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TAX INFORMATION Bulletin

CONTENTS

Inland Revenue
Te Tari Taake

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

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

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 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
ED0150	Draft standard practice statement: Retention of business records in electronic format, application to store records offshore, and application to keep records in Māori	This draft SPS provides guidelines for taxpayers to retain their business records in electronic format; the Commissioner's practice when considering an application to store business records offshore; and the Commissioner's practice when considering an application to keep records in Māori. It updates and integrates two existing SPSs: SPS GNL-430 *Retention of business records by electronic means* (December 2003) and SPS INV-470 *Applications to keep records in Māori* (May 1998). As a result of a recent amendment to section 22 of the Tax Administration Act 1994, the Commissioner now has the discretion to authorise a person (a third party) to keep multiple taxpayers' records offshore, as well as authorising an individual taxpayer to keep their own business records offshore. A third party may include a cloud service provider that uses data centres outside of New Zealand. An authorisation granted to a third party means that the clients of the third party would not need to apply separately for an authorisation. The draft SPS outlines the principles by which the Commissioner would consider an application to store records offshore for both an individual taxpayer and a third party. Note that this draft SPS concerns taxpayers' obligation to retain their business records, and does not relate to Inland Revenue's practice of holding taxpayer data.	21 December 2012

IN SUMMARY

New legislation (continued)

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 12/05: PROCARE HEALTH LIMITED

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by ProCare Health Limited (PHL).

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CB 4, CD 1 and CD 8.

The Arrangement to which this Ruling applies

The Arrangement is the issue by PHL of two tranches of new shares to its existing shareholders and a further two tranches to the ProCare Charitable Foundation (the Trust), and the redemption of one of the tranches issued to existing shareholders.

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

The parties to the Arrangement

1. PHL was incorporated in New Zealand in 1995 and provides management and clinical services to its subsidiaries. One of PHL's subsidiaries is a Primary Health Organisation, which is contracted by the Auckland District Health Board to provide primary healthcare services to patients in the Auckland, Counties Manukau and Waitemata District Health Board domiciles. PHL also has two commercial subsidiaries that provide medical services.
2. PHL currently has 389 shareholders, each of whom are general practitioners (GPs) contracted to PHL. It is currently not mandatory for contracted GPs to hold a share in PHL, and there are approximately 400 GPs currently contracted to PHL who are not shareholders.
3. The Trust will be newly established with PHL as the Settlor. Under clause 2.3 of the draft Procare Charitable Foundation Trust Deed, the Trust has the purpose of promoting the health and wellbeing of disadvantaged communities across the Greater Auckland Region and, to that end, the Trust is authorised to provide grants and funding and develop programmes. The Trust will seek registration as a charitable entity under the Charities Act 2005.

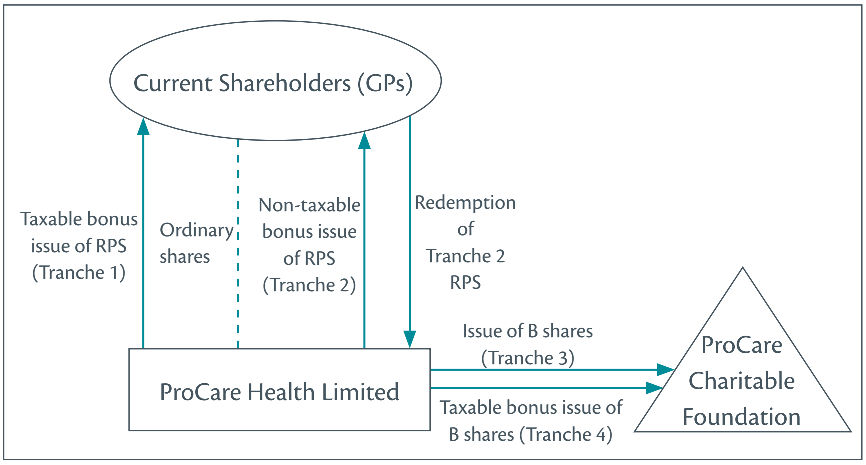
Background to the Arrangement

4. It is proposed that PHL will introduce a mandatory shareholding requirement for contracted GPs. It is hoped that the introduction of mandatory shareholding will increase the engagement of contracted GPs with the organisation, and that it will provide all contracted GPs with the ability to participate in PHL's governance.
5. Following the introduction of mandatory shareholding, PHL will need to issue new ordinary shares to contracted GPs who are not currently shareholders. Before issuing these new shares, PHL will undergo a capital restructure, return value to its existing shareholders, and establish the Trust. PHL has over 90% shareholder approval for the proposed restructure.

Steps involved in the Arrangement

6. The steps involved in the Arrangement are:
   a) The issue by PHL to all existing shareholders of two tranches of non-voting redeemable preference shares (RPS), being:
      i) a fully imputed taxable bonus issue, as defined in s YA 1, subparagraph (b) (Tranche 1); and
      ii) a non-taxable bonus issue as defined in s YA 1 (Tranche 2).
   b) The redemption and cancellation off market by PHL of the Tranche 2 shares at face value (in aggregate, approximately $2.5 million).
   c) The issue by PHL of a small number of non-voting B shares to the Trust (Tranche 3).
   d) The fully imputed taxable bonus issue, as defined in s YA 1, subparagraph (b), by PHL of non-voting B shares to the Trust (Tranche 4).

7. The steps involved in the Arrangement are summarised in the following diagram:



Further details of the Arrangement

8. In issuing and redeeming the shares, PHL will be acting pursuant to the Constitution of PHL. Clause 2.1 of the Constitution provides:

> **Shares on adoption:** Upon or following adoption of this constitution, the Company will have the following classes of share on issue:
>
> a. Ordinary Shares;
>
> b. Redeemable preference Shares; and
>
> c. B Shares.

9. Pursuant to clause 2.1 of the Constitution, PHL may issue different classes of shares, including shares that:

> a. Are redeemable within the meaning of section 68 of the Act;
>
> b. Confer preferential rights to receive distributions of capital or income;
>
> c. Confer special, limited or condition voting rights; or
>
> d. Do not confer voting rights.

10. Clause 2.5 of the Constitution provides:

> **Redemption of Shares:** The Company may exercise an option to redeem redeemable Shares issued by the Company in relation to one or more holders of redeemable Shares.

11. The Tranche 1 shares will be non-voting and will not carry any "shareholder decision-making rights" (as defined in s YA 1). The Tranche 1 shares will pay dividends of approximately 7.5% per annum. PHL will elect to treat the Tranche 1 shares as a dividend pursuant to s CD 8(2). PHL does not intend to redeem the Tranche 1 shares in the foreseeable future.

12. The Tranche 2 will be non-voting and do not carry any "shareholder decision-making rights" (as defined in s YA 1). The Tranche 2 shares will have a face value approximate to that of the Tranche 1 shares. The Tranche 1 and Tranche 2 shares will be issued on near identical terms, but PHL will elect to treat them as shares of different classes. PHL will not elect to treat the Tranche 2 shares as a dividend.

13. As noted already PHL will redeem and cancel the Tranche 2 shares. The amount paid by PHL for the redemption and cancellation will exceed the available subscribed capital of class (ASC) under the ordering rule.

14. The Tranche 3 shares and Tranche 4 shares issued to the Trust will be B shares. These shares will be non-voting and will not carry any "shareholder decision-making rights" (as defined in s YA 1). The B shares will not be able to be traded, and are expected to pay dividends in the future. The total value of the B shares is expected to be approximately $2.5 million. PHL will elect to treat the Tranche 4 shares as a dividend pursuant to s CD 8(2).

15. Following the steps outlined in paragraph 6 above, the contracted GPs who are not currently shareholders of PHL will be required to subscribe for an ordinary share (the subscription amount is expected to be approximately $500 per share).

16. At the time the Tranche 3 shares are issued, the Trustees of the Trust will not be shareholders of PHL or associated with shareholders of PHL. PHL will issue these shares only in order to benefit the Trust and to enable it to carry out its charitable activities.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

a) The Tranche 1 shares will be a dividend and consequently income of the shareholders under s CD 1.

b) The Tranche 2 shares will not be a dividend and consequently will not be income of the shareholders under s CD 1.

c) The payment PHL makes to the shareholders for the redemption and cancellation of the Tranche 2 shares will be a dividend and consequently income of the shareholders under s CD 1.

d) If any shareholder is treated under s CB 4 as having derived income as a result of the payment PHL makes to him or her for the redemption and cancellation of the Tranche 2 shares, the income of the shareholder under s CB 4 will be zero as a result of s CD 53(2).

e) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 October 2012 and ending on 1 October 2015.

This Ruling is signed by me on the 1st day of October 2012.

Howard Davis
Director (Taxpayer Rulings)

PRODUCT RULING BR PRD 12/08: FONTERRA SHAREHOLDERS' FUND

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by Fonterra Co-operative Group Limited (Fonterra).

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CX 56, CX 56B, FC 2, subpart HM and the definition of "foreign investment variable-rate PIE" in s YA 1.

The Arrangement to which this Ruling applies

The Arrangement is the establishment and operation of the Fonterra Shareholders' Fund ("FSF"), a New Zealand resident unit trust through which non-milk-supplying investors ("Public Investors") and farmers supplying milk to Fonterra ("Supplying Shareholders") will be able to invest in units. Units in the FSF will give Public Investors and Supplying Shareholders economic rights in Fonterra shares ("Shares"), but will not provide them with any legal interest in the Shares.

Units in the FSF will be issued when a Supplying Shareholder, registered volume provider ("RVP") (whose Shares will be held in the name of the Custodian on trust for the RVP), or Fonterra has transferred the legal ownership of Shares to the Custodian. The Custodian will hold the economic rights in those Shares on trust for the trustee of the FSF ("Unit Trustee").

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

Parties to the Arrangement

1. The parties to the Arrangement include:
    - Fonterra;
    - The FSF (through the Manager or Unit Trustee);
    - The trustees of the Fonterra Farmer Custodian Trust (the Farmer Trustees);
    - The Custodian;
    - The Unit Trustee;
    - The manager of the FSF (Manager);
    - Supplying Shareholders;
    - RVPs; and
    - Public Investors.
2. Supplying Shareholders, RVPs, the Farmer Trustees, Fonterra and Public Investors may invest in the FSF. Together, they are referred to as the Unit Holders.

Documents relevant to the Arrangement

3. The following documents are relevant to the Arrangement:
    - Unit Trust Deed (which establishes the FSF) (Unit Trust Deed);
    - Authorised Fund Contract, under which the FSF will be established as an "Authorised Fund" under Fonterra's Constitution;
    - Trust Deed of the Fonterra Farmer Custodian Trust, which will hold all of the shares in the Custodian and the Fonterra Unit;
    - Custody Trust Deed of the Fonterra Economic Rights Trust, under which the Custodian will hold the legal title to Shares and the economic rights in Shares on trust for the Unit Trustee; and
    - Form B of Fonterra's constitution (Form B Constitution), which will come into force if Trading Among Farmers is implemented.

Background to the Arrangement

4. Fonterra is simultaneously registered as a co-operative dairy company under Part 3 of the Co-operative Companies Act 1996 and as a company under the Companies Act 1993 (Companies Act). Many aspects of Fonterra's structure and operation are governed by the Dairy Industry Restructuring Act 2001 (DIRA).
5. Supplying Shareholders must generally hold such number of Shares as is determined by the share standard (currently set in Fonterra's constitution as being one share for each kilogram of milksolids obtainable from milk supplied by the farmer in that season, save that Shares cannot be issued to a farmer whose supply of milksolids is less than 1,000kg in a season). These Shares are informally known as "wet" shares, as they are backed by the supply of milk. In practice, Supplying Shareholders must indicate in advance how much milk they wish to supply in a coming season, and they must acquire or dispose of the appropriate number of Shares in order to back that supply (within certain margins).
6. In addition to their "wet" Shares, Supplying Shareholders may currently acquire further Shares (up to 20% of the number of shares that they are required to hold under the share standard). These Shares are

informally known as "dry" Shares, as they are not backed by the supply of milk. Despite the informal distinction between wet Shares and dry Shares, all Shares of Fonterra belong to a single class of Shares.

7. Under s 98 of the DIRA, Fonterra must pay a surrender value for Shares when a notice of withdrawal is given by a Supplying Shareholder under s 97 of the DIRA. The ability for farmers to surrender their Shares has led to volatility in Fonterra's capital. For example, the surrender value for Shares withdrawn in 2008 was approximately $600 million as a result of droughts occurring in 2008, with production increasing to pre drought levels in 2009. Fonterra refers to this volatility as redemption risk.

8. To address this redemption risk, Fonterra has made, or is proposing to make, a number of changes to its capital structure in three stages. The proposal, referred to as Trading Among Farmers, includes:
   i) enabling farmers to acquire up to 100% of the number of Shares that they are required to hold under the share standard as dry Shares;
   ii) the establishment of a Fonterra shareholders' fund that will enable public investment (ie the FSF);
   iii) the creation of a "private market" for the trading of Shares between Supplying Shareholders, RVPs (whose Shares will be held in the name of the Custodian in trust for the RVP) and Fonterra (the Fonterra Shareholders' Market (FSM)). Fonterra is involved in the FSM so that it can manage the size of the FSM by conducting buybacks of Shares.

9. The Trading Among Farmers proposal has required amendments to be made to the DIRA, to remove the requirement for Fonterra to accept the surrender of Shares on request. This amendment when it is brought into force, by Order-in-Council, will remove the redemption risk.

10. The current constitution of Fonterra is the Form A Constitution. The Form A Constitution sets out the framework for the Board of Fonterra to take steps to implement Trading Among Farmers, including the pre-conditions that must be satisfied and the implementation time period. If Trading Among Farmers is implemented, the Form B Constitution, which contains rules relating to the FSM, the FSF and RVPs, will apply.

The Arrangement

11. Fonterra will establish, or procure the establishment of, the FSF—a passive investment vehicle through which a Public Investor can invest indirectly in Fonterra. The FSF will be established as a unit trust under the Unit Trusts Act 1960.

12. As the FSF intends to have investors who are not resident in New Zealand, the FSF will elect to be a "foreign investment variable-rate PIE" (as defined in s YA 1) and will notify the Commissioner of that election.

13. The purpose of the FSF is to provide support to the FSM by acting as a conduit for Public Investors to access the underlying economic rights in a Share, thereby creating a more liquid market for Supplying Shareholders (and RVPs) to trade in Shares. This mechanism will allow Supplying Shareholders to sell economic rights in Shares to the FSF, as well as selling Shares on the FSM. It will also allow an RVP to move between the FSF and FSM to match supply and demand and possibly hedge its position. While Supplying Shareholders may invest in the FSF, it is anticipated that most of the Unit Holders will not be Supplying Shareholders.

14. Fonterra will initially appoint one RVP (although it retains the discretion to appoint further RVPs) to acquire and dispose of Shares (through the Custodian) on the FSM to facilitate trades and liquidity in that market. The principal duties of the RVPs are to ensure the smooth execution of transactions and improve liquidity through continuous quoting of both buy and sell orders with a contracted maximum spread between the buy and sell prices quoted. A key role of the RVPs will be to ensure that the spread between buy and sell prices is restricted to a narrow range.

15. Under the Form B Constitution, RVPs must hold, in aggregate, rights or interests in no more than 5% of the total Shares on issue at any time, excluding treasury stock (such Shares being held in the name of the Custodian in trust for the RVP). Fonterra and the RVPs will not enter into a risk sharing agreement, however where the RVP is suspended from selling economic rights in relation to Fonterra shares to the FSF, Fonterra will compensate the RVP for certain trading losses suffered by the RVP.

16. Like Supplying Shareholders, RVPs will also be able to participate in the FSF. This will promote price convergence between the FSM and the FSF.

The Unit Trustee, the Manager and the Custodian

17. Fonterra will appoint the initial Unit Trustee as trustee of the FSF. The Unit Trustee holds a licence under the Securities Trustees and Statutory Supervisors Act 2011.

18. Fonterra will also appoint the initial Manager of the FSF. The Manager will initially be a company wholly owned by Trustees Executors Limited. Under the Unit Trusts Act 1960, the role of the Manager is to manage the investments of the FSF and issue Units to the public. The Manager will manage the FSF as an investment vehicle and will not undertake an active role (such as actively soliciting farmers to sell economic rights in their Shares). Fonterra will provide a licence (the Licence) to the Manager to use Fonterra's name and brand for the purposes of the FSF.

19. The Unit Trustee and Manager will be party to an arrangement with Fonterra under which Fonterra will provide the FSF with funds (the Funding Arrangement) to cover the reasonable expenses incurred by the FSF, or the Manager, on behalf of the FSF (Operating Expenses).

20. The Custodian will be a limited liability company set up to hold legal title to Shares. The Custodian will hold legal title to any Shares in which economic rights have been sold to the FSF, and will hold the economic rights in Shares on trust for the Unit Trustee (under the Fonterra Economic Rights Trust). The Custodian will also hold legal title to any Shares acquired by the RVP, on trust for the RVP (under a separate trust from the Fonterra Economic Rights Trust).

21. The Custodian will be wholly owned by the Farmer Trustees, as trustees of the Fonterra Farmer Custodian Trust. The Fonterra Farmer Custodian Trust will be a trust set up for the sole purpose of holding the shares in the Custodian and the Fonterra Unit, which confers on the holder rights to prevent certain changes to the Unit Trust Deed (see further discussion at para 39 below). The Farmer Trustees will be three farmer representatives (a farmer directly elected by Supplying Shareholders, a director of Fonterra elected by Supplying Shareholders, and a member of the Fonterra Shareholders' Council). The discretionary beneficiaries of the trust will be Supplying Shareholders and Fonterra will be nominated as final beneficiary of the trust.

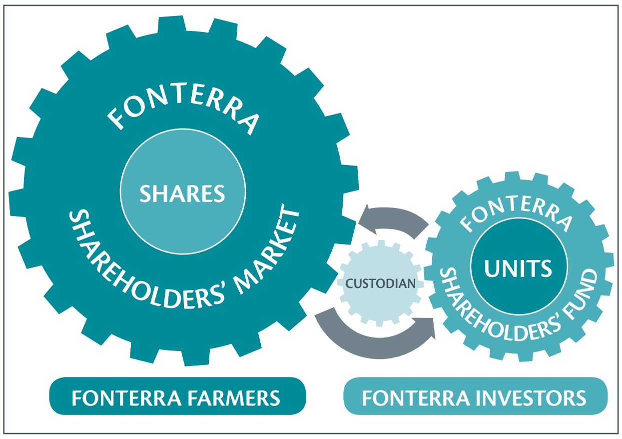
22. The Custodian (and the FSF) will not have any voting rights in Fonterra under Fonterra's Form B Constitution, which restricts voting rights to Supplying Shareholders (ie production based voting rights), except at a meeting of an interest group where there would otherwise be no shareholder entitled to vote at that meeting under clause 24.2(c) of the Form B Constitution. Under clause 7.8 of the Form B Constitution, the Authorised Fund Contract is required to prohibit the FSF and the Custodian from exercising, controlling or exerting any influence over any voting rights attached to the Shares. The Unit Trust Deed and Custody Trust Deed also contain provisions preventing the FSF and the Custodian from exercising any influence over voting rights attached to the Shares.

23. Under clause 7.1 of the Custody Trust Deed, the income of the Fonterra Economic Rights Trust includes amounts of deemed income that arise under tax law and the Custodian is permitted to distribute this income to the FSF.

24. At the time Fonterra pays any dividend to the Custodian and the Custodian distributes any dividend to the FSF as beneficiary income, the FSF will hold a valid "RWT exemption certificate" (as defined in s YA 1).

25. The following diagram summarises how the Arrangement operates, and highlights the relationship between the FSM and the FSF:

Overview of trading among farmers



Operation of the FSF

26. The operation of the FSF is described in the paragraphs below.

27. Supplying Shareholders, RVPs and Fonterra can transfer economic rights in Shares to the FSF. In this context, "economic rights in Shares" means the rights to receive dividends and other benefits derived from a Share, including any change in value of the Share, as well as the other rights and benefits comprised in the Share. It does not include any right to hold the legal title to a Share or a security convertible to a Share, or to exercise production-based voting rights.

28. The process for selling economic rights in Shares to the FSF will involve two steps:

    a) Supplying Shareholders, RVPs, and Fonterra will transfer legal title to a Share to the Custodian (legal title to the Share will not pass to the FSF).

b) The Custodian will hold the economic rights in the Shares on trust for the Unit Trustee.

29. The economic rights in Shares will be the FSF's only material asset. Under clause 7.5 of the Form B Constitution, the aggregate number of Shares in which the FSF may acquire economic rights is limited to 25 percent of the total number of Shares on issue (excluding treasury stock).[1] If this limit is exceeded the Board of Fonterra is obliged to take steps to bring the number of Shares placed with the FSF back within the limit within an appropriate timeframe (clause 7.6 of the Form B Constitution).

30. Units in the FSF will be issued by the Manager upon receipt of economic rights in a Share by the FSF. In addition, if Fonterra issues further Shares in respect of a Share held by the Custodian (in respect of which economic rights are being held in favour of the Unit Trustee), the FSF will issue a corresponding number of Units to its Unit Holders pursuant to clauses 15.1(d) and (e) of the Unit Trust Deed. This ensures that the number of Shares placed with the Custodian in which economic rights are being held in favour of the Unit Trustee will always equal the number of Units on issue. Clauses 15.1(a) and (b) of the Unit Trust Deed provide for the payment of cash dividends or other cash benefits to Unit Holders, mirroring payments on the Shares, as follows:

> (a) upon receipt of a cash dividend or other cash Benefits (other than a Supplementary Dividend) paid by Fonterra, this will be distributed to Unit Holders who were recorded in the Register at the same time and on the same record date as applied by Fonterra to determine the entitlement to the cash dividend or other cash Benefits. The amount to be paid or transferred to each such Unit Holder in respect of each Unit held by that Unit Holder as at that time, will be equal to the amount Fonterra paid or transferred per Share adjusted to take into account any Tax Liability of the Trust relating to the Unit Holder or any adjustments in accordance with s HM 48 of the Tax Act, and less any non-resident withholding tax deducted in respect of the Unit Holder in accordance with Subpart RF of the Tax Act pursuant to section HM 44B of the Tax Act and less any sum authorised in accordance with an Extraordinary Resolution pursuant to paragraph 11.1(b)(viii) of Schedule 1;
>
> (b) upon receipt of any Supplementary Dividend paid by Fonterra, this will be distributed to the Unit Holders that entitled Fonterra to apply section LP 2 of the Tax Act and receive a tax credit for the Supplementary Dividend;

31. Each Supplying Shareholder or RVP who transfers Shares to the Custodian (in which economic rights have been sold to the FSF) will receive either one Unit in the FSF for each such economic right in a Share transferred or a cash sum (clause 5.1 of the Unit Trust Deed) in recognition of the transfer of the economic right in the Share to the FSF. Supplying Shareholders who sell economic rights in Shares to the FSF will also receive "vouchers" (subject to individual limits) that will count towards the share standard and support production-based voting rights and the right to full share backed milk price (clause 5.3 of the Unit Trust Deed).

32. Under the Unit Trust Deed, each Unit issued by the FSF will evidence the entitlement of the holder to the economic benefits (including distributions and other benefits) in the whole of the trust fund. As the number of Units issued by the FSF equals the number of Shares held by the Custodian (in which economic rights are being held in favour of the Trustee of the FSF), in effect each Unit will provide rights to receive the distributions and other benefits in respect of one Share. Individuals and their associates will be permitted to hold no more than 15% of the lesser of the total number of Units on issue or the total voting rights in the FSF under clause 6.1 of the Unit Trust Deed.

33. Clause 4.1(c) of the Unit Trust Deed sets out that the Units do not confer any interest in certain amounts under the Unit Trust Deed, as follows:

> (c) Unless the Manager directs otherwise, Units shall not confer any interest in interest income of the Trust or in monies paid to the Trustee or the Manager to meet their fees or to reimburse either of those parties for (or any advance payment in respect of) any expenses, liabilities, losses and costs incurred by them respectively in or about acting as Trustee or Manager (as the case may be) under this Deed. In all cases, all interest income and such monies will be applied by the Manager to meet the expenses, liabilities, losses and costs incurred by the Manager or the Trustee in or about acting as Manager or Trustee (as the case may be).

34. The FSF Units will trade on a registered market (ie, the NZSX) in which Supplying Shareholders, RVPs, Fonterra and other Public Investors may participate. Standard listing rules (but with various exemptions to those rules recognising that it is a unit trust and to accommodate other characteristics of the Trading Among Farmers proposal) will apply to the FSF. Fonterra and the FSF will co-operate with each other in relation to matters such as disclosure of information, to enable the FSF to comply with the listing rules applicable to the FSF.

[1] It is proposed that this threshold be reduced from 25% to 20%.

35. Supplying Shareholders, RVPs and Fonterra will be able to exchange Units for Shares subject to various limits, but no other investor will be able to do this (clause 9 of the Unit Trust Deed). For example, if a Supplying Shareholder, Fonterra or an RVP wished to acquire a Share, it could do so by either buying a Share on the FSM, or by buying a Unit and presenting that Unit to the Unit Trustee for redemption and demanding that the Trustee procure the Custodian to transfer to it (or in the case of the RVP, to the Custodian to hold on trust for the RVP) one Share.

36. Under clauses 6.5 and 7.8 of the Form B Constitution and clause 15.2 of the Unit Trust Deed, neither the RVPs nor the FSF (or the Custodian in relation to either) is entitled to exercise any voting rights attached to Shares which are from time to time held for them by the Custodian (except on an interest group resolution where otherwise no shareholder can vote, clause 24.2(c) of the Form B Constitution).

37. Except as noted in para 35 above, no Unit Holder shall be entitled or permitted to require the transfer to that Unit Holder of any of the property of the FSF, or any Share. The Unit Trustee will covenant that it will not call for a transfer of the Shares (clause 4.8 of the Custody Trust Deed). In addition, no Unit Holder may redeem their Units for cash other than as described in clause 15.1(h) of the Unit Trust Deed. However, Unit Holders may sell their Units to other investors on the NZSX.

38. In addition to dividends, which are expected to be paid twice a year, other potential distributions in respect of the Shares include:
    a) taxable and non-taxable bonus issues;
    b) in-specie distributions of property;
    c) share buy-backs;
    d) dividend reinvestment schemes;
    e) renounceable and non-renounceable rights issues; and
    f) notional distributions.

39. The Farmer Trustees will hold one Unit in the FSF (the Fonterra Unit) which has special, essentially veto, rights (clauses 4.5 to 4.8 of the Unit Trust Deed). This will require the Farmer Trustees' approval, for example, to an amendment, removal or alteration of a provision of the Unit Trust Deed where that amendment, removal or alteration would change:
    a) the governance structure of the Board of the Manager;
    b) the scope and role of the trust fund;
    c) the obligation of the trust to facilitate the exchange of a Share for a Unit or a Unit for a Share; or
    d) the limit of 15% on the number of Units that can be held by any person or their associated persons (other than Fonterra or a wholly owned subsidiary of Fonterra); or
    e) the terms of the Fonterra Unit.

40. The rights of the Fonterra Unit to proceeds and distributions from the FSF will be the same as for all other Units (clause 4.5(h) of the Unit Trust Deed).

41. Section 16 of the Dairy Industry Restructuring Amendment Act 2012 inserts a new section 161A and 161B into the DIRA to allow Fonterra to hold Units in the FSF. Fonterra will maintain a unitholding in the FSF so that it can manage the size of the FSF. Fonterra's unitholding may increase or decrease depending on market activity, but it will always hold at least one Unit. In respect of Units held by Fonterra, the DIRA prevents Fonterra from exercising those voting rights carried by those Units (section 161A(i)).

42. The FSF may derive income other than from the Shares held by the Custodian on its behalf (Other Income) such as interest on cash held in a bank account. To the extent the Fund derives Other Income or there is assessable income from the Funding Arrangement, clause 4.1(c) of the Unit Trust Deed provides that no Unit Holder has an interest in such other income, unless the Manager directs otherwise. Any Other Income which is available to the FSF will be paid to the Unit Trustee as part of the fees due to the Unit Trustee.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) The requirements of subs HM 55D(5), (6) and (7) and ss HM 55E and HM 55F are met.

b) The FSF is not treated under any double tax agreement as not being resident in New Zealand.

c) The FSF does not carry on the business of life insurance.

d) 90% or more of the FSF's investments (by value of its assets) are investments of a type referred to in s HM 11, other than an interest in land in New Zealand or a right or option in relation to land in New Zealand, in accordance with s HM 19C(1).

e) 90% or more of the income derived by the FSF is of a type referred to in s HM 12, other than an amount derived from an interest in land in New Zealand or the disposal of an interest in land in New Zealand, in accordance with s HM 19C(2).

f) The FSF does not calculate its income tax liability using the provisional tax calculation option in s HM 44.

g) The FSF has not lost its PIE status through the application of ss HM 25, HM 27 and/or HM 29.

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:

a) Following its establishment, the FSF will qualify as a "foreign investment variable-rate PIE" (as defined in s YA 1).

b) The FSF's interest in the Shares is an investment of a type referred to in s HM 11.

c) Income derived by the FSF from its interest in the Shares is income of a type referred to in s HM 12.

d) Income attributed by the FSF to its investors will be "excluded income" (as defined in s BD 1(3)) of the investor under s CX 56(3) provided that:
   - the requirements in ss CX 56(1) and/or CX 56(1B) are met; and
   - the amount is not an amount of attributed PIE income that is derived by a trustee who has chosen a prescribed investor rate referred to in sch 6, table 1, row 5 or 7, as applicable; and
   - the investor is not a person to whom s HM 57B would have applied but who has chosen not to apply that section to determine their prescribed investor rate for a "resident year" (as defined in s HM 57B(3)).

e) Where a Share is transferred to a Unit Holder on redemption of their Unit, that Unit Holder will be treated as acquiring that share for its market value to the FSF on the date of transfer under s FC 2.

f) Any redemption proceeds a Unit Holder receives as a result of the FSF redeeming a Unit (including a distribution of a Share) that are income, will be excluded income of the Unit Holder under s CX 56B.

g) Any distributions from the FSF will be excluded income of each Unit Holder under s CX 56B (and therefore not taxable), other than where the FSF elects to pay non-resident withholding tax in accordance with s HM 44B in respect of the distribution.

h) The Arrangement is not subject to s BG 1.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 25 October 2012 and ending on 30 November 2015.

This Ruling is signed by me on the 25th day of October 2012.

Fiona Heiford
Manager (Taxpayer Rulings)

LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

DETERMINATION DEP82: GENERAL DEPRECIATION RATE FOR MEAL FEEDER – AUTOMATED

Note to Determination DEP82

The Commissioner has set a general depreciation rate for "Meal feeders, automated" by adding a new asset class in the "Agriculture, Horticulture and Aquaculture" industry category. The Commissioner considers that the new asset class has an estimated useful life of 20 years.

What is the asset?

Automated meal feeders are used by primary producers (farmers) to deliver supplementary dry and liquid feed to stock, for example, to cows while they are being milked. Automated meal feeder systems may also be used in other farming activities such as poultry or fish farming.

Although there may be variations to the overall design to meet the customised requirements of each user, an automated meal feeder system generally consists of:

- Meal feed pan;
- Galvanised steel silo to hold the feed until dispensing;
- Polyethylene tank to hold the liquid feed until dispensing;
- Galvanised steel silo which gives the ability to mix the feed being dispensed;
- Associated PVC pipework;
- An internal auger to move the dry feed and alkathene pipe which delivers the liquid feed, from the respective storage facilities;
- Pump which moves the liquid feed to the stainless feed pan;
- Motor or vibratory feeder; and
- Control system.

GENERAL DEPRECIATION DETERMINATION DEP82

1. Application

This determination applies to taxpayers who own depreciable property of the kind listed in the table below.

This determination applies from the 2012 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 "Agriculture, horticulture and aquaculture" industry category a new asset class, estimated useful life, and general diminishing value and straight line depreciation rates as listed below:

Agriculture, horticulture and aquaculture	Estimated useful life (years)	DV rate (%)	SL rate (%)
Meal feeders, automated	20	10	7

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 18th day of October 2012.

Rob Wells
LTS Manager, Technical Standards

SPECIAL DETERMINATION S23: TRANSFER OF ACQUIRED BAD DEBTS BY A CERTAIN NEW ZEALAND COMPANY TO ANOTHER NEW ZEALAND COMPANY IN THE SAME CONSOLIDATED GROUP AND THE UTILISATION OF A PROFIT EMERGING BASIS BY THE TRANSFEREE COMPANY

This determination may be cited as Special Determination S23: "Transfer of acquired bad debts by a certain New Zealand company to another New Zealand company in the same consolidated group and the utilisation of a profit emerging basis by the transferee company".

1. Explanation (which does not form part of the determination)

1. This determination relates to the transfer of acquired bad debts from New Zealand Company Limited (NZC) to a newly incorporated company, New Zealand Company (2) Limited (NZC-2). NZC and NZC-2 are members of the same consolidated group at the time the acquired bad debts are transferred.
2. NZC originally acquired for valuable consideration pools of unpaid loans and receivables, which may consist of a few hundred to a few thousand individual debts (ABDs).
3. NZC can use the profit emerging method of returning income and expenditure pursuant to Special Determination S17: "Utilisation of a profit emerging basis for purchased debt ledgers by a certain New Zealand Company Limited".
4. This determination also relates to the ability of NZC-2 to utilise a profit emerging basis for returning income and expenditure arising from ABDs that are either transferred from NZC (transferred ABDs) or acquired from a person other than NZC (third-party ABDs).
5. NZC-2 acquires the ABDs at a deep discount to their face value. NZC-2 subsequently seeks to recover the overdue balances from debtors through various means.
6. The acquisition of an individual ABD is done on the expectation that its recoveries will be in excess of the purchase price and the cost incurred in attempting collection. Some debts may not achieve any recovery and become uncollectable, and others may be partially collected. The volatility of cash collections may be attributed to such things as the nature of the underlying debt, its age and type, as well as external economic conditions and the effort applied.
7. NZC-2 will apply NZ IFRS 9 to ABDs for financial reporting purposes.
8. This determination provides that NZC-2's contribution to the assessable income and tax liability of the consolidated group for an income year will be based on actual collections reduced by the proportion of purchase cost allocated to that income year.

2. Reference

This determination is made under ss 90AC(1)(bb) and 90AC(1)(j) of the Tax Administration Act 1994.

3. Scope of determination

1. This determination applies to the tax treatment by NZC of transferred ABDs, which were transferred to a member of the same consolidated group. NZC and the transferee company, NZC-2, were not members of the same consolidated group for the whole of the income year of transfer.
2. The determination also applies to the tax treatment by NZC-2 of both transferred ABDs and third-party ABDs.
3. ABDs are pools of unpaid loans and receivables. These pools may consist of a few hundred to a few thousand individual debts.
4. NZC originally acquired the transferred ABDs at a deep discount to their face value on the expectation that its recoveries would be in excess of the purchase price and the cost incurred in attempting collection. NZC applied the profit emerging basis for the recognition of income and deduction of expenditure on the transferred ABDs pursuant to Special Determination S17: "Utilisation of a profit emerging basis for purchased debt ledgers by a certain New Zealand Company Limited".
5. NZC-2 will apply NZ IFRS 9 to ABDs for financial reporting purposes.
6. This determination is made subject to the following conditions:
   i) NZC-2 is satisfied on the basis of objective criteria that a period of no less than five years and no more than seven years is the appropriate period over which cashflows from a third-party ABD are to be forecast. This period is to be ascertained at the time of purchase of the ABD and must match the accounting spreading period for that ABD; and
   ii) NZC-2 will not take a deduction for the acquisition cost of either a transferred ABD or a third-party ABD (or any part thereof) except as set out in this determination; and

iii) NZC-2 treats all underlying debts to which it becomes a party on the acquisition of either a transferred ABD or a third-party ABD (which would otherwise be excepted financial arrangements) as financial arrangements under s EW 8 of the Income Tax Act 2007.

4. Principle

1. NZC will recognise all income and expenditure on the ABDs using a profit emerging basis for the part income year prior to forming the consolidated group in its separate return of income under s FM 14 of the Income Tax Act and ss 33 and 92 of the Tax Administration Act 1994.
2. NZC will perform a base price adjustment pursuant to s EW 31, as modified by s FM 19, when the ABDs are transferred to NZC-2. The consideration for the transfer will be the tax book value of the ABDs on the date of transfer, pursuant to s FM 19(2).
3. All underlying debts to which NZC-2 becomes a party on the acquisition of an ABD are either financial arrangements as defined in s EW 3 of the Income Tax Act 2007 or are treated as financial arrangements by NZC-2 under s EW 8 of the Income Tax Act 2007.
4. This determination specifies that income and expenditure from an ABD for an income year is to be recognised by NZC-2 using a profit emerging method. This method takes into account actual cash flows less an apportionment of the cost of purchase.
5. The apportionment of the purchase cost of a third-party ABD is based on the original forecasted recoveries for the income year as a proportion of the total original forecasted recoveries from the ABD over a period of no less than five years and no more than seven years.
6. For transferred ABDs, NZC-2 will be allowed a deduction in the income years following the transfer for the amount apportioned to the relevant income year as set out in the original forecast for the ABD by NZC.
7. Any cash collections on ABDs will be returned as income in the income year in which they are received.

5. Interpretation

In this determination (and the Explanation), unless the context otherwise requires:

i) words and expressions that are not defined elsewhere in the determination have the same meaning as in s YA 1 of the Income Tax Act 2007;

ii) "NZ IFRS 9" means the New Zealand Equivalent to International Financial Reporting Standard 9 – Financial Instruments, or equivalent as updated or changed from time to time".

6. Method

Profit Emerging Method

The profit emerging method is illustrated in the following formula:

$$AI = AC - ((PC \times OF) \div TECC)$$

Where:

AI = assessable income of an ABD for an income year

AC = actual cash collected from the ABD during the income year

PC = purchase costs of ABD

OF = original cash forecasted to be collected during the income year

TECC = total expected cash to be collected over the spreading period, forecast at date of purchase

Once the cost of the ABD is fully amortised, cash collected after the spreading period will be treated as derived in the income year in which it is received.

Base Price Adjustment Calculation

The base price adjustment calculation arising upon the transfer of ABDs from NZC to NZC-2, members of the same consolidated group at the date of transfer (but not for the whole income year), is illustrated in the following formula:

$$BPA = C - I + E + AR$$

Where:

C = Consideration
= total cash collected + consideration for transfer – purchase cost

Consideration for transfer = PC – D – (F × 336/366)

PC = purchase costs of ABD

D = total deductions allowed in prior income years for the ABD

F = NZC's original forecast deduction for the ABD for the whole of the 2012 income year, expressed as PC × OF/TECC

I = income

E = expenditure

AR = amounts remitted

7. Example

This example illustrates the application of the method (set out in this determination) for determining the income and expenditure attributable to a transferred ABD in each income year. Balance date is 30 June.

This example uses the following parameters.

Purchase date	1 July 2009
ABD purchase cost (PC)	1,000,000
Forecast cash collection (OF)	
Year 1	1,068,000
Year 2	582,000
Year 3	274,000
Year 4	58,000
Year 5	18,000
Total expected cash collected over five years (TECC)	2,000,000

Actual cash collection (AC)	
Year 1	1,106,000
Year 2	600,000
Year 3	293,000
Year 4	88,000
Year 5	20,800
Year 6	6,800
Year 7	500

1. Schedule of expected assessable income from ABD for NZC at purchase date on 1 July 2009

Taxable income	2010	2011	2012	2013	2014	2015	2016	Total
Original forecast cash (OF)	1,068,000	582,000	274,000	58,000	18,000	0	0	2,000,000
Actual cash (AC)	1,106,000	600,000	293,000	88,000	20,800	6,800	500	2,115,100
Actual cash (AC)	1,106,000	600,000	293,000	88,000	20,800	6,800	500	2,115,100
Less (PC × OF/TECC)	534,000	291,000	137,000	29,000	9,000	0	0	1,000,000
Equals assessable income (AI)	572,000	309,000	156,000	59,000	11,800	6,800	500	1,115,100

2. NZC and NZC-2 form consolidated group commencing 30 May 2012

Taxable income of NZC for pre-consolidation period 1 July 2011 to 29 May 2012 (inclusive)

AC = 267,383 (for this example the amount is based on 334 days divided by 366 days; NZC must use actual cash collected)

(PC × OF/TECC) × 334/366 days = 125,022

Taxable income NZC	2010	2011	2012	2013	2014	2015	2016	Total
Original forecast cash (OF)	1,068,000	582,000	274,000	58,000	18,000	0	0	2,000,000
Actual cash (AC)	1,106,000	600,000	267,383	0	0	0	0	1,973,383
Actual cash (AC)	1,106,000	600,000	267,383	0	0	0	0	1,973,383
Less (PC × OF/TECC)	534,000	291,000	125,022	0	0	0	0	950,022
Equals assessable income (AI)	572,000	309,000	142,361	0	0	0	0	1,023,361

3. PDLs transferred from NZC to NZC-2 on 1 June 2012

Base price adjustment to be calculated by NZC on 1 June 2012 (for two days since consolidated group formed)

BPA = C – I + E + AR = (1,974,984 + 49,229 – 1,000,000) – 1,973,383 + 950,022 + 0

BPA = 852

Where:

AC = 1,601 (for this example the amount is based on 2/366 days; actual cash collected to be used by NZC)

(PC × OF/TECC) × 2/366 days = 749

Consideration for transfer = 1,000,000 – (825,000 + (137,000 × 336/366)) = 49,229

4. Taxable income of NZC-2 from 1 June 2012

For 2012 income year ended 30 June 2012:

AC = 24,016 (for this example the amount is based on 30/366 days; actual cash collected to be used by NZC-2)

(PC × OF/TECC) × 30/366 days = 11,229

Taxable income NZC-2	2010	2011	2012	2013	2014	2015	2016	Total
Original forecast cash (OF)	1,068,000	582,000	274,000	58,000	18,000	0	0	2,000,000
Actual cash (AC)	0	0	24,016	88,000	20,800	6,800	500	140,116
Actual cash (AC)	0	0	24,016	88,000	20,800	6,800	500	140,116
Less (PC × OF/TECC)	0	0	11,229	29,000	9,000	0	0	49,229
Equals assessable income (AI)	0	0	12,787	59,000	11,800	6,800	500	90,887

Summary

NZC 2012 assessable income
= 142,361 (to be returned in separate tax return)

Consolidated Group 2012 assessable income
= 13,639
= 852 (NZC) + 12,787 (NZC-2)

Reconciliation

Total assessable income for 2012 income year
= 156,000

Total estimated assessable income for 2012
= 156,000

(Originally forecast by NZC when ABDs acquired)

This determination is signed by me on the 9th day of November 2012.

Howard Davis
Director (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 (ANNUAL RATES, RETURNS FILING, AND REMEDIAL MATTERS) ACT 2012

The Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill was introduced into Parliament on 14 September 2011. It received its first reading on 27 September 2011, the second reading on 2 August 2012 and its third reading on 25 October 2012.

The new Act simplifies returns filing and record-keeping requirements, raises the minimum employee and employer contribution rates for KiwiSaver announced in Budget 2011, and ensures that expenditure on software development is deductible if the software cannot be used and the project is abandoned.

Additional provisions were added to the bill by two supplementary order papers. Supplementary Order Paper No. 1 was released on 7 February 2012 and contained a number of technical amendments to the look-through company and limited partnership provisions. Supplementary Order No. 98, released on 6 August 2012, addressed matters relating to the Canterbury earthquakes and contained measures to ensure the international tax rules work as intended.

The resulting Act received Royal assent on 2 November 2012. It amends several Acts, including the Income Tax Act 2007, Income Tax Act 2004, Income Tax Act 1994, Tax Administration Act 1994, Goods and Services Tax Act 1985, KiwiSaver Act 2006, Child Support Act 1991, the Taxation (Tax Administration and Remedial Matters) Act 2011, as well as certain regulations.

SIMPLIFYING FILING REQUIREMENTS

SIMPLIFYING FILING REQUIREMENTS FOR INDIVIDUALS

The Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill, as introduced, contained three proposals to simplify the income tax filing requirements for individuals. These were:

- Amalgamating the two main income tax return forms for individuals: the income statement, also known as the personal tax summary (PTS) and the IR 3 form. The bill achieved this by removing the requirement for the Commissioner to issue PTSs to certain taxpayers
- Requiring individuals who are not required to file a tax return, but who choose to do so anyway, to file tax returns for the previous four tax years, in addition to the year in which they have chosen to file.
- De-coupling the requirement for individuals to file an income tax return (usually a PTS) merely because they receive Working for Families tax credits.

The bill as enacted has been amended, to remove the proposal that would have had the effect of amalgamating the two main tax return forms for individuals. This proposal was removed to allow Inland Revenue to implement this suite of proposals in a way that is less resource- and system-reliant. The result is that the two returns of income forms for individuals, the IR 3 and the PTS, will continue to be used.

New section 33AA of the Tax Administration Act – annual tax return not required

Sections RC 3 and YA 1 (definition of non-filing taxpayer of the Income Tax Act 2007); sections 3 (definition of tax position), 22(3), 33, 33AA, 33A, 33C, 33D, 38, 43, 80A, 80B, 80C, 80D and 80F of the Tax Administration Act 1994; section 81 of the Child Support Act 1991

Section 33A of the Tax Administration Act 1994 (annual returns of income not required) has been replaced with new section 33AA (exceptions to the requirement for return of income).

Background

As part of drafting the amendments to give effect to the proposed amalgamation of the two main income tax return forms, section 33A of the Tax Administration Act was rewritten. New section 33AA is based on the premise that section 33 of the Tax Administration Act requires that all taxpayers must file, and the new section clearly identifies the individuals that are not required to file an income tax return. This includes not being issued or being required to request a PTS.

Key features

Section 33A has been replaced by new section 33AA of the Tax Administration Act. A number of consequential amendments have been made to the Income Tax Act 2007, the Tax Administration Act 1994 and the Child Support Act 1991 to reflect the reference to, and the structure of, this new section.

The criteria for determining whether an individual has to file a return of income or not, as set out in section 33AA(1), (2) and (3) has not changed. The new provisions set out the criteria in a more logical manner.

Detailed analysis

In general terms, section 33AA(1), (2) and (3) of the Tax Administration Act provides that an individual is not required to file a return of income, be issued with a PTS, or be required to request a PTS for a tax year if the person:

(a) Derives assessable income of the following types:

- Income from employment that is subject to PAYE;
- Interest or dividends that is subject to resident withholding tax (RWT);
- A taxable Māori authority distribution; or
- A personal service rehabilitation payment.

and

(b) Derives a total of $200 or less of a type of income not referred to in (a) above (for example, a dividend received from an Australian listed company).

and

(c) In relation to the types of income listed in (a) above, includes a total of $200 or less of an amount of income that has not been withheld at the correct withholding rate, the obligation to withhold PAYE has not been met, or the income is subject to a flat withholding rate such as employment as an election day worker (17.5% rate).

and

(d) Derives no income from employment that is subject to a special tax code.

and

(e) Has total income of $200 or less from schedular payments or derives no income from schedular payments other than an amount that is treated as expenditure incurred in deriving a schedular payment under section RD 8(3) of the Income Tax Act 2007.

and

(f) Has a total income of $200 or less or derives no beneficiary income.

and

(g) Derives no income from providing personal services to an ACC claimant or meets the requirements of section 33C (that is tax was withheld at the correct rate from the provision of such services – taxable income $14,000 or less and tax withheld at 10.5% from the personal service rehabilitation payment).

and

(h) Is at all times a New Zealand resident or a non-resident deriving only non-resident passive income.

and

(i) Is not a provisional taxpayer (that is a person liable to pay provisional tax under section RC 3 of the Income Tax Act 2007).

and

(j) Is a cash basis holder (that is a person who is not required to use a spreading method to calculate the income and expenditure under a financial arrangement).

and

(k) Has no tax loss (including tax loss carried forward from an earlier tax year) other than a tax loss component under section LE 2 of the Income Tax Act (that is a tax loss resulting from excess imputation being converted to a tax loss component).[1]

and

(l) Has not carried forward to the tax year excess imputation tax credits (that is imputation credits that have not been used to satisfy the person's tax liability for the year.

and

(m) At no time holds a resident withholding tax exemption certificate.

and

(n) The Commissioner does not require the person to file a special return under section 44 of the Tax Administration Act or the Commissioner does not consider that the person should file a return of income.

[1] Since the 2005–06 tax year, excess imputation credits for individuals have been carried forward and not converted to a tax loss.

Example 1

Jo earns a salary of $50,000 a year which has had PAYE deducted by her employer at the M tax code. In addition, Jo derives $100 of interest that had RWT deducted at the 17.5% rate. Jo is not required to file a return of income or be issued with a PTS because she:

- received only income from employment that is subject to the PAYE rules and she has met the obligations under the PAYE rules (used the correct tax code); and
- received interest income under $200, despite an incorrect RWT rate, which should have been 30% as the annual gross was over $48,000 and not more than $70,000.

Jo may request a PTS.

Example 2

Joe has two jobs. He earns a salary of $48,000 a year which has had PAYE deducted by his employer at the M tax code. Also he works part-time at the local video shop and earns $15,000 a year which has had PAYE deducted by his employer at the S tax code. Joe is required to file a return of income (and will be issued a PTS by the Commissioner or is required to request one) because he received more than $200 of secondary income employment that was not withheld at the 30% rate (it was withheld at the 17.5% tax rate).

New section 33D of the Tax Administration Act ensures that a non-resident seasonal worker is not required to file a return of income or be issued with an income statement from the Commissioner. A non-resident seasonal worker is a non-resident person employed under the recognised seasonal employer policy published by the Ministry of Business, Innovation and Employment (the former Department of Labour) under section 13A of the Immigration Act 1987.

Application date

The amendments apply from the 2016–17 income year, unless an Order in Council is made so that the amendments apply from an earlier income year.

Requiring an individual who elects to file to also file across the previous four years

Sections 33AA, 120B and 139B of the Tax Administration Act 1994

New section 33AA of the Tax Administration Act 1994 requires an individual who is not required to file a return of income (including a PTS) but chooses to file to also file returns for the previous four tax years, if no return has been filed for those years.

Background

Currently, taxpayers who are not required to file a tax return, or be issued one by the Commissioner, can choose to file. This allows taxpayers to "cherry pick" the years in which they are due a refund as a result of, say, over-deducted PAYE. In such cases, taxpayers choose not to file in years when they have a tax liability (terminal tax) following an under-deduction of PAYE.

This concern is addressed by requiring these taxpayers to also file for the previous four tax years, resulting in greater fairness across the tax system.

Key features

Section 33AA(4) of the Tax Administration Act requires a person who is not required to file a return of income for a tax year because they satisfy the requirement of section 33AA(1) of that Act, but chooses to file a return of income (PTS), to file returns of income for the each of the five tax years immediately preceding the tax year in which the taxpayer decides to file a tax return.

This requirement will be phased in. For the 2016–17 tax year, the requirement only applies to the current year return. Past tax year returns will be subject to the current rule, which is that there is no requirement to file back-year returns unless the person chooses to do so. For the 2017–18 tax year, a person will need to file returns for both the 2017–18 and 2016–17 tax years. An additional year will be included each year until this requirement is fully in place by the 2020–21 tax year.

Example 1

Joe is a salary and wage earner who has not filed a tax return (PTS) for the tax years 2016–17 to 2019–20 as he meets the requirements of section 33AA(1) of the Tax Administration Act. On 15 August 2021 Joe requests a PTS for the 2020–21 tax year as he is due a refund. Under this rule, Joe is required to file PTSs for the four proceeding tax years; 2016–17, 2017–18, 2018–19 and 2019–20.

Example 2

Joe is a salary and wage earner who has not filed a tax return (PTS) for the tax years 2016–17 to 2020–21 as he meets the requirements of section 33AA(1) of the Tax Administration Act. On 15 August 2021 Joe requests a PTS for the 2018–19 tax year as he realises he is due a refund. Under this rule, Joe is required to file PTSs for the additional following tax years; 2016–17, 2017–18, 2019–20 and 2020–21.

Where section 33AA(4) of the Tax Administration Act applies, new section 33AA(5) allows any tax refunds and any terminal tax arising in respect of each tax year to be offset against each other. It treats the period to which the returns are required to be filed under subsection (4) to be treated as a single period. The resulting amount, if tax is payable, is due either on the date specified in a notice or 60 days after the notice, whichever is the earliest.

Example 3

Joe is a salary and wage earner who has not filed a tax return (PTS) for the tax years 2016–17 to 2020–21 as he meets the requirements of section 33AA(1) of the Tax Administration Act. On 15 August 2021 Joe requests a PTS for the 2020–21 tax year as he is due a refund. Under the four-year rule, Joe is required to file a PTS for the following tax years; 2016–17, 2017–18, 2018–19 and 2019–20. For these returns, Joe is due tax refunds and has tax to pay (terminal tax) as follows:

- 2016–17 $30 tax refund
- 2017–18 ($20) tax to pay
- 2018–19 ($25) tax to pay
- 2019–20 ($30) tax to pay
- 2020–21 $120 tax refund.

Joe will receive an overall tax refund of $75 ($150 – $75).

If Joe had ended up overall with tax being payable, the tax due would be payable on the later of:

- the day specified in the notice; or
- 60 days after the date of the notice.

New subsection 33AA(6) of the Tax Administration Act ensures that a person who is subject to the filing requirements of section 33AA(4) is not liable or entitled to use-of-money interest or late filing penalties. Use-of-money interest does not apply in respect of tax returns for the period from the due date for the payment of tax for the return to the date the return was received by Inland Revenue.

Application date

The amendments apply from the 2016–17 income year, unless an Order in Council is made so that the amendments apply from an earlier income year.

Removing the requirement to file a tax return for taxpayers who receive Working for Families tax credits

Sections 33AA and 41 of the Tax Administration Act 1994

New section 33AA of the Tax Administration Act 1994 which replaces section 33A does not specify that a taxpayer who receives Working for Families tax credits (WFF tax credits) is required to file a return of income. Such a person will only be required to file a return of income if required by another tax law to do so, not merely because they receive these credits. This will also apply to the WFF tax credit recipient's spouse or civil union or de facto partner. They will still be required to file the necessary information such as family scheme income and family details to claim their WFF tax credit entitlements.

Background

Currently, section 33A of the Tax Administration Act specifies that a taxpayer who receives WFF tax credits is required to file a return of income or receive a personal tax summary (PTS). This requirement also extends to a recipient's spouse or civil union partner or de facto partner. Requiring this group of taxpayers to assess their annual income tax liability merely because they receive WFF tax credits is unnecessary.

Key features

New section 33AA of the Tax Administration Act which replaces section 33A removes the requirement for taxpayers who receive WFF tax credits to file a return of income or receive a PTS. This applies also to the recipient's spouse or civil union or de facto partner. The person will only be required to file a return of income if they are required by another tax law to do so or if they are not required but choose to do so. New section 33AA(4) applies to those are not required to file but who choose to do so.

Section 41 of the Tax Administration Act which deals with annual returns by persons who receive WFF tax credits has been amended. Subsection (4) has been replaced by a new provision which sets out the information that a person must provide to the Commissioner for WFF tax credit purposes. A person must furnish a return for the tax year, providing:

- details of each WFF tax credit paid to the person;
- information relevant to calculate the person's family scheme income for the tax year; and
- any other information required by the Commissioner.

Application date

The amendments apply from the 2016–17 income year, unless an Order in Council is made so that the amendments apply from an earlier income year.

Amendment to filing requirements in the Tax Administration Act

Section 33A(1)(b)(via) of the Tax Administration Act 1994

Section 33A(1)(b)(via) of the Tax Administration Act 1994 has been repealed. This subparagraph meant that an individual whose annual income was more than $70,000 had to file a return of income if they received more than $200 of dividends. The provision was originally inserted because the top personal tax rate was higher than the RWT rate on dividends (which is 33%). The misalignment of the top personal tax rate and the rate of RWT on dividends meant there was a possibility for taxpayers on higher personal tax rates to have insufficient tax withheld if they earned more than $200 of dividends. With the change in personal tax rates, and the resulting alignment of the top personal rate and the RWT rate on dividends, this legislative provision is no longer necessary.

Repealing section 33A(1)(b)(via) means that shareholders do not have to file a return of income simply because they receive more than $200 of dividends and their annual income is more than $70,000.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

SIMPLIFYING RECORD-KEEPING REQUIREMENTS FOR BUSINESSES

Sections 22(2) 22(BA), 22(8), 22(9) and 23(1) of the Tax Administration Act 1994

The new legislation introduces amendments to modernise the record-keeping requirements of businesses by making it easier for taxpayers to store records offshore through applications from an Inland Revenue-approved service provider, and by allowing taxpayers who submit returns electronically to store them electronically.

Background

The purpose of the amendments is to make it easier for taxpayers to conduct their tax compliance activities electronically, and to encourage the electronic filing of returns.

Inland Revenue will be able to authorise service providers (for example, a tax agent, accounting payroll provider or a data storage service provider) to keep their clients' records offshore, provided they meet conditions set by the Commissioner of Inland Revenue. The principle for these conditions is that there should be no greater obligation on the service provider than currently exists for the storing of business records in any other format, so long as the Commissioner's access to those records is not unnecessarily compromised.

The administrative criteria will also apply to individuals who apply to keep their own records offshore.

Key features

Generally, taxpayers are required to store their records in New Zealand. As taxpayers are increasingly managing their taxes through payroll or accounting software, the use of offshore data storage for information, records and returns is growing. Previously, the Commissioner could only authorise applications from individual taxpayers to store their records offshore. The amendments now allow a service provider to apply to the Commissioner on behalf of their clients. This will make it easier for taxpayers to store their data offshore if they choose. The Commissioner will also be able to revoke an authorisation, and has the flexibility to authorise the keeping of records in a different form if requested by a taxpayer or a service provider.

Taxpayers will meet their record-keeping obligations under the Tax Administration Act 1994 only if they use Inland Revenue-approved service providers. However the ultimate obligation to comply with tax obligations will always rest with a taxpayer.

A further amendment allows taxpayers to store tax returns electronically that were submitted electronically, thereby removing the requirement to retain a paper copy.

Detailed analysis

How will Inland Revenue protect the privacy of a taxpayer's information when it is stored offshore?

The changes in section 22 relate to a taxpayer satisfying their record-keeping obligations and the Commissioner's discretions, to ensure on-going access to taxpayer records by the Commissioner when required.

Ultimately it is the taxpayer's responsibility to ensure the privacy of their business records, and the security risks associated with storing records offshore is a commercial matter for the taxpayer to consider with their service provider.

Taxpayer information and data held by Inland Revenue is not within the scope of section 22.

Application date

The amendments apply from the date of Royal assent, being 2 November 2012.

CANTERBURY EARTHQUAKE-RELATED MEASURES

DEPRECIATION

Sections EE 22, EE 45(8) and EZ 23B to EZ 23G, of the Income Tax Act 2007

Following the February 2011 earthquake in Canterbury, taxpayers have begun to receive insurance or compensation payments, and to re-establish business or income-earning activities. This has highlighted some particular problems, largely relating to the income tax rules for asset depreciation, the taxation of insurance proceeds that are not received or cannot be used in the conventional way, and the repair or abandonment of damaged buildings and other assets.

Many of these problems have arisen because of the scale of earthquake damage to a significant number of capital assets, which has affected the way insurance claims are being processed and paid.

With some exceptions, the focus of the changes contained in the Taxation (Annual Rates, Returns Filing, and Remedial Matters Act) 2012 is to provide temporary, time-limited earthquake relief and assistance, as reflected in the application dates of some of the provisions.

Key features

Changes to the depreciation rules:

- provide optional matching rules to smooth the timing of income and deductions/disposal losses when insurance proceeds have been received for earthquake-damaged depreciable assets;
- align the tax treatment of depreciable assets that are uneconomic to repair with the treatment of depreciable assets that have been "irreparably damaged" or are "useless for earning income" for tax purposes;
- limit the depreciation recovery income that arises under the tax rules when insurance proceeds have been received for a damaged asset that is repairable to the amount of depreciation deductions previously claimed for the asset;
- allow a depreciation deduction in relation to depreciable property when access to the property is temporarily restricted as a result of a Canterbury earthquake; and
- address minor technical issues with the pool depreciation rules.

Detailed analysis

Consideration when depreciable property is irreparably damaged or rendered useless

Section EE 45(8) has been amended to ensure that the amount derived from a depreciable asset that is irreparably damaged or rendered useless for earning income includes any proceeds from its disposal, for example, any scrap value. Previously, the provision stated that the amount derived from disposal of the asset was the amount of insurance, indemnity or compensation received and did not take into account any disposal proceeds.

Application date

The amendment applies for the 2011–12 and later income years. This includes taxpayers who have been granted an extension of time for filing an income tax return for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011.

Damaged depreciable property that is uneconomic to repair

New section EZ 23C provides for the deemed disposal and reacquisition of assets which are damaged in a Canterbury earthquake and uneconomic to repair.

The tax depreciation rules do not provide an appropriate outcome when an asset has been damaged in a Canterbury earthquake and the insurer considers it to be uneconomic to repair (and requiring replacement), even though the asset may be physically repairable. This is because the current rules make a distinction between assets that are repairable and those that are irreparably damaged or rendered useless for earning income. Assets that are uneconomic to repair are generally included in the former category.

The consequence is that a taxpayer may face a significant unexpected tax liability when an insurance amount is received, as a result of the application of section EE 52. Section EE 52 treats as taxable any insurance proceeds in excess of an asset's adjusted tax value and expenditure on repairing the asset. This means that an amount greater than the depreciation deductions previously claimed for the asset may be treated as taxable. By contrast, for an asset that is irreparably damaged or rendered useless for earning income, the depreciation rules cap depreciation recovery income at the amount of previous depreciation deductions.

In addition, the depreciation "roll-over relief" rule in section EZ 23B, which was developed last year as a response to the Canterbury earthquakes to give taxpayers the ability to defer any depreciation recovery income, applies only to irreparably damaged assets or buildings that are rendered useless for the purpose of deriving income.

Accordingly, amendments have been made to align the treatment of assets that are uneconomic to repair with the existing treatment under the depreciation rules of assets that are irreparably damaged or rendered useless for earning income. This recognises that assets that are uneconomic to repair in the context of the Canterbury earthquakes are, in substance, very similar to assets that are physically irreparable and therefore should receive similar treatment under the depreciation rules.

This objective is achieved through new section EZ 23C which treats assets that are uneconomic to repair as being disposed of for the amount of insurance received for the asset, on the date of the Canterbury earthquake that caused the asset to be uneconomic to repair. This deemed disposal ensures that section EE 48 in the depreciation rules (which applies to irreparably damaged assets) also applies to assets that are uneconomic to repair.

The criteria for an asset to be subject to deemed disposal and reacquisition under section EZ 23C are:

- The depreciable asset is damaged by a Canterbury earthquake, as that term is defined in section 4 of the Canterbury Earthquake Recovery Act 2011.
- The owner of the asset is entitled to an amount of insurance or compensation for the damage to the item.
- The asset has been assessed by the insurer as uneconomic to repair.
- The damage has not caused the asset to be irreparably damaged or rendered useless for earning income in accordance with section EE 47(4).

The term "Canterbury earthquakes" is defined broadly in section 4 of the Canterbury Earthquake Recovery Act 2011 as "any earthquake in Canterbury on or after 4 September 2010, and includes any aftershock". Accordingly, when assets have sustained cumulative damage through multiple earthquakes and aftershocks, taxpayers can use the date of the earthquake which caused the asset to be damaged to the extent that it is uneconomic to repair as the relevant date of the deemed disposal and reacquisition under section EZ 23C.

The asset is treated as being reacquired on the same date as the deemed disposal for nil consideration. This is to ensure that post-earthquake repairs are correctly capitalised (and not treated as deductible expenditure).

Roll-over relief for income tax liabilities arising from the receipt of insurance for earthquake-damaged assets has been extended to assets that are subject to a deemed disposal and reacquisition under section EZ 23C by an amendment to section EZ 23B.

Section EZ 23C overrides section EE 52, which means that for an asset meeting the criteria for section EZ 23C to apply, section EE 52 will not apply.

The deemed disposal and reacquisition under section EZ 23C is not treated as a disposal or reacquisition for the purposes of the land provisions (sections CB 6 to 23).

Example

A building has a cost of $5 million, accumulated depreciation deductions of $4 million and an adjusted tax value (ATV) of $1 million. It is damaged in a Canterbury earthquake and the insurance company decides it has an obligation under the insurance policy to replace it at a cost of $10 million because it is no longer fit for purpose and is uneconomic to repair. The damaged building is retained by the insured party and put to another, less productive, use.

The building meets the criteria for section EZ 23C to apply. Therefore, the building is treated as being disposed of and reacquired for nil consideration on the date of the earthquake which caused the asset to be uneconomic to repair. As the building is treated as having been disposed of, the owner of the asset can apply the matching rule in section EZ 23F to smooth the timing of income calculated under section EE 48.

Under section EE 48, the result will be:

Original cost	$5,000,000
Depreciation deductions	$4,000,000
ATV	$1,000,000
Amount item disposed for (consideration)	$10,000,000
Depreciation recovery income	$4,000,000
Capital gain	$5,000,000

Roll-over relief (under section EZ 23B) is available to the building owner for the $4 million of depreciation recovery income.

Application date

This Canterbury earthquakes-specific amendment applies for the 2010–11 to 2015–16 income years. The Commissioner may exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment.

Cap on depreciation recovery income

New section EZ 23D limits depreciation recovery income calculated under section EE 52 to the amount of depreciation deductions previously taken, when insurance proceeds are received for a repairable damaged asset.

Section EE 52 provides that when insurance proceeds are received for damage to a repairable depreciable asset, the proceeds are taxable to the extent they exceed the cost of any repairs and the asset's adjusted tax value. As noted above, this means that the tax rules may end up taxing more than the amount of earlier depreciation deductions allowed for the asset. In the context of the Canterbury earthquakes, this means that taxpayers may face significant unanticipated income tax liabilities in relation to damaged (but repairable) assets.

The cap on depreciation recovery income determined under section EE 52 is confined to depreciable assets damaged by a Canterbury earthquake (as defined in section 4 of the Canterbury Earthquake Recovery Act 2011), the damage does not cause the asset to be irreparably damaged or rendered useless for earning income, and section EZ 23C does not apply to the asset.

Example

A building costing $5 million was damaged in a Canterbury earthquake but is repairable. The building has an adjusted tax value of $1 million, with depreciation deductions of $4 million taken. Insurance proceeds of $7 million are received, with $1 million of the proceeds being spent on repairing the asset. Section EZ 23C does not apply because the asset is not uneconomic to repair.

Under section EE 52, the depreciation recovery income would be $5 million. However, section EZ 23D caps the amount of depreciation recovery income at $4 million. The remaining $1 million is treated as a capital gain.

Application date

This Canterbury earthquakes-specific amendment applies for the 2010–11 to 2015–16 income years. The Commissioner may exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment.

Optional timing rule for income and deductions when insurance proceeds are received for earthquake-damaged, irreparable depreciable assets

New section EZ 23F provides an optional rule to smooth the timing of income and deductions when insurance proceeds have been received for depreciable property that has been irreparably damaged or rendered useless for earning income as a result of the Canterbury earthquakes. The timing rule also applies to depreciable assets that are uneconomic to repair and to which section EZ 23C applies. The rule applies to individual items of depreciable property, in line with the general approach under the depreciation rules.

The policy intent is that the matching rule allows the net amount of:

- insurance payments
- disposal proceeds

less

- the write-off of the tax book value; and
- expenditure on disposing of the asset

as determined under section EE 48 to be brought to account for tax purposes by a taxpayer.

The timing rule may be used for a depreciable asset when:

- The asset is damaged by a Canterbury earthquake as that term is defined in section 4 of the Canterbury Earthquake Recovery Act 2011.
- The damage causes the asset to be irreparably damaged or rendered useless for earning income and thus meets the requirements of section EE 47(4) or causes the asset to be subject to a deemed disposal and reacquisition under section EZ 23C.
- The owner is entitled to insurance or compensation for the damage.
- The owner chooses to apply the timing rule to all their depreciable assets meeting the above requirements.

The timing rule provides that any income or deductions are recognised at the earlier of:

- when insurance proceeds, the cost of and proceeds from disposing of the asset have been derived or incurred or are able to be reasonably estimated; or
- the 2015–16 income year.

Whether insurance proceeds and other amounts can be reasonably estimated is essentially a question of fact, which will depend on the individual circumstances of each case. However, it is envisaged that some form of documentation would be required, for example, a written quote from an insurer.

Section EZ 23F overrides the timing rules in sections EE 1, EE 22 and EE 48. The section can also be applied to assets depreciated in a pool.

A person who opts to use the matching rule must use it for all their items of depreciable property that meet the criteria for applying the rule. This is to prevent taxpayers "cherry-picking" the assets to which they apply the rule.

A taxpayer's decision to elect into the matching rule will be reflected in the tax position they take in their return of income for each tax year – no prior notice of election is required.

Example

Equipment originally costing $10,000 is irreparably damaged in a Canterbury earthquake. The asset's tax book value is $7,000, with $3,000 of accumulated depreciation deductions. The disposal costs are reasonably estimated to be $1,000 in 2012–13. The insurance proceeds received for the asset are reasonably estimated in 2013–14 as being $9,000. The equipment has a scrap value of $100, which is reasonably estimated in 2012–13.

Applying the matching rule, any income or deductions are recognised in the 2013–14 income year, as this is when the insurance proceeds, disposal costs and disposal proceeds can be reasonably estimated. Accordingly, in the 2013–14 income year, section EE 48 applies to determine the amount of depreciation recovery income or depreciation loss.

Application date

This Canterbury earthquakes-specific amendment applies for the 2010–11 to 2015–16 income years. The Commissioner may exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment.

Optional timing rule for income and deductions when insurance proceeds are received for depreciable property that is damaged but repairable

New section EZ 23G introduces an optional rule to smooth the timing of income and deductions when insurance proceeds have been received for a depreciable asset that has been damaged in a Canterbury earthquake but is repairable. The rule is broadly similar to section EZ 23F in design.

The timing rule may be used for a depreciable asset when:

- The asset is damaged by a Canterbury earthquake as that term is defined in section 4 of the Canterbury Earthquake Recovery Act 2011.
- The asset is not irreparably damaged or rendered useless for earning income and therefore does not meet the requirements of section EE 47(4) and the asset is not subject to a deemed disposal and reacquisition under section EZ 23C.
- The owner is entitled to insurance or compensation for the damage.
- The owner chooses to apply the timing rule to all their depreciable assets meeting the above requirements.

The timing rule provides that any income or deductions are recognised at the earlier of:

- when insurance proceeds and the cost of repairing the asset have been derived or incurred or are able to be reasonably estimated; or
- the 2015–16 income year.

Section EZ 23G overrides the timing rules in sections CG 4, EE 22 and EE 52. The section is also applicable to assets depreciated in a pool.

Example

Machinery originally costing $100,000 is damaged in a Canterbury earthquake. The asset's adjusted tax value (ATV) is $60,000, with $40,000 of accumulated depreciation deductions. The insurance proceeds are estimated in 2011–12 as being $110,000. Repair costs are estimated in 2012–13 to be $20,000 and $10,000 is actually incurred in each of 2012–13 and 2013–14.

Applying the matching rule, any income or deductions are recognised in the 2012–13 income year, as this is when the insurance proceeds and total repair costs can reasonably be estimated. Accordingly, in the 2012–13 income year, sections CG 4 and EE 52 apply.

The repair costs are deductible under the general deductibility rules.

Section CG 4 treats $20,000 of the insurance proceeds as taxable, as this is the amount of insurance proceeds which recovers deductible expenditure.

Section EE 52 applies to the insurance proceeds as follows:

ATV of $60,000 less ($110,000 – $20,000) = ($30,000)

Accordingly, the ATV is reduced to nil and depreciation recovery income under section EE 52 is $30,000.

Application date

This Canterbury earthquakes-specific amendment applies for the 2010–11 to 2015–16 income years. The Commissioner may exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment.

Property that is available for use

For an item of property to be depreciated, the item must be used in a business or available for use. It was unclear how this rule should be applied when access to depreciable property was temporarily restricted following a Canterbury earthquake.

To clarify the tax treatment in this case, new section EZ 23E treats an item of property as being available for use while access to the property is temporarily restricted due to the effects of a Canterbury earthquake (as defined in section 4 of the Canterbury Earthquake Recovery Act 2011), if the following conditions are met:

- The item was used or available for use immediately before the restriction was imposed.
- The item would be used or available for use in the absence of the restriction.
- The income year is the 2015–16 or an earlier income year.

This amendment allows businesses to continue to have depreciation deductions for their depreciable property even though it is temporarily unavailable for use as a result of a Canterbury earthquake.

Application date

This amendment applies for the 2010–11 to the 2015–16 income years.

Amendments to the pool depreciation rules

Section EE 22 has been amended to address some minor technical issues with the depreciation rules for pool assets, arising from the Canterbury earthquakes.

A new subsection (2B) has been included to ensure that when a person receives insurance proceeds for damage caused to an asset included in a pool, any insurance proceeds that are more than the expenditure the person has incurred in repairing the asset is subtracted from the pool's adjusted tax value. The rationale is to align the treatment of damaged pool assets more closely with the treatment of non-pool assets under the depreciation rules. Under the general depreciation rules, insurance proceeds received that are more than the repair costs incurred for a damaged asset reduce the asset's adjusted tax value. Section EE 22(3) has been amended to clarify that insurance proceeds are included as an amount derived from the disposal of an asset included in a pool, and to ensure that any excess of the insurance proceeds over disposal costs or loss is subtracted from the pool's adjusted tax value on the date of disposal. Again, this aligns the pool depreciation rules more closely with the general depreciation rules.

Application date

These generic amendments apply for the 2011–12 and later income years. However, for a person who is granted an extension of time for filing an income tax return for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011, the amendments apply for the 2010–11 and later income years.

Correction of minor drafting error in roll-over relief provision

An incorrect cross-reference in section EZ 23B(2)(b) has been amended. The reference to "subsection (7)" has been changed to "subsection (8)".

Application date

This generic amendment applies from 4 September 2010, the date section EZ 23B came into force.

TIMING OF INSURANCE RECEIPTS FOR EXPENDITURE OR LOSS

Section CG 4 of the Income Tax Act 2007

Previous legislation was developed on the assumption that expenditure incurred on, for example, repairing a damaged asset, would be incurred (and the expense taken as a deduction) before insurance proceeds were received. It was therefore not clear how the legislation would operate if an insurance payout was made before expenditure had been incurred on repairing a damaged asset.

Key feature

An insurance receipt which recovers deductible expenditure will be taxable irrespective of whether the insurance is received before or after the expenditure has been incurred.

Detailed analysis

Previous legislation was based on the assumption that expenditure incurred on, for example, repairing a damaged asset, would be incurred (and the expense taken as a deduction) before insurance proceeds were received. This was consistent with the normal insurance model, where the insurer either undertakes the repairs or reimburses the policyholder after they have undertaken repairs on the affected property. However, in the context of the Canterbury earthquakes, it has been common for insurers to make insurance payouts before the policyholder undertakes the relevant repairs.

The problem with the previous wording of section CG 4 was that it was not clear if it operated when insurance payouts were made before expenditure is incurred on repairing a damaged asset. If the section did not operate in these situations, it could mean there would be a reduction in the damaged asset's adjusted tax value instead, under section EE 52 of the tax depreciation rules. Furthermore, if an amount of insurance was received that was greater than the adjusted tax value, section EE 52 would treat the excess as taxable income upfront, without taking into account repairs undertaken at a later time. In other words, the compensation payment would be treated as depreciation recovered rather than a recovery of the future expenditure on repairs.

Accordingly, the wording of section CG 4 has been amended to resolve this problem. Section CG now provides that an insurance receipt which relates to deductible expenditure is taxable irrespective of whether the insurance is received before or after the repair expenditure is incurred.

In cases when insurance proceeds are received before repair costs are incurred, and those costs are incurred in more than one income year, any income from insurance proceeds must be recognised in each income year that the repair costs are incurred.

Application date

This generic amendment applies for the 2011–12 and later income years. However, for a person who is granted an extension of time for filing an income tax return for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011, the amendment applies for the 2010–11 and later income years.

BUSINESS INTERRUPTION INSURANCE: TIMING OF DERIVATION

Section CG 5B of the Income Tax Act 2007

Under the previous legislation, if a person received an amount of insurance, indemnity, or compensation for an interruption or impairment of business activities following an event, any income arising was allocated to the earlier of the income year in which the amount was reasonably estimated or, in case of interim payments, when they were received.

On this basis, if an insurer estimated in an earlier income year a loss of income for a number of future income years, the entire estimated amount would be allocated to that earlier income year. This result is inconsistent with the general tax and accounting practice of allocating income on an accrual basis.

Key feature

Income derived under a business interruption insurance policy is now allocated to the later of the income year to which the replaced income relates or the income year the amount is reasonably estimated (or, in case of interim payments, when they are received).

Detailed analysis

Section CG 5B(3) of the Income Tax Act 2007 has been amended so that income derived under a business interruption insurance policy is allocated to the later of:

- the income year to which the replaced income relates; or
- 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.

The amendment ensures an entire estimated income amount for a number of future years is not allocated to an earlier income year.

The income derived under a business interruption insurance policy is allocated to the period the income relates to if the income relates to future income years only. If the income relates to past income years, it will continue to be allocated to the income year in which the amount is either received or reasonably estimated. This is to avoid complex compliance and administrative costs involved in amending past years' income tax returns.

Application date

This generic amendment applies for the 2011–12 and later income years. However, for a person who is granted an extension of time for filing a return of income for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011, the amendment applies for the 2010–11 and later income years.

BUSINESS INTERRUPTION INSURANCE FOR A REPLACEMENT PROPERTY AND CAPITAL CONTRIBUTION

Section YA 1 of the Income Tax Act 2007

Previously, if a person received a business interruption insurance payment for a replacement property to restart or continue their business operations, the payment was not recognised in the person's taxable income as it is of a capital nature. Also the person could claim full depreciation deductions for the cost of the replacement property even though they had not paid for the replacement property. Allowing the person to capitalise and claim full depreciation deductions for the total cost of the new replacement property was not consistent with the policy to only allow depreciation deductions for the cost of the property which is actually borne by the person.

Key feature

A business interruption insurance payment that relates to a purchase of a replacement property is now a capital contribution for the purposes of sections CG 8, DB 64 and EE 48.

Detailed analysis

The definition of "capital contribution" in section YA 1 of the Income Tax Act 2007, for the purposes of sections CG 8, DB 64 and EE 48, has been amended to include a business interruption insurance payment that relates to a purchase of a replacement property.

An amount will now be treated as a capital contribution if the amount:

- is paid by a person (other than in their capacity of settlor, partner or shareholder of the recipient) to a recipient under an agreement between them;
- is not income of the recipient, ignoring section CG 8;
- is paid, under the express terms and conditions of the agreement, as a contribution for depreciable property owned or to be acquired by the recipient; and

- if the agreement is a contract of insurance, indemnity or compensation, is paid in relation to an interruption or impairment of business activities.

A capital contribution, including the business interruption insurance payment that relates to a replacement property, is treated as income of the recipient under section CG 8 unless the recipient chooses to reduce the cost base of the replacement property under section DB 64.

Application date

This generic amendment applies for the 2011–12 and later income years.

There is a "savings" provision for people who filed returns before 28 August 2012, which is the date on which the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill was first considered by a Committee of the whole House.

DEDUCTIBILITY OF EXPENSES WHEN THERE IS NO INCOME-EARNING ACTIVITY

Section DZ 20 of the Income Tax Act 2007

After the Canterbury earthquakes, some taxpayers were no longer able to deduct their expenses or losses relating to their income-earning activity. Their activity was so disrupted by the earthquakes that there is no longer a sufficient nexus between the expenses or losses and their activity.

For example, some rental properties or business premises situated in the Christchurch CBD red zone have become untenanted or forcibly closed because the premises are not physically accessible. Given there is no income-earning activity, on-going expenses such as rates may not be deductible under the general permission in section DA 1 even if the activity subsequently resumes.

Key feature

A person whose income-earning activity in greater Christchurch was interrupted by a Canterbury earthquake, may receive a deduction for expenditure relating to the income-earning activity in the year in which that activity resumes. This applies only when the income-earning activity is resumed before the 2016–17 income year.

Detailed analysis

New section DZ 20 provides certainty on the deductibility of expenses or losses for affected taxpayers who intend to continue their income-earning activities. To qualify for this relief, a person must meet all of the following conditions:

- the person has an income-earning activity in "greater Christchurch" (as defined in section 4 of the Canterbury Earthquake Recovery Act 2011) immediately before a Canterbury earthquake (as defined in that section);
- the income-earning activity is interrupted for a period (the period of interruption) as a result of the Canterbury earthquake;
- in the current year, during the period of interruption, the person incurs expenditure or loss (the interruption expenditure) in meeting an obligation relating to the income-earning activity;
- the interruption expenditure does not meet the requirements of the general permission in section DA 1 but would do so but for the interruption; and
- the person resumes the income-earning activity in an income year (the resumption year) before the 2016–17 income year.

If all of these conditions are met, the person is allowed to deduct the interrupted expenditure in the year their income-earning activity is resumed. This new section supplements the general permission in section DA 1. The general limitations in section DA 2 still apply.

Example

Victoria carries on a dry-cleaning business as a sole trader in the Christchurch CBD. She has a loan for the business that requires a $2,000 monthly interest payment. After the earthquake of 22 February 2011 she was no longer able to access her business premise. She temporarily stopped her business activity while considering whether to continue the business elsewhere.

Without new section DZ 20, Victoria would not be able to deduct the interest payments on the business loan since February 2011 because there is no dry-cleaning business so there is no longer a sufficient nexus between the interest expenditure and an income-earning activity.

In September 2012, Victoria resumes the same dry-cleaning business in Hoon Hay. She can deduct $40,000 ($2,000 × 20 months) interest incurred on the business during the interruption period in the 2012–13 income year.

Application date

The amendment applies for the 2010–11 to 2015–16 income years.

ROLL-OVER RELIEF FOR BUILDINGS AND LAND HELD ON REVENUE ACCOUNT

Section CZ 25 of the Income Tax Act 2007

Section CZ 25[2] was introduced in 2011 to provide special roll-over relief for profits arising from compensation payments received in relation to buildings held on revenue account that were destroyed due to a Canterbury earthquake. The relief did not apply to land, or to buildings that were not demolished, or abandoned for later demolition.

If the roll-over relief provision applies, the cost of any replacement building for tax purposes is reduced by [up to] the amount of profit made on the destroyed building. The effect is that, in most cases, a tax liability arising from the profit from compensation or insurance received in relation to the destroyed building is deferred until the replacement building is eventually sold.

Key features

The roll-over relief now also applies to:

- land held on revenue account that is damaged as a result of the Canterbury earthquake; and
- Crown purchases of buildings held on revenue account. This is intended to address purchases being made under the Government's "red zone compensation package", and applies even in situations when the building is not demolished.

Detailed analysis

New section CZ 25(1)(a)(i) applies the roll-over relief provisions to land held on revenue account that is damaged as a result of a Canterbury earthquake.

New section CZ 25(1)(a)(ii) applies the roll-over relief provisions to both land and buildings, if the owner accepts the compensation provided by the Crown's offer of purchase made in accordance with section 53(1) of the Canterbury Earthquake Recovery Act 2011. In this situation only, the roll-over relief can be claimed regardless of whether the building is destroyed or abandoned for later destruction.

The remaining conditions of the roll-over relief, which relate to the replacement building or (now) replacement land, remain unchanged. In summary these are:

- The owner must incur, or intend to incur expenditure on replacement building(s) or land in or before their 2015–16 income year.
- The owner must hold the replacement building(s) or land on revenue account.
- The replacement building(s) or land must be located in the greater Christchurch area (as defined by section 4 of the Canterbury Earthquake Recovery Act 2011).

Amounts received under a Crown offer of purchase for a building may be used to acquire replacement land and vice versa, as long as the remaining conditions are met.

Application date

The amendments apply from 4 September 2010, being the same date as the roll-over relief became effective.

DISPOSAL OF BUILDINGS AND LAND WITHIN 10 YEARS OF ACQUISITION

Section CZ 26 of the Income Tax Act 2007

Under sections CB 6 to CB 12 of the Income Tax Act 2007, the proceeds from land purchased with the intention or purpose of sale are taxable. Broadly speaking, a seller may also derive income from the disposal of land if it is disposed of within 10 years of purchase or within 10 years of improvements being made to the land, and the seller is, or is associated with, a person in the business of dealing in, developing or building on land, or if there has been non-minor development of the land within 10 years of its acquisition.

These provisions could apply to Government purchases of land under its "red zone compensation package", if the person acquired the land within 10 years of accepting the Government's offer of purchase.

Key features

The tax rules relating to disposal of land within 10 years of acquisition, or improvement, or following non-minor development do not apply to Crown purchases of land made under the Government's "red-zone compensation package".

Detailed analysis

The context of the Crown's purchases of buildings and land under section 53(1) of the Canterbury Earthquake Recovery Act 2011, as part of the "red-zone compensation package", is to recognise that a disastrous event has rendered the buildings and land substantially damaged and unusable.

Section CZ 26 ensures that the rules in sections CB 9 to CB 12, which relate to disposals of land with 10 years of the land being acquired, or certain disposals following the development or division of the land, do not apply to Crown purchases of land made under section 53(1) of the Canterbury Earthquake Recovery Act 2011. A person who accepts the Crown's offer of purchase will not be considered to derive income from the disposal of land under those sections.

[2] This roll-over relief provision was originally inserted as section CZ 23 by the Taxation (Tax Administration and Remedial Matters) Act 2011. Section CZ 23 was already in the Income Tax Act 2007, the newly inserted section CZ 23 was renumbered as section CZ 25 by the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act.

The exception does not apply to land that was initially acquired with the intention of resale and development. The general rules in sections CB 6 and CB 7 will continue to operate. However the roll-over relief provisions in section CZ 25 may apply in these circumstances.

There is no requirement that a person to whom the rules in sections CB 9 to CB 12 would have applied, if they were not excepted by the new section CZ 26, must purchase new land with the monies received under the compensation package. However if they do subsequently acquire new land, the 10-year period provisions in sections CB 9 to CB 12 may start afresh for the newly acquired land.

Application date

The amendments apply from 4 September 2010.

OPTIONAL ADJUSTMENT TO ASSETS UNDER THIN-CAP RULES

Section FZ 7 of the Income Tax Act 2007

New section FZ 7 provides an optional adjustment to how group assets are measured for the purposes of the thin-capitalisation rules. The adjustment mitigates a timing problem that arises because insurance proceeds are recognised at a later date than damage caused by the Canterbury earthquakes.

Background

The thin-capitalisation rules are based on accounting measures of assets. For accounting purposes, damaged assets are immediately impaired or derecognised. In contrast, insurance proceeds cannot be recognised until they are reasonably expected (for example, can be given a confirmed value).

Section FZ 7 is designed to mitigate this timing difference by allowing certain taxpayers to carry-back known insurance proceeds to the date on which an asset was impaired or derecognised as a result of damage caused by the Canterbury earthquakes. The amount that can be carried back is limited to the lesser of the amount of damage or the related insurance proceeds.

Key features

Before a person can choose to use the optional adjustment, they must first satisfy the conditions in section FZ 7(1).

These conditions are that:

- an asset of the person's New Zealand group has been damaged as a result of the Canterbury Earthquakes;
- the asset has been impaired or derecognised under generally accepted accounting practice as a result of that damage; and
- insurance for the damage has been recognised at a later date under generally accepted accounting practice.

In such cases, the New Zealand group is able to choose to carry-back the insurance amount and regard this as an asset. The amount that can be carried back is limited to the lesser of the amount of damage or the related insurance proceeds. For impaired assets the damage is measured as the amount the asset has been impaired (as long as the impairment was a result of the earthquake damage rather than other reasons). For derecognised assets the damage is the amount of the derecognised asset (again, as long as the asset has been derecognised as a result of earthquake damage).

Section FZ 7(2) provides for this additional asset to exist for a temporary period beginning on the day that the relevant asset is impaired or derecognised and ending on the day that the corresponding amount of insurance is recognised for accounting purposes.

Section FZ 7(3) requires that if a person chooses to use section FZ 7(2) to increase the assets of their New Zealand group they must also increase the assets of their worldwide group by the same amount for a corresponding period. This ensures the worldwide group test continues to operate on a consistent basis.

A person could receive insurance pay-outs for several different events. In such cases, each insurance pay-out is treated separately and can only be carried back to the date of the related damage.

Example

A company has $1 million of impairment as a result of an earthquake that occurred during its 2010–11 income year. In its 2011–12 income year there is a further $500k of impairment relating to a different earthquake. It receives $1.5 million of insurance pay-outs for both events in the 2011–12 income year. The company would only be able to claim an asset of $1 million in the 2010–11 income year.

Under generally accepted accounting practice the insurance may be recognised all at once if it is for a certain amount. Alternatively, if the person is entitled to reimbursement of costs actually incurred in repairing an asset, then the insurance revenue could be recognised gradually as the repair costs are incurred.

In cases when the insurance is recognised gradually, the amount that is available under the provision should also be reduced gradually, at the same time that the insurance is recognised.

Example

A company has $2 million of impairment, $500k of which is repaired and reimbursed by insurance in 2011–12 and the remaining $1.5 million is repaired and reimbursed in 2012–13. In 2011–12 the company can claim $1.5 million of additional assets under section FZ 7 ($2 million – $500,000 = $1.5 million) and in 2012–13 all the impairment has been met by insurance so section FZ 7 no longer applies ($2 million – $2 million = 0).

Notification requirement

Section FZ 7(4) requires a person who chooses to use section FZ 7(2) to inform the Commissioner that they are applying this rule and to provide some information on its effect, including:

- notice to the Commissioner that section FZ 7 of the Income Tax Act 2007 has been applied;
- the amount of income that would arise under section CH 9 of the Income Tax Act 2007 in the absence of section FZ 7; and
- the amount of income that arises under section CH 9 by applying section FZ 7.

This information should be e-mailed to **competent.authority@ird.govt.nz** by the later of 30 November 2012 or the day that the person is required to make a return of income for the corresponding tax year.

Application date

Section FZ 7 applies for income years ending after 4 September 2010 and before the 2016–17 income year.

KIWISAVER

EMPLOYEE AND EMPLOYER CONTRIBUTION RATES

Clause 7 of schedule 28 of the Income Tax Act 2007, and sections 64 and 101D of the KiwiSaver Act 2006

The new legislation introduces an increase in the default and minimum KiwiSaver employee contribution rate, and the compulsory employer contribution rate, from 2% to 3%, as announced in Budget 2011.

Key features

- The default and minimum employee contribution rate will rise from 2% to 3% of gross salary or wages from 1 April 2013. This new default and minimum rate will apply to existing as well as new members.
- The 3% rate also applies to employee contributions to complying superannuation funds.
- The compulsory employer contribution rate will increase from 2% to 3% from 1 April 2013.

Detailed analysis

Employee contributions

Employers are required to make deductions of KiwiSaver employee contributions from the salary or wages paid to employees aged over 18 who are members of KiwiSaver unless:

- the employee has taken a KiwiSaver contributions holiday;
- the employee is over 65 and has reached their end-payment date and provided a non-deduction notice; or
- in accordance with the PAYE rules, no tax deduction is required to be made from the payment of the salary or wages at the time the payment is made.

Employees can currently choose their KiwiSaver employee contributions to be deducted at 2% (the minimum rate), 4% or 8% of their gross salary or wages. Employees who do not select their own contribution rate have a default rate of 2%.

The default and minimum employee contribution rate will increase from 2% to 3% for payments of salary and wages for pay periods that start on or after 1 April 2013. The 3% contribution rate will apply to existing members currently using the 2% minimum or default rate, and to all new members who join the scheme after that date.

Employees still have the option to select a higher contribution rate of 4% or 8% and employees already contributing at these higher rates will continue to do so.

Employer contributions

Employers are also required to make compulsory employer contributions for each employee for whom they are making deductions of KiwiSaver employee contributions unless:

- the employer is already paying into another eligible registered superannuation scheme for that employee; or
- the employee is aged under 18; or
- the employee is aged over 65 years and has reached their end-payment date.

The compulsory employer contribution rate is currently 2%. This rate will increase to 3% for payments of salary and wages for pay periods that start on or after 1 April 2013.

Application date

The new minimum and default employee rate of 3% applies for payments of salary and wages for pay periods that start on or after 1 April 2013.

The new compulsory employer rate of 3% applies for payments of salary and wages for pay periods that start on or after 1 April 2013.

INTEREST PAID BY INLAND REVENUE

Section 88 of the KiwiSaver Act 2006

A change has been made to the KiwiSaver Act 2006 to enable the Commissioner of Inland Revenue to consolidate and pay interest due on employee and employer contributions for the period they are in the KiwiSaver holding account, on a periodic basis.

Key features

Inland Revenue may consolidate interest due on employee and employer contributions for the period these contributions are in the KiwiSaver holding account, and credit it to members on a periodic basis.

The maximum period over which interest may be consolidated is three months although Inland Revenue envisages that a monthly consolidation period will be used.

Detailed analysis

The Commissioner has established the Inland Revenue KiwiSaver Holding Account into which employee and employer contributions are received before being passed on to the provider. The Commissioner pays interest on contributions that are held in this account, until they are forwarded to the member's KiwiSaver scheme.

For the purposes of computing the interest due, employee contributions are treated as received into the account on the 15th day of the month in which the deduction is made by the employer. Employer contributions are treated as received on the first day of the month in which the money is actually received by Inland Revenue.

At present, interest must be credited to the member's account and then on-paid to their provider at the same time the employee or employer contribution is on-paid. This approach can create lots of small regular credits, many for a few cents, leading to a large volume of low-value transactions and entries on members' statements.

This change will enable Inland Revenue to consolidate interest payments on employee and employer contributions and make a single credit to a member on a periodic basis.

There is no change to the method of calculation of interest due; this will still be computed on a daily basis.

The legislation provides that the maximum period over which interest may be consolidated is three months. However, following consultation with KiwiSaver providers, Inland Revenue intends to use a monthly consolidation period.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

It will take a short period following enactment for Inland Revenue to make the necessary technical changes in order to credit interest on a periodic basis.

FAMILY SCHEME INCOME AND KIWISAVER WITHDRAWALS

Section MB 5 of the Income Tax Act 2007

A change has been made to the Income Tax Act 2007 to ensure that a withdrawal made from a KiwiSaver scheme or complying superannuation fund is not treated as family scheme income of the individual under the Working for Families (WFF) tax credits rules.

Key features

If an individual makes a withdrawal from their KiwiSaver scheme or a complying superannuation fund, the employer contributions that are withdrawn will not be counted as their family scheme income under the WFF rules, even if they continue in employment.

Detailed analysis

Section MB 5 of the Income Tax Act 2007 addresses situations when a person's income for WFF tax credit entitlement purposes is apparently reduced by channelling income through a superannuation scheme. It applies if an individual receives a distribution from the superannuation scheme in an income year and:

- the employer of the individual has made contributions to that superannuation scheme, either in the current income year or in either of the previous two income years;
- the individual continues to work for that employer for at least one month after receiving the distribution; and
- the distribution was not a result of their retirement from employment with that employer.

If section MB 5 applies, any distributions received are counted as the individual's family scheme income, to the extent that the distribution does not consist of amounts that the individual contributed themselves.

A withdrawal from a KiwiSaver scheme (or a complying superannuation fund) is regarded as a distribution from a superannuation scheme. The KiwiSaver rules permit withdrawal on or after the KiwiSaver "end-payment date", as well as providing for early withdrawals for certain purposes; including:

- first home purchase;
- significant financial hardship; and
- serious illness.

Section MB 5 has been amended to ensure that any employer or Crown contributions amounts withdrawn from a KiwiSaver scheme (or a complying superannuation fund) are not included as part of an individual's family scheme income if the individual continues to work for their employer after making the withdrawal.

Application date

The amendment will apply from 1 April 2008, being the date on which the Income Tax Act 2007 came into effect.

KIWISAVER END-PAYMENT DATE

Sections 4, 22, 62, 112B and clauses 3 and 4 of schedule 1 of the KiwiSaver Act 2006

Amendments have been made to the KiwiSaver Act 2006 to clarify aspects of contributions and withdrawals when a member reaches their end-payment date, and their KiwiSaver accumulated funds are no longer locked-in.

Key features

- The start date for employees who are enrolled in KiwiSaver by their employers is clarified to be the 15th of the month in which the employee's first KiwiSaver contribution is deducted, for the purposes of calculating the five-year minimum membership period before a member reaches their end payment date.
- Employees who have reached their end payment date can cease having employee contributions deducted simply by providing their employer with a "non-deduction notice" to cease deductions. Employees who wish to continue contributing to KiwiSaver through direct employer deductions from their salary and wages can still do so.

Detailed analysis

Membership start date

Under the standard withdrawal provisions, a member's KiwiSaver funds are locked in until the later of the date on which the member turns 65, or five years from the start of membership (the "5-year qualification date").

For members who join KiwiSaver by signing up directly with a provider, the date on which they become a KiwiSaver member is established when they sign up.

However, under the KiwiSaver Act employees can also join KiwiSaver via their employer, either by being automatically enrolled as a new employee or by giving their employer a deduction notice. For the purposes of determining when KiwiSaver membership started, the date on which the employee's KiwiSaver contributions began is the relevant factor. The changes to clause 4, schedule 1 of the KiwiSaver Act 2006 clarify this position.

Clause 4 now provides for a "5-year qualification date" for members who enrol into KiwiSaver via their employer. This has been standardised to be calculated from the 15th day of the month in which the first employee contribution is deducted by the employer. This standardisation of the date to the 15th the month aligns with the date Inland Revenue currently treats KiwiSaver employee contributions as received for other purposes.

Employee contributions post end-payment date

KiwiSaver members who have reached their end-payment date may choose to remain in KiwiSaver. They may be able to access their accumulated funds by making partial withdrawals while keeping their KiwiSaver accounts open.

KiwiSaver members may also choose to continue to make contributions to KiwiSaver, although these contributions will no longer attract the Crown's annual contribution (member tax credit).

Members who are still employed may continue to have employee contributions deducted from their salary and wages.

However some members may choose to stop making regular employee contributions once they have reached their end-payment date, because they have access to their KiwiSaver funds. New section 112B of the KiwiSaver Act 2006 enables these employees to give their employer a "non-deduction notice" directing their employer to cease to deduct employee contributions.

Employers should cease deducting employee contributions from the first payment of salary and wages after the non-deduction notice is received.

Employees may request their employers to start deducting employee contributions again at a later date, by providing a *KiwiSaver deduction notice (KS 2)*. An employee cannot provide a KiwiSaver deduction notice within three months of asking their employer to cease deductions via a non-deduction notice, unless the employer agrees.

Application date

The changes apply from 1 July 2012, being the earliest possible date on which members could reach their end-payment date.

WORKING FOR FAMILIES CHANGES

Minor changes have been made to the Working for Families tax credit rules. The changes are to definitions of "family scheme income" and to the definition of "full-time earner" for the in-work tax credit. There is also a small change to the definition of "residence" for the purpose of the credits.

A change to the definition of "family scheme income" as it relates to KiwiSaver withdrawals is discussed under the section on KiwiSaver changes elsewhere in this *Tax Information Bulletin.*

Application date(s)

The changes apply across a range of dates including back to 1 April 2008. The specific application dates are noted in the sections below.

IN-WORK TAX CREDIT

Sections MA 7, MD 9 and MD 10 of the Income Tax Act 2007

Some shareholder employees work full-time for their company but do not pay themselves a wage because, for example, the company has made a loss for that year or has restricted cashflow. Under the previous full-time earner requirements, such a shareholder-employee would not qualify for the in-work tax credit as they did not receive and derive income as set out in section MD 9(1). This is in contrast to other business owners, such as partners in a partnership or a sole trader, in the same situation, who do qualify for the in-work tax credit. Provided their business derives some gross income they will meet the criteria of section MD 9(1) even if they do not pay themselves a wage.

A person can receive weekly compensation as a surviving spouse or partner of a deceased claimant under clause 66 of schedule 1 of the Accident Compensation Act 2001. Section MA 7(2)(b) of the Income Tax Act 2007 provides that a person receiving weekly compensation as a result of an incapacity is deemed to still be employed for the purpose of claiming the in-work tax credit. It was not clear that this provision applied when a person is a surviving spouse.

Furthermore, the wording in section MD 9 required a person to be receiving income from a work activity and deriving income or compensation as set out in section MD 9(2), (3) or (4). While an injured person receiving weekly compensation would meet this requirement, it was unclear that a surviving spouse would qualify as the weekly compensation they receive is not from their work activity but from the deceased spouse's work activity.

Key features

The Income Tax Act 2007 has been amended to remove the reference to a person having to receive income from a work activity from the requirements of the in-work tax credit in section MD 9(1). A person will qualify for the in-work tax credit when they are a full-time earner, as defined in section MA 7, and they:

- derive income as set out in subsections (2) and (3) of section MD 9 as a full-time earner; or
- derive an amount of compensation as described in subsection (4) of section MD 9; or
- are a major shareholder in a close company in which they are a full-time earner, and the company derives gross income in the income year.

Section MA 7 (definition of full-time earner) has been clarified to ensure that a person who is receiving ACC weekly compensation payments as a surviving spouse or partner of a deceased claimant meets the full-time earner definition if the deceased claimant or the couple together would have qualified before the accident causing death. This will allow the surviving spouse to continue to claim the in-work tax credit if they meet all other requirements.

Detailed analysis

Major shareholder-employee of a close company

Section MD 9(1) of the Income Tax Act 2007 has been amended to allow a major shareholder employed but unpaid by a close company to meet the full-time earner requirement of the in-work tax credit. A major shareholder who is a full-time earner in relation to a close company will not have to meet the requirement to derive income as set out in section MD 9(2). Instead, the close company they are a major shareholder in and work for must derive gross income in the income year. This aligns the treatment of shareholder employees and other business owners, such as partners in a partnership.

The major shareholder will still be required to meet all the other requirements for the in-work tax credit as set out in sections MD 5 to MD 8 relating to age, care of a dependent child, residence and not receiving a benefit. The person will also be required to meet the required hours of a full-time earner as set out in section MA 7. A full-time earner is a person who is normally employed for at least 20 hours a week, if they are a sole parent, or at least 30 hours a week in combination with a spouse, civil union or de facto partner.

The terms "major shareholder" and "close company" are defined in section YA 1. A major shareholder is a person who owns, or has the right to acquire, or power to control, at least 10% of the ordinary shares or voting rights, or control of the company. A close company means a company in which five or fewer natural persons hold more than 50% of the interests; or if a market value circumstance exists, five or fewer natural persons hold more than 50% of the market value interests. All natural persons (individuals) associated at the time are treated as one natural person.

Consequential amendments have been made to section MD 10, which relates to the calculation of the in-work tax credit.

ACC survivor spouse

Section MA 7, which defines "a full-time earner", has been amended to provide that a person receiving ACC weekly compensation as a surviving spouse or partner of a deceased claimant is treated as being employed, during the week in which compensation is paid, for the number of hours that the deceased claimant would have been employed previously but for their accident causing death. The deceased spouse's hours are added to the surviving spouse's own hours (if any) to determine if they meet the full-time earner test.

Section MD 9, which contains the full-time earner requirements to qualify for an in-work tax credit, has been amended to remove the requirement for the full-time earner to be receiving income directly from a "work activity". This will allow a surviving spouse to meet the requirements of the section if they derive income as set out in section MD 9(2), which includes ACC weekly compensation payments.

These changes are consistent with the original policy intention of the in-work tax credit. The issue was clearer before the enactment of the Income Tax Act 2007, which is why the clarifying amendment applies from 1 April 2008. A person receiving ACC weekly compensation, including a surviving spouse of a deceased claimant, should continue to receive the in-work tax credit the family previously qualified for, when the person or their spouse is no longer able to work caused by incapacity.

Application date(s)

The changes relating to an ACC surviving spouse are effective from 1 April 2008.

The changes relating to a major shareholder of a close company are effective from 1 April 2011.

FOSTER CARE ALLOWANCES AND FAMILY SCHEME INCOME "OTHER PAYMENTS" CATEGORY

Section MB 13(2)(kb) of the Income Tax Act 2007

The "other payments" category in the definition of "family scheme income" has been amended so that foster care allowances made under the Children, Young Persons and Their Families Act 1989 are excluded from family scheme income. "Family scheme income" is the definition of income used for Working for Families tax credits. It is also used for some community services card recipients and the parental income test for student allowances.

Background

Caregivers who receive orphans and unsupported child benefits or foster care allowances are not entitled to claim the family tax credit relating to the child for whom the benefit or allowance is received, but are eligible for the in-work tax credit relating to that child. Both benefits and allowances are not subject to income tax.

Foster care allowances from Child, Youth and Family help to reimburse caregivers for the day-to-day costs of fostering a child. These allowances are intended to cover the costs of board, personal items such as clothes and pocket money. The amounts vary according to the child's age and specific special needs. Foster care allowances are made under the Children, Young Persons and Their Families Act 1989.

Orphans and unsupported child benefits from Work and Income, which are similar to the foster care allowances, are made under the Social Security Act 1964.

Key features

Foster care allowances made under section 363 of the Children, Young Persons, and Their Families Act 1989 are excluded from family scheme income under section MB 13(1) (Payments included in family scheme income) by section MB 13(2)(kb).

Excluding foster care allowances from family scheme income is consistent with the treatment of orphans and unsupported child benefits, which are also excluded from the "other payments" category by section MB 13(2)(l).

Application date

The change applies from 1 April 2011.

RESIDENCE

Sections MC 5 and MD 7 of the Income Tax Act 2007

Sections MC 5(2)(a) and MD 7(2)(a), which relate to the residence requirements for Working for Families tax credits have been replaced to better reflect the policy intent of this requirement. The change makes it clearer when the requirement for tax residence applies in relation to Working for Families tax credits.

The test for residence is that the person has been:

- both a New Zealand resident (as defined in section MA 8) and present in New Zealand for a continuous period of 12 months at any time; and
- tax resident in New Zealand under section YD 1 (the tax residence test for a natural person) on the days for which a Working for Families tax credit arises.

Application date

The change applies from 1 April 2008.

GST

ZERO-RATING OF LAND TRANSACTIONS

Definition of "land" and "zero-rating of land rules" in section 2(1) and section 11(8D) of the Goods and Services Tax Act 1985

Changes have been made to clarify what type of transactions are subject to the zero-rating rule in section 11(1)(mb) of the GST Act.

Background

Previously, the definition of "land" included a subparagraph (subparagraph (b)(iii)) that specified that certain lump-sum payments made under a lease were subject to the zero-rating rule in section 11(1)(mb). Its purpose was to ensure that the exclusion from the zero-rating rule for commercial leases was not used to generate large input deductions for parties to such transactions. This could otherwise be achieved by large lump sum payments being made alongside rental payments under a lease agreement.

However, the definition did not make it clear whether the assignment or surrender of an interest in land (such as a lease) was to be standard- or zero-rated. The changes clarify that these transactions are to be zero-rated when the general requirements for zero-rating in section 11(1)(mb) are met.

Including this clarification in section 11(8D), and also moving the "lump sum" rule to this section, allows the "land" definition to just refer to interests in land – with transactions involving land being located in section 11.

The lump sum rule is now located in section 11(8D)(b). The wording of the test for whether a payment is to be zero-rated has changed to what was in the "land" definition. This wording change has been made for clarity's sake and does not represent a policy shift. For a period supply (such as a lease), any lump-sum payment that totals more than 25% of the consideration specified in the agreement will be zero-rated. The 25% figure is referable to the longer of:

- the consideration received under the shortest possible fixed term of the agreement; or
- if there is no fixed term, one year.

There is an exclusion for payments that are themselves rental payments. This is to ensure that, for example, regular quarterly payments under a one-year lease do not need to be zero-rated just because there is some slight variance on one or more of them.

Application date

The changes apply from 1 April 2011.

SECOND-HAND GOODS INPUT TAX CREDIT

Section 3A(2)(b) of the Goods and Services Tax Act 1985

In 1995, an amendment was made to the Goods and Services Tax Act 1985 to prevent input tax credits from being claimed twice on the same goods: once when the goods were imported under a lease, and again through the second-hand goods input tax credit, when the leased goods situated in New Zealand were purchased from a non-resident owner.

The 1995 amendment ensured that a second-hand goods input tax credit could not be claimed when the sale of goods is a non-taxable supply by a non-resident, and any GST originally charged at the border on the goods when they were first leased from the non-resident had already been claimed.

However, the 1995 amendment referred to the same non-resident supplier making the supply as when the goods were imported under a lease. This may not always be the case as the original non-resident supplier may later sell the goods (subject to lease) to another non-resident supplier, who later sells the goods to a GST-registered resident.

Key features

Section 3A(2)(b) has been replaced to deny a second-hand input tax credit when the supply:

- is a supply of goods by a non-resident; and
- is a supply of goods that have previously been supplied to a registered person who has entered them for home consumption under the Customs and Excise Act 1996.

It does not matter if the person who enters the goods for home consumption was registered for GST purposes at the time the goods were entered, or was registered at a later date and claimed an input credit under section 21B. It also does not matter whether the non-resident making the supply of goods was the same non-resident who earlier supplied the goods when they were entered for home consumption.

Detailed analysis

Both the 1995 amendment and the current amendment concern the following situation. Goods are leased from a non-resident to a resident. The resident lessee enters the goods for home consumption under the Customs and Excise Act 1996. The New Zealand Customs Service charges GST on the value of the assets, and the registered lessee claims an input tax credit. At a later point, the non-resident owner sells the goods, now situated in New Zealand, to a GST-registered person. As the seller is a non-resident, the supply is not a taxable supply and GST output tax is not charged. However, as the goods are already situated in New Zealand, the registered purchaser is potentially able to claim a second-hand goods input tax credit. This could lead to GST input credits being claimed twice, while GST is paid only once.

The 1995 amendment denied a second-hand goods input tax credit if the non-resident selling the goods is the same non-resident who previously supplied (i.e. leased) the goods to a registered person (the lessee) who entered the goods for home consumption.

The new amendment extends the provision to also deny a second-hand input tax credit when the non-resident owner who sells the goods to a registered person in New Zealand is not the same person who originally leased the goods to a registered person in New Zealand. It also covers the situation when the lessee who entered the goods for home consumption was not registered for GST at the time of entry, but registers after the event and claims a GST input credit under section 21B

Application date

The amendment comes into force on the date of introduction of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill, that is, 14 September 2011.

SUBSEQUENT REGISTRATION

Sections 3A(3C) and 21B of the Goods and Services Tax Act 1985

Section 21B of the GST Act allows a registered person to claim input tax deductions for goods or services acquired before registration. Previously input tax deductions were only when GST has been charged by the vendor. Section 21B also did not allow a deduction for an asset brought into a taxable activity if the original cost of goods or services, excluding GST, was $5,000 or less.

The amended section 21B allows for input tax deductions when:

- there was GST charged on the original supply (as was previously the case);
- there was GST charged on the importation of the goods or services; or
- the goods were acquired from an unregistered person (that is, a secondhand good input deduction).

These changes align the treatment of goods and services acquired prior to registration with those purchased after registration.

In addition, the $5,000 minimum threshold has been repealed. This will allow GST-registered taxpayers to claim input tax deductions for all goods and services acquired before registration.

In relation to secondhand goods, section 21B(5) will limit the input tax deduction to the tax fraction that applied at the time the goods were purchased by the person. This means that if, for example, the goods were acquired in 2010 (when the GST rate was 12.5%) the input deduction would be limited to 1/9th of the purchase price.

The person claiming the deduction must have adequate records to verify the claim. An amendment to section 21B(3)(a)(ii) clarifies that the relevant test for a secondhand goods claim is the same as it would be for any other registered person.

Application date

As this change confirms the intended policy behind assets being brought into a taxable activity, it applies from 1 April 2011.

INPUT TAX AVAILABLE FOR IMPORTED GOODS

Sections 3A(4) and 20(3C) of the Goods and Services Tax Act 1985

Before the introduction of the new apportionment rules, the definition of "input tax" did not apply to the delivery of goods to a person in New Zealand. This ensured that, for example, a courier firm was not able to claim input tax in respect of imported goods when they merely arranged delivery of the goods in New Zealand.

As a result of the changes to the wording of the definition of "input tax" to accommodate the new apportionment rules, the restriction on the ability to claim input tax was inadvertently removed. A registered person could arguably claim input tax deductions in respect of GST paid in the process of delivering the goods to a person in New Zealand. This amendment reinforces the existing policy that an input tax deduction should not be available in these circumstances.

Application date

The change applies from 1 April 2011.

LATE PAYMENT FEES

Sections 5(25) and (26) of the Goods and Services Tax Act 1985

Key features

Prior to this rule change there was some confusion surrounding the GST treatment of certain late payment fees. New sections 5(25) and (26) have been added to clarify that GST generally applies to fees for the late payment of an account in the same way as the underlying supply to which the fee relates.

Background

Previously there was some confusion over whether a late payment fee was:

- a taxable supply, subject to GST;
- default or penalty interest, exempt from GST; or
- an amount that represented liquidated damages or a penalty that was not a "supply" at all for GST purposes.

Late payment fees being subject to GST is consistent with a broad-based tax. In this respect, it is important to differentiate between late payment fees, which can be seen as an increase in the consideration of the underlying goods and services, and default or penalty interest, which is an exempt financial service.

New section 5(25) makes this distinction clear by specifically excluding penalty or default interest from the ambit of the supply. This means that, to the extent an amount consists of such interest, that portion will continue to be exempt.

What is a late payment fee and what is interest will always be determined on a case-by-case basis. For example, if a late payment amount is expressed as a percentage of an outstanding invoice, this may not always mean that the late payment amount is interest. It will depend on whether the late payment amount exhibits enough of the characteristics of penalty or default interest to be categorised as such. It is anticipated that most "one-off" fees will be captured by section 5(24) irrespective of how they are calculated. However, there will always be scope for part of any upfront fee to be categorised as interest if there are compelling reasons for doing so.

The majority of late payment fees will be charged in instances when there are regular billing arrangements between the supplier and recipient (it is unlikely that credit would be extended without a regular billing arrangement or some commercial history between the parties). It is therefore expected that the tax invoice documenting the late payment fee will simply form part of a subsequent invoice for "regular" goods or services provided. When such an arrangement is not in place, a separate invoice for the late payment fee will need to be issued in order to allow the recipient to claim an associated input tax deduction.

Although the late payment fee is, from a policy perspective, an increase in consideration for the underlying goods and services, the mechanics of section 5(25) mean that the late payment fee is a separate supply. The normal time of supply rules will apply to treat the late payment fee as being supplied at the time of the subsequent invoice, so the credit/debit note provisions in section 25 will not apply.

New section 5(26) clarifies that the tax treatment of the late payment fee will follow the treatment of the underlying supply, be this fully taxable, zero-rated or exempt. For example, if the late payment fee was in relation to an exempt financial service, the late payment fee will itself be exempt. If the fee is in relation to a composite supply or more than one supply, part of which is taxable and partly exempt, the GST on the fee should proportionately (by value) follow the treatment of the underlying supply/supplies.

Application date

As this amendment confirms existing policy, and the practice of the majority of registered persons, the application date is 1 April 2003. However, to recognise the fact that some registered persons currently do not charge GST on late payment fees, if a person has previously adopted a regular practice of not charging GST, they must apply the new rules only to fees charged by them from 1 January 2013.

REVERSE CHARGE FOR IMPORTED SERVICES

Sections 8(4B)(b)(ii) and 9(2)(h) of the Goods and Services Tax Act 1985

The changes ensure that the reverse charge rules for imported services operate as intended and with minimal compliance costs to business.

Key features

The new rules:

- amend the reverse charge threshold from 90% to 95% for "percentage actual use", to bring this threshold in line for the initial test of "percentage intended use"; and
- when a registered person has to make an input tax adjustment, change the time of supply from the first day of the relevant adjustment period to the last day of that period (which is generally a year). Under the previous wording there was a possibility of the person not finding out the adjustment was due until after the relevant return was filed.

Application date

The changes apply from the introduction of the apportionment rules, being 1 April 2011.

LIQUIDATORS AND RECEIVERS CHANGING GST ACCOUNTING BASIS

Section 19(3B) of the Goods and Services Tax Act 1985

An amendment has been made to the Goods and Services Tax Act 1985 to preclude liquidators, receivers and voluntary administrators from switching from the payments basis to the invoice basis when accounting for GST.

Background

If a GST-registered person meets certain conditions, for example, when the total value of taxable supplies for a 12-month period has not, or is not likely to exceed $2 million, the registered person may account for GST on a payments basis. Most registered persons (approximately 80%) account for GST using the payments basis. The GST Act allows registered persons who are accounting for GST on a payments basis to change to the invoice basis by applying to the Commissioner of Inland Revenue. There were no restrictions on registered persons making this accounting basis change.

It had become standard practice for liquidators and receivers to adopt the invoice basis for accounting for GST, immediately upon becoming a liquidator or receiver of a registered person that accounts for GST on a payments basis. Moving to an invoice basis allowed the liquidator or receiver to claim input tax credits for supplies received for which no payment had been made. Changing the accounting basis often resulted in refunds being made to the liquidator or receiver despite in many cases there being no realistic prospect that the debt, to which the input credit related, would ever be paid. The practice did not seem to have a commercial purpose other than to generate GST refunds.

Key features

New section 19(3B) of the GST Act prevents a liquidator, receiver, or administrator (as defined in section 239B of the Companies Act 1993) of a registered person who accounts for tax payable on a payments basis applying to change the registered person's accounting basis to an invoice basis.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

"PRINCIPAL PURPOSE"

Section 20A(2) of the Goods and Services Tax Act 1985

When the apportionment rules for claiming input tax were introduced, they removed the concept of "principal purpose" from the GST Act. However, a reference to principal purpose was inadvertently retained in section 20A(2). This amendment corrects that error so the test in section 20A(2) is now consistent with the rest of the Act.

Application date

The change applies from 1 April 2011.

LOGBOOK FOR GST APPORTIONMENT

Section 21(5) of the Goods and Services Tax Act 1985

A motor vehicle is an asset that, if it is used for private and business purposes, is subject to the GST apportionment rules. However, deductions for dual-use motor vehicles are also subject to special rules for income tax purposes. For income tax purposes, a person may keep a logbook as a method for establishing the proportion of business use. To ease compliance costs, this amendment sets out that such a logbook may also be used to determine the taxable use of the vehicle for the purposes of the GST apportionment rules. This means that the registered person will be able to use the same records to help determine their deductions for both tax types.

Application date

As this change confirms what is understood to be standard practice, it applies from 1 April 2011.

WHEN ADJUSTMENTS ARE REQUIRED

Section 21A(c) of the Goods and Services Tax Act 1985

Section 21A sets out when an adjustment is required under the GST apportionment rules. There are de minimis rules (designed for compliance cost purposes) that ensure that small adjustments do not need to be made. These rules are set out in sections 21(2)(c) and (d). When section 21A was introduced, an oversight resulted in only the de minimis in section 21(2)(c) being referred to. This amendment corrects that oversight by introducing into section 21A a cross-reference to section 21(2)(d).

Application date

The change applies from 1 April 2011.

CONCURRENT USE OF LAND

Section 21E(1) of the Goods and Services Tax Act 1985

Section 21E of the GST Act provides a formula that must be used to apportion the taxable and non-taxable use of land in situations when it is used "concurrently". This provision is particularly relevant when a person rents out land (exempt use) or uses land for private purposes while simultaneously using it for making taxable supplies, such as taking steps to sell it.

The amendment clarifies the scope of the provision so that it applies only when the same area of land is simultaneously used for both taxable and non-taxable purposes, rather than when land is used for both taxable and non-taxable purposes, but that use either relates to different parts of the land or is not simultaneous.

Application date

The change applies from 1 April 2011.

DISPOSAL IS THE END OF AN ADJUSTMENT PERIOD

Section 21G(7B) of the Goods and Services Tax Act 1985

New section 21G(7B) clarifies that, if a person disposes of an asset during the time when it is required to be making adjustments, that disposal triggers a final adjustment.

Example

ABC Limited purchases an asset that is required to be accounted for through 10 adjustment periods under section 21G(4)(a). The first adjustment period finishes on 31 March 2013. On 31 May 2013, the asset is sold in the course or furtherance of ABC's taxable activity. The time immediately before the asset is sold (on 31 May) is treated as the end of an adjustment period for that particular asset – despite the fact that the adjustment period will be only two months, rather than the usual 12. This will be the final adjustment for the asset and the disposal calculation in section 21F will then apply.

Application date

The amendment applies from 2 November 2012.

ADJUSTMENTS FOR GOODS AND SERVICES ACQUIRED BEFORE 1 APRIL 2011

Section 21H of the Goods and Services Tax Act 1985

The GST apportionment rules apply to supplies made on or after 1 April 2011. Section 21H is a transitional provision that specifies which rules – the former change-in-use adjustment rules or the new apportionment rules – should be used for goods and services acquired before 1 April 2011.

Previously, there was some confusion over the correct treatment of goods and services that had been acquired before 1 April 2011, but no adjustments had been made under the old rules. These amendments clarify that the former change-in-use rules still apply if the person acquired the goods and services before 1 April 2011 and claimed an input tax deduction in respect of those goods and services, or the supply was zero-rated.[3] The new apportionment rules apply if the person had not claimed an input tax deduction before 1 April 2011.

If the new apportionment rules apply, the first adjustment period is treated as starting on the date of acquisition of the goods or services and ending on the date that is the later of the first balance date falling after the date on which they were first used for making taxable supplies, or the date on which the person becomes a registered person.

Application date

The amendment applies from 1 April 2011. However, a "savings" provision allows taxpayers who applied either the old change-in-use adjustment rules or the new apportionment rules in the period between 1 April 2011 and 14 September 2011 to continue with their chosen treatment.

[3] This is subject to the limitations rules in sections 21H(2) and (3).

TRANSACTIONS INVOLVING NOMINATIONS

Sections 24(7B) and 60B(6) of the Goods and Services Tax Act 1985

The Taxation (GST and Remedial Matters) Act 2010 clarified the GST treatment of transactions that involve nominations. The nomination rules adopt an "economic substance" approach so that the GST consequences of a transaction involving a nomination (such as the entitlement to an input tax deduction) reflect the commercial reality of the transaction. The recipient of the supply could therefore be either the contractual purchaser or their nominee, depending on the circumstances. The new rules applied from 1 April 2011.

The same Act also introduced rules that require supplies of land to be zero-rated in certain circumstances. To ensure that the new zero-rating of land rules could not be bypassed by parties using nominations, the default "economic substance" rule was modified in relation to transactions that involve land to treat a supply as always occurring between the supplier and the nominee.

A supplementary rule also applied to transactions that do not involve land when the contractual purchaser and the nominee have a different registration status. However, the application of this rule may give rise to inappropriate GST outcomes, such as the denial of input tax deductions to the contractual purchaser. This supplementary rule has therefore been repealed to ensure that the default "economic substance" approach applies (without modification) to all transactions that do not involve land.

Application date

The clarification applies from 1 April 2011. However, a "savings" provision allows taxpayers who, in the period between 1 April 2011 and 14 September 2011, claimed an input tax deduction based on the previous wording.

RECORD-KEEPING FOR LAND SUPPLIES

Sections 55(7)(dc), 75(3D), 75(3E), 78F(3), 78F(5) and 78F(7) of the Goods and Services Tax Act 1985

Various provisions related to information that must be provided and the records that are required to be kept for a zero-rated land transaction have been clarified. These are:

- When a member of a group of companies is a party to such a transaction, statements and information provided by or to a member are treated as being provided by or to the group's representative member.
- In a nominee situation, the information required can be provided by the nominee or the contractual purchaser in respect of the nominee. If the purchaser provides the information it is to be based on the purchaser's expectations of the circumstances of the nominee.
- An agent acting on behalf of an undisclosed principal does not have to be registered for GST. Instead, the agent may provide its tax file number in lieu of a GST registration number and the vendor must retain this tax file number for its records.
- An agent must keep the registration number of the principal, including in circumstances when the principal is expected to be a registered person.

Application date

The changes apply from 1 April 2011.

BANKING GROUP'S EQUITY THRESHOLD

Section FE 19(1) of the Income Tax Act 2007

The minimum equity threshold of a reporting bank's New Zealand banking group for a tax year has been increased from 4% of risk-weighted exposures (RWEs) to 6% of RWEs, as announced in Budget 2011.

Background

Since 2005, a special form of thin capitalisation rule has applied for foreign-owned banks. The rule required a New Zealand banking group to hold equity equal to at least 4% of its New Zealand assets – specifically, 4% of its RWEs (less deductions from equity value). The rule has the effect of limiting the interest deductions foreign-owned banks may take against their New Zealand-sourced income for tax purposes.

In line with the announcement in Budget 2011, the minimum equity threshold for tax purposes has been increased from 4% to 6% of RWEs from 1 April 2012. This increase for tax purposes is consistent with recent changes in the commercial and regulatory environment facing banks, which has seen average regulatory capital ratios steadily increase, while the average tax equity capital ratio has remained near the prescribed minimum.

Key features

Section FE 19(1) of the Income Tax Act 2007 contains a formula which a reporting bank must use to calculate the minimum equity threshold of its New Zealand banking group for a tax year. The formula contains a multiplier to be applied to the value of RWEs less deductions from equity value. This formula has been amended by increasing the multiplier from 0.04 to 0.06.

The new formula only applies for measurement dates under section FE 8(3) of the Income Tax Act 2007 for periods beginning on or after 1 April 2012.

Application date

The change applies from 1 April 2012.

OTHER POLICY MATTERS

PROFIT DISTRIBUTION PLANS

Sections CD 7, CD 7B, CD 8, CD 23B, CD 43, RE 14, RE 15, RF 10 and YA 1 (definition of "bonus issue", "profit distribution plan", "taxable bonus issue") of the Income Tax Act 2007

A profit distribution plan (PDP) is a scheme offered by companies whereby the company advises all its shareholders that they will be issued with bonus shares on a particular date. The shareholders are asked if they would like to have the company repurchase those bonus shares immediately after the shareholder receives them. If the shareholder does not elect to have some or all of their bonus shares repurchased, the default option is for the shareholder to retain the bonus shares.

The tax treatment of PDPs has been amended so that bonus shares issued under a PDP are treated as a dividend for tax purposes. These changes were necessary to ensure that the tax treatment of PDPs is consistent with the current policy around imputation credit streaming and the taxation of bonus issues.

Background

Under the previous tax treatment, the bonus issue of shares under a PDP were treated as a non-taxable bonus issue meaning that if a shareholder retained the bonus shares they were not subject to tax. However, if the shareholder elected to have the bonus shares repurchased by the company, the repurchase proceeds were treated as a taxable dividend. Imputation credits could be attached to the cash dividend by the company and used to credit the tax payable by the shareholder.

The previous tax treatment of PDPs was the subject of a specific Inland Revenue product ruling in 2005 (BR PRD 05/08). The ruling held that a distribution of shares under a PDP is treated as a non-taxable bonus issue and consequently does not constitute a dividend in the hands of the shareholder. The ruling was made subject to certain conditions, including that the company making the bonus issue had sufficient credits in its imputation credit account to have fully imputed a cash dividend equal to the bonus issue not redeemed for cash.

After this product ruling, the tax treatment of PDPs was further reviewed and in 2009 the Government announced its intention to amend the tax treatment of PDPs. Later that year, officials released an issues paper, *The taxation of distributions from profit distribution plans*, for public consultation.

In 2009 the Capital Market Development Taskforce specifically considered the tax treatment of PDPs and made the following recommendation:

> The Taskforce considers it important that the tax system treats substitutable transactions neutrally. If PDPs are substitutable for ordinary dividend payments with optional reinvestment, the tax treatment should ideally be identical in both cases. The same goes for other close substitutes. Otherwise, there is a danger that investment decisions will be biased towards companies that offer PDPs, and that there could be significant loss of tax revenue from normal dividend taxation.
>
> At the same time, the Taskforce considers it desirable that the tax system does not impede the supply of capital. A decision on the tax treatment of PDPs should, therefore, take into account the fact that PDPs are an effective way for companies to raise capital.
>
> **Recommendation:** We recommend that changes to the tax treatment of PDPs should be made as part of a broader review of tax settings and take into account any adverse impacts on capital-raising costs.

In 2011 Inland Revenue officials consulted seven interested parties on draft legislation based on the proposal to treat distributions from a PDP as a taxable bonus issue in lieu.

Detailed analysis

Several amendments have been made to achieve the policy intent. The key amendments are as follows.

Taxation of bonus shares

New section CD 7B treats as a dividend bonus shares issued under PDPs. The amount of the dividend is the amount offered by the company for the repurchase of the shares.

Repurchase of shares under a PDP

New section CD 23B is intended to prevent cash amounts under a PDP from being taxed twice. If a shareholder elects for their bonus shares to be repurchased under a PDP, section CD 23B ensures that the repurchase proceeds are not taxable under the ordinary dividend rules. That is, it is only the bonus issue under a PDP that is the taxable event.

For clarification, there are a few points to note:

- Section CD 23B is not intended to apply to on-market repurchases. This section is only intended to apply to shares that are repurchased under PDPs and not to share repurchases generally.
- Section CD 22 is not intended to apply to section CD 23B. Section CD 22 generally applies when a company pays an amount to shareholders, other than on liquidation, because of the off-market cancellation of shares in the company. This section allows the available subscribed

capital of the company (which is generally equal to the amount paid to the company to subscribe for its shares) to be returned to shareholders tax-free if certain criteria are met. New section CD 7B states that section CD 22 does not apply in relation to a share issued under a PDP and repurchased by the company under that plan. If section CD 22 applied to new section CD 23B this could potentially result in double taxation; first when the company issues the bonus shares under a PDP, and secondly when the off-market share cancellation takes place.

- If shares are repurchased by the company outside of the PDP scheme, the ordinary tax rules regarding share repurchases will apply.

Application date

The application date of the changes is 1 October 2012.

TAX TREATMENT OF EXPENDITURE ON UNSUCCESSFUL SOFTWARE DEVELOPMENT

Section DB 40B of the Income Tax Act 2007

The amendment allows an immediate deduction for expenditure incurred on unsuccessful software development projects in the year that the development is abandoned.

Background

On 4 April 2011 the Commissioner of Inland Revenue issued a general notice advising taxpayers that they should not rely on certain parts of a 1993 Policy Statement, "Income Tax Treatment of Computer Software". The 1993 statement indicated that capital expenditure incurred on developing unsuccessful software would qualify for an immediate tax deduction. The 2011 general notice indicated that this was no longer the Commissioner's view of the law, and advised that this part of the 1993 statement should be treated as being withdrawn, from the beginning of the 2011–12 income year.

As a consequence of the Commissioner's revised view of the law, it is possible that some expenditure on unsuccessful software development may never be deductible (either immediately or over time). The non-deductibility of unsuccessful capital expenditure would be akin to "blackhole" expenditure. Disallowing a deduction for this expenditure could discourage firms from undertaking otherwise sensible investment.

Key features

The change allows a deduction when a person incurs expenditure with the intention of developing software for use in their business and the development of this software is abandoned.

The person will be allowed a deduction for the expenditure incurred in the development of the software to the extent that no other deduction has been allowed for the expenditure under New Zealand law.

The deduction will be allowed in the income year that the software development project is abandoned.

Application date(s)

The amendment applies for the 2008–09 and later income years. The application date is retrospective to ensure the tax position of taxpayers who have previously claimed a deduction for the costs of unsuccessful software development.

OVERSEAS DONEE STATUS

Schedule 32 of the Income Tax Act 2007

The following organisations have been granted overseas donee status:

- Aotearoa Development Cooperative
- Deepavali Charitable Trust
- Orphans of Nepal
- School Aid: Global Partnerships Through Schools
- Queen Elizabeth II Diamond Jubilee 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 33⅓% 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.

During Parliament's consideration of the bill, Supplementary Order Paper No. 98 added, with effect from 31 May 2012, the Queen Elizabeth II Diamond Jubilee Trust in the list of donee organisations in schedule 32 of the Income Tax Act 2007. The change is subject to a sunset clause with the effect that the Trust ceases to be listed as a donee organisation after 31 March 2014.

Application date(s)

The amendments apply from 1 April 2013. In the case of the Queen Elizabeth II Diamond Jubilee Trust, the application date is 31 May 2012.

LOOK-THROUGH COMPANIES AND LIMITED PARTNERSHIPS

Sections GB 32, HA 7B, HB 1, HB 11, HG 11, HZ 4B, HZ 4C and YA 1 of the Income Tax Act 2007, and section 55 of the Goods and Services Tax Act 1985

Several amendments have been made to the look-through company (LTC) rules to simplify some administrative provisions, and ensure the rules are consistent with the original policy intent.

The main changes involve the valuation of guarantees or indemnities for the purposes of the LTC deduction limitation formula in section HB 11 of the Income Tax Act 2007 (commonly referred to as the "loss limitation rule"). Changes have also been made to the definition of "income" under that formula.

Similar amendments have been made to equivalent provisions in the limited partnership (LP) deduction limitation formula in section HG 11.

Further changes simplify the initial basis calculation for a former qualifying company (QC) that transitions to either the LTC or LP tax rules, for the purposes of applying the deduction limitation formula under those rules.

There are also several minor remedial amendments to the LTC rules which cover:

- elections, valuation methods and timing methods;
- aggregation of relatives' interests under the look-through counted owner definition;
- benefits provided to shareholders;
- qualifying company amalgamations; and
- GST group-filing rules.

Background

The LTC rules were part of several tax measures introduced by the Government in Budget 2010. The new rules provided an elective look-through income tax treatment for closely held companies, and applied from 1 April 2011.

An LTC's tax treatment is integrated with the tax treatment of the owners. Broadly, the LTC rules provide a transparent tax treatment, similar to that used for partnerships, so that shareholders pay tax on any company profit at their marginal tax rate, and may also use the company's losses, subject to certain limitation rules.

Key features

Amendments to the loss limitation rules

- The definition of "secured amounts" provides for the valuation of a guarantee or indemnity given by an LTC owner, or a person associated with the owner, in respect of the LTC's debt. Similar rules exist for limited partners and LPs.
  - If more than one guarantee is provided for the same debt, the amount of the debt guaranteed is divided by the number of guarantors.
  - If the guarantee provided for an LTC's or LP's debt expressly limits the creditors' recourse by reference to specific property, the secured amount may be limited to the value of the guarantor's interests in that property.
- An owner's share of the LTC income is increased, for the purposes of the loss limitation rules, if an owner's proportionate share of a dividend distributed by a foreign investment fund is higher than their amount of FIF income or FIF loss from that FIF. A similar rule applies for limited partners and LPs.
- The market value method or the accounting book value method may be used by the owner of a transitioning QC for their initial basis calculation, to determine the opening value of the owner's equity or capital contribution. This initial basis valuation applies for the purposes of the LP and LTC loss limitation rules in the year of transition, and in all later years.

Other amendments

- Elections, valuation or timing methods adopted in relation to an LTC's income or property are made or established by the LTC.
- The look-through counted owner test does not aggregate the look-through interests of two people who are connected because one of them is a trustee of a trust under which a relative of the other has benefited or is eligible to benefit.
- Benefits provided by an LTC to a shareholder are treated as a distribution of profits, and not as a fringe benefit of a (non-shareholder) employee associated with the shareholder.
- An amalgamated company cannot use the QC rules following an amalgamation between a non-QC company and a QC.
- An LTC is treated as a company for the purposes of GST group registration.

Detailed analysis

LTC deduction limitation formula (the "loss limitation" rule)

Sections HB 11 and HB 12 of the Income Tax Act 2007 ensure that owners' deductions are restricted if the amount of their deductions exceeds their owner's basis. These sections are widely referred to as the "loss limitation rules", although, more accurately, the sections provide a limitation on deductions. Under these rules the LTC deductions an owner can claim in an income year are limited to an amount equal to their owner's basis. The purpose of the rules is to ensure that owners can offset tax losses only to the extent these reflect their economic risk.

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

> *investments – distributions + income – deductions – disallowed amounts*

The amendments in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act concern items included in the "investments" and "income" categories of this formula only. *Tax Information Bulletin*, Vol 23, No 1, February 2011, has more information on the owner's basis formula and the mechanics of the loss limitation rules in general.

Investments and secured amounts

The "investments" category of the owner's basis formula is the sum of the equity, assets introduced, or services provided, to the LTC, or any amounts paid by the owner on behalf of the LTC. This includes any loans, including shareholder current account credit balances, made by the owner to the LTC. It also includes the owner's share of any LTC debt for which they, or their associate, have provided a guarantee or indemnity; these are known as "secured amounts".

The inclusion of secured amounts within the investments category is intended to reflect that an owner may be at economic risk in respect of guarantees or indemnities that they (or an associate) have provided on the LTC's behalf, although these are not always reflected in the company balance sheet or the shareholder's loan account.

Amendments have been made to the definition of "secured amounts". These ensure that the secured amounts definition includes only appropriate guarantees or indemnities, and clarifies the amount an owner may include in their owner's basis in respect of a guarantee provided by an associated person.

The amendments also simplify what happens in the event that a creditor's recourse under a guarantee is expressly limited to particular property of the person providing the guarantee. Such guarantees are referred to in this guidance as limited recourse guarantees.

Guarantees or indemnities in respect of loans advanced by an owner of an LTC

An owner may include the value of a guarantee or indemnity they provide in respect of an LTC's debt in the "investments" element of the owner's basis calculation. They may also include the value of a guarantee or indemnity given by an associate.

Section HB 11(5)(c) has been amended to ensure that this does not apply to a guarantee or indemnity provided by an owner or an associate in respect of a loan made to the LTC by another owner. This is to prevent double counting, because loans made by an owner are included in that owner's basis under section HB 11(5)(b).

Guarantor

There are several important definitions that are critical to calculating the amount of a guarantee or indemnity that an owner can include in their owner's basis under "secured amounts". A key definition is the definition of "guarantor".

An owner of an LTC will be a guarantor (an "owner guarantor") if:

- the owner provides a guarantee or indemnity for the LTC debt; and/or
- an *owner's associate* provides a guarantee or indemnity for the LTC debt.

An *owner's associate* is a person connected with the owner, such as a relative, or a trustee who is associated in their capacity as trustee (see examples 1a and 1b). An owner's associate cannot hold shares in the LTC (see example 1c).

A person who is not an owner of an LTC, and is not an owner's associate will be a guarantor (a "third party guarantor") if they provide a guarantee or indemnity for the LTC's debt (see example 1d).

Example 1a – Hampton Ltd

Elizabeth is the sole owner of Hampton Ltd, a look-through company. Elizabeth's mother Anne guarantees a bank loan made to Hampton Ltd. For the purpose of the secured amounts definition, Anne is an owner's associate, and so Elizabeth is treated as the guarantor (an "owner guarantor").

Example 1b – Steeple Ltd

Edward and Richard are the joint owners of Steeple Ltd, a look-through company. Their grandmother Cecily guarantees a bank loan made to Steeple Ltd. For the purpose of the secured amounts definition, Cecily is an owner's associate, and so both Edward and Richard are treated as owner guarantors.

Example 1c – Hapsburg Ltd

Mary owns 80% of the shares in Hapsburg Ltd, a look-through company. The remaining 20% of shares are owned by her husband Philip. Philip guarantees a bank loan made to Hapsburg Ltd.

Philip is an owner guarantor.

Mary is not a guarantor because she has not provided a guarantee, and although Philip is her relative, he is not her owner's associate because he is a shareholder in Hapsburg Ltd.

Example 1d – Greensleeves Ltd

Henry is the sole owner of Greensleeves Ltd, a look-through company. Henry provides a guarantee for a bank loan made to Greensleeves Ltd, so he is an owner guarantor. His friend Thomas also provides a guarantee. Thomas is not an owner's associate, because he is not a relative or trustee, so he is a third-party guarantor.

Secured amounts – lesser of

The secured amounts definition provides that the amount of a guarantee or indemnity that an owner may include in their owner's basis is the lesser of two possible amounts, described at paragraphs (a) and (b) of the definition.

It is expected that paragraph (a) will be the operative provision for nearly all LTC owners.

Paragraph (b) concerns guarantees under which the creditor's recourse is expressly limited, which is atypical, and so paragraph (b) is unlikely to apply in most standard guarantee situations.

If paragraph (a) and paragraph (b) both apply, the amount an owner will include in their owner's basis is the lesser of the amounts calculated under each paragraph.

Secured amounts – paragraph (a)

Under paragraph (a) of the secured amounts definition, the amount an owner may include in their owner's basis is the amount of the LTC's debt for which the owner is a guarantor. As explained in the previous section, an owner will be a guarantor via their own guarantees, and guarantees made by an associate (examples 2a and 2b).

When there is more than one guarantor for the same debt, the amount of debt is divided between the number of guarantors (examples 2b and 2c). This includes a third-party guarantor, although they do not, themselves, have any owner's basis (example 2d).

The reason the debt amount is divided in this way is because the guarantors each have equal exposure under their respective guarantees. Apportioning the guaranteed debt amount between them on an equal basis is a way of accounting for this shared risk.

It is important to identify the LTC debt (the "secured debt") to which a guarantee relates. If guarantors provide a guarantee for different debts, or for differing proportions of the same debt, this will affect what is apportioned, and who is included within the apportionment (example 2e).

Example 2a – Hampton Ltd

Hampton Ltd receives a bank loan of $40,000. Elizabeth's mother Anne, an owner's associate, guarantees this loan. Elizabeth, as the owner guarantor, can include $40,000 as a "secured amount" in her owner's basis.

Example 2b – Steeple Ltd

Steeple Ltd receives a bank loan of $60,000. Cecily, the grandmother of its two owners, Edward and Richard, guarantees this loan. Both Edward and Richard are owner guarantors.

Because there are two guarantors, the $60,000 debt is divided by two. Edward and Richard can each include $30,000 in their owner's basis.

Example 2c – Hapsburg Ltd

Hapsburg Ltd receives a bank loan of $100,000. Philip guarantees this loan. Philip, the minority shareholder, is the only owner guarantor and can include $100,000 as a "secured amount" in his owner's basis. Mary, the majority shareholder, cannot include anything, as she is not a guarantor.

If Mary also provided a guarantee for the bank loan, there would be two owner guarantors, Philip and Mary. The $100,000 debt would be divided by two, and Philip and Mary could each include $50,000 in their owner's basis.

Note: The debt is divided by the number of guarantors. The fact that Mary and Philip hold different proportions of shares in Hapsburg Ltd is not relevant to the apportionment of the debt.

Example 2d – Greensleeves Ltd

Greensleeves Ltd receives a bank loan of $50,000. There are two guarantors – Henry, the sole owner of Greensleeves Ltd and his friend Thomas.

The $50,000 debt is divided by two, because there are two guarantors. Henry, as an owner guarantor, can include $25,000 in his owner's basis.

Thomas is not a shareholder in Greensleeves Ltd, so he does not have an owner's basis calculation.

Example 2e – Couer Ltd

Couer Ltd has two owners, Jane and Bess. Couer Ltd has a bank loan of $100,000, for which both Jane and Bess provide guarantees. Couer Ltd also has a loan from a finance company of $30,000, for which Jane is the sole guarantor.

The $100,000 debt is divided by two, because there are two guarantors. Jane and Bess, as owner guarantors, can each include $50,000 in their owner's basis.

The $30,000 debt is not divided, because there is only one guarantor. Jane can include $30,000 in her owner's basis in relation to this debt.

Jane has a secured amount of $80,000 in her owner's basis calculation, while Bess has a secured amount of $50,000.

Secured amounts – paragraph (b)

Paragraph (b) of the secured amounts definition will only be relevant if a guarantee is provided for an LTC's debt and the creditor's recourse is expressly limited under that guarantee. Such a guarantee is referred to in this guidance as a "limited recourse guarantee". Paragraph (b) is concerned with limited recourse guarantees provided by owner guarantors only, that is, guarantees made by an owner or an owner's associate. Guarantees by third-party guarantors are not taken into consideration.

A key definition is "recourse property". When a person provides a guarantee, but the creditor is expressly limited to taking legal recourse only against particular property and has no ability to seek reimbursement over and above what can be realised from that property, the property is referred to as "recourse property".

Example 3 – Dover Ltd

Charles is the sole shareholder in Dover Ltd, a look-through company. Dover Ltd receives a bank loan of $300,000.

Charles's father William, an owner's associate, agrees to provide a personal guarantee for this loan, but also wants to protect some valuable family heirlooms. Under the terms of the guarantee the bank is able to seek full reimbursement of the guarantee from William, but may only take any legal recourse action against William's two rental properties. These rental properties are "recourse property" under this definition.

Note: A creditor may require a mortgage or similar charge to be placed over property owned by the person providing the guarantee, to provide some collateral security. The mortgage charge by itself offers some level of protection to a creditor, but it does not limit the creditor's ability to take legal recourse against any of the guarantor's other assets if necessary, to meet the outstanding loan amounts. In these situations, the property under mortgage charge is not "recourse property". Such guarantees will be dealt with under paragraph (a) of the secured amounts definition.

When there is a limited recourse guarantee, the secured amount under paragraph (b) is the net market value of the recourse property; that is, the market value of the property on the last day of the relevant income year, less any other charges against that property that would have a higher creditor priority.

Example 4 – Dover Ltd (continued)

William has provided a limited recourse guarantee for his son Charles's company, Dover Ltd which has a bank loan of $300,000. William uses his two rental properties as recourse property. Due to some severe storm damage, the rental properties have recently declined in value. Their current market value is $140,000 each and both have an outstanding mortgage loan of $30,000 which would take creditor priority in the event that the properties are sold.

The amount that Charles may include in his owner's basis is $220,000, being the market value of the recourse property ($280,000), less any higher ranking charges ($60,000).

The net market value of the recourse property is attributed to each of the owner guarantors to the extent of their ownership interest in the recourse property, or, where the limited recourse guarantee is provided by an owner's associate, to the extent of the associate's interests in the recourse property.

If there is more than one owner guarantor linked to, or using, the same recourse property for their guarantees, the net market value of the recourse property will be divided amongst the relevant owner guarantors.

Example 5 – Greenwich Ltd

Two brothers, Peter and Paul are the equal shareholders of Greenwich Ltd, a look-through company. Greenwich Ltd has a bank loan of $500,000.

Peter and Paul also own a holiday home, which currently has a net market value of $400,000. This holiday home is used as "recourse property" in guarantees provided by Peter and/or Paul for the bank loan.

If either Peter or Paul provides a guarantee for the bank-loan, he will be an owner guarantor.

The secured amount that Peter and/or Paul may include in their owner's basis calculation will depend on who provides the limited recourse guarantee, and their ownership interests in the holiday home. For example, if the holiday home is owned by Peter and Paul as tenants-in-common, each will own a separate interest in the property, and they can only include the proportionate interest as a secured amount. If the holiday home is held as joint tenants, Peter and Paul have a shared interest in the whole of property, so it will simply be divided equally between them.

<table>
<tr><th rowspan="2">Extent of interest in holiday home (recourse property)</th><th rowspan="2">Limited recourse guarantee(s) provided by</th><th rowspan="2">Number of owner guarantors</th><th colspan="2">Amount included in owner's basis</th></tr>
<tr><th>Peter</th><th>Paul</th></tr>
<tr><td rowspan="3">Joint tenants</td><td>Peter</td><td>1</td><td>$400,000</td><td>N/A</td></tr>
<tr><td>Paul</td><td>1</td><td>N/A</td><td>$400,000</td></tr>
<tr><td>Peter and Paul</td><td>2</td><td>$200,000</td><td>$200,000</td></tr>
<tr><td rowspan="2">Tenants-in-common
Peter's share = 40%</td><td>Peter</td><td>1</td><td>$160,000</td><td>N/A</td></tr>
<tr><td>Paul</td><td>1</td><td>N/A</td><td>$240,000</td></tr>
<tr><td>Paul's share = 60%</td><td>Peter and Paul</td><td>2</td><td>$160,000</td><td>$240,000</td></tr>
</table>

Application date

The amendment applies from 1 April 2011.

Income

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

New section HB 11(7)(ab) provides for the owner's share of the LTC income to be increased where an owner's proportionate share of the dividend actually distributed by a foreign investment fund (FIF) to the LTC is higher than their amount of FIF income as calculated using the owner's chosen FIF calculation method. Any excess is added to the owner's "income" for the purposes of the owner's basis calculation. In the case of a FIF loss being calculated under the FIF rules but FIF dividends being received, the actual dividend amount will be counted.

This is achieved through the formula in section HB 11(7B):

dividend – FIF amount

Where:

dividend is the amount of the actual dividend received by the LTC from a FIF (ignoring section CD 36(1))

FIF amount is the amount of the owner's FIF income for the relevant income year and FIF. If the owner has a FIF loss, the FIF amount is zero (see example 6c).

If the calculation under this formula produces a negative result, then there is no increase in the owner's basis for dividends received from a FIF (see example 6b).

Example 6

Tina is the sole owner of Button Ltd, a look-through company. Button Ltd derives gross trading income of $100 and also receives dividends from a foreign investment fund (FIF) of $20. There are no expenses. Tina selects the comparative value method for calculating her FIF income from her attributing FIF interests.

Example 6a – FIF income < dividend amount

Tina has FIF income of $5 for her interests in this attributing FIF, held via Button Ltd.

Under section HB 1, $105 of income is attributed to Tina from Button Ltd. This $105 is included in the "income" element of her owner's basis formula, in section HB 11(7)(a).

Tina is considered to be at economic risk for the full $20 FIF dividend received in that income year. Therefore the $15 difference between the actual dividend and the amount of FIF income calculated under the FIF rules is added to her owner's basis in section HB 11(7)(ab), through the formula in section HB 11(7B):

dividend – FIF amount =$20 – $5 = $15

Example 6b – FIF income > dividend amount

The comparative value method for the attributing FIF interest gives Tina FIF income of $30.

No additional amount is included in Tina's owner's basis under section HB 11(7)(ab), because the result of the formula at HB 11(7B) would be negative, and so the result is restricted to zero.

dividend – FIF amount = $20 – $30 = –$10
(so restricted to zero)

Example 6c – FIF loss

If Tina had a FIF loss, the "FIF amount" in the formula at HB 11(7B) would be zero; Tina would include the full amount of FIF dividends actually received in her owner's basis.

dividend – FIF amount = $20 – $0 = $20

If an owner does not use the FIF rules, they will not have FIF income or a FIF loss. Instead any actual foreign dividends received will already be included as income under section HB 11(7)(a) and no adjustment will be necessary under section HB 11(7)(ab).

Application date

The amendment applies from 1 April 2011.

QCs transitioning to LTC or LP rules – initial basis

When the LTC rules were introduced, special transitional rules were included for companies that were QCs or LAQCs in the income year immediately before the income year starting on or after 1 April 2011. These are designed to provide a smooth transition for existing QCs to start using the LTC rules if they wish to do so. There is also an option for a QC to transition its business structure into a limited partnership (LP).

After a transition to either an LTC or an LP, the shareholders of the former QC will need to apply the loss limitation rules to determine their owner's or partner's basis respectively. This will require them to determine the amount of equity they have in the LTC or LP. Under the special transitional rules their equity amount "at risk" includes any retained reserves built up during the company's pre-QC and QC years.

When a QC transitions to an LTC, shareholders need to make an initial valuation of their equity amount, that is, for the shares acquired during pre-transition. This is known as their initial basis, and is used in section HB 11(5)(a) in the transitional year, and in all future years.

So, for example, the reference in section HB 11(5)(a) to "the value of shares at the time the person purchases or subscribes for them" will be, for a shareholder in an LTC that has transitioned from being a QC, the value of his or her shares as determined under the initial basis calculation, in all future years when the shareholder applies section HB 11(5)(a) to those shares.

Likewise, for a transition to an LP, a limited partner must make an initial valuation of their equity contribution, which forms the starting point for determining the valuation of their "capital contribution" under section HG 11(5)(a) for all future years.

A shareholder in a transitioning QC has two options for determining their partner's or owner's initial basis under sections HZ 4B and HZ 4C respectively. They can use either:

- the market value or the accounting book value of the relevant items on the last day of the income year before the QC transitions; or
- the historic basis, as if the LP or LTC rules had always applied, and the LP or LTC had always existed.

The "market value" and the "accounting book value" options in this method are broadly the same. However, under the former, shareholders need to obtain a formal market valuation of their shares.

Amendments have been made to the market value or the accounting book value methods of the initial basis calculation to clarify that:

- The valuation of shares is used in determining the amount of an owner's or limited partner's "investments" under the loss limitation formula, for all relevant future years.
- Any change in the value of assets included in the initial basis valuation of equity will be determined using this initial basis valuation, for the purposes of the loss limitation rules. For example, the calculation of a "capital gain" or "capital loss" via sections HB 11(7)(b) and HB 11(8)(b) (see example 7).
- An initial basis calculation, under either the accounting book value or market value method applies only to shares or capital contributions included in the investments category of the loss limitation formula. It is not relevant to other items included in the investments category, such as loans and secured amounts where the valuation is likely to fluctuate each year.

Example 7 – Capital gains and capital losses

A QC transitions to an LTC. The owner's initial basis calculation under the accounting or market value method is:

	Accounting book value	Market value
Shareholder equity		
Paid-up capital	1,000	1,000
Retained earnings	200	200
Revaluation reserve	–	30,000
Total equity	1,200	31,200
Net assets		
Property	50,000	50,000
Revaluation	–	30,000
Total assets	50,000	80,000
Mortgage	−30,000	−30,000
Shareholder loan account	−18,800	−18,800
Total liabilities	−48,800	−48,800
Net assets	1,200	31,200

Using the accounting book value method would give $1,200 equity under the initial basis calculation.

The market value method would include $31,200 equity under the initial basis calculation (due to the revaluation of the property).

If the property was later sold for its revalued amount of $80,000, any capital gain or capital loss should be recognised under either the income or deductions category of the loss limitation formula (sections HB 11(7)(b) and HB 11(8)(b) respectively).

Under the accounting book value method, the property revaluation was not included in the initial basis. So when the property is sold for $80,000, the capital gain of $30,000 (determined as if realised under section CD 44(7)(a)) will be added to the owner's or partner's basis at that point (section HB 11 (7)(b)).

Under the market value method, the property was included in the initial basis calculation at $80,000, because the revaluation reserve was included. So when the property is later sold for $80,000 there will not be a capital gain to be included as income under section HB 11(7)(b), because the owner has counted the property reserve in his "base" cost. Or put another way, the capital gain computation undertaken solely for the purposes of the owner's basis formula will be nil ($80,000 disposal proceeds less $80,000 "cost"). If the property actually sells for more or less than $80,000, the capital gain or capital loss will be recognised under section HB 11(7)(b) or section HB 11(8)(b) respectively.

Application date

The amendment applies from 1 April 2011.

Limited partnerships

Amendments have been made to the "investment" and "income" categories of the calculation for a partner's basis in the limited partnership rules in section HG 11. These are broadly similar to the amendments to the LTC rules, which are discussed in detail above.

Investments – capital contribution

The definition of "capital contribution" has been amended to clarify that loans made by a limited partner to the limited partnership are counted as an investment under section HG 11(5)(a). This amendment clarifies the existing position.

Application date

The amendment applies from 1 April 2008.

Investments – secured amounts

Amendments have been made to the definition of "secured amounts", which mirror the amendments described above for LTCs.

There are two points to note:

- A general partner is only considered to be a guarantor of the partnership's debt under the new definition if the general partner provides a guarantee. The general partner is not otherwise considered to be a guarantor simply by being liable for the debt as a general partner.
- The definition of "partner's associate" is a company in the same wholly owned group as the partner, and a relative of the partner. For the latter purpose, the definition of a "relative" excludes a trustee connected with the partner simply by being the trustee of a trust under which a relative of that partner has benefited or is eligible to benefit.

Application date

These amendments apply from 1 April 2012.

Income – FIF income and FIF loss

Amendments have been made to the income category of the partner's basis calculation, which mirror the amendments described above for LTCs.

Application date

These amendments apply from 1 April 2008, being the date on which the limited partnership rules first applied.

LTC remedial amendments

Tax elections, and valuation and timing methods

Various provisions in the Income Tax Act 2007 require elections to be made for a particular tax treatment for an asset or class of assets, or to apply a particular valuation method to certain assets. Elections relating to the assets of a company would usually be made by its director or other relevant officer.

However, under the LTC rules, each owner is regarded as holding the company's assets directly, and carrying on the activities of the company. This could require each owner to make an election in respect of their portion of the LTC's assets.

New section HB 1(6) simplifies this administrative burden by providing that elections concerning the tax treatment of an LTC's income or property, or any valuation or timing methods adopted in relation to an LTC's income or property, are made or established by the LTC. The election, valuation method or timing method used by the LTC is binding on the owners in respect of their look-through interests in the LTC's property.

For example, section EE 8(1) of the Income Tax Act 2007 provides that a person may elect to treat an item of depreciable property they acquire as not being depreciable property. When such an election is made for an item of depreciable property acquired by an LTC, the election will be made by the LTC. The consequences of that election on the LTCs allowable deductions will be reflected in the LTC's tax return, which will automatically flow through to the owners' tax returns.

Section HB 1(6) applies only to elections made, or valuation or timing methods adopted, in relation to an LTC's income or property. It does not apply to a tax position taken by a shareholder. This is because tax positions will take into account a shareholder's interests outside of the LTC – for example, in determining whether the cost of a person's attributing interests in a foreign investment fund (FIF) are more than $50,000, for the purposes of applying section CQ 5 or section DN 6, attributing interests in a FIF that are held by the shareholder in a personal capacity, as well as their attributed interests via the LTC must be taken into account.

Application date

The amendment applies from 1 April 2011.

Aggregation of relatives' interests under the "look-through counted owner" definition

An LTC must have five or fewer "look-through counted owners". The shareholdings of look-through owners who are relatives are aggregated, and they are treated as one look-through counted owner.

The definition of "relative" in section YA 1 has been amended, for the purposes of determining the number of look-through counted owners, to exclude a person connected with another person simply by being the trustee of a trust under which a relative has benefited or is eligible to benefit.

Application date

The amendment applies from an LTC's first income year starting on or after 2 November 2012, being the date of Royal assent.

Benefits provided to an employee's associates

Under the LTC rules, a shareholder of an LTC may be treated as an employee for PAYE purposes, if he or she elects to be treated as a "working owner".

A working owner is not treated as an employee for fringe benefit tax (FBT) purposes. This is because the cost of providing fringe benefits and paying FBT is borne by the employer. Under the LTC tax transparency rules this would give all of the LTC's shareholders a deduction for the benefit provided to the "working owner" shareholder, which is, strictly, a distribution of profit and not a business expense.

Under section GB 32 of the Income Tax Act 2007, if a benefit is provided by an employer to a person who is associated with an employee, and the benefit would have been a fringe benefit if provided to the employee, the benefit is treated as provided by the employer to the employee for the purpose of the fringe benefit tax (FBT) rules.

Section GB 32 has been amended to ensure that it does not apply to a benefit provided by an LTC to one of its shareholders. This means that the benefit provided to the shareholder will not be treated as a fringe benefit of a (non-shareholder) employee who is associated with the shareholder.

Instead, the benefit provided by the LTC to the shareholder will be considered as a distribution of profits to that shareholder.

The amendment also applies to benefits provided to a partner by their partnership or limited partnership.

Application date

The amendment applies from 2 November 2012, being the date of Royal assent.

Qualifying company amalgamations

When the LTC rules were introduced, the QC rules in subpart HA of the Income Tax Act 2007 were grandparented so that only companies that were already QCs or LAQCs before 1 April 2011 could continue to use the QC rules. No new companies could start using the QC rules after 1 April 2011.

However, it was possible that in an amalgamation that was not a resident's amalgamation an ordinary company could amalgamate with a QC, and this amalgamation would effectively have enabled a new company to start using the QC rules after 1 April 2011.

Section HA 7B of the Income Tax Act 2007 has been amended to ensure that a new company cannot enter into the QC rules through an amalgamation that is not a resident's amalgamation. The amended section means that following an amalgamation between a non-QC company and a QC, the resulting amalgamated company cannot use the QC rules.

Application date

The amendment applies to amalgamations on or after 2 November 2012, being the date of Royal assent.

GST group-filing rules

Under the Goods and Services Tax Act 1985, an LTC is generally regarded as a company and as the registered entity for GST purposes. The company is responsible for complying with any GST requirements, not each individual owner.

Section 55 of the GST Act has been amended to ensure that an LTC can also be regarded as a company in order to meet the "group of companies" requirements for GST group registration. This will reduce compliance costs for LTCs and their owners.

Application date

The amendment applies from 1 April 2011.

INCOME FROM AN INSURANCE BUSINESS OF A CONTROLLED FOREIGN COMPANY

Sections EX 20B(3)(f) and EZ 32E of the Income Tax Act 2007

Profits from a business of insurance of a controlled foreign company (a CFC) are generally taxable. However, certain types of insurance income, such as reinsurance claims income, were unintentionally omitted from the definition of "attributable income" in section EX 20B(3) of the Income Tax Act 2007. This means tax losses have arisen even though there are no economic losses. The new Act amends the definition of "attributable income" with retrospective effect, to include income from a business of insurance, however that income arises.

Key features

The definition of "attributable income" has been amended to include income from a business of insurance or from being an insurer, however that income arises. Where this leads to a retrospective liability for tax, any consequent use-of-money interest charge will be relieved.

Detailed analysis

Section EX 20B(3)(f)

Section EX 20B(3)(f) has been amended to include income from a business of insurance, however that income arises. This includes reinsurance income, third-party recoveries and the like.

Income from a business of insurance is explicitly supplemented by income received by a person from being an insurer. The income will be included even if the insurer is an insurer for just one person and might not be considered to be "carrying on an insurance business" according to the ordinary meaning of that phrase.

Section EZ 32E

The change to section EX 20B is retrospective. As a consequence, tax liabilities for past years may arise and use-of-money interest could be imposed. Section EZ 32D relieves such interest if it arises.

The interest is relieved if a person took a tax position before the enactment of the amendment, and the enactment results in an additional tax liability. Interest is not imposed on the relevant addition, for the period from the initial due date until the later of 30 June 2012 or a revised due date determined by Inland Revenue for the payment of the interest.

Application date

The amendments apply for income years beginning on or after 1 July 2009, which corresponds with the application date for the reformed controlled foreign company rules.

AMENDMENTS TO MAKE TAXATION OF CONTROLLED FOREIGN COMPANIES MORE SYMMETRIC

Sections DN 4, DN 8, DZ 19, EX 18A, EX 20C, EX 20D, EX 21B, EX 73, EZ 32C, EZ 32D, IQ 2 and YA 1 ("election commencement year", "elective attributing CFC", "elective attributing FIF") of the Income Tax Act 2007, and sections 21, 37 and 44 of the Taxation (Tax Administration and Remedial Matters) Act 2011

The controlled foreign company (CFC) rules were extensively reformed in 2009. A New Zealand resident with an income interest of more than 10% in a controlled foreign company is taxed on the passive profits earned by that company. Passive profits comprise passive income, such as interest and royalties, and deductions for related expenditure. To reduce compliance costs, there is also an "active business test": a CFC's profits are not taxed if the CFC's gross passive income is less than 5% of its total income.

In some cases the reformed rules are not working as they should, and income is being taxed while deductions for related expenditure are not being allowed. In particular:

- Some CFCs that take out foreign currency loans to finance their active businesses are being taxed on foreign exchange gains on those loans, but are not allowed deductions if there are foreign exchange losses.
- Some CFCs that incur expenditure in a year when they pass the active business test, to earn passive income in another year, are being taxed on the passive income but are not receiving deductions for the related expenditure.

The Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act addresses these problems.

Key features

When a CFC borrows money to fund its business, income from the loan will normally be taxable only if deductions would be allowed for expenditure on the loan. (Income from a loan would most commonly be an exchange rate gain on a foreign-currency loan.)

A taxpayer may elect not to apply the active business test to a CFC, to enable more deductions to be claimed for expenditure incurred in earning passive income. Restrictions apply to the use of deductions when an election has been made.

Detailed analysis

Section DN 4

Section DN 4 restricts the use of an attributed loss of a CFC when the CFC is an "elective attributing CFC". A CFC is an elective attributing CFC when the taxpayer has elected not to apply the active business test to the CFC under section EX 73.

The first year that an election applies in respect of a CFC is called the CFC's "election commencement year".

The policy principle underlying the legislation is that losses of an elective attributing CFC are tagged with the name of the CFC and the CFC's election commencement year.

The tagged losses may be used to reduce attributed CFC income, but only if the income comes from the same CFC which is still an elective attributing CFC (or FIF), or another elective attributing CFC (or FIF) with the same election commencement year. This condition applies in addition to the other, existing conditions for use of losses, such as jurisdictional ring-fencing.

Unused tagged losses of a CFC are forfeited if the election made in respect of the CFC expires or is revoked.

A new subsection (1B) has been added to section DN 4, to restrict the use of losses of elective attributing CFCs, in the way just described. Subsection (1) has also been rewritten to apply only to losses that are not from elective attributing CFCs; the effect of the rewritten provision is not intended to be different in any other respect from the original.

Example – loss of elective attributing CFC

A taxpayer has the following amounts of attributed CFC income and loss for the 2015–16 income year:

- CFC A (United States), loss of $80 million
- CFC B (United States), income of $60 million
- CFC C (United States), income of $20 million
- CFC D (United States), income of $10 million
- CFC E (United States), loss of $35 million
- CFC F (Austria), income of $50 million.

CFC A, CFC B and CFC F are elective attributing CFCs and all have an election commencement year of 2013–14. CFC D is an elective attributing CFC and has an election commencement year of 2014–15. CFC C and CFC E are not elective attributing CFCs.

Subsection (1B) allows the taxpayer to use $60 million of CFC A's loss, because CFC A and CFC B have the same election commencement year and there is $60 million of attributed CFC income from CFC B.

CFC A's loss may not be used to reduce CFC C's income (because CFC C is not an elective attributing CFC), CFC D's income (because CFC D has a different election commencement year), or CFC F's income (because CFC F is not resident in the United States).

The remaining $20 million of CFC A's loss cannot be used under section DN 4 and must instead be used under subpart IQ.

Subsection (1) allows the taxpayer to use $30 million of CFC E's losses, because CFC E is not an elective attributing CFC, CFC C and CFC D are resident in the United States and the combined income of CFC C and CFC D is $30 million.

The remaining $5 million of CFC E's losses cannot be used to reduce income from CFC F because CFC F is not a United States company, and must instead be used under subpart IQ.

Section DN 8

Section DN 8 makes changes having the same effect as the changes to section DN 4, except that they apply to FIF losses rather than attributed CFC losses.

Section DZ 19

Section DZ 19 has been repealed retrospectively. It was a temporary measure and has been replaced by other measures in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act. (See changes to section EX 20C.)

Section EX 18A

Section EX 18A has been amended so that the taxpayer will calculate attributed CFC income or loss for a CFC if the CFC is an elective attributing CFC for the taxpayer.

The attribution calculation will be undertaken even if the CFC would otherwise be a non-attributing active CFC under section EX 21B.

Section EX 20C

Section EX 20C has been rewritten to change the tax treatment of a CFC's income from a loan that provides funds to the CFC. Income from a loan would typically be the result of an exchange rate gain on a foreign-currency loan.

In most cases, such income will be included in attributable income only to the extent that expenditure or loss relating to the loan would have been included (if there were any). That is, there will generally be symmetry between included income and included expenditure. Previously, the income was included completely.

The rewording of the section is not intended to have any other effects.

Subsection EX 20C(2)

Subsection EX 20C(2) contains the formula for net attributable CFC income or loss:

> *attributable CFC – apportioned funding income – apportioned funding costs – other deductions*

"Attributable CFC" less "apportioned funding income" is, generally speaking, the gross taxable income of the CFC.

"Attributable CFC" is calculated in the same way as it has always been, but the subtraction of "apportioned funding income" is new.

"Apportioned funding costs" and "other deductions" are, generally speaking, tax deductions of the CFC. They are calculated in the same way as they have always been, although some of the terminology in the relevant subsections has changed.

Subsection EX 20C(3)

Subsection EX 20C(3) defines apportioned funding income, which will not be attributed. Ordinarily, apportioned funding income will be determined by the formula:

funding income × funding fraction × (1 – asset fraction)

These terms are defined in more detail in subsections (5), (6) and (8).

In broad terms, "funding income × funding fraction" is the amount of income from loans the CFC has taken out, after adjusting for any on-lending.

Multiplication by *1 – asset fraction* determines the portion of the income that relates to funding of active assets. This portion of the funding income is not taxable. In the same way, expenditure on the loan would be non-deductible if it related to the funding of active assets.

If a CFC is carrying on a business of banking or insurance or is directly or indirectly controlled by someone who is, there is no apportioned funding income.

Subsection EX 20C(5)

Subsection EX 20C(5) defines funding income, which appears in the equation in subsection (3). Funding income is income from a financial arrangement that provides funds to the CFC – income from a loan the CFC has taken out, in other words.

There will not normally be income from a loan, but there can be if, for instance, the loan is in a foreign currency and there is an exchange rate gain on conversion to New Zealand dollars.

Note that only income from financial arrangements is included. Contrast this with paragraph EX 20C(7)(a), which includes certain equity instruments as well as financial arrangements. The underlying assumption here is that a CFC will not have accrual income from equity instruments it has issued, though it may have deductible expenditure in some cases.

Paragraph (b) prevents income from being funding income if the financial arrangement is *expected* to generate income. A key characteristic of a loan taken out is that it will result in expenditure, not income, over its term. If income is expected, it will be attributed.

Exchange rates can vary significantly, and it is quite likely that there will be income in at least one year of a long-term financial arrangement, even though it is not clear which year. The test in paragraph (b) is not intended to catch such a case. Rather, the test is intended to catch cases in which net income is reasonably expected over a particular period that is predictable in advance, such as the entire term of the arrangement or a specific sub-period of the term.

The test is applied when the CFC enters the arrangement and again if the terms of the financial arrangement are altered. It is an objective test. The intentions or expectations of the parties may be relevant, but it is a hypothetical reasonable person's expectations that are being evaluated.

Subsection EX 20C(6)

Subsection EX 20C(6) calculates the item "funding fraction". Funding fraction adjusts the amount of funding income to remove the effects of on-lending. That is, it makes an adjustment if the CFC has provided funding – implicitly out of the CFC's own borrowings – to an associated CFC.

The funding fraction is the proportion of funding which is not implicitly on-lent.

It is compulsory to make the adjustment for on-lending when apportioned funding income is being calculated.

"Funding fraction" also applies in the calculation of apportioned funding costs, but in that case it is optional to make an adjustment for on-lending.

The difference between the cases of income and cost is due to incentives.

In the case of apportioned funding costs, there is an incentive to adjust for on-lending. This will often increase the amount of expenditure that is fully deductible. However, taxpayers are given the option to forego the advantages of adjustment if, say, the calculations would be too costly. The risk that tax revenue will be undermined as a result of this choice is limited.

In contrast, in the case of apportioned funding income, the incentive is not to adjust for on-lending, because that will make more of the funding income tax-free. This would significantly increase the risks of tax revenue being undermined, particularly if choices were made to adjust for on-lending in the case of costs but not in the case of income.

Taxpayers can voluntarily avoid different outcomes for costs and income by adjusting for on-lending in both cases.

Example – calculation of funding fraction

A CFC has taken out a $25 million interest-only loan to fund its active business.

In 2013–14 the CFC has $10 million of funding income. Paragraph EX 20C(6)(c) gives a funding fraction of 1, because there is no on-lending (the item "group funding" is nil).

In 2014–15 the CFC lends $15 million, also on interest-only terms, to an associated CFC.

In 2015–16 the CFC has $10 million of funding costs and the CFC's New Zealand owner decides to rely on paragraph EX 20C(6)(b) to reduce compliance costs. "Funding fraction" is 1.

In 2016–17 the CFC has $10 million of funding income. "Funding fraction" is 0.4.

Subsection EX 20C(8)

Subsection EX 20C(8) calculates the item "asset fraction", which is the fraction of the CFC's assets that generate (gross) attributable income. On-lent amounts (see subsection (7)) are excluded from the calculation if they were excluded in subsection (6), and not otherwise.

A similar fraction is used for calculating apportioned funding costs. However, in that case the fraction is modified if the CFC is excessively debt funded, so that the deductions of an excessively debt funded CFC would be more limited than those of another CFC. The intention of the excessive debt-funding limitation is to discourage excessive debt funding. It would be inconsistent with this intention to also limit the taxation of any income arising from the debt.

Example – calculation of "asset fraction"

In 2015–16 a CFC takes out a $10 million interest-only loan to fund its business. There is no on-lending.

There is $1 million of income from the loan, owing to an exchange rate gain exceeding interest expense.

By value, 80% of the CFC's assets are used to derive an attributable CFC amount (passive income) and not to derive an amount that is not an attributable CFC amount. The asset fraction is therefore 0.8. The amount which can be subtracted as apportioned funding income is $200,000 and $800,000 remains attributable.

Suppose that instead there was $1 million of expenditure on the loan, and that the CFC is excessively debt-funded under section EX 20D with a cost fraction of 0.3. The cost fraction of 0.3 would be used to calculate the apportioned funding costs. Deductions of $300,000 would be attributed and $700,000 would be ignored.

Section EX 20D

Section EX 20D has been amended consequential to the changes made to section EX 20C.

Section EX 21B

Section EX 21B has been amended so that no active business test is carried out for a CFC when the CFC is an elective attributing CFC for the taxpayer.

Section EX 73

Section EX 73 is a new provision allowing the taxpayer to make an election. The taxpayer may elect not to apply the active business test to a CFC in which they have an income interest of 10% or more or to a FIF for which they use the attributable FIF income method.

Subsection EX 73(1)

A taxpayer may elect that a CFC or FIF in which they hold an income interest is an "elective attributing CFC" or "elective attributing FIF" (terms which are defined in section YA 1). The active business test in section EX 21B is not applied to such a CFC or FIF, and there is a full calculation of attributable income.

The election may be made only if the active business test would be applied; that is, only if it is for a CFC in which the person has a 10% or greater income interest, or for a FIF for which the attributed FIF income method is used.

Subsection EX 73(2)

A CFC or FIF may not be an elective attributing CFC or FIF if it carries on a business of banking or insurance or is controlled by somebody who does. Such entities are in any case extremely unlikely to be non-attributing active CFCs.

In addition, a CFC may not be an elective attributing CFC if it qualifies for the Australian exemption in section EX 22.

Subsections EX 73(3) and (4)

An election under section EX 73 is normally effective from the beginning of the income year following the notice of election. That is, elections must be prospective. This is to minimise the likelihood of elections being made only in cases in which a loss arises.

There are two exceptions to this general rule.

First, because section EX 73 applies for income years beginning on or after 1 July 2009, it is possible to make a retrospective election. A retrospective election must be made by the end of the income year in which the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act received Royal assent, or at a later time if Inland Revenue allows it. The expectation is that Inland Revenue would allow a late election only in extraordinary circumstances, such as when the taxpayer's income year ends very soon after the date of Royal assent (2 November 2012). When made, the election applies from the beginning of the first income year beginning on or after 1 July 2009, for a CFC or 1 July 2011, for a FIF.

Secondly, Inland Revenue has some general discretion to allow a late election. The expectation is that this general discretion would be rarely used, such as when a late election was due to factors beyond the taxpayer's control, and not in circumstances in which the election was made merely because a loss actually arose during the year.

Subsections EX 73(5) to (8)

An election under section EX 73, once it applies, is effective until it is revoked or expires. If it is revoked by the taxpayer or it expires, it ceases to be effective from the beginning of the income year in which it is revoked or expires.

In general, it is not intended that taxpayers will revoke elections. The concern here is that an election will be revoked after attributed deductions have been taken but before the related attributable income arises, leading to under-taxation.

However, revocation is possible if it is extremely unlikely that any related attributable income will arise after the revocation. For instance, revocation might be allowed if deductions were taken for exchange rate losses on a bank deposit, and the deposit was subsequently withdrawn and paid out as a dividend. In such a case, it is extremely unlikely that any more attributable income would arise from the deposit. For the revocation to be effective, it must not be made for a purpose or effect of reducing a tax liability, and Inland Revenue must agree to the revocation in writing.

With two exceptions, an election expires automatically if the CFC ceases to be a CFC in which the taxpayer holds an income interest of 10% or more or if the FIF ceases to be a FIF for which the taxpayer uses the attributable FIF income method. Note that a FIF that qualifies for the Australian exemption in section EX 35 is no longer a FIF for which the attributable FIF income method is used, which will trigger expiry of the election. Other exemptions from the FIF rules will have the same effect.

The first exception occurs when a CFC in which the taxpayer holds an interest of 10% or more becomes a FIF for which the taxpayer uses the attributable FIF income method (for instance, if the taxpayer maintains a holding of 20% in the foreign company but an unrelated non-resident acquires the remaining 80% interest). In that case, the election continues to be effective but is treated as having been made for the FIF. The election commencement date is unchanged.

The second exception occurs in the reverse case, when a FIF for which the taxpayer uses the attributable FIF income method becomes a CFC in which the taxpayer has an income interest of more than 10% and which is not a non-attributing Australian CFC. Again, the election continues to be effective, but is treated as having been made for the CFC with no change to the election commencement date.

The election also expires automatically if the foreign company carries on a business of banking or insurance or is controlled by someone who does, or if a CFC becomes eligible for the Australian exemption in section EX 22.

Subsection EX 73(9)

Any CFC or FIF losses attributed to a taxpayer who was subject to an election under section EX 73 for the CFC or FIF, and have been carried forward under subpart IQ, are forfeited when the election is revoked or expires. The relevant losses (those implicitly tagged with the name of the CFC or FIF and an election year) are not carried forward from the previous year into the year in which the revocation or expiry is effective.

Any losses arising from the CFC or FIF in the year that an election ceases to be effective are either normal attributed losses under sections DN 4 or DN 8, if the losses are required to be attributed, or are not recognised at all.

Example – effect of revoking an election

In 2013–14 a taxpayer makes an election under section EX 73 in respect of a CFC. There is an attributed loss of $1.3 million in 2014–15, which is carried forward under subpart IQ. In 2015–16 there is attributed income of $0.6 million, which reduces the carried forward loss to $0.7 million. In 2016–17 an attributed loss of $0.4 million would be calculated.

Suppose that in 2016–17 the taxpayer sets up a banking business, so that the election expires. The remaining $0.7 million of historical losses are not carried forward to 2016–17. However, the attributed loss of $0.4 million is recognised as an ordinary attributed loss and may be used under section DN 4, including by carrying it forward under subpart IQ via section DN 4(3).

Suppose instead that in 2016–17 the CFC becomes Australian-resident and qualifies for the exemption in section EX 22. The remaining $0.7 million of historical losses are not carried forward to 2016–17, and the $0.4 million current-year loss is ignored.

When one of the exceptions in paragraphs EX 73(7)(a) or (b) applies, the tagged losses of the elective attributing CFC or FIF become tagged losses of the elective attributing FIF or CFC respectively, with no change to the date they were incurred. This is to ensure that if the election does subsequently expire, all losses – whether arising before or after the change from CFC to FIF (or vice versa) – are forfeited.

Subsection EX 73(10)

After an election is revoked or expired, it will usually not be possible to make another election in respect of the CFC or FIF. This is to prevent CFCs or FIFs from entering and exiting the tax system in a way that would result in recognition of deductions and non-recognition of related income.

However, following expiry another election may be made if certain conditions are met, and if Inland Revenue agrees to the new election. The expiry must have been due to an oversight, and notice of the new election must be made within a reasonable period.

More importantly, the new election must not be made with a purpose of allowing deductions to be attributed – at any time – without the attribution of corresponding income – also at any time.

It is not expected that Inland Revenue would agree to a new election in many cases, but there could be unusual cases in which it would be appropriate to be able to make a second election.

Example – a second election

In 2013–14 a taxpayer makes an election under section EX 73 in respect of a CFC.

In 2016–17 the directors of the CFC hold some board meetings in New Zealand while participating in trade shows here. They are unaware of the tax consequences of these meetings, one of which is that the CFC becomes a New Zealand resident. However, this is an isolated occurrence and the company ceases to be New Zealand-resident soon after. There is no real change in the activities or balance sheet of the company over its period of residence.

In 2017–18 the taxpayer asks to make a second election in respect of the CFC under section EX 73.

In deciding whether to agree to an election, Inland Revenue might take into account that: any losses attributed while the first election was active were forfeited; the company was subject to full taxation during its period of New Zealand residence; there was no obvious change in the business of the CFC or its assets or liabilities while it was resident; and the directors were unaware of the tax consequences of the New Zealand meetings.

Subsection EX 73(11)

Subsection EX 73(11) is an anti-avoidance provision, to prevent multiple elections and revocations or expiries by the transfer of a CFC interest between associated persons.

If a person has made an election in respect of a CFC or FIF and the election has expired or been revoked, an associated person will not be able to make an election in respect of that foreign company unless Inland Revenue agrees. Inland Revenue must be satisfied that the election has not been made with a purpose of allowing deductions to be attributed without the attribution of corresponding income.

There may be cases in which associated persons quite legitimately make elections in relation to a single CFC. It seems more likely that these would involve individuals rather than companies.

Example – election by an associated person

A parent makes and revokes an election for a CFC and then, on retirement many years later, transfers the CFC interest to an adult child who was previously not involved in the investment.

Acting completely independently, the adult child wishes to make an election for the CFC, and satisfies Inland Revenue that this will not lead to deductions being attributed when corresponding income is not.

Subsection EX 73(12)

Notices of election or revocation under section EX 73 must be made in writing, and provided to Inland Revenue using the prescribed form and by the prescribed means. The current procedure is to send a letter with the relevant details in it to **competent.authority@ird.govt.nz**. For an initial election, the CFC or FIF in question should be identified, as should the period for which the election is made. For revocations or elections for which agreement is sought, further information will be required to satisfy Inland Revenue that the relevant conditions are met.

Section EZ 32C

Section EZ 32C, which was a temporary provision to allow certain exchange rate losses and gains of CFCs to be offset, has been repealed with retrospective effect. It has effectively been made redundant in any case by the addition of the item "apportioned funding income" to section EX 20C(2).

The effect of the retrospective repeal is that section EZ 32C never applies.

Section EZ 32D

Section EZ 32D is a transitional provision for CFCs that have income from borrowed funds. As a result of changes discussed in this *Tax Information Bulletin*, income from such borrowed funds may be subtracted from attributable income under section EX 20C(2).

However, in calculating the amount of income to be subtracted, usually no account is taken of excessive debt-funding of the CFC. This can lead to a higher proportion of income being attributed but a lower proportion of corresponding deductions being allowed. In most cases this is intentional and designed to discourage excessive debt-funding (see the discussion of amendments to section EX 20C(8) elsewhere in this *Tax Information Bulletin*).

There are some cases, though, in which existing loans were taken out before the new CFC rules came into force in 2009. Under the old CFC rules, it is probable that the income and deductions were treated similarly: either both completely within the tax base or both completely outside of it, regardless of the level of debt. To provide some continuity in such cases, a taxpayer who has taken out loans before 21 June 2012 may take excessive debt-funding into account for those loans.

To apply section EZ 32D, the taxpayer effectively undertakes two calculations under subsection EX 20C(3)(b)(ii) for the CFC and adds the results together, instead of undertaking a single calculation under that subsection.

The first calculation is for funding income that relates to old funding arrangements – those entered into before 21 June 2012. The calculation under subsection EX 20C(3)(b)(ii) has been modified so that excessive debt-funding is taken into account, by using the item "cost fraction" instead of the item "asset fraction".

The second calculation is for the remaining funding income, and uses the item "asset fraction" as normally.

Example – transitional rule for excessively debt-funded CFCs

A taxpayer has a CFC that took out a $100 million loan in 2007–08. The outstanding balance of the loan in 2013–14 is $65 million. The CFC takes out another loan in 2013–14 of $40 million.

In 2013–14 there is $6.5 million of funding income from the old loan and $4.0 million of funding income from the new loan. The CFC's asset fraction is 0.6 but the CFC is excessively debt-funded and its cost fraction under section EX 20D is 0.4. The CFC has not lent money to anybody.

Under section EZ 32D, apportioned funding income is calculated in two parts.

First, there is apportioned funding income from the old loan of $6.5 million × 1 × (1 – 0.4) = $3.9 million, because the excessive debt funding is taken into account and the cost fraction is used.

And secondly there is apportioned funding income from the new loan of $4.0 million × 1 × (1 – 0.6) = $1.6 million, because excessive debt funding is not taken into account and the asset fraction must be used.

The total amount of apportioned funding income, which will be subtracted in the attribution formula in section EX 20C(2), is $5.5 million.

Section IQ 2

Section IQ 2 has been amended to restrict the use of a CFC loss or a FIF loss when the CFC or FIF is an elective attributing CFC or FIF.

Subsection (1) has been rewritten to apply only to losses that are not from elective attributing CFCs or FIFs. The effect of the rewritten provision is not intended to be different in any other respect from the original.

Subsection (1BA) has been added to section IQ 2 to restrict the use of losses of an elective attributing CFC or FIF. The amount of loss that may be used to reduce an income tax liability is limited to the amount of attributed income from elective attributing CFCs or FIFs having the same election commencement year as the CFC or FIF. Subsection (1BA), like subsection (1), also requires that the income be from CFCs or FIFs resident in the jurisdiction where the CFC or FIF was resident when the losses arose.

Example – use of carried forward losses of elective attributing CFCs

A taxpayer wholly owns four CFCs:

- CFC A, United States, elective attributing CFC, election commencement year is 2013–14
- CFC B, United States, elective attributing CFC, election commencement year is 2013–14
- CFC C, United States, not an elective attributing CFC
- CFC D, Portugal, elective attributing CFC, election commencement year is 2013–14.

Losses are carried forward to 2014–15 under subpart IQ as follows:

- Losses of elective attributing CFCs: $12 million (United States, CFC A, 2013–14)
- Other CFC losses: $3 million (United States).

And there is CFC attributed income for 2014–15:

- CFC A, $7 million
- CFC B, $1 million
- CFC C, $5 million
- CFC D, $7 million.

$8 million of the $12 million loss that came from CFC A may be used to reduce income, because CFC A and CFC B have the same election commencement year as CFC A, are resident in the United States, and generate combined attributed income of $8 million. The remaining $4 million of loss is carried forward as a loss of the elective attributing CFC to 2015–16.

The $3 million loss that is not a loss of an elective attributing CFC may be used entirely, because CFC C is resident in the United States and has income of $7 million.

(See the discussion of amendments to sections DN 4 and DN 8 for more background information.)

Section YA 1 (election commencement year, elective attributing CFC, elective attributing FIF)

Section YA 1 defines the terms "election commencement year", "elective attributing CFC" and "elective attributing FIF". Their use has been described elsewhere in this *Tax Information Bulletin*.

An elective attributing CFC (or FIF) is an elective attributing CFC (or FIF) only for an interest holder who has made an election under section EX 73. Another holder of an interest in the same CFC who has not made an election does not treat the CFC as an elective attributing CFC. Similarly, the election commencement year of a particular elective attributing CFC is the election commencement year only for the interest holder who made the election.

Application date

The amendments apply for income years beginning on or after 1 July 2009, which corresponds with the application date for the reformed controlled foreign company rules.

APPLICATION OF THE FOREIGN INVESTOR TAX CREDIT RULES TO FOREIGN INVESTMENT PIES

Sections HM 5, HM 17, HM 35, HM 55FB, LP 2, RF 8 and schedule 6, table 1B of the Income Tax Act 2007

These changes apply the supplementary dividend tax credit rules (also known as the foreign investor tax credit (FITC) rules) to foreign investment PIEs. This more closely aligns the tax treatment of non-resident portfolio investments made through foreign investment PIEs with that of portfolio investments made directly.

Background

In broad terms, the FITC rules ensure that the New Zealand tax rate on non-resident portfolio investment is limited to the company tax rate.

The rules achieve this by allowing a New Zealand company to pay a "supplementary dividend" to portfolio non-resident investors to offset non-resident withholding tax payable on imputed dividends from the company. The company receives a tax credit equal to the supplementary dividend paid. The supplementary dividend is based on the amount of imputation credit attached to the dividend. This means the FITC rules apply to the extent that company tax has already been paid.

Previously, the FITC rules were only available to non-residents that made portfolio investments directly into New Zealand companies. As a result, non-residents investing through New Zealand PIEs were disadvantaged compared with those investing into New Zealand companies directly. Applying the FITC rules to foreign investment PIEs removes this distortion.

Key features

- Applying FITC is optional for foreign investment PIEs.
- The FITC mechanism applies at the level of the company paying the dividend to the foreign investment PIE.
- A FITC is only available when a New Zealand-resident company pays a dividend and related supplementary dividend to a foreign investment PIE that has notified foreign investors that have a less than 10% interest in the resident company and have a double tax treaty tax rate of 15% or more (these investors are referred to as "qualifying investors").
- The PIE must notify the company before the dividend distribution of the qualifying investors that it had on the date on which the legal entitlement to the dividend was determined. Notification enables the company to calculate and distribute the supplementary dividend to the qualifying investors.
- A supplementary dividend must only be paid when attached to a fully imputed dividend (or to the part of the dividend that is imputed) and is attributed to notified foreign investors that qualify for the payment of a supplementary dividend, unless the PIE chooses to pay NRWT on dividends.

Detailed analysis

Tax credits for supplementary dividends

Section LP 2

Section LP 2 allows a tax credit for supplementary dividends when a New Zealand-resident company pays a dividend and related supplementary dividend to a foreign investment PIE when:

- the foreign investment PIE has notified foreign investors that have less than a 10% voting interest in the company, and the foreign investors have a double tax treaty tax rate on the dividends and supplementary dividends of 15% or more (these investor are referred to as "qualifying investors"); and
- the dividend and related supplementary dividend are attributed to these qualifying investors, or the PIE chooses to pay NRWT on the dividends; and
- the foreign investment PIE notifies the company of the qualifying investors it had on the date on which legal entitlement to the dividend has been determined.

Notification requirements

Section HM 55FB

To enable the payment of supplementary dividends, it is necessary for the foreign investment PIE to notify the company paying the dividend of the qualifying investors it had on the date on which legal entitlement to the dividend has been determined.

The notification must be made after the company has declared a dividend but before the payment of the dividends. The information must be sufficient to enable the calculation and payment of a supplementary dividend. The company is also required to use the information supplied by the PIE in calculating the supplementary dividend.

NRWT calculation option

Section HM 44B

The foreign investment PIE can choose to pay NRWT on the dividends and related supplementary dividends when the PIE:

- receives dividends with imputation credits attached;
- receives related supplementary dividends;
- has "qualifying investors";
- pays the qualifying investors the total amount of the dividend and supplementary dividend; and
- pays the amount by the required time.

Rights to investment proceeds

Sections HM 5, HM 17, HM 35 and schedule 6, table 1B

The dividend and related supplementary dividend must be attributed to the qualifying investors. The entire amount of the dividend and the supplementary dividend is taxed at 15% as PIE income if the NRWT option has not been chosen.

This ensures that if NRWT has not been paid, the tax credit for supplementary dividends paid is clawed back at the PIE level.

Application date

The new rules apply from 2013–14 and later income years.

NON-RESIDENT FILM RENTERS' TAX RULES

Sections CC 10, CV 17, DW 3, IA 8, OB 29, OP 27, RF 2, YA 1 "schedular income", YD 6, YD 7 and YD 8 of the Income Tax Act 2007

The non-resident film renters' tax rules have been replaced with non-resident withholding tax (NRWT).

Background

Previously, 10% of the gross receipts derived by non-residents from renting films in New Zealand were treated as taxable income under the Income Tax Act 2007. A non-resident film renter was not allowed a deduction in relation to this income. Because the non-resident was invariably a company, this meant that non-resident film renters were subject to an effective tax rate of 2.8% on their gross receipts (28% × 10%).

When income was subject to this rule, the income was not included in the income of the non-resident film renter under any other provision in the Act. Importantly, this income was excluded from the definition of "non-resident passive income" and therefore not subject to NRWT.

The rules for taxing non-resident film renters have existed in various forms since 1928. They were originally introduced because of the difficulties in accurately determining the net profit derived by non-residents from renting films in New Zealand.

The rules are an historical anachronism. The non-resident film renters' tax was not replaced in 1964 when NRWT was introduced because of the 1948 double tax agreement between the United States and New Zealand. That agreement prevented New Zealand taxing the income of United States' film renters except to the extent allowed under the previous rules. The 1982 agreement between

New Zealand and the United States (which replaced the 1948 agreement) and the current agreement (in force from November 2010) contain no similar restriction on New Zealand's ability to tax income derived from New Zealand by United States-resident film renters.

Key features

The non-resident film renters' tax rules have been repealed as there is no longer a sound policy rationale for having separate tax rules for non-resident film renters.

This means that NRWT applies to amounts derived by non-residents from renting films in New Zealand. Practically all amounts that were subject to the non-resident film renters' tax comes within the "royalty" definitions in the Act and in double tax agreements. Only some minor types of receipts such as receipts from the sale or hire of film containers, which were subject to the previous rules, will not be subject to NRWT (because they are outside the "royalty" definition).

NRWT at variable rates will apply in accordance with double tax agreements between New Zealand and other countries, which limit the amount of NRWT that New Zealand can charge on royalties. The agreement royalty rate is generally 10%. However, the rate under the United States and Australian agreements is currently 5%, which will apply to many non-resident film renters. The NRWT rate of 15% applies if there is no applicable double tax agreement.

Persons who make payments to non-resident film renters for renting films in New Zealand will need to deduct and return NRWT from these payments.

Application date

This amendment applies to payments made on or after 2 November 2012.

REMEDIAL MATTERS

GST AND THE CREDIT CARD FEE

Section 226C(3) of the Tax Administration Act 1994

An amendment has been made to clarify that fees charged under section 226 of the Tax Administration Act 1994 are applicable for GST, and the amount set in legislation is GST-exclusive.

Background

Section 226C of the Tax Administration Act 1994 allows the Commissioner of Inland Revenue to charge taxpayers a fee, if they choose to pay their tax and social liabilities by credit or debit card. The fee is set at 1.42% of the total transaction and may be changed by Order in Council.

This fee will not apply to overseas-based student loan borrowers and overseas-based child support liable parents who choose to make their payments by credit or debit card.

Key features

The amendment to section 226C of the Tax Administration Act 1994 makes it clear that if any GST is payable on the credit card or debit card service fee, the amount set in legislation is exclusive of GST.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

TIMING OF DETERMINING SERIOUS HARDSHIP

Section 177(1B) of the Tax Administration Act 1994

The Tax Administration Act 1994 has been clarified to ensure that when a serious hardship application is made, the financial position considered by Inland Revenue is the financial position at the date on which the application for relief is made.

Background

The Tax Administration Act 1994 prevents Inland Revenue from recovering outstanding tax to the extent to which recovery would place a taxpayer (natural person) in serious hardship. The Act defines "serious hardship".

Under the debt rules, late payment penalties stop being imposed when a taxpayer contacts Inland Revenue seeking relief. This provision is aimed at encouraging taxpayers to contact Inland Revenue when they are having problems paying their tax. It was intended Inland Revenue would consider the taxpayer's financial position at the time the taxpayer contacts Inland Revenue.

A recent Court of Appeal decision, *Larmer*[4], found that serious hardship could be determined at the time of application or, alternatively, at the time the tax became due. Determining serious hardship at the time tax becomes due is not consistent with the policy intent and could lead to inconsistent application of the provision.

The debt rules provide incentives for taxpayers to contact Inland Revenue if they cannot pay their tax. In such cases Inland Revenue can enter an instalment arrangement with the taxpayer and, if necessary, write off part or all of the outstanding amount, for example, when payment would place a taxpayer in serious hardship. To determine if an individual will be placed in serious hardship, Inland Revenue will request relevant details of the person's financial position, for example, details of bank accounts and assets held.

It could in practice be very difficult, and in some cases impossible, for Inland Revenue to determine whether a taxpayer was in serious hardship when the tax became due. This is because this could be a date years before the application for relief is made and it could be difficult to reconstruct a person's affairs. It would also remove the incentive on taxpayers to contact Inland Revenue when they cannot pay their tax.

Key features

New section 177(1B) of the Tax Administration Act 1994 provides that when determining whether recovery would place a taxpayer in serious hardship, Inland Revenue considers the taxpayer's financial position at the date on which the application for relief is made.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

RATE FOR EXTINGUISHING TAX LOSSES WHEN TAX IS WRITTEN OFF

Section 177C(5) of the Tax Administration Act 1994

The Tax Administration Act 1994 has been amended to reduce the rate used to extinguish the tax losses of companies when their tax is written off.

Background

The Tax Administration Act 1994 allows Inland Revenue in certain cases to write off tax which cannot be recovered.

If Inland Revenue writes off tax for a taxpayer who has a tax loss, it must extinguish all or part of the taxpayer's tax loss in proportion to the amount written off by dividing the

[4] CA61/2010

amount written off by 33% and reducing the tax loss by that amount. The legislation provided a single rate of 33% for extinguishing tax losses.

When the provision was introduced, the company tax rate was 33% and the top marginal tax rate for individuals was 39%. Submissions on the provision, when it was introduced in 2002, noted that the rate used for extinguishing tax losses should be the taxpayer's marginal tax rate. Officials' response was that a single rate was preferred for simplicity reasons, and the 33% rate would generally either be accurate or taxpayer- friendly.

Since the provision was introduced in 2002, tax rates have been lowered. The top marginal rate for individuals is now 33% and the company tax rate has been lowered from 33% to 28%.

Given these rate changes, the 33% rate for extinguishing losses is too generous in all cases for companies because they are taxed at a flat rate of 28%; in other words, insufficient company losses are extinguished under the current 33% rate. The rate for other taxpayers will remain at 33% to ensure individuals on the top marginal tax rate do not have their losses over-reduced.

Key features

The rate used for extinguishing losses of companies who have tax written off has been reduced to 28%. The rate for other taxpayers remains at 33%.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

EMISSIONS TRADING SCHEME – TECHNICAL AMENDMENTS

Two technical amendments have been made to the provisions which deal with the income tax consequences of transactions in emissions units.

Negotiated Greenhouse Agreements – section ED 1B of the Income Tax Act 2007

The Crown entered into Negotiated Greenhouse Agreements (NGAs) with two businesses some years before the introduction of the Emissions Trading Scheme (ETS). Arrangements have subsequently been entered into between these emitters and the Crown for the transfer of emissions units to these businesses in recognition of the impact of the ETS on the price of their inputs.

The rules which tax income from the receipt of units from the Crown on an accrual basis have been extended to cover all transfers of emissions units referred to in the preceding paragraph. This change follows an earlier extension to section ED 1B, which applied to the first but was not wide enough to cover the procedure subsequently negotiated with the second of the NGA parties.

Application date

The change applies from 1 July 2010.

Treaty of Waitangi settlements – section YA 1 (definition of "pre-1990 forest land emissions units") of the Income Tax Act 2007

The Crown has allocated pre-1990 forest land emissions units in a number of instances when the relevant land is in the process of being transferred to iwi as part of a Treaty settlement. Some Treaty settlements are implemented in two stages – the land and other assets are initially transferred to a representative of a number of iwi, and then on to individual iwi.

Legislation has been amended to ensure that the special tax treatment which applies to pre-1990 forest land emissions units is preserved through this series of transactions. This means that no tax liability will arise if the iwi disposes of the emissions units.

Application date

The change applies from 9 June 2009.

ANNUAL INCOME TAX RATES FOR 2012–13 TAX YEAR

The annual income tax rates for the 2012–13 tax year are the relevant rates specified in schedule 1 of the Income Tax Act 2007.

ELECTRONIC RWT CERTIFICATES, SHAREHOLDER DIVIDEND STATEMENTS AND MĀORI AUTHORITY DISTRIBUTION NOTICES

Sections 25(10)(e), 29(2)(e), and 31(2)(e) of the Tax Administration Act 1994

Section 25(10)(e) ensures that interest payers can make resident withholding tax (RWT) withholding certificates available on their websites, as long as the recipient agrees to receive the certificate in that way. This amendment has been made retrospective to 1 April 2002, to align with interest payers' current practice.

Section 29(2)(e) clarifies that companies can make shareholder dividend statements available electronically as long as the recipient agrees, and section 31(2)(e) clarifies that Māori authorities can make distribution notices available electronically if the recipient agrees.

Detailed analysis

Resident withholding tax withholding certificates

Interest payers are required to send depositors RWT withholding certificates at the end of the tax year.

Since 1 April 2002, interest payers have been able to send RWT withholding certificates electronically under section 25(10)(e) of the Tax Administration Act 1994, provided the depositor agrees to receive the certificate in that way. However, it was not clear that interest payers can make RWT withholding certificates available on their secure websites as well as via email.

In accordance with the original policy intention, section 25(10)(e) has been amended to ensure that interest payers can make RWT withholding certificates available on their websites as well as via email, as long as the recipient agrees to receive the certificate in that way.

Shareholder dividend statements and Māori authority distribution notices

Companies must provide shareholder dividend statements to shareholders when they pay a dividend.

The Electronic Transactions Act 2002 allows companies to meet the requirement to provide dividend statements to shareholders by making the statement available electronically to their shareholders (as long as the recipient consents to receiving the statement in that way).

Section 29(2)(e) of the Tax Administration Act 1994 has been amended to make this explicit for legislative consistency and ease of use.

The Electronic Transactions Act 2002 also permits Māori authorities to meet the requirement to provide Māori authority distribution notices by making the notice available electronically to the recipient, when the recipient consents to receiving the notice in that way. This has been made explicit in section 31(2)(e) of the Tax Administration Act 1994 for legislative consistency and ease of use.

Application date(s)

The amendment to ensure that RWT withholding certificates can be made available on a website applies to RWT withholding certificates provided on or after 1 April 2002 that relate to interest or specified dividends paid in the 2001–02 and subsequent income years. This date is the start date of the existing provision.

The amendments to the provisions relating to shareholder dividend statements and Māori authority distribution notices are effective from the date of enactment.

EMPLOYER SUPERANNUATION CONTRIBUTION TAX

Sections RD 64, RD 65, RD 67 and RD 69 to RD 71 of the Income Tax Act 2007; sections 22, 47, 98 and 143A of the Tax Administration Act 1994

Changes have been made to the Income Tax Act 2007 and the Tax Administration Act 1994 to codify the long-established practice of deducting employer superannuation contribution tax (ESCT) from superannuation contributions made on behalf of past employees, at the ESCT rate of 33%.

Key features

- ESCT must be deducted from superannuation contributions made on behalf of past employees.
- A flat ESCT rate of 33% applies to superannuation contributions made on behalf of past employees.

Detailed analysis

Employer superannuation cash contributions are paid for the benefit of their employees, and are subject to employer superannuation contribution tax (ESCT). Although the majority of employers who pay employer superannuation contributions do so for their current workforce, some employers may occasionally make contributions for the benefit of past employees, particularly in relation to defined benefit schemes.

The original policy intent was to apply the ESCT rules to contributions made for the benefit of past employees. This has been the generally accepted and long-standing practice of employers, practitioners and Inland Revenue. However a technical inconsistency was identified in the definitions of "employer" and "employee" in the Income Tax Act 2007, as they apply in the ESCT rules, which meant that they did not cover employer superannuation contributions paid for former employees. Instead these contributions were taxable as fringe benefits.

These amendments ensure that the ESCT rules apply to superannuation contributions paid by a person for the benefit of their past employees, by changing the definition of an employer's superannuation cash contribution to include such contributions.

The rate at which ESCT must be deducted from these contributions is set at a flat rate of 33%. This ensures consistency with the approach for defined benefit schemes. The variable rates that employers must apply to contributions on behalf of current employees from 1 April 2012 cannot be used because the variable rates rely on recent salary or wage information that is not applicable in the case of a past employee.

Application date

The amendments apply from 1 April 2008.

There is a "savings" provision for any returns filed on a different basis before the introduction of the bill on 14 September 2011. Where this applies, Inland Revenue will consider the basis on which employers have filed their ESCT returns in light of the previous legislative position.

Note: The Taxation (Budget Measures) Act 2011 contained some other changes to the ESCT rules, which apply from 1 April 2012. This necessitated these amendments being drafted in two stages, but the overall outcome is the same.

ADDITIONAL DECLARATION FOR UNILATERAL ADVANCE PRICING AGREEMENT PRIVATE RULINGS

Section 91ED(1B) of the Tax Administration Act 1994

New section 91ED(1B) is relevant for people making an application for a private ruling on how transfer pricing rules apply (including branch income and expenditure apportionment) in sections GC 6 to GC 14 or YD 5 of the Income Tax Act 2007. They will be required to examine the application and confirm that to the best of their knowledge, the information disclosed in the application is comprehensive. This declaration will be submitted with their application for a ruling.

Background

Inland Revenue has had concerns about the completeness of some advance pricing agreement applications and documentation packages. As consideration of transfer pricing issues is heavily dependent on the level of information provided, problems can arise if key details are not supplied, or if the information provided is not comprehensive. The purpose of the amendment is to reduce the number of potentially inaccurate or factually incomplete applications. Due to the fact-intensive nature of advance pricing agreements, tax agents also depend on information received from the taxpayer when acting on behalf of clients.

Key features

Applicants for private rulings relating to advance pricing agreements will now be required to be more explicitly involved in the application process. The additional declaration is to ensure that a person in the applicant's business who has sufficient knowledge of the applicant's international related-party transactions and transfer pricing methodology and has the necessary authority to make the declaration, can declare that the information provided to Inland Revenue in connection with the application is expansive and complete.

Application date

The new section will apply from the date of Royal assent, being 2 November 2012.

COMMISSIONER'S DISCRETION TO DECLINE MAKING A RULING ON APPLICATION OF SECTION GA 1

Section 91E(3B) of the Tax Administration Act 1994

New section 91E(3B) will allow the Commissioner to decline to provide a ruling on how the reconstruction provision in section GA 1 of the Income Tax Act 2007 applies or would apply.

Background

The purpose of the binding rulings regime is to allow taxpayers who apply for a ruling to obtain certainty on how taxation laws apply to an arrangement disclosed to the Commissioner. It is intended that in most cases rulings will be sought and obtained before entering into the arrangement.

If the Commissioner rules that an arrangement is a tax avoidance arrangement, under the existing law the Commissioner may also be asked by the applicant to rule on how section GA 1 will apply. Section GA 1 is the reconstruction provision which allows the Commissioner to adjust the taxable income of a person affected by an arrangement in order to counteract a tax avoidance arrangement.

New section 91E(3B) gives the Commissioner a discretion to decide not to rule on the application of section GA 1. The discretion is unlikely to arise as an issue very often because it would require the Commissioner to take a position that an arrangement is avoidance and for a taxpayer (who still enters into such an arrangement) to seek a ruling on how the reconstruction power will apply.

In order to rule on section GA 1, the Commissioner will need to undertake a thorough investigation of the arrangement, including the persons who may be affected by the arrangement, and other likely situations which might have arisen had the tax avoidance arrangement not been entered into. This can be a lengthy process and rulings are not intended to be investigations or audits, nor is it appropriate or feasible for the Commissioner to handle rulings in that way. Often, because of timing issues, the tax advantage will not have fully crystallised or be able to be properly quantified until a full audit or investigation occurs. In addition, a ruling on section GA 1 could be used to constrain the Commissioner's ability to argue on the appropriate reconstruction in the context of the tax disputes process. Given the difficulty of arguments regarding counterfactuals and reconstruction, this may be undesirable.

A tax avoidance arrangement may affect more than one person. Accordingly, the Commissioner may need to adjust the taxable income of a number of people in order to appropriately counteract the tax advantages obtained. A taxpayer who is not a party to a tax avoidance arrangement can still be subject to the Commissioner's reconstruction power if they have obtained a tax advantage from the arrangement, even though they may not be aware that they have benefited from the arrangement. These matters can be difficult to determine using the binding rulings regime for complex arrangements involving multiple parties (who may not be applicants). This difficulty will be even more pronounced if this involves prospective arrangements.

If an applicant for a ruling were able to require the Commissioner to rule on section GA 1, the Commissioner would have to rely on information (if obtainable) provided by the applicant about these other persons. The binding rulings regime is not the most appropriate way to determine what corrective adjustments may be required to be made to all taxpayers who have benefited, or would benefit, from a tax avoidance arrangement.

Given these difficulties, it will not always be feasible or appropriate for the Commissioner to rule in a definitive and binding manner on the application of the reconstruction power.

Key features

This section provides the Commissioner with a discretion to decide not to provide a ruling on how the reconstruction provision applies or would apply.

Application date

The new section will apply from the date of Royal assent, being 2 November 2012.

MISCELLANEOUS REGULATORY AMENDMENTS

Amendments to the Income Tax (Determinations) Regulations 1987

The current fee-waiver provision has been amended to make it more flexible. The requirement for the Commissioner to publish every determination in the *Gazette* has been replaced with a requirement to publish in a publication chosen by the Commissioner.

Application date

The amendment will apply from the date of Royal assent, being 2 November 2012.

Amendments to the Tax Administration (Binding Rulings) Regulations 1999

The fees provision has been updated to express fees on a "plus any GST" basis. The fees have been increased to reflect the increased costs of providing rulings.

Application date

The amendment will apply from the date of Royal assent, being 2 November 2012.

Amendments to the Income Tax (Depreciation Determinations) 1993

The fees provision has been updated to express fees on a "plus any GST" basis. The fees have also been increased to reflect the increased costs of providing determinations. The current fee-waiver provision has been amended to make it more flexible. An additional consultation reimbursement fee has been added in relation to determinations of a provisional rate under section 91AAG. This fee is payable in certain circumstances after the Commissioner declines to issue a determination or issues one that is unfavourable to the applicant. These circumstances are first, when the applicant requests that a consultant carry out more work but the further work does not cause the Commissioner to issue a ruling which is favourable to the applicant or secondly, when the applicant requests a conference which a consultant attends, but the conference does not cause the Commissioner to issue a ruling which is favourable to the applicant.

Application date

The new section will apply from the date of Royal assent, being 2 November 2012.

TRUSTEES QUALIFYING AS CASH BASIS PERSON

Section HC 24 of the Income Tax Act 2007

Section HC 24(2)(b) has been removed to ensure the legislation better reflects the policy objective that trustees should be able to return income tax in relation to financial arrangements on a cash accounting basis, subject to meeting certain thresholds.

Before changes were made in 2009, only a natural person or a trustee of a deceased estate meeting the criteria under section EW 60 could return income tax in relation to financial arrangements on a cash accounting basis.

The Taxation (Business Tax Measures) Act 2009 changed the financial arrangements rules to allow non-individuals, subject to certain thresholds, to be able to qualify as a "cash basis person".

However, the requirement in section HC 24(2), that in determining a trustee's income tax liability, the trustee is not entitled to be a "cash basis person" unless section EW 60 applies, was not removed as part of these amendments (section EW 60 specifies when a trustee of a deceased's estate is treated as a "cash basis person" for the purposes of the financial arrangements rules).

Application date

The amendment applies for the 2009–10 income year and later income years, to align with the application date for the amendments contained in the Taxation (Business Tax Measures) Act 2009.

DEFINITION OF THE FOREIGN PIE EQUIVALENT

Section HM 3 of the Income Tax Act 2007

The definition of a foreign PIE equivalent has been amended to include an Australian managed investment trust (MIT), provided the MIT is not a New Zealand resident for tax purposes.

Background

A foreign PIE equivalent is, broadly, a non-resident entity that would be eligible to be a PIE if it were resident in New Zealand. Foreign PIE equivalents are able to hold 100% of a New Zealand-resident PIE, and vice versa.

MITs are subject to similar or more stringent investment and investor restrictions as New Zealand PIEs, and would therefore meet the definition of a foreign PIE equivalent. Including MITs within the definition of a foreign PIE equivalent reduces the continued compliance costs of PIEs monitoring whether a MIT meets the specific criteria of a foreign PIE equivalent.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

OPTIONAL LOOK-THROUGH RULES FOR PIES

Section HM 6B of the Income Tax Act 2007

The legislation has been amended to ensure that when a retail foreign investment variable-rate PIE invests into a wholesale foreign investment PIE, the flow-through rules work appropriately.

Background

The rules are intended to allow retail PIEs to treat amounts that are derived by wholesale PIEs as if they had been derived by the retail PIE. Similarly, the rules are intended to allow expenditure incurred by the wholesale PIE to be treated as if it had been incurred by the retail PIE.

The wording of section HM 6B has been clarified to ensure that the rules achieve these results.

Application date

The amendment applies from the 2012–13 income year – the start-date for foreign investment variable-rate PIEs.

ADDING QUAYSIDE HOLDINGS TO SCHEDULE 29

Schedule 29 of the Income Tax Act 2007

Quayside Holdings Limited, the investment arm of the Bay of Plenty Regional Council, has been added to schedule 29, which means its investments are exempt from some of the PIE eligibility criteria.

Background

Normally an entity can only own up to 20% of a PIE and there must be at least 20 investors in a PIE. The rationale for these restrictions is to ensure that PIEs are widely held, so a single investor cannot dominate the actions of a PIE. Entities listed in schedule 29, however, can hold up to 100% of a PIE and can be a PIE's sole investor. This is on the basis that these entities are themselves widely held. The PIE will therefore, in effect, still be widely held even if one such entity has a significant interest in it.

Quayside's investments are held for the benefit of the Bay of Plenty Regional Council's ratepayers. In this sense Quayside is widely held, and it is appropriate for it to be added to schedule 29.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

TAX EXCLUSION FOR NON-PARTICIPATING SHARES

Section CX 55 of the Income Tax Act 2007

The capital gains exemption that applies to PIEs investing in New Zealand and Australian listed shares has been narrowed to ensure that it only applies to shares that carry equity risk.

Background

Section CX 55 of the Income Tax Act 2007 provides that income from a PIE's share-trading gains from New Zealand and certain Australian shares is generally excluded. When this rule was developed, it was only intended that it would apply to shares that provide a true equity interest in the underlying company. Reflecting this intention, the share-trading exemption did not apply to non-participating redeemable shares.

Nevertheless, some types of share do not provide a true equity interest yet do not fall within the definition of a non-participating redeemable share. Further, some elements of the definition are of no concern from a policy perspective, for example, it is irrelevant whether a share carries voting rights.

Accordingly, the share-trading exclusion has been amended to more closely reflect the original policy intent. Specifically, the share-trading exclusion no longer applies to shares that are:

- a fixed-rate share; or
- a share to which the amount payable on its cancellation is no more than the original subscription amount of the share.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

APPLICATION OF ANTI-STREAMING RULE FOR CASH PIES

Section HM 17 of the Income Tax Act 2007

The anti-streaming rule has been amended to clarify that it should not apply when a PIE invests only in financial arrangements, as the streaming for such a PIE has no tax effect and can be useful for commercial reasons.

Background

The PIE rules contain a specific rule to prevent the streaming of different types of investment returns to different investors. This rule is designed to combat tax minimisation strategies. For example, in the absence of the rule a PIE would be able to stream capital gains made on shares (which are not taxed) to its high tax rate investors and stream dividend income (which is taxed) to its low tax rate or charity investors.

This rule creates some difficulties for so-called "cash PIEs". Cash PIEs provide investors with products similar to standard bank accounts, but are structured as PIEs.

Cash PIEs often offer different investors different interest rates (depending on the investment term, for example) but have only one investment – a term deposit with a bank. To give effect to the different interest rates offered to investors, the PIE streams the interest it receives on its term deposit. It allocates a greater percentage of the interest received to its investors entitled to high interest rates and a lesser percentage to its investors entitled to low interest rates. This type of streaming does not provide any tax advantage to investors. It is merely a commercially sensible way of offering different interest rates to different investors.

The anti-streaming rule has therefore been amended so that it does not apply to PIEs that invest in only financial arrangements. This will clarify that the typical cash PIE structure as described above does not fall foul of the PIE rules.

Application date

The amendment applies from the date of Royal assent, being 2 November 2012.

REMEDIAL CHANGES TO THE PIE RULES

A number of technical and editorial changes have been made to clarify the PIE rules, including:

- Section HM 14(1) has been amended to refer to a "listed PIE" instead of "a company listed on a recognised exchange in New Zealand".
- Foreign investment PIEs are not allowed deductions for expenses or credits in relation to "notified foreign investors". It has been clarified that this treatment also applies to transitional residents who have elected a zero percent tax rate with the PIE.
- Section 57B of the Tax Administration Act 1994 has been amended to ensure that foreign investment zero-rate PIEs are not required to file a return with Inland Revenue for exiting investors if the only exiting investors are notified foreign investors. Information relevant to exiting notified foreign investors should be included in the end-of-year return that the PIE is required to provide to Inland Revenue.
- Section HL 21(13) has been amended to correctly refer to an investor's prescribed investor rate, and not to their portfolio investor rate in both 2004 and 2007 versions of the Income Tax Act, with application from 1 October 2007 and 1 April 2008, respectively.
- The erroneous reference to "an exiting investor referred to in section HM 61" has been removed from the definition of "zero-rated investor".
- The rule that provides how a PIE should allocate tax credits has been amended to correctly apply to all types of credit, other than PIE-specific credits.
- The references to "tax year" and "income year" in section HM 34 have been corrected, with application from the beginning of the 2011–12 income year.
- Sections HM 51(1)(b) and HM 53(1)(b)(ii) have been amended to provide that transitional residents that have elected a zero tax rate cannot benefit from certain tax credits.
- Section HM 32(3) has been re-worded (with effect from the date of enactment), while sections 64(3) and 65(5) have been amended (with effect from the date of enactment of the Taxation (Tax Administration and Remedial Matters) Bill to clarify the policy intent.

Application date

These amendments apply from the date of Royal assent, being 2 November 2012, unless otherwise stated.

FDP DEBIT BALANCES

Sections OB 4(3), OC 30(4) and OC 31(3) of the Income Tax Act 2007

Two remedial amendments have been made to the foreign dividend payment (FDP) account rules so that when a company pays further income tax as a result of having an FDP debit balance, an FDP credit arises that eliminates the FDP debit balance.

In the absence of the remedial amendments, the FDP account would remain in debit for the following year, triggering an additional tax liability, even though the correct amount of further income tax has already been paid.

Background

As part of the 2009 international tax changes, an exemption was implemented for foreign dividends paid to companies. This meant that a special levy on foreign dividends, called a foreign dividend payment (FDP), was repealed.

FDP credit accounts were retained for five years to allow companies to distribute FDP credits to shareholders.

Previously, if an FDP account had a debit balance at the end of the year (for example, because excess credits were distributed), an additional FDP liability would be payable. In 2009 this liability was replaced with a further income tax liability to reflect the fact that FDP was repealed.

An unforeseen consequence of this change is that once an FDP account went into debit, the account would remain in debit for the following year, triggering an additional tax liability, even though the correct amount of further income tax has already been paid.

Key features

Under the existing law, a company that has an FDP debit balance at the end of the tax year, or at the time that the company stops being resident in New Zealand, is required to pay a further income tax equal to the FDP debit balance.

New sections OC 30(4) and OC 31(3) create an FDP credit for an amount of further income tax paid in these circumstances.

The payment of further income tax does not create an imputation credit (as otherwise two credits would be received for the same payment). New section OB 4(3)gb ensures this result holds when the company elects to treat the payment of further income tax as satisfying a liability to pay income tax.

Application date

The amendments apply from income years beginning on or after 1 July 2009, as this is consistent with earlier FDP changes that created the issue.

NRWT AND PARTLY IMPUTED DIVIDENDS

Section RF 11B of the Income Tax Act 2007

A remedial amendment has been made to the non-resident withholding tax (NRWT) rules to ensure that some partly imputed dividends are not overtaxed compared with the rate that would apply to an equivalent unimputed dividend under a double tax agreement (DTA).

Background

The rate of NRWT that applies to dividends depends on whether the dividend is imputed or unimputed, and whether the shareholder is from a country which has a DTA with New Zealand.

The complication for partly imputed dividends is that DTAs reduce the NRWT that applies to the total dividend (the average rate of NRWT) as opposed to the rate that applies to the unimputed portion (the marginal rate). This means there may be little or no relief of NRWT in respect of the unimputed portion of the dividend.

For example, if a dividend were half imputed and half unimputed, the average NRWT rate would be 15% which would not be reduced further by the DTA. In contrast, if the same amount could be paid as two separate dividends, an imputed dividend and an unimputed dividend, there would be DTA relief on the unimputed dividend so that the average rate on both dividends would be 7.5%.

To correct this inconsistency, the amendment provides for a lower rate of NRWT on the unimputed portion of a dividend when a DTA would have provided for a lower rate if the entire dividend had been unimputed.

Key features

The amendment clarifies how New Zealand's domestic law and double tax agreements interact when a company pays a partly imputed dividend to a non-resident who would qualify for relief under a double tax agreement.

Taxpayers calculate the post-treaty tax rate that would apply to an equivalent unimputed dividend. This rate will apply to the unimputed portion of the dividend (section RF 11B(b) of the Income Tax Act 2007). Subject to certain conditions being met, the imputed portion of the dividend may then qualify for the 0% NRWT rate under section RF 11B(a), or failing that, the 15% rate under section RF 7.

This approach is likely to be consistent with how taxpayers have been applying the rules.

Detailed analysis

Section RF 11B(a) applies to the extent that a dividend is fully imputed. It provides a 0% rate of NRWT to the fully imputed portion of a dividend if the conditions of section RF 11B(a)(i) or RF 11(a)(ii) are met.

Section RF 11B(a)(i) requires that the shares be directly held by a non-resident and have a 10% or greater voting interest in the company paying the dividend.

Section RF 11B(a)(ii) requires the dividend to be held by a non-resident who does not have a 10% or greater voting interest but who would nonetheless receive a less than 15% rate under a double tax agreement. Currently, New Zealand has no DTAs that provide for this.

Section RF 11B(b) applies to the extent to which the dividend is not fully imputed. It requires the taxpayer to calculate a post-treaty tax rate by assuming that no imputation credits are attached to the dividend (including any portion of the dividend that is in fact imputed). This tax rate is then applied to the unimputed portion of the dividend.

Application date

The amendment applies from 1 February 2010, being the date that the NRWT rate on imputed non-portfolio dividends was reduced to nil.

UPDATED REFERENCE TO INSURANCE LEGISLATION

Section 91AAQ of the Tax Administration Act 1994

Section 91AAQ of the Tax Administration Act 1994 includes several references to "a business of insurance registered and rated under the Insurance Companies (Ratings and Inspection) Act 1994".

These references have been updated to refer to a business of insurance that is subject to section 60(1) of the Insurance (Prudential Supervision) Act 2010.

Background

On 7 March 2012, the Insurance Companies (Ratings and Inspection) Act 1994 was repealed. This was because the requirements in this Act had been superseded by equivalent requirements in the Insurance (Prudential Supervision) Act 2010.

The policy reason for having the reference to "a business of insurance registered and rated under the Insurance Companies (Ratings and Inspection) Act 1994", was that this was a proxy for having a retail insurance business in New Zealand. This Act required insurers to have a current credit rating from an approved rating agency which was published on the Companies Office website. A key feature of this Act is that it did not apply to "captive" insurers. A captive insurer is a company that only insures risks from related parties.

Key features

The requirement in section 91AAQ for a business of insurance to be registered and rated under the Insurance Companies (Ratings and Inspection) Act 1994 has been replaced by the requirement for a business of insurance to be subject to section 60(1) of the Insurance (Prudential Supervision) Act 2010.

Section 60(1) requires licensed insurers to have a current credit rating from an approved rating agency. Due to section 60(2), section 60(1) does not apply to "captive" insurers or insurers whose only business is reinsurance. A captive insurer is defined in section 6(1) as an insurer that is a subsidiary of a non-insurance parent and that only insures risks of that parent or of other subsidiaries of the parent.

Currently, most insurers only have a provisional licence as they are not required to be fully licenced until September 2013. Under section 247 of the Insurance (Prudential Supervision) Act 2010, provisionally licensed insurers only need to comply with the requirements in this Act to the extent that the conditions of their provisional licence require them to comply. However, because the definition of "licensed insurer" in section 6 of the Act includes provisionally licensed insurers, provisionally licensed insurers may be regarded as being subject to section 60(1) of the Act.

Application date

The amendment applies from 7 March 2012 as this was the date that the Insurance Companies (Ratings and Inspection) Act 1994 was repealed.

INDIRECT INCOME INTERESTS OF 10% OR MORE IN AUSTRALIAN COMPANIES

Section EX 35 of the Income Tax Act 2007

A person who has an income interest of 10% or more in a company that is resident and subject to tax in Australia (and that meets certain other conditions specified in section EX 35) does not attribute any income or loss from that Australian company.

An amendment has been made to clarify how this exemption should be applied to Australian companies that are held indirectly through another foreign investment fund (FIF) or a controlled foreign company (CFC).

Key features

An amendment has been made to section EX 35(a) so that the reference to "direct income interest" (which is defined under section EX 30) has been replaced with a reference to "income interest calculated under section EX 50(4)".

Under section EX 50(4) a person works out their income interest in a FIF as though that FIF were a CFC.

Under the CFC rules (and the attributable FIF income method) a person's income interest is calculated by adding their direct income interests and any indirect income interests. Direct income interests are measured under section EX 9. They include interests such as shares that the person holds themselves.

Indirect income interests are calculated under section EX 10 by multiplying a person's direct income interest in a CFC by that CFC's direct income interest in a second CFC. For example, if a person owns 50% of CFC 1 and CFC 1 owns 40% of CFC 2, the person's indirect income interest in CFC 2 would be 20% (50% of 40%).

Under section EX 50(4), the same approach also applies to foreign companies that are not CFCs. That is, if a person has a direct income interest in one foreign company and that foreign company has a direct income interest in another company, the person's indirect interest in the second foreign company is calculated by applying the rules in sections EX 8 to EX 11, EX 13, EX 16 and EX 17 and EX 26 as though both companies were CFCs.

This ensures that a person can still meet the requirement in section EX 35(a) of having at least a 10% income interest in an Australian company when their interest is an indirect interest held through another foreign company.

Examples

A person has a 50% direct income interest in a foreign company which has a 50% direct income interest in an Australian company. The person's indirect income interest in the Australian company is 25%. The person will satisfy the requirement in section EX 35(a).

A person has a 50% direct income interest in a foreign company which has a 10% direct income interest in an Australian company. The person's indirect income interest in the Australian company is 5%. The person will not satisfy the requirement in section EX 35(a), unless they have some other income interests (direct or indirect) in the Australian company which cause their total income interest to add up to 10% or more.

Note that if a person's interest in an Australian company satisfies the exemption in section EX 35, and that foreign company is not a CFC, the person is not required to apply the FIF rules to any indirect interests in FIFs held by that Australian company. In contrast, if a person has a CFC interest in an Australian company they would be required to look-through and apply FIF rules to any indirect interests in other foreign companies due to section EX 22(3).

Example

A person has a 10% direct income interest in an Australian company which has a 50% direct income interest in another foreign company.

If the Australian company is a CFC or a FIF for which the person uses the attributable FIF income method, the person would have a 5% indirect income interest in the other foreign company.

If the Australian company is not a CFC, and the Australian company qualifies for an exemption from the FIF rules (such as the section EX 35 exemption), or the person uses the fair dividend rate, cost, comparative value or deemed rate of return method for the Australian company, the person would not usually be regarded as holding an indirect income interest in the second foreign company.

Further explanation and examples on how to apply the section EX 35 exemption can be found in the *Tax Information Bulletin*, Vol 24, No 6, July 2012.

Application date

The amendment to section EX 35 applies from income years beginning on or after 1 July 2011. This is consistent with the application dates of the international tax reforms in the Taxation (International Investment and Remedial Matters) Act 2012.

INDIRECT INCOME INTERESTS IN FIFS

Sections EX 50(7B) and EX 58(5) of the Income Tax Act 2007

Several amendments have been made to the rules enacted in the Taxation (International Investment and Remedial Matters) Act 2012, to clarify how some exemptions apply to FIFs that are held indirectly through other FIFs or CFCs.

Background

In many cases, a person will own shares in a foreign company which itself owns shares in a second foreign company.

If the shares represent an interest in a CFC, the person is always required to "look through" that CFC to determine if the second foreign company is a CFC (in which case the investor would apply the CFC rules), or an attributing interest in a FIF (for which the investor would apply a FIF calculation method).

However if the first company is not a CFC, the requirement to "look through" to the second foreign company depends on whether the person uses the attributable FIF income method for that company and whether an exception to the "look through" rule applies.

If the fair dividend rate, cost, comparative value or deemed rate of return method is used for a FIF, any foreign shares held by that FIF are not subject to the FIF rules (as in most cases the FIF rules only apply to direct interests in foreign companies. (See section EX 29(2).)

If the attributable FIF income method is used for a foreign company, the default position is to "look through" this foreign company and apply the FIF rules to any shares that the company holds in other foreign companies. This is achieved by the formula in sections EX 50(6) and (7).

However, there are several important exceptions to the "look-through" rule in section EX 50(6). These are listed in section EX 50(7B).

Key features

Several remedial amendments have been made to the "look-through" rule in section EX 50(7B) for calculating additional FIF income from indirect interests in FIFs.

Some amendments have been made to clarify how taxpayers should measure indirect income interests for the purpose of applying the Australian or active income exemptions to such interests.

Other amendments have been made to clarify how taxpayers should apply a modified version of the active business test to a FIF which has non-controlling shareholdings in other foreign companies.

Detailed analysis

Measuring indirect income interests

Section EX 35(a) allows the exemption for certain FIF interests in Australian companies to be applied in cases when a person holds an indirect income interest of 10% or more in an Australian company. If the requirements of section EX 35 are met for the person and their indirect interest in the FIF, the person does not have any attributable FIF income or loss from that FIF.

Section EX 46(3)(a)(ii) allows the attributable FIF income method to be applied in cases when a person holds an indirect income interest of 10% or more in a foreign company.

Sections EX 50(7B)(a)(i), EX 50(7B)(c) and EX 58(5)(b) have been removed. These sections were intended to duplicate the requirements in sections EX 35(a) and EX 46(3)(a)(ii), and highlight that the Australian and active income exemptions could still apply when a person held an indirect income interest of 10% or more.

However, they could have been interpreted more broadly so as to deem the person to directly hold another foreign company's income interest. This meant that a person with a less than 10% indirect income interest could in certain circumstances, be deemed to hold an income interest of 10% or more (for example a person who owns 50% of a company which owns 10% of another company).

This was contrary to the policy intention which was that a person would work out their indirect income interest by multiplying their direct income interest in a foreign company by that foreign company's direct income interest in other foreign companies (this approach is provided by section EX 50(4)).

Examples

A person has a direct income interest of 10% in a FIF which holds a 100% direct income interest in a second foreign company. The person would have a 10% indirect income interest in the second foreign company.

A person has a direct income interest of 50% in a FIF which holds a 10% direct income interest in a second foreign company. The person would have a 5% indirect income interest in the second foreign company so the person would not meet the requirements in sections EX 35(a) or EX 46(3)(a)(ii).

A person with an income interest of less than 10% is not generally able to apply the attributable FIF income method.

There is one exception to this. A person may be able to apply the attributable FIF income method to less than a 10% interest in a CFC if the person and the CFC meet the conditions in section EX 46(3)(b).[5] The main requirement is that a market value for shares in the CFC is not available except by independent valuation (for example, if the CFC is not listed on a stock exchange). In addition there are some restrictions on the types of investors in the CFC.

There are two other circumstances when a person does not strictly apply the attributable FIF income method to indirect income interests in FIFs, but is instead able to include relevant amounts from these indirect interests in FIFs when applying the active business test to a FIF through which they hold these indirect interests. If the test is still passed with these additional amounts included, the person does not attribute income from any FIFs that were included in the test.

[5] Even though the company is a CFC, a person with less than a 10% interest in the CFC (including interests of associated persons) will use the FIF rules rather than the CFC rules to attribute income from the CFC.

Applying the active business test to a consolidated test group

The first case is when a FIF owns more than 50% of another foreign company (that is not a CFC). In this case, the parent FIF and its subsidiaries can be included in the same test group for the purposes of applying the active business test. The test is then applied on a consolidated basis to the test group. If the test group has less than 5% passive income, then no FIF income or loss is attributed to the New Zealand shareholder from any member of that test group.

Applying the active business test when a FIF has non-controlling shareholdings in other foreign companies

The second case is when a FIF owns non-controlling interests, such as shares, in other foreign companies. In these cases, the person can choose to apply a modified version of the active business test that includes some additional amounts in the "added passive" and "reported revenue" terms of the calculation. The additional amounts correspond to the amounts that are reported in the FIF's accounts as being derived from shares in the non-controlling interests.

This rule is set out in sections EX 50(7B) and EX 50(7C).

Section EX 50(7B)(b) has been modified to explicitly allow a person to choose to include none, some, or all the FIF's non-controlling interests in foreign companies when applying the modified active business test in section EX 50(7B). Note however, that if a person chooses to exclude an indirect interest from the modified test, they will usually be required to "look through" and apply a FIF calculation method to that indirect interest in a FIF in accordance with section EX 50(6).

New section EX (7C)(b) prevents a person from using the result of the test for a FIF and a group of foreign companies, if the person has used the result of a different test for that FIF and a different grouping of foreign companies. The purpose of this condition is to prevent a taxpayer from manipulating their test results by applying multiple tests to smaller groups consisting of the same parent FIF and only some of that FIF's shares in other companies. Such manipulation could ensure that each test resulted in less than 5% passive income when there would have been more than 5% passive income had the test been applied to a larger group that included all of the foreign shares in the same test.

Both of these changes are illustrated in the following example.

Example

A person uses the attributable FIF income method for a FIF that has non-controlling shareholdings in two other companies, company A and company B.

The FIF has $9.3 million of total revenue and no passive income. This means the person does not attribute income from the FIF as the FIF passes the active business test.

The FIF's accounts include profits of $0.3 million from company A and $0.4 million from company B.

The person can apply the modified test in section EX 50(7B) to determine if they need to attribute FIF income from company A or company B.

The person can only include the FIF and each company in one test for the purpose of section EX 50(7B)(b). This means they can apply the test to one of three possible groups. A group comprising the FIF and company A, a group comprising the FIF and company B or a group comprising the FIF and companies A and B.

If the person applies the test to a group comprising the FIF and company A, the result is 3.1% (= 0.3 ÷ 9.6). This is less than 5% so they do not attribute FIF income from company A. However they would still have FIF income from company B as the profit from company B was not included in the test.

If the person applies the test to a group comprising the FIF and company B, the result is 4.1% (= 0.4 ÷ 9.7). This is less than 5% so they do not attribute FIF income from company B. However they would still have FIF income from company A as the profit from company A was not included in the test.

If the person applies the test to the FIF and both companies A and B the result would be 7% (= 0.7 ÷ 1) so they would have FIF income from companies A and B.

Further explanation and examples on how to apply the attributable FIF income method can be found in the *Tax Information Bulletin*, Vol 24, No 6, July 2012.

Application date

The amendments to sections EX 50(7B), EX 58(5) apply from income years beginning on or after 1 July 2011. This is consistent with the application dates of the international tax reforms in the Taxation (International Investment and Remedial Matters) Act 2012.

FIF REMEDIAL: ASX EXEMPTION

Section EX 31 of the Income Tax Act 2007

Section EX 31 of the Income Tax Act 2007 provides an exemption from the foreign investment fund (FIF) rules for shares held in certain Australian companies. However, among other requirements, the Australian company must have its shares included on an "approved index" of the Australian Stock Exchange (ASX).

Section EX 31 has been amended to update the reference to an approved index, which is now an approved index under the ASX Operating Rules. The previous reference to ASX Market Rules was out of date.

Application date

The amendment applies from 1 August 2010, the date the updated ASX rules were introduced.

FIF REMEDIAL: MEASUREMENT OF COST

Section EX 68 of the Income Tax Act 2007

When the new foreign investment fund (FIF) rules were introduced, a temporary 5-year exemption was provided to companies with significant New Zealand shareholders, such as Guinness Peat Group (GPG). This exemption expired at the beginning of the 2012–13 income year. This means many shareholders in GPG will now need to calculate tax on their GPG shares using the fair dividend rate (FDR) method.

Because of the expiry of the exemption, a minor remedial amendment was required to define how "cost" is measured for the FIF rules.

The FIF rules do not apply to natural persons (individuals) or certain trusts if the cost of their FIF investments is equal to or less than $50,000. For the purposes of determining cost, section EX 68 of the Income Tax Act 2007 provides that a taxpayer can use half an investment's 1 April 2007 value in place of its cost if it was purchased before 1 January 2000. This is because such an investment's cost may not be readily available.

For investments to which the temporary 5-year exemption applied, this modification to "cost" was not appropriate. It may be difficult to obtain price data for long-held investments purchased after 1 January 2000.

Accordingly, section EX 68 has been amended so that a taxpayer can elect to treat an investment in a FIF's cost as its market value at 1 April 2012 if that investment was previously covered by the 5-year temporary exemption and the investment was entered into before 1 January 2005. The investment's market value, as opposed to half its market value (as in the existing rule), must be used because share prices are historically very low.

Application date

The amendment applies from the beginning of the 2012–13 income year.

REMOVAL OF OBSOLETE REFERENCES

The following references have been omitted from the Income Tax Act 2007 as they refer to sections which have been repealed as a result of earlier international tax reforms:

- In section LF 8, a reference to "sections CW 9 to CW 11" has been replaced with a reference to "sections CW 9 and CW 10" as section CW 11 was repealed for income years beginning on or after 1 July 2011. This change is effective from 1 July 2011.
- In section FM 6 (3), a reference to "section GB 40" has been omitted as section GB 40 was repealed for income years beginning on or after 1 July 2012. This change is effective from 1 July 2012.
- In Table O4, Row 8 has been omitted as it refers to section OC 19 which was repealed for income years beginning on or after 1 July 2011. This change is effective from 1 July 2011.
- In section RE 2(5)(c), a reference to "attributed repatriation" has been removed as the attributed repatriation rules were repealed for income years beginning on or after 1 July 2009. This change is effective from 1 July 2009.

OUTSTANDING CLAIMS RESERVE – CONSEQUENCES ON TRANSFER

Sections DW 4(6), ED 3 and EY 5(4) of the Income Tax Act 2007

Technical changes have been made to the Income Tax Act 2007 to clarify the tax position of general insurance companies when there is a transfer of business partway through an income year.

Background

The Income Tax Act 2007 allows general insurers a deduction for movements in the outstanding claims reserve (OCR) – or income depending on the nature of the actual movement. Changes in the OCR were measured on an income year basis. This meant that the rules did not provide an appropriate closing value if the OCR for a particular line of general or non-life insurance business was transferred at a point in time other than at the end of an income year.

Key features

New section ED 3 sets out a legislative code for the transfer of OCR balances for general insurance.

Detailed analysis

How the rules work

Under the Income Tax Act, a deduction connected with movements in a general insurer's outstanding claims reserve (or income depending on the nature of the actual movement) is calculated on an income year basis. The deduction is allowed (or income derived), by reference to sections CR 4 and DW 4, for general insurers who use IFRS 4 for determining their tax position.

If, in an income year, an insurer (insurer A) transfers its insurance contracts to another insurer (insurer B), insurer A is required to make a part-year calculation of its OCR on the day the transfer occurs to determine its closing value. Any movement between the opening and closing balance gives rise to a deduction or income to insurer A.

The amount calculated by insurer A immediately before the transfer is treated as insurer B's new OCR opening balance. Deductions for any claims underlying the opening OCR balance for insurer B are allowed as the claims are met – section DW 4(5). A consequential change to section DW 4(6) ensures that the capital limitation does not apply to amounts transferred to insurer B for the purposes of section DW 4(5).

If insurer B has a different opinion about the value of the OCR, any adjustment to the value should ultimately be reflected post-transfer through the closing balance for the income year in which the transfer occurred.

Example

As part of a strategic shift in its market position, Insurer A sells a block of its insurance book to another New Zealand insurer (Insurer B).

The opening balance of the OCR for the relevant block of business is $500,000. As part of Insurer B's due diligence work it is agreed that the OCR value for the block of business is $450,000 – the difference arises because legal action regarding the validity of claim falls in favour of Insurer A.

On 29 June, Insurer A transfers the block of business including the relevant OCR balance. Insurer A records the closing balance of the OCR at the time of transfer as $450,000 and recognises income of $50,000 under section CR 4 of the Income Tax Act 2007 ($500,000 – $450,000).

Insurer B records the opening balance of the OCR as $450,000. Shortly after, an appeal against the earlier decision about the claim goes against the insurer and Insurer B increases the OCR balance to $510,000.

During the year, Insurer B meets claims totalling $250,000 (deductible under section DW 4(5)) and new insured events arise that add a further $400,000 to the OCR.

At the end of the tax year, 31 March, Insurer B's OCR closing balance is $660,000 ($450,000 + $60,000 – $250,000 + $400,000). As the balance has increased from $450,000, Insurer B is able to claim a deduction for $210,000 (section DW 4(3) $450,000 – $660,000).

Applying the new rules to earlier income years

The changes apply to transfers that occur on and after 1 October 2012.

To facilitate responses by insurers to the enactment of the Insurance (Prudential Supervision) Act on 7 September 2010, insurers have the option to apply new section ED 3 to earlier income years if the transfer occurred on and after 7 September 2010 and:

- the transfer was to a non-resident who does not carry on a business in New Zealand; and
- the transfer was made for the purposes of complying with the Insurance (Prudential Supervision) Act 2010.

Consequential change to section EY 5(4)

To mirror the point in time the closing balance should be valued under section ED 3, a consequential change has also been made to the transfer rules of life insurers – section EY 5(4) refers.

Application date

The changes apply to transfers made on and after 1 October 2012, but can be backdated in limited circumstances to 7 September 2010, the date the Insurance (Prudential Supervision) Act 2010 was enacted.

REMEDIAL CHANGES TO THE TAXATION RULES FOR LIFE BUSINESS

Sections EY 28, EY 30 and YA 1 of the Income Tax Act 2007

Technical changes have been made to the transition rules supporting the 2009 life insurance tax reforms.

Background

Changes to the taxation of life insurance business, enacted by the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, included a set of transitional rules designed to grandparent life insurance policies sold before the date the new rules started. Grandparented life policies are eligible for relief that preserves, for a limited period, the application of the previous life taxation rules.

Subsequent taxation bills have amended aspects of the transitional rules to remove uncertainties and deal with practical problems identified by life insurers.

On-going consultation with life insurers about the effect of the taxation reform has continued to identify a number of remedial, and often technical, issues with the operation of the transitional rules. The amendments made by this Act, the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012 deals with issues connected with profit participation policies, restoration of cancelled life risk policies, and life reinsurance contracts.

Key features

The changes:

- Clarify that the simplified method that applies to "existing business", as defined by section EY 28, continues to apply to profit participation policies that are transferred or sold to another life insurer. "Existing business" is defined as a profit participation policy that was sold before 30 June 2009, or a policy sold after that date if it replaces an earlier participation policy and provides for substantially the same terms and conditions. Changes made by the Finance and Expenditure Select Committee also ensured that any increase in premiums payable for the transferred profit participation policy, provided that the increase is no greater than the higher of the CPI rate or 10%, will not result in it being removed from the definition of "existing business".
- Consequential changes have also been made to section EY 30 to preserve transitional relief available to life-risk policies in the event those policies are sold or transferred to another life insurer.
- Clarify that transitional relief under section EY 30 continues to apply to life-risk policies that are cancelled by the policyholder but later restored by the life insurer on the same terms and conditions. The restoration needs to occur within 90 days from when the life insurer receives notice of the cancellation.
- Remove ambiguities about how the transitional rules in section EY 30 apply to life reinsurance contracts. Life reinsurers can claim transitional relief on life reinsurance policies that were in force before the new life insurance rules started on 1 July 2010 or earlier at the life insurer's election, to the extent that the underlying life insurance policy is or could be grandparented.
- Remove the definition of "life insurance rules" from the Income Tax Act 2007. Following the changes made to the taxation of life insurance business in 2009, the definition was redundant.

Application date

The changes apply from 1 July 2010. Life insurers have the option to apply the rules from the beginning of their income year, if that year includes 1 July 2010.

REMEDIAL AMENDMENT TO SHAREHOLDER CONTINUITY RULES

New section YC 19B of the Income Tax Act 2007

New section YC 19B allows continuity of shareholding in a company when a trust that is established for the sole benefit of the New Zealand or an overseas Government is terminated and the shareholding is transferred to the Government.

Background

During the recent global financial crisis, some troubled companies were bailed out by Governments by setting up a trust to hold their ownership interest in the bailed-out company for the sole benefit of the Government.

Before the amendment, when the trust terminates and transfers the shareholding to its sole Government beneficiary, the shareholder interest in the bailed-out company changed from the trustees of the trust to the Government beneficiary. This is because when the shares are owned directly or indirectly by a trust, there is no tracing through to the beneficiaries of the trust; section YC 9 treats all the trustees of a trust as an ultimate shareholder.

As a consequence, the bailed-out company faced a substantial change of ownership interest when the ownership of its shares changed from the trustees of the trust to the Government beneficiary, preventing it from carrying forward its losses or tax credits. This occurred even though, in substance, there was no change of economic and beneficial ownership.

Key features

New section YC 19B allows continuity of shareholding in a company when a trust that is established for the sole benefit of the New Zealand or an overseas Government is terminated and the shareholding is transferred to the Government. The Government beneficiary is treated as acquiring the ownership interests in the company that are transferred by the trustees of the trust on the date the trustees acquired the ownership interests.

Application date

This amendment applies from 1 January 2011.

AUCKLAND COUNCIL – INDEPENDENT MĀORI STATUTORY BOARD

Section YA 1 of the Income Tax 2007 and section 2(1) of the Goods and Services Tax Act 1985

The Income Tax Act 2007 and the Goods and Services Tax Act 1985 have been amended to treat the Auckland Council Independent Māori Statutory Board as a "local authority" for the purpose of those Acts. These amendments mean that the Board is treated in the same way as other advisory-type boards of the Auckland Council.

Background

Section 81 of the Local Government (Auckland Council) Act 2009 established the Board and set out its purposes. The purpose of the Board is to assist the Auckland Council to make decisions concerning the promotion of cultural, economic, environmental and social issues of significance to Māori, and to ensure that the Council acts in accordance with statutory provisions referring to the Treaty of Waitangi.

The Board is established as "a body corporate", separate from the Auckland Council. Consequently, the Board is a separate legal entity that can, and does, act in its own name, including in relation to the acquisition of supplies of goods and services required for its purpose and incurring expenditure in relation to such supplies. In contrast, the Pacific Peoples Advisory Panel and the Ethnic Peoples Advisory Panel established by the Mayor of Auckland Council are not separate legal entities. Their functions are carried out under the Auckland Council umbrella.

The amendments ensure that:

- The funding provided by Auckland Council to the Board is not subject to income tax. Local authorities are generally exempt from income tax under section CW 39 of the Income Tax Act 2007.
- The Board can register for GST purposes and claim back the GST content of expenses that it incurs in carrying out its functions. Local authorities are deemed to be carrying on a "taxable activity" under section 6(1)(b) of the Goods and Services Tax Act 1985.

Key features

The Auckland Council Independent Māori Statutory Board has been added to:

- the definition of "local authority" in section YA 1 of the Income Tax Act 2007; and
- the definition of "local authority" in section 2(1) of the Goods and Services Tax Act 1985.

Application date

The amendments apply from 1 November 2010, the date on which the Board was established.

REWRITE 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. A number of minor drafting matters have also been corrected, including cross-references, punctuation and terminology, in the interests of consistency.

Livestock Valuation Rules

Section EC 1 of the Income Tax Act 2004 and Income Tax Act 2007 (sections 30 and 245 of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012)

These sections restore the business nexus requirement to the livestock valuation rules set out in subpart EC for both the 2004 and 2007 Acts. The business nexus requirement was inadvertently omitted in rewriting the livestock valuation rules in subpart EE of the Income Tax Act 1994.

Background

As part of the rewrite of the trading stock rules in subpart EE of the Income Tax Act 1994 into the Income Tax Act 2004, the livestock valuation rules were separated from the general trading stock rules (subpart EB). The livestock valuation rules were placed in a separate subpart (subpart EC). Subpart EC was re-enacted in the Income Tax Act 2007.

However, under section EE 1 of the 1994 Act, the trading stock valuation rules in subpart EE of the Income Tax Act 1994 applied to a person carrying on a business. Therefore in the 1994 Act, the livestock valuation rules applied only to a person carrying on a business and to their livestock held as part of the normal incident of carrying on that business. The Rewrite Advisory Panel agreed with a submission that the business nexus requirement was inadvertently omitted in rewriting the livestock valuation rules now set out in subpart EC of the Income Tax Act 2007.

Detailed analysis

This amendment restores the business nexus to subpart EC in both the 2004 and 2007 Acts. However, livestock held in a dealing business is valued under the general trading stock valuation rules in subpart EB (section EB 2(3)(f)). This distinction is also made explicit in this amendment by providing that the livestock valuation rules do not apply to a livestock dealing business.

The business nexus will normally be satisfied for livestock held over several years, such as dairy cattle, sheep, goats and the like, which are held for their fleece or their progeny (or both). The business nexus would normally be satisfied for this type of livestock because the disposal of these animals beyond their useful life is a normal event in a farming business.

Application date(s)

The amendment is retrospective to the commencement of the 2005–06 income year. However, a savings provision applies in the event a taxpayer has taken a tax position on or before 31 May 2011, relying on the provisions of subpart EC prior to this amendment.

Trustee income

Section HC 25(1) of the Income Tax Act 2007 (section 84 of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012)

The amendment resolves an ambiguity by clarifying that section HC 25(1) applies to a foreign-sourced amount derived by a trustee in an income year that is trustee income. The clarification ensures that section HC 25 does apply to a foreign-sourced amount that is distributed as beneficiary income.

Background

The Rewrite Advisory Panel noted that section HC 25(1) contains an ambiguity and could be read as applying to income derived from a source outside New Zealand by a non-resident trustee of a trust having a resident settlor even if that income is distributed as beneficiary income.

However, the Panel also identified that the Interpretation Act 1999 provided for headings to sections to be relevant indicators for statutory interpretation, and so the ambiguity can be resolved by normal interpretive approach. However, the provision is amended to ensure consistency with the rewrite objectives of clear, accessible legislation.

Detailed analysis

This amendment clarifies that section HC 25 applies to income derived by a trustee in an income year that is not also beneficiary income.

If income derived by a trustee for an income year is not distributed as beneficiary income, that income is included in the trustee's taxable income as trustee income. In most circumstances, trustees are taxed on income derived if it is either sourced from New Zealand or derived by a trust having a resident settlor.

Section HC 25 is essential to the settlor basis for taxing trusts as it ensures that a non-resident trustee of a trust having a resident settlor (and certain other types of trusts) is taxable on income derived from a source outside New Zealand.

Application date

The amendment applies from the 2008–09 income year.

Minor maintenance items

A number of minor maintenance items arising from the rewrite of income tax legislation have been referred to the Rewrite Advisory Panel. These may include:

- ambiguities;
- compilation errors;
- cross-references;
- drafting consistency, including readers' aids, for example, the defined terms lists;
- grammar;
- punctuation;
- spelling;
- consequential amendments arising from substantive rewrite amendments; or
- the consistent use of terminology and definitions.

The following amendments have been made:

Section in Amending Act	Section	Amendment	Application date
Income Tax Act 2007			*From beginning of 2008–09 income year*
11	CE 5(1)	Improving the consistency of terminology	
15	CW 15	Correction to defined terms list	
16	CW 17(1)	Improving the consistency of terminology	
23	DC 15(1) "employee" (a), (b)	Improving the consistency of terminology	
39	EJ 2(1)	Correction to cross-reference	
69	FE 8(4)	Improving the consistency of terminology	
72	FM 8(3)(b)(ii)	Improving the consistency of terminology	
82	HC 18	Correction to cross-reference	
115	LD 3	Correction to defined terms list	
117	LJ 7(3)	Improving the consistency of terminology	
154(7)	YA 1 "dividend", para (b)	Correction to cross-reference	
156	YC 18(6)	Improving the consistency of terminology	
157	YC 18B(2)(c)	Correction of spelling	
Income Tax Act 2004			*From beginning of 2005–06 income year*
241	CE 5(1)	Improving the consistency of terminology	
242	CW 13(1)	Improving the consistency of terminology	
244	DC 14(1) "employee" (a), (b)	Improving the consistency of terminology	
247	EJ 2(1)	Correction to cross-reference	
Income Tax Act 1994			*From beginning of 1995–96 income year*
251	DO 2	Correction to cross-reference	
Tax Administration Act 1994			*From beginning of 2005–06 income year*
170	Section 3 "petroleum permit"	Correction to cross-reference	

ORDER IN COUNCIL

INCOME TAX (MINIMUM FAMILY TAX CREDIT) ORDER 2012

Section ME 1 of the Income Tax Act 2007

The Income Tax (Minimum Family Tax Credit) Order 2012, made on 23 October 2012, increases the after-tax income level guaranteed by the minimum family tax credit. The after-tax income level will rise from $22,568 to $22,724 a year from 1 April 2013.

Key features

The order increases the prescribed amount in the definition in the formula for calculating the minimum family tax credit, in section ME 1(3)(a) of the Income Tax Act 2007.

The order also revokes the Income Tax (Minimum Family Tax Credit) Order 2010 as it is now spent. It amends the Income Tax (Minimum Family Tax Credit) Order 2011.

Application date

The increase applies for the 2013–14 and later tax years.

Income Tax (Minimum Family Tax Credit) Order 2012 (SR 2012/325)

OTHER NOTICES

INCOME TAX (WORKING FOR FAMILIES INDEXATION – BUDGET MEASURES) AMENDMENT ACT 2012

Sections MF 7(1)(a), (2) and (2B) of the Income Tax Act 2007

The Income Tax (Working for Families Indexation – Budget Measures) Amendment Act 2012 received Royal assent on 23 October 2012 [Indexation Amendment]. It was previously part of the Customs and Excise (Tobacco Products – Budget Measures) Amendment Bill. The Indexation Amendment was separated out at the Committee of the Whole House stage by SOP number 129.

Background

Most of the rates of family tax credit are increased whenever the cumulative rate of inflation since the previous adjustment exceeds 5%. These higher rates take effect from the following 1 April. The family tax credit rates were last increased on 1 April 2012.

In 2010, section 94 of the Taxation (Budget Measures) Act 2010 changed the measure of CPI to be used for the family tax credit from the CPI: All Groups measure to the CPI: All Groups excluding cigarettes and other tobacco products measure. This applied for the calculation of Working for Families tax credit entitlements for the 2011–12, 2012–13 and 2013–14 tax years and reflected specific increases in tobacco excise for 2010 through to 2012.

The Customs and Excise (Tobacco Products – Budget Measures) Amendment Act 2012 [the Customs Amendment] seeks to continue to discourage tobacco consumption through higher prices for tobacco by further increasing tobacco excise. The Customs Amendment provides for four cumulative increases of 10% in tobacco excise from 1 January 2013 through to 1 January 2016.

The excise increases are expected to increase the level of inflation as measured by the Consumer Price Index (CPI): All Groups measure. As with the previous 2010 to 2012 tobacco excise increases, a number of consequential amendment Acts will ensure that recipients of social assistance are not reimbursed for the increases in tobacco prices through CPI adjustments, as this would counteract the purpose of increasing the tobacco excise.

Key features

The Indexation Amendment will continue, for another four years, the change to the inflation measure to be used in calculating the rates of family tax credit. Sections MF 7(1), (2) and (2B) of the Income Tax Act 2007 have been amended so that the period for the change in CPI measure will be extended up to and including the 2017–18 tax year.

This will mean that the price changes in cigarettes and tobacco products, during 2013 to 2016 when specific tobacco excise increases occur, will not be included in the cumulative measure of inflation used for determining when, and by how much, the rates of family tax credit are increased.

Application date

The change applies for Working for Families entitlements from the 2014–15 tax year up to and including the 2017–18 tax year.

NOTIFYING COMMISSIONER OF CHANGE TO THE ATTRIBUTABLE FIF INCOME METHOD

Section EX 62 of the Income Tax Act 2007

The branch equivalent and accounting profits methods of calculating a person's foreign investment fund (FIF) income have been repealed for income years beginning on or after 1 July 2011. The new attributable FIF income method applies from the same date. These changes were included in the Taxation (International Investment and Remedial Matters) Act 2012.

Taxpayers who would like change from another FIF calculation method to the attributable FIF income method will generally be required to give notice to the Commissioner before the end of the first income year or accounting period for which the change is to take effect (for further details refer to the recently amended section EX 62 of the Income Tax Act 2007).

This notice can be a declaration that they are changing their calculation method due to the branch equivalent or accounting profits methods being repealed. The declaration can be emailed to **FIFnotice@ird.govt.nz**. Taxpayers who do not make the election will generally default to the fair dividend rate calculation method.

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 12/13: INCOME TAX – IS A TAX CREDIT ALLOWED FOR STATE INCOME TAX PAID IN THE UNITED STATES OF AMERICA?

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

This Question We've Been Asked is about ss LJ 1, LJ 2, LJ 3, LJ 4, LJ 5, LK 1 and YA 2 of the Income Tax Act 2007.

Question

1. Is a tax credit allowed for state income tax paid in the United States of America (United States)?

Answer

2. Subpart LJ allows a tax credit for state income tax paid on United States-sourced income, provided the state income tax is of substantially the same nature as New Zealand income tax.
3. The tax credit allowed cannot be more than the amount of New Zealand income tax payable on the United States-sourced income.
4. The Double Taxation Relief (United States of America) Order 1983 (the DTA) does not apply. This is because state income taxes are not covered by the DTA.

Explanation

Background

5. We have been asked to clarify whether a tax credit is allowed for state income tax paid in the United States. The DTA refers to federal income tax but does not mention state income taxes. Some taxpayers have taken this to mean that a tax credit is not allowed for state income tax paid in the United States.

Discussion

6. A New Zealand resident who derives foreign-sourced income is liable for New Zealand income tax on that income. However, the New Zealand resident may be entitled to a tax credit for foreign income tax paid on that income.

Double Taxation Relief (United States of America) Order 1983

7. The DTA does not apply. This is because state income taxes are not covered by the DTA. However, the fact that the DTA does not cover state income taxes is irrelevant. Relief is available under subpart LJ.

Application of subpart LJ

8. Tax credit relief is available under subpart LJ. Section LJ 1(2) states:

> *Limited application of rules*
>
> (2) The rules in this subpart apply only when—
>
> (a) a person resident in New Zealand derives assessable income sourced from outside New Zealand; and
>
> (b) foreign income tax is not paid in a country or territory listed in schedule 27 (Countries and types of income with unrecognised tax) to the extent to which the foreign income tax is paid on the types of income listed in the schedule.

9. Therefore, to claim a tax credit a person must:
   - be resident in New Zealand for income tax purposes (s YD 1 determines residency for natural persons and s YD 2 determines residency for companies);
   - have derived assessable income that is not sourced in New Zealand (s YD 4 lists the classes of income treated as having a New Zealand source); and
   - have paid foreign income tax on the assessable income.

10. Section LJ 1(2)(b) states that subpart LJ will not apply if foreign income tax is paid in a country or territory listed in sch 27. There are currently no countries or territories listed in sch 27, so this limitation has no effect. A person who meets the criteria of s LJ 1(2) is entitled to a tax credit for an amount of foreign income tax paid on the foreign-sourced income (s LJ 2(1)).
11. Section LJ 3 defines "foreign income tax" to mean "an amount of income tax of a foreign country". The meaning of "income tax" in subpart LJ is varied by s YA 2(5):

> *Tax of other countries*
>
> (5) The term income tax, when specifically used in relation to tax of another country, whether imposed by a central, state, or local government,—

(a) means a tax of substantially the same nature as income tax imposed under section BB 1 (Imposition of income tax); and

(b) includes a tax, imposed as a collection mechanism for the foreign tax, that is of substantially the same nature as provisional tax, pay-as-you-earn (PAYE), resident withholding tax (RWT), or non-resident withholding tax (NRWT).

12. The meaning of "income tax" is therefore varied to include tax imposed by a central, state or local government, provided the tax is of substantially the same nature as income tax imposed under s BB 1; or a tax imposed as a collection mechanism for the foreign tax that is of substantially the same nature as provisional tax, pay-as-you-earn, resident withholding tax or non-resident withholding tax.

13. In summary, if a person satisfies the requirements of s LJ 1(2), then they are entitled to a tax credit or credits for an amount of "foreign income tax" paid under s LJ 2(1). (The number of credits will depend on the number of foreign countries and the sources or the nature of the income derived (ss LJ 4 and LJ 5).) The meaning of "income tax" in this context is modified by s YA 2(5) to mean a tax (whether imposed by a central, state or local government) that is of "substantially the same nature" as income tax.

14. Section LJ 2(2) restricts the amount of the tax credit. The tax credit allowed must not be more than the amount of New Zealand income tax payable on that foreign-sourced income, as calculated under s LJ 5.

United States state income taxes

15. Most states in the United States impose a state income tax. The Commissioner's view is that, for the most part, state income taxes will be of substantially the same nature as income tax imposed under s BB 1.

16. However, it cannot be assumed that all state income taxes are the same. Each state income tax needs to be assessed individually each tax year to determine whether it is of substantially the same nature as New Zealand income tax. The name or title of the tax is not determinative. The characteristics of the tax will need to be evaluated and compared with New Zealand income tax to establish whether it is of substantially the same nature.

Tax credits relating to attributed controlled foreign company income

17. Section LK 1(1) allows a tax credit for tax paid or payable on an amount of attributed controlled foreign company income. Tax paid or payable includes "foreign income tax". The s LJ 3 definition of "foreign income tax" also applies to subpart LK, as does s YA 2(5). To this extent, the conclusions in this item regarding s YA 2(5) apply equally to subpart LK.

Conclusion

18. A tax credit for United States state income tax is allowed under subpart LJ provided the state income tax is a tax of substantially the same nature as New Zealand income tax.

19. The tax credit allowed under s LJ 2(2) cannot be more than the amount of New Zealand income tax payable on the United States-sourced income, as calculated under s LJ 5.

20. The DTA does not apply. This is because state income taxes are not covered by the DTA. However, the fact that the DTA does not cover state taxes is irrelevant.

References

Subject references
State income tax; tax credit; United States of America
Legislative references
Income Tax Act 2007, ss BB 1, LJ 1, LJ 2, LJ 3, LJ 4, LJ 5, LK 1, YA 2, YD 1, YD 2,YD 4 and sch 27; Double Taxation Relief (United States of America) Order 1983

ITEMS OF INTEREST

STATUS OF THE COMMISSIONER'S ADVICE

This item sets out the status of advice (other than binding rulings) given by the Commissioner.

Some of the subject-matter of this item was covered by "Amendment and re-opening of assessments: Policy statement by Commissioner of Inland Revenue", *Public Information Bulletin* No 123 (January 1984). Much of that item is now redundant, having been overtaken, for example, by the Standard Practice Statement on s 113 of the Tax Administration Act 1994 "SPS 07/03 Requests to amend assessments", *Tax Information Bulletin* Vol 19, No 5 (June 2007). Any remaining parts of the item that were still relevant are superseded by this current item.

This item may overlap with "Remission of penalties and interest – SPS 05/10", *Tax Information Bulletin* Vol 17, No 9 (November 2005), insofar as that item deals with remission where Inland Revenue has given incorrect advice to a taxpayer. New legislation provides that no interest will be charged where a taxpayer relies on a "Commissioner's official opinion". However, SPS 05/10 still applies to a variety of circumstances where it is possible to obtain remission not covered by the new legislation.

All legislative references are to the Tax Administration Act 1994 unless otherwise stated.

Introduction

1. From time to time, the Commissioner provides advice to taxpayers to help them to comply with the tax laws. This advice is provided in different contexts and to different audiences (eg, advice to specific taxpayers and advice to the wider public).

2. This item clarifies some issues in relation to advice the Commissioner gives. In particular, it considers:
   - the legal status of the Commissioner's advice and when the Commissioner will be bound by statements made;
   - taxpayers' liability for substantive tax, penalties and use of money interest where the Commissioner's advice is incorrect;
   - application dates for public statements;
   - the Commissioner's position in relation to court and tribunal decisions that the Commissioner believes do not accurately reflect the law; and
   - the status of Standard Practice Statements the Commissioner issues.

Status of the Commissioner's advice

3. Taxation laws are made by Parliament, not the Commissioner, or Inland Revenue. It is acknowledged that, as a matter of principle and good tax administration, taxpayers should generally be able to rely on advice the Commissioner gives. However, the Commissioner is under an obligation to apply the law correctly. With the exception of the binding rulings regime, the law is not changed merely by the Commissioner giving a different view (whether published or otherwise).

4. The binding rulings regime was enacted in 1995 to help taxpayers achieve certainty in relation to their tax affairs through public rulings and taxpayer-specific private and product rulings. Where a binding ruling has been issued that applies to a taxpayer, that taxpayer, by following the binding ruling, can be certain about how the Commissioner will apply the law (an application for a private ruling must disclose all relevant facts and documents relating to the arrangement for which the ruling is sought).

5. By contrast, as a matter of practice, Inland Revenue will generally follow public statements. However, the Commissioner is not strictly bound by such statements or other advice unless they are binding rulings that apply to the particular taxpayer and arrangement: *CIR v Ti Toki Cabarets* (1989) Ltd (2000) 19 NZTC 15,874, *Lemmington Holdings Ltd (No 2) v CIR* (1983) 6 NZTC 61,576 and *Westpac Banking Corporation v CIR* (2008) 23 NZTC 21,694. This statement outlines the Commissioner's approach to advice that is **not binding** on the Commissioner.

Incorrect advice – liability for substantive tax

6. From time to time the Commissioner will take the view that advice that has previously been given is incorrect. This may occur when:
   - a court decision clarifies the law, which shows that the earlier advice is incorrect;
   - the Commissioner discovers an error in the earlier advice; or
   - the Commissioner reconsiders the earlier advice and takes a different view.

7. This raises issues about the liability of taxpayers who have returned their tax based on the advice given.

8. Where the Commissioner has given incorrect advice (other than a binding ruling), this does not operate so as to change the tax legally payable on the basis of the correct application of the law. This is because the Commissioner cannot simply choose to alter the statutory basis of assessment: s 6A, *Vestey v IRC* [1979] 3 All ER 976 and *R v IRC, ex p Wilkinson* [2005] BTC 281. Any assessments previously made on the basis of that incorrect advice are, therefore, incorrect and can potentially be corrected by the Commissioner.
9. The question that arises is whether the Commissioner will amend the assessment to correct it. This statement now considers different situations where this can arise.

Formal settlements and time barred assessments

10. Where a taxpayer has entered into a formal settlement with the Commissioner, this settlement will not be reversed.
11. Similarly, if the statutory time bar applies to the original assessment, the Commissioner cannot amend that assessment.

Published public statements

12. The following paragraphs apply to situations where the Commissioner's view of the law changes from what has been outlined in a published public statement that is still authoritative (that is, not outside any applicable application date and not overtaken by legislation or a later public statement).
13. Published public statements are statements that Inland Revenue produces in hardcopy and/or on Inland Revenue's website. These include formal statements such as interpretation statements, interpretation guidelines, and Questions We've Been Asked as well as other publications such as Inland Revenue guides, *Agents Answers* and *Business Tax Update* newsletters. Published public statements apply to all taxpayers that come within their terms.

Where a new position is more favourable for taxpayers

14. In cases where the change in view in a published public statement creates a more favourable position for taxpayers, the Commissioner will apply the principles set out in the Standard Practice Statement on s 113 on a case by case basis to determine whether to amend past assessments. (These are currently set out in "SPS 07/03 Requests to amend assessments", *Tax Information Bulletin* Vol 19, No 5 (June 2007) (the SPS)). Some of the relevant considerations include:
    - whether a taxpayer has made an error as a result of relying on advice given by an Inland Revenue officer;
    - whether the taxpayer has provided all relevant information with their amendment request;
    - the length of time since the incorrect position was taken;
    - whether the resources required to make the amendment would be disproportionate to the amount of tax at stake; and
    - any other relevant care and management considerations.
15. However, in any case, all of the relevant considerations referred to in the SPS must be weighed. For the purposes of applying the SPS, following an incorrect position set out in a published statement of the Commissioner will be treated as a genuine error rather than a "regretted choice" (see paragraph 15 of the SPS).

Where a new position is less favourable for taxpayers

16. Where the change in view taken in a published public statement creates a less favourable position for taxpayers, the Commissioner will generally apply the new position prospectively from a stated date or income year or assessment period (as most appropriate).
17. However, in exceptional cases, prospective application will not be appropriate, and immediate or retrospective application will be necessary or desirable (subject to the operation of the time bar). In deciding whether to use s 113 to apply a new position retrospectively, the Commissioner will apply the care and management principles in sections 6 and 6A. Factors the Commissioner will consider include (but are not limited to):
    - The amount of revenue at stake;
    - The number of taxpayers affected—including the extent to which some taxpayers have been following the earlier incorrect position while others were taking the correct position;
    - The resources necessary to identify, audit and reassess the relevant taxpayers;
    - Whether retrospective application is likely to undermine or support the integrity of the tax system; and
    - Whether retrospective application is likely to promote or adversely affect taxpayer compliance.
18. For more details on the Commissioner's interpretation of care and management principles, see "IS 10/07: Care and management of the taxes covered by the Inland Revenue Acts – Section 6A(2) and (3) of the Tax Administration Act 1994", *Tax Information Bulletin* Vol 22, No 10 (November 2010).

Taxpayer-specific advice

19. The following paragraphs apply to situations where the Commissioner has a different view of the law than was previously communicated to a particular taxpayer in specific advice to them (other than in a binding ruling).

Where a new position is more favourable for the taxpayer

20. Where taxpayer-specific advice replaces earlier advice and creates a more favourable position for the taxpayer, the Commissioner will apply the principles set out in the Standard Practice Statement on s 113 on a case by case basis to determine whether past assessments will be amended to reflect the more favourable position. As noted above, some of the relevant considerations include:
    - whether a taxpayer has made an error as a result of relying on advice given by an Inland Revenue officer;
    - whether the taxpayer has provided all relevant information with their amendment request;
    - the length of time since the incorrect position was taken;
    - whether the resources required to make the amendment would be disproportionate to the amount of tax at stake; and
    - any other relevant care and management considerations.

21. However, in any case, all of the relevant considerations referred to in the SPS must be weighed. For the purposes of applying the SPS, following specific incorrect advice given by the Commissioner will be treated as a genuine error rather than a "regretted choice" (see paragraph 15 of the SPS).

Where a new position is less favourable for the taxpayer

22. Where taxpayer-specific advice replaces earlier advice and creates a less favourable position for the taxpayer, the Commissioner will apply the principles in the care and management interpretation statement to determine whether to apply s 113 to amend the assessment of a taxpayer who has relied on that earlier advice (other than in a binding ruling). This will involve considering factors such as those set out above in relation to published public advice. In the case of advice given to a specific taxpayer these factors are generally more likely to support an amended assessment than in the case of reliance on incorrect published public advice.

Application dates for public statements

23. The Commissioner acknowledges that it is desirable for taxpayers to have certainty around when changes in view will be applied from. This is particularly the case when changes in view are unfavourable to taxpayers.

24. Where an incorrect public statement is replaced by a new published public statement that is less favourable to taxpayers, the new statement will explicitly state the date from which it will apply or, in exceptional cases, that it applies to prior periods.

25. An application date will also be provided where a published public statement represents a change in the Commissioner's official position that is less favourable to taxpayers even if the previous position was not set out in a published public statement.

26. If there is no existing position an application date will not generally be necessary. However, an application date may be stated if it is thought this will assist taxpayers.

Commissioner's official opinions – liability for interest and shortfall penalties

27. The previous part of this statement considered the position in relation to taxpayers' liability for substantive tax where the Commissioner changes a previously communicated view. The next part of the statement considers taxpayers' liability for interest and shortfall penalties where the Commissioner has given a "Commissioner's official opinion". Section 120W provides that for "Commissioner's official opinions" given on or after 7 September 2010:

    > A taxpayer that, but for this section, is liable to pay interest on unpaid tax to the Commissioner, is not liable to pay that interest to the extent to which it arises because they relied on a Commissioner's official opinion.

    For Commissioner's official opinions that are in writing, the opinion will be "given" on the date it is issued.

28. Further, s 141B(1D) provides that:

    > A taxpayer does not take an unacceptable tax position to the extent to which they have taken their position because they have relied on a Commissioner's official opinion.

29. This exclusion applies to shortfall penalties under sections 141A (not taking reasonable care), 141B (unacceptable tax position), 141C (gross carelessness) and 141D (abusive tax position). Sections 141A to 141D all effectively require taxpayers to have taken an "unacceptable tax position": sections 141A(3), 141B(2), 141C(4), 141D(4) and s 3 definition of "acceptable tax position".

30. Therefore, to the extent that taxpayers take an incorrect tax position because they rely on a "Commissioner's official opinion", they will not be liable for interest on unpaid tax, or for a shortfall penalty under sections 141A, 141B, 141C and 141D. The term "Commissioner's official opinion" is defined in s 3 as:

(a) means, for a taxpayer,—

(i) an opinion of the Commissioner concerning the tax affairs of the taxpayer, given by the Commissioner, either orally or in writing, after all information relevant to forming the opinion has been provided to the Commissioner, if that information is correct:

(ii) a finalised official statement of the Commissioner, in writing, if it specifically applies to the taxpayer's situation:

(b) does not include a private binding ruling

31. There are two types of "Commissioner's official opinion": taxpayer-specific opinions and official statements. The first type is an opinion the Commissioner gives in relation to the tax affairs of a specific taxpayer. Therefore, only the taxpayer concerned may rely on the opinion. The opinion can be oral or written. However, the Commissioner must first have been provided with all information relevant to forming the opinion, and that information must be correct. Consequently, if the taxpayer has not provided all the information that is relevant to the Commissioner reaching a correct view (whether intentionally or otherwise), or not all of the relevant information is correct, then the view given will not be a "Commissioner's official opinion".

32. The second type of "Commissioner's official opinion" is a finalised official statement of the Commissioner. These must be in writing and will be published by Inland Revenue, in hardcopy and/or on the Inland Revenue website. Examples include interpretation statements, interpretation guidelines, Questions We've Been Asked, Inland Revenue guides, *Agents Answers* and *Business Tax Update* newsletters. An official statement must apply to a taxpayer's situation specifically before a taxpayer is able to rely on that statement. These statements must also be finalised. Draft statements the Commissioner issues are not "Commissioner's official opinions". However, the Commissioner will generally not impose shortfall penalties under sections 141A–141D when taxpayers follow the position set out in a draft statement.

33. Where advice given is not a "Commissioner's official opinion", then the provisions relating to interest and shortfall penalties will apply to taxpayers in the usual way (see also "Remission of penalties and interest – SPS 05/10" *Tax Information Bulletin* Vol 17, No 9 (November 2005)).

Standard Practice Statements

34. Standard Practice Statements are general guidelines the Commissioner issues. These statements describe how the Commissioner will usually exercise a statutory discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts. The Commissioner will usually apply positions set out in Standard Practice Statements. However, there may be times where it is appropriate for the Commissioner not to follow a position set out in a Standard Practice Statement for example, if it is necessary for the proper exercise of the Commissioner's discretion in a particular fact situation. In this regard, as with all statements (except binding rulings) Standard Practice Statements are not binding on the Commissioner.

35. Standard Practice Statements are, however, a "Commissioner's official opinion". To the extent that taxpayers take a tax position in reliance on a Standard Practice Statement and that tax position is incorrect, sections 120W and 141B(1D) apply as discussed above.

Court or tribunal decisions

36. Occasionally, a court or tribunal may make a decision that the Commissioner does not consider correctly reflects the law. The Commissioner may appeal the decision or seek to test the issue in a subsequent case. In such cases, because the Commissioner considers the decision in question does not reflect the law correctly, the approach taken by the Commissioner may not be modified to reflect the decision until its correctness has been established.

37. Where this is the case, the Commissioner will advise taxpayers in a *Tax Information Bulletin* as soon as practicable of the position being taken and that taxpayers should not rely on Inland Revenue adoption of the decision in the interim. The Commissioner will generally not impose shortfall penalties under sections 141A–141D when taxpayers follow the position taken in a current court decision.

38. From time to time there will also be cases where a decision is confined to its own facts. In such cases the decision will not be precedential and may not be applied outside of the unique facts of the case. Where possible the Commissioner will set this out in a decision impact statement following the decision or subsequently advise taxpayers in a *Tax Information Bulletin*.

References

Related rulings/statements
"IS 10/07: Care and management of the taxes covered by the Inland Revenue Acts – Section 6A(2) and (3) of the Tax Administration Act 1994", *Tax Information Bulletin* Vol 22, No 10 (November 2010)
"Remission of penalties and interest – SPS 05/10", *Tax Information Bulletin* Vol 17, No 9 (November 2005))
"SPS 07/03 Requests to amend assessments", *Tax Information Bulletin* Vol 19, No 5 (June 2007)
Subject references
Advice; Care and Management; Commissioner's official opinions
Legislative references
Income Tax Act 2007 ss 141A, 141B, 141C, 141D; Tax Administration Act 1994 ss 3 (definition of "Commissioner's official opinion"), 6, 6A, 113, 120W
Case references
CIR v Ti Toki Cabarets (1989) Ltd (2000) 19 NZTC 15,874
Lemmington Holdings Ltd (No 2) v CIR (1983) 6 NZTC 61,576
R v IRC, ex p Wilkinson [2005] BTC 281
Vestey v IRC [1979] 3 All ER 976
Westpac Banking Corporation v CIR (2008) 23 NZTC 21,694

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.

NO MERIT IN "SLIP RULE" APPEAL

Case	NTH Douglas & Others v Commissioner of Inland Revenue
Decision date	23 October 2012
Act(s)	High Court Rules
Keywords	Sealed judgments, rule 11.10

Summary

The Court of Appeal considered the appeal by the appellants from the High Court decision not to invoke rule 11.10 of the High Court rules had no merit and accordingly dismissed the appeal.

Facts

This was an appeal against a judgment of Courtney J, which was delivered on 8 July 2011. In that judgment Courtney J had declined the appellants' application to invoke rule 11.10 of the High Court Rules to set aside judgments that had been sealed by the High Court against the appellants.

The parties in this proceeding have been engaged in litigation in a number of different courts and over a number of years. The litigation has concerned the validity of assessments made in respect of people who had participated in tax arrangements known as the Russell Template organised by their tax agent, Mr Russell. The Russell Template has been held by the Privy Council to be tax avoidance.

In a February 2009 judgment, Courtney J dealt with issues that remained following an earlier judicial review decision, her interim decisions on a number of appeals by way of cases stated from the Taxation Review Authority (TRA), and the unsuccessful appeals from those decisions (February 2009 judgment).

Courtney J rejected the appellants' submission that the matter ought to be remitted back to the TRA for consideration of further evidence and/or further issues and instead, with the exception of deductions permitted to corporate taxpayers for a consultancy fee charged by Mr Russell, confirmed the amended assessments that had been the subject of the original cases stated to the TRA.

Her Honour made a number of orders to give effect to that decision, including the order that "Judgment made against any of the individual taxpayers may only be sealed upon the filing and service of an affidavit annexing the case stated to the TRA for that taxpayer …".

The affidavits were sworn on various dates from January 2010 but were not filed and served until 14 September 2010.

The Registry sealed the orders on the same day, 14 September 2010, and before service of the affidavits was effected.

The appellants applied to the Court by memorandum of counsel, supported by an affidavit from Mr Russell, seeking orders that the existing judgments were not validly sealed and must not be acted upon by any party.

In a decision dated 8 July 2011, Courtney J accepted that the slip rule could be invoked to amend a Court order to give effect to the intention of the Court. However, her Honour rejected the appellants' submission that in the February 2009 judgment she intended the appellants would have the opportunity to respond to the affidavits filed by the Commissioner. Courtney J held it was perfectly clear from that decision, read as a whole, that there was no intention the appellants would have the right to respond and challenge the affidavits filed by the Commissioner for the purposes of obtaining the sealed judgments. As stated above, her Honour declined to make the orders sought.

Decision

It was noted by the Court of Appeal that the issue in the appeal was the objective interpretation of the February 2009 judgment. The Court of Appeal considered that when the February 2009 judgment is considered as a whole and in context, its intent is clear, as is the purpose for requiring the respondent to file and serve the affidavits annexing the individual taxpayer's amended assessments.

The Court of Appeal was satisfied that it is clear there was no intention that the appellants would have the right to respond (and the Commissioner then reply) and that there would then be a further hearing to settle the judgment.

The clear intent of the February 2009 judgment was to finalise the long, drawn-out process of litigation. The Court of Appeal considered that it was for that purpose and to enable the sealed judgment to reflect the amended assessments, that the Commissioner was required to file and serve the affidavits annexing the full cases stated to the TRA.

The Court of Appeal considered that the requirement for service of the affidavits was effectively a courtesy and for the information of the appellants only.

The Court of Appeal found that Courtney J was also right to find failure to serve the affidavits prior to sealing the judgment could have made no difference to the appellants' position.

The appellants submitted the argument that the purpose of requiring the Commissioner to file the affidavits was to enable the appellants to consider their position and, as such, was a substitute process for referring the matter back to the TRA. The Court of Appeal considered that this argument ignored and was inconsistent with Courtney J's rejection of the appellants' request for the cases to be remitted back to the TRA.

Similarly, the Court of Appeal considered that the appellants' purported reliance on the fact the TRA reserved leave for the parties to apply with regard to any issues "not covered or consequential" did not assist them. The Court of Appeal considered that Courtney J must have been correct when her Honour noted in the February 2009 judgment that, despite that reservation, no matters had been raised by the appellants pursuant to it and that once the appellants had required the TRA to state a case for the High Court, the reservation of leave was superseded by the appeal.

The Court of Appeal rejected the submission that the appellants had in some way been prejudiced as a consequence of their inability to reply to the affidavits. The Court of Appeal said that if the appellants considered they would have a right to raise the matter again, they were wrong. The Court of Appeal reiterated that it was never intended that the appellants would have the opportunity to reply and concluded that there could be no prejudice.

The Court of Appeal dismissed the appeal.

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.

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