at 31 March 2010).

It is therefore advisable for companies who wish to use the proceeds from sales of their own earlier deposits as a new tax pooling deposit to seek to enter into commercial contracts with their tax pooling intermediaries and the purchasing party that result in the sale, payment and new deposit all occurring contemporaneously.

In the above example this date would be 1 February 2011 and the outcome would then be as set out below.

On this date the company sold its deposit to another taxpayer in the same tax pool. The purchasing taxpayer pays the amount into the tax pooling intermediary's trust account on 1 February 2011 to complete the sale.

XYZ Consolidated Group Ltd decides to deposit the funds it has received as a new tax pooling deposit, instead of having these paid out to it by the tax pooling intermediary, and this is also done on 1 February 2011. On 1 February 2011 a $50,000 imputation debit arises due to the sale and also a $50,000 credit arises due to the new deposit. The $50,000 debit is firstly allocated to the 2010 imputation year to the extent of the $20,000 closing credit balance. Secondly, the remaining $30,000 debit is allocated to the 2011 imputation account against the $60,000 credit balance on 1 February 2011.

Because the imputation credit balance as at 1 February 2011 is more than the $30,000 debit allocated, no unallocated balance remains to be applied to the 2010 imputation year (ie, the 2010 imputation closing balance will remain at $0.00, not go into debit).

If the funds being transferred are purchased funds the same imputation debit rules apply, however the company will also receive an imputation credit on the day the funds are transferred pursuant to section OP 9(3)(c).

(b) Consolidated imputation refund from a tax pooling account

Where a consolidated imputation group receives a refund of its own funds or funds it has purchased (ie, it does not use them to meet an obligation to pay tax) a debit will arise in the consolidated group's imputation account, pursuant to section OP 32 of the Income Tax Act in exactly the same way as for a transfer of the company's own funds (set out above).

The only difference is that if the funds being refunded are purchased funds (including by way of transfer, swap, etc) on the same day as the refund is issued from the tax pooling account, an imputation credit will arise pursuant to section OP 9(3)(b).

(c) Imputation transfer within a tax pooling account and refund from a tax pooling account for all other imputation companies

For all other companies except for qualifying companies, the same imputation rules as for consolidated imputation groups apply. The equivalent provisions are:

Consolidated group	Other companies (excluding qualifying companies)
Section OP 32	Section OB 34
Section OP 33	Section OB 35
Section OP 9	Section OB 6

For a qualifying company the debit arises in its imputation account on the same date the transfer or refund, as applicable, is made (ie, the date the transfer or refund is processed by the Commissioner).

Tax pooling forum

Inland Revenue has established a tax pooling intermediaries' forum. The objectives of the forum include:

- discussing tax pooling related issues and finding workable solutions to these within the legislative provisions the Commissioner administers;
- communicating information on tax pooling matters to tax pooling intermediaries;
- raising issues of interpretation of the tax pooling rules for Inland Revenue to consider and resolve; and
- providing feedback to the Commissioner on proposed operational changes or implementation of new tax pooling operational policies and interpretation of the tax pooling rules.

DEDUCTIBILITY OF USE-OF-MONEY INTEREST

Sections DB 3B, EF 4, EF 5 and EF 6 of the Income Tax Act 2007; section DB 3B of the Income Tax 2004; section DB 2 of the Income Tax 1994; and section 184AA of the Tax Administration Act 1994

The amendments clarify that use-of-money interest (UOMI) payable to Inland Revenue is deductible for tax purposes and the deduction is made in the year the UOMI is paid.

Background

The penalty and interest rules have applied since the 1997–98 income year. The policy intention of the interest rules was that interest paid on overpayments of tax would be taxable, and interest charged on underpayments of tax would be deductible under the normal income tax rules. This approach provided consistency with the treatment of interest generally, removed the need to convert rates to after-tax rates and distinguished between penalties and interest. Furthermore, the discussion documents released before the introduction of the rules noted interest would be deemed to be interest on money lent for the purposes of determining whether a deduction was available under the Income Tax Act. This was, however, never specified in the legislation.

Over time questions were raised as to whether UOMI was in fact deductible. This led to a number of taxpayers seeking case-specific rulings from Inland Revenue on this issue. There appeared to be some inconsistency over whether interest is deductible for companies and individuals. Generally companies were automatically entitled to deduct interest, but other taxpayers (specifically individuals) needed to satisfy a nexus with assessable income requirement—meaning that interest may not have been deductible. This inconsistency arose as a result of a lack of clarity over what Parliament's intention was on the nexus requirement and resulted in calls for legislative clarity on the deductibility of UOMI.

Key features

The amendments clarify that UOMI is deductible for tax purposes. The amendments ensure consistency, in particular between companies (for whom interest was typically always deductible) and individuals. The amendment also ensures symmetry in treatment for tax purposes so that UOMI is both taxable and deductible.

The provisions setting out which period the deduction is allocated to have also been amended. Previously the UOMI deduction was allocated to the same year to which the tax liability relates, the following year or to the income year following the income year in which the Commissioner issues the notice of amended assessment. This meant that if there was a dispute involving court proceedings which was eventually resolved in the Commissioner's favour, the previous rules could inappropriately allocate the deduction to a year many years earlier than the year in which the interest is paid. The previous rules could also inappropriately allocate the deduction to the year of assessment in cases when the taxpayer simply failed to pay any relevant tax and the UOMI may not be paid until much later (if at all).

The timing provisions have been amended to provide for the deduction of UOMI in the year in which the UOMI is paid. This approach provides taxpayers with certainty on this issue and deals appropriately with the problematic cases described previously. Importantly, a paid approach is also consistent with the timing of assessability, that is, UOMI is assessable in the year the Commissioner pays the interest.

The amending provisions override the capital limitation, the employment limitation and the private limitation. This means the provision is consistent with section DB 3 (which allows for the deduction of expenditure incurred in calculating or determining tax liabilities).

Under section RM 2 of the Income Tax Act 2007, the Commissioner may refund tax if the four-year period for the amendment of an assessment has not ended. The four-year period can be extended to eight years in certain circumstances, for example, if the refund arises from a clear mistake or simple oversight of the taxpayer. These amendments apply retrospectively from the 1997–98 income year (the start of the UOMI rules). Therefore the time limitations on the Commissioner refunding tax do not apply to prevent these amendments being effective.

Application dates

The amendments clarifying the deductibility of UOMI apply retrospectively from the 1997–98 income year (the start of the UOMI rules) for taxpayers who have claimed deductions for UOMI in returns filed or notices of proposed adjustment issued before the date of introduction of the amending legislation, that is 24 November 2010. These amendments also apply generally to the 2010–11 and later income years.

The amendments to the timing provisions for UOMI deductions apply for the 2011–12 and later income years.

LISTED PIES – GROUPING OF TAX LOSSES

Section IC 3 of the Income Tax Act 2007; and section 55(1)(a) of the Goods and Services Act 1985

The Act has amended the loss grouping tax rules in order to restrict a listed PIE (a type of portfolio investment entity that is a listed company) to grouping only with its own wholly-owned subsidiaries.

Background

Under the tax rules for grouping tax losses and credits, a listed PIE was previously allowed to use its parent company's tax losses to offset its taxable income.

We were concerned about the potential for New Zealand companies with tax losses that would otherwise be difficult to use, to establish structures involving listed PIEs that could utilise these losses. This could be achieved by a loss-making New Zealand company that wanted to raise capital from the retail sector establishing a listed PIE. The listed PIE would raise funds, in the form of preference shares, from retail investors. It would then lend these funds to its loss-making parent—with the parent paying interest to the listed PIE.

This structure raises policy concerns as it undermines the company tax and imputation system. Under the previous tax grouping rules, the listed PIE would be able to offset the interest income it received against its parent's losses and thereby reduce or eliminate its tax liability. Under the PIE rules, this could provide the PIE investors with a tax-free return and would provide the parent with a mechanism to utilise its tax losses.

The amendment ensures that listed PIEs are treated in a similar manner to multi-rate PIEs under the loss grouping rules (the latter are confined to grouping tax losses with land-owning subsidiaries or other multi-rate PIEs).

Key features

Section IC 3(1) has been amended to exclude a listed PIE from the phrase "a group of companies". New section IC 3(2C) provides that a listed PIE can only group with its own wholly-owned subsidiaries.

A consequential change has been made to section 55(1)(a) of the Goods and Services Act 1985 to ensure this limitation does not prevent a group of companies that includes a listed PIE from grouping for GST purposes provided the companies meet the other relevant criteria.

Application date

The amendment applies from 29 August 2011.

SHAREHOLDER CONTINUITY: DIRECTORS' KNOWLEDGE PROVISION

Section YC 15 of the Income Tax Act 2007; and section OD 8(5) of the Income Tax Act 2004

Amendments have been made to the directors' knowledge provision under the shareholder continuity tax rules (section YC 15 of the Income Tax Act 2007 and section OD 8(5) of the Income Tax Act 2004). The amendments exclude minor "off-market" transactions from the scope of the provision in order to provide more certainty and clarity when applying the provision.

Background

The shareholder continuity and tracing rules govern the carry forward of tax losses and imputation credits to ensure that the benefits from these are enjoyed, in general, by the same persons who were shareholders when the benefits were incurred or derived. The standard tracing rules require tracing the ownership of shares in a company through to the ultimate natural person shareholders.

There are a number of concessions that simplify the standard tracing rules, in particular, with respect to listed companies. These concessionary rules are subject to section YC 15, under which shareholder continuity is deemed to be breached when the directors of a company know or could reasonably be expected to know, that the requirements of any continuity provision would not have been satisfied.

While there is uncertainty as to the interpretation of the current section, on its plain words, it seems that directors are presumed to be aware of all "off-market" transactions.

The frequency with which some minor "off-market" transactions occur (eg, employee share schemes) means that the application of section YC 15 may limit access to the tracing concessions for at least some listed companies. In such cases, the effect is that these companies may then be required to undertake full tracing, which may be onerous.

In addition, it is considered that, given section YC 15 is an anti-avoidance rule, when applying the provision, companies should only have to include in their continuity calculation those transactions which their directors would know of or which it is reasonable to expect the directors to know of. It is unlikely that company directors will have either actual or constructive knowledge of minor "off-market" transactions. Therefore, these transactions should not be taken into account in applying the section.

Key features

Section YC 15 is amended to exclude from its scope minor "off-market" transactions, ie, share transactions occurring outside of a recognised stock exchange (examples are employee share schemes, dividend reinvestment plans and small private sales between shareholders).

More specifically, the Act amends section YC 15 to exclude the following transactions from its scope:

- "off-market" transactions between less than 5 percent shareholders in a company in the income year; and
- "off-market" transactions between a company and its shareholders which in aggregate are less than 5 percent of the shareholding in a company in the income year.

This is in order to remove current uncertainty about how the section should apply with respect to "off-market" transactions and to reduce compliance costs.

Application date

The amendments apply retrospectively, for income years beginning on or after 1 April 2005.

Detailed analysis

The rationale for excluding the above transactions is that, when applying the provision, companies should only have to include in their continuity calculation those transactions of which their directors have knowledge or of which it is reasonable for their directors to have knowledge. Furthermore, given that the purpose of the directors' knowledge provision is to target share transactions intended to take advantage of the tracing concessions, companies should not have to count minor transactions which are unlikely to be mischievous in nature.

Accordingly, in line with the existing approach under the directors' knowledge provision, on-market trading between minor shareholders should be excluded. This is consistent with the tracing concession under the shareholder continuity rules which provides that persons having a less than 10 percent direct interest in a company are treated as a "notional single person"—thereby preventing the need for companies to trace ownership changes in relation to their minor shareholders.

New paragraph (iv)

"Off-market" transactions between shareholders with less than 5 percent holdings, eg, small private sales, should be excluded because companies are unlikely to be aware of such transactions. The proposed 5 percent threshold aligns with the threshold that exists under securities law for triggering disclosure by shareholders of their interests in a New Zealand-listed company to that company. The 5 percent holding test applies both before and after any transaction (ie, the holding must be less than 5% both before and after the transaction).

New paragraph (v)

With respect to off-market trading where the company is a party, a de minimis of 5 percent is appropriate in order to exclude minor "off-market" transactions which are undertaken in the company's ordinary course of business, eg, employee share schemes and dividend reinvestment plans. This is measured on an income year basis (ie, pro rating of the 5 percent threshold is not required if the continuity period is less than an income year).

The wording is also intended to cover the common scenario under an employee share scheme where a company transfers shares to a trustee who holds the shares on trust for the benefit of company employees and then subsequently transfers the shares to those employees.

CORPORATE SPINOUTS

Section YC 13 of the Income Tax Act 2007

Background

The corporate spinout rules in section YC 13 of the Income Tax 2007 were originally enacted in 2002 to ensure that companies involved in a spinout do not have a shareholder continuity breach and forfeit losses and credits if there is no change in underlying economic ownership as a result of the spinout. A "spinout" is a process whereby a company ("the original parent company") transfers its shares in another company ("the spun-out company") to the shareholders of the original parent company.

The spinout rules treat the spun-out company as holding the ownership interests in a subsidiary that were, before the spinout, deemed to be held by the original parent company on behalf of its small shareholders. Without these spinout rules, the concessionary tracing rules in section YC 11 may treat the restructuring as a substantial change of ownership interests. As a result, unless extensive tracing through to the ultimate natural person shareholders in the original parent company is carried out, the restructuring may prevent the carry forward of losses and credits by the spun-out company and its subsidiaries. This is the case even though, in substance, there has not been a breach of shareholding continuity.

Before the amendment, the concessionary spinout rules were not available if the original parent company did not own 100% of the spun-out company before the spinout despite the spun-out company's immediate shareholding pre- and post- spinout, in substance, being unchanged. In such circumstances, the spinout, in conjunction with section YC 11, may have resulted in a breach of the shareholder continuity requirements for loss and credit carry forward purposes.

Key features

Section YC 13(1)(c) has been amended to allow the corporate spinout rules to apply if the original parent company holds more than 50% of the voting interests and, if a market value circumstance exists, market value interests in the spun-out company immediately before the spinout.

This amendment is consistent with the original policy intent which is to ensure the shareholder tracing rules do not adversely affect the companies involved in a spinout to the extent that there is no underlying change in the economic ownership of the spun-out company and its subsidiaries.

Application date

The amendment applies from 1 May 2011.

WORKING FOR FAMILIES – DEPENDENT CHILD'S INCOME

Section MB 11 of the Income Tax Act 2007

Background

The Taxation (GST and Remedial Matters) Act 2010 introduced a more comprehensive definition of "family scheme income". This new definition of family scheme income applies for Working for Families (WFF) tax credits and community services cards for families with dependent children from 1 April 2011.

The new definition of family scheme income includes passive income of a dependent child above a threshold of $500 per annum. The dependent child's passive income is potentially counted twice when calculating a family's combined family scheme income for abatement purposes, once for the principal caregiver and once for their partner.

Key features

Section MB 11 of the Income Tax Act 2007 is amended to prevent double counting of a dependent child's passive income when calculating family scheme income.

The amount of a dependent child's passive income is included in a principal caregiver's family scheme income if the amount exceeds $500 per year. If there is more than one principal caregiver for a child, such as where there is shared care of a dependent child, the amount is divided equally between these people.

Application date

The amendment applies from 1 April 2011.

TIMING OF BASE PRICE ADJUSTMENT (BPA) WHEN CHANGING FROM FAIR VALUE METHOD TO ANOTHER METHOD

Section EW 29(13) of the Income Tax Act 2007; and sections EW48(1)(b) and (2) of the Income Tax Act 2004

Section EW 29(13) has been amended to clarify when a base price adjustment is calculated.

Key features

When taxpayers change from the fair value method to another spreading method as allowed in the Act they are required to perform a base price adjustment (BPA) rather than a change of spreading method adjustment. The Act provided that the BPA is to be performed at the "date of a change for the financial arrangement". The application of the timing of this BPA has caused some confusion amongst taxpayers and the change clarifies when this BPA calculation is to be applied.

The change provides that the BPA is performed "for the first income year for which a changed method is used for the financial arrangement …". This means a taxpayer will calculate the BPA as at the end of the year of change to the new method so that in the year of change the only income or expenditure under the financial arrangement is from the BPA calculation. The BPA cannot be performed in the previous year (the last year of using the fair value method) because the taxpayer is still using the fair value method for that year and the decision to use the new method is not effected until the year of change. The situation is the same as when a change of spreading method adjustment occurs ie the spreading method adjustment is the only income or expenditure for the financial arrangement in the year of change of method.

The consideration received/paid to be used for the BPA "deemed disposal/acquisition" is the fair value of the financial arrangement at the end of the year of change. For the following years the taxpayer calculates income and expenditure under the new method using the fair value used for the BPA deemed disposal/acquisition as consideration paid/received and for the ultimate BPA for that financial arrangement.

Application dates

The amendments apply retrospectively from the application dates of the original legislation.

BUSINESS INTERRUPTION INSURANCE: TIMING OF DERIVATION

Section CG 5B of the Income Tax Act 2007

New section CG 5B clarifies that amounts received under a business interruption insurance policy are generally derived in the income year in which the amount can be reasonably estimated.

Background

Business interruption insurance policies generally provide cover from losses resulting from a business interruption caused by an event, such as a fire or a natural disaster. Previously, it was not clear at law when amounts received under such a policy were derived. This lack of clarity was undesirable and could be problematic for taxpayers.

Application date

This clarification applies from 4 September 2010.

Detailed analysis

New section CG 5B is designed to apply when a person receives a payout under a business interruption insurance policy. It provides that any income arising from the payout is treated as allocated to the earlier of:

- the income year in which the amount is received; or
- the income year in which the amount is reasonably able to be estimated.

In some cases an insurer may make interim payments before a taxpayer's total loss has been fully established. These interim payments are treated as allocated to the year in which they are received, even if the taxpayer's total loss cannot yet be reasonably estimated.

Section CG 5B(2) provides that, for an insurance payout, the amount attributable to income that the taxpayer would have derived but for the event, is income of the taxpayer. This provision is meant to reflect the existing common law principle that insurance receipts that substitute for income are themselves income. Importantly, it is not intended that this section be interpreted that, if part of the insurance payment is not a substitute for income, it is not income. Existing common law principles for determining this should continue to apply.

FOREIGN SHARES HELD BY ACTIVE INSURANCE CFCS

Section EX 58(7) of the Income Tax Act 2007

Section EX 58(7) amends the controlled foreign company rules so that an active business exemption for insurance companies will apply in respect of related holdings of foreign shares. This change is retrospective, to ensure affected taxpayers do not have an unintended tax liability.

Background

Under the CFC rules, a New Zealand insurance company that uses a controlled foreign company (CFC) to conduct an insurance business offshore can apply to the Commissioner of Inland Revenue for a special exemption from the CFC rules. This is provided as a temporary measure until more detailed rules are developed for applying an active income exemption to active financial CFCs.

Under the existing tax rules, when a CFC holds shares in another foreign company, those shares are generally taxed as though they were held directly by the New Zealand shareholders in the CFC. In contrast, CFCs that hold bonds are treated as holding the bonds themselves.

As a consequence of this approach a New Zealand insurance company with an insurance CFC was required to attribute income from any foreign shares that are held as part of the CFC's insurance business.

This result was inconsistent with the fact that no New Zealand tax will be payable on bonds when these are held by insurance CFCs that qualify for the special exemption.

Because the core business of insurance CFCs involves making investments in financial markets, it is not appropriate to tax foreign shares or bonds when these investments are used to support the insurance business.

One condition for getting the special exemption is that the CFC's investments must be commensurate with the insurance policies that the CFC sells in its jurisdiction. This prevents the CFC from holding an excessive amount of investment assets. The Commissioner of Inland Revenue would be able to revoke the exemption if this occurred.

Key features

Section EX 58 applies when a person has an income interest of 10% or more in a CFC and that CFC has an interest in a FIF. Because of section EX 21(33) income earned by the FIF is not treated as being income of the CFC. Instead, the FIF income is attributed to the New Zealand person.

Section EX 58(7) stops the general "look-through rule" in section EX 58 from applying in respect of a CFC that meets the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994.

Application date

Section EX 58(7) applies to income years beginning on or after 1 July 2009.

EXTENDING THE AMALGAMATION TAX RULES TO BUILDING SOCIETIES

Sections FO 4 and YA 1 (definitions of "amalgamated company", "amalgamating company" and "amalgamation") of the Income Tax Act 2007; and section 75 of the Tax Administration Act 1994

Amendments have been made to the Income Tax Act 2007 and the Tax Administration Act 1994 to ensure that building societies that transfer all of their engagements under the Building Societies Act 1965 are subject to the tax amalgamation rules, like ordinary companies.

Background

Ordinarily, for the purposes of the Income Tax Act 2007, the definition of a 'company' includes a building society. Previously, the tax rules for amalgamations only applied if companies amalgamated under the Companies Act 1993. Building societies are unable to amalgamate under the Companies Act 1993 because that Act does not recognise a building society to be a company. As a result, the income tax treatment for amalgamations previously did not apply to building societies.

For tax purposes, the end result of building societies that transfer all of their engagements to another building society under the Building Societies Act 1965 is sufficiently similar to companies that amalgamate. Therefore, legislative amendments have been made to extend the amalgamation tax treatment to building societies that transfer all of their engagements under the Building Societies Act 1965. This is supported by the fact that generally, for income tax purposes, building societies are treated as companies.

Key features

- Amendment to the "amalgamation", "amalgamating company" and "amalgamated company" definitions.
- Requirement for the amalgamating building society to notify the Commissioner of the amalgamation.

Application date

The amendments apply from 30 September 2010.

Detailed analysis

Amendment to the "amalgamation", "amalgamating company" and "amalgamated company" definitions

Amendments have been made to the definitions of "amalgamation", "amalgamating company" and "amalgamated company" to extend the amalgamation tax rules to building societies. Only building societies that transfer all of their engagements under the Building Societies Act 1965, and that meet other certain criteria, will be able to use the amalgamation tax rules.

As part of the new definitions, the building society that is transferring all of its engagements is required to transfer or assign all funds, property or assets before being removed from the register of building societies. However, the transferring building society is allowed to retain funds, property or assets to the extent required to "settle its affairs" before being removed from the register. This term is intended to cover a range of events necessary to wind up a building society. For the avoidance of doubt, the term "settling its affairs" is intended to include disposal of cross shareholdings.

Requirement for the amalgamating building society to notify the Commissioner of the amalgamation

This amendment to the Tax Administration Act 1994 is an extension of the current requirement for amalgamated companies to notify the Commissioner of Inland Revenue of the amalgamation.

CANTERBURY EARTHQUAKE RELIEF MEASURES

Sections CZ 23, EE 1, EE 44, EE 45, EE 47, EE 48 and EZ 23B of the Income Tax Act 2007

Background

In the aftermath of the Canterbury earthquake and its aftershocks there are sound reasons for providing relief, in limited circumstances, for certain income tax liabilities arising from the destruction, loss or abandonment of property.

Key features

The Act contains the following amendments.

- Firms in certain circumstances will be allowed to defer (or rollover) income tax liabilities arising from the receipt of insurance or compensation payments for irreparably damaged or abandoned buildings held on revenue account.
- Includes as a disposal event, for the purposes of the tax depreciation rules, the damage of property in the neighbourhood of a building or grandparented structure, causing the building or grandparented structure to be useless for the purpose of deriving income; and the property is demolished or abandoned for later demolition.
- The income year that an amount of depreciation loss or an amount of depreciation income is derived is now the earliest income year that the consideration can be reasonably estimated.
- Firms in certain circumstances will be allowed to defer (or rollover) depreciation recovery income liabilities arising from the receipt of insurance or compensation payments for irreparably damaged, lost or abandoned items of depreciable property (not including intangible depreciable property) due to the Canterbury earthquakes and their aftershocks.

Application date

These changes apply from 4 September 2010.

Detailed analysis

Revenue account buildings

Section CZ 23 is intended to provide building owners that hold on revenue account a building that has been irreparably damaged or abandoned because of the Canterbury earthquakes, the option to defer (or rollover) income tax liabilities arising from the receipt of insurance or compensation payments—provided they acquire, build, or purchase a replacement building in greater Christchurch before the end of their 2015–16 income year.

Section CZ 23 applies if all of the following criteria are met:

1. a person receives a payment of insurance or compensation for buildings held on revenue account before their 2016–17 income year; and
2. the payment is received because a building has been rendered useless for the purpose of deriving income as a result of the Canterbury earthquakes and is demolished or abandoned; and
3. in the absence of new section CZ 23, the payment would have resulted in an amount of income under section CG 6 (receipts from insurance, indemnity, or compensation for trading stock); and
4. the person plans to acquire a building to replace the useless building before the end of their 2015–16 income year and the replacement building is located in greater Christchurch; and
5. the person provides the required annual notice of election to the Commissioner of Inland Revenue.

In such cases, the total amount of income under section CG 6 from insurance or compensation is not income of the person except to the extent that an amount is attributable to a later income year under subsection (5).

When a person acquires a replacement building its cost, for the purposes of section EA 2 (other revenue account property), is treated as being reduced by an amount of unallocated suspended income attributed to the replacement building by section CZ 23 (3)(a). Section CZ 23(3)(b) requires the person to reduce the amount of suspended income by the amount allocated to a replacement building.

Section CZ 23(5) provides that an amount of unallocated suspended income is income to the person in the earlier of:

- the end of the person's 2015–16 income year; or
- the income year the person decides not to acquire an amount of replacement property; or
- the income year the person goes into liquidation or becomes bankrupt.

Section CZ 23(6) requires that a person that elects to rely on section CZ 23 must give written notice to the Commissioner of Inland Revenue by the later of 31 January 2012 or the date that the return is filed for the income year in which the amount of income can be estimated. Section CZ 23(7) requires that the written notice must:

- describe the affected property; and
- give details of the replacement property acquired in the current year; and

NEW LEGISLATION

- give the cost of the replacement property and the reduction of that expenditure under subsection (3) of that cost for the purposes of section EA 2; and
- give the amount of the unallocated suspended income at the end of the current year.

Example 1

In February 2011, a 31 March balance date firm's revenue account building is destroyed in the earthquake. The building originally cost $3 million. The replacement insurance proceeds are $6 million and the insurance company "delivers" the replacement building on 15 June 2014. In the absence of any rollover relief the building owner will have taxable income of $3 million under section CG 6.

New section CZ 23 allows the owner to defer the CG 6 income tax liability by allocating an amount of the $3 million suspended income to the replacement building—provided the replacement building is located in greater Christchurch.

As a result of negotiations between the building owner and the insurance company, the insurance proceeds are capable of being reasonably estimated on 30 June 2011.

In the tax return for the tax year ending on 31 March 2012 the building owner files a written election to defer the $3 million of income—pending the acquisition of a replacement building. Provided the taxpayer continues to elect to defer the income the income remains suspended for the tax years ending on 31 March 2013 and 2014.

The replacement building is delivered on 15 June 2014. The tax return for the tax year ending on 31 March 2015 will include this new building at a cost of $3 million (being the $6 million cost of the new building less the $3 million of rollover relief). A notice will have to be filed with the tax return for the tax year ending on 31 March 2015 advising that the deferred income has been rolled into the tax base for the replacement asset. The person must also give notice that the amount of unallocated suspended income has been reduced by $3 million to $0.

When the replacement asset is eventually sold, the difference between the $3 million cost and the sales proceeds will be taxable provided it is sold for at least $3 million.

Losses on buildings

After the central New Zealand floods of 2004 section EE 48 of the Income Tax Act was amended to allow a generic write-off for any loss on buildings that were destroyed by an event beyond the owner's control. Floods and earthquakes are good examples of such events.

After the 4 September 2010 Canterbury earthquake submissions were received that this provision should be extended to cover the situation where the building has to be destroyed as a result of such an event, even if the building itself was relatively undamaged or repairable. Examples include where the building has to be demolished to allow the land underneath the building to be repaired, or to allow for another building to be demolished.

In response to these submissions section EE 47(4) has been amended. It now includes as a disposal event the damage of property in the neighbourhood of a building or grandparented structure, causing the building or grandparented structure to be useless for the purpose of deriving income; and the property is demolished or abandoned for later demolition. It is a generic amendment—not limited to the Canterbury earthquakes.

Recognition of consideration

The amount of insurance or compensation arising from damage to assets destroyed, lost or abandoned due to the Canterbury earthquakes and their after shocks may not be quantifiable until months or even a year after the event. Following more general tax and accounting practice, section EE 48 has been amended so that amounts of depreciation loss or an amount of depreciation recovery income are derived in the earliest income year in which the consideration can be reasonably estimated.

This amendment is effective from 4 September 2010. It is a generic amendment—not limited to the Canterbury earthquakes.

Depreciation roll-over relief

In the context of the Canterbury earthquakes and insurance recoveries, the Government has decided that it is appropriate to provide taxpayers with the ability to defer a depreciation recovery income liability in certain circumstances.

Rollover relief is provided by section EZ 23B. This section is intended to apply when:

- a person, in an income year before their 2016–17 income year either:
  - receives insurance or compensation for items of plant and equipment lost or irreparably damaged as a result of the Canterbury earthquakes; or

   - owns a building or grandparented structure that is rendered useless for the purpose of deriving income; and is demolished or abandoned for later demolition because of damage to this property or the neighbourhood of this property as a result of the Canterbury earthquakes; and
- in the absence of this section, the person would have an amount of depreciation recovery income under section EE 48 for the items of affected property;
- the person plans in the current year to acquire depreciable property (being replacement property) that meets the following requirements:
   - it is not intangible depreciable property; and
   - it is acquired in or before the end of the person's 2015–16 income year; and
   - it is included in the same category of property if the old property was a building or a grandparented structure, or commercial fit-out (neither of which were depreciated under the pool method) and it is located in greater Christchurch, unless the replacement item is plant and equipment; and
- the person provides written notice to the Commissioner of Inland Revenue by the later of 31 January 2012 or the date that the return of income is filed for the income year in which the amount of depreciation recovery income can be estimated; and
- the person provides the required annual notice of election to the Commissioner of Inland Revenue.

Provided the above conditions are met, an amount that would be depreciation recovery income, in the absence of this section, becomes an amount of suspended recovery income (section EZ 23B(2)). The amount of suspended recovery income is available to be allocated to replacement items. Any unallocated amount of suspended recovery income can be attributed to the earlier of:

- the end of the 2015–16 income year, where an amount of suspended recovery income remains unallocated under subsections (3) or (6); or
- the income year that a person decides not to acquire an amount of replacement property. The amount they decide not to spend is depreciation recovery income in that year; or
- the income year that the person goes into liquidation or bankruptcy.

Subsections (3), (4), and (5) allocate an amount of suspended recovery income for old items of depreciable property where the pool method was not used. Subsection (3)(a) reduces the amount of expenditure or costs for calculating an amount of depreciation loss for the replacement item for the purposes of section EE 16(4) or section EE 22. Subsection (3)(b) reduces the amount of unallocated recovery income available for future allocation. The amount of the reduction in subsections (3)(a) and (3)(b) is given by subsection (4).

Subsection (4) calculates the relevant proportion of remaining suspended recovery income that can be allocated to the replacement item. The amount of unallocated suspended recovery income (that is available for future allocation) is reduced by the amount that has been allocated to the replacement item in that income year. If, in an income year, the amount spent on replacement items is equal to or greater than the unallocated suspended recovery income, then the amount of the reduction to additional replacement property is zero. The formula in subsection (4)(b) uses the lesser of the amount of unallocated recovery income remaining or the amount of expenditure on the replacement item. This also limits the total amount of suspended recovery income that can be allocated to replacement items.

Example 2

Plant and equipment (not previously depreciated under the pool method) destroyed by the Canterbury earthquake had a cost of $1 million. On the day of the earthquake the plant and equipment had an adjusted tax book value of $700,000. The owner receives an insurance payment of $1 million. The net depreciation recovered is, therefore, $300,000. The replacement assets were acquired over two years at a cost of $400,000 per year. In year three the owner decides to acquire no more replacement assets, even though they originally expected to spend well over $1 million on the replacement assets.

The $300,000 suspended recovery income is allocated in the following way

Year 1 ($400,000 × $300,000) ÷ $1,000,000 = $120,000

Year 2 ($400,000 × $300,000) ÷ $1,000,000 = $120,000

The balance of $60,000 is taxed in the year that the taxpayer decides to make no further investment in replacement property.

Example 3

Plant and equipment (not previously depreciated under the pool method) destroyed by the Canterbury earthquake had a cost of $1 million. On the day of the earthquake the plant and equipment had an adjusted tax book value of $700,000. The owner receives an insurance payment of $1 million. The net depreciation recovered is, therefore, $300,000. The replacement assets were acquired over two years at a cost of $400,000 per year.

In year three the taxpayer decides to acquire a further $400,000 of replacement assets.

As per the previous example, the taxpayer has already rolled over $240,000 of depreciation recovery income in years 1 and 2. Applying the formula in EZ 23B(4)(b) the limited replacement cost is the lesser of $1,000,000 – $800,000 = $200,000 and the $400,000 spent on acquiring the replacement property. The amount of the reduction to the item's opening adjusted tax value and the amount of suspended recovery income (under subsection (3)(a) or (b)) is $60,000 (($200,000 × $300,000) ÷ $1,000,00).

One month later the taxpayer decides to acquire another item of plant for $10,000. Applying subsection (4)(a) the amount of the reduction under subsection (3)(a) or (b) is zero. This is because the cost of the affected property is less that the person's total expenditure in acquiring other replacement property. In this example the person has spent $1,210,000 replacing property that originally cost $1,000,000.

Subsection (6) provides the reduction method for the cost or adjusted tax book value of replacement items where the old item was accounted for under the pool method. Subsection (6)(a) reduces the amount of expenditure incurred on replacement items and the reduction is applied depending upon the depreciation method applied to the replacement item. Subsection (6)(b) is intended to reduce the amount of unallocated recovery income (that is available for allocation in the future) by the amount allocated by subsection (6)(a).

Under section EZ 23B(9) and (10) a person seeking to suspend an amount of depreciation recovery income under this section is required to file a notice annually with the Commissioner of Inland Revenue providing the following details:

- describing the items of old property; and
- indicating which of the following categories each item of old property is included: (i) a building or grandparented structure not previously accounted for under the pool method; (ii) commercial fit-out not previously accounted for under the pool method; (iii) depreciable property previously accounted for under the pool method; and (iv) depreciable property previously accounted for as plant and equipment; and
- each item of replacement property acquired in the current year and the category of old property the item is being linked to; and
- the amount of expenditure on the replacement item and the reduction of that expenditure because of the deprecation recovery income being linked to the replacement item; and
- giving the amount, for each category of old property, of the unallocated recovery income at the end of the current year.

The annual notice is not required for the income year after the person has filed their completed return for their 2015–16 income year.

Example 4

In February 2011, a 31 March balance date firm's building is destroyed in the Canterbury earthquake. The building originally cost $3 million. The book value is $2 million, reflecting accumulated depreciation of $1 million. The replacement insurance proceeds are $6 million and the insurance company "delivers" the replacement building on 15 June 2014. In the absence of any rollover relief the building owner will have depreciation recovered taxable income of $1 million. The insurance proceeds over the $3 million cost price are still a tax free capital gain.

The law now allows the owner to roll the depreciation recovered into the replacement building, provided the replacement building is located in greater Christchurch. The insurance proceeds are known on 30 June 2011. The depreciation recovery income would be allocated to the tax year ending 31 March 2012.

In the tax return for the tax year ending on 31 March 2001, the taxpayer files a written election to defer the depreciation recovered pending acquisition of the replacement building. Therefore the depreciation recovery income is suspended for taxation purposes. For the tax years ending on 31 March 2013 and 2014 this income stays suspended, provided the taxpayer continues to elect to defer the depreciation recovery income.

The replacement building is delivered on 15 June 2014. The 31 March 2015 tax return will include this new building at a cost of $6 million, and, immediately upon acquisition, it will have an adjusted tax value of $5 million. However, for straight line depreciation purposes, its cost will be $5 million.

Again notice will have to be filed with the 31 March 2015 tax return advising that the deferred depreciation recovered income has been allocated to the replacement building.

When the replacement asset is sold the difference between the adjusted tax value and building cost, in this case $1 million, will be fully taxable as depreciation recovery income (provided it is sold for at least $6 million). Therefore the tax liability associated with disposal of the destroyed building has been rolled forward until disposal of the replacement building.

RELIEF FROM USE-OF-MONEY INTEREST FOR FOREIGN WORKERS IN NEW ZEALAND AFTER THE CANTERBURY EARTHQUAKES

Section 183CB of the Tax Administration Act 1994

Background

Foreign workers in New Zealand are subject to New Zealand tax if their stay here is long enough (typically 183 days but this varies). This includes foreign workers who have come to New Zealand for work that relates to the Canterbury earthquakes.

When the stay becomes long enough, New Zealand tax obligations are backdated to the first day of presence here. If New Zealand tax obligations are backdated and no tax has been withheld, the workers owe overdue tax.

Some workers have not arranged for tax to be withheld because they expected to be here for only short stays, but have since had their stays prolonged because of the unexpected continuation of aftershocks.

Currently, use-of-money interest is imposed on the overdue tax, but this is inappropriate in the circumstances, because workers may have become liable through extremely unusual events beyond their control.

Key features

The Tax Administration Act has been amended to relieve certain use-of-money interest for foreign workers in New Zealand following the Canterbury earthquakes.

The amendment applies to workers, including companies that have been contracted to do work here, that were not residents and did not have a significant presence in New Zealand at the time of the 4 September 2010 earthquake, but have since become subject to tax here.

The amendment relieves interest in two ways. Firstly, it relieves interest on tax that was required to be withheld from the income of the worker (for example, PAYE). This is relief for the person paying the worker. And secondly, it relieves interest on tax that would be paid directly by the worker (provisional tax). This is relief for the worker.

Interest relief ceases to apply from the date it was clear that the worker had a New Zealand tax liability. That is, relief ceases on the date exemptions in domestic law or double tax agreements could no longer apply. As noted above, this is often after 183 days of presence here, but could be less in some cases. In addition, interest relief cannot extend beyond 4 September 2011.

After the date relief ceases, the overdue tax liability needs to be settled and any further tax obligations need to be complied with to prevent new use-of-money interest accruing.

Application date

The amendment applies from 4 September 2010 until 4 September 2011.

QUALIFYING COMPANIES TRANSITIONING TO LOOK-THROUGH COMPANY RULES

Section HZ 4C of the Income Tax Act 2007

The legislation introduces an amendment to the transitional rules for a qualifying company (QC) or a loss-attributing qualifying company (LAQC) which is transitioning to become a look-through company (LTC).

Background

When the new LTC rules were introduced, transitional rules were included to provide a smooth transition for existing QCs and LAQCs wanting to become LTCs.

Key features

Section HZ 4C has been amended to clarify that when a QC or LAQC uses the transitional rules and becomes an LTC, any elections and valuation methods it previously adopted (for example, depreciable property or livestock valuation elections) will carry over to the LTC. The LTC does not have to re-establish these elections.

Application date

The amendment applies from 1 April 2011, when the LTC rules came into effect.

DEFINED BENEFIT FUNDS AND EMPLOYER SUPERANNUATION CONTRIBUTION TAX (ESCT)

Section RD 67 of the Income Tax Act 2007

A change has been made to the Income Tax Act 2007 to allow employers making employer's superannuation cash contributions to a defined benefit fund to deduct employer's superannuation contribution tax (ESCT) at a rate of 0.33 cents.

Background

The Taxation (Annual Rates and Budget Measures) Act 2011 removed the ESCT flat rate of 0.33 as a default rate from 1 April 2012. Instead ESCT must be deducted at an ESCT rate based on an employee's annual salary or wages and employer contributions.

However for superannuation schemes which operate on a principle of unallocated funding, like defined benefit schemes, employer's superannuation cash contributions may not be attributed for the benefit of any particular employee. This can make it impractical for employers to determine the appropriate ESCT rate, as they cannot link contributions with particular employees' annual salary or wages and employer contributions.

Key features

Section RD 67 of the Income Tax Act has been amended to provide employers with the option of an ESCT rate of 0.33 cents, but only for employer's superannuation cash contributions paid to a defined benefit fund.

Application date

The amendment applies from 1 April 2012, being the date the current default ESCT rate is removed.

NEW DEFINITION OF "DOCUMENT"

Sections 3(1), 16(1), 16B, 16C(1) and (2), 16C(5) to (7), 17(1), 17(1B), 17(1D), 17(3), 17(4), 17(6), 17A(15), 19(1), 20(1) to (6), 20B(1) to (3), 20C, 20D, 20E, 20F(1) and (2), 20G(1) and (2), 21(8), 81(3), 81(4)(b), 81(4)(c), 81(4)(l), 86(2), 87(2), 143(1)(a), 143(1B), 143A(1)(a), 143B(1)(a) and 150D of the Tax Administration Act 1994; section 15(2) of the Taxation Review Authorities Act 1994; and section 2(1) of the Goods and Services Tax Act 1985

The definition of "book and document" in section 3 of the Tax Administration Act 1994 has been replaced with a new definition of "document". The new definition removes references to redundant technology.

Background

Before the amendment, section 3 of the Tax Administration Act 1994 defined "book and document" and "book or document" as including:

> all books, accounts, rolls, records, registers, papers, and other documents and all photographic plates, microfilms, photostatic negatives, prints, tapes, discs, computer reels, perforated rolls, or any other type of record whatever.

The definition had not been updated since 1974 and therefore did not reflect changes in technology since then. For example, some of the terminology referred to out-of-date technology such as computer reels and perforated rolls.

In a recent Court of Appeal decision it was decided that computer hard drives were a "book or document" under the Tax Administration Act 1994, as the definition already included "or any type of record whatever".[11] Therefore, the new definition does not extend the current definition but instead updates it, for example, by removing references to redundant technology.

Updating the definition does not affect departmental practice because it is Inland Revenue's view that the previous definition included any records in electronic form. Inland Revenue's practice is to use cloning technology to copy computer records on site whenever practicable rather than remove computers from premises, thereby minimising any impact on taxpayers' activities.

Key features

The definition of "book and document" in section 3 of the Tax Administration Act 1994 has been replaced with a new definition "document". The new definition of "document" covers the medium on which information is stored, the information itself and any device associated with the medium which allows the information to be communicated.

The words "book and document" throughout the Inland Revenue Acts have been replaced with the new term "document".

Application date

The amendments apply from the date of Royal assent, being 29 August 2011.

[11] *Avowal Administrative Attorneys Ltd & Ors v The District Court at North Shore & the Commissioner of Inland Revenue*

REARRANGEMENT OF FORESTRY INTERESTS TO FACILITATE A TREATY SETTLEMENT

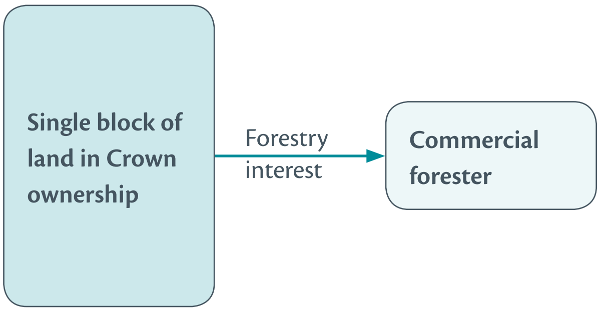
Sections CW 1B, DP 9B and DP 11(4B) of the Income Tax Act 2007; sections CW 1B, DP 8B and DP 10(4B) of the Income Tax Act 2004; and sections CB 17 and DL 1(16), (17), and (18) of the Income Tax Act 1994

Income tax legislation is amended to provide for the exemption of any income which arises when a forestry interest is extinguished and re-granted solely for the purposes of facilitating a Treaty of Waitangi claim settlement process. These amendments were introduced by Supplementary Order Paper No. 254 during the passage of the Taxation (Tax Administration and Remedial Matters) Bill.

Background

Many Treaty of Waitangi settlements involve forestry land owned by the Crown over which forestry interests have been granted to commercial foresters.

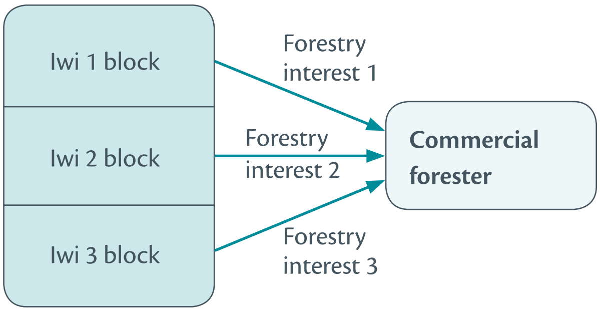
Original situation



This issue will usually arise with land which is in Crown ownership. It may also arise when the land is held by an interim entity to facilitate the Treaty process at the time of the surrender. The new legislation is designed to deal with both situations.

These large blocks of land sometimes need to be divided into smaller blocks of land which will then be transferred to different iwi claimant groups. To enable each of those iwi claimant groups to manage their relationships with the commercial foresters separately, the commercial foresters are being asked to surrender their existing interests in exchange for the issue of multiple interests. These multiple interests will have the same basic terms and cover in aggregate the same area as the original right, but match the new land boundaries for individual blocks.

Future situation



Under the law which existed prior to this amendment, a tax liability could arise when the commercial foresters surrender their original forestry interests with no immediate offsetting deduction for the grant of the replacement forestry interests. A tax liability may also arise to the person who grants the new rights. Taxation of these transactions which take place purely to facilitate Treaty settlements and which are not motivated by the commercial interests of the parties was not consistent with the policy intent of the original legislation.

Key features

A new exempt income rule is created which treats any income arising from a rearrangement of existing forestry rights to enable the implementation of a Treaty settlement as exempt income.

Application date

The amendments apply from 1 April 1995.

Detailed analysis

For the purposes of this section, the Income Tax Act 2007 statutory references are used, although the amendments to the 2004 and 1994 acts are identical.

Section CB 24 provides that an amount derived from disposing of a right to take timber is income.

New section CW 1B provides that this income is exempt income where:

a) the sole reason for the new rights replacing the old right is to facilitate a Treaty of Waitangi claim settlement process; and

b) the rights and obligations of the new rights are equivalent to the old rights, ignoring differences that are solely for the reason set out in the paragraph above.

These paragraphs restrict the exemption to situations where the sole reason for the new rights replacing the old rights is to facilitate a Treaty settlement. This means that the exemption will not apply where old rights are replaced with new rights for another reason, such as where the parties wish to enter into new commercial arrangements.

The exemption will also not apply if the parties take the opportunity of the issue of the new rights to simultaneously document new commercial arrangements which are over and above replacing the existing rights.

However, there are four situations where what might appear to be differences between the old right and the new rights will still fall within the exemption.

The first is where the old right was a Crown Forestry Licence, and the new right is a forestry right under the Forestry Rights Registration Act. This change is made in reflection of the fact that the land-owner when the original right was granted was the Crown, but the new land-owner will be iwi. This difference falls within the last part of paragraph b)—it is solely for the reason in paragraph a)—so the exemption applies.

The second situation is where the old right was a Crown Forestry Licence and a new forestry right under the Forestry Rights Registration Act is granted over part of the land the Crown Forestry Licence originally covered, with the remainder of the land still being subject to the Crown Forestry Licence. In this case, the exemption is still available because the person holding the rights has the same rights and obligations after the transaction as before it.

The third situation is where the new rights contain additional provisions which deal with wahi tapu—culturally sensitive areas comprised in the area which the forestry rights cover. Variations of this sort are also considered to fall within the exemption, as they are made to facilitate the Treaty of Waitangi claim settlement process.

The fourth situation is where variations to the original rights, such as giving the ability to replant, have been agreed between the commercial forester and the iwi which eventually acquires the land prior to the grant of the replacement rights (and these variations constitute rights in themselves). These variations are not documented in the original rights, but may be documented in the replacement rights. If this occurs, then the exemption is still available. This is because the test compares the rights which existed prior to the redocumentation with the rights which existed afterwards—where those rights were documented is not relevant.

AUTHORITY FOR THE COMMISSIONER OF INLAND REVENUE TO IMPOSE FEES FOR CREDIT CARD PAYMENTS

Section 226C of the Tax Administration Act 1994

Section 226C of the Tax Administration Act is a new section which allows the Commissioner of Inland Revenue to offer a credit card facility for payment of all tax and social liabilities subject to an appropriate credit card transaction fee if taxpayers choose to use this facility.

Background

Since 2004, the Commissioner has accepted credit card payments from student loan borrowers and child support liable parents who are based overseas. Section 226C extends this facility to all payments of tax and social policy liabilities and gives the Commissioner authority to charge taxpayers a credit card transaction fee. The overall benefit of extending this facility is that it will provide taxpayers with another payment option to meet their liabilities.

Key features

Section 226C of the Tax Administration Act 1994 allows the Commissioner to charge taxpayers a fee, if they choose to use a credit card. The current fee is set at 1.42 percent of the total transaction and this fee may change by Order in Council.

The fee is not applicable to overseas-based student loan borrowers and overseas-based child support liable parents who choose to make their payments by credit card.

Overseas child support parents and student loan borrowers

The fee is passed on to domestic-based student loan borrowers and child support parents by Inland Revenue. These individuals also have other practical ways in which they are able to comply with their repayment obligations, such as internet banking. Overseas liable parents and borrowers have fewer repayment options than people based in New Zealand. Absorbing the fee helps reduce their compliance costs. Inland Revenue will, therefore, continue to absorb the fee for credit card payments made by overseas liable parents and overseas student loan borrowers.

Application date

The application date will be from the date of Royal assent, 29 August 2011.

GST AMENDMENTS

INPUT TAX ADJUSTMENT ON DISPOSAL OF GOODS OR SERVICES

Section 21F of the Goods and Services Tax Act 1985

A change has been made to the Goods and Services Tax Act 1985 (GST Act) to clarify that goods and services that have been zero-rated and to which the apportionment rules apply are subject to section 21F which applies an adjustment on disposal of the goods and services.

Background

The Taxation (GST and Remedial Matters) Act 2010 introduced a number of substantial changes to the GST rules, including new apportionment rules and the zero-rating of supplies that involve land.

Under the new apportionment rules, the portion of a deduction that a registered person can claim in respect of acquired goods and services must correspond with the portion of the asset's use for making taxable supplies. 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, section 21F allows them to claim an additional amount of input tax.

The amount of the deduction that is available under the provision is calculated by reference to a formula. Although the formula works as intended where the GST is charged at the standard-rate on both the acquisition of goods or services and their subsequent disposal, it provides an incorrect result where the original acquisition or the subsequent disposal have been subject to GST at the rate of 0%.

Key features

Subsection (4) has been inserted into section 21F to provide a formula for calculating an input tax deduction on the disposal of goods or services which were zero-rated when they were originally acquired by the supplier:

tax fraction × consideration × (1 – previous use)

Subsection (5) provides definitions for terms used in subsection (4).

Tax fraction is the meaning given in section 2(1), unless subsection (7) applies to the disposal.

Consideration is the amount of consideration received, or treated as received, for the supply.

Previous use is the percentage intended use or the previous actual use in the period before the period in which the disposal occurs.

Subsection (6) specifies that the amount calculated under the formula must not be more than the amount of output tax that is accounted for by the person under section 20(3J)(a)(iii)—in effect, the initial amount of the deduction not claimed—together with any later adjustments already made under the apportionment rules.

Subsection (7) provides that if GST on a disposal is charged at the rate of 0%, the *tax fraction* in the new and old formulae in section 21F is treated as 15%.

Application date

The amendments apply to supplies made on or after 1 April 2011.

ENTITLEMENT TO INPUT TAX DEDUCTIONS WHERE THE CHANGE IN USE IS A RESULT OF THE CHANGES IN THE GST ACT

Section 21HB

Changes have been made to the GST Act to amend the apportionment rules to allow input tax deductions where the change in use occurs as the result of the changes to the definitions of "dwelling" and "commercial dwellings" and the affected person is required to be GST-registered.

Background

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". The definitions of "dwelling" and "commercial dwelling" have therefore been amended.

A result of new definitions is that some supplies of accommodation that were treated as exempt before 1 April 2011 will now be subject to GST.

If a supplier has been treated as making exempt supplies of accommodation before 1 April 2011, they would likely not have claimed input tax deductions in respect of the supplies. If these suppliers are required to charge GST on their supplies after 1 April 2011, they should be able to claim input tax deductions for GST on goods and services related to the making of the supplies.

Key features

Section 21HB(1) specifies that section 21HB applies when goods or services acquired or produced before 1 April 2011 were not acquired or produced for the principal purpose of making taxable supplies but, because of the changes made to the definitions of *commercial dwelling* and *dwelling*, the goods or services are treated from 1 April 2011 as being used for making taxable supplies. For the purposes of the provision, the person making the adjustment must be registered for GST under section 51(1) either before or after 1 April 2011.

If section 21HB applies, subsection (2) allows a person to deduct input tax under section 20(3C), the general input tax apportionment provision, to the extent to which a deduction has not been made under the old apportionment rules. For the purposes of the apportionment rules, the person must treat the goods or services as acquired on 1 April 2011 at their original cost (section 21HB(3)).

Application date

The amendments apply to supplies made on or after 1 April 2011.

THE REQUIREMENT TO PROVIDE THE REGISTRATION NUMBER OF THE RECIPIENT

Section 78F

A change has been made to section 78F of the GST Act to require a GST-registered recipient to provide their registration number to the supplier.

Background

The new zero-rating rules, which apply from 1 April 2011, require a supply that involves land to be zero-rated for GST purposes where both the supplier and the recipient are registered for GST and certain other conditions are met.

In these circumstances, section 78F requires the recipient to provide a statement in writing to the supplier as to whether they are, or expect to be, registered for GST.

In contrast, section 75(3B) requires the supplier of a zero-rated supply to maintain sufficient records to enable the registration number of the recipient to be ascertained.

A reconciliation of the two sections is necessary to require the recipient to provide their registration number to the supplier.

Key features

Section 78F(2B) requires a recipient, who is a registered person, or who expects to be a registered person, to provide their registration number to the supplier at or before the date of settlement.

Application date

The amendments apply from 29 August 2011.

INFORMATION REQUIREMENTS FOR ZERO-RATING TRANSACTIONS THAT INVOLVE UNDISCLOSED AGENCIES

Sections 78F(6) and (7), and 75(3C), (3D) and (3E)

Changes have been made to section 78F of the GST Act to allow an agent for an undisclosed principal to make limited representations to the supplier for the purposes of the zero-rating rules.

Background

To help the supplier to decide whether a supply of land should be zero-rated, section 78F requires the recipient to provide to the supplier the information regarding their registration status and intentions in respect of land.

A purchaser may use an agent to acquire goods or services on their behalf. In some situations, the agency may be done on the basis that the identity of the de-facto purchaser, or principal, will remain unknown to the supplier.

The purpose behind the undisclosed agency would be defeated if, in order to zero-rate a supply of land, the undisclosed principal had to reveal their identity and provide their registration details to the supplier. Moreover, since in undisclosed agency situations the supplier would be unaware of the identity of the recipient, the supplier would not be able to satisfy the requirements in section 75(3B) to maintain sufficient records to enable the name and address of the recipient and the registration number of the recipient to be ascertained.

Key features

Section 78F(6) states that when a supply is made to a person who is, for the purposes of the supply, an agent acting on behalf of an undisclosed principal, the information requirements of section 78F(2) are met if the agent provides a statement in writing to the supplier as to whether, at the date of settlement, the principal as recipient:

- is, or expects to be, a registered person;
- is acquiring the goods or services with the intention of using them for making taxable supplies; and

- does 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).

Section 78F(7) specifies that the agent must also provide their registration number to the supplier at or before the date of settlement.

As a consequence of the above changes, suppliers' record-keeping requirements have also been amended.

Sections 75(3C), (3D) and (3E) state that when a supply that wholly or partly consists of land is made to a person who is, for the purposes of the supply, an agent acting on behalf of an undisclosed principal, the supplier's record-keeping requirements will be met if the supplier maintains sufficient records to enable the particulars of the name, address, and registration number of the agent to be ascertained. In turn, the agent must maintain sufficient records in relation to the undisclosed principal to enable the name, address, and registration number of the principal to be ascertained.

Application date

The amendments apply to supplies made on or after 1 April 2011.

EXCLUSION OF CERTAIN DWELLINGS FROM ZERO-RATING RULES

Section 5(15)

Changes have been made to section 5(15) of the GST Act to deem the supply of land that falls under section 14(1)(d) to be a separate supply from the supply of any other real property included in the supply.

Background

Section 14 lists supplies that must be treated as exempt supplies for GST purposes and includes under section 14(1)(d) a sale by the registered person in the course of or furtherance of their taxable activity of a dwelling that has been used for making supplies of accommodation for a period of 5 years or more before the date of supply.

The GST Act requires a supply that involves land to be zero-rated if certain conditions are satisfied. In theory, a sale of land that falls under section 14(1)(d) would also be zero-rated if it was supplied as part of a larger supply of land.

There are no policy reasons for zero-rating rather than exempting such supplies of land used for dwelling. Therefore, the legislation has been amended to deem the supply of land that falls under section 14(1)(d) to be a separate supply from the supply of any other real property included in the supply.

Key features

Section 5(15) has been amended to state that when either of the following supplies are included in a supply, they are deemed to be a separate supply from the supply of any other real property that is included in the supply:

- a supply of a principal place of residence; and
- a supply referred to in section 14(1)(d).

Prior to the amendment, only a supply of "principal place of residence" was treated as a separate supply.

Application date

The amendment applies to supplies made on or after 1 April 2011.

INPUT TAX DEDUCTIONS IN RESPECT OF TAXABLE USE BY PARTNERSHIPS

Section 21B

Changes have been made to section 21B of the GST Act to extend the application of section 21B relating to input tax deductions for pre-registration goods and services to situations where the person's partnership uses the goods and services for making taxable supplies.

Background

Section 21B allows a registered person to claim input tax deductions for goods and services purchased by them before registration.

The section applies when, before becoming GST-registered, a person acquires goods and services that were subject to GST and later becomes registered for GST and uses the goods and services for making taxable supplies.

In some situations, the person may conduct their business through a partnership and allow the partnership to use in making taxable supplies the goods and services that were acquired by the person while not registered. To ensure that the business choice of acting through a partnership does not prevent an input tax deduction from being claimed, section 21B has been extended to situations where the person's partnership uses the goods and services for making taxable supplies.

Key features

Subsections (1)(b), (2) and (3) of section 21B have been amended with references to a "partnership", therefore extending the application of section 21B to situations where the person's partnership uses the goods and services for making taxable supplies.

Application date

The amendments apply to supplies made on or after 1 April 2011.

DRAFTING AMENDMENT IN SECTION 11(8C)

A change has been made to the transitional rule in section 11(8C) of the GST Act to refer to the time of supply as being "on or after" 1 April 2011.

Background

The zero-rating of land rules applies to supplies made "on or after" 1 April 2011.

Section 11(8C) provides an election to apply the new rules if there is a binding agreement before 1 April 2011, and the time of supply is "after" 1 April 2011.

Key features

To ensure consistency with the zero-rating provisions, section 11(8C) is amended to refer to a time of supply "on or after" 1 April 2011.

Application date

The amendment applies to supplies made on or after 1 April 2011.

DEFINITIONS OF "PRINCIPAL PLACE OF RESIDENCE" AND "LAND" IN THE GST ACT

Section 2

Changes have been made to section 2 of the GST Act to ensure that the definition of "principal place of residence" only applies for the purposes of the definition of "dwelling" and that the definition of "land" only applies for the purposes of the zero-rating of land rules.

Background

Provisions in the GST Act concerned with the definition of "dwelling" and the zero-rating of supplies that involve land, use the term "principal place of residence". Although the same term is used, it is intended to convey slightly different meanings in the context of different provisions. In the context of the definition of "dwelling" the "principal place of residence" is intended to mean premises which are being supplied as accommodation to a person and which the person occupies as their main residence for the duration of an agreement. In the context of the zero-rating provisions the "principal place of residence" is intended to indicate land which is used by its owner or their relatives as their main place of residence.

Section 2(1), among other things, defines the "principal place of residence" for the purposes of the definition of "dwelling". However, owing to an oversight, the definition is also stated to apply to the zero-rating provisions (sections 5(15), 11(1)(mb), and 78F) in the GST Act.

Section 2(1) also includes a definition of "land" for the purposes of the zero-rating rules. The definition has been drafted broadly to ensure that most land-related supplies that could give rise to "phoenix" fraud concerns are zero-rated. The term "land" is also used in a number of provisions concerned with the apportionment of input tax. In the context of those sections, "land" is intended to be interpreted in accordance with its usual meaning.

Owing to an oversight, the definition of "land" in section 2(1) is also stated to apply to the apportionment provisions (sections 21E, 21G(5), 21H(3)) in the GST Act.

Key features

The definition of "principal place of residence" in section 2 has been amended to omit references to the zero-rating provisions in the GST Act.

The definition of "land" in section 2 has been amended to omit references to the apportionment provisions in the GST Act.

Both of the amendments are subject to savings provisions to protect persons who relied on the definitions as they were before the amendments.

Application date

The amendments apply to supplies made on or after 1 April 2011.

GST TREATMENT OF CERTAIN EMISSIONS UNIT TRANSACTIONS

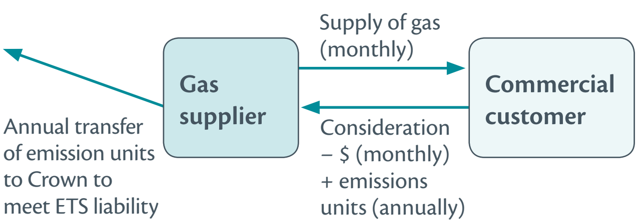
Sections 10(2)(b) and (2B) of the Goods and Services Tax Act 1985

Amendments are made to enable fully taxable parties to agree the value of emissions units supplied in the future when those emissions units are part of the consideration for another taxable supply.

Background

A number of businesses with liabilities under the Emissions Trading Scheme (ETS) require their large commercial customers to pay for supplies received with a combination of monetary consideration and the agreement to transfer emissions units in the future.

This is illustrated by the diagram below, which uses the example of the supply of gas:



The Goods and Services Tax Act 1985 values a supply by reference to the market value of the consideration paid for it. This would be straightforward if the emissions units were supplied straight away—the value of the supply of gas would be the cash paid and the value of the emissions units. Under previous law, valuation difficulties arose here because the emissions units are to be supplied in the future—potentially as long as 15 months after invoicing for the supply of gas. The value of emissions units fluctuates in accordance with supply and demand so future prices are unpredictable.

Key features

The parties to a transaction can agree the value of goods and services supplied between them where that transaction involves the right to receive emissions units in the future, and some other key tests are met.

Application date

The amendments apply from 1 July 2010.

Detailed analysis

Section 10(2) is amended to add a new provision which in certain circumstances overrides the default position that where a barter transaction takes place, the value of a supply is the open market value of the consideration for that supply. Under the amendment, the supplier and the recipient can agree any value for the supply when all of the following tests are met:

- the supply is of a right to receive a specified number of emissions units at a future date;
- the supplier and the recipient are not associated;
- each of the supplier and the recipient, in the transaction of which the supply is a part;
  - makes a taxable supply; and
  - acquires a taxable supply for use in making taxable supplies.

NEW LEGISLATION

OVERSEAS DONEE STATUS

Schedule 32 of the Income Tax Act 2007

The following organisations have been granted overseas donee status from the 2012–13 tax year:

- Jasmine Charitable Trust No. 2
- New Zealand Good Samaritan Heart Mission to Samoa Trust
- NZ-Iraqi Relief Charitable Trust
- RNZWCS Limited
- Ruel Foundation
- The Cambodia Charitable Trust
- The Unions Aotearoa International Development Trust.

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 amendments will apply from 1 April 2012.

REMEDIAL MATTERS

DEFINITION OF REVENUE ACCOUNT PROPERTY – NON-KYOTO GREENHOUSE GAS UNITS

Section YA 1 of the Income Tax Act 2007

Background

Specific tax rules apply to transactions in emissions units, which are defined in section YA 1 to include certain emissions units which can be traced back to the Kyoto Protocol.

Some of these rules are extended to non-Kyoto greenhouse gas units, which are "voluntary" emissions units which do not originate from the Kyoto Protocol but which have been created by parties from forestry or emissions reduction projects. See **http://goldstandard.apx.com/** for an example.

Key features

A remedial amendment is made to add non-Kyoto greenhouse gas units to the definition of revenue account property.

Application date

This amendment applies from 1 January 2009.

AMENDMENTS TO THE PIE RULES

Sections DB 23, CX 56, HL 10, HL 21, HM 5, HM 6, HM 12, HM 14, HM 21, HM 25, HM 36, HM 38, HM 45, HM 56, HM 57B, IC 3, LS 2, OK 6B and table O17 of the Income Tax Act 2007; sections HL 10, HL 20 and MK 4 of the Income Tax 2004; section 57B of the Tax Administration Act 1994

Several amendments have been made to the portfolio investment entity (PIE) rules to ensure they operate as originally intended. The most significant of these is a change to how prescribed investor rates for recent migrants are set to more accurately reflect their income.

Application dates

The amendments apply from various dates as set out below.

Detailed analysis

Prescribed investor rates for recent migrants

Sections CX 56, HM 57B and LS 2

Section HM 57B provides that a recent migrant, in calculating their prescribed investor rate (PIR), must take into account their non-resident foreign-source income.

Previously, PIRs were generally based on the lower of a person's New Zealand taxable income in the past two income years. However, this drafting resulted in an inappropriate outcome. Recent migrants often have very little New Zealand taxable income prior to migration. Accordingly, recent migrants were generally able to select low PIRs in their initial years in New Zealand, regardless of their actual New Zealand income.

Under the new rule, it is a recent migrant's net, not gross, world-wide income that is counted when determining their PIR. That is, if the person incurred expenditure in deriving their non-resident foreign-sourced income, those expenses should be subtracted from that income before determining the appropriate PIR.

In addition to taking account of non-resident foreign source income, section HM 57B(4) provides that a transitional resident must include income that has been exempted under section CW 27 when determining their PIR. This is appropriate as PIEs are able to invest into New Zealand.

This new rule applies when a person first becomes resident in New Zealand; however, it has an enduring effect. In subsequent years, when the investor determines their PIR, they must continue to include their worldwide income from years when they were not resident and disregard income exempted under section CW 27.

Example

For the purposes of this example, assume that the top PIR in all years is 28% and applies if a person's New Zealand taxable income is over $70,000.

Mike will move to New Zealand on 1 April 2012 from France. His net taxable income from France and New Zealand in different income years will be:

Year	France	New Zealand
2010–11	NZ$100,000	NZ$0
2011–12	NZ$125,000	NZ$0
2012–13	NZ$125,000	NZ$0
2013–14	NZ$30,000	NZ$50,000
2014–15	NZ$30,000	NZ$50,000

The NZ$30,000 Mike earns from France in 2012–13 and later years (ie, after his migration) is investment income. As Mike qualifies as a transitional resident, this income is exempt income in New Zealand. Mike has no other income.

NEW LEGISLATION

In all of the income years from 2012–13 to 2014–15, Mike will have a PIR of 28%.

For the 2012–13 year, Mike's worldwide taxable income in the previous two income years was $100,000 and $125,000.

For the 2013–14 year, Mike's worldwide taxable income in the previous two income years was $125,000.

In determining Mike's PIR for the 2014–15 year, the lower of Mike's income in the previous two income years was from the 2013–14 year. Considering that year, Mike's New Zealand taxable income was only $50,000 as his $30,000 French income was exempt under section CW 27. However, for the purposes of determining his PIR, this exemption is ignored, resulting in a 28% PIR.

Exception if income significantly different

Under section HM 57B(3), a person who has moved to New Zealand can choose for this section to not apply in one, or both, of the income years in which they are first resident if they expect their New Zealand taxable income for that year to be significantly lower than it was before they migrated. This may occur, for example, if the person has educational qualifications that are not recognised in New Zealand.

If a person elects for this rule not to apply, their PIR will be determined as usual; that is, based on their New Zealand taxable income. However, section CX 56 will not apply to any PIE attributed income they derive. This means the person will have to include any PIE income in their own tax return, although they will receive a credit for any tax paid by the PIE on their behalf.

This new rule applies to PIR calculations for the 2012–13 and later income years for both new and existing migrants to New Zealand.

Investment by charities into PIEs

Section HM 21

Section HM 21 has been amended to allow registered charities to hold more than 20 percent of a PIE and be a PIE's only investor, provided the charity earns only tax exempt income under section CW 41 or 42. This amendment allows a charity to control a PIE.

On its face this amendment seems inconsistent with the general principle that a PIE should be widely-held. The rationale for this general rule is that it prevents a person from controlling a PIE and using it as their personal investment vehicle, which could provide a tax advantage compared to investing directly. However, there is no mischief in allowing a charity to control a PIE as the charity's income would be exempt whether the income was derived directly or through a PIE.

This amendment applies from 29 August 2011.

Income from life insurance

Sections HL 10, HM 12 and HL 10 of the Income Tax Act 2004

Section HM 12 has been amended to ensure that PIEs are able to derive income from life insurance policies. PIEs are restricted to earning only passive types of income, such as income from financial arrangements and dividends. Income from life insurance policies is another type of passive income; however, such income was inadvertently not included in the list of types of income that a PIE can derive.

This amendment applies from the beginning of the PIE regime, 1 October 2007. Accordingly, similar amendments have been made to section HL 10 of the Income Tax Act 2004 and 2007.

Intra-group financing of land investment companies

Section IC 3

Section IC 3 has been amended to provide that a PIE is able to group with wholly owned subsidiaries, provided the subsidiaries are:

- multi-rate PIEs;
- land investment companies;
- a company that meets the requirements of sections HM 7(a) and (d) (ie, a company that could be a PIE if it elected to be one); or
- foreign PIE equivalents.

This amendment is intended to accommodate intra-group financing between land investment companies and PIEs in the same tax group. For example, a subsidiary company of a PIE could be set up to borrow money and on-lend it to another subsidiary company, with that second company using the money to purchase land. Under the amended rules both companies would generally be able to group with the PIE. Such grouping was generally not previously possible.

This amendment applies from 29 August 2011.

Double counting of income

Sections HL 21, HM 56 and HL 20 of the Income Tax Act 2004

Under the previous PIE rules it was possible for some of an individual's taxable income to be counted twice when calculating their PIR. This occurred if a person informed a PIE of a rate that was too low, resulting in the PIE income becoming taxable income. The amount was counted twice because PIRs are determined with reference to both a person's taxable income and their attributed PIE income.

Accordingly, the person's attributed PIE income would have been counted as both attributed PIE income and taxable income, possibly resulting in an excessively high PIR for subsequent years.

Accordingly, section HM 56 has been amended to ensure that this double counting does not occur.

This amendment applies from the beginning of the PIE regime, 1 October 2007. Similar amendments have therefore been made to section HL 21 of the Income Tax Act 2007 and section HL 20 of the Income Tax Act 2004.

Conditional entitlements

Section HM 38

Section HM 38 sets out the appropriate tax treatment of conditional employer contributions to superannuation funds. These are contributions made on behalf of employees, but where the employee only becomes entitled to them after a vesting period, which is normally a minimum period of employment. Previously, the interest earned on a conditional employer contribution is taxed at the employee's rate if the vesting period is no longer than five years. If it is longer, the interest is taxed at the PIE's tax rate until the vesting period is over.

Section HM 38 has been amended so that, if a vesting period is within the five-year period, the interest earned on conditional employer contributions is taxed at the employee's tax rate. This removes any tax disadvantage of having a vesting period longer than five years.

This amendment applies from the beginning of the 2012–13 income year.

Other amendments

The other amendments to the PIE rules are as follows:

- Section DB 23 has been amended to ensure that revenue account investors in a PIE cannot inappropriately claim deductions for the cost of an investment if they are not taxed on the proceeds of that investment. This amendment applies from 29 August 2011.
- Section HM 14 has been amended to remove the requirement that a multi-rate PIE that is listed have only one investor class. This amendment applies from the beginning of the 2010–11 income year.
- Section HM 45 has been amended to clarify that a PIE is able to make a voluntary payment of tax at any time, even if an investor has not reduced the amount invested in the PIE. This amendment applies from 29 August 2011.
- Section HM 25 has been amended to shift the date that a PIE loses its PIE status by 1 day, to make the current PIE rules consistent with the rules that applied prior to 1 April 2010. This amendment applies from the beginning of the 2010–11 income year.
- Sections HM 5 and 6 have been amended to correct minor drafting errors, with effect from the beginning of the 2010–11 income year.
- Section HM 36 has been amended to clarify the types of expense a PIE is able to deduct from the net income of its investments on behalf of its investors. This amendment applies from the beginning of the 2010–11 income year.
- Section LS 2 is amended to ensure that investors in a PIE receive tax credits for tax paid on their behalf if their attributed PIE income is not excluded under section CX 56. This amendment applies from the beginning of the 2010–11 income year.
- New section OK 6B is inserted and table O17 is modified to ensure that a Māori Authority receives a credit to its Māori Authority credit account when it is attributed imputation credits by a PIE. A similar amendment has been made to section MK 4 of the Income Tax Act 2004. These amendments apply from 1 October 2007.
- Section 57B of the Tax Administration Act 1994 has been modified to provide that a PIE which performs its tax calculations quarterly does not need to provide an investment summary for an exiting investor until the next 30 June if the PIE has made a payment of tax on behalf of that investor. This amendment applies from 29 August 2011.

ATTRIBUTABLE CFC AMOUNT

Sections EX 20B(3) and EX 21E(8) of the Income Tax Act 2007

New sections EX 20B(3)(o) and EX 21E(8)(e) have been inserted to ensure that a controlled foreign company's (CFC's) portfolio investment entity (PIE) income is accounted for correctly in determining its passive income.

The sections provide that, if a CFC has invested into a PIE but has not been taxed correctly on the resulting income, the income is deemed to be "passive" (that is, an attributable CFC amount under section EX 20B or an added passive amount under section EX 21E). Such income is often taxable in New Zealand. This is on the basis that the income has not been taxed correctly in New Zealand previously.

If, on the other hand, a CFC has been taxed correctly on its PIE income (ie, at 28 percent), there is no need for that income to be deemed to be "passive" income as it has been taxed appropriately in New Zealand. Treating the income as passive could result double-taxation of the CFC's investors.

Application date

These amendments apply from the date of commencement.

AMENDMENTS TO TAX STATUS OF NEW ZEALAND SUPERANNUATION FUND

Sections HR 4B and YD 3B, and schedule 1 of the Income Tax Act 2007; section 76 of the New Zealand Superannuation and Retirement Income Act 2001

The New Zealand Superannuation Fund (NZSF) is a Government investment fund that was set up to pre-fund a portion of New Zealand's future superannuation requirements. The NZSF is not a separate legal entity, but a pool of funds owned by the New Zealand Government.

Amendments to the Income Tax Act 2007 and the New Zealand Superannuation and Retirement Income Act 2001 (NZSRIA 2001) have been made to better reflect the fact that the NZSF is an integral part of the Crown, and not a separate entity. Under the new legislation, tax on income derived by the Crown through the NZSF continues to be calculated in the same way that it was previously.

Amendments also clarify that the NZSF, as part of the New Zealand Government, is a resident of New Zealand for tax purposes.

Background

The NZSF was set up in 2001 to pre-fund a portion of New Zealand's future superannuation requirements. The NZSF is intended to smooth the future amount spent on New Zealand superannuation on a 40-year rolling horizon.

Part 2 of the NZSRIA 2001 governs the operation of the NZSF.

The NZSF is not (and never has been) a separate legal entity. Rather, it is a pool of funds that remains the property of the Crown (section 40 of the NZSRIA 2001). Earnings from the NZSF are taxed using the company tax rate. The NZSRIA 2001 is generally clear on this point.

The Guardians of the NZSF are charged with managing and administering the NZSF, in accordance with the NZSRIA 2001. However, the Guardians are not a trustee of the NZSF (section 51(2) of the NZSRIA 2001), and the legal owner of the NZSF is the Crown, not the Guardians of the NZSF or any other entity.

The NZSRIA 2001 and the Income Tax Act 2007 were amended to better reflect the status of the NZSF—that the NZSF is a pool of funds owned by the Crown and is not a separate legal entity.

An amendment also clarifies that the Crown is a resident of New Zealand. This will ensure that domestic law is consistent with the position under New Zealand's tax treaties. Double tax agreements (DTAs) usually specify that the Government is to be treated as a resident for the purposes of the DTAs. This ensures the Crown, including its various pools of funds (such as NZSF) obtain the benefits of these DTAs, including lower withholding rates.

Key features

Section 76 of the NZSRIA 2001 has been repealed. A transitional provision ensures that the effect of this amendment does not result in the liquidation or creation of any entity or person.

Section HR 4B clarifies that although the NZSF is part of the Crown, the amount of tax on the Crown's income relating to the NZSF will be calculated using the company tax rules.

The provision specifies that the company tax rules apply to the amount of income to be calculated. This means therefore that rules such as the basic tax rate that applies to companies applies to Crown income derived through the NZSF. It also applies to provisions such as section DB 7, which provides that no nexus with income is needed for interest incurred by most companies to be deductible.

Because the NZSF is not deemed to be a body corporate, the obligations that are specifically imposed on companies, such as the obligation to maintain an imputation credit account, do not apply.

Schedule 1 has been amended to ensure that the tax rate applicable to the NZSF is the same as the company tax rate.

Section YD 3B clarifies, for the avoidance of doubt, that the Crown is a resident of New Zealand.

Application date

The amendments apply from 1 April 2011.

FAIR DIVIDEND RATE METHOD: QUICK SALE GAIN AMOUNT

Sections EX 52(13) and EX 54(1) of the Income Tax Act 2007

The fair dividend rate ("FDR") rules in the Income Tax Act 2007 have been amended to ensure that the formula for calculating the "quick sale gain amount", ie, the gain on shares purchased and disposed of within the same income year, takes into account share reorganisations between the date the shares were purchased and when they were sold.

Under section EX 52(7), a quick sale adjustment is the lesser of two amounts—the "peak holding method amount" and the "quick sale gain amount".

For the "peak holding method amount", an adjusted calculation of average cost is used if a share reorganisation occurs. In such cases, average cost is calculated under section EX 54.

However, the rules do not currently provide an equivalent adjusted calculation of "average cost" when determining the "quick sale gain amount" in the event of a share reorganisation. This means that the calculation of average cost under the "quick sale gain amount" formula may not be accurate when there has been a share reorganisation.

Therefore, section EX 52(13) has been amended to provide that the adjusted average cost definition under section EX 54 can be used to determine the "quick sale gain amount", if a share reorganisation occurs.

Additionally, section EX 54(1)(b) is amended to include a reference to section EX 52(12).

Application date

The change applies for income years beginning on or after 1 April 2008.

DIVIDENDS PAID WITHIN A NEW ZEALAND WHOLLY OWNED GROUP

Section CW 10 of the Income Tax Act 2007

The amendment (section 8 of Taxation (Tax Administration and Remedial Matters) Act 2011) removes the common balance date requirement from section CW 10.

Background

Section CW 10 of the Income Tax Act 2007 treats as exempt income, dividends paid between New Zealand-resident companies that are in the same wholly owned group.

However, this exemption does not apply if common balance date requirements are not satisfied. This distorts the original purpose of the rules, which is to allow the movement of capital within a wholly owned group of companies, and imposes an unnecessary compliance cost upon those companies.

Key features

The repeal of the common balance date requirement removes an inappropriate restriction on the dividend exemption for New Zealand-resident wholly owned companies. The restriction created additional compliance costs for taxpayers, and proved to be inconsistent with the purpose of the rule.

Application dates

The amendment will apply to dividends derived by a company on or after the first day of that company's 2010–11 income year, unless the company is a Māori Authority.

For a company that is a Māori Authority, the amendment applies to dividends derived by the Authority on or after the first day of the 2012–13 income year.

The later application date for a Māori Authority ensures that Māori Authority Credits attached to a taxable distribution from a Māori Authority do not give rise to unintended retrospective effects for beneficiaries of a Māori Authority.

Detailed analysis

The purpose of the intra-group dividend exemption within a wholly owned group is to facilitate the movement of capital around a wholly owned group, without taxation being a distortionary or inhibiting factor.

At present, if the paying and receiving companies do not have a common balance date, and the differences in the balance dates are not supported by commercial reasons, the dividend is not exempt.

In practice, the provision did not often apply because companies in a wholly owned group not meeting the common balance date requirement tended to use non-dividend methods to move capital around the wholly owned group company.

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 the submissions and their recommendations on its websites.

In addition, there are also a number of minor drafting matters that have been brought to the attention of the Rewrite Advisory Panel, In general, these amendments consist of corrections of cross-references, spelling, punctuation, terminology, and consistency of drafting. The Rewrite Advisory Panel publishes lists of these maintenance items on its website.

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 Income Tax Act 1994. The Rewrite Advisory Panel performs this review function. The process for making a submission to the Panel is set out in its statement, RAP 001. This statement is published on the Panel's website.

In general, the Panel recommends that a provision is:

- amended to counter the effect of an unintended change; or
- identified in schedule 51 of the 2007 Act; or
- contains no change in outcome when compared to its corresponding provision in the earlier Act.

The Finance and Expenditure Committee also noted in its commentary on the Income Tax Bill that there may be a situation in which: "… the Government of the day decides to retain the rewritten law without retrospective amendment".

The Committee went on to say:

> Such a decision would be a change in policy, and the Inland Revenue Department would be obliged to require taxpayers to meet any increased tax. The department has advised us that it intends to inform taxpayers through an appropriate publication that, in such cases, where taxpayers rely on the transitional provisions, they will be required to meet the tax obligation but will not be subject to penalties, and any use of money interest incurred will be remitted. The taxpayer must have taken reasonable care and adopted a reasonable tax position under the old law. We agree with this approach …

Inland Revenue has published two standard practice statements setting out how it will apply the penalty and interest rules within the context of the comments of the Finance and Expenditure committee referred to above. Those two statements are SPS 08/03, issued in relation to the 2007 Act (published *TIB* Vol 20, No 10, December 2008) and SPS 05/02, issued in relation to the 2004 Act (published *TIB* Vol 17, No 5, July–July 2005).

Application date

Unless otherwise stated all rewrite-related amendments will apply retrospectively, with effect from the beginning of the 2008–09 income year.

DISPOSAL OF PETROLEUM MINING ASSETS TO RELATED PARTIES

Section DT 9 of the Income Tax Act 2004 and the Income Tax Act 2007

Key features

Sections 19 and 197 of the Taxation (Tax Administration and Remedial Matters) Act 2011 amend section DT 9 of the Income Tax Act 2007 and the Income Tax Act 2004 to address an ambiguity identified by the Rewrite Advisory Panel and correct a cross-reference.

Application date

Section DT 9 is amended to restore the effect of the corresponding provisions in the 1994 Act. As this amendment relates to both the 2007 and 2004 Acts, the amendment has retrospective effect to the beginning of the 2005–06 income year.

Detailed analysis

Section DT 9 applies when a petroleum mining asset is disposed of by a petroleum miner to a related party, and unamortised development expenditure forms a part of the cost of the asset. Under the petroleum mining rules, the full amount of development expenditure that is an allowable deduction is taken into account in calculating taxable income over a seven year period, under an amortisation rule.

If the owner of a petroleum mining asset disposes of that asset before the end of the seven-year amortisation period, the balance of the unamortised deduction for the development expenditure included in the cost of the asset is allocated to the year of sale.

However, if a petroleum mining asset is disposed of to a related party within the seven year amortisation period, section DT 9 limits how much of the unamortised deduction for development expenditure can be allocated to the year of sale. That amount is limited to no more than the profit on the sale of the asset. This rule prevents a group of companies creating a deductible loss from the disposal of a petroleum mining asset to a related party.

The amendment removes an ambiguity in section DT 9(1) and corrects the cross-references from section DT 9(2) to refer to section EJ 16(2).

Section DT 9 applies to a petroleum miner who disposes of a petroleum mining asset to an associated person. An ambiguity in section DT 9(1) could result in the petroleum miner having a lower amount of unamortised development expenditure allocated to the income year than would have occurred under the corresponding provisions of the Income Tax Act 1994.

BASE PRICE ADJUSTMENT CALCULATION

Section EW 31(4) of the Income Tax Act 2004 and the Income Tax Act 2007

Key features

Section 34 of the Taxation (Tax Administration and Remedial Matters) Act 2011 improves the cross-referencing for sections EW 31(4) in both the 2004 and 2007 Acts and ensures that the outcome from the interaction between section EW 31(4) and the related interest deduction rules in Part D gives the same outcome as under the corresponding provisions in the 1994 Act.

Application date

The amendment to section EW 31(4) applies, with retrospective effect, from the beginning of the 2005–06 income year.

Detailed analysis

Section EW 31(4) of the 2004 and 2007 Acts requires a taxpayer to perform the base price adjustment for a financial arrangement on disposal or maturity of that financial arrangement. The base price adjustment is a "wash-up" calculation, which requires a taxpayer to compare total cashflows (received and paid) under the terms of the arrangement against the income and deductions from that arrangement.

If the base price adjustment produces a negative result, the negative amount is treated as interest expenditure. The "normal rules" in Part D for the deductibility of interest are applied to determine whether that negative amount is deductible (ie, incurred in deriving income, or carrying on a business, or incurred by certain companies).

If any part of that negative result to the extent it relates to income returned in a prior income year is not deductible under those "normal rules" of deductibility for interest, then section DB 11 provides for a statutory deduction. That statutory deduction is limited to the extent that the negative amount represents a "reversal" of assessable income derived in prior years or in the current income year.

APPORTIONING INTEREST DEDUCTIONS AND WHOLLY OWNED GROUPS

Section FE 6(3) of the Income Tax Act 2004 and the Income Tax Act 2007

Key features

Section 45(3) Taxation (Tax Administration and Remedial Matters) Act 2011) amends section FE 6(3) of the Income Tax Act 2004 and ensures that the interest apportionment provided for under section FE 6 is able to be allocated, electively, across companies within a wholly owned group of companies.

Detailed analysis

Under the 2004 Act, section FG 8(2) provided that, in relation to a wholly owned group of companies, the interest apportionment provided for under section FE 6 could be allocated electively across companies within the group of companies. This rule is a compliance cost reduction measure for wholly owned groups of companies.

This amendment restores to the 2007 Act, the effect of section FG 8(2) of the 2004 Act.

THIN CAPITALISATION – ON-LENDING CONCESSION

Section FE 12(1) of the Income Tax Act 2007

Key features

Section 46 of the Taxation (Tax Administration and Remedial Matters) Act 2011 amends section FE 12(1) of the Income Tax Act 2007 to ensure that a financial institution is able to utilise the on-lending concession in determining whether the thin capitalisation rules apply.

Detailed analysis

Under the thin capitalisation rules, a company controlled by non-residents has its interest deductions reduced if the group debt levels exceed 75% of total group assets. However, a concession applies to allow financial institutions to borrow beyond the 75% threshold if borrowings are on-lent to either:

- a person who is not associated with the taxpayer; or
- a non-resident who also does not operate a business through a fixed establishment in New Zealand.

The concession treats borrowings by the entity as being first used in making advances to other entities. The effect of the rule is that the debt ratio is calculated against mainly fixed assets. In the 2004 Act, the on-lending concession applied to all classes of taxpayers, not just natural persons, as intimated in section FE 12(1) prior to this amendment.

This amendment ensures that the on-lending concession for the thin capitalisation rules includes all classes of taxpayers.

FOREIGN TAX CREDITS AND INCOME WITH MULTIPLE SOURCES

Section LJ 1 of the Income Tax Act 2007

Key features

Section 100 of the Tax (Tax Administration and Remedial Matters) Act 2011 amends section LJ 1(2)(a) of the Income Tax Act 2007 to ensure a taxpayer has a foreign tax credit for foreign tax paid on income sourced outside New Zealand, even if that income also has a source in New Zealand.

Detailed analysis

The Rewrite Advisory Panel agreed with a submission that, under section LJ 1(2)(a) of the 2007 Act, a New Zealand resident taxpayer is prevented, inadvertently, from receiving a foreign tax credit:

- for income sourced in another jurisdiction that is subject to an income tax in that other jurisdiction; and
- or withholding tax paid in the country in which the foreign income is sourced.

Under section LC 1 of the 2004 Act, it was possible for foreign-sourced income to be contemporaneously sourced in New Zealand. An example where this may arise is in relation to a New Zealand resident with an investment business in New Zealand that receives dividends paid from a foreign company (as part of that investment business).

Under the source rules (and associated case law) this dividend is:

- sourced in the country in which the company paying the dividend is resident; and
- sourced in New Zealand as the country in which the business is carried on.

The foreign tax credit rules in the 2004 Act permitted a taxpayer a foreign tax credit for foreign tax paid on this income.

The amendment to section LJ 1(2)(a) restores to the 2007 Act, the effect of section LC 1 of the 2004 Act.

FOREIGN TAX CREDIT – CALCULATION OF NEW ZEALAND TAX PAYABLE ON FOREIGN SOURCED INCOME

Section LJ 5 of the Income Tax Act 2007

Key features

Section 101 of the Taxation (Tax Administration and Remedial Matters) Act 2011 amends section LJ 5 of the Income Tax Act 2007 to ensure that a taxpayer, when determining the amount of their foreign tax credits for foreign sourced income, must take into account any excess of deductions over income from any source (including New Zealand sourced income). This adjustment is made to ensure that the foreign tax credits allowed do not exceed the amount of New Zealand tax payable calculated in relation to the taxpayer's notional income tax liability.

Detailed analysis

The Rewrite Advisory Panel agreed that, prior to this amendment, the formula in section LJ 5(4) of the 2007 Act incorrectly takes into account deductions that are not attributable to any particular income source. This could result in foreign tax credits exceeding the New Zealand tax that is calculated in relation to the taxpayer's net income, after applying a loss balance under section IA 4(1)(a).

This approach ensures that, on an item by item basis, excess deductions incurred in deriving a particular amount of income are spread across all foreign tax credit calculations. The amendments to section LJ 5 clarify a number of points. The clarifications are as follows:

- The calculation, under section LJ 5(2), of the maximum foreign tax credit allowed for each segment of foreign-sourced income is explicitly placed on an income year approach.
- The result of the calculation in section LJ 5(2) cannot give a negative result.
- If the maximum amount of foreign tax credit calculated under section LJ 5(2) exceeds a person's notional income tax liability, the person must apply section LJ 5(4B) to adjust downward each maximum amount of foreign tax credit calculated under section LJ 5(2).
- In the formula in section LJ 5(4B), the meaning of the term "New Zealand tax" is being amended in section LJ 5(4C) to:
  - include all segments of income, wherever sourced; and
  - exclude expenditure that does not satisfy the nexus test under section DA 1, for each segment of income (for example, a deduction under section DB 3 for expenditure incurred in preparing an income tax return).

IMPUTATION CREDIT FOR OVERPAID PROVISIONAL TAX TRANSFERRED WITHIN A GROUP

Sections OB 4(1) and (4) of the Income Tax Act 2007

Key features

Section 112 of the Taxation (Tax Administration and Remedial Matters) Act 2011 amends section OB 4 of the Income Tax Act 2007 to clarify the timing for an imputation credit arising for a company on the transfer of overpaid provisional tax by one company within a wholly owned group of companies to another company in the same group. The timing of this imputation credit is the date the notice of the transfer of the tax is given to the Commissioner.

Detailed analysis

Section MB 33 of the 2004 Act provided that when a company transfers the benefit of its overpaid provisional tax to another company in the same wholly owned group of companies, the transferring company receives a debit to its imputation credit account for the amount of the transferred tax, and the recipient company is treated as having paid the tax and receives a credit for the same amount.

Under the 2004 Act, the date of the debit and credit for this transfer of overpaid provisional tax within a wholly owned group of companies was the date the notice of the transfer was given to the Commissioner.

Section OB 4 is amended to replicate more accurately the effect of the 2004 Act in relation to the timing of an imputation credit arising for a company receiving the benefit of the transfer of overpaid provisional tax from another company in the same wholly owned group of companies.

FURTHER INCOME TAX PAYABLE FOR DEBIT BALANCE IN IMPUTATION CREDIT ACCOUNT

Section OB 67 of the Income Tax Act 2007

Key features

Section 113 of the Taxation (Tax Administration and Remedial Matters) Act 2011 amends section OB 67 of the Income Tax Act 2007 to ensure that an amount of a debit balance of an ICA at the end of one tax year is not counted twice in debit balances of the ICA for the immediately following tax year.

Detailed analysis

This amendment corrects an unintended change to the imputation rules, which could have resulted in an incorrect amount of further income tax being charged than under section OB 67's corresponding provisions in the 2004 Act.

Under the provisions of section ME 9(7)–(9) of the 2004 Act, if the ICA remains in debit throughout the next year, these provisions ensured that one year's debit balance is not counted again as part of the ICA debit balance at the end of the immediately following tax year. This rule prevents double taxation arising for further income tax, because of the same debit amount being included in the debit balance of an ICA for consecutive tax years.

BETA DEBIT RULES

Sections OE 7, OE 8, OP 101 and OP 102 of the Income Tax Act 2007

Key features

Sections 115, 116, 119 and 120 of the Taxation (Tax Administration and Remedial Matters) Act 2011 correct an unintended change in law in sections OE 8 and OP 102 and clarify sections OE 7 and OP 101, all being provisions of the Income Tax Act 2007.

In addition, some retrospective technical amendments have been made to the branch equivalent tax account (BETA) rules.

Background

A BETA is a memorandum account designed to prevent the double New Zealand taxation of income earned through offshore subsidiaries. A BETA debit represents New Zealand tax paid on foreign dividends and is intended to offset tax paid under the controlled foreign company (CFC) rules on the underlying profits. Foreign dividends received by companies are now generally exempt and the BETA mechanism for companies is being removed. The technical changes discussed here are therefore relevant mainly to earlier years.

Key features

A number of minor drafting changes have been made to sections OE 7 and OP 101. These improve the clarity of the provisions and achieve consistency with the position under the Income Tax Act 2004.

In addition, sections OE 8 and OP 102 have been repealed. A technical drafting error allowed a company's entire BETA debit balance to be converted into a tax loss, meaning that BETA debits could offset a New Zealand company's income from all sources, and not just from CFCs. This went beyond the intent of the BETA regime, which was only meant to prevent double taxation of CFC income. A law change was made in December 2007 specifically to address this problem. However, the rewritten Income Tax Act 2007 (enacted in November 2007) included, by mistake, provisions that effectively allowed this practice to continue. The repeal of sections OE 8 and OP 102 addresses this issue.

MEANING OF EMPLOYEE

Section YA 1 "employee" of the Income Tax Act 2007

Key features

Section 130 of the Taxation (Tax Administration and Remedial Matters) Act 2011 amends the definition of "employee" in section YA 1 of the Income Tax Act 2007 to ensure that a shareholder-employee who elects that their employment income not be subject to PAYE is an employee for the purposes of the FBT rules.

Application date

The amendment applies from the beginning of the 2008–09 income year.

However, a savings provision ensures that the retrospective amendment does not apply for a taxpayer who has taken a tax position on the application of the FBT rules prior to 30 November 2010 relying on the definition of employee prior to this amendment.

Detailed analysis

In the 2007 Act, an employee is defined as a person who is entitled to receive income that is subject to PAYE. As a shareholder-employee of a close company (a company with five or fewer shareholders) may elect to opt out of the PAYE rules for employment income derived from the company, a shareholder-employee does not come within the meaning of employee.

The Rewrite Advisory Panel concluded this is an unintended change in law, and noted that a shareholder-employee who opts out of the PAYE rules should be subject to the FBT rules.

The amendment to the definition of "employee" in section YA 1 ensures that the meaning of employee includes shareholder-employees for the purpose of the FBT rules.

TRACING OF SHAREHOLDER INTERESTS

Section YC 11(3) of the Income Tax Act 2007

Key features

Section 131 of the Taxation (Tax Administration and Remedial Matters) Act 2011 amends section YC 11(3) of the Income Tax Act 2007 to clarify that the market value interest referred to is the market value interest in the issuing company.

Detailed analysis

In the 2007 Act, a number of rules for two or more companies depend on whether there are the same ultimate shareholders of those companies. Examples of these rules include the loss carry-forward provisions and the loss grouping provisions, among many others.

To determine who the ultimate shareholders of a company are, the tracing rules look through a chain of companies interposed between the company of interest and the ultimate shareholders. However, in section YC 11, if the company holding the shares is a limited attribution company, that company is treated as the ultimate shareholder if:

- the shareholder company's voting interest or market value interest (without tracing to its shareholders) in the underlying company is less than 50%; or
- the shareholder company is not associated with the issuing company and has an interest of less than 10%.

As section YC 11(3) may refer to more than one limited attribution company, the provision is being amended to clarify that the market value interest referred to in the section are the interests of the issuing company.

LUMP SUM PAYMENTS ON THE OCCASION OF RETIREMENT

Section YZ 3 of the Income Tax Act 2007; section YA 5C and schedule 22A of the Income Tax Act 2004

Background

The Rewrite Advisory Panel considered a submission that the rewrite of section DF 5 of the 1994 Act into section DC 1 of the 2004 Act contained an unintended change. After consideration, the Panel agreed there is an intended change in the law, and this should be indicated in schedule 22A of the 2004 Act.

Section DC 1 allows a deduction for a lump sum payment made on retirement if the payment is not deductible under any other provision of the Act. Under section DC 1, the deduction is allocated to the income year in which the payment is made.

Key features

Schedule 22A of the 2004 Act is amended to identify an intended change in the timing rule in section DC 1, which relates to the timing for lump sum payments made on the occasion of the retirement of a taxpayer. Section DC 1 of the 2004 Act was re-enacted into the 2007 Act, without amendment.

Application date

The amendment to schedule 22A applies from the beginning of the 2005–06 income year.

However, if a taxpayer has taken a tax position, prior to 22 February 2011, in relation to a lump sum payment on retirement, based on the wording of section DF 5 of the 1994 Act, savings provisions in both the 2004 and 2007 Acts (sections YA 5C and YZ 3 respectively) apply. These provisions continue the effect of section DF 5 of the 1994 Act in relation to that tax position.

Detailed analysis

In the 1994 Act, the corresponding provision to section DC 1 was section DF 5. This section allowed a deduction for a lump sum payment made on retirement if the payment is not deductible under any other provision of the Act.

An amendment to this provision in 2002 linked the timing of the deduction for a lump sum payment on retirement to the accrual expenditure rules for monetary remuneration in section EF 1 of the 1994 Act. Under this rule, a payment of a lump sum retiring payment that was monetary remuneration made after the end of an income year, but within the 63 days of the end of an income year, was allocated to the immediately preceding income year to the year in which the payment was made.

However, section DF 5 of the 1994 Act applied only if the payment was not deductible under the general permission.

The history of section DF 5 shows that the Courts have identified just a few limited circumstances to which the provision would be applied. Examples where the Courts have applied section DF 5 (or earlier corresponding rules) include:

- a payment to secure a restraint of trade (ie, a capital payment, and a capital receipt for the former employee). This payment was not monetary remuneration;
- a payment for expenditure incurred after the business has ceased. A payment of this nature incurred after cessation of a business would not satisfy the general permission; and
- an ex gratia payment to a retiring employee. An ex gratia payment deductible under this provision has no connection to employment, nor is it incurred in carrying on a business. Again, timing rules for monetary remuneration were not applicable.

The linkage between section DF 5 and the 63-day rule accrual expenditure rule in section EF 1 of the 1994 Act was considered to have no real effect, and so that linkage was omitted in rewriting section DF 5. That resulted in the timing of the deduction in section DC 1 of the 2004 Act (and in the 2007 Act) being on a payments basis.

REWRITE MAINTENANCE ITEMS

The following provisions, most of which come into force on 1 April 2008, are amended as follows:

- cross-references;
- grammar;
- spelling;
- punctuation;
- terminology and definitions;
- drafting consistency, including readers aids, for example the defined terms lists; and
- some defined terms.

Section	Act	Amendment
CD 32(2)	ITA 2007	Correction to cross-reference
CD 44(7)(b)	ITA 2007	Drafting error corrected
DV 19(1), (4), (6)	ITA 2007	Drafting clarity improved for certain transactions with members of the association
EC 16(3)	ITA 2007	Correction to cross-reference
EC 16(3)	ITA 2004	Correction to cross-reference
EF 5(2)	ITA 2007	Correction of terminology
EF 5(2)	ITA 2004	Correction of terminology
FE 6(3)	ITA 2007	Correction to cross reference
GC 5	ITA 2007	Correction of terminology
IP 4	ITA 2007	Correction of terminology

Section	Act	Amendment
Subpart IQ	ITA 2007	Improve the introductory provisions for subpart IQ, which set out the purpose for subpart IQ (sections IQ 1 and IQ 2)
IQ4	ITA 2007	Improve the clarity of section IQ 4, which permits the grouping of attributed CFC net losses
LJ 7(4)	ITA 2007	Clarify the time for due date of certain payments is 30 days after the later of the two options within the provision
LJ 8(5)	ITA 2007	Clarify the time for due date of certain payments is 30 days after the later of the two options within the provision
LK 1(8)	ITA 2007	Clarify the time for due date of certain payments is 30 days after the later of the two options within the provision
MC 5(2)(a) and (3)	ITA 2007	Correction of terminology
OB 80(2)	ITA 2007	Correction of terminology
RD 5(8)	ITA 2007	Correction to cross-reference
RD 6(1)(a)	ITA 2007	Correction to cross-reference
OZ 5(1)	ITA 2007	Correction to terminology
80KF	TAA	Correction to cross-reference

GAINS ON LIABILITIES OF CONTROLLED FOREIGN COMPANIES

Sections DZ 19, EX 20C and EZ 32C of the Income Tax Act 2007

New and temporary provisions have been added to the Income Tax Act 2007. These provide relief to investors in controlled foreign companies who have been taxed on foreign exchange rate gains on liabilities, if certain requirements are met.

Background

The taxation of investments in controlled foreign companies (CFCs) was reformed in 2009. Investments in CFCs are now taxed only when the CFC earns passive income such as financial arrangement income, royalties and rent.

In unusual cases involving foreign currency loans and significant foreign exchange movements, financial arrangement income may arise from money that a CFC has borrowed; that is, from a liability. This may result in taxation of the investment in the CFC.

In general, it was not intended that a CFC's borrowing on its own would affect its taxation. Even CFCs undertaking entirely active businesses—manufacturing, retailing and so on—need to borrow money to finance their operations. Such CFCs would not be able to claim deductions for financial arrangement expenditure, so taxation of financial arrangement income can result in over-taxation when exchange rates fluctuate.

However, there are concerns that simply ignoring financial arrangement income from liabilities might open a loophole. Indeed, legislation was enacted to close such a loophole in the old controlled foreign company rules.

Therefore, as a temporary solution to the problem that has been identified, deductions for some financial arrangement expenditure are instead allowed to offset taxation of financial arrangement income.

This solution applies only to holding companies in a narrow range of circumstances. Further work is being undertaken to establish whether a more comprehensive but less complex solution can be developed that does not pose unacceptable risks to the tax base.

Key features

Investors in a CFC may be entitled to claim deductions for financial arrangement expenditure that would otherwise be denied under section EX 20C(2) because the item "fraction" in the formula in that section would be less than 1, if the CFC:

- is not a banking or insurance business and is not controlled by one;
- has a main activity of borrowing to invest in shares in foreign companies that it controls;
- has financial arrangements that are liabilities providing funds to the CFC (loans);
- has net foreign currency gains or losses on the loans, and any net currency gains included in the investors' income exceed the total net currency gains or losses; and
- has net gains (taking into account the whole arrangement, not just currency movements) from the loans that are included in the investor's income.

Net gains and losses are to be calculated over a period that will generally include the current year and the preceding four years (the offset period).

In such cases, the excess of the net currency gains that are taxed over the total net currency gains is available to reverse the denial of deductions, including denial in a prior period within the offset period.

However, the total reversal of denied deductions may never exceed the total net gains (currency or otherwise) from the arrangements in question. That is, relief provided by the new provision will never go further than effectively ignoring the arrangements altogether.

If the investor has a net loss from the CFC as a result of reversing the denial of deductions, or an increased net loss, the loss or increase in the loss may be carried back to an earlier year in the offset period.

The amount of loss that may be carried back to a year must not exceed the lesser of:

- the amount of net income in that year that is due to currency movements on loans; or
- the amount of net income in that year from the loans (whether due to currency movements or otherwise).

The new provisions apply on a per-CFC basis. It is not possible to average currency movements across CFCs.

Application date

The new provisions are temporary. They apply for income years beginning on or after 1 July 2009 and ending before 1 July 2013.

Detailed analysis

Subsection EZ 32C(1) – when the provision applies

The new provision in section EZ 32C applies if a number of conditions are met.

Paragraph (a) – CFC not involved in banking or insurance

If the CFC is in the business of banking or insurance, or is controlled by a person in a business of banking or insurance, the provision does not apply.

Paragraph (b) – CFC's main activity is borrowing to invest in shares

The provision does not apply unless the CFC's main activity is borrowing to invest in shares in foreign companies that it controls.

That is, the provision is intended only for use by holding companies which debt-fund the capitalisation of subsidiaries.

Paragraph (c) – CFC has loans and anti-avoidance rule does not apply

For the provision to apply, the CFC must be a party to financial arrangements that are liabilities of the CFC and that provide funds for the CFC (put briefly, loans). The provision is intended only to relieve tax effects that arise from currency gains on money the CFC has borrowed.

In addition, at the time the financial arrangement is entered into, or at a later time when the terms of the arrangement are altered, there must not be any reasonable expectation that the CFC will have more income than expenditure from the financial arrangement.

This is an anti-avoidance rule to prevent use of the provision when, through manipulation, a person might deliberately create income from a liability to take advantage of the relief offered.

The provision is meant to apply in the much more likely situation that a person has taken a loan on arm's-length terms with an expectation that there will be net expenditure on the loan (interest expenditure will exceed net exchange rate gains).

Paragraphs (d) and (e) – CFC is affected by currency movements on its loans, and calculation of loan currency amount

As a result of foreign exchange rate movements the CFC must have had gains or losses from its loans in at least two periods within a certain period (usually a five-year period, but see subsection (9)). The provision is only useful when there is an exchange rate loss that has been effectively ignored in one period, but a gain in another that has been taxed.

The example below is a loan denominated in United States dollars. Conversion to New Zealand dollars required under section EX 21(7), along with movements in the NZD–USD exchange rate, lead to increases or decreases of the outstanding loan principal. Those increases or decreases are gains or losses.

The amount of currency gain or loss for a particular loan in a particular income year is called the *loan currency amount*.

Example

CFC Co has an interest-only loan of US$100 million, which it takes out at the end of the 2010 income year.

The NZD–USD exchange rate at the beginning of the 2011 year is 0.76. At the end of the 2011 year it is 0.74. There is a currency loss of $100 \div 0.74 - 100 \div 0.76 = \text{NZ\$}3.6$ million, and a loan currency amount of −$3.6 million.

The exchange rate at the end of the 2012 year returns to 0.76. There is a currency gain of NZ$3.6 million and a loan currency amount of +$3.6 million.

NEW LEGISLATION

Paragraphs (f) and (g) – there has been expenditure relating to the loan in a period and some of the expenditure has not been taken into account for tax purposes

The provision is only useful if there has been some denial of deductions for financial arrangement expenditure under section EX 20C(2) because the item fraction is less than one. The effect of the provision is to reverse some or all of the denial in such a case.

Paragraph (f) contains the requirement that a loan currency amount must have been included in the calculation of expenditure that contributes to the item "limited funding costs" in the formula in section EX 20C(2), limited funding costs being subject to multiplication by the item "fraction".

Paragraph (g) contains the requirement that the item fraction, in the year that limited funding costs includes a contribution from a loan currency amount, is less than 1.

Paragraph (h) – person chooses to use the provision or has used it in the past

Use of the new provision in section EZ 32C is optional. It does not apply unless the taxpayer elects to apply it.

However, once it has been used to reduce income or increase loss in an income year, it must continue to be used in every later income year.

Subsections (2) and (3) – calculation of included currency amount

If all the requirements in subsection (1) are met, the provision in EZ 32C operates firstly by comparing amounts of currency gain or loss (*loan currency amounts* determined in subsection (1)) to amounts of currency gain or loss that would be subjected to tax under the CFC rules.

Roughly speaking, if more net gain would be subjected to tax than has actually arisen, then the difference should be available to relieve tax obligations.

Subsection (2) defines amounts of currency gain or loss that would be subjected to tax under the CFC rules. These are called *included currency amounts*. Subsection (3) defines the items used in the formula in subsection (2).

A loan currency amount for a particular arrangement and a particular year is an included currency amount to the extent it contributes to items in the formula for net attributable CFC income or loss in subsection EX 20C(2), other than the item "later losses" in that formula. Where the loan currency amount contributes to more than one item, a separate included currency amount is calculated for each item.

Example

CFC Co has financial arrangement income of $50 million for the 2011 income year. This consists of an interest expense of $150 million and a loan currency amount of $200 million (a gain). The $50 million is all included in the item attributable CFC. Therefore, the loan currency amount is also included in the item attributable CFC and the included currency amount is $200 million.

If the loan currency amount relates to a financial arrangement for which there is income in the relevant year, then to the extent that the loan currency amount is included in the item "attributable CFC" in the formula in section EX 20C(2), the loan currency amount is an included currency amount.

If the loan currency amount relates to a financial arrangement for which there is financial arrangement expenditure in the relevant year, then there are two ways in which the amount may be an included currency amount.

Firstly, to the extent the expenditure contributes to the item "other deductions" in the formula, the loan currency amount is an included currency amount. And secondly, to the extent the expenditure contributes to the item "limited funding costs" in the formula and is not reduced by the item "fraction", the loan currency amount is also an included currency amount.

Example

Alter Co, a CFC, has borrowed money and on-lent 40% of the money to an associated active CFC. Apart from the on-lent money, 80% of Alter Co's assets produce active (non-attributable) income. Because of its borrowing, Alter Co has financial arrangement expenditure of $10 million for the 2018 income year. This consists of an interest expense of $5 million and a loan currency amount of –$5 million (a $5 million currency loss).

$2 million of the $5 million currency loss is included in the item "other deductions" in the formula in section EX 20C(2). That is, 40% of the $5 million loss is not part of limited funding costs under subsection EX 20C(5). The $2 million is fully deductible under paragraph EX 20C(9)(b). The included currency amount is –$2 million (–$10 million × 50% × 100% × 40% = –$2 million).

$3 million of the $5 million currency loss is included in the item "limited funding costs" in the formula in section EX 20C(2). The item "fraction" is 20% because Alter Co has 20% of its assets that generate attributable income. Therefore, the included currency amount is –$0.6 million (–$10 million × 50% × 20% × 60%).

Total included currency amounts for the 2018 year are –$2.6 million.

In summary:

	$m	
Loan currency amount	–5	
Other amounts	–5	
Loan currency amount as percentage of total	50%	[1]
Contribution of loan currency amount to other deductions	–2	(40% × –10 × [1]) [2]
Applicable fraction	100%	[3]
Included currency amount	**–2**	**[2] × [3] = [4]**
Contribution of loan currency amount to limited funding costs	–3	(60% × –10 × [1]) [5]
Applicable fraction	20%	[6]
Included currency amount	**–0.6**	**[5] × [6]**

Example

CFC Co has financial arrangement expenditure of $350 million for the 2012 income year. This consists of an interest expense of $150 million and a loan currency amount of –$200 million (a loss). This $350 million is all included in the item "limited funding costs" in the formula in section EX 20C(2). However, the item "fraction" in the formula in section EX 20C(2) is zero because CFC Co has no assets that generate attributable income. Therefore, the included currency amount is zero.

Example

Fortune Co has financial arrangement income of $1 million for the 2011 income year. This consists of an interest expense of $150 million and a loan currency amount of $151 million (a gain). The $1 million is all included in the item "attributable CFC" in the formula in section EX 20C(2). Therefore, the included currency amount is $151 million.

Short Co has financial arrangement expenditure of $1 million for the 2011 income year. This consists of an interest expense of $150 million and a loan currency amount of $149 million (a gain). The $1 million is all included in the item limited funding costs in the formula in section EX 20C(2). Short Co has no assets that generate attributable income, so the item fraction in the formula in section EX 20C(2) is zero and the included currency amount is also zero.

When the included currency amounts exceed the loan currency amounts for a CFC, the excess may be available to reverse the effective denial of deductions in section EX 20C(2) (if the item fraction is less than 1). To the extent effective denial is reversed, part of the excess is not available to be used again. This is reflected in the item *earlier adjustments* in the formula in subsection EZ 32C(2).

Example

CFC Co's included currency amounts for 2011 and 2012, before taking into account earlier adjustments, are $200 million. This amount exceeds the total of loan currency amounts, which is nil, by $200 million.

Suppose that once the calculation for 2011 and 2012 is done, $50 million of the excess is able to be applied to effectively increase deductions in the 2011 year.

In 2013, and assuming no further exchange rate change, the total of included currency amounts for the period 2011–2013 will be $150 million, being $200 million less $50 million of earlier adjustments. The excess of this amount over total loan currency amounts is $150 million, which is the amount that may be available to provide further relief.

Subsection (4) – when denial of deductions may be reversed

Subsection (4) states that effective denial of deductions may be reversed when the included currency amounts are both positive and in excess of the loan currency amounts. That is, when more net currency gain has been taxed than has actually arisen.

Subsection (4) is a precondition. Effective reversal of denial actually occurs in subsection (7). The reversal of denial makes nil or negative included currency amounts more negative; that is, it decreases nil or negative included amounts.

Subsections (5) and (6) – amount available for reversing denial of deductions

Subsection (5) says that the amount of denial that may be reversed is limited to the lowest of three amounts calculated for the CFC.

The first amount is the total of the included currency amounts for the offset period (subsection (9) describes the offset period). Relief will never exceed the amount of net currency gain that has actually been brought to tax.

The second amount is the excess of the total included currency amounts over the total loan currency amounts for the offset period. Relief is only available to the extent that the taxable net gain exceeds the actual net gain.

The third amount is the total of *all* amounts brought to tax under the relevant financial arrangements for the offset period, including currency gains or losses but also any other contributions. Relief is only available to the extent some net income has been brought to tax over the period (no relief is given if there has been net expenditure allowed in the calculation of net attributable CFC income or loss, even if the allowed expenditure is less than total net expenditure). The detailed calculation of total amounts is given by paragraph (5)(c) and subsection (6).

The maximum amount of denial that may be reversed is called the total current adjustment.

Paragraph (5)(c) and subsection (6) – calculating total contributions of the financial arrangement

The formula for the total of all amounts brought to tax under the relevant financial arrangement follows the model in subsections (2) and (3). However, instead of including all or part of currency gains or losses, all or part of all income or expenditure under the arrangement is included.

Example

CFC Co has financial arrangement income of $50 million in 2011, consisting of a $200 million foreign exchange gain and a $150 million interest expense, and financial arrangement expenditure of $350 million in 2012, consisting of a $200 million foreign exchange loss and $150 million of interest expenditure.

The total of the loan currency amounts in 2011 and 2012 is $0. The item fraction is zero in the formula in section EX 20C(2), so that the total of included currency amounts for 2011 and 2012 is $200 million. Thus, the excess of included currency amounts over loan currency amounts is $200 million.

In the formula in paragraph (5)(c) the loan contribution made in 2011 is $50 million and fraction is 1. In 2012, the loan contribution is –$350 million and fraction is 0. As a result, the total current adjustment is limited to $50 million.

Subsections (7) and (8) – how to reverse effective denial

The total current adjustment is to be applied to reverse effective denial of deductions; that is, to allow more financial arrangement expenditure to be taken into account when it relates to currency movements and has been limited by a fraction that is less than 1 in section EX 20C(2).

Effective denial may be reversed in the current year or in any of the prior years in the offset period.

Subsection (7) requires that the total current adjustment be first used in the current accounting period of the CFC (the year for which the total current adjustment is calculated, referred to in subsection (1)). Any amounts remaining may then be used in earlier periods in the offset period, beginning with the earliest period.

Within an accounting period, cases are identified in which included currency amounts are nil or negative but would have been more negative but for the item fraction being less than 1 in section EX 20C(2).

Example

Esra Co has two loans. In 2011, there is financial arrangement income of $50 from loan 1, comprising a $200 currency gain and $150 of interest expense. There is financial arrangement expenditure of $350 from loan 2, comprising a $200 currency loss and $150 of interest expense. The item fraction in the formula in section EX 20C(2) is zero.

For loan 1, there is no difference, since the included currency amount is positive. For loan 2, there is a difference of $200, being the positive amount subtracted from the included currency amount ($0) to get the loan currency amount (–$200).

The difference of $200 is able to be reduced if there is a total current adjustment. Since the total current adjustment in 2011 is only $50 (because of the item in paragraph (5) (c)) not all of the $200 can actually be reduced in 2011, and $150 will remain available to be reduced if there are suitable currency movements in later years.

The formula in paragraph (d) is applied to allocate the total current adjustment across the positive differences found in paragraph (c).

If the total current adjustment is enough to reduce all positive differences in the accounting period, any remaining amount is available to be used in other years in the offset period.

Example

Luc Co has two loans. In 2011, there is financial arrangement expenditure of $250 from loan 1, comprising a $100 currency loss and $150 of interest expense. There is financial arrangement expenditure of $100 from loan 2, comprising a $50 currency gain and $150 of interest expense. The item fraction in the formula in section EX 20C(2) is 0.5 at all times.

For loan 1, there is a difference of $50 (the positive amount subtracted from –$50 to get –$100). For loan 2, there is no difference because the included currency amount is positive.

In 2011, the total current adjustment is zero, so no amount is actually applied to loan 1 at that time.

In 2012, there is financial arrangement income of $50 from loan 1 ($200 of currency gain and $150 of interest expense) and financial arrangement income of $150 from loan 2 ($300 of currency gain and $150 of interest expense).

For loans 1 and 2 in 2012, there is no available difference since included currency amounts are positive.

The total current adjustment for 2012 is $25. There is nothing to apply this to in 2012. However, the difference of $50 for loan 1 remains available in 2011. The total current adjustment of $25 may be applied to that arrangement in the 2011 income year.

If the total current adjustment is not enough to reduce all positive differences in the accounting period, the total current adjustment is to be used on a pro-rata basis to reduce all the positive differences.

Example

Lana Co has three loans. In 2011, there is financial arrangement income of $50 from loan 1, comprising a $200 currency gain and $150 of interest expense.

Loans 2 and 3 are identical. There is financial arrangement expenditure of $175 from each, comprising a $100 currency loss and $75 of interest expense. The item fraction in the formula in section EX 20C(2) is zero.

For loan 1, there is no available difference. For each of loans 2 and 3, there is a difference of $100.

The total current adjustment for 2011 is $50. This is allocated according to the formula in paragraph (7)(d), giving $100 × $50 ÷ $200 = $25. $25 is applied to each of loans 2 and 3 in the 2011 year.

Subsection (9) – when current period is able to be adjusted (the offset period)

Subsection (9) gives the periods in which, for any year in which section EZ 32C is applied, adjustments may be made. This is referred to in subsection (1) as the offset period, and is also the period from which figures are included for the calculations in subsections (4) and (5).

In general, the offset period is the current accounting period (when section EZ 32C is applied), as well as the previous four accounting periods.

However, it does not include any period corresponding to an income year that ends before 1 July 2009. This means that only years in which the new CFC rules apply (they were introduced in 2009) are included in the offset period.

The offset period may be shortened if the CFC has changed its residence or if its ownership has changed. This is intended as a safeguard against relief being transferred between jurisdictions or taxpayers.

Subsections (10) and (11) – adjustment of income

The application of section (7) results in decreased net attributable CFC income or increased net attributable CFC loss in the current year or an earlier year in the offset period, through the item *later losses* in the formula in section EX 20C(2) and subsection (10). It also results in increased financial arrangement expenditure for the relevant financial arrangement, in the unlikely event that such expenditure has not already been included, for the purposes of any base price adjustment, through subsection (11).

Subsection (12) and section DZ 19 – carrying back losses

Subsection (12) and section DZ 19 permit certain losses resulting from the application of section EX 32C to be carried back from an income year to an earlier year in the offset period.

This treatment may result in tax paid in an earlier year (because of currency gains at that time) being refunded in a later year because of subsequent currency losses.

The amount of loss that may be carried back may not reduce net income or increase net loss in the earlier year by more than would have been the case had all loan currency amounts in the year been reduced to nil or the relevant financial arrangements been completely ignored in that year.

Complete example

Example

CFC Co has no passive assets at any time, so that the item fraction in section EX 20C is always zero. It has a loan of US$1 billion.

In 2011, it makes a foreign exchange gain of NZ$200 million on the loan and has a NZ$150 million interest expense (after currency conversion). In the formula in section EZ 32C(2), the item "currency contribution" is NZ$200 million and the amount fraction is 1, giving an included currency amount of $200 million (and a loan currency amount of $200 million). The amount under section EZ 32C(5)(c) would be $50 million, being the amount included in the item attributable CFC.

In 2012, CFC Co makes a foreign exchange loss of NZ$200 million and has a NZ$150 million interest expense. The item "currency contribution" is – NZ$200 million and the amount fraction is 0, giving an included currency amount of $0 (and a loan currency amount of –$200 million). The amount under section EZ 32C(5)(C) would be zero because the item fraction in EX 20C(2) is zero.

The total amount of loan currency amounts is $0 and the total of included currency amounts is $200 million. This means that, in principle, up to $200 million is available for adjustments. However, summing the total amounts of arrangement income and expenditure (not just those due to currency) gives $50 million, so the total current adjustment in 2012 is limited to $50 million. This is allocated against the 2012 year, so that "later losses" in section EX 20C(2) becomes $50 million and $50 million is subtracted from net attributed CFC income or loss.

Suppose that the CFC has no income or loss other than from its loan and the CFC investor has no income or loss from other sources. Then there is a $50 million loss as a result of the operation of sections EZ 32C(7) and (10).

In 2011, if the loan had not been denominated in a foreign currency there would have been no net income, as opposed to $50 million of net income. Similarly, if the loan had not existed there would have been no net income. Therefore, the amount given by subsection EZ 32C(13) in relation to the 2011 year is $50 million. The loss of $50 million in the 2012 year may be carried back to 2011, leading to a refund of income tax paid on 2011 income. The loss then ceases to be available in the 2012 year.

In 2013, suppose that there is income from the arrangement of $100 million, made up of a foreign exchange gain of $250 million and interest expense of $150 million. At the end of 2013, the total current adjustment amount will be $100 million (note that this is after removal of $50 million because of the earlier adjustment made in 2012). This amount of $100 million will be available to apply to the 2012 year.

THIN CAPITALISATION – CONCESSION FOR GROUPS WITH LOW INTEREST DEDUCTIONS

Section FE 6 of the Income Tax Act 2007

Section FE 6, which includes a concession for groups of companies with low deductions for interest paid, has been amended to ensure it works as intended.

Analysis

The Taxation (International Taxation, Life Insurance and Remedial Matters) Act 2009 widened the thin capitalisation rules in subpart FE to include New Zealand groups with investments in controlled foreign companies.

The wider rules included a concession for groups with deductible interest expenses of less than $2,000,000. If the expenses were less than $1,000,000 the thin capitalisation rules effectively did not apply at all. If the expenses were between $1,000,000 and $2,000,000 the thin capitalisation rules had limited effect.

The intention was always that when applying the concession, the relevant limits would be deductible interest expenses of the relevant group rather than the expenses of an individual taxpayer within the group. However, this was not reflected in the legislation as originally enacted.

Subparagraphs FE 6(3)(ac)(ii) to (iv) have been amended to make it clear that the concession relates to the interest deductions of the New Zealand group of a taxpayer.

Example

There are two members in the New Zealand group; X Co and Y Co. X Co has a "total deduction" amount under section FE 6(3)(a) of $0.7 million and Y Co has a total deduction amount of $0.5 million.

The group finance cost is $1.2 million. Since this is between $1 million and $2 million, subparagraph (iii) applies. $800,000 is the amount by which $2 million exceeds the group finance cost.

For X Co, the ratio of the member finance cost to the group finance cost is $0.7 million ÷ 1.2 million = 7/12. The amount "adjust" in the formula in section FE 6(2) is therefore 7/12 × $800,000 = $466,667. For Y Co, "adjust" is $333,333.

Application date

The amendments apply from the date of introduction of the Taxation (Tax Administration and Remedial Matters) Bill, being 23 November 2010.

RING-FENCED LOSSES OF CONTROLLED FOREIGN COMPANIES – LOSSES INCURRED PRIOR TO ACTIVE INCOME EXEMPTION

Section IQ 2 of the Income Tax Act 2007

Section IQ 2 has been substantially redrafted as part of an exercise to improve the clarity of subpart IQ in the rewritten Income Tax Act.

One effect of the redrafting is to clarify the application of the transitional rules in section IQ 2B. Section IQ 2B applies to losses incurred before an active income exemption for controlled foreign companies was introduced.

It is now clear that section IQ 2B applies to losses made available to a taxpayer by other companies in the same group, as well as to the taxpayer's own carried-forward losses.

Application date

The relevant changes apply for income years beginning on or after 1 July 2009.

FIXED-RATE SHARE REMEDIAL AMENDMENT

Sections EX 46(10)(a) and YA 1 of the Income Tax Act 2007

Section EX 46(10)(a) has been amended to fix an error that affects foreign fixed-rate shares held by individuals and trustees. Persons who have already filed tax returns will not face any additional tax, whether they had been applying the rules as they were intended to be applied or applied them in accordance with the unintended change.

Background

The fair dividend rate method, which is the standard way of taxing offshore portfolio investment, is not available for certain debt-like investments referred to in the legislation as "non-ordinary shares".

The definition of a non-ordinary share is contained in section EX 46(10). Prior to 2009 section EX 46(10)(a) referred to "a fixed-rate share". This was changed to "fixed-rate foreign equity" in 2009, which had the unintended consequence of limiting the provision to fixed-rate shares held by companies (whereas previously it also applied to individuals and trustees).

Key features

The reference to "fixed-rate foreign equity" in section EX 46(10)(a) is changed to "a fixed-rate share". This is necessary because the definition of "fixed-rate foreign equity" in section YA 1 is limited to fixed-rate shares that are held by companies and so would exclude fixed-rate shares held by individuals and trusts.

In addition, some cross-references to section EX 46(10)(a) and subpart FE have been inserted into the section YA 1 definition of "fixed-rate share". These cross-references clarify the definition of "fixed-rate share" that applies in these cases (as the definition of "fixed-rate share" can have slightly different meanings in different parts of the Act).

Application date

The amendment to section EX 46(10)(a) generally applies to income years beginning on or after 1 July 2009. However, in respect of those tax returns that have been filed for an income year beginning after 1 July 2009 and before 29 August 2011 any affected taxpayers are able to choose to retain the tax position that they included in those returns. This ensures that these taxpayers do not face any additional tax, whether they had been applying the rules as they were intended to be applied or applied them in accordance with the unintended change.

The new cross-references to section EX 46(10)(a) and subpart FE in the section YA 1 definition of "fixed-rate share" apply to income years beginning on or after 1 July 2009.

INTEGRAL FEES WHERE THE MODIFIED FAIR VALUE METHOD APPLIES

Sections EW 15(1)(a)(ii) and (b)(ii) of the Income Tax Act 2004 and the Income Tax Act 2007

Key features

The modified fair value spreading method is based on the fair value method and the consideration for the latter method is defined to ignore non-integral fees (an IFRS GAAP term). The consideration for the modified fair value method should also ignore non-integral fees. This was an oversight in the original legislation which has been amended by the Taxation (Tax Administration and Remedial Matters) Act 2011.

Application dates

The amendments apply retrospectively from the application dates of the original legislation.

ANTI-ARBITRAGE RULES FOR THE USE OF THE FAIR VALUE METHOD

Section EW 15D(2B)(b) of the Income Tax Act 2007

Key features

The anti-arbitrage rules were amended in 2009 to get them working as they were originally proposed, being to prevent income and expenditure being deferred/advanced on two financial arrangements which are in an IFRS designated hedging relationship. However, in amending the rules last year the ability to use the fair value method for financial arrangements which are used to hedge other financial arrangements (being agreements for the sale and purchase of property in foreign currency subject to determination G29) has been inadvertently denied. This oversight has been corrected in the Taxation (Tax Administration and Remedial Matters) Act 2011 and is very specific in its terms. No other changes to the application of the anti-arbitrage rules or the taxation of the other financial arrangements under Determination G29 are intended to result from this correction.

Application dates

The amendments apply retrospectively from the application dates of the original legislation.

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

DETERMINATION DEP78: TAX DEPRECIATION RATES GENERAL DETERMINATION NUMBER 78

1. Application

This determination applies to taxpayers who own depreciable property of the kind listed in the table below.

This determination applies from the 2010–11 and subsequent income years.

2. Determination

Pursuant to section 91AAF of the Tax Administration Act 1994 the general determination will apply to the kind of items of depreciable property listed in the table below by:

- adding into the "Manufacturers (not elsewhere specified)" and the "Shops" industry categories a new asset class, estimated useful life, and general diminishing value and straight line depreciation rates as listed below.

Asset class	Estimated useful life (years)	DV rate (%)	SL rate (%)
Plumbing display products and custom display stand	5	40	30

3. 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 9th day of September 2011.

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.

SUPREME COURT FINDS INCOME DIVERSION TO BE AVOIDANCE

Case	Penny and Hooper v Commissioner of Inland Revenue
Decision date	24 August 2011
Act(s)	Income Tax Act 1994, Tax Administration Act 1994
Keywords	Avoidance, income splitting, income diversion, commercially realistic salary, evidence exclusion

Summary

Two surgeons who used companies and trusts to divert what was previously personal income were held by the Supreme Court to have avoided tax under section BG 1 of the Income Tax Act 1994 ("ITA"). The structures they used were of themselves legitimate, but they were used in conjunction with artificially low salaries, paid to the surgeons personally, which amounted to tax avoidance.

Impact of decision

The Commissioner has released a revised revenue alert setting out his views on the practical implications of this highly precedential decision. The revenue alert can be found at **www.ird.govt.nz** (keyword: RA11/02) and in this issue of the *TIB*.

Facts

The two plaintiffs are orthopaedic surgeons. Each practices in both the public and private sector. Initially each practiced on their own account but after a period they each incorporated their practices. Each surgeon was then employed by their company to undertake the services they provided as sole practitioners.

Mr Hooper began practicing in the private sector in 1989. The practice operated from a shared orthopaedic centre. In 1991, Mr Hooper and his wife were settlors of two "mirror trusts". The trustees of both trusts were their solicitor and their accountant. The beneficiaries were the spouse, children and grandchildren. The trusts were established to buy a share of the premises occupied by Mr Hooper. In 2000, the practice arrangement was "restructured" and Hooper Orthopaedic Limited ("HOL") was formed. Mr Hooper was the sole company director. Mr Hooper then sold his practice to HOL. HOL employed Mr Hooper for a salary of $119,990 between 2001 and 2003. He was the sole orthopaedic surgeon employed by HOL and as sole director he determined the salary. HOL received patient fees as income. HOL derived $593,914 from patient fees in 2001, $447,915 in 2002, and $502,882 in 2003. During this time the mirror trusts received fully imputed dividends from HOL.

Mr Penny commenced practice as a private orthopaedic specialist in 1991. In 1997, he incorporated Penny Orthopaedic Services Limited ("POS") of which he was the sole shareholder. He also set up Orthopaedic Surgical Consulting Limited ("OSCL") and AC Penny Trust No 1 ("the Trust"). All shares in POS were owned by the Trust. The premises from which Mr Penny worked were initially leased by Mr Penny to POS and were later sold to the Trust. His orthopaedic practice was transferred to POS in February 1997. In April 1997, OSCL purchased the surgical and medical practice and goodwill from POS. After the restructuring, OSCL became Mr Penny's employer. OSCL received the patient fees as income. OSCL had incomes of $484,779 in 2001, $609,871 in 2002, and $566,183 in 2003. In each of those three years his salary was set at $99,996.

The salary alterations took effect around the time the top marginal tax rate was increased from 33 to 39 cents in the dollar.

The case summaries published in respect of the High Court and Court of Appeal decisions can be found in the "Case notes 2010" section of our website at **www.ird.govt.nz**

Decision

The Court held unanimously that the arrangements constituted tax avoidance.

In a preliminary matter, the Court considered the operation of the evidence exclusion rule in section 138G of the Tax Administration Act 1994 ("TAA"). The Appellants argued that the Commissioner's evidence about loans made to the taxpayers by the Trust was excluded under section 138G of the TAA. The Commissioner, they argued, had not set these facts out as part of the "arrangement" until after the discovery process. The Court held that such was the function of discovery that these facts were not disclosed until then, and that in any event, the Commissioner was entitled to respond to certain statements in Mr Penny's SOP which entrained the loan issue.

The Commissioner had also argued that large parts of Mr Shewan's evidence in the High Court were inadmissible. The Supreme Court upheld the Court of Appeal's decision to disregard such argument in the guise of evidence. It went further to state:

> It is undesirable and wasteful of time and effort of both parties when such material appears in expert briefs of evidence. The practice of including it should stop. If it persists, courts should require amended briefs to be filed.

On the substantive tax avoidance issue, the Court noted at the outset that the case differed from *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289. The Court stated that there was nothing wrong with the structure the Appellants had adopted, and that the use of such a "familiar trading structure" was a choice they were entitled to make.

Neither was there anything wrong with the Appellants being employed within that structure on a salaried basis. Further, the Court said there was nothing in the ITA that required salaries to be set at any particular level. There was thus no issue with any failure to comply with any express provision of the ITA and it was possible to move straight to a consideration of section BG 1.

The Court considered there were some instances where such an arrangement might not amount to tax avoidance, such as setting a salary to absorb profits, or to allow for business development or meet financial difficulties. However, "… if the setting of the annual salary is influenced in more than an incidental way by a consideration of the impact of taxation, the use of the structure in that way will be tax avoidance".

The Court then examined why the Appellants' salaries were set at the level they were. In so doing, the Court discounted arguments that such structuring minimised exposure to professional negligence claims. It noted that such protection already existed through accident compensation and insurance cover. The Court also observed that Mr Penny immediately borrowed the money back so that it "never left his hands".

This was not a revolutionary concept the Court said, referring to the 50-year-old Privy Council case of *Peate v Commissioner of Taxation of Commonwealth of Australia* (1962–1964) 111 CLR 443, which concerned eight doctors restructuring a partnership into company shareholdings. In particular, the Court took notice of dicta within the decision of the High Court of Australia. As in the present matter, the Court in *Peate* found that it was not the novelty of trading through corporate structures that was offensive, but the way they used those structures to obtain tax advantages. Legislative and mechanical differences (such as reconstruction rules) had no bearing on the applicability of this authority to the present dispute.

Analysing other authorities, the Court held that the role of section BG 1 was, following *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA), to be "… able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages". Nor did any specific anti-avoidance rules (such as the Personal Services Attribution "PSA" rules) override the general anti-avoidance provision, which continues to have a residual function.

The Appellants argued that there was no concept of a "commercially realistic salary" within the ITA. The Court in response agreed that the choice of structures was open to taxpayers to address commercial or family needs. However, that can not be the case where a more than merely incidental purpose of the reduced salary is to obtain tax advantages. It also noted that legislation sometimes sanctions the choice of a lower tax rate, such as with the PIE regime (Portfolio Investment Entities), but such parliamentary contemplation must be obvious.

The Court considered also the applicability of two earlier authorities; *Hadlee v Commissioner of Inland Revenue* [1991] 3 NZLR 517 ("*Hadlee*") and *Loader v Commissioner of Inland Revenue* [1974] 2 NZLR 472 (SC) ("*Loader*"). In the former, the Appellants argued that the context differed from the present matter and that an assignment was not to be compared with an outright sale. The Court considered that the case was nonetheless analogous but left open the question of whether *Hadlee* has wider application. In the case of *Loader*, a similar company/trust structure was set up to conduct an earthmoving business, and the taxpayer's salary was set at a level that left the company with substantial profits. Cooke J had held that the arrangement was not tax avoidance as there were accepted business and family reasons for so doing. The Court considered while tax saving was a motive, it was purely incidental and the Commissioner's attack on the arrangement was centred on the formation of the company rather than the setting of the salary level. Accordingly, the case was of little support to the Appellants' arguments in this case.

Result

The appeal was dismissed with costs of $25,000 and reasonable disbursements to the Commissioner.

ACCESS OPERATIONS JUDICIAL REVIEW

Case	Tauber & Ors v Commissioner of Inland Revenue
Decision date	12 August 2011
Act(s)	Tax Administration Act 1994, Judicature Amendment Act 1972, New Zealand Bill of Rights Act 1990, Declaratory Judgments Act 1908
Keywords	Judicial review, section 16, access operations, search and seizure, reasonableness, lawfulness, validity

Summary

Judicial review proceedings were filed by the applicants challenging the lawfulness and reasonableness of search and seizure operations undertaken by the Commissioner, pursuant to section 16 of the Tax Administration Act 1994 ("TAA"), on a number of business premises and private residences.

Impact of decision

The Judge found no fault in the procedures followed by the Commissioner's access and removal teams, and shows they were methodical, justifiable and not unreasonable.

The judgment also confirms the decision of *Avowal Administrative Attorneys Ltd v District Court at North Shore* [2010] 2 NZLR 794 ("*Avowal*"). That is that the statutory form of warrant is sufficient; the Commissioner need not exhaust alternative investigatory powers before relying on section 16 of the TAA; and other persons may accompany the officer executing the warrants so long as their presence is necessary for the effective exercise of the search and inspection powers.

The judgment highlights that judicial review is an inappropriate mechanism to challenge the issue, validity and execution of a search warrant. Fact-intensive issues of the reasonableness of the search and/or the excessiveness of any seizure are not appropriate in a judicial review context.

Facts

On 16 March 2011, as part of his investigation into the tax affairs of Messrs Tauber and Webb and entities associated with them, the Commissioner executed access and removal warrants in respect of residential and commercial premises in Auckland and Hamilton. A total of eight sites were accessed: six in Auckland and two in Hamilton.

A total of 111 boxes of hard-copy books and documents were removed, along with approximately 9.5 terabytes of electronic media. Late on 16 March 2011, a blanket privilege claim was made over all hard-copy and electronic information removed. Subsequently the material was sealed in the offices of the Crown Solicitors in Auckland where it has remained since.

On 8 April 2011, the applicants filed a judicial review application challenging the lawfulness and reasonableness of the access and removal operations for the six Auckland sites.

Decision

Were the section 16(4) and 16C(2) warrants too widely drawn, too general and lacking in specificity?

Justice Venning first outlined the Commissioner's powers to obtain information as set out in Part 3 of the TAA, in particular sections 16 to 19. Under section 16 the only statutory criteria for access to information is that the Commissioner must consider it necessary or relevant for his statutory purposes. The warrant to access private dwellings under section 16(4) must be considered in that context. The District Court Judge need only be satisfied that the exercise of the Commissioner's functions requires access to private dwellings (along with the reasonableness requirements of section 21 of the New Zealand Bill of Rights Act 1990 ("NZ BoRA")).

The Court considered whether the warrants were too widely drawn and lacked specificity. Noting that the warrants were issued in the form prescribed by the Tax Administration (Form of Warrant) Regulations 2003, Justice Venning cited *Avowal*, a case also involving the Commissioner's search powers under section 16. Case law on this issue has confirmed that the statutory form of warrant is sufficient. The warrants could not be criticised because they followed and complied with the prescribed form.

The challenge that the warrants were too widely drawn and lacked specificity was dismissed.

Were the section 16(1) searches necessary and were the section 16(4) and 16C(2) warrants required to enable the exercise of the Commissioner's functions?

The applicants submitted that the reasonableness of the access operation depended on whether the Commissioner had exhausted other less intrusive alternatives, such as asking for the information by telephone; applying to the District Court under section 17A of the TAA; seeking an interview under section 19 of the TAA and/or holding a targeted inquiry before a District Court Judge under section 18 of the TAA.

Justice Venning again cited *Avowal* and noted that there is no requirement for the Commissioner to exercise all or any of his other powers in Part 3 of the TAA before choosing to use the access provisions in section 16. Furthermore, the question for the judicial officer considering whether to issue a warrant is whether the exercise of the Commissioner's functions under section 16 of the TAA requires access to a private dwelling. It was not for the judicial officer to second-guess or review the decision of the Commissioner to invoke his powers to obtain information under section 16.

Justice Venning found that it was not unreasonable for the Commissioner to have invoked his powers under section 16, including the power of access to private dwellings under section 16(4). It was entirely reasonable for the Commissioner to expect that relevant documentation would be found in the three private homes that were accessed. It was also not unreasonable for the District Court Judge to conclude that the exercise of the Commissioner's functions may have required the removal of books and documents for a full and complete inspection. The issue will always be whether access to private homes is required and whether the search of them in the circumstances of the case was reasonable.

The searches were found to be necessary and the section 16(4) and 16C(2) warrants were required and justified.

Were the searches carried out in an unreasonable manner?

The applicants pointed to a number of factors that they alleged made the searches unreasonable. These factors were the excessive number of persons engaged in the search of the premises, the duration of the searches, the search of areas that were wholly irrelevant and of roof spaces, the perusal of intimate, personal and obviously irrelevant records, the parking of vehicles on private property, the officers remaining on the property during lunch times, damage to personal items and searches of records relevant to ongoing Taxation Review Authority (TRA) proceedings.

Justice Venning cited the Court of Appeal's decision in *Gill v Attorney-General* [2011] 1 NZLR 433 where it was noted that "the use of the rather blunt instrument of judicial review should rarely be permitted to be used to challenge the issue, validity and execution of a search warrant". Justice Venning stated that it was not possible to resolve the details and nuances of the factual issues concerning the searches on a judicial review application.

Nevertheless, Justice Venning went on to consider the applicants' complaints. As to the number of officers involved, the Commissioner's process of employing a team of officers was considered and approved in *Avowal*. Not only did the warrants specify that the officer executing it may be accompanied by other person(s), each of the other persons had a role to play. Further there was a balance between the number of people involved in the search and the length of time the search will take. In this case, the number of persons involved in the search did not make it unreasonable.

The next complaint was that irrelevant areas were searched. Justice Venning noted how it was "not possible to rule out any particular areas of a dwelling as irrelevant as documents or books can be hidden or stored anywhere" [60]. His Honour noted further that the searches were focused. Processes were in place to deal with privileged material and occupiers were advised of their rights and given an opportunity to consult with a solicitor.

There were complaints that personal and irrelevant items were unnecessarily searched and inspected. Justice Venning found that this complaint could not be resolved in this judicial review application. However, it was noted that the searches of private bedrooms and living areas took a fraction of the total time spent on site.

Other complaints were made about cars parked on private property. Justice Venning noted section 16(2) of the TAA requires occupants to provide the Commissioner with all reasonable facilities and assistance for the effective exercise of his powers under the section. His Honour noted that the cars served a readily discernable function and that the provision of reasonable facilities in section 16(2) could extend to the provision of temporary parking facilities. The complaint about officers eating their lunches was similarly dealt with, in that section 16(2) requires the provision of reasonable facilities.

Mr Tauber complained that he was arbitrarily detained. Justice Venning found that Mr Tauber was not arbitrarily detained as he was free to leave the property once the search of his car was completed.

The final complaint about the conduct of the searches was that the access teams removed material relating to ongoing TRA proceedings. This was also said to breach section 27(3) of the NZ BoRA. Justice Venning cited *Vinelight Nominees Ltd & Anor v Commissioner of Inland Revenue* (2005) 22 NZTC 19,298 where this issue has been considered and referred to recently by the Court of Appeal in the decision of *Commerce Commission v Air New Zealand* [2011] 2 NZLR 194. The fact that there were TRA proceedings on foot did not constrain the Commissioner from exercising his search powers under section 16. There was no evidence that the dominant or principal purpose of the search was to obtain information relating to the TRA proceedings.

Justice Venning concluded that the searches and seizures were not unreasonable in terms of section 21 of the NZ BoRA.

Was the application for the warrants deficient?

The applicants submitted that much of what was put before the District Court Judge to justify the warrant application was erroneous and that the cumulative effect of it was that the affidavit as a whole was misleading to a material degree.

Justice Venning considered the separate allegations in the light of the *Tranz Rail Ltd v Wellington District Court* [2002] 3 NZLR 780 (CA) decision where it was stated that "(c)ertainly there will be cases when it can be said that although something relevant has not been disclosed the non-disclosure can have made no difference". Correct information was put before the District Court Judge and statements were not made in bad faith. Whatever errors or failings contained in the affidavit were confined to emphasis only. In the context of a lengthy affidavit these were not found to be material and could not possibly have affected the District Court Judge's decision to issue the access warrants under section 16(4) and the warrants under section 16C(2) of the TAA.

The challenges to the issue of the warrants and subsequent search were not made out. The judicial review application was dismissed.

JUDICIAL REVIEW OF TAX CREDIT CLAIM DISALLOWED

Case	Irene Yeh Leng Goh v Commissioner of Inland Revenue
Decision date	26 July 2011
Act(s)	Injury Prevention Rehabilitation and Compensation Act 2001, Tax Administration Act 1994
Keywords	Gross benefit, domestic purposes benefit, compensation

Summary

A taxpayer's claim of tax credit against the Commissioner resulting from tax paid on compensation by the Accident Compensation Corporation ("ACC") was struck out for being untenable and for abuse of process.

Impact of decision

This is a further case illustrating the inappropriateness of judicial review proceedings to challenge the correctness of an assessment.

Facts

Between March 1998 and September 2005 ("the relevant period"), Ms Irene Goh ("Ms Goh") received the domestic purposes benefit ("the benefit") from the Ministry of Social Development ("MSD") as a result of her physical injury. The benefit paid by MSD included payment of PAYE to Inland Revenue on behalf of Ms Goh.

Ms Goh was later found to be entitled to compensation from ACC for the relevant period when she was in receipt of the benefit. ACC calculated the compensation by deducting an amount equivalent to the gross amount of the benefit paid by MSD for the relevant period.

ACC then, as was required by the relevant statutes, paid to MSD the net amount of the benefit and its tax component to Inland Revenue ($10,049.08). It was ACC's payment of the tax to Inland Revenue that Ms Goh took issue with. She claimed that ACC had no right to pay the tax component as it was the net amount of the benefit that had to be repaid to MSD.

Ms Goh claimed the tax component of the benefit paid by ACC to Inland Revenue in the form of a tax credit for her tax income year ending 31 March 2006. Ultimately, the matter was considered by Inland Revenue's Adjudication Unit, which decided against Ms Goh.

Ms Goh commenced judicial review proceedings against the Commissioner, challenging the decision of the Adjudicator. The Commissioner applied to strike out Ms Goh's claim on the basis that her judicial review proceedings was an abuse of process and was untenable. The High Court agreed with the Commissioner and struck out Ms Goh's claim. She appealed to the Court of Appeal.

Decision

Abuse of process

The Court of Appeal agreed with Justice Woodhouse in the High Court that Ms Goh's challenge was about the validity of the Commissioner's assessment disallowing a tax credit. The appropriate remedy is through the dispute process and not by judicial review.

Claim untenable

The Court also agreed with Justice Woodhouse that the benefit ACC had to pay MSD was the gross amount of benefit, which included the tax component part-paid to Inland Revenue. The inter-government arrangement provided under the statutes for Inland Revenue to reimburse MSD for the earlier tax component paid by MSD. Inland Revenue did repay the tax it received from MSD. The ultimate result was that Ms Goh lost nothing in the scheme of things and was not taxed twice.

APPROVED ISSUER LEVY STRUCTURE FOUND TO BE TAX AVOIDANCE

Case	VI Limited and WI Limited v Commissioner of Inland Revenue
Decision date	5 August 2011
Act(s)	Income Tax Act 1994, Tax Administration Act 1994
Keywords	Shortfall penalties, trust, investment company, unacceptable position, resident withholding tax, statute bar, tax avoidance and abusive tax position

Summary

Taxpayer WI Limited ("WIL") is a Hong Kong resident company. It incorporated a company VI Limited ("VIL") in New Zealand. WIL made substantial loans to VIL which were converted to redeemable preference shares in VIL. The Commissioner asserted that WIL was a New Zealand tax resident and accordingly should have resident withholding tax (RWT) as opposed to payment of an approved issuer levy (AIL). The Commissioner also asserted that the structure had a purpose or effect of avoiding non-resident withholding tax (NRWT) as tax avoidance.

The Taxation Review Authority (TRA) found in favour of the Commissioner on issues 1 to 4 but concluded that a shortfall penalty did not apply.

Impact of decision

The TRA has suggested that a subjective test for unacceptable tax position may be relevant where the case is complicated or the structure used appears compliant until "deeply analysed" and that an objectively unacceptable position may not be an "unacceptable tax position" for the purposes of the penalty provisions.

Further, it is implied from the decision that while the position may have a dominant purpose of tax avoidance (on an objective basis) the position may still be an "acceptable tax position".

Facts

WIL is a Hong Kong registered company, incorporated in 1982 when the C family resided in Hong Kong. In 1989, the family moved back to New Zealand and incorporated a company VIL to undertake property investment. In 1990, WIL made substantial loans to VIL which were converted to redeemable preference shares in VIL. These were redeemed in 1996 by VIL on the basis that their value was left as a debt owing by VIL to WIL as an "on demand" loan.

In May 1997, Mr and Mrs C transferred their shares in WIL to their three children who were appointed additional directors. A deed was executed recording that V Trust owed WIL over $3 million (the loan owed by VIL to WIL was novated to the V Trust). The loan was repaid in 2005. An AIL was paid in respect of the interest payments.

The Commissioner accepted WIL remained a Hong Kong resident until 1998 (and again from 2004 onwards). The Commissioner asserted that from 31 March 1999 to 31 March 2003, WIL was a New Zealand tax resident and accordingly should have deducted RWT as opposed to AIL. The Commissioner asserted that for the purposes of the 2004 income year and following (and, should the Commissioner be incorrect in his residency arguments, also in relation to the 1999 to 2003 income years) a tax avoidance arrangement existed which had the purpose or effect of avoiding NRWT.

Decision

The TRA found in favour of the Commissioner in respect of tax residency, filing RWT returns, statute bar issues and tax avoidance, however concluded that the shortfall penalty did not apply.

Residency

The TRA accepted that the centre of management test in section OE 2(1)(c) of the Income Tax Act 1994 ("ITA") refers to day-to-day management at an administrative level and that the control test in section OE 2(1)(d) refers to directorial control, being something distinct from management on a day-to-day basis. Barber DJ also agreed that the residency test is a factual enquiry about actual control and actual management functions as opposed to de jure control or management. The TRA rejected the submission that in a period where little or no business was carried out there is "insufficient business to identify a place of either central management; or director control".

With respect to directorial control, the TRA also accepted that the law indicates that it is where the "brain which controls the company resides" even if the majority of the directors live elsewhere. Barber DJ also accepted that the control test is satisfied if control by the directors is exercised from New Zealand on a continuing basis and any occasional control from outside New Zealand is not relevant.

Barber DJ concluded on the facts that the centre of management of WIL was in New Zealand, based on a large amount of documentary and oral evidence. The TRA also agreed with the Commissioner that the directorial control was exercised by Mr C in New Zealand (even taking into account the fact that he considered the children as professionals could have resisted Mr C's advice had they thought it necessary).

In concluding on his residency remarks, Barber DJ again restated that the centre of management of WIL was carried out by Mr C in New Zealand. However, the TRA stated that it was *arguable* that Mr C also controlled the directorate of WIL and its decisions, accepting that to a large degree he was the controlling mind of the companies, but stating that as the children were all intelligent and sensible they could not be regarded as controlled by Mr C except to some degree by default (they respected their parents and their acumen and left it to Mr C to obtain and implement tax advice).

Sections NF 2(4) and NF 5

The disputants had raised a new argument that even if WIL was a tax resident, section NF 2(4) did not apply and so the V Trust was not required to pay RWT. The TRA accepted that the interest payments were made in the course or furtherance of V Trust's taxable activity of lending money, investing in shares, managing property and leasing cars. Accordingly, WIL was obliged to account for RWT.

The disputants had also argued that section NF 5 applied to excuse V Trust from accounting for RWT as it concluded the payment was non-resident withholding income on reasonable grounds and having made all reasonable enquiries. Barber DJ concluded that Mr and Mrs C needed to have obtained advice from the accountants (who had been instructed since 1996) to have reasonable grounds and to have made reasonable inquiries. The TRA accepted that there was no evidence of the disputants having received any such advice until May 2003. Accordingly, section NF 5 did not apply to excuse payment of RWT.

Statute bar

The disputants had argued that the filing of AIL returns precluded it from filing NRWT and RWT returns and, therefore, the AIL returns should be construed as the relevant RWT returns for the purposes of section 108 of the Tax Administration Act 1994 ("TAA"). Barber DJ accepted the Commissioner's submission that AIL returns are not RWT returns, noting these are prescribed in section 50 of the TAA as being the IR 15P form. Barber DJ also referred to section NF 13 of the ITA which provides that the provisions of the TAA apply to every amount a person is liable to pay in the RWT rules as if it were income tax.

The TRA also stated (citing *Miller v CIR* (1998) 18 NZTC 13,961) that it was irrelevant that there may be some overlap of information in the AIL and RWT returns. Barber DJ also referred to section NF 5 and noted that this provision excuses a person from the obligation to pay RWT when AIL returns are filed and all reasonable inquiries have been made, implying that if not all reasonable inquiries are made, the expectation is that RWT will be paid irrespective of whether AIL returns have been filed.

The disputants also argued that as annual IR 15S reconciliation forms had been filed (to account for RWT paid in periods not in dispute) arguably RWT returns had been filed. The TRA accepted the Commissioner's submission that the IR 15S does not constitute a return for the periods where no IR 15P was filed—it only reconciles the RWT paid in the periods where a return has been filed. Barber DJ stated that section 99(2) of the TAA deems the Commissioner to have made an assessment on the receipt of each IR 15P form.

Accordingly, section 108 did not apply and the assessments were not statute barred.

Tax avoidance

The TRA referred to the *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 decision, concluding there was a tax avoidance arrangement which frustrated the scheme of the AIL and RWT regimes and clearly had tax-induced features as its dominant purpose. The TRA rejected the disputants' submission that using a clear, concessionary provision (the AIL regime) could not frustrate the scheme and purpose of the TAA, concluding that the arrangement was contrived in that the disputants colluded to siphon profits from New Zealand investment companies into the V Trust and remit those profits to WIL at a 2% tax rate.

Abusive tax position

The TRA concluded that Mr C was relying on professional accounting advice and so was entitled to assume he was complying with "quite subtle tax laws" and the position taken was at least as likely as not to be correct. Barber DJ acknowledged that this was a subjective approach and the test is an objective test, but considered that in the context of a quite complicated case the "structures seem compliant until deeply analysed". Barber DJ stated that while he may be "stretching the point" and although he found the position taken was unacceptable, it was not an unacceptable tax position as defined.

With regard to the dominant purpose of tax avoidance element of the provision, despite stating that he considered the dominant purpose in the mind of Mr C was to pay as little tax as he needed as opposed to actually voiding tax, he stated that he could conclude on an objective basis that the dominant purpose of the arrangement was tax avoidance.

The TRA concluded that no penalty applied because the disputants did not take an unacceptable tax position.

COMMISSIONER'S STRIKE-OUT APPLICATION PARTIALLY SUCCESSFUL

Case	Chesterfields et al v Commissioner of Inland Revenue
Decision date	5 August 2011
Act(s)	High Court Rules
Keywords	Strike out, misfeasance in public office

Summary

The Commissioner was only successful in part in attempting to strike out the taxpayer's claim of misfeasance in public office by the Commissioner.

Impact of decision

As this was a strike-out application, the Court assumes the correctness of the allegations found in the taxpayer's pleadings. This result does not ensure the taxpayer will be successful at the substantive hearing at which assumptions made for the purposes of considering a striking-out application are not made and the taxpayers must prove their case.

Facts

The parties have been involved in a long-running judicial review. The taxpayers are one individual (Mr Hampton) together with two partnerships involving that individual (in partnership with his then wife) and two companies of which Mr Hampton is the director.

The taxpayers have made a claim that the Commissioner was liable under the tort of misfeasance in public office and another claim, of malicious prosecution. Essentially seven alleged causes of action were disclosed by the taxpayers:

1. Failure by the Commissioner to make a decision on the GST returns filed by one of the plaintiffs for a number of years;
2. Failure by the Commissioner to abide by various alleged payment arrangements;
3. Failure by the Commissioner to remit penalties;
4. Non-disclosure of the Aronsen file notes—these notes allegedly prove the existence of instalment arrangements;
5. Failure to disclose the Aronsen file notes when using section 157 powers—also alleged against the Commissioner's counsel;
6. Failure to disclose the Aronsen file notes in discovery—also alleged against the Commissioner's counsel; and
7. Failure to comply with the New Zealand Bill of Rights Act 1990 ("NZ BoRA")—also alleged against the Attorney General.

The Commissioner sought to strike out the claims on the basis the claims could not possibly succeed.

Decision

The Court struck out the sixth and seventh causes of action as untenable but did not strike out the others.

The sixth cause of action was struck out because witness immunity applies to the affidavit of discovery made in the course of the earlier litigation. The principle applicable is that those involved in the judicial process are immune from liability for anything said, written or done in the course of proceedings or immediately preparatory to those proceedings.

The seventh cause of action was struck out as the impugned conduct by the Commissioner (which the taxpayers argued the Attorney General had responsibility for under the NZ BoRA) was not an adjudication of the kind a tribunal was expected to make.

However, the first five causes were not struck out. In a complex decision, Associate Judge Osborne took guidance from *Reid v CIR* (2007) 23 NZTC 21,194 and [2007] NZCA 576.

In summary, Associate Judge Osborne concluded the following:

a) While the five causes did not specify any breach of a statutory duty, there was sufficient ground to raise the tort of misfeasance, but these causes may need to be rephrased to do so clearly.

b) It was possible the Commissioner could be held directly liable for the actions taken in his name.

c) While no particular decision leading to malicious conduct was identified by the taxpayers, the plaintiff's were looking that the Commissioner's conduct generally and the Commissioner was arguably directly responsible for the impugned conduct.

d) The Commissioner is arguably vicariously liable for the conduct of his employees but the taxpayers must establish whether or how this arises.

e) Failure to make a decision may well become wrongful over time.

f) Whether or not there was an improper motive or intention was a matter of evidence at the substantive trial.

He also concluded that Commissioner's counsel could be attached with liability in the circumstances. He rejected the Commissioner's submission that counsel was not a public officer, citing *NZDF v Berryman* [2008] NZCA 392 and accepted that it was at least arguable that counsel was in public office.

COURT OF APPEAL FINDS IN FAVOUR OF THE COMMISSIONER WITH REGARD TO APPLICATION OF CASTING VOTES AT A WATERSHED MEETING

Case	Damien Grant & Steven Khov v Commissioner of Inland Revenue
Decision date	15 August 2011
Act(s)	Companies Act 1993
Keywords	Voluntary administration, Deeds of Company Arrangement ("DOCAs"), casting vote, oppressive or unfairly prejudicial DOCAs

Summary

A casting vote can only be used to break a deadlock between a number of creditors for or against a Deed of Company Arrangement ("DOCA"). It cannot be used to overcome a shortfall in support from the creditors representing 75% of the company's total debt.

Furthermore any DOCA which does not take into account the Commissioner's preferential debt in liquidation may be terminated by the Courts.

Impact of decision

The ruling confirms the Commissioner's interpretation of when a casting vote can be used in a watershed meeting.

Facts

On 5 December 2008, the appellants were appointed voluntary administrators for three publishing companies. There was common ownership and directorship of the three companies (with a minor exception). The one of particular relevance to this matter is Jones Publishing Limited.

During a voluntary administration there must be a watershed meeting. At the watershed meeting a DOCA can be proposed. Under section 239AK(2) of the Companies Act 1993 ("the Act"), for a DOCA to be passed it has to be adopted by a majority in number (of the creditors) representing 75% in value (a "super-majority" of the total debt).

Jones Publishing Limited went into voluntary administration. At the watershed meeting a DOCA was proposed. The Commissioner voted against and the seven other creditors voted for the resolution. The Commissioner was owed roughly 30% of the total debt. Therefore, the seven other creditors did not get the required 75% supermajority. The appellants argued at the watershed meeting, and continued to argue in the Courts, that they were entitled to exercise a casting vote in this situation.

The Commissioner argued that the casting vote can only be exercised when required to break a deadlock in number (for example, five creditors vote for and five against) but not to break a deadlock between the number of creditors and the required super-majority of 75% of the total debt.

It is also significant to note that, while New Zealand legislation was clearly influenced by the Australian equivalent Act, New Zealand has enacted a super-majority provision whereas Australia only requires a plain majority.

The High Court had confirmed the Commissioner's view, and this was an appeal of that decision.

Issues

There were two issues to be considered by the Court of Appeal:

1. The meaning of the term "casting vote" in section 239AK(3) of the Act—specifically whether an administrator, acting as chair of the watershed meeting, can exercise a casting vote when the majority of a company's creditors vote in favour of a resolution but lack the statutorily prescribed super-majority in value.
2. Whether a DOCA is oppressive or unfairly prejudicial under section 239ADD(2) of the Act if it fails to take into account the preferential position that a creditor would have had under the Act if liquidation had occurred and, if this happened in this case, whether the Court should use its discretion to terminate the DOCA.

Decision

Regarding the casting vote issue; the chair of a watershed meeting may only use a casting vote where (as per Stephens J):

> the votes for and against the resolution are equal in number (Condition 1). But before the casting vote may be used, the votes in favour of the resolution must also represent at least 75 per cent of the value of the debt (Condition 2). In other words, **a casting vote can only be used to break a numerical deadlock so as to comply with Condition 1. It cannot be used to make up any shortfall in relation to value under Condition 2**.
>
> [Emphasis added]

Regarding the DOCA being oppressive or unfairly prejudicial by not taking into account the Commissioner's preference on liquidation; the Court of Appeal agreed with the High Court that termination of a DOCA is likely if consequent priorities in liquidation are not acknowledged by the DOCA. Stevens J said:

> We have no doubt that it is completely artificial to consider only the position at the time of the voting process. To exclude from the assessment what will happen on liquidation is to view only half the story … It is now the norm in cases of voluntary administration for the Commissioner's preferential debts to be recognised in the DOCA.

GST DEREGISTRATION ISSUE TO BE HEARD BY THE SUPREME COURT

Case	Lewis Gaire Herdman Thompson v Commissioner of Inland Revenue
Decision date	22 August 2011
Act(s)	Goods and Services Tax Act 1985
Keywords	Deregistration, GST

Summary

The Supreme Court has granted the appellant leave to appeal.

Impact of decision

The case law on deregistration as set out in *Lopas v Commissioner of Inland Revenue* (2006) 22 NZTC 19,726 (CA) may be reviewed and either confirmed or overruled.

Facts

Mr Thompson (the appellant) applied to the Supreme Court for leave to appeal the decision of the Court of Appeal dated 5 April 2011.

Decision

The Supreme Court granted the appellant leave to appeal on the following grounds:

a) When did the appellant become entitled to be de-registered for GST purposes?

b) In light of that determination, and the circumstances in which they took place, did the second and third sales of land attract GST?

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 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.