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TAX INFORMATION Bulletin

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YOUR OPPORTUNITY TO COMMENT

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

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

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 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
QWB0110	Abusive tax position penalty and the anti-avoidance provision	This question we've been asked answers a question that has arisen in respect of Interpretation Statement IS0061: *Shortfall penalty for taking an abusive tax position penalty* (*Tax Information Bulletin* Vol 18, No 1 (February 2006): 24). The QWBA discusses whether the abusive tax position penalty under s 141D of the Tax Administration Act 1994 applies automatically where there is a "tax avoidance arrangement" under s BG 1 of the Income Tax Act 2007. The QWBA also discusses the factors that differentiate a case where s BG 1 applies but the abusive tax position penalty does not.

IN SUMMARY

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BR Prd 12/02 applies to the sale of smartcard-based ticketing media by Auckland Transport for use on the Auckland public transport network to the public, and the loading of an amount of stored value, pre-paid trip or period pass to be used for travel on buses, trains or ferries, and the use of the card by a cardholder to undertake travel.

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Other remedial changes

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Student Loan Scheme (Budget Measures) Amendment Act 2012

Taxation (Budget Measures) Act 2012

Items of interest

Movement of assessment function from the Adjudication Unit to the Service Delivery Group 64

From 1 July 2012 the responsibility for making assessments in disputed cases that have been considered by the Adjudication Unit has been shifted to the Service Delivery Group (SDG).

Questions we've been asked

QB 12/07: Goods and services tax – treatment of transitional services supplied as part of the sale of a business (that includes the supply of land) 65

QB 12/07 considers the GST treatment of transitional services (such as vendor assistance with business operations for a period of time) where those services are provided by the vendor as part of the sale of a business (that includes the supply of land). In particular the item looks at when those services will be part of the same "supply" as the business (zero-rated) and when they will be a separate supply (standard rated).

QB 12/08: Income tax – look-through companies: interest deductibility on funds borrowed to repay shareholder current accounts 70

QB 12/08 sets out the circumstances where interest is deductible when a look-through company (LTC) borrows money on arm's length terms to repay current account loans from shareholders. Interest will be deductible to the extent the borrowing replaces current account loans from shareholders that were used directly in the LTC's assessable or excluded income earning activity or business.

QB 12/09: Income tax – look-through companies: interest deductibility where funds are borrowed to make a payment to shareholders to reflect an asset revaluation 72

QB 12/09 considers whether interest is deductible under the principles in *FC of T v Roberts; FC of T v Smith* 92 ATC 4380 when a look-through company borrows money to make a payment to shareholders reflecting the increase in the value of an asset of the company. It concludes that interest is not deductible in these circumstances.

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The plaintiff appealed to the High Court on the basis that the District Court had erred in its decision to strike out the plaintiff's claim. The plaintiff made submissions on taxable activity, output tax and money had and received. The High Court dismissed the appeal and held that the proceedings were frivolous, vexatious, and an abuse of process. The Court held that it was simply an attempt to re-litigate matters that had already been disposed of by the lower courts.

Court of Appeal confirms Commissioner's broad powers of reconstruction 75

This case was an appeal from the High Court, which found the arrangements had the purpose and effect of tax avoidance. The Court of Appeal upheld the High Court judgment and further added that the overall scheme was the means by which the profits were laundered, together with other related income without paying income tax. Accordingly, the Court of Appeal concluded that the income is to be attributed to Mr Russell because he was the governing mind of the template arrangements, which were designed to shelter the income earned.

Supreme Court considers the application of sections 52(1) and (2) of the Goods and Services Tax Act 1985 78

Upon an appeal from the Court of Appeal, the Supreme Court was required to consider the dates of deregistration following three sale transactions; the *Lopas* decision; and the wording of section 52 of the Goods and Services Tax 1985.

The Court held that the rental income following the sales showed an on-going supply and therefore the de-registration dates must be according to the Commissioner's assessments. The Court further looked at the Lopas decision of relevance and confirmed that the statutory language must govern any other interpretation. The Court further provided a test under section 52 that deregistration depends on the Commissioner being "satisfied" that taxable supplies for the following 12-month period were not going to exceed the threshold.

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 12/02

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 Auckland Transport.

Taxation Laws

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Ruling applies in respect of ss 5(11E), 5(11F), 8(1), 9(1), 10, 24(6)(b) and 60.

Exceptions

This Ruling does not consider or rule on the GST treatment of:

- payments that Auckland Transport makes to Transport Operators under cl 3.4 of the Settlement Agreement
- amounts that are forfeited and become the property of Auckland Transport under the HOP Card Terms of Use
- administration fees Auckland Transport may charge Cardholders under the HOP Card Terms of Use.

The Arrangement to which this Ruling applies

The Arrangement is the sale of a smartcard-based ticketing media (HOP Card) issued by Auckland Transport for use on the Auckland public transport network to a member of the public (Cardholder), and:

- the loading of an amount of stored value to be used for travel on buses, trains or ferries (HOP Money product); or
- the loading of a bus, train or ferry pre-paid trip (for travel between specific points) (pre-paid trip product); or
- the loading of a bus, train or ferry period pass (period pass product);

on to the purchased HOP Card and the use of the HOP Card by a Cardholder to undertake the appropriate travel.

Auckland Transport is a body corporate and a council-controlled organisation of the Auckland Council, established by s 38 of the Local Government (Auckland Council) Act 2009. Auckland Transport is "resident" in New Zealand and is a "registered person" and a "local authority" as those terms are defined in s 2(1).

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

Background

1. Public transport within the Auckland region is currently highly fragmented and is provided by a number of independent transport operators, each of which has its own fare structure and ticket formats.
2. Public transport in the Auckland region comprises three modes of transport: bus, train and ferry.
    - Buses in the Auckland region carry around 50 million passengers a year, and are provided by several different operators. Each operator has its own fare structure and ticketing options, although in some cases a multi-operator pass is available.
    - Trains in the Auckland region carry around nine million passengers a year. Auckland Transport is responsible for planning, developing and operating the Auckland train network, and contracts the day-to-day running of the train network to an independent commercial transport operator.
    - Nine ferry services in the Auckland region transport around five million passengers a year. Auckland Transport contracts ferry operators to run some of these services. However, the majority of passenger ferry services are run by four independent companies.
3. Three "types" of arrangement exist between Auckland Transport and the transport operators providing public transport services in the Auckland region (Transport Operator/s): gross contracts, net contracts and commercial registration.
    - Gross contracts are based on the gross operating price payable by Auckland Transport to the Transport Operator for providing the service. The Transport Operator is reimbursed at an agreed rate

for the operating costs associated with providing the service. Auckland Transport bears any revenue risk.

- Net contracts are based on the net cost payable by Auckland Transport to the Transport Operator for performing the service after the deduction of fare revenue earned by the operator. The Transport Operator is reimbursed a tendered rate, so bears the revenue risk for providing the service.
- A commercial registration arrangement is where Transport Operators are responsible for registering a commercial service. The services are operated without funding assistance from Auckland Transport, and the Transport Operator bears all the revenue risk.

4. The type of arrangement held between Auckland Transport and Transport Operators will impact on the revenue allocated to each Transport Operator per customer transaction, as well as the nature in which revenues are settled between Transport Operators.
5. Transport Operators are "resident" in New Zealand and are "registered persons" as those terms are defined in s 2(1).

Auckland integrated fare system

6. To improve public transport accessibility and efficiency, Auckland Transport intends to introduce an integrated fare system (AIFS) using smartcard technology. Under the AIFS, all Transport Operators servicing the Auckland region will operate under the same fare structure, and customers will be able to purchase tickets to use transport with all Transport Operators in the region. The new AIFS will enable Cardholders to travel on Auckland's public transport using a variety of smartcard products: pre-paid trips, period passes and HOP Money (AIFS Products) across multiple operators and modes.
7. Auckland Transport will be responsible for the overall management and oversight of the AIFS.
8. Retailers for AIFS Products (Retailers), other than Auckland Transport and Transport Operators, have yet to be decided. However, it is likely that there will be a large number of Retailers, and that the number of approved Retailers will increase, and change, with time. Retailers are "resident" in New Zealand and are "registered persons" as those terms are defined in s 2(1).
9. Retailers will pay all funds received from the sale of HOP Cards (Issuance Fees) and AIFS Products into a separate "ring fenced" bank account (Stakeholder Account) controlled and administered by Auckland Transport as Stakeholder.

Relevant documents

10. The documents relevant to the Arrangement are the:
    - Settlement Agreement to be entered into between Auckland Transport and each Retailer and Transport Operator, which will be in a form that is not materially different to the "Settlement Agreement" supplied to Inland Revenue on 4 May 2012 (Settlement Agreement).
    - HOP Cards Terms of Use that govern a Cardholder's possession and use of a HOP Card, in a form that is not materially different to the "HOP Cards Terms of Use" supplied to Inland Revenue on 4 May 2012 (Terms of Use).

Clearing and settlement

11. Clearing and settlement entails the identification and distribution of earned revenues between Transport Operators, Retailers and Auckland Transport. Auckland Transport will be responsible for apportioning funds between these relevant parties for all transactions performed over an agreed number of business days, and the subsequent revenue earned by each party will be based on apportionment rules as defined by Auckland Transport.

Settlement Agreements

12. Auckland Transport will enter into a Settlement Agreement with each licensed Transport Operator and Retailer (AIFS Participant).
13. Clause 1.1 of the Settlement Agreement contains the following relevant definitions:

> **AIFS** means the Auckland integrated fare system to be managed by AT [Auckland Transport] on and from the Start Date;
>
> **AIFS Product** means the Pre-paid Trip Product, Period Pass Product or HOP Money Product and AIFS Products has a corresponding meaning;
>
> …
>
> **Cardholders** means holders of the HOP Cards;
>
> **Card Terms of Use** means the general terms of use, as amended from time to time by AT, that apply to the use of the HOP Cards;
>
> …
>
> **HOP Cards** means the AIFS cards issued by AT;
>
> **HOP Money Product** means the stored monetary value a Cardholder has loaded onto a HOP Card;
>
> …
>
> **Issuance Fee** means the fixed fee to purchase a HOP Card as set by AT from time to time;
>
> …
>
> **Period Pass Product** means a pass credit loaded onto a HOP Card allowing the Cardholder to undertake

unlimited travel within a particular area for a specified number of days;

Pre-paid Trip Product means a discounted trip credit loaded onto a HOP Card for trips over a specified number of stages for buses and trains or with a particular ferry service;

…

Retailers means retailers of the HOP Cards and the AIFS Products appointed from time to time by AT;

…

Stakeholder means AT as appointed pursuant to clause 3.1;

Stakeholder Account means the [***Insert details of account***] controlled and administered by AT on behalf of AT, the Transport Operators and the Retailers or such replacement account;

…

Transport Operators means the operators of passenger transport services in the Auckland region that agree to take part in AIFS on the terms set out in this agreement.

14. The Settlement Agreement will appoint Retailers to sell HOP Cards as agents for Auckland Transport. Clause 2.1 of the Settlement Agreement provides as follows:

    2.1 Sale of HOP Cards: each Retailer is appointed to sell HOP Cards as agent for and on behalf of AT;

15. The Settlement Agreement will appoint Auckland Transport and all other Retailers to sell AIFS Products as agents for each Transport Operator with whom an AIFS Product voucher is ultimately redeemed. Clause 2.2 of the Settlement Agreement provides as follows:

    2.2 Sale of AIFS Products: AT and each Retailer is appointed to sell AIFS Products as agent for and on behalf of each Transport Operator with whom, and to the extent that, an AIFS Product voucher is ultimately redeemed.

16. The Settlement Agreement will appoint Auckland Transport as the Stakeholder. Clause 3.1 of the Settlement Agreement provides as follows:

    3.1 Appointment of Stakeholder: On and from the Start Date, the parties agree that AT is appointed as Stakeholder to establish, control and maintain the Stakeholder Account.

17. The Settlement Agreement will provide that, for GST purposes, Auckland Transport and each Retailer, as agent for the Transport Operator, is selling a "voucher" to the Cardholder (and not "travel"). Clause 4.1 of the Settlement Agreement provides as follows:

    4.1 GST Treatment of HOP Cards and AIFS Products: On and from the Start Date, the parties agree to account for GST on the sale and purchase of HOP Cards and AIFS Products in accordance with the Product Ruling. For GST purposes, AT and each Retailer, as agent for the Transport Operator, sell a "voucher" to the Cardholder (and not "travel"). GST is not due and payable when a HOP Card is purchased or when AIFS Products are loaded onto the HOP Card.

18. The Settlement Agreement will provide that Retailers will not issue a "tax invoice" or a "credit note" or a "debit note" (as those terms are defined in s 2(1)) on behalf of Auckland Transport or a Transport Operator in relation to the sale of a HOP Card or an AIFS Product. Clause 4.2 of the Settlement Agreement provides as follows:

    4.2 No Tax Invoices Issued by Retailers: AT and each Retailer agree not to issue a "tax invoice", "credit note" or "debit note" to any Cardholder on behalf of AT or a Transport Operator for the sale of a HOP Card or AIFS Product.

19. The Settlement Agreement will provide for the payment of commission by Auckland Transport to Retailers for providing sales services to Auckland Transport as manager of the AIFS. Clause 5.1 of the Settlement Agreement provides as follows:

    5.1 Sales Commission: To the extent that the AIFS Participant is a Retailer, AT will pay commission to the AIFS Participant for providing sales services to AT as manager of AIFS.

Stakeholder Account

20. The Settlement Agreement will provide that all Issuance Fees Cardholders pay on the sale and purchase of HOP Cards and all amounts Cardholders pay on the sale and purchase of AIFS Products will be paid into the Stakeholder Account. The Settlement Agreement will also set out how and when funds received from the sale of HOP Cards and AIFS Products are to be deposited into the Stakeholder Account. Clause 3.2 of the Settlement Agreement provides as follows:

    3.2 Deposit of Amounts into Stakeholder Account: All amounts collected from the sale and purchase of HOP Cards (Issuance Fees) and the sale and purchase of AIFS Products will be paid into the Stakeholder Account in accordance with the following provisions:

    (a) **Funds Collected by Retailers**: All amounts paid by Cardholders to Retailers will be paid into the Stakeholder Account by the Retailers. Each Retailer agrees to initially process and bank such amounts into the Retailer's bank account on the Business Day received (or if not received on a Business

Day then the next available Business Day) and then to settle such amounts into the Stakeholder Account at the end of that same Business Day or next available Business Day;

(b) **Cash Collected by Vending and Reload Devices**: Cash takings collected by third parties appointed by AT via vending and reload devices will be paid by the third parties into the Stakeholder Account at the end of each Business Day received (or if not received on a Business Day then the next available Business Day);

(c) **Credit Card and Eftpos Amounts**: Amounts collected by credit card or eftpos via vending and reload devices, the MAXX Customer Contact Centre or the MAXX website will be paid into the Stakeholder Account at the end of each Business Day such sums are received (or if not received on a Business Day then the next available Business Day); and

(d) **Payments by AT**: Amounts collected by cash, credit card or eftpos by AT at its ticket offices or via its website will be paid into the Stakeholder Account at the end of each Business Day such sums are received (or if not received on a Business Day then the next available Business Day).

21. Funds Retailers deposit into the Stakeholder Account will form a pool out of which payments will be made to Auckland Transport for the supply of HOP Cards and to Transport Operators for the supply of AIFS Products. The transactions performed using stored value, pre-paid trips or validation of period passes will be used to apportion the relevant amounts owed to each Transport Operator. With the exception of pre-paid ferry trips, funds held in the Stakeholder Account from the sale of AIFS Products will not be allocated to Transport Operators until a trip has actually been taken by a Cardholder using an AIFS Product. The amount settled will consider the number of trips taken by Cardholders for each Transport Operator, as well as factors such as the product type, trip distance and type of contractual or commercial arrangement between Auckland Transport and the relevant Transport Operator. The amount of funds to be apportioned to each Transport Operator per Cardholder's trip will largely depend on the type of AIFS Product used by the Cardholder.

22. Clause 3.3 of the Settlement Agreement sets out how amounts held in the Stakeholder Account will be apportioned and provides as follows:

3.3 **Apportionment of Amounts from Stakeholder Account**: All amounts collected from the sale and purchase of HOP Cards and AIFS Products and paid into the Stakeholder Account pursuant to clause 3.2 will be held in the Stakeholder Account and apportioned by the Stakeholder in accordance with the following provisions:

(a) **Payments to AT**: Payments will be made from the Stakeholder Account each Business Day to AT for:

(i) **Issuance Fees**: Issuance Fees collected that Business Day (or if not collected on a Business Day then the next available Business Day); and

(ii) **Refunds**: Any refund of the remaining balance of HOP Money Products loaded on a HOP Card requested by a Cardholder in accordance with the Card Terms of Use;

(b) **Payments to Transport Operators**: Payments will be made from the Stakeholder Account to Transport Operators in accordance with the following provisions:

(i) **HOP Money Products**: For transport journeys undertaken using the HOP Money Product, the Stakeholder will apportion amounts out of the Stakeholder Account to Transport Operators each Business Day (or the next available Business Day) based on usage of HOP Money Products that day as calculated by AT. Deductions will be made for any discounts or concessions offered by AT to Cardholders using the HOP Money Product;

(ii) **Pre-Paid Trip Products**: For transport journeys undertaken using the Pre-paid Trip Product, the Stakeholder will apportion amounts out of the Stakeholder Account as follows:

(A) to bus and train Transport Operators, each Business Day (or the next available Business Day) based on usage of Pre-paid Trip Products that day as calculated by AT; and

(B) to ferry Transport Operators, the full amount collected from a Cardholder for the Pre-paid Trip Product will be paid to the Transport Operator on the Business Day the Pre-paid Trip Product is loaded on a HOP Card (or if not loaded on a Business Day then the next available Business Day);

(iii) **Period Pass Products**: For transport journeys undertaken using the Period Pass Product, the Stakeholder will apportion amounts out of the Stakeholder Account as follows:

(A) to bus and train Transport Operators, based on the proportion of Period Pass trips undertaken by Cardholders with the respective Transport Operator, once the Transport Operator's entitlement has been calculated by AT and within seven days of a Period Pass Product expiring; and

(B) to ferry Transport Operators, the full amount collected from a Cardholder for the Period Pass Product will be paid to the Transport Operator on the Business Day the Period Pass Product is loaded on a HOP Card (or if not loaded on a Business Day then the next available Business Day).

23. Under cl 4.3 of the Settlement Agreement each Transport Operator will agree to account for GST on payments received from the Stakeholder Account. Clause 4.3 provides as follows:

> **4.3 Transport Operators to Account for GST**: Each Transport Operator agrees to account for GST on payments received from the Stakeholder Account pursuant to clause 3.3(b).

24. Under cl 3.4 of the Settlement Agreement, Auckland Transport will separately reimburse Transport Operators for the difference between any amounts a Transport Operator receives from the Stakeholder Account for any concessionary fare and/or discount offered by Auckland Transport and the full fare amount for that journey, out of Auckland Transport's own bank account. Clause 3.4 of the Settlement Agreement provides as follows:

> **3.4 Compensation for Discounts and Concessionary Fares**: AT will separately reimburse in full Transport Operators the difference between any amounts a Transport Operator receives from the Stakeholder Account in accordance with clause 3.3(b)(i) for any concessionary fare and/or discount offered by AT from time to time to Cardholders using the HOP Money Product and the full fare amount for that journey.

25. All amounts collected from the sale of HOP Cards and AIFS Products will be paid into the Stakeholder Account controlled by Auckland Transport (see para 20). Auckland Transport will not derive any benefit from holding the money while it remains in the central Stakeholder Account apart from retaining any interest earned, which it will apply towards the costs of operating the Stakeholder Account.

26. The Stakeholder will hold and have available, sufficient records to establish the particulars of all transactions relating to the sale of HOP Cards and AIFS Products, including (but not limited to) details of all deposits made by Retailers into the Stakeholder Account and all payments made to Auckland Transport and to each individual Transport Operator out of the Stakeholder Account.

HOP Card

Purchase of HOP Card

27. As part of the AIFS, Cardholders will be able to use HOP Cards to pay for travel on any bus, rail and ferry public transport service provided by public Transport Operators in the Auckland region. The HOP Card will be accepted by all public Transport Operators in the Auckland region. HOP Cards will need to be "topped up" with stored value or loaded with another AIFS Product before they can be used to purchase travel.

28. All HOP Cards will remain the property of Auckland Transport. Clause 8.3 of the Terms of Use provides as follows:

> **8.3** all HOP Cards will remain our property at all times and we retain the right to manage and change the software and data on the HOP Cards at any time;

29. Cardholders will be able to purchase a HOP Card for a non-refundable fixed fee (Issuance Fee) (currently $10 inclusive of GST) from Auckland Transport ticket offices, a network of third party Retailers and online via the Auckland Transport website. The purchase of a HOP Card will give the Cardholder the right to load AIFS Products onto the card and to use the pre-loaded AIFS Products to undertake travel in the Auckland region, in accordance with the terms and conditions of the HOP Card Terms of Use and the relevant Transport Operator.

30. Under cl 31 of the Terms of Use no invoice or tax invoice will be provided to a Cardholder when they purchase a HOP Card or an AIFS Product. Clause 31 provides as follows:

> **31. GST**: The charges and other amounts payable to us or our Retail Agents under these Terms are stated and payable in New Zealand dollars inclusive of any GST, if any. No invoice or tax invoice will be provided to you when you purchase a HOP Card or load any Products on

a HOP Card. If you need to make an expense claim or GST claim, please use a printout from your Online Account as a basis for your claim.

31. In relation to the initial sale of a HOP Card, the Settlement Agreement will (see paras 14–23):
    - Appoint Retailers (who may include Transport Operators) as agents for Auckland Transport to sell HOP Cards on its behalf.
    - Provide that all Issuance Fees paid by Cardholders on the sale and purchase of a HOP Card will be paid into the Stakeholder Account administered by Auckland Transport as Stakeholder.
    - Set out the terms and conditions of the stakeholder relationship, including details of how and when money received from the sale of a HOP Card to a Cardholder will be paid into the Stakeholder Account and how and when amounts will be paid by the Stakeholder to Auckland Transport out of the Stakeholder Account.

32. Under the Terms of Use of the HOP Card, Cardholders will be entitled to use a HOP Card to pay for public transport journeys using any of the AIFS Products. Clause 4 of the Terms of Use provides as follows:

    4. HOP Cards: You may use a HOP Card to pay for public transport journeys provided by public transport operators (Public Transport Operators) in the Auckland region using any of the following System products (Products):

    4.1 **HOP Money**: stored money value loaded onto a HOP Card (HOP Money), which can be used to purchase public transport journeys or paper tickets for public transport journeys;

    4.2 **Period Pass**: a pass credit loaded onto a HOP Card allowing you to have unlimited journeys within a number of days (Period Pass); or

    4.3 **Pre-paid Trip**: a discounted trip credit loaded onto a HOP Card for trips over a number of stages for buses and trains or a particular ferry service (Pre-Paid Trip).

33. Auckland Transport will apply the Issuance Fee towards the following:
    - a non-refundable travel deposit, allowing the Cardholder to end a journey with a negative balance;
    - various administrative costs associated with implementing the AIFS and issuing the card;
    - the cost of the card itself.

34. Cardholders will be able to register their HOP Cards online. Registration will enable the Cardholder to protect any AIFS Products stored on their card. Registered HOP Cards that are damaged, lost or stolen will be able to be replaced at a reduced fee.

35. A single HOP Card will be able to hold all three AIFS Products (pre-paid trips, period passes and stored value) simultaneously. The HOP Card will not be able to be used to purchase other goods or services.

36. When a Cardholder wants to travel on public transport using an AIFS Product, they will need to use their HOP Card to "tag on" before starting their trip and "tag off" when disembarking a bus or ferry or exiting a station or ferry wharf. When a Cardholder tags on and off, the respective boarding and alighting locations will be recorded as part of the transaction, as well as the time and date, route, device number and operator identification number. The AIFS will use this tag on and tag off information to calculate the relevant fare to be paid and to deduct or validate AIFS Products that have been loaded onto the Cardholder's HOP Card.

Stored value reserve and nominal fare

37. Because the AIFS cannot predict the type of trip a Cardholder will take from the tag-on event alone, regardless of the type of AIFS Product used to travel, every time a Cardholder tags on to board a new service a "nominal fare" will be deducted from the "stored value reserve" of the Cardholder's HOP Card. The nominal fare will vary depending on the transport mode and will equate to a reasonable fare should the Cardholder fail to tag off.

38. When the Cardholder tags off as they complete their trip, one or more of the following will occur:
    - the validity of any period pass will be verified;
    - an appropriate pre-purchased stage trip will be deducted;
    - the actual fare will be calculated and deducted from the stored value purse.

    The nominal amount of stored valued deducted at the tag-on event will be credited back to the HOP Card "stored value reserve" on successful tag-off.

39. If a Cardholder fails to tag off after a trip has been completed, the nominal fare will not be re-credited to the stored value reserve of the HOP Card and will represent the fare paid for the trip taken. Therefore, the Cardholder will be charged the amount of the nominal fare for undertaking a trip on the service. Transport Operators under a net contract or commercial service will be apportioned the nominal fare amount for the trip taken in this instance.

40. The stored value balance and the status of all other AIFS Products loaded onto a HOP Card will be

displayed each time the HOP Card is tagged on and off at a "fare payment device" or "electronic gate". When tagging on, the current stored value balance, pre-paid trip balance or period pass expiration date will be communicated to the Cardholder via the device display. At the end of the trip when the Cardholder tags off, the fare payment device or electronic gate will display the fare paid using stored value and the remaining stored value balance, the validation of a pre-paid trip being used to pay a fare and the pre-paid trip balance; or state the validation of an applicable period pass and the pass expiration date.

Cancellation of a HOP Card

41. All Cardholders who have registered their HOP Card online and who want to discontinue their use of a HOP Card that has stored value remaining on it, will be entitled to apply to Auckland Transport for a refund of the remaining balance, less an administration fee, on surrendering the card. Auckland Transport will not provide refunds for unused period passes or pre-paid trips loaded onto a Cardholder's HOP Card. Clause 11.1 of the Terms of Use provides as follows:

> **11. Cancellation and Refund:**
>
> 11.1 If your HOP Card is registered on our Website (**Registered HOP Card**) you may apply to cancel your HOP Card and receive a refund in cash of the remaining HOP Money on your HOP Card (less a $10 administration fee) within 14 days of surrender of your HOP Card. Only unused HOP Money can be refunded. No refunds are available for Period Passes or Prepaid Trips or paper tickets purchased using HOP Money. Any refund given by us is inclusive of any goods and services tax (GST).

42. A HOP Card will expire if it is not used for a continuous period of two years. When a HOP Card expires, any remaining stored value reserve and any remaining AIFS Products will be forfeited and become the property of Auckland Transport. Clause 9 of the Terms of Use provides as follows:

> **9. Expiry**: The HOP Card (including any Products loaded on the HOP Card) will expire if the HOP Card is not used, no refund is requested, the HOP Card is cancelled, or no Products are loaded onto the HOP Card for a continuous period of two years. When a HOP Card expires, any Products remaining on the HOP Card will be forfeited and become our property on and from the date the HOP Card expires.

AIFS Products

43. In relation to the sale of AIFS Products, the Settlement Agreement will (see paras 14–23):
    - Appoint Retailers as agents for Transport Operators to sell AIFS Products on their behalf.
    - Provide that all amounts Cardholders pay on the sale and purchase of an AIFS Product will be paid into the Stakeholder Account administered by Auckland Transport as Stakeholder.
    - Set out the terms and conditions of the stakeholder relationship, including details of how and when money received from the sale of an AIFS Product to a Cardholder will be paid into the Stakeholder Account and how, when and what amount of funds held in the Stakeholder Account will be apportioned by the Stakeholder and paid out of the Stakeholder Account to Transport Operators for the sale of AIFS Products.

HOP Money product

44. Stored value (HOP Money) is an electronic record of monetary value that has been pre-loaded onto a HOP Card. The AIFS HOP Money stored-value product allows Cardholders to store money on a HOP Card that can be used at a later date to undertake travel of equivalent value to the amount stored on the card. The Cardholder will be able to use stored value on a HOP Card to undertake travel on all bus, train and ferry services provided by any Transport Operator in the Auckland region.

45. HOP Cards will be able to be "topped up" with stored value at Auckland Transport ticket offices, through a network of Retailers, through self-service vending machines located within some stations and large transport exchanges, by calling the MAXX Customer Contact Centre and online via the Customer Web Portal.

46. By default, when a Cardholder initially purchases a HOP Card, the stored value purse will have a zero balance and a stored value reserve amount. Cardholders will be able to end a trip with a negative stored value balance. However, to initiate a journey, a Cardholder must have a zero or positive stored value balance.

47. The HOP Money product will be used when any pre-paid trip product and/or period pass product that may be on the HOP Card does not match the specific trip undertaken by the Cardholder ascertained from the tag-on and tag-off events.

48. The minimum amount of stored value that can be added to a HOP Card will be $5 (including GST). HOP Cards are currently only able to store a maximum of $200 at one time. Clause 34 of the Terms of Use

provides as follows:

34. HOP Money:

34.1 Each time you add HOP Money to a HOP Card, you must add at least $5 (incl. GST). You will only be able to add HOP Money equal to or above these minimum loadable values.

34.2 The maximum amount of HOP Money that may be held on a HOP Card is $200 (incl. GST).

34.3 Notwithstanding section 23 (Right to Refuse), Public Transport Operators may permit you to commence a public transport journey, and to complete each leg of the route, as long as there is a positive or $0.00 HOP Money balance on the HOP Card at the start of your journey. HOP Money contained on multiple HOP Cards cannot be combined to pay a single fare.

49. Cardholders may be provided with various discounts when using stored value to undertake travel including a stored value discount, stored value daily fare capping and transfer discount.

- Stored Value Discount – a 10% discount on the adult cash fare that would have been charged for the same journey.
- Stored Value Daily Fare Capping – a daily fare cap, whereby any travel initiated after that fare cap has been reached will not incur a charge.
- Transfer Discount – a discount for transfers between different train and bus services to reduce the overall cost of using public transport for people who need to use multiple services to complete their journey. The transfer discount will apply only for transfers taken within a 30-minute period.

50. HOP Cards can be topped up an infinite number of times, unless they are reported lost or stolen or are cancelled for some other reason.

51. If a HOP Card has been registered online, the Cardholder will be able to "top up" online. The stored value balance on a registered HOP Card that is lost, stolen or damaged will be able to be transferred to a replacement card.

52. Cardholders will be able to obtain a refund of any stored value on their HOP Card from Auckland Transport if they choose to cancel the card. However, if a HOP Card is not cancelled and remains inactive for more than two years the stored value will become the property of Auckland Transport (see para 42).

53. No interest will be payable to, or by, Cardholders in respect of any positive or negative AIFS Smartcard balance.

Revenue flows resulting from topping up stored value on a HOP Card

54. The topping up of stored value onto a HOP Card involves:

- the Cardholder
- the Retailer
- Auckland Transport
- the Transport Operator.

55. The flow of funds resulting from the topping up of stored value onto a HOP Card is as follows:

i) The Cardholder pays the amount of topped-up stored value to be loaded onto their HOP Card to the Retailer (as agent for each Transport Operator with whom the HOP Money product is ultimately redeemed).

ii) The Retailer pays the funds on a daily basis to the Stakeholder.

iii) The Stakeholder clears the funds to the Transport Operator.

56. Funds collected from stored value top-ups will be paid to Transport Operators daily, based on actual usage. Each journey a Cardholder takes using stored value has a set fee that is determined by the number of travel zones covered. The amount of funds to be paid to each Transport Operator will be based on the total value of trips taken by Cardholders and the amounts deducted from stored-value balances.

57. Transport Operators with whom HOP Money products are ultimately redeemed will not elect to treat the supply made on redemption as a supply of goods and services.

Pre-paid trip product

58. Pre-paid trips are discounted trip credits that are loaded onto (and stored electronically on) a Cardholder's HOP Card for future use. The trips are defined by the number of stage points a Cardholder wishes to travel for a bus or train service or the particular ferry service a Cardholder wishes to travel on.

59. For bus and train services, Cardholders will be able to purchase pre-paid trips for a point-to-point journey between two specific points. The Transport Operator could be any bus or train operator providing travel between those points. The particular bus or train Transport Operator providing the service will not be known until a Cardholder actually uses the pre-paid trip product to undertake a journey. Pre-paid trips for travel on a ferry service will be for travel on a particular ferry service with an identifiable ferry Transport Operator.

60. Pre-paid trips must be purchased in multiples of 10, with a maximum of 40 stage-based pre-paid trips and 40 service-based pre-paid trips being able to be stored on a HOP Card at any one time. HOP Cards will only be able to store one type of stage-based pre-paid trip and one type of service based pre-paid trip at one time.
61. A HOP Card will need to be loaded with a pre-paid trip product, before a Cardholder can use it to undertake the appropriate travel. Pre-paid trip products will be able to be loaded onto HOP Cards at Auckland Transport ticket offices, through a network of Retailers, through self-service vending machines located within some stations and large transport exchanges, by calling the MAXX Customer Contact Centre and online via the Customer Web Portal.
62. To use a pre-paid trip, Cardholders must tag on to the transport service when they board, and tag off the transport service before disembarking or leaving the station or ferry wharf. If the journey matches a pre-paid trip, then the pre-paid trip is used. If the journey undertaken does not match the pre-paid trip type, either stored value or an applicable period pass will be used instead.
63. If a HOP Card has been registered online, the Cardholder will be able to set up automatic renewals of pre-paid trips. Pre-paid trips that are stored on a registered HOP Card that is lost, stolen or damaged will be transferable to a replacement card.

Revenue flows resulting from purchase of a pre-paid trip product

64. The sale and use of a pre-paid trip product involves:
    - the Cardholder
    - the Retailer
    - Auckland Transport
    - the Transport Operator.
65. The flow of funds resulting from the purchase of a pre-paid trip product is as follows:
    i) The Cardholder pays the cost of the pre-paid trip product to the Retailer (as agent for each Transport Operator with whom the pre-paid trip is ultimately redeemed).
    ii) The Retailer pays the funds on a daily basis to the Stakeholder.
    iii) The Stakeholder clears the funds to the Transport Operator.
66. Bus and train Transport Operators will be paid for each individual trip Cardholders take on their service using a pre-paid trip product. Funds collected from the sale of bus and train service pre-paid trips and held in the Stakeholder Account will be apportioned and paid to bus and train Transport Operators at the end of each day, based on the actual usage of pre-paid trips by Cardholders on a Transport Operator's service on that day.
67. Ferry Transport Operators will be paid (from the Stakeholder Account) the full amount collected from the sale of a pre-paid trip product, on the day it is loaded onto the Cardholder's HOP Card.
68. Transport Operators provide the actual transport to holders of pre-paid trips. Cardholders do not pay Transport Operators directly for their services.

Period pass product

69. The period-pass is an electronic product that is stored on a HOP Card. To purchase a period pass under the AIFS, a customer must hold a HOP Card.
70. A period pass will entitle a Cardholder to unlimited travel within the defined travel area for a specified number of days. A travel period begins on the date that a period pass is activated for the first time by the Cardholder tagging on with a Transport Operator. A travel period ends when the specified number of days has elapsed since the period pass was first activated.
71. For the purpose of period passes, the Auckland region will be split into three travel zones, with period passes being available for travel within either a single zone, which must be specified at the time of purchase, or all zones. Bus and train period passes will be available for unlimited bus and train travel within a defined number of zones, but will not be able to be used on ferry services.
72. Ferry period passes will be service based and operator specific, meaning that a period pass will be able to be used for unlimited travel on a specific ferry service. Ferry period passes will not be able to be used for bus or train travel.
73. HOP Cards will only be able to store one type of bus and train period pass and one type of ferry period pass at one time. However, a new period pass may be loaded onto a HOP Card up to seven days before expiry of the current period pass.
74. A HOP Card will need to be loaded with a period pass product, before a Cardholder can use it to undertake the appropriate travel. Period pass products will be able to be loaded onto HOP Cards at Auckland Transport ticket offices, through a network of Retailers, through self-service vending machines located within some stations and large transport exchanges, by calling the MAXX Customer Contact Centre, and online via the Customer Web Portal.

75. To use a period pass, passengers must tag on to the transport service when they board, and tag off the transport service before disembarking or leaving a station or ferry wharf. If the travel begins and ends within the defined travel area of the period pass, then the period pass will be used. If the actual travel begins or ends outside the geographic area covered by the period pass, the fare will be deducted from the Cardholder's stored value purse or pre-paid trips balance (depending on availability of products on the HOP Card).

76. If a HOP Card has been registered online, the Cardholder will be able to set up automatic renewals of period passes.

77. Period passes that are stored on a HOP Card that is lost, stolen or damaged may be transferred to the replacement card, if the original card was registered online.

Revenue flows resulting from purchase of a period pass product

78. The sale and use of a period pass product involves:
    - the Cardholder
    - the Retailer
    - Auckland Transport
    - the Transport Operator.

79. The flow of funds resulting from the purchase of a period pass product is as follows:
    i) The Cardholder pays the cost of the period pass product to the Retailer (as agent for each Transport Operator with whom the period pass is ultimately redeemed).
    ii) The Retailer pays the funds on a daily basis to the Stakeholder.
    iii) The Stakeholder clears the funds to the Transport Operator.

80. Funds collected from the sale of all period passes will be held in a revenue pool in the Stakeholder Account, until such time as each Transport Operator's entitlement is able to be determined. Funds collected from bus and train period passes will be paid to bus and train Transport Operators based on the proportion of period pass trips undertaken by Cardholders. Therefore, even when a period pass has been used to initiate travel with a particular Transport Operator, it will not be possible to determine the amount that a particular Transport Operator is entitled to, as this will be dependent on the proportion of total trips initiated with the period pass. For example, if only one bus or train trip is undertaken by a Cardholder using a period pass, the relevant Transport Operator will receive 100% of the purchase price of the period pass; if 100 bus and/or train trips are undertaken using a period pass, Transport Operators will receive only 1% of the purchase price of the period pass for each trip they provided to the Cardholder.

81. Funds collected from the sale of bus and train period passes will be paid to bus and train Transport Operators within seven days of the period pass expiring. Funds collected from the sale of a ferry period pass will be paid to the relevant ferry Transport Operator on the day it is loaded onto the Cardholder's HOP Card.

82. Transport Operators provide the actual transport to holders of period passes. Cardholders do not pay Transport Operators directly for their services.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- The sale of a HOP Card is a supply of goods and services by Auckland Transport subject to GST under s 8(1).
- Under s 9(1), the time of supply of a HOP Card is the earlier of the time an invoice is issued or the time the funds are paid out of the Stakeholder Account to Auckland Transport.
- Under s 10, the value of the supply will be such amount as, with the addition of the GST charged, is equal to the Issuance Fee received by Auckland Transport for the HOP Card.
- Loading a HOP Money product onto a HOP Card is the issue or sale of a voucher with a face value which is treated as a supply under s 5(11E), and which is subject to GST under s 8(1).
- Under s 60, the supply of each HOP Money product voucher shall be deemed to be made by the Transport Operator with whom, and to the extent that, the HOP Money product voucher is redeemed.
- Under s 5(11F), there is no supply of goods and services when a HOP Money product voucher is redeemed by a Cardholder by undertaking travel with a Transport Operator.
- Under s 9(1), the time of supply of each HOP Money product voucher is the earlier of the time an invoice is issued or the time the funds are paid out of the Stakeholder Account to the Transport Operator with whom the HOP Money product voucher is redeemed.
- Under s 10, the value of the supply of each HOP Money product voucher will be such amount as, with the addition of the GST charged, is equal to the amount of money paid out of the Stakeholder Account to the

Transport Operator with whom the HOP Money product voucher is redeemed.

- Loading a pre-paid trip product onto a HOP Card is the issue or sale of a voucher with no face value, which is treated as a supply of goods and services under s 5(11E), and which is subject to GST under s 8(1).
- Under s 60, the supply of each pre-paid trip product voucher shall be deemed to be made by the Transport Operator with whom, and to the extent that, the pre-paid trip product voucher is redeemed.
- Under s 5(11F) there is no supply of goods and services when a pre-paid trip product voucher is redeemed by a Cardholder.
- Under s 9(1), the time of supply of each pre-paid trip product voucher is the earlier of the time an invoice is issued or the time the funds are paid out of the Stakeholder Account to the Transport Operator with whom the pre-paid trip product voucher is redeemed.
- Under s 10, the value of the supply of each pre-paid trip product voucher will be such amount as, with the addition of the GST charged, is equal to the amount of money paid out of the Stakeholder Account to the Transport Operator with whom the pre-paid trip product voucher is redeemed.
- Loading a period pass product onto a HOP Card is the issue or sale of a voucher with no face value which is treated as a supply of goods and services under s 5(11E), and which is subject to GST under s 8(1).
- Under s 60, the supply of each period pass product voucher shall be deemed to be made by the Transport Operator with whom, and to the extent that, the period pass product voucher is redeemed.
- Under s 5(11F), there is no supply of goods and services when a period pass product voucher is redeemed by a Cardholder.
- Under s 9(1), the time of supply of each period pass product voucher is the earlier of the time an invoice is issued or the time the funds are paid out of the Stakeholder Account to the Transport Operator with whom the period pass product voucher is redeemed.
- Under s 10, the value of the supply of each period pass product voucher will be such amount as, with the addition of the GST charged, is equal to the amount of money paid out of the Stakeholder Account to the Transport Operator with whom the period pass product voucher is redeemed.
- Under s 24(6)(b), Retailers will not be required to issue a tax invoice for the sale of HOP Cards or AIFS Products.
- The provision of sales services by a Retailer to Auckland Transport is a supply of services by the Retailer subject to GST under s 8(1).
- Under s 9(1), the time of supply of the sales services is the earlier of the time an invoice is issued by the Retailer or Auckland Transport or the time payment of commission is received by the Retailer from Auckland Transport.
- Under s 10, the value of the supply will be such amount as, with the addition of the GST charged, is equal to the amount of commission received by the Retailer from Auckland Transport.

The period or income year for which this Ruling applies

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

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

Fiona Heiford
Manager (Taxpayer Rulings)

BINDING RULINGS

NEW LEGISLATION

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

TAXATION (INTERNATIONAL INVESTMENT AND REMEDIAL MATTERS) ACT 2012

The Taxation (International Investment and Remedial Matters) Bill was introduced into Parliament on 26 October 2010. It received its first reading on 9 November 2010, the second reading on 9 February 2012 and its third reading on 1 May 2012.

At the report-back stage of the Bill the Finance and Expenditure Committee recommended a number of changes to the legislation, including several intended to make the rules easier to apply.

The Taxation (International Investment and Remedial Matters) Act 2012 received Royal assent on 7 May 2012. It amends the Income Tax Act 2007, the Tax Administration Act 1994 and the Stamp and Cheque Duties Act 1971.

Overview

The Taxation (International Investment and Remedial Matters) Act 2012:

- allows the controlled foreign company (CFC) rules (active income exemption) and the portfolio foreign investment fund (FIF) methods (fair dividend rate and cost methods) to be used by investors with interests of 10% or more in foreign companies that are not CFCs;
- introduces a zero rate of approved issuer levy for interest paid to non-residents in respect of retail bonds;
- introduces an alternative thin capitalisation method for firms with high-value intangible assets; and
- includes a number of technical amendments relating to the earlier reform of the CFC rules in 2009.

The new legislation builds on and extends earlier international tax reforms. The main change is that it allows an investor with a shareholding of 10% or more in any foreign company to apply the active income exemption (provided they have sufficient information to perform the necessary calculations). Previously this exemption was limited to investors with a shareholding of 10% or more in a CFC.

In 2009 an active income exemption was introduced for foreign companies that are controlled by New Zealand investors. The reform was designed to ensure that New Zealand businesses that expand offshore by operating subsidiaries in foreign countries can compete on an even footing with foreign competitors operating in the same country. This means that a New Zealand-owned manufacturing plant in China would generally face the same tax rate as other manufacturers operating in China.

An "active business test" is used to reduce the tax and compliance costs associated with calculating and attributing small amounts of passive income. The test is passed, and no income is attributed, if less than 5% of the gross income of the CFC is passive. If the test is failed, only the passive income (that is, highly mobile income such as interest, rent or royalties) is attributed to the shareholder.

In 2007 new methods were introduced for calculating income from less than 10% shareholdings in foreign companies (portfolio foreign investment funds). As a consequence, these investors generally calculate income based on an assumed 5% rate of return (fair dividend rate method), although natural persons and trustees of trusts for the benefit of loved ones or charities can choose to be taxed on the actual returns of all of their foreign portfolio investments. However, if there is an overall loss across all holdings this is reduced to zero.

The 2007 and 2009 reforms did not apply to interests that are between 10% and 50% in companies that are not controlled by New Zealanders (non-portfolio FIFs). Within this tranche there are some investors who take an active role in managing the foreign company or who invest in companies that are strategically aligned with their own business (akin to a CFC). Others will enter an investment based mainly on expected dividends and share gains (akin to a portfolio shareholding).

The new Act provides consistency in the tax treatment between similar types of foreign investment by extending the active income exemption and active business test (with some small modifications) to non-portfolio FIFs. It also extends and rationalises the portfolio FIF reforms so those investors who are unable, or who prefer not to use the active income exemption will generally be deemed to have FIF income equal to 5% of the value of their investment.

The main exception to the rules is for foreign companies that are located in Australia. The new legislation replaces

the grey list for non-portfolio FIFs with an exemption for non-portfolio FIFs that are resident and subject to tax in Australia. This is consistent with earlier reforms that replaced the eight-country "grey list" exemptions with an exemption for CFCs that are resident and subject to tax in Australia and with an exemption for ASX-listed companies.

Thin-capitalisation

As part of the 2009 CFC reforms, interest allocation rules were introduced for New Zealand-based groups with offshore investments. These rules limit the deductions that New Zealand companies can take for borrowings used to fund offshore investment, because earnings from most CFC investments will be exempt from New Zealand tax. Consistent with extending the active income exemption to FIFs, the interest allocation rules have been extended to apply to New Zealand residents who have non-portfolio holdings in FIFs for which they use the active income exemption or the Australian exemption.

The way these interest allocation rules work can produce harsh results for firms with high value intangible assets such as brands. The Act mitigates this effect by providing an alternative mechanism for calculating the limit on deductions for New Zealand-based groups that invest in CFCs or active FIFs.

Memorandum accounts

As a result of the 2009 reforms, branch equivalent tax accounts and conduit tax relief accounts became obsolete. In 2009 it was announced that these accounts would be repealed after a two-year phase-out period. The new Act therefore repeals these accounts.

Approved issuer levy

In 2009 the Capital Market Development Taskforce recommended that the approved issuer levy be reduced from 2% to nil for some public issues of debt by New Zealand residents. The new Act amends the Stamp and Cheque Duty Act 1971 in order to provide a zero rate of AIL for bonds that are traded in New Zealand.

Application dates

The changes to the FIF rules apply to income years beginning on or after 1 July 2011.

The extension of the thin-cap rules to FIFs that use the active income exemption applies to income years beginning on or after 1 July 2011. Other thin-cap changes apply to income years beginning on or after 1 July 2009, or to income years beginning on or after 1 July 2011.

The repeal of branch equivalent tax accounts applies to income years beginning on or after 1 July 2012. The repeal of conduit tax relief accounts applies to income years beginning on or after 1 July 2011.

The zero rate of AIL for interest paid on bonds that are traded in New Zealand applies to interest payments made on or after 7 May 2012. A rule requiring revaluation of inherited grey-list shares also applies on 7 May 2012.

Most of the remedial changes apply to income years beginning on or after 1 July 2009.

FIF rules

The following terms are used throughout this *Tax Information Bulletin* item.

"This Act" and other legislative references

To improve readability, the Taxation (International Investment and Remedial Matters) Act 2012 is often abbreviated to "this Act".

The Act amends several core Taxation Acts:

- the Income Tax Act 2007;
- the Tax Administration Act 1994; and
- the Stamp and Cheque Duties Act 1971.

These Acts are referred to by their full titles. Unqualified references to sections refer to the Income Tax Act 2007.

Person

"Person" is the term used in the Income Tax Act for the taxpayer. In the context of the CFC or FIF rules, the person will be the New Zealand resident with the interest in the FIF or CFC. This interest will generally be a shareholding.

Foreign investment fund

There are three types of foreign investment funds (FIFs):

- foreign companies;
- foreign superannuation schemes; and
- foreign life insurance policies.

The Taxation (International Investment and Remedial Matters) Act 2012 mainly affects foreign companies, particularly interests of 10% or more in foreign companies that are not controlled foreign companies (CFCs).

Controlled foreign company

A controlled foreign company (CFC) is a foreign company that is controlled by five or fewer New Zealand residents or that is at least 40% owned by a New Zealand resident and has no single non-resident with a higher shareholding. CFCs are a subset of FIFs.

The controlled foreign company rules were reformed in 2009. See Part II of *Tax Information Bulletin* Vol 21, No 8, October/November 2009 for more detail on these reforms.

FIF interest

A FIF interest is an interest in a foreign company, foreign superannuation scheme or foreign life insurer. Unless an

exemption from the FIF rules applies, a person with a FIF interest has to apply the FIF rules and attribute income under a FIF calculation method.

CFC interest

A CFC interest is used to describe an interest to which the CFC rules apply. The CFC rules apply to an income interest of 10% or more in a CFC, including any interests held by associated persons (see section EX 15 of the Income Tax Act 2007).

CFC rules

The CFC rules are used to calculate a person's net income from their CFC interests. They are found in sections EX 1 to EX 27 of the Income Tax Act 2007.

FIF rules

The FIF rules are used to calculate a person's income from their FIF interests. They are found in sections EX 28 to EX 72 of the Income Tax Act 2007.

Exemptions from the FIF rules

There are various exemptions from the FIF rules. For example, if a natural person's FIF interests have a collective cost of less than $50,000, the FIF rules will generally not apply (see section CQ 5(1)(d)). A similar exemption applies to some trustees of trusts for the benefit of a loved one or charity in section CQ 5(1)(e)). The other exemptions from the FIF rules are found in sections EX 31 to 43 of the Income Tax Act 2007.

FIF calculation method

A person is required to use a FIF calculation method to calculate the income that they derive from each of their FIF interests. The FIF calculation methods are listed in section EX 44 of the Income Tax Act 2007. For all income years beginning on or after 1 July 2011, the available FIF calculation methods are:

- the attributable FIF income method;
- the comparative value method;
- the deemed rate of return method;
- the fair dividend rate method; and
- the cost method.

For income years beginning before 1 July 2011, the available FIF calculation methods were:

- the accounting profits method;
- the branch equivalent method;
- the comparative value method;
- the deemed rate of return method;
- the fair dividend rate method; and
- the cost method.

The FIF rules include rules which limit a person's ability to choose or change from a FIF calculation method.

Attributable FIF income method

The attributable FIF income method is a new method for calculating a person's FIF income under the FIF rules. The calculation is based on the CFC rules, with certain modifications. This means that active income is exempt from New Zealand tax. Active income is not exempt under the other FIF methods.

APPLYING THE FIF RULES

When a person has an interest in a FIF, they must first establish if an exemption from the FIF rules applies to that FIF.

If an exemption from the FIF rules applies, the normal domestic tax treatment applies. This generally includes taxation of any dividend and taxation of gains on sale if the FIF interest is held on revenue account.

If no exemption from the FIF rules applies, the choice of FIF method determines the tax treatment. In particular, using the new attributable FIF income method means that dividends will not usually be taxable if received by a company. Using the other methods, dividends are usually ignored entirely.

In addition, dividends will usually be taxable when they are received from exempt FIFs (exceptions are dividends received by companies from CFCs or FIFs that satisfy the section EX 35 exemption). In contrast, dividends will usually be exempt if the FIF rules apply (an exception is when a dividend is received by a person who is not a company and that uses the attributable FIF income method for that FIF).

The exemptions from the FIF rules and the foreign dividend exemptions are explained below.

Application date

Except when otherwise noted, the changes to the FIF rules apply to income years beginning on or after 1 July 2011.

Examples

Example 1

Company A has a 30 April balance date. For its income year of 1 May 2011 to 30 April 2012 it will continue to apply the previous FIF rules. From its income year beginning 1 May 2012 it will apply the new FIF rules.

Example 2

Company B has a 30 June balance date. From its income year beginning 1 July 2011 it will apply the new FIF rules.

Example 3

Company C has a 30 October balance date. From its income year beginning 1 November 2011 it will apply the new FIF rules.

EXEMPTION FOR INTERESTS OF 10% OR MORE IN AUSTRALIAN FIFS

Section EX 35 of the Income Tax Act 2007

Key features

A person with an income interest of 10% or more in a company that is resident and subject to income tax in Australia (and meets certain other conditions), will not have any income or loss attributed to them from that Australian company.

Detailed analysis

A person with an income interest of 10% or more in a foreign company will not have an attributing interest in a FIF if the company is resident and subject to tax in Australia and meets the other requirements in section EX 35.

"Resident in Australia" means resident in Australia according to the Income Tax Act 2007. (See, for example, section YD 3.) There is also a requirement that the FIF is treated as a resident of Australia under every tax treaty between Australia and another country. This requirement might not be satisfied if, for instance, the FIF was incorporated in Australia but was managed from another country. In that case, it would be common for a tax treaty to treat the FIF as resident in the other country and Australia would lose worldwide taxing rights over the FIF.

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

A FIF will not qualify for the section EX 35 Australian exemption if the FIF has had its liability for Australian income tax reduced due to one of the following concessions that are provided under Australian tax law:

- an exemption for income that is derived from business activities carried on outside Australia; or
- the special tax rules that apply to Australian offshore banking units.

A person will not qualify for the exemption from the FIF rules in section EX 35 if they are a portfolio investment entity, a superannuation scheme, a unit trust, a life insurer or a group investment fund.

EXEMPTION FOR INTERESTS OF 10% OR MORE IN A CFC

Section EX 34 of the Income Tax Act 2007

A person does not have an attributing interest in a FIF if they have an income interest of 10% or more in a CFC (including any interests held by associated persons). The person will instead have a CFC interest and will apply the CFC rules to that interest. This is provided for by section EX 34, which is unchanged by this Act.

A person with less than a 10% income interest in a CFC (including any interests held by associated persons) will have an attributing interest in a FIF (unless another exemption from the FIF rules applies).

EXEMPTION FOR INTERESTS IN AN ASX-LISTED COMPANY

Section EX 31 of the Income Tax Act 2007

A person does not have an attributing interest in a FIF if they have shares in an Australian company that is listed on the ASX. This is provided for by section EX 31, which is unchanged by this Act.

To help taxpayers apply the section EX 31 exemption correctly, in June of each year, Inland Revenue publishes a list of the Australian shares that qualify for the ASX exemption, for the previous tax year (the IR 871 publication).

Note that when a person has less than a 10% interest in the ASX-listed company, the domestic tax treatment will apply. This generally includes taxation of any dividend and taxation of gains on sale if the FIF interest is held on revenue account.

OTHER EXEMPTIONS FROM THE FIF RULES

Sections EX 32, EX 33 and EX 36 to 43 of the Income Tax Act 2007

In addition to the exclusions discussed earlier, a person will not have an attributing interest in a FIF if their interest in the FIF qualifies for one of the following exemptions:

- section EX 32 (certain Australian unit trusts);
- section EX 33 (Australian-regulated superannuation schemes);
- sections EX 36, 37 or 37B (various exemptions for venture capital companies);
- section EX 38 (Exemption for employee share purchase schemes of a grey list company);
- EX 39 (Exemption for grey list company with numerous NZ shareholders);
- EX 40 (Foreign exchange control exemption);
- EX 41 (Income interest of a non-resident or transitional resident);
- EX 42 (New Resident's accrued superannuation entitlement exemption); or
- EX 43 (Non-resident's pension or annuity exemption).

These exemptions are not amended by this Act.

Note that if a FIF qualifies for one of these exemptions the normal domestic tax treatment applies. This generally includes taxation of any dividend and taxation of gains on sale if the FIF interest is held on revenue account.

EXEMPTION FOR NATURAL PERSONS WITH LESS THAN $50,000 OF FIF INTERESTS

Subsections CQ 5(1)(d) and (e) and DN 6(1)(d) and (e) of the Income Tax Act 2007

Key features

Under the previous rules, sections CQ 5(1)(d) and (e) provided an exemption from the FIF rules for natural persons if the cost of all of their attributing interests (for example, their entire foreign share portfolio other than shares exempt from the FIF rules under sections EX 31 to 42) in FIFs was $50,000 or less.

This Act modifies these exemptions to allow these persons to elect to use the FIF rules. This means they would use a FIF calculation method to calculate FIF income from their FIF interests (other than any interests to which the exemptions in sections EX 31 to EX 42 apply).

A person with less than $50,000 of attributing interests in FIFs and who chooses to file a return on the basis of the FIF rules applying is generally required to continue to apply the FIF rules in each subsequent tax year. This is to prevent taxpayers from switching between the FIF rules and dividend taxation, depending on which approach would have provided the most favourable tax treatment in that particular year.

Detailed analysis

Section CQ 5(1) provides the general rule for when an investor has FIF income from their attributing interests in a FIF. Section CQ 5(1)(d)(i) provides that a natural person has FIF income if the total cost of all their attributing interests in FIFs, at any time during the income year, is more than $50,000. If the total cost is less than $50,000, no FIF income arises. Section CQ 5(1)(e)(i) provides a similar exemption for persons acting as the trustee of a trust that meets certain requirements (specified in section CQ 5(5)).

As an alternative to these exemptions, such persons will have the option of applying the FIF rules. To exercise this option a taxpayer simply has to complete their tax return using the FIF rules. This option is provided for by sections CQ 5(1)(d)(ii) and CQ 5(1)(e)(ii).

A person with less than $50,000 of attributing interests in FIFs, and who chooses to file their return on the basis of the FIF rules, is generally required to continue to apply the FIF rules in each subsequent tax year. This is to prevent taxpayers from switching between the FIF rules and dividend taxation, depending on which approach would provide the most favourable tax treatment in that particular year.

However, there is one exception to this general consistency rule. If a person has less than $50,000 of attributing interests in FIFs, they will not be required to apply the FIF rules if, for each of the four previous tax years:

- the person had no attributing interests in FIFs (for example, they had no foreign shares, or only had foreign shares which were exempt from the FIF rules); and/or
- the person had more than $50,000 in attributing interests in FIFs (note that for these years they would have been required to apply the FIF rules).

Example 1

Jane has less than $50,000 of attributing interests in FIFs in 2012, but chooses to include FIF income in her tax return for 2012. She sells all her attributing interests in FIFs during 2012 and holds no attributing interests in FIFs in each of the four years 2013–16. In 2017 she purchases some attributing interests in FIFs. These new FIF interests have a cost of less than $50,000.

Because Jane had no attributing interests in FIFs for each of the previous four years, she can choose whether or not to include FIF income in her tax return for 2017. If she does not apply the FIF rules, Jane will instead be taxed on any foreign dividends or disposal of foreign shares that are held on revenue account (consistent with the way New Zealand shares are taxed).

Example 2

Thomas purchases FIF interests in 2012 that had a cost of more than $50,000. For the 2012 year, Thomas is required to include FIF income in his tax return. During 2012 Thomas sells some of his FIF interests so that at the beginning of 2013 he has FIF interests of less than $50,000. Thomas can choose whether or not to include FIF income in his tax return for 2013, because even though he included FIF income in his 2012 tax return, this was because he had more than $50,000 of attributing interests in FIFs in 2012. If he does not apply the FIF rules, Thomas will instead be taxed on any foreign dividends or disposal of foreign shares that are held on revenue account (consistent with the way New Zealand shares are taxed).

FOREIGN DIVIDEND EXEMPTIONS

Section CW 9 of the Income Tax Act 2007

Key features

Most foreign dividends are exempt from New Zealand tax. The exceptions to this general rule depend on whether the person who receives the dividend is a company, or not a company.

If the person is not a company, foreign dividends will be assessable income of the person if the person uses the attributable FIF income method, or if an exemption from the FIF rules applies (including the exemption for interests of 10% or more in CFCs). The exemptions from the FIF rules have been described previously.

If the person is a company, foreign dividends will be assessable income if they are paid in relation to fixed-rate shares or if the dividend is tax-deductible in the foreign company's country of residence. They will also be assessable income if certain exemptions from the FIF rules apply (most notably the exemption for interests in ASX-listed companies), as long as sections EX 34 or EX 35 do not also apply.

Detailed analysis

When a person uses the comparative value, deemed rate of return or cost method for a FIF, they are treated as not receiving dividend income from that FIF (see section CD 36(1)), so any dividends received are effectively exempt.

When a taxpayer uses the fair dividend rate method for a FIF there is only one rare situation where dividends from certain Australian FIFs are assessable income of the person (see the section CD 36(2) example below). In all other cases the dividends are effectively exempt (section CD 36(1)).

Example when section CD 36(2) applies

At the beginning of their 2012–13 income year, a person holds an interest of 10% or more in an Australian company. The person's interest in the FIF would have satisfied the section EX 35 Australian exemption if they had maintained a 10% or greater income interest for the entire year. However, during the course of that year, the person's income interest in the FIF drops below 10% (for example, they may have sold some shares).

Because an exemption from the FIF rules no longer applies, the taxpayer uses the fair dividend rate method for the Australian company. For the 2012–13 income year the person has no income attributed under the fair dividend method for the Australian company (as the opening market value is treated as zero). However, any dividends that the Australian company pays to the person in 2012–13 are assessable income. From 2013–14 onward, there will be fair dividend rate income from the FIF and dividends will be exempt income of the person.

Foreign dividends are generally exempt when they are received by a New Zealand company. This is achieved by section CW 9(1). However, there are some complex exceptions to this. The effect of section CW 9 is summarised in the following table:

Type of FIF interest	Dividends
The dividend is paid in relation to fixed-rate foreign equity or deductible foreign equity.	Dividends are assessable income. (See sections CW 9(2)(b) and (c).)
One or more of the following exemptions from the FIF rules applies: • section EX 31 (ASX-listed companies); or • section EX 32 (certain Australian unit trusts); or • sections EX 36, 37 or 37B (various exemptions for venture capital companies); AND neither of the following two exemptions apply: • section EX 34 (a 10% or greater interest in a CFC); nor • section EX 35 (a 10% or greater interest in a FIF that is resident and subject to tax in Australia).	Dividends are assessable income. (See section CW 9(2)(a).)
All other cases.	Dividends are exempt income if received by a company.

Section CW 9 achieves the above results. Section EX 20B(3)(a) mirrors section CW 9(2) by attributing income from these dividends when they are received by CFCs or FIFs for which the person uses the attributable FIF income method.

Section CW 9(3)(a) prevents any type of PIE from accessing the foreign dividend exemption previously; only multi-rate PIEs were excluded from the foreign dividend exemption. Note that dividends received by PIEs will only be taxed in cases where an exemption from the FIF rules applies. For attributing FIF interests, the PIE will use one of the methods listed in section CD 36(1) and so will be treated as not receiving dividend income from those FIFs.

CHOICE OF FIF CALCULATION METHOD

Sections EX 46, EX 47, EX 48 and EX 62

If none of the exemptions from the FIF rules apply (as discussed previously), the person has an attributing interest in a FIF.

Calculation methods

For each attributing interest in a FIF, the person must choose one of the five FIF calculation methods listed in section EX 44:

- the fair dividend rate method;
- the cost method;
- the comparative value method;
- the deemed rate of return method; or
- the attributable FIF income method.

Sections EX 46, EX 47, EX 48 and EX 62 limit a person's choice of calculation method.

Section EX 46 outlines the general rules for choosing each of the FIF calculation methods. Section EX 62 limits a person's ability to change from a method that they are currently using for a particular FIF.

Choosing the attributable FIF income method

Section EX 46(3) limits the attributable FIF income method to interests in FIFs that are companies (as opposed to FIFs that are foreign superannuation schemes or foreign life insurance policies).

Portfolio investment entities that hold interests in foreign companies cannot use the attributable FIF income method.

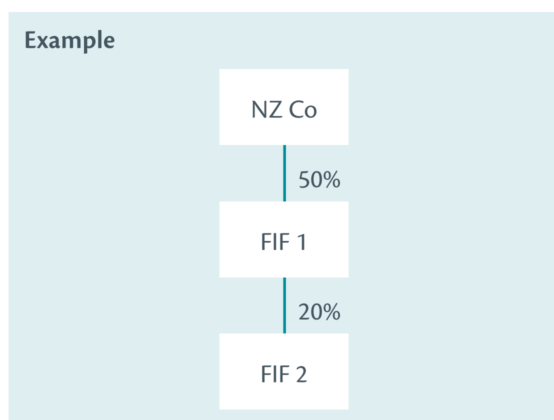
Section EX 46(3) also prevents a person from using the attributable FIF income method if they cannot obtain sufficient information to perform the calculations in section EX 50. Note that there are two types of information that may be relevant for the purposes of this requirement:

- If a person has sufficient accounting information to apply and satisfy the active business test in section EX 21E so that the FIF is non-attributing, they will comply with this requirement.

- If a person is unable to satisfy the active business test in section EX 21E, they will only comply with this requirement if they can access the more detailed financial information that would be required to calculate attributable income under the tax concepts in sections EX 21D or EX 18.

Generally, a person must hold a 10% or greater income interest in a foreign company in order to apply the attributable FIF income method. Note that this interest can be held indirectly through a CFC or another FIF that uses the attributable FIF income method. This is because the person's income interest is calculated to include an indirect income interest (see sections EX 50(4) and EX 10). For example, in the following structure NZ Co would have an income interest of 10% in FIF 2.

Example



A person with less than a 10% interest in a foreign company may nevertheless be able to use the attributable FIF income method if the foreign company is a CFC[1] and 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 restrictions on the types of investors in the CFC.

Neither the person nor a person with an interest of 10% or more in the CFC can be:

- a listed company;
- a group investment fund;
- a superannuation fund;
- a unit trust;
- a portfolio investment entity; or
- a trustee of a trust with a beneficiary who is one of the above.

Example

John has 1% of the shares in a CFC. A listed company has 8% of the shares in the CFC. John is able to use the attributable FIF income method, but the listed company cannot. If the listed company had 10% or more of the shares in the CFC, John would not be able to use the attributable FIF income method.

Choosing the fair dividend rate method

If a person is unable to use the attributable FIF income method, or does not want to use this method, the main alternative is the fair dividend rate method.

The fair dividend rate method can be used for an attributing interest in a FIF that is an ordinary share and for which a market value is available. If a person cannot obtain a market value for an interest that is an ordinary share, they will generally use the cost method.

Choosing the cost method

The cost method calculates income in a similar way to the fair dividend rate method.

In order to use the cost method, the FIF interest must be an ordinary share and the person must not be able to obtain a market value for the interest except by independent valuation. If a person is able to obtain a market value without an independent valuation (for example, if the FIF is listed on a stock exchange), they will usually be required to apply the fair dividend method.

Non-ordinary shares

Persons with non-ordinary shares are generally required to use the comparative value method if they can obtain a market value, or the deemed rate of return method if they cannot obtain a market value. Non-ordinary shares are defined in section EX 46(10).

Deemed rate of return method

When a person has a non-ordinary share and cannot obtain a market value for that share, they are generally required to use the deemed rate of return method.

Choosing the comparative value method

Aside from non-ordinary shares, the only persons who can apply the comparative value method are natural persons and trustees of a trust for the benefit of a loved one or charity (see section EX 46(6)). If a natural person or a trustee of a trust for the benefit of a loved one or charity chooses to apply a comparative value method to any of their FIF interests, they cannot use the fair dividend rate method or the cost method for any of their other FIF

[1] 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 as opposed to the CFC rules to attribute income from the CFC.

interests. This implies that these persons must be able to use the comparative value (or the attributable FIF income method) for all of their attributing FIF interests.

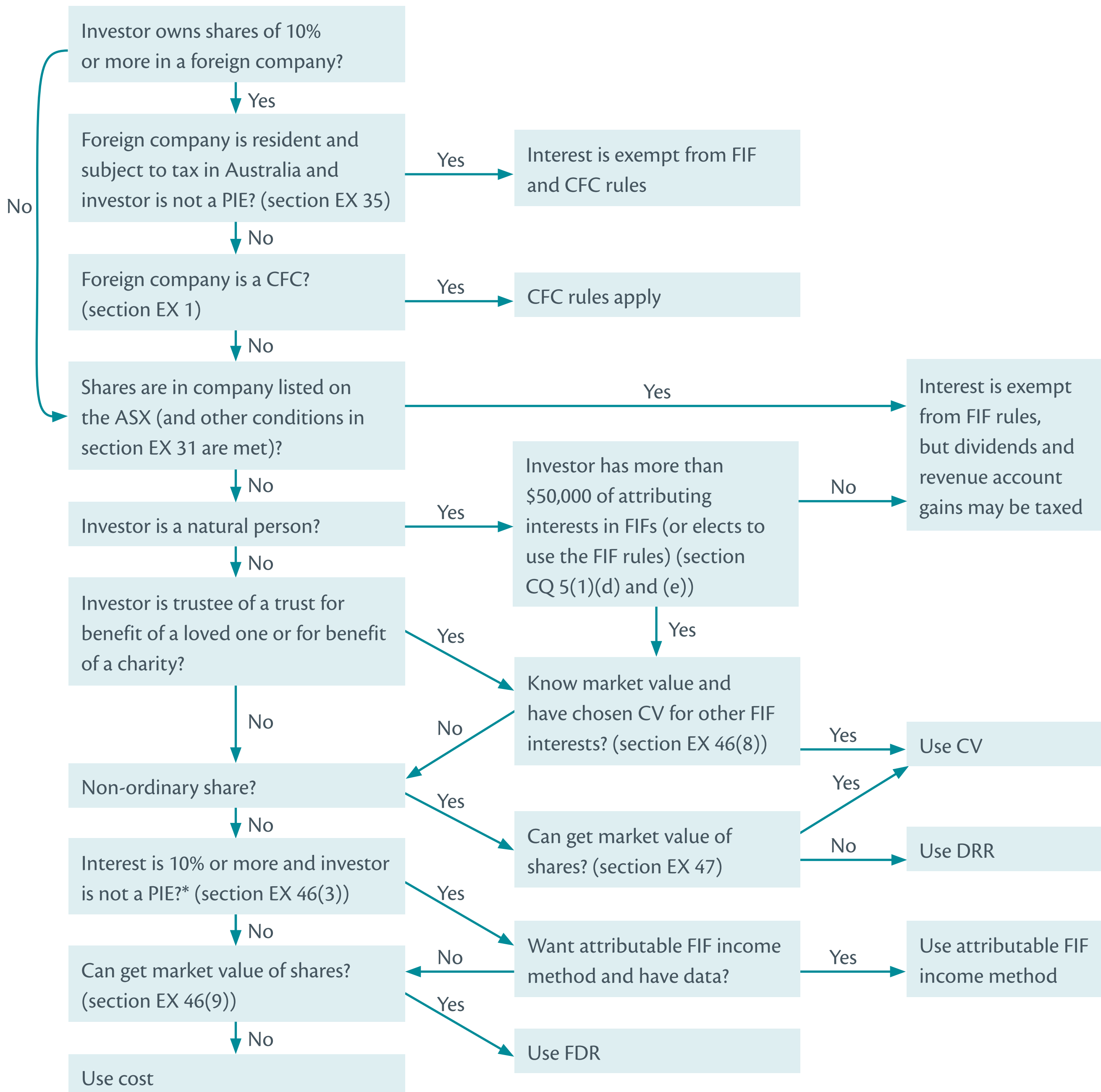
When the comparative method is used for ordinary shares, the gains or losses on all of those shares are combined to produce an overall gain or loss for that year. If there is an overall loss across all of these holdings the person is considered to have zero income from these interests (see section EX 51(8)). In other words, the FIF losses cannot be used to offset other income.

However, if the comparative value method is used for non-ordinary shares, any losses on these shares can be used to offset other income. (Section EX 51(8) does not apply to non-ordinary shares.)

Summary diagram of main exemptions and limitations on choice of method

The following diagram summarises the main exemptions to the FIF rules and limitations that would apply to an investor's choice of calculation method under the new rules. Note the diagram does not include the rules in section EX 62 which limit an investor's ability to change from a method that they are currently using to a different method. The changes to section EX 62 are described below.

Note: This is a simplified illustration. In particular, it assumes the interest is a share in a foreign company and it excludes a number of the less commonly used FIF exemptions.



* Subject to certain conditions a person with a less than 10% interest in a CFC may be able to use attributable FIF income method.

Limitations on changing method

In general, once investors start to use a calculation method for a FIF interest they are required to continue using the same calculation method. Section EX 62 supports this approach by providing a set of rules that limit an investor's ability to change from a FIF calculation method that they are currently using to a different FIF calculation method.

Changing from the accounting profits method

A person who used the accounting profits method in the year preceding the repeal of this method can change to any other method (see section EX 62(2)(a)).

Changing to, or from, the attributable FIF income method

A person who used the branch equivalent method in the year preceding the repeal of this method can change to the attributable FIF income method (see section EX 62(6)(a)).

A person can change from the attributable FIF income method if sections EX 46(a) and (b) prevent them from using the attributable FIF income method, or if it is impossible to obtain enough information to continue to use the method. Note that this second condition could be met in cases when a person previously satisfied the active business test but now no longer satisfies the test and cannot access sufficient information to calculate their attributable income under normal tax concepts.

If the previous paragraphs do not apply, there are additional requirements that must be met before a person can change to, or from the attributable FIF income method. These requirements differ depending on whether it is the first time that the person has for, that particular FIF, changed to the attributable FIF income method (from a different FIF calculation method), or from the attributable FIF income method (to a different FIF calculation method).

If it is their first change, they only need to notify the Commissioner of Inland Revenue of the change, and the reason for the change of method.

If the person has already used their one "free" change that they are allowed for a particular FIF, but wants to change to, or from, the attributable FIF income method a second time, they must notify the Commissioner as above, but as part of their notification they must also be able to show that:

- there has been a change in circumstances that significantly changes the person's ability to obtain enough information to use the attributable FIF income method; and
- altering their income tax liability is not the principal purpose or effect of the change.

Changing to the fair dividend rate method

Taxpayers are generally able to change to the fair dividend rate method from the accounting profits method, the branch equivalent method or the deemed rate of return method if they are using the fair dividend rate method for their first income year beginning on or after 1 July 2011. This recognises the fact that the accounting profits method and the branch equivalent method have been repealed and the deemed rate of return method is now restricted to non-ordinary shares.

Taxpayers are able to change from the fair dividend rate method if it becomes impossible to obtain a start-of-year market valuation except by independent valuation (see section EX 62(2)(f)).

They are also able to change from the cost method to the fair dividend rate method if they are able to use the fair dividend rate method and can now get a market value for the FIF other than by independent valuation, for example, if the FIF becomes listed on a stock exchange. (See section EX 62(2)(g).)

Natural persons and trustees of a trust for the benefit of a loved one or charity are able to change between the fair dividend rate and comparative value methods in consecutive years without restriction (see section EX 62(8)). However, if they use comparative value for one interest, they cannot use the fair dividend rate for another interest. This means that the comparative value method will generally apply to their entire share portfolio.

PIES WITH NON-PORTFOLIO INTERESTS IN CFCS OR FIFS

Sections EX 14, EX 34 and EX 46(3)

It is not appropriate for portfolio investment entities (PIEs) to use the active income exemption for their foreign investments. This is because there would be no New Zealand tax when PIEs distributed active income to their shareholders. In contrast, if a New Zealand company receives CFC or FIF income, New Zealand tax will usually be levied when unimputed dividends are paid to shareholders. Similarly, non-companies are taxable on foreign dividends received from CFC interests and interests in FIFs for which they use the attributable FIF income method.

For this reason sections EX 14 and EX 34 deem all CFC interests held by a portfolio investment entity (PIE) to **not** be CFC interests. Note that the foreign company will continue to be CFC, but the PIE will use the FIF rules as opposed to the CFC rules. Other persons with CFC interests in the CFC will continue to use the CFC rules.

A similar amendment prevents PIEs from using the attributable FIF income method.

Key features

Under sections EX 14 and EX 34 a person has a CFC interest if they have a 10% or greater income interest in the controlled foreign company and if they are not a PIE. If they are a PIE they will have a FIF interest in the company.

Section EX 46(3) prevents a PIE from using the attributable FIF income method.

ATTRIBUTABLE FIF INCOME METHOD

Section EX 50

The branch equivalent method has been replaced with the attributable FIF income method. The attributable FIF income method is based on the CFC rules with certain modifications (see section EX 50). These modifications are described below.

When a person uses the attributable FIF income method, they first apply an active business test to the FIF. If the FIF satisfies the active business test, either independently or as part of a group of FIFs, the person will have no attributed income from that FIF. Persons with FIF interests that do not satisfy the active business test, attribute the portion of attributable income that corresponds with their income interest in the FIF (the person's income interest is worked out by applying the CFC rules). If the attributable FIF income method is used, the attributable income is calculated by applying sections EX 18 to EX 21.

In other parts of the Income Tax Act 2007, such as subpart FE, there are references to "a person who uses the attributable FIF income method for a FIF". Note that a person is still considered to use the attributable FIF income method in cases where the FIF passes the active business test. If the person uses a different FIF calculation method such as the fair dividend rate or cost methods to attribute income from the FIF, these references do not apply.

Using the attributable FIF income method (section EX 50)

Section EX 50 outlines how a taxpayer applies the attributable FIF income method.

Taxpayers who use the attributable FIF income method for a FIF generally calculate their attributed income from that FIF as though the FIF were a CFC. This means they use the CFC rules in sections EX 18 to EX 21, although some modifications are made to make these rules easier to apply to foreign companies that are not CFCs, as described below.

The active business test is relaxed for persons who apply the attributable FIF income method. This change enables them to use consolidated accounting information to apply the test to related groups of FIFs (including when those FIFs are in different jurisdictions). The accounts can be prepared in accordance with New Zealand IFRS (IFRS), International IFRS (IFRSE) or United States generally accepted accounting principles (US GAAP). Note, US GAAP accounts cannot be used when applying the active business test to an interest of 10% or more in a CFC, and the active business test can only be applied to groups of CFCs if all the CFCs are controlled by the New Zealand person and are resident in the same jurisdiction.

If an investor applies the CFC rules or the attributable FIF income method to a foreign company, and that foreign company holds shares in another foreign company, the investor is generally required to "look-through" and apply a FIF calculation method to the investor's indirect interest in the second foreign company. There are several exceptions to this look-through rule that apply when the upper-tier company is a FIF, but do not apply when the upper-tier company is a CFC.

The exemption that applies to payments of interest, rent and royalties from an active CFC to an associated CFC (that is, 50% common ownership) has been modified so that a similar exemption applies when there is a group of persons who control (own more than 50%) of both FIFs. These modifications are explained in the detailed analysis below.

These modifications are made by sections EX 50(4B) and EX 50(7B) and are covered in more detail below.

Note that any references to "the CFC" in sections EX 18 to EX 21, including those that are modified by section EX 50(4B), should be read as references to "the FIF" when a person applies the attributable FIF income method to that FIF (see section EX 50(3)(a)).

Key features

Active business exemption

A person with an interest in a FIF for which they use the attributable FIF income method will not have to include attributed FIF income or loss in the person's gross income if the FIF passes an active business test. This is expected to result in most users of the attributable FIF income method being relieved of the need to calculate attributed income.

A FIF will pass the active business test (and so will not have to attribute any income) if it has attributable income that is less than 5% of its gross income. Attributable and gross income, for the purposes of the test, are measured using either financial accounting or tax measures of income. These measures are defined in the legislation.

It is expected that most people will prefer to use accounting measures of income, because they will be more readily available or easier to calculate. Accounting measures may be used to calculate the ratio if they are taken from accounts that comply with IFRS or US GAAP, and certain other conditions are met.

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

FIFs that are commonly controlled may be consolidated for the purposes of the calculation of the 5% ratio calculation, subject to certain conditions.

Detailed analysis

Requirements for using the active business test

The active business test can be performed using accounting information or tax concepts. Certain accounting and audit requirements must be satisfied for accounting information to be used.

The active business test can be performed for an individual FIF or for a FIF test group. Additional requirements must be met for a FIF to be included in a FIF test group.

Accounting requirements for using the accounting-based test

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

Section EX 21C, as modified by section EX 50(4B) outlines the accounting standards that may be used to calculate the ratio of a FIF or FIF test group's attributable income to total income under section EX 21E. Three types of accounting standards can be used:

- New Zealand IFRS (IFRS);
- International IFRS (IFRSE); or
- United States generally accepted accounting principles (US GAAP).

Note that section EX 21C is modified by section EX 50(4B) to allow US GAAP accounts to be used. This means that US GAAP accounts can be used only when the attributable FIF income method applies. US GAAP accounts cannot be used for interests of 10% or more in CFCs.

Taxpayers should use the accounting standard that is most appropriate. For example, if the FIF prepares IFRSE accounts, it should use IFRSE accounting concepts as opposed to US GAAP concepts.

An "IFRSE" is defined in section YA 1 as "an International Financial Reporting Standard approved by the International Accounting Standards Board, as amended from time to time".

Certain conditions must be satisfied before any particular set of accounting standards can be used. This means the person may be unable to use any of the sets of accounting standards because the relevant conditions are not satisfied. A person may also choose not to use any of the sets of accounting standards, even if they are available.

The main requirement is that the FIF's income appears in IFRS or IFRSE accounts. This ensures that, whatever accounting standard might be used by the FIF itself, the resulting income—at least in aggregate—will be subject to an audit that checks for compliance with IFRS or IFRSE.

There are two ways that this requirement can be met.

The FIF's income could appear in IFRS / IFRSE accounts firstly because the FIF's accounts are fully or partially consolidated into the IFRS or IFRSE accounts.

Alternatively, it could appear if the FIF's income is included in the IFRS or IFRSE accounts using the equity method in IAS 28 or IAS 31, or by inclusion of dividends and fair value changes under IAS 39. If the FIF's income is included under one of those standards, the FIF itself must also produce accounts under an acceptable standard, including US GAAP.

Once it has been determined that there is an acceptable set of accounts, information used to prepare those accounts, including underlying information, may be used as long as it is consistent with the relevant standard (see existing section EX 21E(4)(b)).

For instance, if a FIF's income was recognised in the IFRS accounts of the New Zealand investor under IAS 28, and the FIF itself used US GAAP, it would be possible to take the detailed US GAAP information and use this in the active business test calculation in most cases. However, there would be an exception if the associate's profit appearing in the IFRS accounts was not the same as the US GAAP profit because of an adjustment made to ensure compliance with IFRS. In such a case, it would be necessary to adjust the detailed US GAAP information to ensure consistency.

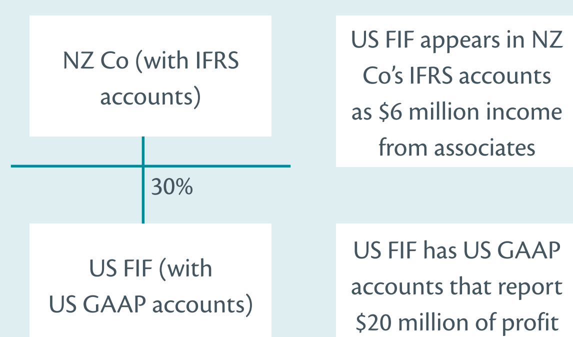
Example

NZ Co has a 30% shareholding in a US company (US FIF) that prepares US GAAP accounts.

The US GAAP accounts report $20 million of profit being earned by the US FIF.

NZ Co has IFRS accounts. The IFRS accounts include a line item for income from associates. This item displays $6 million from the US FIF (30% of the $20 million).

Because the US GAAP accounts are reported consistently in the IFRS accounts, NZ Co will be able to use the information underlying the FIF's US GAAP accounts for the purpose of applying the active business test in section EX 21E to the US FIF.



Audit requirements for using the accounting-based test

Subsection EX 21C(8) contains the two audit requirements that must be met in each of subsections EX 21C(2) to (7). The first requirement in subsection (8) is that the accounts in question must be audited by a chartered accountant who is independent of the FIF and of the person. In the case of a test group, the chartered accountant must be independent of all the FIFs in the test group.

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

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

Requirements for applying the active business test to a FIF test group

Under the CFC rules, New Zealand investors that have more than one majority-owned CFC in a jurisdiction are allowed to use consolidated accounts for all their majority-owned CFCs in that jurisdiction for the purposes of the active business test. The purpose of this measure is to simplify the application of the test when accounting information is available at a consolidated level, such as when a group produces segmental reporting by country.

The attributable FIF income method provides a similar consolidation rule for groups of FIFs. This should enable more investors to use the active business test as it may be easier to access consolidated accounting information for an entire group of FIFs than to access information for each separate company.

In cases where the test is applied and passed by a test group or a top-tier FIF that includes amounts from lower-tier FIFs, the investor may not be required to "look-through" the top-tier FIF and apply a FIF attribution method to the lower-tier FIFs. This is explained in the next section ("Applying FIF calculation methods to indirect interests in foreign companies").

The requirements for being able to apply the active business test to a group of foreign companies under the attributable FIF income method are more relaxed than those that apply to a group of CFCs.

The CFC rules require the investor to have more than a 50% income interest in each CFC. Under the attributable FIF income method, it is the FIF for which that method is used which must have more than a 50% voting interest in the lower-tier foreign companies.

The CFC rules also require all the CFCs to be in the same jurisdiction in order to apply the active business test on a consolidated basis to a group of CFCs. Under the attributable FIF income method, the foreign companies can be in different jurisdictions. However, none of the foreign companies can be a CFC (an actual CFC, as opposed to a FIF that is treated as a CFC because of section EX 50).

Finally, the CFC rules require the investor to remove amounts corresponding to income interests not held by the investor (such as minority interests). The attributable FIF income method omits this requirement so amounts belonging to other investors are included in the calculations. This concession is purely because of concerns about the practical difficulties for a non-controlling shareholder in identifying amounts attributable to other shareholders.

CFC test groups and FIF test groups

	CFC test group	FIF (non-CFC) test group
Control requirement?	Control by NZ investor	Control by a top-tier FIF
Requires all companies in the test group to be in the same jurisdiction?	Yes	No
Remove income owned by other shareholders?	Yes	No

The above modifications to the CFC rules occur through sections EX 50(4B) and EX 50(7B).

Note that the modifications in section EX 50(4B) should be read as replacing the sections that they refer to. For example, the requirement that the companies in the test group be located in the same jurisdiction has been replaced by a requirement that none of the companies can be a CFC.

As a consequence, when applying section EX 21D(1) to a FIF that is using the attributable FIF income method, that section should be read as follows (replacement text in italics):

A person (the **interest holder**) with an interest in a *FIF* may choose to apply this section for the *FIF* as a member of a group (a **test group**) if the group consists of companies—

(a) *none of which is a CFC; and*

(b) in each of which the *FIF holds a voting interest of more than 50%*; and

(c) each of which is required to use the same currency under section EX 21(4); and

(d) that are consolidated for the purposes of this section—

(i) using like tax treatments for like transactions and for other events in similar circumstances; and

(ii) eliminating in full all balances, transactions, income, and expenses arising between members of the test group.

When applying section EX 21E(2) to a FIF that is using the attributable FIF income method, that section should be read as follows (replacement text in italics):

(2) The interest holder may choose to apply this section for the *FIF* as a member of a group (a **test group**) if—

(a) the group consists of companies required under the applicable accounting standard to consolidate, whether or not with companies that are not in the group; and

(b) *none of the other companies [in the test group] is a CFC; and*

(c) *the FIF holds a voting interest of more than 50% in each of the other companies in the test group*; and

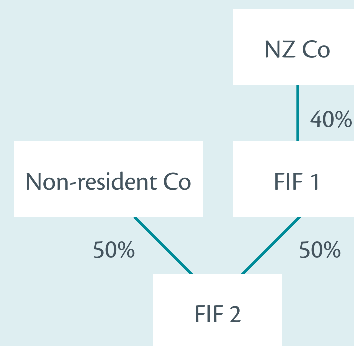
(e) there are audited and consolidated financial statements that—

(i) include the accounts of the companies in the group, whether or not with accounts of companies that are not in the group; and

(ii) comply with the applicable accounting standard.

Note that the top-tier FIF must hold a **more than** 50% voting interest in each of the underlying FIFs.

Example

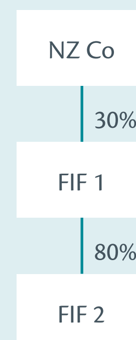


In this example, NZ Co would **not** be able to group together FIF 1 and FIF 2 for the purposes of applying the active business test because FIF 1 does not hold a voting interest of **more than** 50% in FIF 2.

Unlike CFC test groups, FIF test groups are not required to remove (subtract out) amounts that correspond to income interests held by other shareholders. This is achieved by sections EX 50(7)(f) and EX 50(7)(j) which omit these CFC requirements for FIF test groups.

Example

FIF 1 and FIF 2 apply the test as a consolidated group. Although FIF 1 only owns 80% of FIF 2, 100% of the relevant amounts of FIF 2 can be included when working out the formula for the FIF test group under section EX 21E(5).



APPLYING FIF CALCULATION METHODS TO INDIRECT INTERESTS IN FOREIGN COMPANIES

Sections EX 50(6), EX 50(7) and EX 50(7B)

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) and is consistent with the previous rules that applied under the branch equivalent method.

Example

NZ Co uses the attributable FIF income method for FIF 1. NZ Co will generally have to "look-through" their direct interest in FIF 1 and apply a FIF calculation method to their indirect interest in FIF 2.

However, there are several important exceptions to the "look-through" rule in section EX 50(6). These are listed in section EX 50(7B).

Consider a person with an interest in a FIF for which they use the attributable FIF income method. The FIF holds shares in a second foreign company. The person will need to consider if any of the exceptions in section EX 50(7B) apply. If, so they will not need to apply the FIF rules to the second foreign company.

One case where the FIF rules do not apply is when the person's indirect interest in the second foreign company would satisfy the requirements of the section EX 35 exemption for foreign companies that are resident and subject to tax in Australia (see section EX 50(7B)(c)). For example, this condition could be met when a person owns 20% of a US company that owns 50% of an Australian company (a 10% indirect income interest).

Another case is when the person can demonstrate that the second foreign company is able to apply and pass the active business test (see section EX 50(7B)(a)(i)). Note that the second foreign company would have to satisfy the requirements for applying the attributable FIF income method and applying the active business test.

Alternatively, a person will not need to apply a FIF attribution method to a second-tier company if that company has been included in the same test group as another FIF which has applied and passed the active business test when that test is applied on a test group basis (see section EX 50(7B)(a)(ii)). For the FIF and the second foreign company to be part of the same FIF test group the FIF would have to have a more than 50% voting interest in the second foreign company as well as meet several other requirements (see the previous section on the "Requirements for applying the active business test to a FIF test group").

In cases where a FIF has less than a 50% voting interest in a second foreign company, the person will not be able to include the FIF and the second foreign company in the same FIF test group. However, section EX 50(7B) allows the person to apply a modified version of the active business test to the FIF, which includes additional amounts relating to the FIF's shareholdings in other foreign companies. If the FIF passes both the ordinary active business test and the modified test, then the person will not need to attribute FIF income from any foreign companies whose amounts have been included in the modified test.

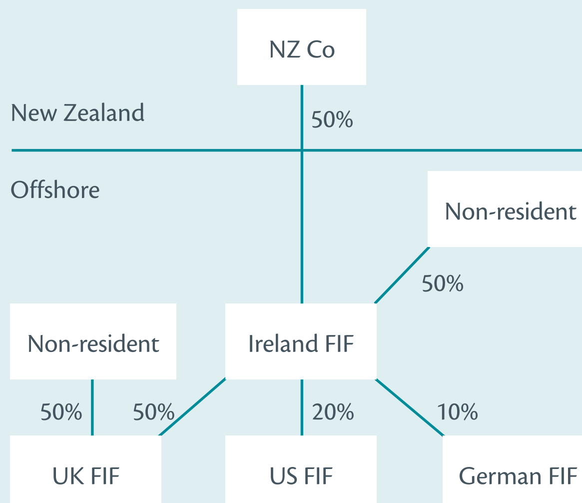
The FIF must first pass the active business test, excluding these additional amounts. It then performs the accounting-based active test in section EX 21E a second time, this time including the additional amounts that are reported in the FIF's accounts and that relate to the FIF's non-controlling interests in other foreign companies. More specifically, for the second test, the following amounts are included in the "added passive" and "reported revenue" items:

- Amounts which are recognised in the FIF's profit or loss accounts under the equity method in accordance with New Zealand Equivalent to International Accounting Standard 28 (NZIAS 28) or an equivalent IFRSE, or an equivalent US GAAP standard or principle. These amounts should show up in the accounts as the share of the associate's profit.
- Amounts which are recognised in the FIF's profit or loss accounts under proportionate consolidation in accordance with NZIAS 31 or an equivalent IFRSE, or an equivalent US GAAP standard or principle. These standards may apply when the FIF has income from a joint venture investment.
- Any dividends and net fair value changes are recorded under NZIAS 39 or an equivalent IFRSE, or equivalent US GAAP standard or principle. Note that because the definition of NZIAS 39 includes an equivalent standard issued in its place, this reference will include NZIFRS 9 when this standard replaces NZIAS 39. Note also that, when a taxpayer includes a dividend as part of the "added passive" item, this dividend cannot also be included in the "removed passive" item. (Normally, most dividends can be included in the removed passive item and therefore ignored for the purpose of the active business test.) This is achieved by section EX 50(4B)(l).

The above amounts will be net amounts (so they could be negative). The active business test usually only considers gross amounts.

Example

NZ Co invests into a 50/50 joint venture in Ireland (Ireland FIF) which holds 50% of the shares in a UK FIF, 20% of the shares in a US FIF and 10% of the shares in a German FIF.



The Ireland FIF has $1,000 of sales income and $20 of interest income and so has a result of 2% after applying the formula in section EX 21E(5). This means the Ireland FIF passes the active business test as an independent company. As a consequence, NZ Co does not attribute income from the Ireland FIF.

	Ireland FIF accounts
Income	
Sales	1,000
Less cost of goods sold	800
Profit	200
Other income	
Interest	20
Active business test	
Reported Passive	20
Added Passive	0
Total Passive	20
Total Revenue	1,000
% Total Passive to Total Revenue	2.00

NZ Co must now determine whether it needs to apply FIF calculation methods with respect to its indirect shareholdings in the UK FIF, US FIF and German FIF.

It does this by performing the active business test a second time, but this time it adds the amounts that appear in the Ireland FIF's accounts that relate to profits from the UK FIF, the US FIF and the German FIF.

	Ireland FIF accounts		UK FIF	US FIF	German FIF
		Ireland FIF's shareholding	50%	20%	10%
Sales	1,000				
		Profit	70	−100	100
Interest	20				
Share of associates' profit (calculated under the equity method)	15		35	−20	
Change in net fair value of investments	8				8
Dividend received	2				2
Reported Passive	20				
Added Passive	25				
Total Passive	45				
Total Revenue	1,045				
% Total Passive to Total Revenue	4.31				

The amounts that go into the formula are total passive of $45 and total revenue of $1,045. This results in a passive income to revenue ratio of 4.31%. Because this result is less than 5%, section EX 50(7B)(b) applies and the investor would not apply a FIF calculation method to the UK FIF, the US FIF or the German FIF.

If this result had been 5% or greater, the NZ Co would be required to apply FIF calculation methods in respect of its indirect interests in the UK FIF, the US FIF and the German FIF. This result only applies for the look-through rule in section EX 50(7B). It does not disqualify the Ireland FIF from being an active non-attributing FIF, so NZ Co would not attribute income from the Ireland FIF.

Alternatively, NZ Co could choose to use a different FIF calculation method for the Ireland FIF (other than the attributable FIF income method). This would mean that income would be attributed from the Ireland FIF, but not from the indirect interests in the UK FIF, the US FIF or the German FIF because the look-through rule in section EX 50(7B) would not come into play.

ATTRIBUTABLE INCOME

No income or loss attributable from active FIFs and certain Australian FIFs

Subsections CQ 5(1)(c) and DN 6(1)(c)

No income is attributable from a FIF if it applies the attributable FIF income method and passes the active business test. This is provided for by section CQ 5(1)(c)(xv). An equivalent provision in section DN 6(1)(c)(xv) ensures that no loss is attributable if a loss-making FIF passes the active business test.

Similar provisions in sections CQ 5(1)(c)(v) and DN 6(1)(c)(v) prevent income or loss arising from interests in FIFs that satisfy the requirements of the Australian exemption in section EX 35.

Attributing income under the attributable FIF income method

If a person uses the attributable FIF income method for a FIF, and they are required to attribute income from that FIF (because it fails the active business test), they must apply section EX 50 in conjunction with sections EX 20B to EX 21 to work out their net attributable FIF income or loss from that FIF.

In general, the attribution rules are identical to those that were introduced in 2009 for CFCs. However, the Taxation (International Investment and Remedial Matters) Act 2012 makes some small modifications to the attribution rules which are detailed below.

Dividends

Subsection EX 20B(3)(a)

Section EX 20B(3)(a) mirrors section CW 9(2) by attributing income from CFCs and FIFs which use the attributable FIF income method in respect of those dividends that would be taxable if they were received directly by a New Zealand company. The previous section on the foreign dividend exemption has more detail on how section CW 9(2) operates.

Attributable telecommunications income

Subsection EX 20B(3)(m)(ii)

Subsection EX 20B(3)(m)(ii) of the Income Tax Act 2007 deems certain telecommunications services income to be attributable income to the extent to which the equipment is owned by "the CFC or by another CFC that is associated with the CFC". This subsection has been amended so it also covers situations when a CFC (or a FIF using the attributable FIF income method) is associated with any CFC or FIF. In the absence of this change it would be possible to reduce a foreign company's attributable income by dealing with an associated FIF that is not a CFC.

Exemption for intra-group payments

Sections EX 50(4B)(a), (b) and (c) and EX 50(4C)

Under the existing CFC rules, there is an exemption for interest, rent and royalty payments between associated CFCs so long as both CFCs are in the same jurisdiction and the CFC that makes the payment is a non-attributing active CFC (in other words, it passes the active business test).

A slightly different exemption applies under the attributable FIF income method.

While the CFC rules require the two CFCs to be associated companies, the attributable FIF income method requires both FIFs to be commonly controlled by a group of persons that hold more than 50% voting interests in both companies. This is achieved by section EX 50(4C) in conjunction with sections EX 50(4B)(a) to (c).

Section EX 50(4C)(a) requires the foreign company that makes the payments to be a FIF for which the person uses the attributable FIF income method. It is implicit that the FIF that receives the payments must also be using the attributable FIF income method, otherwise section EX 50(4C) would not apply.

Section EX 50(4C)(b) requires the foreign company that makes the payment to be a company that would be a non-attributing CFC or FIF. When determining whether the CFC or FIF is non-attributing, the exclusions in sections EX 20B(5)(c)(i), EX 20B(7)(c), and EX 20B(12)(a) as modified by section EX 50(4C) are ignored. This is necessary to avoid a circularity problem whereby the status of the paying company cannot be determined, because that company itself needs to apply the same exclusions.

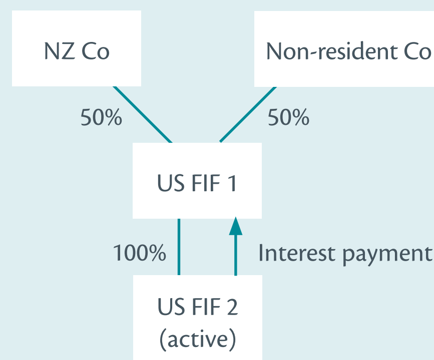
Section EX 50(4C)(ab) requires there to be a group of persons with more than 50% voting rights in both foreign companies.

Section EX 50(4C)(c) requires both foreign companies to be resident and subject to tax in the same jurisdiction.

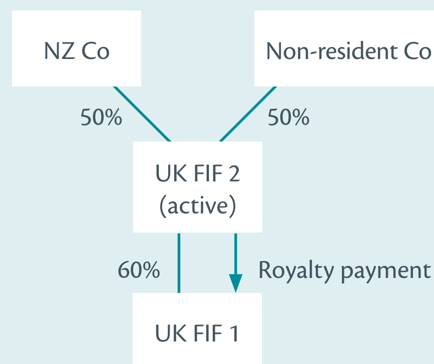
Examples

Interest, rent or royalty payments in examples 1, 2 and 3 would be not be attributable income of the FIFs that receive those payments.

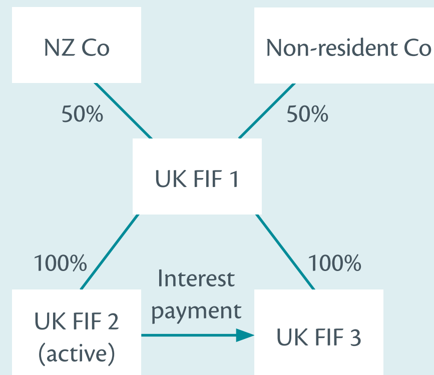
Example 1



Example 2

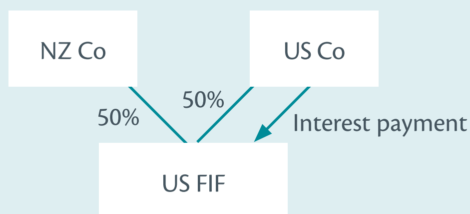


Example 3



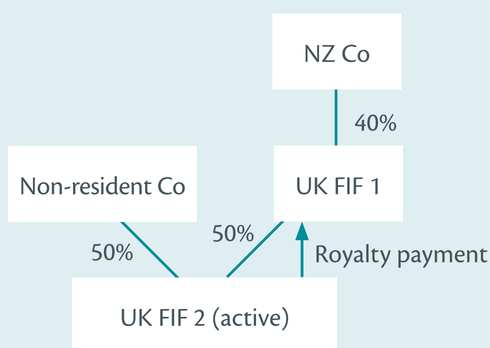
The payment in Example 4 would be attributable income of the US FIF as the person (NZ Co) does not use the attributable FIF income method in relation to the US company that pays the interest, rent or royalty (in fact they do not even have an income interest in the company that makes the payment).

Example 4



The payment in Example 5 would be attributable income of UK FIF 1 as UK FIF 2 is not controlled by the same persons as UK FIF 1.

Example 5



Rules for deducting certain non-ordinary dividends

Sections EX 20C and EX 20D

Section EX 20C includes rules that limit the deductibility of interest payments. Similar rules limit the deductibility of payments made in respect of fixed rate foreign equity or deductible foreign equity.

These rules have been modified to reflect the fact that such payments may now be deductible when paid by a FIF for which the person uses the attributable FIF income method.

Whether section EX 20C provides a deduction for a fixed-rate foreign dividend or a deductible foreign dividend depends on the following principles:

1. A deduction is generally provided when the recipient could face New Zealand tax on the dividend. This occurs when the dividend is paid to a New Zealand company, a CFC or a FIF that uses the attributable FIF income method (see section EX 20C(6)(a)(ii)).
2. However, the deduction is limited, based on the payer's ratio of passive to total assets (for example, if the paying CFC or FIF has 100% passive assets they will be entitled to a full deduction. If the paying CFC or FIF has 50% passive assets, they will only be able to claim half the deduction).
3. An on-lending concession is provided which allows a full deduction when the dividend is paid to an associated CFC or to an associated FIF for which the person uses the attributable FIF income method (see section EX 20C(6)(c)(i) and (7)(b)(i)).

Sections EX 20D and EX 20E restrict interest deductions if some CFCs are excessively debt-funded relative to other CFCs in the group. More specifically, if the CFC has a debt-to-asset ratio determined under section EX 20D(4) of more than 0.75, and also has a relative debt-asset ratio, determined under section EX 20E of more than 1.10, a portion of their interest deductions is non-deductible. The portion is determined by the formula in section EX 20C(8).

For the purposes of working out these ratios, fixed-rate foreign equity and deductible foreign equity issued by the CFC or FIF to New Zealand residents, CFCs or FIFs for which the attributable FIF income method is used, count towards the CFC or FIF's total debt.

EXTENDING THE THIN-CAP RULES TO ACTIVE AND AUSTRALIAN FIFS

Subsections FE 1(1)(a), FE 2(1)(e) and FE 3(2)(b), and sections FE 5(1C) and FE 16(1B)

The Act modifies the thin capitalisation rules so that investments in FIFs for which the investor uses the attributable FIF income method or the section EX 35 Australian exemption are treated the same as investments in CFCs.

In the absence of such rules there could be an incentive for businesses to reduce their taxable income by stacking additional debt against their New Zealand operations when in fact they are using these funds to equity finance their exempt offshore investments.

Application date

The changes apply to income years beginning on or after 1 July 2011.

Key features

The Act modifies the thin capitalisation rules so that investments in FIFs for which the investor uses the attributable FIF income method or the section EX 35 Australian exemption are treated the same as investments in CFCs.

When the thin-cap rules apply

The thin-cap rules apply to New Zealand persons that are controlled by a single non-resident or that have an interest in a CFC or an interest in a FIF for which they use the attributable FIF income method or that use the section EX 35 exemption for FIFs resident in Australia.

Sections FE 1(1)(a) and FE 2(1)(e) have been modified so that the thin capitalisation rules in subpart FE apply to persons with CFCs or with FIFs for which they use the attributable FIF income method or the section EX 35 exemption for FIFs resident in Australia.

Note that a person is considered to "use the attributable FIF income method for a FIF" when the FIF passes the active business test so that no income is attributed, as well as when the FIF fails the active business test and income is attributed under the attributable FIF income method.

It is expected that the new legislation will have limited impact in practice, as most investors in the affected FIFs will also have CFC investments and already be subject to the thin-capitalisation rules.

Special rules for excess debt outbound entities

A person is regarded as an excess debt outbound entity if they:

- have an interest in a CFC or in a FIF for which they use the attributable FIF income method, or use the section EX 35 Australian exemption for FIFs resident in Australia;
- are not a non-resident;
- are not controlled by a single non-resident; and
- are not a bank.

An excess debt outbound entity is excluded from applying the thin capitalisation rules if it is part of a New Zealand group which has less than $1 million of interest deductions (section FE 6(2)(ac)) or if the assets of the New Zealand group are 90% or more of the assets of the worldwide group (section FE 5(1B).)

In other cases, excess debt outbound entities are subject to the thin capitalisation rules, although there are several concessions that apply only to excess debt outbound entities. These concessions are:

- The ratio of New Zealand debt to New Zealand assets must exceed 75% (compared with 60% for excess debt inbound entities) before interest deductions are denied.
- The portion of interest deductions that are denied is reduced to the extent to which the New Zealand group has less than $2 million of interest deductions.

An alternative thin-capitalisation method may be used if the excess debt outbound entity meets certain requirements (see the next section "Alternative thin-cap rule for low-asset companies").

New Zealand group assets

In general, assets from investments in CFCs and investments in FIFs which qualify for the section EX 35 Australian exemption, or for which a person in the New Zealand group uses the attributable FIF income method (section FE 16(1B)), are excluded from the New Zealand group's assets for the purposes of determining the New Zealand group's debt-to-asset ratio. The only exceptions are if the New Zealand group has on-lent debt to the CFCs or FIFs, or if the CFCs or FIFs derive income from a source in New Zealand which is not relieved under a double tax agreement. In such cases, the assets can be included only to the extent to which they are on-lent debt or relate to New Zealand-sourced income which is not relieved under a double tax agreement.

Worldwide group assets

In respect of companies, the new legislation does not change how the assets of the worldwide group are measured. This means that if a New Zealand company owns shares in a CFC or a FIF for which they use the attributable FIF income method or the section EX 35 Australian exemption, these shares could still count as assets of that company's worldwide group, even though these shares would be excluded from the assets of the company's New Zealand group.

For individuals and trustees of trusts, the worldwide group includes that person's New Zealand group plus the group's interests in CFCs and interests in FIFs which qualify for the section EX 35 Australian exemption or for which a person in the New Zealand group uses the attributable FIF income method (sections FE 3(2)(b) and FE 5(1C)).

ALTERNATIVE THIN-CAPITALISATION TEST FOR SOME LOW ASSET COMPANIES

Subsections FE 5(1B), FE 5(1D) and (1E), FE 5(1BC), FE 5(1BD) and FE 5(1BB) and sections FE 6B and FE 12B of the Income Tax Act 2007 and section 65B of the Tax Administration Act 1994

The Act introduces an alternative thin capitalisation test for certain New Zealand-based groups with offshore investments. This will give certain New Zealand taxpayers an option to apply an alternative method under the thin capitalisation rules. New Zealand multinational groups that have a high level of arm's length debt (provided that certain other conditions are met) can choose a test for thin capitalisation based on a ratio of interest expenses to pre-tax cashflows, rather than on a debt-to-asset ratio.

Application date

The alternative thin-capitalisation test applies for income years beginning on or after 1 July 2009. The measure applies retrospectively so that companies that may have experienced difficulties immediately after the extension of the thin capitalisation rules will be able to obtain relief.

Key features

A new thin capitalisation test is available for certain New Zealand-based multinationals.

The test is available to a group if:

- the worldwide debt of the multinational is more than 75% of its worldwide assets (excluding any recognised goodwill);
- at least 80% of the worldwide group's debt is from lenders that are not associated with a member of the group; and
- the New Zealand part of the multinational group and the worldwide group both have net income and net interest expenses (not net losses or net interest income).

The test is not available to entities that are non-residents or controlled by a single non-resident.

If the alternative test can be used, the taxpayer will calculate a ratio of net interest expense to net income, rather than the debt-to-asset ratio used under the existing test.

To the extent that the ratio for the New Zealand group is less than the lesser of 50% and 110% of the ratio for the worldwide group there will be no denial of interest deductions under the rules. If these conditions are not met, some interest deductions may be denied.

Detailed analysis

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

Background

The thin capitalisation rules, which limit excessive interest deductions against the New Zealand taxable income of multinationals, were extended in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009.

Previously, they applied only to non-residents and residents controlled by non-residents. The 2009 Act extended the thin capitalisation rules to other taxpayers with controlling interests in foreign companies. As part of the Taxation (International Investment and Remedial Matters) Act 2012, the rules have been further extended to some taxpayers with non-controlling interests in foreign companies.

Extending the rules has created difficulties for a small number of New Zealand-based groups reported to have high indebtedness.

The rules currently deny interest deductions if a group has a New Zealand debt-to-asset ratio that is both more than 75% and more than 110% of the worldwide debt-to-asset ratio of the group.

In other words, some deductions are denied if the group's debt appears to be concentrated in New Zealand.

The problem arises partly from the way assets are measured. Measurement is based on generally accepted accounting principles (GAAP). GAAP does not allow the recognition of some intangible assets, such as internally developed goodwill. Companies that have highly valuable brands, for example, cannot include those in the measure of assets unless they were purchased on the open market. This increases the debt-to-asset ratio and increases the potential for interest deductions to be denied.

A New Zealand company with valuable brands that looks to expand offshore by taking on debt may therefore find itself subject to the thin capitalisation rules, even though it is not unreasonably arranging to have its debts in New Zealand.

There are good reasons for the exclusion of internally developed goodwill and some other intangible assets from the GAAP measure of assets. Primarily, it can be extremely difficult to value intangible assets if there has not been an arm's-length transaction.

However, in cases where a company has significant intangible assets that cannot be counted for the purpose of the thin capitalisation rules, it is possible that a debt-

NEW LEGISLATION

to-asset ratio will be a misleading indication of whether excessive debt has been stacked in New Zealand.

Alternative test

To address the problem that some New Zealand-based groups are facing, a new test has been developed as an alternative to the existing debt-to-asset ratio test. It uses a measure that approximates an interest coverage ratio (interest-to-cashflows). Arm's-length lenders may be prepared to lend against cashflows even when recognised assets are low (interest coverage is often used in lending covenants).

Requirements for use of alternative test

Paragraph FE 5(1B)(ab)

An "excess debt outbound entity" is, broadly speaking, a person who is subject to the thin capitalisation rules solely by reason of a direct or indirect outbound investment from New Zealand.

Paragraph (ab) of section FE 5(1B) provides that an excess debt outbound entity is not required to apply the existing thin capitalisation rule in section FE 6 if it is able to choose, and does choose, to apply the alternative rule in section FE 6B.

Subsection FE 5(1BB)

This subsection provides that a person can choose the alternative rule in section FE 6B if all of the following four requirements are met:

- Both the New Zealand group and the worldwide group of the person must have a positive amount of adjusted net profit for the year (adjusted net profit is further defined in subsection FE 5(1BC) and is determined mainly using financial accounts).
- Both the New Zealand group and the worldwide group of the person must have a positive amount of net interest expense, determined using the rules in the Income Tax Act as if there were no thin capitalisation rules, as if the relevant members of the worldwide group were residents, and as if the group were consolidated to eliminate internal balances and transactions (see commentary on section FE 12B).
- The worldwide group's debt-to-asset ratio, excluding any recognised goodwill but otherwise determined using the existing thin capitalisation rules, must be 75% or more.
- 80% or more of the worldwide group's debt (calculated in the normal way under the thin capitalisation rules) must be from people that are not associated persons of a member of the group.

The first two requirements are to prevent distortion when the formula in section FE 6B is applied. The third requirement is that the worldwide group is highly indebted if all of its recognised goodwill is disregarded. If the group is not highly indebted in this circumstance, the existing test is more likely to work (it is less likely to be difficult for the company to push some debt offshore, for example). The fourth requirement is to ensure that most of the debt is genuinely arm's-length debt, and not, for example, capital injected by shareholders in the form of debt.

Definition of adjusted net profit

Subsections FE 5(1BC) and FE 5(1BD)

The adjusted net profit of a group is a proxy, albeit an imprecise one, for net cashflow from operations. It corresponds approximately to the "earnings before interest, tax, depreciation and amortisation" measure used in financial markets, usually referred to by its acronym EBITDA.

The formula begins with net profit before tax for the relevant group (New Zealand or worldwide), determined using generally accepted accounting principles (GAAP) and consolidating companies for the purposes of eliminating intra-group transactions (see commentary on section FE 12B). A net loss is treated as a negative net profit. A pre-tax measure is used partly because the measure of tax expense used for GAAP purposes is unlikely to be a meaningful indication of current tax liabilities (or associated cashflows).

For the New Zealand group, certain income arising from an interest in a foreign company is then removed, again using generally accepted accounting principles to measure this income. The income is removed if the interest is an income interest in a controlled foreign company, or an interest in a foreign investment fund that qualifies for the Australian exemption in subsection EX 35(1), or an interest in a foreign investment fund for which the attributable FIF income method is used.

This income is removed because it is typically not subject to tax in New Zealand. An important purpose of the thin capitalisation rules is to prevent excessive deductions being allocated to income that is not taxable in New Zealand.

Net interest deductions (deductions less income), as determined under the Income Tax Act but again on a consolidated basis, are then added to the remaining net profit. This gives an estimate of cashflows before interest expense. In the case of the worldwide group, relevant members are treated as if they were resident for this purpose.

Depreciation and amortisation, measured under GAAP, and again on a consolidated basis, are then added back. These are non-cash expenses.

When there is no interest apportionment (no denial of deductions)

Subsections FE 5(1D) and (1E)

An excess debt outbound entity is not denied any interest deductions under the apportionment rule in section FE 6B, if its New Zealand group's ratio of net interest to adjusted net profit is below the lesser of 50% or 110% of the worldwide group's net interest to adjusted net profit ratio.

For example, if the worldwide group's net interest to adjusted net profit ratio was 40%, the excess debt outbound entity would face some interest denial if the equivalent New Zealand group ratio was more than 44%. If instead, the worldwide group ratio was 60%, the excess debt outbound entity would face some interest denial if the New Zealand group ratio was more than 50%.

Net interest is defined in the same way as in subsections FE 5(1BB) and (1BD). The use of a net interest figure allows entities to reduce their apparent interest deductions for the purposes of thin capitalisation by on-lending their borrowings to foreign companies (pushing some debt offshore) and receiving corresponding interest income. Adjusted net profit is defined in subsections FE 5(1BC) and (1BD).

The apportionment calculation

Section FE 6B

If a person chooses to apply the alternative apportionment calculation and is not excluded by subsections FE 5(1D) and (1E) from having to actually apportion, section FE 6B is the section used to perform the actual apportionment.

The amount of interest deduction denied is given by the formula in subsection (2). In practice, deductions are denied by adding back income rather than reducing deductions. The terms in that formula are based on the interest-to-income ratio given by section FE 5(1E) and the thresholds seen in section FE 5(1D). "Net interest" is the actual amount of net interest deduction for the taxpayer (not the group) in the absence of the thin capitalisation rules.

Parallels with the existing interest allocation calculation in section FE 6 are evident.

Example: Interest deductions denied

X Co, a resident company with a single resident shareholder, owns 100% of Y Co, a foreign company. X Co would have net interest deductions of $1 million in the absence of the thin capitalisation rules, and the worldwide group would have net interest deductions of $3 million. X Co's adjusted net profit is $3 million and the worldwide group's adjusted net profit is $12 million. Assume X Co is able to use the alternative apportionment calculation. Then:

net interest is $1 million;

NZ group ratio is 0.333… ($1 million ÷ $3 million);

threshold ratio is 0.275 (1.1 × $3 million ÷ $12 million); and the formula gives a result of $175,000 ($1 million × [0.333… – 0.275] ÷ 0.333…).

Therefore only $825,000 of interest deductions is effectively permitted.

Note that if X Co instead had $825,000 of interest deductions in the first place, and the worldwide group's deductions were unchanged, the NZ group ratio would be exactly equal to 110% of the ratio for the worldwide group, and deductions would not be denied.

Machinery provision

Section FE 12B

Section FE 12B specifies that certain amounts used in the thin capitalisation test are to be calculated using generally accepted accounting principles and on a consolidated basis.

In the case of interest deductions and interest income, there are specific instructions to use tax concepts rather than accounting concepts to calculate the base amounts, but consolidation of these amounts is still undertaken using accounting principles. This is similar to the treatment of debt under the existing thin capitalisation test, in which the relevant debts are determined by the tax rules but consolidation occurs using accounting principles.

Section FE 12B also limits the consolidation of amounts of any non-resident group members to the amount that is attributable to New Zealand-sourced income.

Administrative requirements

Section 65B of the Tax Administration Act 1994

Taxpayers who use the proposed new rule must meet the following administrative requirements:

- First, the taxpayer must advise the Commissioner, in any manner the Commissioner may specify, that the rule has been applied.
- Secondly, the taxpayer must provide reconciliations of adjusted net profit to GAAP net profit, and of goodwill to items presented in the GAAP balance sheet, in any manner the Commissioner may specify.

The advice and reconciliations must be furnished to the Commissioner by the due date for the taxpayer's tax return for the relevant tax year under section 37 of the Tax Administration Act 1994. The current procedure is to send these to **competent.authority@ird.govt.nz**

These requirements will enable Inland Revenue to monitor the extent of use of the alternative thin capitalisation rule and the appropriateness of the measures used in it.

STATE-OWNED BANKING GROUPS

Sections FE 2(5), FE 36(1), FE 36B and YA 1

The thin capitalisation rules have been altered to permit the Kiwibank group of companies to be treated separately from the rest of the New Zealand Post group. This is to reduce compliance costs and to ensure that the appropriate thin capitalisation test is used for the non-banking part of the New Zealand Post group.

Application date

The changes apply for income years beginning on or after 1 July 2009.

This measure applies retrospectively.

Key features

The thin capitalisation rules have been altered so that:

- a state-owned banking group (the Kiwibank group of companies) is not subject to the thin capitalisation rules by reason of New Zealand Post's non-banking activities; and
- the New Zealand Post group may exclude the Kiwibank group of companies from its New Zealand group, so that it will apply the ordinary thin capitalisation rules rather than the thin capitalisation rules for banks.

These alterations apply only so long as the Kiwibank group of companies is not subject, in its own right, to the thin capitalisation rules (for example, by directly acquiring a controlled foreign company).

Detailed analysis

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

Background

The thin capitalisation rules, which limit excessive interest deductions against the New Zealand taxable income of multinationals, were extended in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009.

Previously, they applied only to non-residents and residents controlled by non-residents. After the 2009 Act, they also applied to other taxpayers with controlling interests in foreign companies.

The New Zealand Post group has such controlling interests, so is newly subject to the thin capitalisation rules.

Because of the way the existing rules work, every New Zealand member of the group is subject to the rules, including Kiwibank. Because Kiwibank is a registered bank, the entire group must apply the special subset of thin capitalisation rules that apply to banks.

This requires undertaking costly calculations for the non-bank members of the group (for bank members the calculations are based on information that is already produced) and allows debt to be, roughly, 94% of assets. This might be an appropriate ratio for a bank, but is unusually high for the significant non-banking operations of the group (75% is the standard ratio for New Zealand-based groups without a registered bank).

Changes to rules

The law has been changed so that a New Zealand state-owned banking group can be treated separately from non-banking activities in the same group.

Subsection FE 2(5)

Subsection FE 2(5) removes the requirement for a member of a state-owned banking group, to which section FE 36B applies, to take into account CFC or FIF interests held by associates outside the group (such as under sections FE 38, FE 41 or EX 15).

In effect, this removes Kiwibank from the scope of the interest apportionment rule in section FE 7 so interests held by non-banking members of the New Zealand Post group no longer need to be counted. However, it only removes Kiwibank from this scope because no member of the banking group currently has its own interest in a non-portfolio FIF or CFC. If a member were to acquire such an interest, all members of the group would be within the scope of section FE 7 again.

Section FE 36 and 36B

The definition of a New Zealand banking group has been altered so that, in the exclusive case of a registered bank that is 100% owned by the New Zealand Government, the group consists of:

- the registered bank;
- a company with a direct 100% voting interest in the registered bank; and
- entities that are part of the financial reporting group for which the registered bank is the reporting entity, or would be part of it but for relevant materiality thresholds. The terms "financial reporting group" and "reporting entity" are defined by the Financial Reporting Act 1993.

This isolates the Kiwibank group from the rest of the New Zealand Post group. Without the alteration, the entire New Zealand Post group including Kiwibank would be treated as a New Zealand banking group.

The isolation relies on the definition of a New Zealand group for a company that is not part of the Kiwibank group. Paragraph FE 28(1)(c) excludes members of a New Zealand banking group from that New Zealand group (a New Zealand banking group exists despite the non-application of section FE 7 to that group). In other words, that company's New Zealand group will be all the New Zealand-based entities in the New Zealand Post group except those in the Kiwibank group. That company will therefore use the standard apportionment rule in section FE 6 and not the banking rule in section FE 7.

The new rule in section FE 36B may not apply in certain situations. Specifically, a member of the New Zealand banking group (determined as if section FE 36B applied) may have interests in an offshore company that would bring it within the scope of section FE 2, even ignoring interests of associated persons outside the group under sections EX 15, FE 38 and FE 41. If that is the case, the existing rules in section FE 36 are invoked. (To prevent circularity, subsection FE 2(5) is ignored when deciding whether or not section FE 2 would apply.)

That is, if a member of the Kiwibank group had an interest in a controlled foreign company or certain interests in foreign investment funds, the entire New Zealand Post group would again be a New Zealand banking group.

EXEMPTION FROM THE OUTBOUND RULES

Section FE 5(1B)(b) of the Income Tax 2007 (repealed)

Under the previous rules, section FE 5(1B)(b) provided an exemption from the thin capitalisation rules for excess debt outbound companies if total interest deductions for the New Zealand group did not exceed $250,000. This exemption was rendered effectively redundant by section FE 6(3)(ac)(ii) which reduces to zero the deductions subject to apportionment under the rules if the finance costs of an outbound entity do not exceed $1 million. Accordingly, section FE 5(1B)(b) has been repealed.

Application date

The change applies to income years beginning on or after 1 July 2011.

Detailed analysis

Section FE 5(1B)(b) and section FE 6(3)(ac)(ii) provided overlapping exemptions from the thin capitalisation rules for excess debt outbound companies. Because the threshold for the latter exemption is more generous, section FE 51B(b) became largely redundant and has been repealed.

There are some minor differences in scope between section FE 5(1B)(b) and section FE 6(3)(ac)(ii), as noted below.

Section FE 5(1B)(b) set the $250,000 exemption threshold based on interest deductions under sections DB 6 to DB 8, whereas the $1 million threshold in section FE 6(3)(ac)(ii) also takes account of fixed-rate dividends (see section FE 6(3)(ab)). In this regard, section FE 6(3)(ac)(ii) is less generous than section FE 5(1B)(b) was, and it is possible that, where fixed-rate equity is used in place of ordinary debt, the latter may have provided an exemption where the former does not. However, since the thin capitalisation rules now extend to cover fixed-rate dividends, the approach taken in section FE 6(3)(ac)(ii) is appropriate.

The $250,000 exemption under section FE 5(1B)(b) was not available when the New Zealand group included an entity with an income interest in a CFC that was deriving rent from land in the CFC's local jurisdiction. There is no equivalent exclusion from the $1 million exemption under section FE 6(3)(ab).

APPLICATION TO NON-RESIDENTS WITH NO FIXED ESTABLISHMENT

Subsections FE 13(3) and FE 6(1B)

Changes have been made to the thin capitalisation rules to limit their application when non-resident companies do not carry on business through a fixed establishment in New Zealand. Those companies will no longer be subject to the rules if all their New Zealand-sourced income that is not relieved under a double tax agreement is non-resident passive income.

Application date

The change applies to income years beginning on or after 1 July 2011.

Detailed analysis

The thin capitalisation rules currently apply to non-resident companies that have New Zealand-sourced income that is not relieved under a double tax agreement, even if the company has an insignificant physical presence in New Zealand.

This is to ensure that such non-residents are not artificially lowering their taxable income by debt-funding their New Zealand activities or investments.

However, the inclusion of such companies causes difficulties with the definition of the "New Zealand group" under the rules, and may bring in non-resident entities that should not logically be included.

When the New Zealand-sourced income is "non-resident passive income", it is subject to a withholding tax in New Zealand which is typically a final tax. That is, no interest deductions may be taken against the income. In such a case, it is not necessary to apply the thin capitalisation rules.

Accordingly, the thin capitalisation rules are modified to exclude non-resident entities that do not have a fixed establishment in New Zealand and whose only New Zealand-sourced income is non-resident passive income. If the non-resident entity has a mixture of non-resident passive income and other income that is sourced from New Zealand, they will still be included in the New Zealand group to the extent that their New Zealand-sourced income qualifies for relief under a double tax agreement.

ZERO RATE OF AIL ON RETAIL BONDS

Sections 86I and 86IB of the Stamp and Cheque Duties Act 1971

The approved issuer levy (AIL) is imposed on interest payments made by New Zealanders to foreigners. The levy is 2% of the interest paid, and is paid to the Government by the borrower. AIL is an alternative to paying non-resident withholding tax (NRWT), which applies at a rate of 15%, or 10% with treaty countries, on the interest. The option to pay AIL is available only when certain requirements are met, such as the borrowing being from an unrelated party.

When AIL was introduced in 1991, the central aim was to substantially reduce the tax imposed on loans from unrelated parties on the basis that NRWT raised the cost of capital to the New Zealand borrower in these circumstances. The basic operation of the approved issuer levy is explained in *Tax Information Bulletin* Vol 3, No 2, August 1991, pp 7–8.

Unlike the 1991 reform, the measure in the Taxation (International Investment and Remedial Matters) Act 2012 aims to remove a potential tax impediment to the development of New Zealand's traded bond market, rather than reducing the cost of unrelated debt across the board.

The Act amends the Stamp and Cheque Duty Act 1971 by providing a zero rate of AIL for bonds that are traded in New Zealand. Strict criteria are used to prevent ordinary loans, syndicated lending, private placements and other forms of closely held or non-traded debt from qualifying for the zero rate of AIL.

The 2% rate of AIL is retained and AIL will be considered to be paid when either the existing 2% rate is paid, or the new nil rate applies.

Application date

The changes apply to interest payments made on or after 7 May 2012. This means that the zero rate can be used in respect of future interest payments on bonds issued before enactment of the legislation.

Key features

To qualify for AIL generally, the debt security must first comply with the existing AIL registration requirements in section 32M of the Tax Administration Act 1991 and section 86H of the Stamp and Cheque Duties Act 1971.

In cases where these requirements are met, the borrower can pay a 2% rate of AIL.

Section 86IB of the Stamp and Cheque Duties Act 1971 sets out the additional requirements that a registered security must meet to qualify for the zero rate of AIL. These are:

- that the security is denominated in New Zealand dollars;
- that the security was offered to the public for the purposes of the Securities Act 1978;
- that the security was not issued as a private placement;
- that the security is not an asset-backed security;
- that the registry and paying agent activities for the security are conducted through one or more fixed establishments in New Zealand; and
- that the security is listed on an exchange registered under the Securities Market Act 1988 (the NZDX) or alternatively, the security is traded in a market that brings together buyers and sellers of securities and satisfies a widely held test.

The main test is the NZDX test, with a widely held test as a back-up option for bonds that are traded in New Zealand but not listed on the NZDX.

The widely held test is outlined in new section 86IB(2). A bond must satisfy the widely held test at, or before, the time of the interest payment. This means that if the test has been satisfied on one previous occasion, it is not necessary to re-apply the test a second time.

There are two parts to the widely held test:

- The securities must be held by at least 100 separate persons whom the issuer could not reasonably expect to be associated with the issuer or with one of the other bond-holders. Bond-holders that are associated with each other count as one person for the purposes of this test. Persons who would be associated with the issuer due to the existence of a trust which is established for the main purpose of protecting or enforcing beneficiaries' rights under the class of securities can still be counted, so long as they are not associated with the issuer in some other way.
- No person or group of associated persons can hold more than 10% of the value of the securities at the time the test is applied.

Regardless of whether they pay AIL at 2% or 0%, the approved issuer will need to file an AIL return/payment slip.

Detailed analysis

In order to access the zero rate of AIL, the issuer of the security must first register to pay AIL. The issuer of the security must be an approved issuer under section 32M of the Tax Administration Act 1991 and must have registered the security under section 86H of the Stamp and Cheque Duties Act 1971. This allows them to pay AIL at a rate of 2%.

Section 86I of the Stamp and Cheque Duties Act 1971 has been amended so that AIL is considered to be paid when either the existing 2% rate is paid, or the new nil rate applies. When AIL is considered to be paid, a nil rate of non-resident withholding tax will apply under section RF 12 of the Income Tax Act 2007 as long as the borrower and lender are not associated, and as long as the interest is not jointly derived with a New Zealand resident.

Section 86IB of the Stamp and Cheque Duties Act 1971 sets out the requirements that a registered security must meet to qualify for the zero rate of AIL.

Issued in New Zealand

The objective of the zero rate of AIL is to remove a potential obstacle to the further development of the New Zealand bond market (bonds issued in New Zealand and denominated in New Zealand dollars) rather than reducing taxes on foreign debt funding more generally.

Two requirements are used to limit the zero rate of AIL to bonds which are issued in New Zealand.

The first requirement is that the securities are denominated in New Zealand dollars (section 86IB(1)(a)).

A supporting requirement is that the activities of the registrar and paying agent for the security are conducted through one or more fixed establishments in New Zealand (section 86IB(1)(d)). This means that these activities occur in New Zealand. Bonds will be registered with a registrar whose role is to check that the bonds comply with relevant legal obligations and that the amount of bonds on issue matches the amount of bonds authorised by the company. A paying agent is an agent who accepts payments from the issuer of a security and then distributes the payments to the holders of the security.

Issued publicly

Two requirements are used to limit the zero rate to bonds that are issued publicly.

First, the securities must be an offer of securities to the public under the Securities Act 1978 (see section 86IB(1)(b)(i) of the Stamp and Cheque Duties Act 1971). The Securities Act does not expressly define an offer of securities to the public, but section 3 of the Act provides guidance on how the phrase should be interpreted. Section 3 of the Act lists people who are not considered to be members of the public. These include associates, institutional investors, underwriters and investors who pay a minimum subscription price of at least $500,000 before allotment of the securities. The Securities Act requires the preparation of an investment statement, a registered trust deed and (generally) a registered prospectus before a debt security can be issued to the public.

Secondly, the securities cannot be issued as a private placement (section 86IB(1)(b)(ii)). A "private placement" is not a formally defined term in the Income Tax Act 2007 so this exclusion relies on the ordinary commercial meaning of a private placement. For example, securities that were exclusively issued to a group that were pre-selected by the issuer would probably be considered to be a private placement.

Not an asset-backed security

The securities cannot be asset-backed securities (section 86IB(1)(c)). Again, an "asset-backed security" is not formally defined so would be interpreted using the ordinary commercial meaning of this term. For example, securities whose interest payments were directly financed out of cashflows from a pool of financial assets such as mortgages or other loans could be considered to be asset-backed securities.

In cases where a company issues bonds and then on-lends all of the funds to a related party, the bonds will not usually be an asset-backed security. With an asset-backed security, the interest payment on the bond is dependent on the performance of the underlying assets. This is not the case when the funds are simply on-lent to a related party.

The purpose of this requirement is to deny the zero rate of AIL in cases when a group of loans have been bundled together and securitised into a bond. The concern is that such securities could be used to effectively shift the profit margin earned on closely held loans (such as mortgages) outside the New Zealand tax base.

Traded in a market

The securities must either be listed on an exchange registered under the Securities Market Act 1988 (see section 86IB(1)(e)(i) of the Stamp and Cheque Duties Act 1971), or alternatively, must be traded in a market that brings together buyers and sellers of securities and also satisfy a widely held test (section 86IB(1)(e)(ii)). This means that non-traded instruments such as bank term deposits will not qualify for the zero rate of AIL. Currently, the NZDX is the only debt exchange that is registered under the Securities Market Act.

Securities listed on the NZDX will not need to apply the widely held test and are expected to generally satisfy the other requirements listed above.

Widely held test

The widely held test is outlined in section 86IB(2). A bond needs to satisfy the widely held test at, or before, the time of the interest payment. This means that, if the test has been satisfied on one previous occasion, it is not necessary to re-apply the test a second time.

The securities must be held by at least 100 separate persons whom the issuer could not reasonably expect to be associated with the issuer or with one of the other bond-holders. Bond-holders that are associated with each other count as one person for the purposes of establishing if there are at least 100 separate bond-holders. Persons who would be associated with the issuer due to the existence of a trust which is established for the main purpose of protecting or enforcing beneficiaries' rights under the class of securities can count toward the 100 persons, so long as they are not associated with the issuer in some other way. See the next section, "AIL and associated persons remedial", for a discussion on why this exclusion for bond trusts is necessary.

Note that the securities need not all be issued on the same date so long as the debt securities are identical (that is, they are fungible). This means that issuers can build up to 100 investors over time, although they will only get the nil rate of AIL in respect of interest payments made on or after the first day that the securities satisfy the test.

Example

If half the bonds were issued in January 2012 and half in August 2012, and by the 14th of September 2012 the total number of bond-holders has reached 100 persons, then the test could be satisfied in respect of interest payments made on or after the 14th of September 2012.

If the number of persons who hold the bonds subsequently drops below 100, the test will still be satisfied so long as this threshold was not met simply because of an arrangement (that the issuer could reasonably be expected to be aware of) that was intended to temporarily increase the number of persons holding the bonds.

The second part of the widely held test is that no person or group of associated persons holds more than 10% of the value of the securities at the time the test is applied. If a person subsequently comes to hold more than 10% of the bonds, the test will continue to be satisfied. Note that both parts of the widely held test (requiring 100 persons and that no person holds more than 10% of bonds) must be satisfied on the same date.

Filing requirements

Regardless of whether they pay AIL at 2% or 0%, approved issuers will need to continue to file an AIL return/payment slip by the 20th day of the month following the month in which the interest payment was made (sections 86I and 86K). This slip will now require the approved issuer to record the total amount of interest payments which have been zero-rated. A person will not generally be able to use the zero rate of AIL in respect of any interest payments for which they fail to provide this information by the 20th day of the following month. However, there is scope for the Commissioner to provide a later deadline in a notice given to the approved issuer (section 86I(b)(ii)). Alternatively an approved issuer that is late at supplying this information would still be able to get a 2% rate of AIL (section 86I(a)(ii)) if they pay AIL at a later date, along with any interest and penalties.

AIL AND ASSOCIATED PERSONS REMEDIAL

Subsection RF 12(1) of the Income Tax Act 2007

In 2009 a change was made to the associated persons definition. This had the unintended consequence of making some bond issuers and bond holders associated persons when they were only associated through the use of a bond trust.

This meant that bond issuers were required to pay non-resident withholding tax (NRWT) on interest payments to non-resident bond-holders. Prior to the 2009 changes, they were able to pay the approved issuer levy which applies at a lower rate than NRWT.

Key features

Section RF 12(1)(a)(ii) has been amended so that a zero rate of NRWT is still available in cases when the approved issuer and the non-resident are associated only due to the use of a trust which has been established for the principal purpose of protecting and enforcing the rights which the beneficiaries of a trust have under the registered security.

Note that if the non-resident is also associated with the issuer for another reason (for example if the non-resident owns 50% of the shares in the issuer) they are not eligible for a zero rate of NRWT.

Application date

The amendments apply for the 2010–11 and later income years. This is consistent with the date on which the new associated persons definition in subpart YB began to apply.

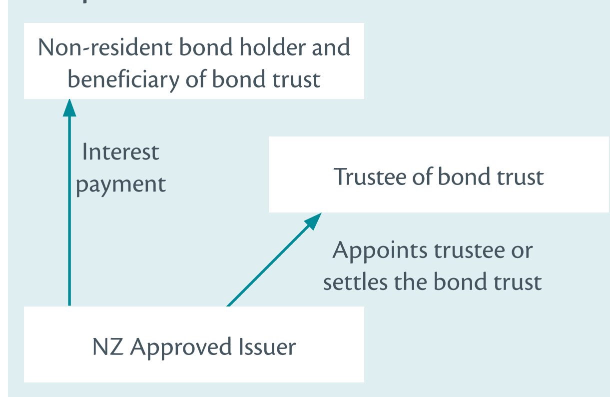
Detailed analysis

Section RF 12(2) provides a zero rate of NRWT if the conditions in section RF 12(1) are met.

Section RF 12(1)(a) sets out three requirements for the zero rate of NRWT. These are that AIL has been paid, that the bond-holder and bond issuer are not associated and that the interest is not jointly derived by a resident.

The Act amends section RF 12(1)(a)(ii) so that, if the approved issuer and the non-resident person who receives the interest are associated only due to the use of a trust which has been established for the principal purpose of protecting and enforcing the rights which the beneficiaries of a trust have under a debt security, then a zero rate of NRWT is still available if AIL is paid.

Example



In the above example the non-resident bond holder could be associated in several ways with the New Zealand approved issuer because of the bond trust.

The non-resident bond holder is a beneficiary of the bond trust so would be associated with the trustee of the bond trust under section YB 6.

If the approved issuer appointed the trustee of the bond trust they would be associated with the bond trust under section YB 11. Alternatively, in some cases the approved issuer could potentially qualify as a settlor of the trust and be associated with the trustee under section YB 8. In either case the tri-partite rule in section YB 14 would come into play and deem the approved issuer and the non-resident bond holder to be associated with each other because they are each associated with the trustee of the trust.

If the approved issuer and the non-resident bond holder are associated only due to one of the above circumstances, that is they are associated only because of the existence of the bond trust, then they will still be able to get a zero rate of NRWT in cases where AIL was paid (and the interest was not jointly derived by a resident).

If the non-resident bond holder was associated for a reason that is not due to the existence of the bond trust, such as holding 50% of the shares in the approved issuer, then they would not qualify for a zero rate of NRWT under section RF 12.

ATTRIBUTED FOREIGN INCOME – LIABILITY TO TAX

Sections EX 20B(7)(a), EX 20B(11)(a), EX 21D(1)(a) and EX 21E(2)(b), subsections EX 20B(16), EX 21D(10), EX 21E(14), and definition of associated non-attributing active CFC in section YA 1

The Act expands the scope of income that can be excluded from attributed foreign income, by permitting some companies, which are not recognised for tax purposes in the country they operate in, to nevertheless be treated as resident in that country.

The Act also adds requirements to prevent abuse of the rules that allow some income to be ignored.

Application date

The changes apply to income years beginning on or after 1 July 2009.

Key features

- Income that a controlled foreign company receives from a non-attributing active CFC (an active business) resident in the same country may be ignored for tax purposes even if one or both CFCs are not liable to tax in that country.
- Income that a controlled foreign company receives from rental property in the same country may be ignored even if the CFC is not liable to tax in that country.
- Income that a controlled foreign company receives from telecommunications services between the country in which it is resident and New Zealand may be ignored even if the CFC is not liable to tax in that country.
- A CFC may be part of a test group in the country in which it is resident, even if it is not liable to tax in that country.

For these to apply, all the following requirements must be met:

- The CFC is a resident of the country in question under section YD 3 (this does not require liability to tax).
- The CFC is wholly owned (directly or indirectly through a wholly owned chain of companies) under the laws of both New Zealand and the foreign country, by another CFC that is resident in that country under section YD 3.
- That other CFC is liable to tax in the jurisdiction on the income of the CFC by reason of its domicile, residence, place of incorporation or centre of management, in the same period as the CFC would be liable if it were an ordinary company liable to tax.
- Neither the CFC nor the other CFC is treated as a dual-resident.
- Neither the CFC nor the other CFC has a fixed establishment or a permanent establishment outside the country.

The first, fourth and fifth requirements are extended to apply to all companies, not just those that are not liable to tax in a particular country. If these requirements are not met, it will not be possible to use the exemptions for payments from a non-attributing active CFC, rent from property in the same country or income from telecommunications services between the CFC's country of residence and New Zealand, or to be in a test group, regardless of liability to tax.

As well as applying to CFCs, the changes also apply to FIFs that use the attributable FIF income method.

Detailed analysis

Same country exemptions

Existing law provides that amounts that would be included in attributed foreign income for taxpayers with interests in foreign companies may be ignored in some cases where the income arises in the same country as the foreign company (see paragraphs EX 20B(5)(c), (7)(a), (7)(c), (11)(a), (12)(a), and paragraphs EX 21D(1)(a) and 21E(2)(a)).

To take advantage of these "same country exemptions", the foreign company must show it is resident in that country by reason of liability to tax.

When same country exemptions do not apply (not liable to tax)

Some entities that New Zealand considers to be foreign companies are not treated as taxable entities in the country in which they are registered or organised. For example, a United States Limited Liability Company (LLC) such as a so-called "Delaware company" is often considered by the United States to be analogous to a partnership for tax purposes. In that case, it is not liable to tax in that country (though its shareholders may be) and the foreign company is not able to take advantage of the same country exemptions.

When the current position is logical

Excluding entities such as LLCs from the same country exemptions is often the correct result. For example, if an LLC owns an ordinary active company in the same country, and is able to extract the profit from that active company in the form of an interest payment, there may be very little foreign tax imposed on the income of the LLC, its shareholders, or the active company. In that case, it would not be appropriate to exempt the income from New Zealand tax.

When the exemptions should apply even though there is no liability to tax

However, there are cases when excluding entities such as LLCs from the same country exemptions is unnecessary and even counterproductive.

In particular, if the LLC is wholly owned by another company in the same country, and that other company is liable for tax on the LLC's income, the outcome should be similar to the case in which all of the companies are liable to tax in that country. In those cases, normal tax is paid on the active income of the group in the foreign country and New Zealand should be prepared to exempt the income here.

Remedial amendments when liability to tax is not an issue

The widening of the same country exemptions to entities that are not liable to tax in the foreign country has highlighted some situations in which the existing exemption—for entities that are liable to tax in the foreign country—may be too wide.

Companies may be resident by reason of liability to tax in more than one country. Or they may be resident in one country but conduct significant operations in another. In that case, it may not be appropriate to assume that the country in which income is being earned is ultimately taxing the income.

Imposing additional conditions on the same country exemptions for all entities

Sections EX 20B(7)(a), EX 20B(11)(a), EX 21D(1)(a) and EX 21E(2)(b), subsections EX 20B(16), EX 21D(10), EX 21E(14), and definition of associated non-attributing active CFC in section YA 1

To limit the use of the same country exemptions to cases when it is more likely that active income is being taxed normally by the relevant foreign country, there are three additional conditions for residence.

These are:

- first, that the CFC is a resident of the country in question under section YD 3;
- secondly, that the CFC is not treated as a dual-resident; and
- thirdly, that the CFC does not have a fixed establishment or a permanent establishment outside the country.

The existing section YD 3 determines a single country of residence of a CFC (it does not require liability to tax).

A CFC is regarded as a dual-resident if one or more of three conditions is met:

- The CFC is treated as a resident of a country other than the country in section YD 3 under the law of the relevant jurisdiction.
- The company is liable to income tax by reason of its domicile, residence, place of incorporation, or centre of management in a country other than the country in section YD 3.
- The company is treated as a resident of a country other than the country in section YD 3, under an agreement that would be a double tax agreement if New Zealand was a party to it.

"Fixed establishment" is a defined term in the Income Tax Act. "Permanent establishment" is an analogous term used in double tax agreements and extensively discussed in the OECD's commentary to the *Model Tax Convention on Income and on Capital.*

Widening the same country exemptions for entities with no liability to tax

Sections EX 20B(7)(a), EX 20B(11)(a), EX 21D(1)(a) and EX 21E(2)(b), subsections EX 20B(16), EX 21D(10), EX 21E(14), and definition of associated non-attributing active CFC in section YA 1

At the same time as clarifying the requirements for all companies that use the same country exemptions, the new Act widens the scope of the exemptions to include entities that are not liable to income tax because they are not considered to be taxable entities in the country where they are resident.

A CFC that is not liable to tax in the relevant country may still make use of the exemption if it meets the conditions for residence (see previous section) and two further conditions are met:

- the CFC is wholly owned, under the laws of New Zealand and the foreign country, either directly or through a chain of wholly owned companies, by another CFC that meets the conditions for residence in the previous section; and
- the other CFC is liable to tax on the income of the CFC in the relevant country by reason of its domicile, residence, place of incorporation or centre of management, in the same period as the CFC would be liable if it was an ordinary company liable to tax there.

Example: Using same country exemptions when not liable to tax

Hold Co owns 100% of LLC Co, which in turn owns 100% of Op Co. All three companies are CFCs incorporated in and managed from the United States, and are treated as residents of the United States under section YD 3. None of the companies has operations outside the United States.

Op Co and Hold Co are liable to tax by reason of residence in the United States, but LLC Co is treated as a partnership for tax purposes and so is not liable to tax.

Op Co is a non-attributing active CFC.

Op Co pays interest to LLC Co.

The interest is not subject to tax in the United States in the hands of LLC Co, but is subject to tax in the hands of Hold Co.

LLC Co can ignore the payment of interest from Op Co, even though it is not liable to income tax in the United States. LLC Co is wholly owned by owned by Hold Co, and Hold Co is liable to tax in the United States on LLC Co's income (including interest income).

ACTIVE BUSINESS TEST – CLARIFICATIONS AND REMEDIAL AMENDMENTS

The Act amends the meaning of passive income and total income used in the active business test for controlled foreign companies. This will make it easier to pass the active business test that is based on accounting data.

The Act also clarifies that, when the active business test is applied to a group of CFCs, a CFC may not be included in more than one group.

Application date

The amendment applies to income years beginning on or after 1 July 2009. This amendment is retrospective so that affected taxpayers can benefit from the policy from the inception of the international tax rules, consistent with the original intent.

Key features

The Act proposes changes to ensure that:

- Rental income may be included in the measure of reported income in section EX 21E (which contains the active business test using accounting data).
- Income from financial arrangements that is received from a non-attributing active CFC may be excluded from the measure of passive income in section EX 21E.
- Income from some financial assets that are in the nature of accounts receivable may be excluded from the measure of passive income in section EX 21E.
- A CFC that is part of a "test group" for the purposes of the active business test under sections EX 21D or EX 21E cannot be part of another test group and cannot apply the test as an individual CFC.

The first three proposed changes fix unintended omissions. The final change is for clarification only, and does not—in our view—result in the effect of the law changing.

Detailed analysis

The active business test is used when a New Zealand resident has an income interest in a foreign company. If the foreign company passes the active business test, the New Zealander may ignore the current income of the foreign company for tax purposes.

There are two forms of the test, one using accounting data and one using the usual provisions of the Income Tax Act for calculating income. In concept, both are similar—they measure the amount of passive income of the foreign company as a proportion of total (gross) income, and deem the company to be an active business if the proportion is less than 5%.

Passive income is exhaustively defined. For example, it explicitly includes rental income and interest income. However, there are numerous exceptions which allow a person to remove items if they wish. Total income is also defined.

It is possible for companies in the same country (in the case of some interests in foreign investment funds, companies in any country) to undertake the test as a group, using consolidated accounts. This may reduce compliance costs and also simplifies the treatment of holding companies or other companies with non-operational functions within the group.

Remedial changes

Paragraph EX 21E(10)(ab)

Reported revenue in section EX 21E(10) is the measure of total income for the purposes of the active business test using accounting concepts. Reported revenue includes "revenue" if IFRS is used, a term which is defined by International Accounting Standard 18. Lease income is generally excluded from the definition of "revenue" under that standard. Lease income is brought in under another item that is part of reported revenue, but only if it is income other than rent from finance or operating leases.

This means that rental income may not be able to be included in the measure of total income. This is not intended, and this Act contains an amendment to the definition of reported revenue so that rent may be included.

Paragraph EX 21E(9)(cb)

Reported passive in section EX 21E(7) is the measure of passive income that is used in the active business test using accounting concepts. One component of reported passive is income or loss from a financial asset, other than a derivative or a share on capital account. Accounts receivable can be financial assets. This means that gains or losses on accounts receivable—for example, due to exchange rate fluctuations—may be included in the measure of passive income. However, accounts receivable may relate to active businesses so including them is not necessarily appropriate.

Reported passive income also includes interest received from associated non-attributing CFCs.

Such interest may not be ignored even though other forms of passive income from such CFCs can be (see paragraphs EX 21E(9)(a) to (c)).

The Act changes the measure of passive income to address these problems. The change allows gains or losses on financial assets (including interest income) to be excluded from the measure of passive income if:

- they are included in the measure to begin with (see the existing provision at the beginning of subsection EX 21E(9)); and
- they could be excluded under the active business test that uses tax rules (see subsection EX 20B(12), but subject to the modification described below).

This allows the exclusion of amounts that are, broadly speaking, payments from related active entities and gains or losses relating to accounts receivable.

The exclusions in subsection EX 20B(12) are exclusions from financial arrangement income. The subsection does not apply to financial arrangement expenditure.

However, in the context of section EX 21E, it would be inappropriate not to exclude expenditure if income was being excluded; section EX 21E refers to gains *or losses* from financial assets. Therefore, paragraph EX 21E(9)(cb) refers to any gain or loss on a financial asset that is a financial arrangement or agreement referred to in subsection EX 20B(12), whether or not it actually generates income under that subsection. That is, a person may exclude gains under paragraph EX 21E(9)(cb), but only if they also exclude similar losses.

Clarification – test groups

Subsection EX 21B(4)

Subsections EX 21D(1) and EX 21E(2) each define a "test group" for the purposes of the active business test.

Subsection EX 21B(4) clarifies that a CFC may not be part of more than one test group, and may not apply the test on an individual basis if it is part of a test group.

THIRD-PARTY ROYALTIES PAID THROUGH A CHAIN OF CFCS

Section EX 50B(5)(d)

In general, royalty payments are attributable income when they are received by a CFC. However there are several exceptions to this. One of these exceptions did not operate as intended and has been corrected.

The exception in section EX 20B(5)(d) provides an exemption for royalty payments in cases where a New Zealand company owns intellectual property and licenses this to a CFC which in turn sub-licenses it to a person who is not associated with the CFC.

The Act modifies the exemption so that it also applies to royalty payments that pass through a chain of two or more associated CFCs, so long as the royalty:

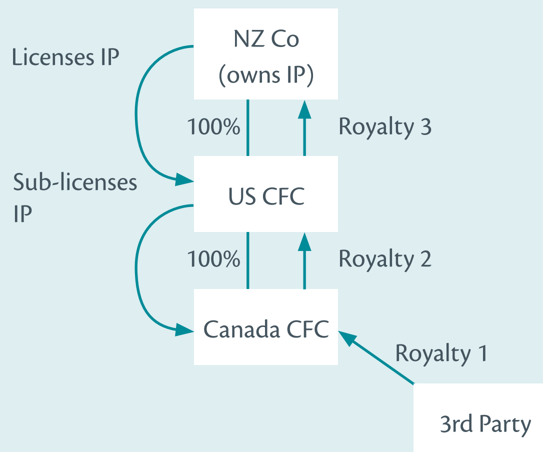
- is paid in relation to intellectual property that is owned by a New Zealand resident;
- is licensed to one of the CFCs in the chain; and
- is ultimately derived from another royalty that is paid by person who is not associated with the chain of CFCs.

The reference to "ultimately derived" means that the royalty should be for an amount that is similar to the amount of the original third-party royalty.

Note that the transfer pricing rules could apply if the related party royalties are significantly different from the third party royalty.

Example

Consider the following chain of associated CFCs.



Royalty 1 is exempt income of Canada CFC because it is paid by a person who is not associated with Canada CFC.

Royalty 2 is exempt income of US CFC because it is paid by Canada CFC which is associated with US CFC and it arises from Royalty 1 which was paid by a person who is not associated with these CFCs.

Royalty 3 is taxable income of NZ company. It is expected that royalty 3 should be for an amount that is the same or similar to the amount of the original royalty from the third party.

ATTRIBUTING TELECOMMUNICATIONS INCOME

Sections EX 20B(11)(c) and (d)

Most income of a CFC from services performed in New Zealand is attributable (that is, subject to New Zealand tax under the CFC rules). This is to prevent income that should properly be entirely within the New Zealand tax base from being diverted to an exempt offshore company.

However, a concession was made for certain telecommunications income, on the grounds that a service is unavoidably performed in New Zealand when a CFC connects calls from its country to New Zealand. This concession is currently limited to cases in which the CFC does not use its own equipment or staff, or those of an associated CFC, to perform the service in New Zealand. These limitations have caused difficulties in practice.

The Act replaces these limitations with requirements that the person performing the service in New Zealand:

- is not the CFC;
- is subject to New Zealand tax on income that they receive from performing the service (either because they are resident in New Zealand or earn the income through a fixed establishment in New Zealand), and;
- performs the service as part of a substantial telecommunications business in New Zealand.

This amendment is designed to maintain protection of the New Zealand tax base while accommodating commercial arrangements that existed before the enactment of the recent CFC rules.

AMENDMENTS TO THE EXEMPTION FOR INSURANCE CFCS

Sections 91AAQ(5B) and 91AAQ(4)(b) of the Tax Administration Act 1994

As part of the Taxation (International Tax, Life Insurance, and Remedial Matters) Act 2009, an exemption was introduced for insurance CFCs as a transitional measure until further work was done to develop special rules for financial CFCs more generally.

To qualify for this exemption the insurance CFC must first have applied for and obtained a determination from the Commissioner of Inland Revenue, and this determination must not have expired or been revoked. Section 91AAQ of the Tax Administration Act 1994 regulates this process.

Discretion for Commissioner to impose conditions on a determination

The Act inserts section 91AAQ(5B) which enables the Commissioner to stipulate conditions that must be satisfied in addition to the existing requirements for a CFC or CFC group member to qualify as a non-attributing active CFC. For example, a determination could be made conditional on the insurer informing the Commissioner of any significant changes to its organisational structure, funding or major business activities.

Note that the Commissioner already has the ability to revoke a previously issued determination.

Reinsurance claim income is disregarded

To be granted a determination that an insurance CFC is a non-attributing active CFC, the Commissioner must be satisfied that the CFC does not earn a significant amount of its income from activities unrelated to the provision of insurance services that cover risks in the CFC's jurisdiction.

This is achieved through subparagraph 91AAQ(4)(b) which requires the Commissioner to consider if the insurance business of the CFC or group of CFCs earns all or nearly all of its income from:

- premiums from insurance contracts (excluding reinsurance premiums) that cover risks that arise in the country or territory of the business of the CFC; and
- proceeds from investment assets, but only if those investment assets are commensurate with the value of the insurance contracts.

There are basically three ways that an insurance CFC could fail to satisfy these requirements:

- if it earned a significant proportion of income unrelated to premiums or investment proceeds, for example, banking or sales income;
- if it earned a significant proportion of income from reinsurance premiums, or from premiums derived from insurance contracts that cover risks from a jurisdiction that is different from the one in which the CFC's business is located. Reinsurance premium income is disregarded because reinsurance contracts may effectively be insuring an ultimate risk that is in a different jurisdiction from the one in which the CFC is located; and
- if the CFC held a level of investment assets that was in excess of the level that comparable insurance businesses would generally hold and earned a significant proportion of its income from these excess assets.

The original provision failed to recognise that insurers can receive another type of income in the form of reinsurance claim income for liabilities which they have reinsured. Amounts from reinsurance claims could be significant in some years when adverse events arise.

It would not be sensible to deny a determination in such circumstances as this would discourage insurance CFCs from taking out reinsurance to spread their risk.

For this reason, subparagraph 91AAQ(4)(b) of the Tax Administration Act has been amended to exclude reinsurance claim income when considering the total income of the CFC. Note that reinsurance premium income is still included when considering the total income of the CFC.

REVALUING FORMER GREY LIST SHARES THAT WERE INHERITED AT A NIL COST

Section EX 67B

The Act re-values some foreign shares that were inherited at a nil cost before 1 April 2007. This revaluation can have two tax consequences. First, the shares could enter into the FIF attribution rules. Secondly, in cases when the shares are held on revenue account and the shares have a market value that is higher than the market value on the date of inheritance, the holder will be taxed on the difference between these two values.

In cases when the shares are held on revenue account and the shares have a market value that is higher than the market value on the date of inheritance, they will be taxed on the difference between these two values.

Application date

The revaluation of these shares occurred on 7 May 2012.

Key features

New section EX 67B applies to shares in FIFs that were inherited at zero cost. It applies only if the FIF was a grey list company at the time the shares were inherited and if the shares were inherited before 1 April 2007 (when the grey list exemption was abolished for portfolio shares). These shares are subject to a deemed sale and reacquisition at market value on the 7 May 2012.

The deemed sale and reacquisition can have two tax consequences. First, the shares could enter into the FIF attribution rules. The FIF rules will not apply if the total cost of the person's FIF interests (including the newly determined market value of the re-valued shares) is less than $50,000, unless the person elects to apply the FIF rules (see subsections CQ 5(1)(d) and (e)). They will also not apply if some other exemption (for example, sections EX 31 to 39) applies to the shares.

Example

Sandy inherited some foreign shares at zero cost. The inherited shares have a market value of $20,000 on 7 May 2012 which is the date that section EX 67B re-values them. Sandy has some other foreign shares that are worth $40,000, although $5,000 of these shares are in ASX-listed companies that qualify for the section EX 31 exemption.

Excluding the ASX-listed shares, the value of Sandy's foreign shares is $55,000. This is more than $50,000, so Sandy must apply the FIF rules to the foreign shares (other than the ASX-listed foreign shares), beginning from the income year that includes 7 May 2012.

Secondly, in cases when the shares are held on revenue account, there may be a taxable gain, depending on whether the shares have become more valuable since they were inherited. If the market value of the person's shares at the time of the disposal in section EX 67B(2) is more than the market value at the time of the inheritance, any revenue account gain on the affected shares is limited to an amount equal to the difference between the market value at the time of the disposal and the market value on the date the shares were inherited. If the market value of the person's shares at the time of the disposal in section EX 67B(2) is less than the market value at the time of the inheritance, the person is treated as having no revenue account gain or loss on the shares.

If there is a revenue account gain on the shares, the resulting tax liabilities are able to be spread over three consecutive years, with at least one-third paid in the first year after the year the disposal takes effect, one-half of the remaining tax paid in the second year, and the rest in the third year.

A taxpayer can only spread revenue account income. They cannot spread FIF income that arises after the deemed reacquisition.

Example 1

John inherited shares at a zero cost on 5 January 2001. The shares had a market value of $20,000 on 5 January 2001. The shares are worth $30,000 on 7 May 2012. Because the shares are held on revenue account, John is taxed on the $10,000 difference between these two market values. The $3,300 tax liability can be spread over three years, in which case John would pay $1,100 in each of the next three years.

Example 2

Sam inherited shares at a zero cost on 6 November 2006. The shares had a market value of $200,000 on 6 November 2006. The shares are worth $100,000 on 7 May 2012. Sam would not have a tax liability under section EX 67B(2B) and this section does not create a revenue account loss.

NEW RESIDENTS' SUPERANNUATION SCHEMES

Section EX 42

The exemption from the FIF rules for rights in a foreign employment-related superannuation scheme has been amended to properly reflect the policy intent. The exemption applies to contributions made while a person is non-resident or in the first four full income years after becoming resident. This amendment will ensure that ongoing fluctuations in the value of those exempt contributions, which occur after the four-year period ends, are also exempt from attribution under the FIF rules.

Background

The FIF rules contain an exemption for certain rights held in a foreign employment-related superannuation scheme. The exemption was introduced in 1992 and extended in 2006. Contributions to a qualifying foreign superannuation scheme made before a person became resident or in the first four full income years after becoming resident (the "exempt period") are not treated as being part of an attributing interest in a FIF. Contributions made outside the exempt period are attributing FIF interests (if they exceed the $50,000 minimum threshold).

The policy intent is for ongoing gains and losses in the value of the non-attributing contributions made during the exempt period – for example, arising from investment gains or exchange rate fluctuations – to also be non-attributing interests. This policy was reflected in the original legislation. Since 2006, however, ongoing fluctuations in the value of contributions made during the exempt period have inadvertently been attributable. Whether gains are exempt from the FIF rules now depends on when those gains accrued, not on which contributions they are attributable to. This was an unintended consequence of rewriting the formula in section EX 42 of the Income Tax Act 2007 to incorporate the extension.

The result is that a portion of a person's foreign superannuation interest could be non-attributable one year and attributable the next, even if that person made no further contributions after the end of the fourth full income year since becoming resident.

Key features

Section EX 42 has been amended to ensure that the policy intent of the provision is achieved. The exemption from the FIF rules for interests in a foreign employment-related superannuation scheme will apply to:

- contributions made while a person is non-resident or in the first four full income years after becoming resident; and
- gains and losses in the value of those contributions that accrue after the end of the four-year period (section EX 42(2)(c)).

In other words, if a person does not make any further contributions to their foreign superannuation scheme after the end of the four-year period, they will not have any attributable FIF income in relation to that foreign superannuation interest.

Contributions made after the four-year period ends, as well as ongoing gains on those contributions, will remain attributing FIF interests subject to the $50,000 minimum threshold.

Note that contributions and associated gains that are exempt from the FIF rules under section EX 42 may still be taxable on distribution to a New Zealand resident.

Application date

The amendment applies from the date of Royal assent, being 7 May.

REPEAL OF BRANCH EQUIVALENT TAX ACCOUNTS OF COMPANIES AND CONDUIT TAX RELIEF ACCOUNTS

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 made major changes to the tax treatment of foreign investments.

Those changes made branch equivalent tax accounts of companies (BETAs) and conduit tax relief accounts (CTRAs) obsolete.

At the time, the Government announced that these memorandum accounts would be retained for a transitional period of two years, to allow the use of remaining BETA debits (to prevent double-taxation of foreign income) and the distribution of conduit-relieved income (to prevent the dilution of foreign dividend payment credits).

The new Act removes the BETAs and CTRAs at the end of the relevant period, and repeals associated provisions and references.

Application date

The repeal of BETAs and related provisions applies, in most cases, from the beginning of the fourth income year after the taxpayer becomes subject to the new international tax rules (that is, the first income year beginning on or after 1 July 2012).

A restriction on elections to use BETA debit balances, limiting the use to relieving tax on attributed foreign income that is allocated to the second year under the international tax rules or to an earlier year, applies from the first income year beginning on or after 1 July 2009.

The repeal of CTRAs and related provisions applies from the beginning of the first income year beginning on or after 1 July 2011.

Key features

BETAs have been repealed after three years under the international tax rules passed in 2009. Debit balances will be able to be used to relieve tax on attributed foreign income only where that income is allocated to the second year under the new rules or to an earlier year. BETAs remain for the third year only to allow determination of income and filing of returns for the second year.

CTRAs have been repealed after two years under the 2009 international tax rules. Dividends not paid before that date will not be able to have conduit tax credits attached to them.

Detailed analysis

All references are to the Income Tax Act 2007, unless noted.

Branch equivalent tax accounts (BETAs) of companies

Branch equivalent tax accounts of companies are being phased out. Branch equivalent tax accounts of individuals (non-companies) are unaffected.

Paragraph FM 6(3)(d)

Paragraph FM 6(3)(d) has been repealed along with BETA accounts of companies. Dividends between companies in a consolidated group are normally ignored, but are still taken into account for the purposes of the rules relating to BETAs. Once BETAs of companies cease to exist, this section will become redundant.

Section GB 40

Section GB 40 has been repealed. Arrangements to avoid continuity restrictions on BETA account balances will cease to be relevant when BETA account balances are repealed.

Arrangements affecting balances before the repeal will still be caught, since the section applied at the time.

Paragraphs OA 2(1)(d), 5(5)(a), 5(5)(c), 6(5)(a), 6(5)(c), subparagraphs OA 7(2)(d)(i) and (iii), paragraphs OA 8(6)(c) and (g)

These provisions have been repealed or altered. With the repeal of BETAs of companies from the first income year beginning on or after 1 July 2012, no further credits or debits will arise in the accounts and there will not be any balances in the accounts. No further BETA debits will be used by companies to meet tax liabilities.

Section OA 9(4), paragraphs OA 10(1)(d) and 10(3)(c), subsection OA 14(6), and paragraphs OA 15(1)(c) and 15(3)(c)

These provisions have been repealed or altered. Previously, if an amalgamating company had a BETA, BETA debits and credits had to be transferred across to the BETA of the amalgamated company. The requirement to transfer will no longer be necessary if either the amalgamating or amalgamated company has no BETA account.

Paragraph OB 4(3)(h)

Paragraph OB 4(3)(h) has been repealed. From the beginning of the first income year beginning on or after 1 July 2012, a company will not be able to make an election to use a BETA debit balance to meet an income tax liability. In addition, even if it makes an election before that date, it will not be able to make the election in respect of a tax liability for income relating to an income year beginning on or after 1 July 2011. Paragraph (h) will therefore be redundant.

Subsections OE 7(3) and OP 101(2)

When the repeal of BETAs of companies was announced, the Government said that there would be a two-year transitional period during which existing debit balances could continue to be used.

That is, companies will still be able to reduce their tax liability for attributed foreign income earned in the first two income years following application of the new income tax rules.

Because the amount of income for the second year will not be known immediately, it will be impractical to make elections to use BETA debit balances before the end of the second year. For that reason, BETAs will remain for a third year.

New requirements have been introduced in sections OE 7 and OP 101 to prevent elections to use BETA debits unless:

- the election is made before the end of the third income year; and
- the election relates to a tax liability for attributed foreign income that has been allocated to the second year or to an earlier year.

These requirements apply retrospectively from the date of application of the new international tax rules.

Subsections OE 1(1) and (3), sections OE 2 to OE 4, OE 6 to OE 16B and OP 97 to OP 104B

These provisions, which impose requirements on BETA companies to keep BETAs and make appropriate entries in them, have been repealed with effect from the first income year beginning on or after July 2012. The BETA mechanism for companies and requirements to keep such accounts will be no longer required from that date.

Accounts must still be kept for the final year of the BETAs, even if only for a part tax year because of the repeal (BETAs always have a 31 March "balance" date, which may not correspond to the end of an income year). Relevant information must also be provided in an imputation credit account (ICA) return for the final year, and records must continue to be kept for the normal record-keeping period (see commentary on changes to the Tax Administration Act 1994, below).

Subsection OE 5

This provision has been modified to apply only to BETA accounts of individuals, following the repeal of the rules for companies.

Section OZ 16

This provision was repealed at the same time as BETAs of companies. This was a transitional provision to reduce remaining balances in BETAs following changes to the corporate tax rate in Budget 2010.

Subparagraph YC 17(12)(b)(iii) and subsection YC 18B(3)

These provisions have been repealed or modified to remove redundant references to BETAs.

Paragraph 22(2)(f) and subsection 22(7) of the Tax Administration Act 1994

References to BETA accounts were redundant from the time those accounts were repealed, so have been removed. Records for periods when BETA accounts were in existence are still required to be kept – that requirement arose before the repeal.

Paragraph 69(1)(e) of the Tax Administration Act 1994

This paragraph has been repealed. BETA information of companies will no longer have to be included in the annual ICA return under this section, once returns have been completed for the tax years up to and including the year during which BETAs were repealed. It is possible that the BETA will not exist for the entire tax year in the year BETAs are repealed. Nevertheless, under the existing provision, the company is still required to include relevant BETA information in the ICA return (the person was a BETA company during the tax year).

Section 77 of the Tax Administration Act 1994

This provision has been repealed. The provision previously required an amended annual ICA return if a retrospective election to be a BETA company was made, to ensure that a complete record of BETA transactions would be returned. It will not be possible to make elections to become a BETA company from the beginning of the income year beginning on or after 1 July 2012, retrospective or not. Since an ICA return must already (under section 69) be provided for any tax year falling wholly or partly within the last income year for which a BETA exists, section 77 is now redundant.

Conduit tax relief accounts

Section CW 11

Section CW 11 has been repealed. Dividends that are fully credited for conduit tax relief will no longer be exempt income of conduit tax relief holding companies if they are paid later than the beginning of the first income year of the recipient beginning on or after 1 July 2011. A number of consequential amendments have been made to remove references to section CW 11 in other provisions.

Section FE 21(12)(a)(ii)

Section FE 21(12)(a)(ii) has been repealed. It will neither be possible for companies to attach conduit tax relief credits to dividends, nor to be conduit tax relief holding companies, from income years beginning on or after 1 July 2011. This makes section FE(12)(a)(ii) redundant from the beginning of that income year.

Section GZ 2

Section GZ 2 has been repealed, on the same date as CTRAs (income years beginning on or after 1 July 2011). This was an anti-avoidance rule, which after the repeal of CTRAs, became redundant and its removal from the Income Tax Act 2007 therefore aids clarity. Note that prior to the date of repeal, the Taxation (International Investment and Remedial Matters) Act 2012 makes some remedial amendments to section GZ 2.

The rule in section GZ 2 was enacted to prevent people from accumulating CTRA credit balances in anticipation of them being cancelled under the 2009 international tax rules, and then effectively directing tax-relieved income to residents.

The rules apply to an arrangement involving transactions that occurred between the date on which repeal of conduit accounts was announced and the enactment of the international tax rules, after which further conduit tax relief was prevented. The anti-avoidance rule will still apply to such arrangements even after repeal of section GZ 2. The rule still applies because the arrangement was entered into before the repeal and the rule would have applied at that time, triggering the imposition of additional income tax.

Section HG 2(4)(c)

Section HG 2(4)(c) has been repealed. This provision states that partnerships are not subject to the “no streaming” rules in subsection HG 2(2) in respect of CTR additional dividends. There will be no such dividends paid in any income year beginning on or after 1 July 2011.

Section LQ 5

Section LQ 5 has been repealed. Since conduit tax credits will no longer be attached to dividends by a company in any income year beginning on or after 1 July 2011, CTR additional dividends will not be payable by the company from that time either.

Paragraph OA 2(1)(c), subsections 5(4) and 6(4), paragraph OA 7(2)(c), and subsections OA 8(5) and 18(1)

These paragraphs and subsections have been repealed. With the repeal of CTRAs from the first income year beginning on or after 1 July 2011, no further credits or debits will arise in the accounts and there will not be any balances in the accounts. No further CTR credits will be attached to dividends.

Paragraphs OA 10(1)(c), 10(3)(b), subsection OA 10(4) and paragraphs OA 15(3)(b), OB 24(3)(c) and OB 53(3)(c)

These paragraphs have been repealed or altered. At one time, if an amalgamating company had a CTRA but the amalgamated company did not, CTR credits were converted to imputation credits and FDP was paid. The requirement to transfer the credits ceased when the 2009 international tax rules came into force.

Sections OC 19 and OP 70

These sections were repealed because CTRAs have ceased. They allow for a transfer from a foreign dividend payment memorandum account to a CTRA in certain circumstances. With no CTRA, such transfers will no longer be possible.

Subpart OD and sections OP 78 to 80, OP 83 to 87, OP 89 to 94 and OP 96

The subpart and sections, which impose requirements on CTR companies to keep CTRAs and make appropriate entries in them, have been repealed with effect from the first income year beginning on or after July 2011. From that time, there will be no CTRAs to meet requirements for.

Accounts must still be kept for the final year of the CTRAs, even if only for a part tax year because of the repeal (CTRAs always have a 31 March “balance” date, which may not correspond to the end of an income year). Relevant information must also be provided in an ICA return for the final year, and records must continue to be kept for the normal record-keeping period (see commentary on changes to the Tax Administration Act 1994, below).

Section OZ 17

Section OZ 17 was repealed at the same time as CTRAs. This was a transitional provision to reduce remaining credit balances in CTRAs following changes to the corporate tax rate in Budget 2010.

Paragraphs RF 8(1)(c) and (f), subsections RF (9)(1), 9(6) and (7), paragraph RF 10(3)(a), subsection RF 10(4), paragraph RF 10(5)(e) and subsection RF 10(7)

These paragraphs were repealed or modified at the same time as CTRAs, since it will no longer be possible to attach CTR credits to dividends or to pay a CTR additional dividend.

Sections YD 9 to YD 11

Sections YD 9 to YC 11 were repealed at the same time as CTRAs. A CTRA holding company must be a CTR company, so these provisions have become redundant following the repeal of CTRAs.

Paragraph 22(2)(k) and sections 29, 30A and 68A of the Tax Administration Act 1994

References to CTR accounts or to CTR credits were redundant from the time those accounts were repealed. CTR credits can no longer be attached to dividends, so these references have been removed.

Paragraph 69(1)(f) of the Tax Administration Act 1994

This paragraph has been repealed. CTRA information no longer has to be included in the annual ICA return under this section, once returns have been completed for the tax years up and including the year during which CTRAs were repealed. It is possible that the CTRA will not exist for the entire tax year in the year CTRAs are repealed. Nevertheless, under the existing provision, it is still required to include relevant CTRA information in the ICA return (the person was a CTR company during the tax year).

REMEDIAL AMENDMENTS: BRANCH EQUIVALENT TAX ACCOUNTS OF COMPANIES

Sections OE 6, OE 9, OP 100 and OP 103

The Act makes minor changes to branch equivalent tax accounts (BETAs) to ensure that these cannot go into credit.

Following the changes in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, all credit balances in branch equivalent tax accounts of companies (BETAs) were cancelled.

However, debit balances remained for a transitional period of two years. As these debit balances are used, credits are put into the account to cancel them out.

Minor changes to the rules are included in the new legislation to ensure that BETAs cannot go back into an overall credit balance as a result of these credits.

Credits arising under sections OE 6, OE 9, OP 100 and OP 103 are now limited to the amount of an overall debit balance in the account at the time.

Application date

The remedial amendment applies to income years beginning on or after 1 July 2009.

AMENDMENT TO NON-RESIDENT EXCLUSION FROM CONDUIT ANTI-AVOIDANCE RULE

Section GZ 2

The conduit anti-avoidance rule in section GZ 2 has been amended to exclude conduit tax relief received by a CTR-group member to the extent that the CTR group member is owned by non-residents.

Application date

The remedial change to section GZ 2 applies to income years beginning on or after 1 July 2009.

Note that the Taxation (International Investment and Remedial Matters) Act 2012 also includes a provision to repeal section GZ 2 that applies from the beginning of the first income year beginning on or after 1 July 2011. This is because section GZ 2 has now become redundant and so it makes sense to remove it from the Income Tax Act 2007 at the same time as conduit tax relief accounts, in order to aid clarity. The amendment described here therefore affects only the first two years of the new CFC rules.

Key features

Under the conduit tax rules, chains of New Zealand holding companies were defined as "CTR group members" and each CTR group member was treated as non-resident for the purposes of the conduit rules to the extent that it was owned by non-residents (see sections YD 9 to YD 11).

The conduit anti-avoidance rule is intended to apply to tax relief arrangements that ultimately benefit a New Zealand-resident investor. Amendments have been made to the conduit anti-avoidance rule in section GZ 2 and the application of sections YD 9 to YD 11 to ensure that the definitions of resident and non-resident are consistent with those that previously applied under the recently repealed conduit tax relief rules.

Background

The conduit anti-avoidance rule is intended to claw back conduit tax relief from arrangements that were entered into in anticipation of the repeal of the conduit rules, and that had the effect of reducing the tax liabilities of New Zealand shareholders. This reflects the fact that conduit tax relief was designed to relieve tax on non-residents investing through New Zealand into CFCs.

Conduit tax relief was not intended to apply to income that was ultimately owned by New Zealand residents. The conduit anti-avoidance rule applies to arrangements that generated conduit tax relief credits between 4 December 2007 (when an issues paper announcing this policy was released) and the date from which conduit tax relief was repealed. The anti-avoidance rule does not apply to conduit tax relief received by the conduit tax relief company itself, or by a CTR holding company for the CTR company.

These exclusions are intended to ensure that the anti-avoidance rule does not apply to residents that are holding companies for non-resident investors. However the exclusions fail to accommodate conduit tax relief companies that are held through a chain of more than two New Zealand companies that are ultimately owned by non-residents. Under the conduit tax rules such chains of companies were defined as "CTR group members" and each CTR group member was treated as non-resident for the purposes of the conduit rules to the extent that it was owned by non-residents (for example, a CTR-group member that was 100% owned by non-residents would be 100% non-resident). (See sections YD 9 to YD 11.)

Consistent with this, the Act amends the anti-avoidance rule in section GZ 2 so that this rule does not apply in respect of conduit tax relief received by a CTR-group member to the extent that the CTR-group member is owned by non-residents.

LOSSES OF CONTROLLED FOREIGN COMPANIES – TRANSITIONS

Sections IQ 2B(1) and (2)

Transitional provisions dealing with losses arising under the old international tax rules, and carried forward under the new international tax rules, have been reworded to ensure the policy intent of these provisions is realised.

Subsections IQ 2B(1) and IQ 2B(2)

These provisions reduce carried-forward losses of controlled foreign companies (CFCs). This is because the losses arose at a time when all income was expected to be taxed, whereas only passive income is taxed under the new international tax rules.

CFC losses are "ring-fenced" by country, so that they may be used only to offset CFC income from the same country. References to "a CFC or FIF that is resident in a country" were intended to refer to this ring-fencing, but may have created doubt that the transitional provisions apply to carried-forward losses of CFCs that have been liquidated or migrated.

The provisions have been reworded to make clear that the transitional rule applies to all ring-fenced losses, as intended.

The changes apply to income years beginning on or after 1 July 2009.

FOREIGN TAX CREDITS OF CONTROLLED FOREIGN COMPANIES – TRANSITIONS

Section LK 5B

Transitional provisions dealing with foreign tax credits arising under the old international tax rules, and being carried forward under the new international tax rules, have been reworded to ensure the policy intent of these provisions is realised.

Subsections LK 5B(1) and LK 5B(2)

These provisions are intended to reduce carried-forward foreign tax credits of controlled foreign companies (CFCs).

The provisions have been reworded to make clear that the transitional rule applies to all carried-forward credits, as intended.

The changes are analogous to those for carried-forward losses (see the section on carried-forward losses above).

The changes apply for income years beginning on or after 1 July 2009.

OTHER REMEDIAL CHANGES

Sections HA 8B, DX 3, IQ 2B(11), YA 1 and schedule 31 of the Income Tax Act 2007, and section 183AA(4)(b) of the Tax Administration Act 1994

Section HA 8B has been amended to remove a reference to "attributing". This clarifies that qualifying companies cannot hold any non-portfolio interests in FIFs (including non-attributing active FIFs and FIFs that qualified for the grey list exemption). This change was necessary as qualifying companies would otherwise be able to distribute dividends from such FIFs with no further tax impost. This would have been inconsistent with the fact that such dividends would have been taxable if they were paid directly to non-company shareholders.

Section DX 3 has been repealed with effect from the 2013–14 income year. This repeal was missed when other provisions relating to supplementary dividend holding companies were repealed in an earlier amending act.

A new subsection IQ 2B(11) provides an explicit currency conversion rule for determining carried-forward losses during a transitional period from the old to the new international tax rules. An explicit rule was not provided at the time the transitional rule was first enacted. The rule follows, broadly speaking, the existing treatment of foreign currency amounts in subpart YF. The amendment has retrospective effect.

The section YA 1 definition of "old company tax rate", which is used for imputation credit transitional rules, has been updated to account for two old rates, 30% and 33% and the fact that the company tax rate reduced to 28% from 2011–12.

The table in schedule 31 has been updated to provide the correct abatement figures for Working for Families tax credits.

Section 183AA(4)(b) of the Tax Administration Act 1994 has been re-enacted to ensure it has the right effective date. This corrects an error in the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010.

BUDGET 2012

The Taxation (Budget Measures) Bill was introduced under urgency on 24 May 2012. On 25 May 2012, at the Committee of the Whole House stage, the Bill was split by Supplementary Order Paper No 31 into two amending acts: the Student Loan Scheme (Budget Measures) Amendment Act 2012 and the Taxation (Budget Measures) Act 2012. The resulting legislation was enacted on 29 May 2012.

The Student Loan Scheme (Budget Measures) Act 2012 repealed the 10% student loan voluntary repayment bonus.

The Taxation (Budget Measures) Act 2012:

- repealed the tax credits for income under $9,880 and the tax credit for childcare and housekeeper expenditure;
- replaced the tax credit for the active income of children with a limited tax exemption; and
- legislated a change to the livestock valuation election rules.

STUDENT LOAN SCHEME (BUDGET MEASURES) AMENDMENT ACT 2012

REPEALING THE VOLUNTARY REPAYMENT BONUS

Sections 118 (repealed), 121(1)(a) (repealed), 121(1)(b) (repealed), Part 3 Subpart 1 (repealed), 110, 111 of the Student Loan Scheme Act 2011

Sections 31(2), 32, 37, 39, 40 of the Student Loan Scheme Amendment Act 2012 all repealed

Background

The objective of the bonus scheme was to encourage faster repayments by borrowers who were slow to repay their student loan and, as a consequence, to reduce the costs to the Government of the Student Loan Scheme. The voluntary repayment bonus took effect from 1 April 2009 and gave borrowers a 10% bonus for any repayments of $500 or more over and above the borrower's repayment obligations.

The voluntary repayment bonus is not fulfilling its policy intent of encouraging faster repayments from those slow to repay and the level of savings from the voluntary repayment bonus is lower than originally estimated. The take-up of the policy has largely been by individuals who were already paying back their loans quickly.

Key features

The Student Loan Scheme Act 2011 and the Student Loan Scheme Amendment Act 2012 have been amended to repeal the voluntary repayment bonus.

- The voluntary repayment bonus will be repealed from 1 April 2013 with effect from the 2013–14 tax year.
- Payments that are made after the 2012–13 tax year but are deemed to have been made in that tax year (for example final interim payments due on 7 May 2013) will continue to be included in the bonus calculation for that tax year.
- Voluntary repayment bonuses granted for the 2012–13 year will be taken into account when assessing overseas-based borrower repayment obligations for the 2013–14 tax year.

Application date

The repeal of the voluntary repayment bonus comes into effect on 1 April 2013.

The consequential amendments to how overseas-based borrower obligations are set come into effect on 1 April 2014.

Detailed analysis

The terms "10% bonus" and "final excess repayment" are no longer defined in the Act (section 118 repealed).

Borrowers will no longer be eligible for a 10% bonus on excess repayments from 1 April 2013 (sections 121(1)(a), 121(2)(b) and subpart 1 of Part 3 all repealed).

When an overseas-based borrower's repayment obligation is determined the consolidated loan balance is no longer adjusted to take into account any voluntary repayment bonus for the previous tax year (sections 110 and 111 both repealed).

The spent amending provisions in the Student Loan Scheme Amendment Act 2012 are repealed (sections 31(2), 32, 37, 39, 40 all repealed).

TAXATION (BUDGET MEASURES) ACT 2012

TAX CREDIT CHANGES

Sections CW 55BB, LC 3 to LC 12, YA 1 and schedule 2 of the Income Tax Act 2007 and 24B, 24H and 41A of the Tax Administration Act 1994

As part of Budget 2012, changes were made to three tax credits that have become outdated—the income under $9,880 tax credit, the tax credit for childcare and housekeeper expenditure, and the tax credit for the active income of children. The first two credits were repealed while the last was replaced by a limited tax exemption.

Background

These credits were identified by the Government as poorly targeted, outdated and inconsistent with New Zealand's broad-based, low-rate tax framework. Claiming the credits was often the sole reason for many people filing tax returns.

Key features

- Three tax credits have been changed, effective from the 2012–13 and later tax years:
  - the income under $9,880 tax credit (referred to in the legislation as the "transitional circumstances tax credit");
  - the tax credit for childcare and housekeeper expenditure;
  - the tax credit for the active income of children.
- The first two credits have been repealed, while the last has been replaced with a limited tax exemption.

Detailed analysis

Repeal of tax credits

The Taxation (Budget Measures) Act 2012 repeals sections LC 3 through to LC 12. These are the sections dealing with the income under $9,880 tax credit, the tax credit for childcare and housekeeper expenditure, and the tax credit for the active income of children.

Several consequential omissions or amendments to definitions in section YA 1 have also been made, reflecting that these credits have been repealed. Section 41A of the Tax Administration Act 1994 has been similarly amended.

Transitional rules

These changes have effect from the 2012–13 tax year. This application date is possible as, by and large, these credits are claimed at year-end by filing tax returns. However, it was possible to claim two of the credits—the income under $9,880 credit and the credit for the active income of children—during the year through the PAYE system. Because of this, the amended Act contains transitional provisions.

The objective of these provisions is to allow employers to continue their current payroll and PAYE-withholding practices until 31 March 2013. The transitional rules are also designed to ensure that a taxpayer receiving these credits through the PAYE system is not required to file solely because of this. To support this objective, people currently claiming these credits through the PAYE system will be able to get the benefit of the credits in the 2012–13 tax year if they do not file a tax return. If they do file, their tax liability will be assessed as it is for other taxpayers; the credits will not be available. This may mean that they have tax to pay as their employer will have deducted insufficient tax throughout the year.

Schedule 2 of the Income Tax Act and section 24B of the Tax Administration Act are amended, both with effect from the 2013–14 and later tax years. The effect of these amendments is that the "ML" tax code, which allows a taxpayer to claim the income under $9,880 tax credit through the PAYE system, remains available for the remainder of the 2012–13 tax year, after which it is repealed.

These amendments work in concert with the repeal of section 24H(7), which has effect from the beginning of the 2012–13 income year. This provision prohibited the use of the "ML" code by someone who was not eligible for the tax credit; the omission of the provision means people are able to remain on the "ML" code despite the repeal of the credit.

There is no specific provision in the Income Tax Act that provides for the tax credit for the active income of children to be claimed through the PAYE system. Instead, this is achieved under a Commissioner's discretion in section RD 11, which allows the Commissioner to modify the PAYE rules in respect of a class of persons. The Commissioner will continue to exercise this discretion, allowing the credit to be claimed through the PAYE system, until 31 March 2013.

Limited tax exemption for children

New section CW 55BB is inserted providing that a school child does not need to pay tax on up to $2,340 of income which is not taxed at source (such as money for mowing the neighbour's lawn). The exemption does not apply to income on which tax has already been paid, such as salary and wages or interest.

If a child earns more than $2,340 from income which is not taxed at source, the exemption does not apply to any of the income. The child is required to pay tax on the full amount.

For the purposes of this new section, a school child is someone who is:

- 14 or under;
- 15, 16 or 17 and still attending school (excluding tertiary institutions); or
- 18, and turned 18 on or after 1 January in the previous tax year and continued at school.

Example

Kate is at secondary school and has a part time job at the local retail store earning about $2,000 a year. Her employer deducts PAYE from her wages each week. Kate also gets paid for the occasional babysitter job for neighbours. She makes around $300 a year from babysitting. She also earns $50 in interest on her savings from which Resident Withholding Tax (RWT) is deducted.

Under the previous tax credit for a child's active income, Kate could file a tax return to claim back her PAYE, but not her RWT. The tax credit would also offset the tax payable on her babysitting income. With the new child's income tax exemption, Kate would not be required to file and pay tax on the babysitting income. She would not be able to claim back the PAYE or RWT.

Application date(s)

These changes apply for the 2012–13 and later tax years unless specified above.

LIVESTOCK ELECTIONS

Sections EC 8(3) of the Income Tax Act 2007

As part of Budget 2012, the tax rules have been changed so that elections to use the herd scheme method are effectively irrevocable. This means that farmers using other valuation methods are able to elect into the herd scheme method, but once they have elected into it, they are generally unable to exit and change to another valuation method. For farmers that have elected out of the herd scheme method since 18 August 2011, their elections are ineffective.

Previously, the ability to switch methods effectively allowed farmers to time their elections in and out of the herd scheme method to maximise the tax-free herd scheme gains and the tax deductible result of exiting from the herd scheme.

Further, related changes are planned to be made in a tax bill that is expected to be introduced later this year. These changes will include an exception that allows famers to elect out of the herd-scheme method if they are changing to a fattening operation. As with the change to the election rules enacted on 29 May 2012, the application date for the exception is expected to be 18 August 2011.

The application date of other related changes is generally expected to be 28 March 2012, being the date that the Minister of Finance and the Minister of Revenue issued a media statement announcing the Government's intention to tighten the livestock valuation election rules.

Background

The term "specified livestock" refers to dairy cattle, beef cattle, sheep, deer, goats and pigs. Under the Income Tax Act 2007 there are two main methods that farmers use to value specified livestock. These methods are the herd scheme, and national standard cost.

The herd scheme method of valuation recognises that specified livestock can have characteristics of capital assets (for example, the ability to produce milk and progeny) and, for tax purposes, should be treated as a capital asset. The herd scheme uses annually announced national average market values to value livestock. The effect of using this method is that gains and losses in value are treated as being of a capital nature for tax purposes and are therefore outside the tax base.

The national standard cost method treats specified livestock as trading stock that is held on revenue account. This method uses national average costs (except for livestock purchases, where actual costs are used) rather than farm-specific costs. The effect of using the national standard cost method is that gains and losses in value are treated as being of a revenue nature for tax purposes.

Farmers are able to move between these two valuation methods. The original policy intent for allowing farmers to switch between these methods was to recognise that when there is a change in the type of farming operation, it may be appropriate to change the valuation method.

However, farmers could previously time their elections in and out of the herd scheme to maximise the tax-free herd scheme gains and the tax deductible result of exiting from the herd scheme. This was not in line with the original policy intent for changing between valuation methods.

Application date

The application date is 18 August 2011. This is the date that the officials' issues paper was released for public consultation.

ITEMS OF INTEREST

MOVEMENT OF ASSESSMENT FUNCTION FROM THE ADJUDICATION UNIT TO THE SERVICE DELIVERY GROUP

From 1 July 2012 the responsibility for making assessments in disputed cases that have been considered by the Adjudication Unit has been shifted to the Service Delivery Group (SDG).

Disputes come to the Adjudication Unit as part of the dispute resolution process. The Adjudication Manager previously made any necessary assessments in respect of disputed matters referred to Adjudication. The initiating entries for making the computer-generated notice of assessment were done by SDG officers based on the conclusions set out in the Adjudication report. Under the law there is a difference between the making of an assessment and giving notice of that assessment, and some tensions and ambiguities existed in respect of adjudicated disputes. An example is the potential ambiguity as to who held all the necessary information to make the final decision, with a different assessing officer from the person who formed the Commissioner's *proposed* adjustment, especially in light of the impact of the evidence exclusion rule (which relates to the Statement of Position). In addition, a lack of clarity sometimes arose as to the start date from which any subsequent challenge timeframes ran.

Disputes will continue to be referred to Adjudication in most cases as previously (eg, unless an exception applies in terms of s 89N(1)(c) of the Tax Administration Act 1994). The change is that the relevant SDG officer will now formally make any assessments that may be required, rather than the Adjudication Manager. This resolves the previous ambiguities and tensions, and provides more certainty as to the date from which challenge rights accrue for taxpayers. It also provides more consistency of approach between disputed and non-disputed assessments, as well as between different disputes that are resolved or assessed at different stages of the disputes process.

An important point to note is that in all cases the SDG officer making an assessment will be bound by the Adjudication Unit's conclusions and will assess in accordance with them. Section 114(b) of the Tax Administration Act 1994 ensures that this constitutes a valid assessment.

In disputes that involve a disputable decision and no assessment, the Adjudication Unit will continue to either confirm the decision or retake the decision (as necessary). In all cases, each of the parties will still be provided with an Adjudication Report providing the full reasoning behind the decision (and which will only have a subtle difference in wording as to the decisions made). Taxpayers and practitioners will not notice any significant difference in practice.

If after referral to the Adjudication Unit the taxpayer has been unsuccessful, the two-month response period to file challenge proceedings with the Taxation Review Authority (TRA) or High Court will run from the date of the notice of assessment issued by the SDG officer (unless the taxpayer has previously been provided with a challenge notice in terms of s 89P of the Tax Administration Act 1994).

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 12/07: GOODS AND SERVICES TAX – TREATMENT OF TRANSITIONAL SERVICES SUPPLIED AS PART OF THE SALE OF A BUSINESS (THAT INCLUDES THE SUPPLY OF LAND)

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Question We've Been Asked applies in respect of ss 5(24) and 11(1)(mb) of the Goods and Services Tax Act 1985.

Question

1. We have been asked whether transitional services provided by the vendor as part of the sale of a business (that includes the supply of land) will be zero-rated for GST purposes where:
   - the services and the sale of the business form part of the same contractual arrangement, and
   - the services are not provided for a separately identifiable consideration.

Answer

2. Whether transitional services provided by the vendor as part of a sale of a business (that includes the supply of land) will be zero-rated will depend on whether the transitional services and the business/land are part of the same supply.
3. Most often the business and related land will be part of the same supply. Transitional services will also be part of that same supply (and therefore zero-rated) where they are not an aim in themselves for the recipient, but rather are a means of better enjoying the business supplied. This will include situations where the transitional services provide merely ancillary, incidental, minor or peripheral benefits and are not in any real or substantial sense part of the consideration for which the payment is made. Whether the transitional services are an aim in themselves for the recipient is a question of fact that must be determined in each case.

Explanation

4. Section 11(1)(mb) provides that a supply of goods that is chargeable with tax under s 8 is zero-rated if:

   > (mb) the supply wholly or partly consists of land, being a supply—
   >
   > (i) made by a registered person to another registered person who acquires the goods with the intention of using them for making taxable supplies; and
   >
   > (ii) that is not a supply of land intended to be used as a principal place of residence of the recipient of the supply or a person associated with them under section 2A(1)(c) …

5. The key elements of s 11(1)(mb) are:
   - There must be a "supply".
   - That "supply" must consist "wholly or partly" of land (ie, it will apply no matter how small the land component part of the supply is).
   - The "supply" must be "made by a registered person to another registered person who acquires the goods with the intention of using them for making taxable supplies".
   - The land must not be intended to be used as a principal place of residence of the recipient or an associated person.
6. Where these requirements are satisfied, the supply of land and goods will be zero-rated.
7. Where services are provided as part of a supply for the purposes of s 11(1)(mb), s 5(24) applies to treat the services as a supply of goods. It states:

   > If a supply that wholly or partly consists of land is made, and the supply includes the provision of services, the supply of the services is treated as a supply of goods for the purposes of section 11(1)(mb).

8. The following analysis assumes the third and fourth requirements in paragraph [5] are met and that there is the sale of a business that includes the sale of the land. Where transitional services are supplied as part of the sale of a business that includes the supply of land, whether the transitional services are zero-rated will depend on whether they and the sale of the business/land are part of the same "supply".

What is a "supply" in terms of ss 11(1)(mb) and 5(24)?

9. It has been suggested that the concept of "supply" in ss 11(1)(mb) and 5(24) is wider than "supply" in the rest of the GST Act. However, the Commissioner's view is that "supply" in these sections should be given the same meaning as in the rest of the Act. Section 11(1)(mb) applies where "**the supply** wholly or partly consists of land". This suggests that it is necessary to first find a "supply" and then to determine whether land forms the whole, or a part of, that supply. Further, a zero-rating provision only applies where a supply would otherwise be taxable. The primary provision in the GST Act is s 8. Section 8 charges GST on "the supply" of goods and services. Section 11 then applies to zero-rate "a supply of goods that is chargeable with tax under section 8". This suggests that the supply being considered in s 8 is the same supply that is zero-rated under s 11. "Supply" should, therefore, be given the same meaning in both sections.

10. The courts have developed a number of principles to help determine the relevant "supply" (or supplies) made as part of a transaction. The leading New Zealand case on whether something is a separate supply or part of a larger supply is *Auckland Institute of Studies v CIR* (2002) 20 NZTC 17,685 (HC). This case concerned a taxpayer, the Auckland Institute of Studies (AIS), that specialised in providing educational services to overseas students. A subsidiary was incorporated to carry out AIS's overseas activities. The subsidiary was entitled to charge the students an "overseas assistance fee" for assistance provided to the students prior to their arrival in New Zealand. The students were not charged separately for the overseas assistance fee. Instead, it was part of the fee charged for tuition and other services. The issue was whether the overseas assistance fee was for a separate supply from the supply of tuition services such that the overseas assistance fee would be zero-rated as being for services performed outside New Zealand.

11. Hansen J reviewed the case law on the principles of apportionment, concluding that the cases in the United Kingdom under the Value Added Tax Act 1983 were of assistance. He observed that the approach of the United Kingdom courts had been to sever zero-rated or exempt supplies where it was "practicable and realistic" to do so (*Rayner & Keeler Ltd v CEC* [1991] VATTR 532 at 538). He stated that, for this purpose, an enquiry is made into "the true and substantial nature" of the consideration given for the payment (*Bophuthatswana National Commercial Corp Ltd v CEC* [1993] STC 702 (CA) at 708). In particular, Hansen J considered the following four cases:
    - *British Airways plc v CEC* [1990] BTC 5124 (CA)
    - *CEC v United Biscuits (UK) Ltd* [1992] BTC 5045 (IH acting as the Court of ExD)
    - *CEC v Wellington Private Hospital Ltd* [1997] BTC 5140 (CA)
    - *Card Protection Plan Ltd v CEC* [2001] 2 All ER 143 (HL).

12. Ultimately Hansen J found that the pre-arrival services were ancillary to the supply of tuition services to overseas students in that they helped to facilitate that supply. Therefore in that case the pre-arrival services were not a separate supply and the overseas assistance fee could not be zero-rated.

13. In *College of Estate Management v CEC* [2005] 4 All ER 933 (HL) the House of Lords clarified that a distinct element could be a separate supply even if it was not ancillary to the dominant element of the supply (see also *CIR v Motorcorp Holdings Ltd* (2005) 22 NZTC 19,126). *College of Estate Management* involved the provision of distance-learning courses. The College provided students with written materials, face to face teaching and examination services. The issue was whether the written materials were a separate supply. The tribunal found that the written materials were not an end in themselves for the students. Further, although the means of educating the students relied principally on the provision of the written materials that did not detract from the College providing overall a single supply of education. The tribunal concluded that the College made a single supply of the provision of education and that the supply of the printed materials was an ancillary element and a means of better enjoying the provision of education. The decision was upheld by the High Court and then overturned by the Court of Appeal. On appeal the House of Lords agreed with the tribunal's conclusion that the written materials were not an end in themselves for the students and that the College was making a single supply of education services. However, their Lordships disagreed with the tribunal's conclusion that the supply of written materials was ancillary to the provision of education. They stated at [12]:

    > But the mere fact that the supply of the printed materials cannot be described as ancillary does not mean that it is to be regarded as a separate supply for tax purposes. One has still to decide whether, as a matter of statutory interpretation, the College should

> properly be regarded as making a separate supply of the printed materials or, rather, a single supply of education, of which the provision of the printed materials is merely one element.

14. And further at [30]:

> … there are other cases (including the *Faaborg* case, the *Dr Beynon* case and the present case) in which it is inappropriate to analyse the transaction in terms of what is 'principal' and 'ancillary', and it is unhelpful to strain the natural meaning of 'ancillary' in an attempt to do so. Food is not ancillary to restaurant services; it is of central and indispensable importance to them; nevertheless there is a single supply of services (see the *Faaborg* case). Pharmaceuticals are not ancillary to medical care which requires the use of medication; again, they are of central and indispensable importance; nevertheless there is a single supply of services (see the *Dr Beynon* case).

15. The relevant principles taken from the above cases can be summarised as follows:
    - It is necessary to identify the essential features of the transaction to determine the nature of a supply. This requires consideration of the contract between the parties including identifying the true and substantial nature of the consideration provided for the payment made by the recipient of the supply. The true and substantial nature of the consideration is to be determined objectively.
    - All the circumstances in which the transaction takes place must be considered.
    - Where the supply involves one or more major elements and one or more other elements, the enquiry is to determine whether those non-major elements of the transaction (or consideration given) are:
      - a necessary or integral part of the major elements; or
      - merely ancillary to or incidental to those other elements.

      In either case there will be one supply (including both the dominant and ancillary elements).
    - Where more than one element is major, it is necessary to consider whether the elements are so closely linked as to form a single supply.
    - In either case, where an element is an aim (or an end) in itself for the recipient (rather than a means of better enjoying the overall supply) then it will be a separate supply.

16. Consequently, where a business is being supplied, most often the supply will include all of the elements that make up that business. For example, the supply of a farm may include land, farm buildings, stock, farm vehicles and miscellaneous farm equipment. However, there are circumstances where a single agreement and consideration could involve multiple supplies. An example may be where the agreement for the sale of the above farm also included the sale of a luxury yacht.

17. The following examples illustrate how these principles have been applied by the courts in different fact situations:
    - *British Airways* dealt with a transaction involving air transport. The court considered whether the in-flight catering was a separate supply from the air transport or whether it was merely ancillary/incidental to the air transport such that there was only one supply of air transport. The court accepted the supply of food and beverages was not necessary or essential to the supply of air transport but was merely an optional extra. The cost of the food and beverages was reflected in the price of the ticket but the food and beverages supplied were not in any real and substantial sense part of the consideration (objectively ascertained) for the payment made by passengers. The food and beverages were an ancillary, incidental, minor, or peripheral element of the transaction. Therefore, the court held there was only one supply of air transport.
    - *Sea Containers Ltd v CEC* [2000] BVC 60 (QB) dealt with a transaction involving train travel. The court considered whether the food and drink provided on the day train excursions was a separate supply from the supply of transport. The court considered the catering was an important part of what the customer was paying for. The importance of the catering was demonstrated by the references in the marketing brochures (for the train travel) to "a unique series of lunch and dinner excursions". The court held that the significance of the catering went beyond the point where it could merely be seen as a way of better enjoying the transport element of the transaction. Instead, it was an aim in itself for the customers. Therefore, the court decided the food and drink provided was a separate supply from the supply of transport.
    - In *CEC v British Telecommunications* [1999] BVC 306 (HL) the issue was whether a car and the delivery of the car were separate supplies. It was held that there was a single supply of a delivered car. The supply contracted for was a delivered car and the delivery of the car enabled the completion of the transaction.
    - In *Card Protection Plan*, the House of Lords considered whether a card protection plan offered

to credit cardholders was a single supply with some ancillary services or two independent supplies comprising an exempt insurance supply and a non-exempt card registration service. It was held that there was a single supply of insurance. The essential feature of the transaction was insurance against loss arising from the misuse of credit cards. The other features in the transaction (the maintenance of a register of credit cards, the ordering of replacement cards, a change of address service, lost key location tags and luggage stickers to ensure the quick return of lost keys and luggage) merely assisted in the administration of the insurance scheme.

- In *Dr Beynon v CEC* [2004] 4 All ER 1091 the House of Lords found that the personal administration of a drug (such as a vaccine) by a doctor was a single supply of medical services. Their Lordships held that the reality was that the transaction was the patient's visit to the doctor and should not be artificially split into the supply of medical services and the supply of a drug.
- In *Tumble Tots (UK) Ltd v R & C Commrs* [2007] BVC 179 (ChD) it was held there was a single supply of membership of a club that conferred on a child the right to attendance at classes involving structured physical play. Other benefits received on admission to membership (a DVD, CD, gym bag, membership card, T-shirt, personal accident insurance for a child while attending a class and a subscription for a magazine) were not separate supplies.

Application to transitional services

18. The following factors will be useful for determining whether transitional services are a separate supply or part of the supply of the business/land:
    - The length of time the transitional services are to be provided for.
    - The nature and extent of the services (for example if they are in the nature of a vendor being made available for "trouble-shooting", this is more likely to suggest that they are part of the same supply. On the other hand if they are more like the provision of a full-time consultant/manager this is more likely to suggest that they are an end in themselves).
    - Whether the services are provided for in a separate contract with the payment of a separately identifiable fee. This item assumes that the services are provided in the same contract and without a separately identifiable consideration. A separate contract and consideration may suggest a separate supply. However, this would not be determinative.
    - Where the agreement to provide transitional services is entered into subsequent to settlement of the sale of the business/land. This would suggest that the transitional services are provided as a separate supply.

Examples

19. The following examples are included to assist in explaining the application of the law.

Example 1 – Basic services provided as part of the sale of a business

20. Valerie Snips (a registered person) enters into an agreement with Sally Shears (a registered person) to sell her hairdressing business. The sale and purchase agreement includes the sale of the land and building where the hair salon is located. The agreement also provides that Valerie will be onsite for a week from the day of transfer to show Sally how the business operates, to answer any questions that Sally has and to facilitate a smooth transfer of the business. No separate consideration is provided for these transitional services in the agreement. How should these services be treated for GST purposes?

21. The transitional services are part of the supply of the business and should be zero-rated under ss 11(1)(mb) and 5(24) along with the land and business. The dominant element of the agreement is the supply of the business (including land). The services are not extensive and are provided for only a short period of time. Further, the nature of the services is to facilitate a smooth transfer of the business to Sally. Consequently, the services provided are ancillary and incidental to the supply of the business. They do not constitute an aim in themselves, but rather are a means for Sally to better enjoy the supply of the business.

Example 2 – Extensive services provided as part of the sale of a business

22. Sam Dryer (a registered person) enters into an agreement with Tim Cleaner (a registered person) to sell his dry-cleaning business. The agreement includes the land and premises where the dry-cleaning business is situated. Tim lives overseas and does not intend to run the dry-cleaning business

himself. Consequently, as part of the agreement Sam will manage the dry-cleaning business for Tim for an initial period of 12 months. These services are included in the purchase price of the business. How should these services be treated for GST purposes?

23. There are two supplies—one of the land/business and one of transitional services. The supply of these transitional services should be standard rated, as ss 11(1)(mb) and 5(24) do not apply. The services are relatively extensive and are provided over a 12 month period. They are an aim in themselves for Tim who requires someone to run the dry cleaning business on an on-going basis.

24. As noted, no amount of consideration has been attributed to the transitional services. Therefore, the total consideration provided for under the agreement will need to be apportioned between the zero-rated supply (the business/land) and the standard rated supply (the transitional services).

References

Subject references
Land; Supply; Transitional services; Zero-rating
Legislative references
Goods and Services Tax Act 1985, ss 5(24), 11(1)(mb)
Case references
Auckland Institute of Studies v CIR (2002) 20 NZTC 17,685 (HC) *Bophuthatswana National Commercial Corp Ltd v CEC* [1993] STC 702 (CA) *British Airways plc v CEC* [1990] BTC 5124 (CA) *Card Protection Plan Ltd v CEC* [2001] 2 All ER 143 (HL) *CEC v British Telecommunications* [1999] BVC 306 (HL) *CEC v United Biscuits (UK) Ltd* [1992] BTC 5045 (IH acting as the Court of ExD) *CEC v Wellington Private Hospital Ltd* [1997] BTC 5140 (CA) *CIR v Motorcorp Holdings Ltd* (2005) 22 NZTC 19,126 (CA) *College of Estate Management v CEC* [2005] 4 All ER 933 (HL) *Dr Beynon v CEC* [2004] 4 All ER 1091 (HL) *Rayner & Keeler Ltd v CEC* [1991] VATTR 532 *Sea Containers Ltd v CEC* [2000] BVC 60 (QB) *Tumble Tots (UK) Ltd v R & C Commrs* [2007] BVC 179 (ChD)

QB 12/08: INCOME TAX – LOOK-THROUGH COMPANIES: INTEREST DEDUCTIBILITY ON FUNDS BORROWED TO REPAY SHAREHOLDER CURRENT ACCOUNTS

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

This Question We've Been Asked applies in respect of ss DB 6 and HB 1.

Question

1. We have been asked whether interest is deductible where a look-through company (LTC) borrows money on arm's length terms to repay current account loans from its shareholders.

Answer

2. Interest will be deductible to the extent the borrowing replaces current account loans from shareholders that were used directly in the LTC's assessable or excluded income earning activity or business. This is subject to ss HB 11 and HB 12 and to paragraphs [3] and [4] below.
3. The LTC must be carrying on an income earning activity or business for the purpose of deriving assessable or excluded income both at the time the funds are borrowed and at the time interest on those funds is payable.
4. Interest will not be deductible to the extent the borrowed funds are used to replace current year income.

Explanation

5. The Commissioner has received inquiries from taxpayers asking when interest will be deductible where an LTC borrows to repay current account loans from its shareholders. This issue has arisen because some taxpayers have interpreted "look-through" to mean you simply ignore all transactions between the LTC and the owner of an effective look-through interest in the LTC. This would mean you look through the LTC to the owner's use of the funds. In many cases, this would mean the requirements for interest deductibility would not be satisfied.
6. However, the Commissioner considers the above interpretation is incorrect. The Commissioner's view is that the owner's use of the funds received from the LTC for the repayment of a current account loan is not relevant to the issue of interest deductibility.

Discussion

Interest deductibility

7. Usually a company would be entitled to an automatic interest deduction under s DB 7. However, LTCs are not companies for the purposes of s DB 7.
8. A deduction for interest incurred may be available under s DB 6. Section DB 6 allows a deduction for interest incurred provided the general permission in s DA 1 is satisfied. Section DA 1 allows a deduction for interest incurred by a taxpayer in deriving their assessable income or incurred by them in the course of carrying on a business for the purpose of deriving their assessable income. Section HB 1(4) provides that the LTC's activity is treated as being carried on by persons holding "effective look-through interests" in the LTC. Consequently, persons with effective look-through interests in the LTC will be entitled to any interest deductions that the LTC would have been entitled to (in the absence of s HB 1) in proportion to that person's effective look-through interest.
9. The Commissioner's view is that the interest deductibility test is satisfied where a sufficient connection exists between the interest incurred and the assessable income. A sufficient connection will be established where borrowed funds are used to **replace** amounts invested in income-earning activities and to **repay** those amounts to the persons who invested them.
10. This is established by *FC of T v Roberts; FC of T v Smith* 92 ATC 4380. In this decision, the Full Federal Court of Australia held that a partnership could deduct interest payments to the extent it used the borrowed money to replace and repay amounts actually invested in it by the partners. By contrast, the court held that interest payments could not be deducted to the extent the partnership used the borrowed money to make payments out of unrealised asset revaluations or internally generated goodwill. This was because unrealised asset revaluations and internally generated goodwill were not amounts tangibly invested by the partners into the partnership – they were only account entries.

11. In Public Rulings BR Pub 10/14–BR Pub 10/19 "Interest Deductibility – *Roberts and Smith* – Borrowing to replace and repay amounts invested in an income earning activity or business", published in *Tax Information Bulletin* Vol 22, No 10 (December 2010), the Commissioner took the position that *Roberts and Smith* is good law in New Zealand. The Commentary to Public Rulings BR Pub 10/14–BR Pub 10/19 extensively considers *Roberts and Smith*. Readers should consult the Commentary to better understand the Commissioner's view of *Roberts and Smith*. BR Pub 10/18 is the most relevant to the issues considered in this QWBA.
12. Applying the principles in *Roberts and Smith* to the scenario outlined in the question, the LTC has used the borrowed funds to replace and repay amounts the shareholders have invested in it by way of the current account loans. Therefore, in accordance with *Roberts and Smith*, an interest deduction would be allowed.
13. For completeness, it is necessary to note the effect of the expense limitation rule s HB 11 (commonly known as the "loss limitation rule"). This provision applies to LTCs. It operates to limit the deductions a person with an effective look-through interest can deduct in an income year. It applies to all deductions, including interest. Section HB 12 applies to allow a person with an effective look-through interest to carry forward any limited deductions into future years, subject to the expense limitation rule in s HB 11. Broadly speaking, the expense limitation rule ensures an owner can offset losses only to the extent these reflect their economic losses.

References

Related rulings/statements
BR Pub 10/14–BR Pub 10/19 "Interest Deductibility – *Roberts and Smith* – Borrowing to replace and repay amounts invested in an income earning activity or business" *Tax Information Bulletin* Vol 22, No 10 (December 2010)
Case references
FC of T v Roberts; FC of T v Smith 92 ATC 4380
Subject references
Interest deductibility; Look-through company
Legislative references
Income Tax Act 2007, ss DA 1, DB 6, DB 7, HB 1, HB 11, and HB 12

QB 12/09: INCOME TAX – LOOK-THROUGH COMPANIES: INTEREST DEDUCTIBILITY WHERE FUNDS ARE BORROWED TO MAKE A PAYMENT TO SHAREHOLDERS TO REFLECT AN ASSET REVALUATION

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

This Question We've Been Asked applies in respect of ss DB 6 and HB 1.

Question

1. We have been asked whether interest is deductible where a look-through company (LTC) borrows money in the following circumstances:
   - the LTC purchases an asset from which it derives income;
   - the asset is subsequently re-valued above its purchase price; and
   - the LTC uses the borrowed money to make payments to its shareholders reflecting the increase in the asset's value.

Answer

2. The principle from *FC of T v Roberts; FC of T v Smith* 92 ATC 4380 will not justify a deduction for interest payments. The borrowed money is making a payment out of an unrealised asset revaluation and, therefore, is not replacing and repaying amounts tangibly invested in the LTC by the shareholders.
3. A deduction may be available under general interest deductibility principles where the relevant nexus is met (for example if the funds were advanced to shareholders at a market rate of interest).

Explanation

4. The Commissioner has received inquiries from taxpayers asking whether interest will be deductible where an LTC borrows to make payments to shareholders that reflect the increase in value in an asset owned by the LTC.

Discussion

Interest deductibility

5. Usually a company would be entitled to an automatic interest deduction under s DB 7. However, LTCs do not qualify for the deduction under s DB 7.
6. A deduction for interest incurred may be available under s DB 6. Section DB 6 allows a deduction for interest incurred provided the general permission in s DA 1 is satisfied. Section DA 1 allows a deduction for interest incurred by a taxpayer in deriving their assessable income or incurred by them in the course of carrying on a business for the purpose of deriving their assessable income. Section HB 1(4) provides that the LTC's activity is treated as being carried on by persons holding "effective look-through interests" in the LTC. Consequently, persons with effective look-through interests in the LTC will be entitled to any interest deductions that the LTC would have been entitled to (in the absence of s HB 1) in proportion to that person's effective look-through interest.
7. The Commissioner's view is that the interest deductibility test is satisfied where a sufficient connection exists between the interest incurred and the assessable income. A sufficient connection will be established where borrowed funds are used to **replace** amounts invested in income-earning activities and to **repay** those amounts to the persons who invested them.
8. This is established by *FC of T v Roberts; FC of T v Smith* 92 ATC 4380. In this decision, the Full Federal Court of Australia held that a partnership could deduct interest payments to the extent it used the borrowed money to replace and repay amounts actually invested in the partnership by the partners. By contrast, the court held that interest payments could not be deducted to the extent the partnership used the borrowed money to make payments out of unrealised asset revaluations or internally generated goodwill. This was because unrealised asset revaluations and internally generated goodwill were not amounts tangibly invested by the partners into the partnership—they were only account entries.
9. In Public Rulings BR Pub 10/14–BR Pub 10/19 "Interest Deductibility – *Roberts and Smith* – Borrowing to replace and repay amounts invested in an income earning activity or business", published in *Tax Information Bulletin* Vol 22, No 10 (December 2010), the Commissioner took the position that *Roberts and Smith* is good law in New Zealand. The Commentary to Public Rulings BR Pub 10/14–BR Pub 10/19 extensively considers *Roberts and Smith*. Readers should consult the Commentary to better understand the Commissioner's view of *Roberts and Smith*.
10. Applying the principles in *Roberts and Smith* to the scenario outlined in the question, the borrowed money has been used to make payments out of an unrealised asset revaluation. As the revaluation has

not been realised by sale, the increased value is only an account entry. Consequently, the borrowed funds have not been used to replace and repay amounts tangibly invested in the LTC by the shareholders. Therefore, in accordance with *Roberts and Smith*, no interest deductions would be allowed.

11. A deduction may be available under general interest deductibility principles where the relevant nexus is met. An example of this is where the funds borrowed were advanced to shareholders at a market rate of interest. In these circumstances deductibility does not rely on an application of the replace and repay principle from *Roberts and Smith*.

References

Related rulings/statements
BR Pub 10/14–BR Pub 10/19 “Interest Deductibility – *Roberts and Smith* – Borrowing to replace and repay amounts invested in an income earning activity or business” *Tax Information Bulletin* Vol 22, No 10 (December 2010)
Case references
FC of T v Roberts; FC of T v Smith 92 ATC 4380
Subject references
Interest deductibility; Look-through company
Legislative references
Income Tax Act 2007, ss DA 1, DB 6, DB 7, and HB 1

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.

ABUSE OF PROCESS

Case	HH Jiao, HH Wu and SC Chiao as Trustees of the Harsono Family Trust v Commissioner of Inland Revenue
Decision date	22 May 2010
Act(s)	Goods and Services Tax Act 1985, District Court Act 1947, Judicature Act 1908, Tax Administration Act 1994
Keywords	Strike out, abuse of process, input tax credit, GST, money had and received

Summary

The plaintiff appealed to the High Court on the basis that the District Court had erred in its decision to strike out the plaintiff's claim. The plaintiff made submissions on taxable activity, output tax and money had and received. The High Court dismissed the appeal and held that the proceedings were frivolous, vexatious, and an abuse of process. The Court held that it was simply an attempt to re-litigate matters that had already been disposed of by the lower courts.

Impact of decision

This decision again confirms the well-settled principles relating to strike-out and abuse of process.

Background

This proceeding is an appeal of the striking out of the Harsono Family Trust's ("HFT") District Court claim, which sought a reversal of a GST assessment requiring HFT to repay the $137,500 GST input tax credit it had received from the Commissioner of Inland Revenue.

This particular matter has a lengthy history, which is summarised below to provide some context to the present appeal.

In March 2002, Freeport Development Ltd (the vendor) entered into an agreement with Mr Barge (the purchaser) for the sale and purchase of 45 Anzac Ave, Auckland ("the Property").

Shortly after this agreement for sale and purchase went unconditional, HFT approached Freeport Development Ltd and expressed an interest in purchasing the Property for a higher price than Mr Barge had agreed to pay.

Following a number of interceding steps, HFT entered into its own sale and purchase agreement for the Property. HFT then paid the purchase price, accounted for GST on the purported sale, and claimed a GST input credit of $137,500 on the sale from the Commissioner.

Subsequently, Mr Barge disputed the legitimacy of HFT's purchase of the property and issued proceedings against HFT. In October 2005, the High Court held that HFT's agreement for sale and purchase of the property was invalid and, amongst other things, that:

a) HFT had wrongly induced and procured the vendor to breach its previous agreement for sale and purchase with Mr Barge; and

b) HFT was involved in an unlawful means conspiracy causing loss to Mr Barge.

HFT appealed the High Court's decision to the Court of Appeal but was unsuccessful. The Supreme Court refused leave to appeal the Court of Appeal's decision.

Following the High Court's decision that the purported sale and purchase was invalid, the Commissioner issued a GST assessment reversing the $137,500 input tax credit that had been paid to HFT.

HFT disputed this assessment but in May 2009 the Taxation Review Authority ("TRA") confirmed the assessment's correctness (*Case Z16*). HFT applied for a recall but the TRA held that to do so would be "inconsistent with the objective of finality and certainty in litigation and is an abuse of process" (*Decision 13/2009*). HFT appealed the TRA's decision, but this was dismissed by the High Court for want of jurisdiction.

HFT later issued a fresh proceeding against the Commissioner in the District Court seeking a reversal of the GST assessment (that had itself reversed the $137,500 GST

input tax credit), claiming unjust enrichment, relief under section 94A of the Judicature Act 1908, money had and received, and restitution.

In October 2011, HFT's District Court claim was struck out on the Commissioner's application, on the grounds that it was untenable, an abuse of process and disclosed no reasonable cause of action. HFT appealed the strike-out decision to the High Court, whose decision is the subject of this summary.

At issue was whether the District Court had erred in its decision to strike out HFT's claim.

Decision

At the High Court appeal hearing, HFT submitted that as a consequence of the earlier High Court and TRA decisions, their purchase transaction in respect of the Property had no legal effect and, therefore, there had been no taxable activity. Accordingly, HFT's payment of $137,500 should not be considered a payment of GST output tax and, therefore, HFT was entitled to have that amount refunded by the Commissioner. HFT also submitted that, for the same reasons, sections 109 and 165 of the Tax Administration Act 1994 had no application. HFT further argued in the alternative that, amongst other things, the $137,500 had been paid by mistake and was therefore recoverable under the Judicature Act 1908, or in equity.

HFT concluded its submissions by asserting generally that the District Court had incorrectly applied the law and as such, the claim should not have been struck out.

In his decision, Venning J categorised the proceeding as frivolous, vexatious, and an abuse of process. Venning J held that although HFT had tried to argue that their latest claim was not about tax, it was simply an attempt to re-litigate matters that had already been disposed of by the TRA. His Honour held that the District Court had been correct to strike out the proceeding and accordingly dismissed HFT's appeal.

On the question of indemnity costs sought by the Commissioner, the Court asked HFT to file written submissions in relation to this point.

COURT OF APPEAL CONFIRMS COMMISSIONER'S BROAD POWERS OF RECONSTRUCTION

Case	John George Russell v Commissioner of Inland Revenue
Decision date	3 April 2012
Act(s)	Income Tax Act 1976
Keywords	Template, Russell, income, loss companies, arrangement, tax avoidance, reconstruction, section 99(3), section 99(4)

Summary

This case was an appeal from the High Court, which found the arrangements had the purpose and effect of tax avoidance. The Court of Appeal upheld the High Court judgment and further added that the overall scheme was the means by which the profits were laundered, together with other related income without paying income tax. Accordingly, the Court of Appeal concluded that the income is to be attributed to Mr Russell because he was the governing mind of the template arrangements, which were designed to shelter the income earned.

Impact of decision

The Court of Appeal confirmed the Commissioner's broad powers to reconstruct assessments; despite the income not being earned personally. This is a very fact-specific case.

Facts

This is an appeal from the High Court (*Russell v Commissioner of Inland Revenue* (No 2) (2010) 24 NZTC 24,463). In the High Court, Wylie J concluded that Mr Russell was affected by an arrangement having the purpose and effect of tax avoidance by which he obtained tax benefits. The Commissioner's assessment of Mr Russell's income was upheld.

This appeal relates mainly to the Commercial Management Partnership ("CM Partnership") whose activities during the period 1985 to 2000 were conducted by two partners, both were companies.

Both companies were controlled by Mr Russell. In addition, the individual partners would enter agency and management agreements with tax loss companies. The tax loss companies were also controlled by Mr Russell. The partners would account to the loss companies for any income earned and that income would be sheltered by the loss in the loss company. As the tax losses of any particular company were used up, a new tax loss company would be substituted in (using agency and management agreements).

However, the cash would be "banked" with finance companies controlled by Mr Russell.

On filing the appeal, Mr Russell raised the four "live issues" that were addressed in the High Court and raised a further five grounds of appeal. After exchanging submissions and further oral submissions, the Court of Appeal considered that the only additional ground for which leave would be granted was the ground dealing with section 99(4) of the Income Tax Act 1976 ("the 1976 Act").

Issues

1. In relation to the scope of the alleged arrangement, whether the scope of the broader arrangement was as asserted by the Commissioner and in particular, whether an arrangement requires a consensus or a meeting of minds between the parties involved that the other will act in a particular way.
2. Was the alleged arrangement a tax avoidance arrangement?
3. Was the appellant affected by the alleged arrangements?
4. Did the appellant obtain a tax advantage from the alleged arrangements?
5. Was the Commissioner correct in reconstructing the income to Mr Russell personally?
6. Was the assessment process incomplete because section 99(4) of the 1976 Act had been ignored?

Decision

Scope of the arrangement

The Court of Appeal agreed with Wylie J on this issue, that there was an "arrangement" as defined in section OB1 of the 1994 Act and the anti-avoidance provisions of the 1976 Act.

There was an arrangement far broader in scope than the limited form of arrangement which Mr Russell conceded in the High Court and in his submissions. The Court of Appeal held that Mr Russell had put in place one overall arrangement and operated it over the years 1985 to 2000.

The "arrangement" did not need to obtain consensus, it just needed to be a plan, which here Mr Russell created, designed and executed.

A tax avoidance arrangement

Mr Russell sought to characterise the Commissioner's complaint regarding tax avoidance as in reality arising from the fact that the principal partners in the business had tax losses "which they reduced by their share of the profits so they did not actually pay any money to the Commissioner". He contended that if the partners had not carried forward losses, they would have paid tax on their share of the profits and that tax avoidance would not have been perceived.

The Court of Appeal found that the arrangement put in place was "contrived" and "involved pretence". The Court noted that Wylie J in the High Court found "[t]he arrangement was in my view so tortuous that it is hard to escape the conclusion it was put in place simply to obfuscate the situation and to confuse even the most diligent tax inspector".

The Court of Appeal concluded that the arrangement was clearly tax avoidance.

A person affected by the arrangement and obtaining a tax advantage

Mr Russell has always contested that he never entered into a business transaction personally, and did not personally benefit from the arrangement.

The Court of Appeal was satisfied that Mr Russell was a person affected by the arrangement. Mr Russell was a direct party to the arrangement; he controlled all the entities involved; funds were transferred to finance companies to allow him to meet his personal obligations; and he was effectively in control of untaxed money which was generated by the arrangement.

The Court of Appeal was also satisfied that Mr Russell obtained a tax advantage from the arrangement that was more than incidental as he did not pay tax on any income that was derived from the Russell template transactions.

While the Court of Appeal considered it true that the business of the CM Partnership was carried on by means of various partnership and corporate entities, these entities also did not pay income tax because of the artificial introduction by Mr Russell of the various loss companies alongside the partners to offset the net profits earned by the CM Partnership.

The Court of Appeal differed with Wylie J's reasoning that the monies resulting from the CM Partnership business ought to be characterised as "personal exertion income". Their preference was to rest their conclusion as to the purpose of the overall arrangement and the tax advantage derived from it on a broader basis. Accordingly, the Court of Appeal concluded that the overall scheme was the means by which the profits were laundered together with other related income without paying income tax.

Reconstruction to Mr Russell?

Mr Russell argued that the Commissioner should not have reconstructed the income to him personally. The Judges rejected this, recognising that the Commissioner has broad powers of reconstruction under section 99(3) of the 1976 Act. In *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275 (CA), Blanchard J stated:

> Section 99(3) gives the Commissioner a wide reconstructive power. He 'may' have regard to the income which the person he is assessing would have or might be expected to have or would in all likelihood have received but for the scheme, but the Commissioner is not inhibited from looking at the matter broadly and making an assessment on the basis of the benefit directly or indirectly received by the taxpayer in question.

The Court of Appeal considered that Mr Russell "saw to it that he received only nominal income for the provision of consulting services". The Court of Appeal went on to note that substantial funds flowed into the CM Partnership and these were placed on deposit with one of the finance companies controlled by Mr Russell. The Court further noted similarities in regards to the low levels of salary received as in *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433.

In the High Court, Wylie J considered that it was a decisive factor that Mr Russell was diverting into the CM Partnership the income which he generated by his personal exertions, but as mentioned above, the Court of Appeal had a differing view and said that where the income was earned by the CM Partnership and other entities within the structure that was set up, utilising the staff employed in the entities, this income ought not to be characterised as income earned by Mr Russell personally. Notwithstanding this differing view, the Court of Appeal concluded that the income is to be attributed to Mr Russell because he was the governing mind of the template arrangements, which was designed to shelter the income earned.

Section 99(4) Income Tax Act 1976

This ground of appeal was allowed to be brought despite the fact that it had not been pursued in the High Court. Mr Russell claims that the Commissioner has not completed the assessment process as required by this section. Section 99(4) provides:

> Where any income is included in the assessable income … of any person pursuant to subsection (3) of this section, then, for the purposes of this Act, that income shall be deemed to have been derived by that person and shall be deemed not to have been derived by any other person.

Mr Russell contended that on its correct interpretation section 99(4) is "instantaneous and automatic" and requires the Commissioner to make an adjustment as soon as any income is included in the assessable income of any person pursuant to section 99(3). This is because the income is deemed to have been derived by the person assessed and "shall be deemed not to have been derived by any other person". Mr Russell submitted that the failure by the Commissioner to adjust as required by section 99(4) "vitiates the assessments which should be cancelled as a result". Mr Russell was asserting that other entities had been assessed for the income which was the subject of the Court of Appeal proceeding and therefore pursuant to section 99(4), the Commissioner was prevented from assessing him for the same income personally.

The Commissioner accepted that section 99(4) provided a statutory immunity so that where any income is reconstructed under section 99(3), that income shall be deemed not to have been derived by any other person. However, the Commissioner submitted that for the taxpayer to rely on this section, he would need to show the quantum of assessable income confirmed in the CM Partnership accounts had already been assessed to some other person.

The Court of Appeal considered that if any part of the assessment made by the Commissioner in respect of Mr Russell for the income years 1985 to 2000 included income deemed by section 99(4) to be income of someone else, such an assessment is not void. However, in such a situation, it is open to the Commissioner or the Authority, to remedy the position at a later point.

The Court of Appeal agreed that for the Commissioner to remedy such a situation if he is persuaded that there is a genuine inconsistency, Mr Russell would be the person ideally placed to establish the true position and bring the inconsistency to the notice of the Commissioner.

In any event, the Court of Appeal did not see any inconsistency in effectively taxing the shareholders of the template companies on the fees paid to the Russell group of companies and also attributing those fees to Mr Russell personally for taxation purposes. The Court of Appeal recognised that money paid may often be non-deductible on one side and yet assessable to another party to whom it is paid. Linking it to the present case, the Court of Appeal said the fees paid were treated as non-deductible as they were paid for a tax avoidance scheme. However, that does not make the fees any less assessable when paid to entities established by Mr Russell as payment for services rendered.

As a consequence, Mr Russell was unsuccessful in establishing any merit in the section 99(4) point.

SUPREME COURT CONSIDERS THE APPLICATION OF SECTIONS 52(1) AND (2) OF THE GOODS AND SERVICES TAX ACT 1985

Case	Lewis Gaire Herdman Thompson v Commissioner of Inland Revenue
Decision date	10 May 2012
Act(s)	Goods and Services Tax Act 1985, Tax Administration Act 1994
Keywords	De-registration, *Lopas*, output tax, turnover, contemplated, planned, GST, section 52(1), section 52(2)

Summary

Upon an appeal from the Court of Appeal, the Supreme Court was required to consider the dates of deregistration following three sale transactions; the *Lopas* decision; and the wording of section 52 of the Goods and Services Tax 1985 ("GST Act").

The Court held that the rental income following the sales showed an on-going supply and therefore the de-registration dates must be according to the Commissioner's assessments. The Court further looked at the *Lopas* decision of relevance and confirmed that the statutory language must govern any other interpretation. The Court further provided a test under section 52 that deregistration depends on the Commissioner being "satisfied" that taxable supplies for the following 12-month period were not going to exceed the threshold.

Impact of decision

The *Lopas* decision is reaffirmed. Proceeds from sales which were planned or contemplated as likely to occur at the time of deregistration should be allowed for in the section 52(2) assessment, which gives effect to the statutory language of section 52.

The Supreme Court has provided some helpful guidelines regarding the proper approach to deregistration for GST, and these are intended to assist in the future application of section 52.

Facts

This is an appeal from the Court of Appeal.

Mr Thompson owned just over 200 hectares of land near Rolleston that he acquired in 1979. It was leased out as a rental, which, because the rent included rates, was in excess of $30,000 per annum.

Mr Thompson was registered for goods and services tax (GST) purposes but applied to de-register on the premise that his taxable supplies would not exceed $30,000 within the 12 months following de-registration. The Commissioner accepted Mr Thompson's application to de-register and Mr Thompson's de-registration was effective from 30 November 1999.

After his de-registration, Mr Thompson disposed of the Rolleston land in three sale transactions, which occurred in December 1999, March 2000 and September 2000. The two latter sales were to an associated party. Mr Thompson did not account for output tax on any of the land sales given his de-registered status.

Despite his de-registration, up until mid-June 2000 (when the first land sale was finalised), Mr Thompson continued to recover the same amount of rent and GST. Following an investigation, the Commissioner cancelled the November 1999 de-registration and reinstated Mr Thompson's registration until 31 January 2001.

Mr Thompson challenged the Commissioner on the new de-registration date and was successful in the Taxation Review Authority ("TRA") where it was concluded that the proceeds of future sales were irrelevant to the section 52(2) assessment, but given that such sales were going to occur, his future rental receipts as at 30 November 1999 were going to be under the threshold.

Subsequent to the TRA decision, the Court of Appeal released *Lopas v Commissioner of Inland Revenue* (2006) 22 NZTC 19,726 (CA) where the Court of Appeal held that a proposed disposal of assets, which in that case had been "planned" at the de-registration date, was relevant to the section 52(2) assessment. They therefore rejected the approach to section 52(1)(c) which had been taken by the TRA in *Lopas* and which the TRA had applied in Mr Thompson's challenge. The Supreme Court subsequently declined leave to appeal in *Lopas*.

The Commissioner appealed the TRA decision given the result in *Lopas*. Millar J allowed the Commissioner's appeal and directed that a rehearing, which was necessary, should be in the High Court. Mr Thompson appealed to the Court of Appeal.

The Commissioner was partially successful in the High Court, which upheld the assessments of output tax on the first two sales but not the third, and completely successful in the Court of Appeal, which upheld all three assessments.

Both the High Court and Court of Appeal considered *Lopas* and, in particular, the significance of the word "planned". The Court of Appeal took the view that the High Court was wrong to focus on the words used in *Lopas* (and in particular the word "planned") rather than the text of the statute.

Issues

The Supreme Court granted leave on the following grounds:

a) When did the appellant become entitled to be de-registered for GST purposes?

b) In light of that determination, and the circumstances in which they took place, did the second and third sales of land attract GST?

The most important issue in the case was whether at the two possible de-registration dates proposed by Mr Thompson (namely 9 February and 31 July 2000), the proceeds of the second and third land sales were required to be taken into account in assessing prospective turnover.

Given that the case was dealt with differently in the High Court and Court of Appeal, the Supreme Court addressed the significance of the rental turnover, which involved considering whether the prospective rental income alone would have surpassed the threshold at the two possible de-registration dates proposed by Mr Thompson, before addressing the significance of the proceeds of future land sales.

Decision

Rental income

The Supreme Court considered that by 31 July 2000, Mr Thompson had resolved the problem that the rent he had been receiving included GST and as the first two sales had occurred, the rental turnover for the following 12 months would be under the threshold.

However, the Supreme Court considered the earlier date problematic. As at 9 February 2000, Mr Thompson was in the course of the "unsatisfactory implementation of a doubtful tax plan" and therefore was not a promising candidate for the favourable exercise of a discretionary judgment to move his de-registration date. In any event, Mr Thompson had continued to collect GST from his tenant until June 2000, which meant that he could not obtain a de-registration date that preceded the time of supply in relation to the second sale.

Relevance of the proceeds of future land sales

The Supreme Court disagreed with the High Court's interpretation of "planned" in the *Lopas* case. Although the *Lopas* judgment used the word "planned" in the context of a sale being planned at the time of deregistration, it also used the words "in contemplation", which in that context suggested that proceeds from sales that were contemplated at the time of deregistration should be allowed for in the section 52(2) assessment. Accordingly, the Supreme Court reaffirmed the *Lopas* decision although making it clear that the statutory language must govern.

The Supreme Court held that on any possible approach to section 52(2), it could not be predicated as at 30 November 1999, 9 February 2000 or 31 July 2000 that there would not be a sale of the balance of the land within the next 12 months.

Application of the test under sections 52(1) and (2)

The Supreme Court stated that de-registration depends on the Commissioner being "satisfied" that taxable supplies for the following 12-month period were not going to exceed the threshold.

The Supreme Court provided the following advice to assist in the application of section 52:

a) The section means what it says and there is not much point in trying to paraphrase it.

b) The section requires the Commissioner to be satisfied that turnover will not exceed the threshold. This involves an objective, forward looking assessment, not one controlled by hindsight.

c) The test will not be satisfied when transactions which would result in the turnover being exceeded are either:

    i) being implemented at the proposed de-registration date, or

    ii) planned to occur (or contemplated as likely to occur) in the course of the following 12 months.

d) The test will probably only be satisfied where a taxpayer can show a settled intention that such transactions will not take place.

Both grounds on appeal were dismissed.

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