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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.

IN SUMMARY

Interpretation statements

IS 14/04: Income tax – deductibility of company administration costs 5

This interpretation statement considers whether a range of expenditure incurred by companies is deductible under the Income Tax Act 2007. The expenditure is of a type incurred by companies as a result of their inherent nature and the regulatory environment applicable to them. The costs considered include: audit fees; costs of meetings of shareholders; costs associated with paying dividends; fees for listing with registered exchanges; share registry costs; costs of filing statutory returns; and associated legal and accounting costs.

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Legal decisions – case notes

Commissioner awarded discovery orders 138

This case concerned an application by the Commissioner of Inland Revenue for discovery of documents supporting the disputant's statement in her Statement of Position explaining how she funded her losses.

Employee entitlement fund and tax avoidance 139

The High Court confirmed the decision of the Taxation Review Authority and dismissed the appeal of HC Services Ltd.

Statement of position declared invalid 140

The respondent's Statement of Position was considered invalid and the respondent was therefore unable to challenge the assessments under Part 8A of the Tax Administration Act 1994.

Leave to continue challenge 141

The disputant showed a genuine wish to continue the litigation and the right to a hearing and determination should not be lightly denied. The disputant was granted leave to proceed with the challenge proceeding.

Sovereign Assurance refused leave to appeal to the Supreme Court 142

The Supreme Court refused Sovereign Assurance's application for leave to appeal the Court of Appeal decision in Sovereign Assurance Company Limited v Commissioner of Inland Revenue [2013] NZCA 652.

Summary judgment for $367 million 143

A summary judgment was entered by the Court as there was no arguable defence, and no grounds upon which the Court ought to exercise its residual discretion to decline

Registration appeal and tax challenge proceedings consolidated 145

The National Council of Women of New Zealand Incorporated (NCWNZ) applied, among other things, for an order that its appeal against a decision of the Charities Registration Board not to backdate its registration be consolidated with its tax challenge of income tax assessments made by the Commissioner of Inland Revenue for the period that NCWNZ was deregistered as a charity. Clifford J granted the order on the basis that both the appeal and the tax challenge arose out of the same facts and circumstances, and both involved related interpretational issues.

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GST implications on the supply of equipment 146

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The Crown's legal professional privilege 147

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INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 14/04: INCOME TAX – DEDUCTIBILITY OF COMPANY ADMINISTRATION COSTS

All legislative references are to the Income Tax Act 2007, unless otherwise stated. Reproduced in the Appendix are the relevant legislative provisions.

Introduction

1. This Interpretation Statement considers the deductibility of certain expenditure relating to the administration of a company ("company administration costs") being:
   - accounting fees associated with company administration costs
   - audit fees
   - costs relating to the payment of dividends
   - legal fees associated with company administration costs
   - listing fees incurred by a company to obtain and maintain registration on a recognised exchange
   - share registry costs
   - costs relating to meetings of shareholders
   - statutory return preparation and filing costs.

   Before discussing these company administration costs, this statement briefly considers the principles of deductibility that underlie the analysis of the particular administration costs.

2. This statement applies from the 2014–15 and subsequent income years, contemporaneously with the commencement of amendments made by s 50 of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014. These amendments inserted three provisions into the Act as follows:
   - Section DB 63 provides that a company is allowed a deduction for expenditure incurred in authorising, allocating, or processing the payment of a dividend or in resolving a dispute concerning these matters.
   - Section DB 63B provides that a listed company is allowed a deduction for expenditure incurred as periodic fees of a recognised exchange for maintaining the registration of the company on the exchange.
   - Section DB 63C provides that a company is allowed a deduction for expenditure incurred in holding an annual meeting of shareholders but is denied a deduction for expenditure incurred in holding a special or extraordinary meeting of shareholders.

3. This statement does not consider specific deductibility provisions that may apply to some types of company expenditure. These include expenditure related to:
   - the determination of tax that may be deductible under s DB 3 (fees for return preparation, objections and litigation expenses), and
   - the preparation and registration of a lease that may be deductible under s DB 18.

4. In addition, the transfer pricing rules set out in ss GC 6 to GC 14 may also apply to substitute an arm's length consideration for the expenses referred to in this statement.

5. In many instances, each type of company administration cost will relate to a variety of different outgoings. It is likely these outgoings will include composite payments for which issues of dissection or apportionment may arise. Therefore, the principles of apportionment discussed from para 36 may need to be considered in determining the tax treatment of any particular payment.

Summary

Accounting fees associated with company administration costs

6. The deductibility of accounting fees depends on whether the underlying transaction or issue requiring the fees to be incurred is of a capital or revenue nature. For example, accounting fees relating to the acquisition of a capital asset would generally be

an item of a capital nature and non-deductible. In contrast, accounting fees associated with dealing with creditors or other operational matters would be of a revenue nature and therefore deductible.

Audit fees

7. Audit fees are incurred to provide shareholders and others with reliable financial information. Reliable financial information enables the shareholders to exercise their power to control the company and other stakeholders to make decisions regarding their relationship with the company.
8. The Commissioner considers audit fees are deductible because there is a sufficient relationship between annual audit fees and a company's business and the fees are not capital expenditure.

Dividends

9. Expenditure incurred in authorising, allocating, or processing the payment of a dividend (including expenditure incurred in resolving a dispute in relation to these matters) is deductible for the 2014–15 and subsequent income years. Section DB 63 provides a deduction for this expenditure. To qualify for a deduction under s DB 63, the expenditure in question does not need to satisfy the general permission contained in s DA 1. The deduction is also not prohibited by the capital limitation.

Legal fees associated with company administration costs

10. Like accounting fees mentioned above, the deductibility of expenditure on legal fees depends on whether the underlying transaction or issue requiring the fees to be incurred is of a capital or revenue nature. For example, legal fees relating to the acquisition of a capital asset or drafting changes to a company's constitution would generally be items of a capital nature and non-deductible. In contrast, legal fees associated with dealing with creditors or other operational matters would be of a revenue nature and therefore deductible.
11. However, s DB 62 overrides the capital limitation to provide a deduction for legal fees that meet the general permission but would otherwise be non deductible as capital expenditure. Section DB 62 applies where the taxpayer's total legal expenses for an income year are equal to or less than $10,000.

Listing fees

12. A company listing with a licensed operator of a financial products market will incur expenditure on the initial listing of the company's securities plus further fees for any subsequent listing of additional securities (referred to in this statement as "additional listing fees"). It will also incur periodic fees to maintain the company's listing. Initial and additional listing fees are treated differently to periodic fees for income tax deductibility purposes.
13. Listing facilitates capital raising because it enhances the marketability of a company's securities by providing liquidity to investors. The capital raised from the funds provided by shareholders subscribing to shares is a contribution to the capital structure of the company. Generally, expenditure incurred in borrowing money to raise capital is capital expenditure.
14. Accordingly, the Commissioner considers that initial listing fees and any additional listing fees are not deductible because they are capital expenditure, being expenditure that facilitates the raising of capital. However, if initial listing fees or any additional listing fees are incurred in relation to debt securities, then s DB 5 or the financial arrangements rules in subpart EW of the Act may apply depending on the facts of the case (see Interpretation Statement, IS 13/03: "Income Tax – deductibility of expenditure incurred in borrowing money – Section DB 5", *Tax Information Bulletin* Vol 26, No 1 (February 2014): 3).
15. In contrast, periodic listing fees incurred to maintain the listing of a company are considered deductible under s DB 63B. Section DB 63B supplements the general permission in s DA 1 and specifically provides for the deductibility of periodic fees incurred to maintain registration of a listed company on a recognised exchange, regardless of whether the company is carrying on a business or income-earning activity. Section DB 63B also overrides the capital limitation.

Share registry expenses

16. Expenditure incurred on the maintenance of the share register is deductible where a company carries on a business. The maintenance of the share register is necessary to identify the persons who are the shareholders who have the power to make decisions relating to the company's business, such as at annual shareholder meetings. The Commissioner considers there is a sufficient relationship between the expenditure and the company's business. The expenditure is generally not capital expenditure. The expenditure is recurrent and does not result in the creation of a structural asset or enduring benefit (with the possible exception of costs incurred in relation to mergers, acquisitions or company migration).

Shareholder meetings

Direct expenditure incurred in holding a meeting

17. Direct expenditure incurred in holding a meeting would include expenditure incurred on:
    - Venue hire and any other costs related to preparation of the venue.
    - Equipment hire (eg, audiovisual equipment).
    - Refreshments provided to those attending the meeting.
    - Printing, publishing, postage and advertising of notices of the meeting.
    - Preparation of resolutions.
    - Travel costs for directors and other persons required to attend the meeting.
    - Any other costs directly related to physically holding or conducting the meeting.
18. Such expenditure incurred in holding a meeting of shareholders is:
    - Deductible where the expenditure is incurred in holding an annual meeting, regardless of whether the company is carrying on a business or income earning activity and whether the expenditure is capital in nature: s DB 63C(1).
    - Not deductible where the expenditure is incurred in holding a special or extraordinary meeting: s DB 63C(2).

Indirect expenditure incurred in relation to meetings of shareholders

19. Indirect expenditure in relation to a meeting would be any other expenditure that is incurred for, or in preparation for, a meeting of shareholders that is not a direct cost of physically holding or conducting the meeting.
20. The tax treatment of indirect expenditure incurred for a meeting of shareholders depends on the purpose of the meeting for which the expenditure was incurred.
21. Indirect expenditure incurred for the following purposes will be deductible or non-deductible as shown:
    - *Ordinary business purposes of an annual meeting* – Deductible where the company is carrying on a business.
    - *Alteration of the company's constitution* – Generally not deductible but may be in some situations (such as in *Commissioners of Inland Revenue v Carron Company* (1968) 45 TC 18 (HL)).
    - *Alteration of shareholders' rights* – Generally not deductible because the general permission is not met and the capital limitation applies. May be deductible where inseparable from, or ancillary or incidental to, business objectives that meet the general permission.
    - *Arrangements with creditors* – Deductible where the company is carrying on a business.
    - *Liquidation* – Not deductible because the general permission is not met and the capital limitation applies.
    - *Major transactions under the Companies Act 1993* – Depends upon the facts. Not deductible where incurred after the company has committed to a major transaction because the capital limitation will apply.
    - *Ratifying directors' actions or breaches in their duty to the company* – For the ratification of directors' actions under s 177 of the Companies Act 1993, deductibility depends on the actions ratified. Expenditure incurred for the purpose of a shareholders' meeting to ratify breaches of the directors' duty to the company is generally deductible where the company is carrying on a business.
    - *Takeovers (target company)* – Not deductible where incurred to preserve position of existing shareholders or to obtain a benefit of a capital nature.

Statutory return fees

22. A primary reason for incurring expenditure on statutory returns, such as return filing fees, is to ensure that the company remains on the register of companies. This allows the company to continue to operate as a company and meet obligations to third parties in any commercial contracts.
23. In addition, failure to register the annual return or notices of change of the company's address for service or registered office may result in documents or notices not being sent to the company correctly. Unless it receives a notice a company may not be able to respond to actions that may be taken against the company and that may have an impact on the company's business.
24. In the Commissioner's view, the commercial necessity for the expenditure provides grounds for finding that expenditure on return filing fees has a sufficient relationship with the company's business. The costs are deductible. The expenditure is not capital expenditure. The expenditure is recurrent and does not result in the creation of a structural asset.

Summary table of deductibility of company administration costs

Company administration cost	Deductibility	Para ref.
Accounting fees	Depends on the purpose of the services. Follows treatment of the underlying cost.	45–50
Audit fees	Deductible for companies carrying on a business.	51–61
Dividends	Deductible. No need to meet general permission and capital limitation overridden: s DB 63.	62–64
Legal fees	Depends on the purpose of the services. Follows treatment of the underlying cost unless s DB 62 applies.	65–67
Listing fees	*Initial listing fees and any additional listing fees:* Not deductible: capital limitation applies unless fees relate to debt markets and s DB 5 or financial arrangements rules apply.	68–81
	Periodic listing fees: Deductible. No need to meet general permission and capital limitation overridden: s DB 63B.	82–84
Share registry costs	Deductible where company is carrying on a business (capital limitation may apply if for mergers, acquisitions or migrations).	85–98
Shareholder meetings	*Direct costs incurred in holding meetings:* • *Annual Meetings:* Deductible. No need to meet general permission and capital limitation overridden: s DB 63C(1). • *Special/extraordinary meetings:* Not deductible. Section DB 63C(2).	99–153
	Indirect costs incurred for meetings of shareholders for: • *Ordinary business of annual meeting:* Deductible where company is carrying on a business. • *Alteration of constitution:* Generally not deductible but may be deductible when the alterations facilitate business operations. • *Alteration of shareholders' rights:* Generally not deductible – general permission not met and capital limitation applies. May be deductible where inseparable from, or ancillary or incidental to, business objectives that meet the general permission. • *Arrangements with creditors:* Deductible where the company carries on a business. • *Liquidation:* Not deductible, capital limitation applies. • *Major transactions under the Companies Act 1993:* Depends on the facts. Not deductible if incurred after commitment to major transaction when the capital limitation applies. • *Ratifying directors' actions or breaches of their duty to the company:* – *Ratification under s 177 Companies Act 1993:* depends on action being ratified. – *Ratification of breach of directors' duty:* generally deductible where the company is carrying on a business. • *Takeovers (target company):* Not deductible where incurred to preserve position of existing shareholders or to obtain a benefit of a capital nature.	
Statutory return fees	Deductible where company is carrying on a business.	154–162

ANALYSIS

Introduction

25. When considering the deductibility of company administration costs, it is helpful to have a general understanding of the principles of deductibility under the Act, including the general permission, the capital and private limitations and apportionment. Accordingly, this statement first discusses these principles before considering (from para 43) the deductibility of each company administration cost.

Principles of deductibility

General permission

26. The following discussion summarises the main aspects of the principles of deductibility only. For a more detailed discussion of the general permission and the capital limitation, see the Commissioner's Interpretation Statement, IS 10/06: "Deductibility of business relocation costs" published in *Tax Information Bulletin* Vol 22, No 8 (September 2010): 20.

27. To determine whether company administration costs are deductible the general permission in s DA 1 must first be considered. Section DA 1 states:

> *Nexus with income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
>
> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income; or
>
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income.
>
> *General permission*
>
> (2) Subsection (1) is called the **general permission**.
>
> *Avoidance arrangements*
>
> (3) Section GB 33 (Arrangements involving depreciation loss) may apply to override the general permission in relation to an amount of depreciation loss.

28. The following principles of deductibility can be drawn from case law:

- For expenditure to be deductible there must be a sufficient relationship between the expenditure and the taxpayer's income-earning process. It is a question of fact and degree in each case: *CIR v Banks* [1978] 2 NZLR 472 (CA); *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA).
- Determining whether the necessary relationship exists requires considering the true character of the expenditure and its relevance to the taxpayer's income-earning process. This includes considering the scope of the taxpayer's income-earning process and the factual situation at the time the expenditure was incurred: *Banks*; *Buckley & Young*.
- For expenditure to be deductible a particular item of expenditure need not be linked with a particular item of income. Also, income need not have been produced in the year of expenditure: *Commissioner of Taxation (NSW) v Ash* (1938) 5 ATD 76 (HCA) at 78; *Eggers v CIR* (1988) 10 NZTC 5,153 (CA).
- Paragraph (b) of s DA 1(1) applies only to taxpayers who are carrying on a business. In contrast to s DA 1(1)(a), under s DA 1(1)(b) expenditure need not be directly related to the derivation of income but is deductible when incurred in carrying on a business for the purpose of deriving income. This permits a broader approach:
  - To be expenditure incurred in carrying on a business, the expenditure must be incurred as part of the taxpayer's business operations to obtain assessable income: *FCT v Wells* 71 ATC 4,188 (HCA); *John Fairfax and Sons Pty Ltd v FCT* (1959) 101 CLR 30 (HCA).
  - Whether expenditure has a sufficient relationship to the taxpayer's business operations is usually determined from objective matters. However, subjective matters may be relevant where the expenditure was incurred by choice and the relationship between the expenditure and the business operations is more indirect and remote: *Banks* at 477; *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4,542 (FCAFC) at 4,548, 4,558–4,559; *Fletcher v FCT* 91 ATC 4,950 (HCA) at 4,957; *Putnin v FCT* 91 ATC 4,097 (FCAFC); *Schokker v FCT* 99 ATC 4,504 (FCAFC).
  - Longer-term objectives can be considered. A deduction is permitted for expenditure incurred to protect or advance a business or to avoid or reduce expenditures: *Europa Oil (NZ) Ltd (No 2) v CIR* (1974) 1 NZTC 61,169 (CA) at 61,196–61,197; *Cox v CIR* (1992) 14 NZTC 9,164 (HC) at 9,168.

Capital limitation

29. If company administration costs meet the general permission, then whether any of the general limitations of s DA 2 apply to deny a deduction must

also be considered. The general limitations of s DA 2 override the general permission (s DA 2(7)). Of particular relevance to company administration costs are the private and capital limitations. The capital limitation in s DA 2(1), which will be considered first, states:

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

30. To decide whether the capital limitation applies, the various tests the courts have formulated for determining whether expenditure is capital or revenue in nature must be considered. The approach of Lord Pearce in *BP Australia Ltd v FCT* [1965] 3 All ER 209 (PC) has been described as being the governing approach for distinguishing between capital and revenue receipts or expenditure. This approach has recently been endorsed again in New Zealand by the High Court in *TrustPower Ltd v CIR* [2013] NZHC 2,970, (2013) 26 NZTC ¶21-047.

31. In *BP Australia*, Lord Pearce considered that the solution was not to be found by any rigid test. He considered it is derived from the whole set of circumstances, some of which may point in one direction, some in the other. One circumstance, pointing in one direction, may dominate other vaguer circumstances pointing in the contrary direction. What is required is a common-sense appreciation of all the guiding features. Where the categories of capital and revenue are distinct and easily ascertainable in obvious cases that lie far from the boundary line it may not be necessary to apply all the tests: *CIR v L D Nathan & Co* [1972] NZLR 209 (CA).

32. The courts have identified seven tests to assist in determining whether expenditure is capital or revenue in nature. They are summarised as follows:

    - The **need or occasion** that calls for the expenditure. This important test focuses on the principal reason or need for incurring the expenditure. It can form the basis for applying other tests: *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981 (CA); *Carron*.
    - Whether the expenditure is **recurrent** in nature. This involves considering whether the expenditure is recurrent (suggesting a revenue outlay) or a once and for all payment (suggesting a capital outlay): *Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes)* (1910) 5 TC 529 (CtSess) at 536; *W Nevill and Co Ltd v FCT* (1937) 4 ATD 187, (1937) 56 CLR 290 (HCA); *BP Australia; Sun Newspapers Ltd v FCT* (1938) 5 ATD 87, (1938) 61 CLR 337 (HCA).
    - Whether the expenditure is sourced from **fixed or circulating capital**. Fixed capital is what an owner turns to profit by keeping it in their possession. Circulating capital is that which comes back as part of the trading operations. A fixed capital source suggests a capital outlay: *BP Australia; John Smith & Son v Moore (Inspector of Taxes)* [1921] 2 AC 13 (HL); *Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017 (HC); *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834 (HC).
    - Whether the expenditure creates an **identifiable asset**. Where an asset of a capital nature has been acquired or where money is spent on improving the asset, making it more advantageous or getting rid of a disadvantageous asset, the expenditure will be on capital account: *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 (HL); *CIR v McKenzies* (1988) 10 NZTC 5,223 (CA).
    - Whether the expenditure is a once and for all payment producing assets or advantages that are of an **enduring benefit**. Expenditure will be regarded as capital where it brings into existence an asset or advantage for the enduring benefit of the business: *British Insulated and Helsby Cables Ltd v Atherton* [1925] All ER Rep 623 (HL) at 629; *Anglo-Persian Oil Co Ltd v Dale* (1931) 16 TC 253 (KB) at 262; *McKenzies*.
    - How the expenditure is treated under **ordinary principles of commercial accounting**: *FCT v James Flood Pty Ltd* (1953) 88 CLR 492 (HCA); *Broken Hill Theatres Pty Ltd v FCT* (1952) 85 CLR 423 (HCA).
    - Whether the expenditure is on the **business structure** or **business process**. This test focuses on the distinction between expenditure on the business structure set up to earn profit (capital), and regular expenditure on the process by which regular returns are obtained (revenue): *Buckley & Young* at 61,274; *Sun Newspapers; Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HCA); *Anglo-Persian Oil; Fullers Bay of Islands Ltd*.

33. Many of the above tests will overlap and some factors will carry more weight than others in given circumstances. Therefore, while these tests are a useful guide, a final judgement of whether the expenditure is capital or revenue in nature must be made by analysing the facts as a whole and weighing up which factors carry the most weight in light of these facts. Generally, no case will be decided under one test.

Private limitation

34. The Taxation Review Authority has considered several times whether a company can incur expenditure subject to the private limitation where the expenditure is for the private benefit of a shareholder or employee. See, for instance: *Case L31* (1989) 11 NZTC 1,188; *Case L89* (1989) 11 NZTC 1,508; *Case M82* (1990) 12 NZTC 2,484.

35. However, none of these decisions considered company administration costs. The Commissioner considers it unlikely that company administration costs will be incurred for the private benefit of a shareholder or employee. Therefore, the private limitation is not relevant to the issue of whether company administration costs are deductible under the Act.

Apportionment

36. Section DA 1 allows a deduction for expenditure "to the extent to which" it is incurred in deriving income and so expressly contemplates apportionment: *Banks* (at 476 477).

37. In *Banks*, Richardson J drew a distinction between dissecting and apportioning expenditure. This distinction was drawn from the Australian High Court decision of *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 59. Where expenditure has distinct and severable deductible and non-deductible components it can be divided or dissected. This occurs where the distinct and severable components can be related to differing tax treatments, such as assessable and non-assessable income or to revenue and capital or private expenditure. Dissection would be possible for a composite amount that relates to, say, an itemised invoice, or to several things or services with discrete parts.

38. In contrast, where a single outlay serves two or more objects indifferently, dissection is impractical. Here, apportionment on a fair and reasonable basis (such as time, area or some other quantifiable basis), applies. The court noted in *Ronpibon Tin* that entire sums, such as directors' fees, are not normally able to be dissected so are subject to apportionment.

39. Richardson J also drew a distinction between two circumstances where dissection or apportionment would either apply or not apply: *Buckley & Young* at 489 (citing *Anglo-Persian Oil* at 139–140). One was where a payment secures two advantages, one of which is merely ancillary to the other and does not affect the true character of the payment. Deductible expenditure with some ancillary non deductible object remains entirely deductible based on its true character (and vice versa). In these circumstances, dissection or apportionment does not apply. The second circumstance was where a payment serves more than one distinct and separately identifiable advantage or outcome, in which case it should be subject to dissection or apportionment.

40. This distinction can be seen in *Christchurch Press Company Ltd v CIR* (1993) 15 NZTC 10,206 (HC). In *Christchurch Press*, Gallen J considered that although there may be more than one reason for making a payment, the principal reason for a payment determined the nature of the expenditure. Therefore, the court considered that wages of employees who were engaged in installing a capital asset did not cease to be capital expenditure, even though there may have been a secondary revenue-related reason for the expenditure of improving the production of the newspaper. So, where a payment secures dual outcomes a need for apportionment may arise. However, if one outcome is ancillary or incidental to the principal outcome, the principal outcome will determine the nature of the expenditure.

41. In *Buckley & Young*, Richardson J commented that the appropriate basis for apportionment of expenditure will depend on the circumstances. At 61,282 Richardson J acknowledged that there may be cases where it is difficult or impossible to determine the amount that is attributable to each advantage (particularly where each advantage is intangible and there is no obvious basis for apportionment). However, he considered that such a situation is likely to be rare and the mere fact that apportionment might be difficult would not of itself be reason for failing to formulate an answer.

42. In summary, the following can be drawn from case law regarding apportionment:
    - Apportionment issues arise because expenditure is deductible under s DA 1 "to the extent to which" it is incurred in deriving income: *Banks*.
    - Apportionment encompasses situations where undivided items of expenditure can either be dissected or not: *Banks*; *Ronpibon Tin*.
        - Dissection can apply where the expenditure relates to distinct and severable parts divisible between those parts that give rise to deductible expenditure and those parts that do not.
        - Where the expenditure serves both deductible and non deductible objects at the same time, dissection may not be possible and a fair and reasonable assessment must be made of

the extent of the relationship between the expenditure and deductible objects.

- Apportionment is not required where the expenditure has some incidental non-deductible object and the true character of the expenditure remains deductible: *Buckley & Young*; *Christchurch Press*.
- The most appropriate way of apportioning expenditure depends on the circumstances of the case but practical difficulties alone in determining how apportionment should apply does not mean apportionment should not be made: *Buckley & Young*.

Deductibility of company administration costs

43. While company administration costs are discussed below as distinct costs, in some instances each cost will encompass a range of different outgoings falling under the one head. It is likely these outgoings will include composite payments for which issues of dissection or apportionment may arise.

44. Therefore, in the context of the deductibility of company administration costs, the "importance of identifying the true character of the outgoing for which the deduction is sought" (*Buckley & Young*) should be borne in mind. In addition, the principles of apportionment discussed above may need to be considered in determining the tax treatment of any particular payment.

Accounting fees associated with company administration costs

45. Accounting fees do not of themselves create a category of deductible expenditure. The correct tax treatment of accounting fees depends on whether the underlying transaction or issue requiring the fees to be incurred is of a capital or revenue nature.

46. In *Case Y17* (2008) 23 NZTC 13,171 there was an underlying assumption that accountancy fees incurred for the preparation of annual financial accounts and tax returns by a company operating a business were deductible. At issue was the timing of the deduction and the Taxation Review Authority found that the fees were deductible in the year the accountancy services were performed.

47. This assumption also underlies s EA 3. Section EA 3 provides rules affecting the timing of deductible expenditure. Determination E12 *Persons excused from complying with section EA 3 of the Income Tax Act 2007* provides exemptions from compliance with s EA 3. The Determination includes an exemption for "mandatory accounting costs" incurred for the purpose of meeting statutorily imposed information requirements. Such costs are exempted on the presumption they would otherwise be deductible and potentially subject to s EA 3.

48. Other examples of deductible accounting fees are those associated with dealing with creditors or other operational matters relating to a business.

49. In contrast, accounting fees relating to the acquisition of a capital asset will generally be an item of a capital nature and non-deductible. In *Case K50* (1988) 10 NZTC 411 accounting costs incurred by the taxpayer to investigate whether to purchase a veterinary practice were found to be capital costs and as such were not deductible. The Authority considered the accounting costs related to the taxpayer's business structure and were not incurred as a revenue item in gaining or producing assessable income.

50. Another example is the Australian decision in *Case E29* 73 ATC 241, which concerned a company that was incorporated after preliminary studies into establishing a large industrial enterprise were favourable. However, an overseas promoter ultimately withdrew from the project and the enterprise was not established. The company had incurred substantial expenses, including legal and accounting expenses, over several years. The Board held that all the expenses incurred were losses or outgoings of a capital nature for the purpose of establishing a "profit-yielding subject" and so were not deductible.

Audit fees

51. The Companies Act 1993 requires some companies to appoint an auditor. An annual audit of a company's accounts is generally sought because the ownership of the company is separate from the management of the company. An audit is necessary to ensure that the financial accounts prepared by the directors accurately reflect the company's financial position. This protects the company from the consequences of errors in the accounts and provides shareholders with reliable financial information. Reliable financial information enables the shareholders to monitor the performance of the directors. Others who rely on the accuracy of audited financial statements include the providers of goods or services to a company (such as general trade creditors and financiers). Also, as a matter of practice, a company will generally be required to supply financial statements to its financiers on a regular basis.

52. Not every company that is carrying on a business for the purpose of gaining income will be required to appoint an auditor. However, in practice, audit fees will generally be incurred only by companies

that are carrying on a business and are required to report trading results either to their shareholders or financiers. As the function of the audit is to disclose the company's business to its shareholders or financiers, there are strong grounds for finding that such expenditure has the necessary relationship with the business carried on by the company. Where a company has the option not to appoint an auditor but elects to do so, the appointment will generally be dictated by business ends, such as a requirement to report the business operations to shareholders or third parties with an interest in the company.

53. Treating audit fees as a deductible expense is consistent with the UK decision of *Caparo Industries plc v Dickman* [1990] 1 All ER 568 (HL) in which Lord Oliver said at 583:

> It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, second, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.

54. The discussion in *Caparo* suggests there is a relationship between the auditing of a company's accounts and the company's business because it would not be possible for a company to make appropriate decisions as to the use of its funds if its accounts were not accurate. The Canadian Exchequer Court in *British Columbia Power Ltd v MNR* 66 DTC 5,310 also considered that audit fees were deductible. Support for treating audit fees as deductible can also be found in *Worsley Brewery Co Ltd v Commissioners of Inland Revenue* (1932) 17 TC 349 (CA) and *Rushden Heel Co Ltd v Keene (Inspector of Taxes)* (1948) 30 TC 298 (KB).

55. In addition, Canadian cases have taken a broader interpretation of expenses incurred for the purpose of gaining income from a business. These cases establish that a company's expenses in communicating with its shareholders can be considered a necessary part of carrying on business through a company and that those communications can be part of the process of earning business income. These cases include *British Columbia Power Corporation v MNR* 67 DTC 5,258 (SCC) and *Boulangerie St-Augustin Inc v The Queen* 95 DTC 164 (TaxCC). The Commissioner considers that one aspect of communicating with shareholders will be ensuring the accuracy of the information via the audit process.

56. In the Supreme Court of Canada case of *British Columbia Power*, the court had to consider the deductibility of legal expenses incurred in a court action to defend a company's title to shares in a subsidiary that were to be expropriated by the government. In addition, certain expenses were incurred for communicating with shareholders to inform them of the expropriation and ensuing developments. The court found that expenditure incurred in relation to communicating with shareholders was a deductible expense. The court considered that, as shareholders hold the ultimate control of a company and the power of shareholders to determine a company's policy could not be properly exercised unless they are informed periodically of its affairs, the reasonable furnishing of such information is properly part of the company's business.

57. Referring to *British Columbia Power* (SCC), the Tax Court in *Boulangerie* also considered that a company must communicate regularly with its shareholders as part of the process of earning business income. The court considered that the expenses in communicating with shareholders and share transfer costs were inherent in the management of every business corporation and were part of the general administration expenses that every company must incur to earn business income. Such expenditure was a legitimate expense made in the ordinary course of the company's business.

58. The court did not accept that the expenditure was incurred to preserve the existing shareholders' positions as owners of the company. Neither was it incurred to obtain any enduring benefit, such as additional funds or the expansion of the company's business. Any enduring benefit, in the form of the advancement of the company's long-term interests, was a secondary consequence of the expenditure. As a result, the expenditure incurred was not capital expenditure. The decision was upheld by the Federal Court of Appeal (*The Queen v Boulangerie St-Augustin Inc* 97 DTC 5,012 (FCA)).

59. On the basis of the above approach by the courts, audit fees are deductible where a company carries on a business. The provision of accurate information to shareholders on the company's financial position is essential to enable the shareholders to exercise their power to control the company and for other stakeholders to make decisions regarding their relationship with the company. The auditing of the

company's accounts is undertaken to ensure that financial information can be relied on.

60. Therefore, the Commissioner considers that audit fees are revenue expenditure because the fees are:
    - an on-going annual cost;
    - generally incurred where there is a need to report trading results to shareholders and financiers;
    - incurred to accurately inform shareholders of those trading results to allow the shareholders to exercise their power of control over the company; and
    - incurred to help protect the company from the consequences of undetected errors and wrongdoing.

61. The Commissioner also considers that audit fees are not capital expenditure. The need or occasion for such expenditure is to report trading results. The expenditure does not create an identifiable asset or an enduring benefit for the company. It is a recurrent annual expense, most likely funded out of circulating capital, and is treated as a revenue expense under ordinary accounting principles. Therefore, overall, the expenditure has the character of a revenue expense.

Dividends

62. Expenditure incurred in paying dividends is deductible for the 2014–15 and subsequent income years. This is provided by s DB 63, which allows a company a deduction for expenditure incurred in authorising, allocating, or processing the payment of a dividend. Section DB 63 also provides a deduction for expenditure incurred in resolving a dispute concerning authorising, allocating, or processing the payment of a dividend.

63. Section DB 63 supplements the general permission contained in s DA 1, meaning the general permission does not need to be satisfied to achieve a deduction. Also, the limitation on deducting capital expenditure does not apply. Section DB 63 states:

> **DB 63 Expenses in paying dividends**
>
> *Deduction*
>
> (1) A company is allowed a deduction for expenditure incurred in—
>
> (a) authorising, allocating, or processing, the payment of a dividend:
>
> (b) resolving a dispute concerning a matter referred to in paragraph (a).
>
> *Link with subpart DA*
>
> (2) This section supplements the general permission and overrides the capital limitation. The other general limitations still apply.

64. In the Commissioner's opinion, s DB 63 provides a deduction for all expenses usually encountered by a company in paying dividends.

Legal fees associated with company administration costs

65. Legal fees do not of themselves create a category of deductible expenditure. Similar to accounting costs, discussed from para 45, the correct tax treatment of legal fees associated with company administration costs will depend on the purpose for which such services have been employed. As stated by Dixon J in *Hallstroms* at 647:

> The claim is to deduct legal expenses, and legal expenses, we may assume, take the quality of an outgoing of a capital nature or of an outgoing on account of revenue from the cause or the purpose of incurring the expenditure. We are, therefore, remitted to a consideration of the object in view when the legal proceedings were undertaken, or of the situation which impelled the taxpayer to undertake them.

66. Accordingly, if the underlying cause or purpose for incurring the legal fees is deductible in nature, the fees will also be deductible. If the cause or purpose is capital in nature, the fees will not be deductible.

67. However, s DB 62 may allow a deduction for some legal expenses despite the underlying cause or purpose being capital in nature. Section DB 62 provides that a deduction is allowed for legal expenses that are deductible under the general permission but are of a capital nature and total, for an income year, $10,000 or less. Section DB 62 specifically overrides the capital limitation, but the general permission and other general limitations still apply. Legal expenses are defined for s DB 62 as fees for legal services (as defined in the Lawyers and Conveyancers Act 2006) provided by a person who holds a practising certificate issued by the New Zealand Law Society or an Australian equivalent. Where the total legal expenses for an income year exceed the $10,000 limit, then the legal expenses must be treated in the normal way as described above.

Listing fees

68. A company may enter into a listing agreement with the operator of a financial products market licensed under the Financial Markets Conduct Act 2013: s 327. Usually, an initial listing fee is payable for admission to the market and listing of financial products. Additional listing fees are payable for any subsequent listing of additional financial products. Companies that have listed also pay a periodic fee to remain listed. Whether listing fees are deductible depends on whether the fees incurred are periodic listing fees or

whether they are initial or additional listing fees. These two types of fees are considered separately below.

Initial and additional listing fees

69. To determine whether initial and additional listing fees are deductible, the true character of the advantage sought or obtained by a company from listing must be identified (*Buckley & Young*). Listing a company's shares or debt securities facilitates capital raising because it enhances the marketability of a company's securities by providing liquidity to investors. Another advantage of listing is that it raises the profile of the company and its brands. It can also aid a company's ability to attract and retain senior employees through the use of share options and the use of its shares as currency for mergers and acquisitions.

70. Viney, in McGrath's *Financial Institutions, Instruments and Markets* (5th ed, McGraw-Hill, Sydney, 2007), states at para 5.3:

> Listing on a stock exchange provides access to a large equity capital market that is not available to an unlisted business entity. Access to this market enables a listed corporation to extend the funding base on which it can expand and grow its business activities into the future. Also ... shares issued by listed companies are very liquid; that is, they can easily be sold through a stock exchange, and therefore are an attractive investment option for investors. Another advantage of listing for a corporation is that it raises its profile in the financial markets and in the markets for its products and services.

71. A publication by NZX Ltd, *From Good to Great, Book One: The story of listing with NZX* (New Zealand Exchange Ltd, October 2006), at 17, explains that listing provides access to additional capital after the initial capital raising through secondary capital raising options (including new issues to existing shareholders, placement or subsequent public offerings). It also suggests how listing on the market could raise a company's profile and brand leverage at 35:

> The day of listing can be a great PR opportunity for your firm should you choose to publicise it. This is because interest in your company will be at its highest – and naturally, media attention will follow. Having the media interested in your company will grow your reputation and image and sharpen your competitive advantage. The benefit is that it will be easier for you to naturally attract new customers and suppliers as well as improving your company's creditworthiness in the eyes of banks and suppliers, who can rely on the release of publicly available information for analysis.
>
> Ongoing, the fact that the public now hold an interest and ownership stake in your company presents you with a unique marketing opportunity. With disclosure obligations, you will be required to make regular public announcements and the media will take a more active interest in your business. Generally, the more information in the public domain, the more the media will follow your brand.

72. As mentioned, listing on the market raises the profile of a company and its brands. In other words, listing helps build a company's goodwill. Goodwill has been defined as "the attractive force which brings in custom": *Commissioners of Inland Revenue v Muller & Co's Margarine Ltd* [1901] AC 217 (HL).

73. Goodwill is generally regarded as an asset of a capital nature, so that expenditure relating to the acquisition of goodwill is capital expenditure: *CIR v L D Nathan & Co Ltd*; *Buckley & Young*. Goodwill can be built up by expenditure to generate brand, product and business name recognition that helps to generate revenue. Though goodwill is a capital asset of a business, it is frequently earned and maintained by the daily activities of those engaged in the business. The valuable, if intangible, asset of goodwill frequently grows out of activities for which the cost is a charge on revenue account. Expenditure that results in the creation of goodwill would not cease to be expenditure of a revenue nature merely because such expenditure enables goodwill to be earned or maintained. However, listing fees are paid principally to facilitate the acquisition of additional capital (that is, an advantage of a capital nature).

74. Funds provided by shareholders subscribing to shares are a contribution to the capital structure of the company: *FCT v The Midland Railway Co of Western Australia* (1952) 85 CLR 306 (HCA). Also, expenditure incurred in borrowing money to raise capital is generally capital expenditure: *Texas Land & Mortgage Co v Holtham (Surveyor of Taxes)* (1894) 3 TC 255 (QB); *New Zealand Dairy-Farm Mortgage Co Ltd v Commissioner of Taxes* [1941] NZLR 83 (CA); *Case E1* 73 ATC 1; *Montreal Coke and Manufacturing Co v MNR* [1944] 1 All ER 743 (PC); *Ure v FCT* 80 ATC 4,264 (NSWSC); *CIR v Inglis* (1992) 14 NZTC 9,180 (CA).

75. The initial and additional listing fees are paid for the same purpose, the listing of the company's securities. The advantage sought or obtained from the initial and additional listing fees is the facilitation of the raising of capital, whether equity or debt. Equity funding is fixed capital. Generally, debt funding is also fixed capital. Therefore, initial and additional listing fees (whether relating to listing equity or debt securities) will generally be capital expenditure on the basis that it is paid to facilitate the obtaining of fixed capital.

76. There are circumstances where expenditure incurred in borrowing money is revenue expenditure. This will be so where a taxpayer is in the business of borrowing and lending money and the borrowed money is borrowed for on-lending in the ordinary course of the taxpayer's business: *Scottish North American Trust v Farmer (Surveyor of Taxes)* [1912] AC 118 (HL); *Canada Permanent Mortgage Corporation v MNR* 71 DTC 5,409 (FCTD); *AVCO Financial Services Ltd v FCT* 82 ATC 4,246 (HCA); *Coles Myer Finance Ltd v FCT* 93 ATC 4,214 (HCA).

77. Accordingly, the Commissioner considers that the initial and additional listing fees are a cost of raising capital. The advantage obtained from listing is the facilitation of both the initial capital raising and the raising of additional capital by the issue of further securities. Therefore, in the Commissioner's view, initial and additional listing fees are not deductible on account of being capital expenditure.

78. However, the implications of s DB 5 and the financial arrangements rules need to be considered in the context of initial and additional listing fees for debt securities. Those matters are set out briefly below. For a comprehensive discussion of s DB 5, including the implications of the financial arrangements rules in this context, see Interpretation Statement, IS 13/03: "Income Tax – deductibility of expenditure incurred in borrowing money – Section DB 5".

Section DB 5 and financial arrangements rules

79. Paragraph 12 of IS 13/03 states:

> Section DB 5 allows a person a deduction for expenditure incurred "in borrowing money that is used as capital in deriving their income". For expenditure to be deductible under s DB 5, the:
>
> - expenditure must be incurred by the taxpayer;
> - expenditure must be incurred in borrowing money; and
> - the taxpayer must use the borrowed money as capital in the derivation of their income.

80. A deduction is allowable under s DB 5 for expenditure incurred as a transaction cost in borrowing money where that expenditure would otherwise be capital expenditure. To be expenditure incurred in borrowing money, the expenditure must be incurred under a contractual obligation entered into in connection with the establishment of a loan: *Ure*; *Brown v CIR* (1995) 17 NZTC 12,385 (HC); *MNR v Yonge-Eglinton Building Ltd* 74 DTC 6,180 (FCA).

81. Initial and additional listing fees for debt securities may form part of the consideration arising under a financial arrangement subject to the financial arrangements rules of subpart EW. If applicable, the financial arrangements rules will take precedence over s DB 5 in determining the deductibility of the fees: s EW 2. Whether initial or additional listing fees for debt securities are deductible under s DB 5 or fall under the financial arrangements rules will depend on the particular circumstances.

Periodic listing fees

82. Unlike initial or additional listing fees, periodic listing fees are not directly related to the raising of particular funds. The true character of the advantage sought or obtained by a company from incurring periodic listing fees is to maintain the advantages that the initial or additional listing fees have secured.

83. Where a listed company incurs periodic listing fees in the course of carrying on a business for the purpose of deriving income, the Commissioner considers that, unlike the initial or additional listing fees, the periodic listing fees are deductible under the general permission in s DA 1 and are not capital expenditure.

84. This conclusion has been confirmed and expanded upon for the 2014/15 and subsequent income years. The deductibility of periodic listing fees is now dealt with by a specific provision in the Act: s DB 63B. Section DB 63B supplements the general permission in s DA 1, overrides the capital limitation and provides a deduction for expenditure incurred on periodic fees of a recognised exchange. Accordingly, all companies, whether or not they are carrying on a business or income-earning activity, are able to deduct periodic listing fees under s DB 63B. Generally, licensed markets under the Financial Markets Conduct Act 2013 will be a "recognised exchange" as defined in s YA 1 of the Income Tax Act 2007. Section DB 63B states:

> **DB 63B Periodic company registration fees**
>
> *Deduction*
>
> (1) A listed company is allowed a deduction for expenditure incurred as periodic fees of a recognised exchange for maintaining the registration of the company on the exchange.
>
> *Link with subpart DA*
>
> (2) This section supplements the general permission and overrides the capital limitation. The other general limitations still apply.

Share registry expenses

85. The Companies Act 1993 places companies under a duty to maintain a share register. Failure to comply leaves both the directors and the company open to prosecution. The share register must contain the names and addresses of all shareholders over the last 10 years. If shares have been issued, repurchased,

redeemed or transferred, the register must contain the dates of each transaction and the name of the shareholder to, or from, whom shares were transferred. A company must also make the share register available for inspection by members of the public. A share register is intended to show persons dealing with the company, such as creditors, to whom and what they have to trust: *Oakes v Turquand & Harding* (1867) LR 2 HL 325 at 367.

86. The entry of a shareholder's name on the register is prima facie evidence of legal title to shares. In the absence of a register or if the register is defective, a shareholder's title to shares may be established by other evidence: *Haddow Nominees Ltd v Rarawa Farms Ltd (in liq)* [1981] 2 NZLR 16, (1981) 1 NZCLC 98,171 (CA). For a person to receive distributions, exercise rights and be entitled to receive notice of and attend meetings, their name must appear in the share register of the company.

87. Under the Companies Act 1993, the shareholders hold the power to make certain decisions relating to the company's business, such as the appointment or removal of directors at annual shareholder meetings. The persons who hold the power to make such decisions are the persons whose names are registered in the share register on the relevant date. The share register must be maintained to enable the company to establish who holds the power to make decisions on matters relating to the company's business. Accordingly, a share register:

- provides prima facie evidence of legal title to shares
- records and discloses who the shareholders of the company are.

88. Under the general permission in s DA 1, expenditure incurred in maintaining a share registry may not immediately be regarded as having a direct connection with the derivation of a company's income or to the carrying on of a business. Given that all companies are required to maintain a register whether or not they are carrying on a business, it is arguable that share registry expenses are not wholly dictated by business ends. These issues do not appear to have been considered by the courts of New Zealand, Australia or the United Kingdom.

89. In the Canadian case of *Distillers Corporation Seagrams Ltd v MNR* 58 DTC 1,168, the Exchequer Court considered issues of apportionment concerning various items of expenditure incurred by a holding company, including what might be regarded as "share registry expenses". These were amounts paid for the services of transfer agents and registrars of the company's shares and dividend disbursing agents. The court considered these amounts were not deductible because they were incurred in connection with dealings with the company's own shareholders or in connection with the administration of the capital structure of the company.

90. However, as discussed above in paras 55 to 58 in the context of audit fees, more recent Canadian cases (*British Columbia Power* (SCC) and *Boulangerie* (FCA)) have taken a broader interpretation of expenses incurred for the purpose of gaining income from a business. These cases establish that the expenses of communicating with shareholders can be considered deductible. In the earlier discussion of audit fees, the Commissioner considered that an aspect of communicating with shareholders relevant to that expense was ensuring the accuracy of the information communicated. Similarly, the Commissioner considers that another aspect of communicating with shareholders relevant to share registry expenses is the need to establish the identity and contact information of the company's shareholders. The share register identifies who the shareholders are and facilitates the company's ability to communicate with them.

91. The Supreme Court in *British Columbia Power* does not refer to Distillers. In *Boulangerie* (TaxCC), the court considered that *Distillers* had been implicitly reversed by the Supreme Court in *British Columbia Power*. Under the New Zealand test of deductibility, a sufficient relationship between the expenditure and the taxpayer's business or income-earning process must be established. In the Commissioner's view, the conclusions in *British Columbia Power* (SCC) and *Boulangerie* (TaxCC) and (FCA) are consistent with the New Zealand test of deductibility.

92. Other case law also establishes that expenditure relating to a company's capital structure and transactions with shareholders may be deductible in some circumstances: *Carron*; *Truckbase Corporation v The Queen* (2006) DTC 2,930 (TaxCC); *St George Bank Ltd v FCT* [2009] FCAFC 62, 2009 ATC ¶20-103. In each case, the true character of the advantage sought or obtained from the expenditure must be determined. An ancillary or incidental advantage does not alter the character of a payment: *Buckley & Young*.

93. *Carron* and the other cases suggest:

- The fact that expenditure relates to dealings with a company's shareholders does not necessarily mean that the expenditure is not deductible (as in some circumstances the interests of the shareholders may be inseparable from those of the company).

- The cost of meeting obligations relating to a company's capital structure is not necessarily capital expenditure. Whether such expenditure is capital expenditure depends on whether the company obtains an advantage from the expenditure that is capital in nature.

94. As indicated, the New Zealand courts have not considered the issue of whether share registry costs have the necessary relationship to a company's business operations. If called upon to do so, they are likely to take an approach that reflects the commercial realities of the relationship between a company and the business it carries on. Such an approach would be consistent with the findings of Richardson J in Banks at 477, where he indicated the reluctance of judges to establish hard and fast rules for the interpretation of the primary deductibility provisions:

> The language of s 111 [now s DA 1(1)(b)] is deceptively simple. The width and generality of the statutory language has posed problems for the courts and tribunals faced with applying the provisions in a practical way. There has been an understandable unwillingness in the cases to establish hard and fast rules to cover all situations in an area of the law which, so far as possible, should reflect commercial realities.

95. In New Zealand, a company structure is a preferred structure for operating a business. There are many reasons for this, such as limitation of liability, the ability to raise capital, controlling ownership and succession planning. The commercial view is that, once an entity is chosen for a business, expenditure on maintaining that entity is an administrative cost that should be regarded as necessarily incurred in carrying on its business. As a matter of good management practice, and as a practical requirement of running a business through a company structure, a company is bound to comply with the provisions of the Companies Act 1993 and its own constitution.

96. In the Commissioner's opinion, sufficient support exists for the view that, once a company is chosen as the entity through which a business activity is to be carried on, generally the administrative costs of maintaining the company will meet the general permission. The reason for this view is that such expenditure will be dictated by commercial necessity for the period during which the company is carrying on a business.

97. However, even if such expenditure meets the general permission, a deduction will be disallowed if it is expenditure of a capital nature. The following observations can be made regarding the tests or indicia formulated by the courts:

    - The need or occasion for the expenditure is to comply with statutory requirements and there is no wider object in view. Failure to comply with those requirements is an offence under the Companies Act 1993.
    - The identifiable asset test does not apply to share registry expenses. No asset is acquired or brought into existence. There is no improvement to an asset nor can such expenses be said to produce any enduring benefit. They can be viewed as maintenance type expenses, having been accepted as being of a revenue nature: *Tucker v Granada Motorway Services Ltd*.
    - The expenses associated with maintaining a share registry are expenses that are recurrent and may be contrasted with the "once and for all" type of expenditure that might be regarded as being associated with bringing into existence an enduring benefit. Expenses will be incurred on an on going or annual basis to the extent that the expenditure may be concerned with annual reports, meetings or proxies associated with such meetings. Expenses will also be incurred on maintaining the register with each change of shareholding.
    - The expenses incurred in relation to share registry matters relate to the income-earning structure rather than the process of earning income. However, share registry expenses do not relate to the creation, acquisition or enlargement of the permanent structure of a company and are related to maintaining its operational structure.
    - The most likely treatment of share registry costs under the ordinary principles of commercial accounting would be to treat them as revenue expenses, given that the expenditure does not give rise to an asset.

98. Having regard to the various capital/revenue tests, only the test relating to whether the expenditure is on the income-earning structure or income-earning process might lead to a view that the expenditure is of a capital nature. Otherwise, the tests support a finding that generally share registry expenses are on revenue account. However, some share registry expenses could possibly relate to matters that will create an enduring benefit to the company in particular situations (such as in relation to mergers, acquisitions or migrations). In such situations, the facts in each case must be considered.

Shareholder meetings

Introduction

99. The powers reserved to shareholders by the Companies Act 1993 may be exercised at a meeting of shareholders or by a resolution in lieu of a meeting. Shareholders must be given a reasonable opportunity at meetings to question, discuss or comment on the management of the company and they can pass a non-binding resolution relating to the management of the company. Under the Companies Act 1993, a company must have an annual meeting of shareholders but other meetings, called special meetings, are possible.

100. An annual meeting of shareholders must be called not later than 6 months after balance date and not later than 15 months after the previous annual meeting. Generally, the ordinary business of an annual meeting is to:
   - consider the financial accounts and auditors' report;
   - confirm the appointment and removal of directors and determine their remuneration; and
   - confirm the appointment of auditors and determine their remuneration.

101. A special meeting of shareholders may be called at any time, either by the board, by someone authorised by the constitution or by shareholders holding not less than 5% of the voting rights. The board of a company is likely to call a special meeting when there is a major transaction requiring shareholder approval or if there are constitutional matters that need to be considered. Often, the purpose of a special meeting is to consider:
   - alterations to the company's constitution (including alterations to shareholders' rights);
   - arrangements with creditors;
   - liquidating the company;
   - major transactions, as required by s 129 of the Companies Act 1993;
   - ratifying the actions of directors; or
   - matters relating to a takeover offer.

102. Occasionally, meetings of shareholders may also arise as a result of a court order. A court has the power to make a wide range of procedural orders, including ordering meetings of shareholders or any class of them be held to consider, and approve if appropriate, arrangements under Parts 14 (Compromises with creditors) and 15 (Approval of arrangements, amalgamations, and compromises by court) of the Companies Act 1993.

103. The tax treatment of expenditure incurred for shareholder meetings is subject to s DB 63C, which provides:

> **DB 63C Meetings of shareholders**
>
> *Deduction*
>
> (1) A company is allowed a deduction for expenditure incurred in holding an annual meeting of the shareholders of the company to consider the affairs of the company.
>
> *No deduction*
>
> (2) A company is denied a deduction for expenditure incurred in holding a special or extraordinary meeting of the shareholders of the company.
>
> *Link with subpart DA*
>
> (3) Subsection (1) supplements the general permission and overrides the capital limitation. Subsection (2) overrides the general permission. The other general limitations still apply.

104. Section DB 63C applies to expenditure incurred in "holding" a meeting. The Commissioner considers that expenditure incurred in holding a meeting comprises only the costs directly incurred in physically holding or conducting the meeting. This is based on the meaning of "holding" or "hold", which, according to the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011), is:

> **9** arrange and take part in (a meeting or conversation).

105. This means that expenditure likely to be incurred by companies for a shareholders' meeting can be divided into two categories:
   - Expenditure incurred in holding a meeting.
   - Other expenditure incurred in relation to a meeting.

   This division is necessary because different tax treatments can apply to the two categories of costs.

106. Direct expenditure incurred in holding a meeting would include costs of:
   - Venue hire and any other costs related to preparation of the venue (eg, hire of audiovisual equipment).
   - Refreshments provided to those attending the meeting.
   - Printing, publishing, postage and advertising of notices of the meeting.
   - Preparation of resolutions.
   - Travel for directors and other persons required to attend the meeting.
   - Any other costs directly related to physically holding or conducting the meeting.

107. Indirect expenditure for a meeting would be any other expenditure incurred for matters to be considered or tabled at a meeting of shareholders that is not a direct cost of physically holding or conducting the meeting. This would include expenditure such as consultants' fees or internal costs incurred in the preparation of reports to the board specifically on matters concerning the meeting. Other indirect costs could include costs relating to determining the contents of meeting agendas, reports and shareholder resolutions or polling shareholders on likely voting decisions.

Direct expenditure incurred in holding a meeting

108. The tax treatment of expenditure incurred in holding a meeting is provided for by s DB 63C for the 2014–15 and subsequent income years. Accordingly, expenditure incurred in holding a meeting of shareholders is:
   - deductible where the expenditure is incurred in holding an annual meeting
   - not deductible where the expenditure is incurred in holding a special or extraordinary meeting.

109. To qualify for a deduction under s DB 63C(1) for annual meeting costs, the expenditure in question does not need to satisfy the general permission in s DA 1. Deductibility of the expenditure is also not prohibited by the capital limitation.

Indirect expenditure incurred for a meeting

110. The tax treatment of indirect expenditure incurred for a meeting of shareholders depends on identifying the true character of the advantage sought or obtained from the expenditure: *Banks*; *Buckley & Young*. This requires examining the purpose of the meeting for which the expenditure was incurred.

Indirect meeting costs relating to the ordinary business purposes of an annual meeting

111. The Commissioner considers that where the indirect expenditure was incurred for the ordinary business of an annual meeting it will be deductible where the company is carrying on a business. As mentioned at para 100, the ordinary business of an annual meeting would generally include:
   - Considering the financial accounts and auditors report.
   - Confirming the appointment and removal of directors and determining their remuneration.
   - Confirming the appointment of auditors and determining their remuneration.

112. The Commissioner considers that the ordinary business of an annual meeting has a sufficient connection with a company's business so that the indirect meeting costs would be deductible. For instance, reporting to shareholders on the financial performance of the company should be regarded as a proper part of carrying on the company's business: *British Columbia Power* (SCC); *Boulangerie* (TaxCC) and (FCA). The management of the business is in the hands of the directors and this requires shareholders to discuss and approve their remuneration. This requirement often originates from the carrying on of a business by the company. Generally, the power of shareholders to determine the company's policy is exercised by appointing directors who agree with the shareholders. *British Columbia Power* (SCC) also supports the view that expenditure incurred to enable shareholders to exercise their power to determine the company's policy is deductible. Also, audit fees are considered to be deductible (see discussion from para 51). It follows that expenditure incurred to appoint auditors should also be deductible, including indirect costs incurred for a meeting of shareholders to confirm their appointment and remuneration.

Indirect meeting costs relating to other meeting purposes

113. Here, the other meeting purposes considered are the:
   - alteration of the company's constitution;
   - alteration of shareholders' rights;
   - making of arrangements with creditors;
   - liquidation of the company;
   - approval of major transactions under the Companies Act 1993;
   - ratification of directors' actions or breaches of their duty to the company; and
   - consideration of takeover offers by a target company.

Alteration of constitution

114. Where expenditure is incurred to make alterations to the constitution of a company, whether there is the required nexus with the carrying on of the business or income earning activity by the company must first be established. Consistent with the approach approved in Banks, to determine whether such expenditure is deductible, it is necessary to:
   - consider the circumstances in which the expenditure was incurred;
   - identify the true nature of the advantage sought or obtained from the expenditure—this requires consideration of the commercial objective of the expenditure; and

- consider whether there is a sufficient relationship between the expenditure and the company's business or income-earning activity.

115. In many cases, expenditure on altering a company's constitution will not have an impact on the earning of income and will relate to the distribution of income, so the necessary nexus will not be established. Also, expenditure incurred for the alteration of a company's constitution is more likely to be capital expenditure. Such matters are related to the business entity rather than to the carrying on of a business. An alteration to the constitution is a matter affecting the entity or the capital structure of the company and is expenditure that is "once and for all" rather than recurrent expenditure. Such expenditure may create some enduring benefit for the company.

116. However, *Carron* shows that this may not always be the case. *Carron* involved a company that incurred legal expenses to obtain a supplementary charter, as its original charter affected the profitability of the company's business because:

    - the company's borrowing powers were limited so that it was unable to raise sufficient finance for expansion; and
    - there were restrictions on the transfer of shares that made it difficult to obtain a suitable person for the position of managing director.

    The company's profitability had increased following obtaining the supplementary charter.

117. In the House of Lords, the Revenue argued that the supplementary charter included provisions that were irrelevant to the company's business operations. The House of Lords rejected that argument. Their Lordships considered that the purpose of amending the company's constitution was to facilitate the company's trading operations and that any constitutional amendments going beyond that purpose could be disregarded.

118. The Revenue also argued that the expenditure was capital expenditure because it secured an enduring benefit in the form of a better administrative structure and that the company's constitution itself was a capital asset. That argument was also rejected. Lord Reid (with whom Lord Morris agreed) considered that the advantage obtained from the expenditure was of a revenue nature, in that it enabled the company's business to be carried on more efficiently and to be financed more easily. Lord Guest considered that the advantage obtained was of a revenue character as the removal of restrictions in the original charter enabled the company's day-to-day business to be carried on more efficiently. The advantages gained from the expenditure were in the nature of repair and modernisation of the trading machinery.

119. *Truckbase Corporation v The Queen* is another case where the necessary nexus was established. In *Truckbase*, the taxpayer had incurred legal and accounting fees for the redrafting of unanimous shareholder agreements that were the means by which the shareholders could limit the powers of the directors. The agreements had the same function as a constitution. The revision of these agreements took operational powers away from the shareholders and gave it to the managers. McArthur J accepted that the revision of the agreements made the company more profitable as it gave employees the motivation to become an integral part of the business. His Honour considered that the costs were incurred for the purpose of a business reorganisation that facilitated effective management, good governance and protection for the company against any disruption due to the disability of key shareholder–employees. Therefore, the court held that the fees were incurred to earn income. McArthur J also considered that the fees were comparable to expenditure on "repairs" to the initial shareholder agreements and were not capital expenditure.

120. The above cases confirm that expenditure is not necessarily non-deductible because it relates to a company's administration or structure.

Alteration of shareholders' rights

121. A company is a separate entity from the shareholders. They do not own the company's property or its business, other than through the ownership of a share. The shares confer on the shareholders an interest in the company to the extent of the rights and obligations defined in the company's constitution or in the Companies Act 1993. A company must not take any action that affects the rights attached to shares unless that action has been approved by a special resolution of each interest group.

122. Expenditure incurred to alter shareholders' rights will most likely be regarded as non deductible because it fails to have the necessary nexus to the company's business or it is capital expenditure. This is because such matters will usually be related to either the right to distributions of profit or the right to control the company (affecting voting rights). These matters are related to the business entity, rather than to the carrying on of a business.

123. In *St George Bank*, Perram J considered that the number of shares on issue and the arrangements about the distribution of profits were not related to the company's income-earning activities. However, Perram J noted (at [97]–[98]) that in some circumstances (not present in the case), the position and rights of the shareholders may be enmeshed with the company's business. That is, expenditure could be deductible in some circumstances even though the expenditure relates to the position and rights of shareholders. In *St George Bank* it was held that expenditure incurred in obtaining an advantage relating to a company's business may be deductible although the expenditure also results in the alteration of the rights of shareholders.

124. It is difficult to be definitive about the circumstances in which a company may obtain an advantage of a revenue nature from expenditure incurred in altering shareholders' rights. One possibility might be where the rights of shareholders are altered in conjunction with an alteration to the company's constitution to obtain a revenue advantage. *Carron* is authority that expenditure incurred in altering a constitution to obtain a revenue advantage is deductible.

125. Therefore, the Commissioner considers that generally expenditure incurred in altering the rights of shareholders will not satisfy the general permission. However, in some circumstances, the interests of the shareholders may coincide with the interests of the company. The alteration of the rights of shareholders may be an ancillary or incidental effect of expenditure incurred for the company's business. In such circumstances, the fact that the expenditure also results in the alteration of the rights of shareholders does not necessarily mean that the expenditure is not deductible. In each case, the true nature of the advantage sought or obtained from the expenditure must be identified.

Arrangements with creditors

126. A company that is in financial difficulties may wish to take advantage of provisions in Parts 13, 14 and 15 of the Companies Act 1993 that allow it to implement compromises, arrangements, amalgamations and reconstructions.

127. Andrew Beck in *Guidebook to NZ Companies and Securities Law* (8th ed, 2010, CCH, Auckland) at [1134] states that common outcomes from compromises with creditors are an extended time to repay debts, acceptance of less than the full amount of the debt owing, and priority for some creditors over others. A compromise that is approved by creditors at a creditors' compromise meeting is binding on the company and on all creditors, or all creditors of the particular class of creditors, to whom notice of the proposal is given.

128. Part of this process may include a shareholders' meeting to consider directors' proposals relating to creditors. It is primarily these costs that are being considered here, not the costs in relation to compromise meetings of creditors.

129. *FCT v Snowden & Willson Pty Ltd* (1958) 99 CLR 431 suggests that expenditure incurred in enforcing debts owed to a taxpayer and in resisting claims by debtors of the taxpayer for a reduction of their liability is deductible. The High Court of Australia held that the expenditure was deductible because the matters at issue could have had an effect on the company's business.

130. The Commissioner considers that similar considerations would arise for debts owed by a taxpayer to creditors. Dealing with creditors may be regarded as an ordinary incident of a business and expenditure incurred in dealing with creditors will generally have the necessary connection with the carrying on of the business of the company.

131. Therefore, expenditure to consider a directors' proposal involving dealings with creditors is likely to be deductible, as such an arrangement with creditors is made to get approval from creditors to allow the company to keep on trading. An analogy can be drawn with *Carron* in that such an arrangement is made to remove impediments to efficient trading. Dealing with creditors is an ordinary incident of a company's business and is recurrent throughout the life of a company.

132. The Commissioner considers that the indirect meeting costs incurred in these circumstances are not capital expenditure. Expenditure on an arrangement with creditors is unlikely to be made "once and for all" and does not bring into existence an identifiable asset. The source of funds is likely to be circulating capital and on ordinary accounting principles the expenditure will be treated as being on revenue account. Although it could be argued that the expenditure relates to maintaining the business entity or capital structure, the expenditure is more closely related to the operations of the business.

Liquidation

133. The shareholders of a company may appoint a liquidator by a special resolution of shareholders. The principal duty of a liquidator is to take possession of,

protect, realise, and distribute the company's assets. If there are surplus assets remaining, the liquidator is required to distribute the assets or the proceeds of realisation in accordance with the company's constitution or in accordance with the Companies Act 1993.

134. Andrew Beck, in *Guidebook to NZ Companies and Securities Law*, states at [1501] that normally the winding up of a company (which terminates the existence of the company) is preceded by liquidation.

135. In the Commissioner's view, indirect meeting costs incurred for shareholders to consider the liquidation of a company are not deductible. This is because:

- Expenditure incurred in closing down a business is not deductible as it is incurred in disposing of a business and ceasing to derive income, rather than in deriving income.
- If the company's business has already ceased, the costs will not be incurred in the course of deriving income: *Amalgamated Zinc (de Bavay's) Ltd v FCT* (1935) 54 CLR 295 (HCA).
- Costs of appointing a liquidator are capital expenditure, being expenditure incurred to distribute the company's assets (that is, to dismantle the business structure).

Major transactions under the Companies Act 1993

136. A major transaction is one that, under s 129 of the Companies Act 1993:

- involves the acquisition of assets or disposition of assets of the company where the value of those assets is equal to more than half the value of the company's assets; or
- has the effect of the company either acquiring rights or interests, or incurring obligations or liabilities, the value of which is more than half the value of the company's assets prior to the transaction.

137. The management of a company is generally reserved to the directors but s 129 provides a limitation on the directors, in that a company must not enter into a major transaction unless it is contingent on, or has the approval of, shareholders by way of a special resolution. However, if the approval of the shareholders is not obtained, a major transaction would still be valid unless the other party to the transaction knew or ought to have known that the consent of shareholders had not been obtained: s 18(1)(a) Companies Act 1993.

138. The legislative history of s 129 suggests Parliament's purpose for the section was to provide a protection for shareholders. The report of the Law Commission, *Company Law Reform and Restatement* (NZLC R9, June 1989), included the first draft of what became the Companies Act 1993. The report commented on s 99, the "major transaction" provision that was enacted as s 129. The Law Commission stated:

> 499 The provision is based on the view that some dealings have such far-reaching effects that they should be referred to shareholders. **Shareholders should not find that massive transactions have transformed the company they invested in without warning.** Clearly, unless the constitution of a company restricts its activities, all shareholders will have to accept a large measure of change. Normally that may be achieved over some time, permitting the shareholder who does not like the direction the company is taking to leave or to exercise his rights to call management to account. **What we are concerned about is abrupt and substantial change which transforms the nature of the enterprise.** We think that recent experience in New Zealand has demonstrated that such transformation is a problem that should be faced up to and that it has often operated to the detriment of the company and the shareholders.
>
> [Emphasis added]

139. There is also some support in case law for the view that s 129 protects shareholders. In *Xylem Fund I, LP and Xylem Investments GP Inc v Fletcher Challenge Forests Ltd* (2002) 9 NZCLC 262,955, the High Court refused an application by minority shareholders for an order restraining the company from allowing another shareholder to vote on a s 129 resolution seeking approval for the company to acquire certain assets (Resolution 1). The minority shareholders sought the order because the other shareholder was to be involved in various transactions that would provide funding for the acquisition. The court refers to s 129 as providing protection for shareholders, at 262,963:

> The necessity for a special resolution under s 129 is the appropriate protection for shareholders in relation to Resolution 1.

140. Significantly, a shareholder who votes against a successful s 129 resolution has a further protection provided by s 110 of the Companies Act 1993. Section 110 entitles them to require the company to purchase their shares. This suggests the scheme of the Companies Act is primarily for s 129 to provide protection for shareholders, rather than reserving a significant management power to shareholders.

141. In practice, prudent directors would generally only commit to proceed with a major transaction once it

was fully investigated and they would only incur the expense of holding a meeting of shareholders when they were fairly confident of gaining shareholder approval. Section 129 provides for a company to enter into a major transaction contingent on shareholder approval. If the transaction proceeds without approval, the Companies Act provides that the transaction could still be valid. Accordingly, shareholder approval under s 129 will often be a contingency to a decision that precedes it, providing shareholders some protection of their interests in the company.

142. In the Commissioner's Interpretation Statement IS 08/02: "Deductibility of feasibility expenditure", *Tax Information Bulletin* Vol 20, No 8 (July 2008): 12, feasibility expenditure is defined as expenditure incurred to determine the practicability of a new proposal. However, IS 08/02 draws a distinction between expenditure incurred in the course of carrying on a business to enable a taxpayer to make an informed decision on the acquisition of a capital asset (or other enduring advantage) and expenditure incurred once the decision is made to proceed with the acquisition. Expenditure incurred once a decision is made to proceed with the acquisition is more likely to be capital expenditure.

143. In IS 08/02, the Commissioner concludes that commitment to proceed with a capital project can still be made despite recognising that whether the development or acquisition ultimately goes ahead may be contingent on particular factors. For example, the taxpayers in *Milburn* had committed to developing the quarry sites, but the obtaining of appropriate resource consents was a known contingency. Other contingencies that may be recognised are the need for technical refinement to occur and the obtaining of the final construction cost. Such matters would not necessarily mean a commitment or decision to proceed with the acquisition or development of a capital asset had not been made, if the facts or circumstances otherwise showed that the taxpayer was actively proceeding. Also, IS 08/02 concludes that "commitment does not require a legal or other form of binding decision that is final and irrevocable" (at para 186).

144. In the Commissioner's view, it is most likely that approval under s 129 occurs after a company commits to a capital transaction and is part of the costs of acquiring or disposing of an asset under the "major transaction". Whether this is the case will always be a question of fact. Indirect meeting costs to consider major transactions incurred after the company has committed to the transaction are non-deductible because of the capital limitation.

Ratifying directors' actions or breaches of their duty to the company

145. Section 177 of the Companies Act 1993 gives shareholders the power to ratify the purported exercise by the directors of a power vested in the shareholders. The section contemplates a situation where the directors did not have the power to act, so that the action taken by the directors is invalid. If ratified, the purported exercise of that power is deemed to be a valid exercise of the power. In other words, if the purported exercise by the directors of a power vested in the shareholders is ratified, the exercise of the power is treated as the exercise of the power by the shareholders. On that basis, expenditure incurred in considering whether to ratify the exercise by the directors of a power that is vested in the shareholders should have the same treatment as expenditure incurred in exercising the power directly.

146. In addition, s 177(4) of the Companies Act 1993 preserves the existing rules of law relating to the ratification or approval by shareholders of any act or omission of the directors. Under the common law the directors have a fiduciary duty to the company analogous to that of trustees: *Re Smith & Fawcett Ltd* [1942] 1 All ER 542 (CA). The duties of directors under the common law are set out in the Companies Act 1993. These duties are:

- to act in good faith and in the best interests of the company when exercising their powers or performing duties;
- to exercise a power for a proper purpose;
- not to act, or agree to the company acting, in contravention of the Companies Act 1993 or the company's constitution;
- not to agree to the business of the company being carried on in a manner likely to create a serious loss or risk to the company's creditors;
- not to incur an obligation unless the directors believe on reasonable grounds at the time that the company will be able to perform the obligation when required;
- to exercise care, diligence and skill that reasonable directors would exercise in the same circumstances taking into account the nature of the company, the nature of the decision and the position of the directors, and the nature of the responsibilities undertaken by them.

147. A transaction that is entered into in breach of a duty of the directors is voidable by the company. Ratification by the shareholders has the effect of affirming the transaction: *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589 (PC); *Bamford v Bamford* [1969] 1 All ER 969 (CA). Ratification does not release the directors from personal liability and ratification in this context means no more than an election by the company not to exercise its right to rescind a transaction.

148. Where the directors have acted in breach of their duty to the company in exercising their power to manage the company and its business, the company has a choice whether to rescind or ratify the directors' actions. That decision can only be made by the shareholders. Therefore, in the Commissioner's view, expenditure incurred for shareholders meeting to consider the ratification of such a breach of duty by the directors is incurred in exercising a management power in carrying on the company's business. Such expenditure has a sufficient relationship with the carrying on of the company's business. Whether the expenditure is deductible does not depend on the action that is ratified (that is, on whether it relates to a transaction of a capital nature).

Takeovers (target company)

149. The costs considered are those of a target company in receipt of a takeover offer incurred to allow shareholders to meet to consider the takeover offer. Under the Takeovers Code, the target company is entitled to recover from the offeror any costs incurred on an offer or a takeover notice. However, the target company could be faced with expenditure that it has not been able to recover. The costs incurred by the entity making a takeover bid are not considered here.

150. *FCT v The Swan Brewery Co Ltd* 91 ATC 4,637 (FCAFC) shows that the existence of a statutory obligation to incur expenditure (such as under the Takeovers Code) does not necessarily mean that expenditure incurred in complying with the obligation is deductible. In *Swan Brewery*, the company had a statutory obligation to provide an independent report on the takeover offer to shareholders and to provide advice on the takeover offer to shareholders. However, the court held that there was no relationship between the carrying on of the company's business and expenditure incurred in providing information to shareholders. *Swan Brewery* also supports the view that the fact that the carrying on of a business results in takeover activity is not sufficient. The court considered that expenditure incurred in providing information regarding a takeover offer to shareholders related to the interests of the shareholders in the company. See also *St George Bank*, in which Perram J commented that the costs incurred by companies in complying with regulatory obligations may in some cases be capital expenditure.

151. The Australian Tax Office (ATO) considers that costs incurred by the target company of a takeover bid (including legal and accounting fees, stockbrokers' fees, consultancy fees, printing, advertising and mailing costs and the costs of independent reports) are not incurred in gaining or producing income: Taxation Ruling, IT 2656: "Income tax: Deductibility of takeover defence costs" (October 1991, addendum September 1998). The ATO also considers that takeover defence costs are capital expenditure, being costs incurred to protect or preserve the capital structure or the ownership of the company.

152. However, in *Boulangerie* (TaxCC), Archambault TCCJ did not accept that the expenditure in question was incurred to preserve the existing shareholders' positions as owners of the company. The expenditure was considered to be incurred to secure an advantage of a revenue nature for the company. In that case, in making their recommendation to shareholders, the directors considered the effect of one of the proposed takeovers on the company's relationship with its employees and customers and the continuity of the company's business. Also, the directors recommended that the shareholders did not accept the highest offer. The offer the board recommended replaced all of the existing shareholders, rather than improving the positions of existing shareholders. However, Archambault TCCJ noted that if the company had wanted to maintain the status quo, the expenditure would have been capital expenditure.

153. In the Commissioner's view, whether expenditure incurred to allow shareholders to consider a takeover offer is deductible depends on the facts in each case:

- Expenditure incurred merely to provide information to shareholders as to the adequacy of the takeover offer or to preserve the position of existing shareholders is not deductible. There is an insufficient relationship between expenditure incurred for the benefit of shareholders, or to satisfy a duty to shareholders, and the company's business: *Swan Brewery*.
- Expenditure incurred in providing information to shareholders on a takeover offer to obtain a benefit of a capital nature (such as the prevention of the

winding up of the company's business, new equity funds, the expansion of the company's business) is capital expenditure: *Boulangerie* (TaxCC) and (FCA).

- Expenditure incurred in providing information to shareholders regarding a takeover offer with a view to preventing a takeover offer that would detrimentally affect the company's ability to continue its business in the same form is deductible: *Boulangerie* (TaxCC) and (FCA); *Swan Brewery*.

Statutory return fees

154. A company is required to file certain information with the Companies Office as part of the disclosure requirements in the Companies Act 1993. This includes:
    - Notice of change of registered office;
    - Notice of change of address for service;
    - Annual return.

155. Service of documents relating to legal proceedings and delivery of other documents to the company is effective if the documents are delivered or posted to the address for service or registered office notified in the Companies Register. Failure to file the annual return or notices of change of the company's address for service or registered office may result in documents served or delivered at an incorrect address being treated as effective although the company may not have received the documents. A company cannot take steps in response to actions taken against the company, and that may have an impact on the company's business, unless it receives notice of the proposed action.

156. Complying with these requirements is an administrative matter to ensure that there is accountability for persons carrying on business through a company. Such expenditure is required to be met by all companies, regardless of whether the company is carrying on business. To that extent, it may be argued that such expenses are not dictated by the business ends.

157. However, a primary reason for incurring the expenditure is to ensure that the company remains on the register so that it can continue to operate as a company. A company may agree to meet these obligations in commercial contracts entered into between the company and third parties. While a contract between the company and a third party cannot determine the tax treatment of expenditure incurred pursuant to the agreement, it indicates how the business community views such obligations.

158. As mentioned, *Distillers* concerned apportioning various items of expenditure incurred by a holding company because the company's income included exempt income. The company had incurred general expenses, including "minor filing fees". The court considered some of the expenses were deductible in full and that apportionment was required for others, including the filing expenses because they could not be traced exclusively to any particular type of income. The case supports the view that statutory filing fees would generally be deductible. The court did not explain the basis for the conclusion but stated (at 1,172) in relation to all the expenses (including the filing fees) that:

    > All of such expenses may very well have been incurred for the purpose of gaining or producing income from the appellant's business, and the evidence, so far as it goes, tends to support the fact so assumed.

159. In the *Distillers* litigation, the Tax Appeal Board (*No. 226 v MNR* 55 DTC 18) had considered that the expenditure considered in the case was in the nature of maintenance expenditure, being expenditure that is required to satisfy obligations that a company has under the Canadian equivalent to the New Zealand Companies Act 1993 "to do certain things each year in order to remain a subsisting corporation" (at 19).

160. The reality is that a company cannot continue its business if it fails to meet its filing obligations as it could be struck off the register for non-compliance. Similarly, if it fails to comply with obligations imposed by a third-party lender, it could be in default of its obligations under its financing agreements. Clearly, where a company is not carrying on a business, it would not be possible to establish a relationship between the statutory filing fees and any business. In the Commissioner's view, where a company is carrying on a business, it is likely that a court would hold that expenditure incurred by a company in complying with statutory obligations relating to the administration of the company is deductible, being expenditure that is analogous to maintenance expenditure.

161. Accordingly, in the Commissioner's view, the commercial necessity for the expenditure provides strong grounds for finding that expenditure on such filing fees should be regarded as having the required relationship to the business operations of a company.

162. However, the expenditure must still be tested against the capital limitation. The Commissioner considers statutory filing expenses are not capital expenditure as:

- The filing fees are by their nature recurrent, create no asset and have no benefit that endures in the way that fixed capital endures.
- Such expenses are likely to be met out of the circulating capital of the company as such expenses are part of the recurrent business cycle of a company.
- Although statutory filing expenses are related to the corporate structure, they are expenses relating to maintaining the company as a statutorily compliant company rather than enlarging or altering the business structure.

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Interpretation Statement IS 10/06: "Deductibility of business relocation costs", *Tax Information Bulletin* Vol 22, No 8 (September 2010): 20
Interpretation Statement IS 13/03: "Income Tax – deductibility of expenditure incurred in borrowing money – Section DB 5", *Tax Information Bulletin* Vol 26, No 1 (February 2014): 3
Subject references
General permission, capital limitation, private limitation
Company administration costs – annual and special meeting costs; audit fees; dividend related costs; listing fees; share registry costs; statutory filing costs; associated legal and accounting fees
Legislative references
Companies Act 1993 – ss 128, 129, 177,
Financial Markets Conduct Act 2013 – s 327
Income Tax Act 2007 – ss DA 1, DA 2, DB 5, DB 62, DB 63, DB 63B, DB 63C, EA 3, EW 2, YA 1 "recognised exchange"
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APPENDIX – LEGISLATION

1. Section DA 1: General permission:

Nexus with income

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

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

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

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

(i) their assessable income; or

(ii) their excluded income; or

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

General permission

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

Avoidance arrangements

(3) Section GB 33 (Arrangements involving depreciation loss) may apply to override the general permission in relation to an amount of depreciation loss.

2. Section DA 2: General limitations:

Capital limitation

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

Private limitation

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

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

3. Section DB 5 provides for a deduction for the costs of borrowing money in some circumstances:

DB 5 Transaction costs: borrowing money for use as capital

Deduction

(1) A person is allowed a deduction for expenditure incurred in borrowing money that is used as capital in deriving their income.

...

Link with subpart DA

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

4. Section DB 62 provides for a deduction for legal expenses in some circumstances:

DB 62 Deduction for legal expenses

When this section applies

(1) This section applies to a person when their total legal expenses for an income year is equal to or less than $10,000.

Deduction

(2) The person is allowed a deduction for the legal expenses.

Definition

(3) For the purposes of this section, **legal expenses** means fees for **legal services** (as defined in the Lawyers and Conveyancers Act 2006) provided by a person who holds a practising certificate issued by the New Zealand Law Society or an Australian equivalent.

Link with subpart DA

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

5. Section DB 63 provides a deduction for the costs of authorising, allocating and paying a dividend:

DB 63 Expenses in paying dividends

Deduction

(1) A company is allowed a deduction for expenditure incurred in—

(a) authorising, allocating, or processing the payment of a dividend:

(b) resolving a dispute concerning a matter referred to in paragraph (a).

Link with subpart DA

(2) This section supplements the general permission and overrides the capital limitation. The other general limitations still apply.

6. Section DB 63B provides a deduction for periodic listing fees with recognised exchanges:

DB 63B Periodic company registration fees

Deduction

(1) A listed company is allowed a deduction for expenditure incurred as periodic fees of a recognised exchange for maintaining the registration of the company on the exchange.

Link with subpart DA

(2) This section supplements the general permission and overrides the capital limitation. The other general limitations still apply.

7. Section DB 63C provides rules for the deductibility of costs of holding meetings of shareholders:

DB 63C Meetings of shareholders

Deduction

(1) A company is allowed a deduction for expenditure incurred in holding an annual meeting of the shareholders of the company to consider the affairs of the company.

No deduction

(2) A company is denied a deduction for expenditure incurred in holding a special or extraordinary meeting of the shareholders of the company.

Link with subpart DA

(3) Subsection (1) supplements the general permission and overrides the capital limitation. Subsection (2) overrides the general permission. The other general limitations still apply.

8. A "recognised exchange" is defined for the purposes of the Act in s YA 1:

recognised exchange, at any time,—

(a) means a recognised exchange market in New Zealand or anywhere else in the world that at the time has the features described in paragraphs (c) to (e); and

(b) includes a recognised exchange market that at the time is approved for the purposes of this definition by the Commissioner, having had regard to the features described in paragraphs (c) to (e); and

(c) for the purposes of paragraphs (a) and (b), the first feature is that the exchange market brings together buyers and sellers of shares or options over shares; and

(d) for the purposes of paragraphs (a) and (b), the second feature is that the exchange market involves the listing of prices, whether by electronic media or other means, at which persons are willing to buy or sell shares or options; and

(e) for the purposes of paragraphs (a) and (b), the third feature is that the exchange market provides a medium for the determination of arm's length prices likely to prove fair and reasonable, having regard to—

  (i) the number of participants in the market or having access to the market; and

  (ii) the frequency of trading in the market; and

  (iii) the nature of trading in the market, including how prices are determined and transactions are effected; and

  (iv) the potential or demonstrated capacity of a person or persons significantly to influence the market; and

  (v) any significant barriers to entry to the market; and

  (vi) any discrimination on the basis of quantity bought and sold unless based on the risks involved, the transaction costs, or economies of scale

LEGISLATION AND DETERMINATIONS

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

DETERMINATION CFC 2014/03: NON-ATTRIBUTING ACTIVE INSURANCE CFC STATUS (TOWER INSURANCE LIMITED)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager under section 7 of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

Under sections CQ 2(1)(h) and DN 2(1)(h) of the Income Tax Act 2007, subject to sections CQ 2(2B) and DN 2(2), no attributed CFC income or loss arises from a CFC that is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC that is an insurer meeting the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 is a non-attributing active CFC. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because insurance income is otherwise treated as passive income and an attributable CFC amount by section EX 20B(3) of the Income Tax Act 2007.

Section 91AAQ(1)(b) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of the members of a group of CFCs, if the members satisfy subsection (3). TOWER Insurance Limited has made application in respect of the members of the group of CFCs set out below.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the members of the group of CFCs satisfy the requirements set out in section 91AAQ(3) of the Tax Administration Act 1994 and are accordingly non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of determination

The CFCs to which this determination applies are:

Name	Jurisdiction
National Insurance Company (Holdings) Limited	Fiji
TOWER Insurance (Fiji) Limited	Fiji
Southern Pacific Insurance Company (Fiji) Limited	Fiji

Interpretation

In this document, unless the context otherwise requires:

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a CFC as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994 I hereby determine that the above CFCs are non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2013–14 and 2014–15 income years.

This determination is signed by me this 30th day of June 2014.

Tracey Lloyd
Investigations Manager

DETERMINATION CFC 2014/04: NON-ATTRIBUTING ACTIVE INSURANCE CFC STATUS (TOWER INSURANCE LIMITED)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager under section 7 of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

Under sections CQ 2(1)(h) and DN 2(1)(h) of the Income Tax Act 2007, subject to sections CQ 2(2B) and DN 2(2), no attributed CFC income or loss arises from a CFC that is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC that is an insurer meeting the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 is a non-attributing active CFC. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because insurance income is otherwise treated as passive income and an attributable CFC amount by section EX 20B(3) of the Income Tax Act 2007.

Section 91AAQ(1)(b) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). TOWER Insurance Limited has made application in respect of the CFC set out below.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of determination

The CFC to which this determination applies is:

Name	Jurisdiction
National Pacific Insurance (Tonga) Limited	Tonga

Interpretation

In this document, unless the context otherwise requires:

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a CFC as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994, I hereby determine that the above CFC is a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2013–14 and 2014–15 income years.

This determination is signed by me this 30th day of June 2014.

Tracey Lloyd
Investigations Manager

DETERMINATION CFC 2014/05: NON-ATTRIBUTING ACTIVE INSURANCE CFC STATUS (TOWER INSURANCE LIMITED)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager under section 7 of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

Under sections CQ 2(1)(h) and DN 2(1)(h) of the Income Tax Act 2007, subject to sections CQ 2(2B) and DN 2(2), no attributed CFC income or loss arises from a CFC that is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC that is an insurer meeting the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 is a non-attributing active CFC. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because insurance income is otherwise treated as passive income and an attributable CFC amount by section EX 20B(3) of the Income Tax Act 2007.

Section 91AAQ(1)(b) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of a CFC, if the CFC satisfies subsection (2). TOWER Insurance Limited has made application in respect of the CFC set out below.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the CFC satisfies the requirements set out in section 91AAQ(2) of the Tax Administration Act 1994 and is accordingly a non-attributing active CFC for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of determination

The CFC to which this determination applies is:

Name	Jurisdiction
Tower Insurance (Cook Islands) Limited	Cook Islands

Interpretation

In this document, unless the context otherwise requires:

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a CFC as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994 I hereby determine that the above CFC is a non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2013–14 and 2014–15 income years.

This determination is signed by me this 2nd day of July 2014.

Maryanne Hansen
Investigations Manager

DETERMINATION CFC 2014/06: NON-ATTRIBUTING ACTIVE INSURANCE CFC STATUS (TOWER INSURANCE LIMITED)

Reference

This determination is made under section 91AAQ of the Tax Administration Act 1994.

This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager under section 7 of the Tax Administration Act 1994.

Explanation (which does not form part of the determination)

Under sections CQ 2(1)(h) and DN 2(1)(h) of the Income Tax Act 2007, subject to sections CQ 2(2B) and DN 2(2), no attributed CFC income or loss arises from a CFC that is a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Section EX 21B(3) of the Income Tax Act 2007 provides that a CFC that is an insurer meeting the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 is a non-attributing active CFC. In the absence of such a determination, a CFC carrying on an insurance business is unlikely to be a non-attributing active CFC, because insurance income is otherwise treated as passive income and an attributable CFC amount by section EX 20B(3) of the Income Tax Act 2007.

Section 91AAQ(1)(b) of the Tax Administration Act 1994 allows a person to apply to the Commissioner for such a determination in respect of the members of a group of CFCs, if the members satisfy subsection (3). TOWER Insurance Limited has made application in respect of the members of the group of CFCs set out below.

It has been determined, having regard to the matters set out in subsections (4) and (5) of section 91AAQ of the Tax Administration Act 1994, that the members of the group of CFCs satisfy the requirements set out in section 91AAQ(3) of the Tax Administration Act 1994 and are accordingly non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Scope of determination

The CFCs to which this determination applies are:

Name	Jurisdiction
Southern Cross Marine Limited	Papua New Guinea
TOWER Insurance (PNG) Limited	Papua New Guinea

Interpretation

In this document, unless the context otherwise requires:

"Attributed CFC income or loss" means attributed CFC income under section CQ 2 or attributed CFC loss under section DN 2 of the Income Tax Act 2007.

"CFC" means a CFC as defined in section YA 1 of the Income Tax Act 2007.

"Non-attributing active CFC" means a non-attributing active CFC under section EX 21B of the Income Tax Act 2007.

Condition

This determination is made subject to the following condition:

- Subject to the requisite approval(s) from the relevant regulatory body(ies), that the level of investment assets of the Southern Cross CFC Group will be reduced to a level that does not materially exceed the quantum of net insurance liabilities retained in the ordinary course of business by the end of 30 June 2015.

Determination

Pursuant to section 91AAQ of the Tax Administration Act 1994 I hereby determine that the above CFCs are non-attributing active CFCs for the purposes of section EX 21B of the Income Tax Act 2007.

Application date

This determination applies for the 2013–14 and 2014–15 income years.

This determination is signed by me this 2nd day of July 2014.

Maryanne Hansen
Investigations Manager

NEW LEGISLATION

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

TAXATION (ANNUAL RATES, EMPLOYEE ALLOWANCES, AND REMEDIAL MATTERS) ACT 2014

The Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill was introduced into Parliament on 22 November 2013. It received its first reading on 10 December 2013, second reading on 27 May 2014 and the third reading on 19 June 2014 followed by Royal assent on 30 June 2014.

The new legislation:

- clarifies the tax treatment of employer-provided accommodation, accommodation payments and other allowances made by employers to cover employee expenditure;
- tightens the thin capitalisation rules;
- tightens the rules relating to the tax treatment of land-related lease payments;
- removes uncertainty and distortions arising from the current "black hole" tax treatment of certain types of expenditure;
- introduces provisions to allow New Zealand's financial institutions to more easily comply with the United States' Foreign Account Tax Compliance Act;
- introduces new tax rules for charities which have been removed from the register of charitable entities;
- clarifies the tax status of certain community housing entities that provide home-ownership products to low-income households;
- clarifies the acquisition date of land, and agreements for the sale and purchase of property or services in foreign currency to give greater certainty to taxpayers;
- makes various changes to the GST rules to make them easier apply; and
- makes various remedial changes to ensure the tax rules remain fit for purpose.

The new Act amends the Income Tax Act 2007, Income Tax Act 2004, Tax Administration Act 1994, Goods and Services Tax Act 1985 and the Child Support Act 1991.

EMPLOYEE ALLOWANCES

Sections CE 1, CE 1B, CE 1C, CE 1D, CE 1E, CE 5, CW 16B, CW 16C, CW 16D, CW 16E, CW 16F, CW 17, CW 17CB, CW 17CC, CX 19, CZ 23, CZ 29, CZ 30 and CZ 31 of the Income Tax Act 2007; section 91AAT of the Tax Administration Act 1994

Changes have been made to the taxation of employer-provided accommodation, accommodation payments, and other allowances and payments made by employers to cover employee expenditure.

From 1 April 2015, a new set of rules in the Income Tax Act 2007 replaces the previous rules applying to accommodation, allowances and payments. The rules can be applied retrospectively in some cases.

These changes are intended to bring greater clarity and cohesion to the rules, making it easier for taxpayers to understand and comply with their obligations.

Key features

The key changes are as follows.

Accommodation

- Time limits on when accommodation provided in relation to out-of-town secondments and capital projects is non-taxable (up to two years for secondments and three years for capital projects);
- A special transitional rule for Canterbury earthquake recovery projects;
- A multiple workplace rule that exempts accommodation provided when an employee has to work at more than one workplace on an ongoing basis;
- An exemption for accommodation provided when an employee is required to attend a meeting, training course or conference as part of their job that requires at least an overnight stay;
- Confirmation that the taxable value of accommodation provided is the market rental value, less any rent paid by the employee and any adjustment for business use of the accommodation;
- Specific exclusions from the definition of "accommodation";
- A specific valuation rule for accommodation supplied by religious bodies to their ministers (confirming a longstanding administrative practice);
- A specific valuation rule for accommodation provided by the New Zealand Defence Force to personnel, reflecting the specific limitations imposed on these properties;
- Capping the taxable value of employer-funded accommodation as part of an overseas posting at the average or median rental value for accommodation in the vicinity that the employee would live in if in New Zealand.

Meals

- Exempting meal payments linked to work travel, subject to a three-month upper time limit at a particular work location;
- Exempting without time limit meal payments and light refreshments outside of work-related travel, such as at conferences.

Clothing

- Payments provided to cover the cost of distinctive work clothing, such as uniforms, will be exempt (mirroring the treatment under the fringe benefit tax rules);
- Payments to meet the costs of plain clothes allowances paid to members of a uniformed service who are required to wear ordinary clothing instead of their uniform will also be exempt, provided certain conditions are met.

Other

- A power allowing the Commissioner of Inland Revenue the discretion to issue a determination in relation to an expenditure payment made to a wide group or class of employees, determining the extent to which the particular type of expense payment is taxable. A determination will be binding on the Commissioner but not the taxpayer, meaning it will act as a safe harbour.

Background

Over recent years there have been some significant concerns around the tax treatment of employer-provided accommodation, accommodation payments, and other allowances, reimbursements and payments by employers to cover employee expenditure (generically referred to as employee expenditure payments). Previous tax legislation could lead to impractical outcomes that may have differed from the way employers applied the rules in practice.

Under the previous rules, when an employee expenditure payment was made, provided it was to cover a work expense, it was not taxable, as long as there was no private, domestic or capital element to the expense. This treatment matched the general deductibility rules in the legislation. However, when there was a private or domestic element in the linked expense, that element was taxable. This was because it was considered to be in effect an alternative to receiving more salary or wages, which would be taxed.

An expense is private or domestic in nature if it is intended to further some personal purpose or provide a private or

domestic benefit. As meals, accommodation and normal clothing are inherently private benefits, the starting position under tax law is that any employee expenditure payment to cover these sorts of expenses should be taxed.

In many instances, however, the private aspect is either incidental to the business objective or is minimal or hard to measure, and apportionment between the private and employment purpose is not practical given the compliance costs associated with separating out the relative elements. Accordingly, under the new rules, specific exemption provisions apply the principle that the private amount should be ignored when it is low in value or hard to measure, and is not provided as a substitute for salary or wages.

The new rules were developed after significant consultation, both leading up to the release of the November 2012 issues paper, *Reviewing the tax treatment of employee allowances and other expenditure payments*, and subsequently. A total of 27 submissions were received on the suggestions in the officials' issues paper. Most focussed on the tax treatment of accommodation expenses, and establishing a boundary between private and work-related expenditure.

Subsequently, Inland Revenue officials carried out further consultation with key stakeholders, including the Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants and the Canterbury Earthquake Recovery Authority. The main area of concern was that any new rules should encompass not only work-related secondments but also employee involvement in longer-term projects. Those projects included work on the Canterbury earthquake recovery and projects in other locations throughout New Zealand (for example, the ultra-fast broadband roll-out, dam rebuilds and other major water storage projects, and road building projects). The legislation introduced in the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill took this feedback into account.

The Finance and Expenditure Committee received 25 written submissions (from 20 submitters) on the employee allowances provisions in the bill. Generally, submitters were supportive of the overall aims of the changes, subject to areas where clarifications or amendments were sought. As with the earlier consultation, the majority of submissions were in relation to the accommodation rules. The Committee recommended the following changes:

- Four exceptions where accommodation provided in connection with employment would not be subject to tax, to allow for situations involving shift work or remote workplaces when it is considered it would be inappropriate to tax accommodation provided in connection with employment. The exceptions cover mobile workplaces such as ships, trucks or oil rigs, a station in Antarctica, lodging provided for shift workers such as fire-fighters, ambulance staff and care-givers, and accommodation provided at remote locations where an employee is expected to "fly in and out", such as mines in Australia.
- A regulation-making power so other exceptions can be made in future – while the exceptions provided in the legislation are considered reasonably comprehensive, there may be unforeseen situations that arise when it would be inappropriate for work-related accommodation to be taxed.
- Allow uneven apportionment of shared accommodation if the employees involved and their employer agree it is reasonable – for example, to reflect a difference in the size of their rooms.
- Refine and simplify the valuation rule for accommodation provided by churches to ministers of religion.
- Amend the rule regarding accommodation provided in relation to secondments or capital projects to better allow for situations when expectations about the length of secondment change.
- Include snack foods within exempt "light refreshments" and remove the requirement for an employee to work at least seven hours in order to be entitled to exempt light refreshments.
- Allow application of the new work-related meal rules to be backdated to 1 April 2011, provided the employer has not treated the work-related meals as taxable, to allow the status quo to continue without the need to reopen tax positions (provided they fall within the new rules).

Application dates

The majority of the amendments apply from 1 April 2015.

However, employers have the option to backdate the accommodation rules to accommodation provided from 1 January 2011 provided they have not taken a tax position before 6 December 2012 that the accommodation was taxable.

Similarly, employers have the option to apply the work-related meal rules from 1 April 2011, provided they have not already taken a tax position that the expenditure was taxable.

Other exceptions:

- The distinctive work clothing rule applies from 1 July 2013.
- The transitional rules for Canterbury earthquake-related accommodation are treated as coming into force on 4 September 2010.

- The transitional rule for New Zealand Defence Force-provided accommodation is treated as coming into force on 6 December 2012.

DETAILED ANALYSIS

The main taxing provisions for accommodation remain in section CE 1, which deals with amounts derived in connection with employment. This section includes a definition of "accommodation" which includes board or lodging, and the use of a house or living premises (or part thereof), whether permanent or temporary.

The inclusive aspect of the definition of "accommodation" is unchanged from the previous rules. Ordinarily, "board or lodging" can refer to the provision of the employee's meals and somewhere to sleep. When an employee is provided with a self-contained living space with most of the facilities necessary for independent living, what is provided is the use of a house or living premises (or part thereof). We expect, in practice, that in most cases what is provided is the use of a house or living premises (or part thereof).

Exclusions from the definition of "accommodation"

Under the new rules the definition of "accommodation" in section CE 1 has been modified by introducing four specific exclusions involving shift work or remote workplaces, namely:

- a berth, room or other lodging provided on a mobile workplace such as a ship, truck or oil rig;
- a station in Antarctica;
- lodging provided for shift workers such as fire-fighters, ambulance staff and care-givers when they are periodically required to sleep at their workplace, and the accommodation is provided only for the duration of the performance of the duties; and
- accommodation provided at remote locations outside New Zealand, such as mines in Australia, where an employee is expected to "fly in and fly out".

In addition, section CE 1(4) enables the Governor-General, by Order in Council, to make regulations to add to the types of accommodation that are excluded from the definition of "accommodation". While the exceptions provided are considered reasonably comprehensive, there may be other situations that arise in future when it would also be inappropriate for work-related accommodation to be taxed.

Section CE 1 includes an expanded definition of "employer" to ensure that accommodation provided by an overseas employer is covered. The expanded definition also covers situations when an employee is seconded by their employer (Company A) to another company (Company B), and the accommodation is provided by Company B, but the employee remains employed by and paid by Company A.

"Accommodation" that is tax-exempt

When the accommodation falls within the statutory definition of "accommodation" it may still be exempt from tax. The new rules specifically set out a number of exemptions.

1. Employee accommodation – out-of-town secondments and projects

Employer-provided accommodation or an accommodation payment provided because an employee needs to work at a new work location (and that location is not within reasonable daily travelling distance of their home) is tax-exempt provided the following conditions are met:

- there is either a reasonable expectation that the employee's secondment to that work location will be for a period of two years or less, in which case the payment will be exempt for up to two years; or
- the move is to work on a project of limited duration whose principal purpose is the creation, enhancement or demolition of a capital asset and the employee's involvement in that project is expected to be for no more than three years, in which case the maximum exemption period is three years.

If the move is to work on Canterbury earthquake recovery projects, the maximum period is extended to five years if the employee starts work in the period commencing on 4 September 2010 and ending on 31 March 2015, and to four years if the employee starts work in the period commencing 1 April 2015 and ending 31 March 2016. The maximum period reverts to three years if the employee starts work on or after 1 April 2016.

Example 1

Adam is an accountant who has worked for his employer in Auckland for 10 years where he lives with his family. He is sent by his employer to New Plymouth for three months to carry out an audit of a large client before returning to the Auckland office. Adam's employer reimburses his hotel costs in New Plymouth. As Adam's employer expects him to work in New Plymouth for less than two years, the payment that Adam receives reimbursing him for his accommodation costs in New Plymouth is exempt income.

Example 2

Bill lives in Wellington. His job is moved permanently to Auckland but he chooses not to move his family and commutes on a weekly basis, returning to Wellington at the weekend. Bill's employer pays him an accommodation allowance towards his Auckland accommodation costs. Bill and his employer expect he will work at the Auckland workplace for more than two years. The accommodation allowance is not tax exempt under the two-year rule.

Accommodation linked to long-term projects of limited duration

The maximum exempt period of three years allowed for involvement in longer-term projects takes into account certain business practices, particularly in the construction industry. The employees might be housed at or near the construction site, might share accommodation and might be employed on a "fly in/fly out" basis so would not be relocating. Employees may be recruited specifically from overseas with no intention that they ever relocate permanently to New Zealand.

Example 3

Eddie is seconded by his employer to work on a dam construction project for a client in a remote area of the North Island. Because of the scale of the project, the number of workers and the remoteness of the location, Eddie's employer sets up an accommodation facility to house its employees. The dam project is expected to take around five years to complete. However, Eddie's employer expects him to work on the project for only the first two and a half years.

Eddie is working on a project involving the construction of a capital asset so the three-year upper time limit applies. His employer expects him to be working at the distant work location for less than three years so the value of the accommodation is exempt.

While the projects covered by the three-year maximum exemption will often relate to the construction industry, they may also involve, for example, upgrades of existing infrastructure and information technology development and implementation. The duration of the project can be longer than three years as the test is based on the time the employee is involved in the project, rather than the length of the project.

The project will also have to satisfy the following requirements:

- creation of a capital asset—the principal aim of the project will have to be the creation of a capital asset of some form, whether a new capital asset, a replacement of an existing asset, an upgrade, or refurbishment;
- employment duties specific to the project—the employee will need to be engaged exclusively on project work (bar incidental activities); and
- the project must involve work for a client not related to the employer.

When does the exemption cease?

The payment or the employer-provided accommodation will cease to be tax-exempt before the respective maximum period if any of the following occur:

- the employer pays the employee's costs associated with buying a house in or near the new work location, as an eligible relocation expense;
- there is a change in the expectation that the employee will be at the new location for, as relevant, a maximum of two years or three years; or
- the employee's involvement in the secondment or project comes to an end before the maximum time is up.

Example 4

Donna works for an employer in Auckland. Her employer sends her to work in Hamilton for an expected 18-month period. After four months, Donna decides that she wants to relocate permanently to Hamilton and her employer agrees to make her job there permanent. Donna's employer has agreed to pay her an accommodation allowance for the first six months after arrival.

Up to the four-month point, Donna's employer's expectation was that she would not be working in Hamilton for more than two years, and payments to cover accommodation up to that point are exempt under the two-year rule. But given the expectation is now that Donna will be working in Hamilton for more than two years, payments to cover Donna's accommodation after four months would be taxable.

The point in time at which an expectation is treated as having changed is when the employer has a firm expectation that the secondment or role on the project will last longer than initially expected. This may be evidenced by modification in the employee's terms of employment, but in many cases there may not be a written agreement. Instead, there may be other documentation such as board minutes, planning documents, correspondence with the third party for whom the employer is carrying out the capital project, and so on, that will demonstrate that the expectation has changed.

What if the expected period initially exceeds the time limit but subsequently reduces?

If a secondment is initially expected to exceed the relevant two or three years, it will be subject to tax. However, if this expectation changes during the course of the secondment, and the total period will be less than the relevant time limit, the payment or employer-provided accommodation becomes tax-exempt from the date the expectation changes. The payment or employer-provided accommodation up to the date the expectation changes remains taxable (there is no retrospective exemption following the change in expectation).

Example 5

Sam lives in Napier. His employer sends him to Tauranga to set up and manage a new office. The initial expectation is that Sam will be in Tauranga for two years and six months. Sam's employer provides him with accommodation in Tauranga. The accommodation will be taxable as the secondment is expected to exceed two years.

One year into the secondment Sam's employer decides that Sam only needs to stay in Tauranga another six months as the company has found someone to run the office on a permanent basis. As the expectation of the total secondment duration is now less than two years (18 months total), the final six months of the accommodation provided to Sam are exempt from tax. The first 12 months, before the change in expectation, remain taxable.

Workplace

The various new exemptions refer to the employee's "workplace". "Workplace" is defined as a particular place or base:

a) at which an employee performs their employment duties; or

b) from which an employee's duties are allocated.

This means that a workplace is not confined to premises of the employer but can also be any place from which the employee performs employment duties, which could be a client's premises. For example, a salesperson who is required to travel to clients located in various areas of the country will have multiple workplaces.

Residence and reasonable daily travelling distance

To qualify for the accommodation exemptions, an employee must be moving to a workplace that is not within reasonable daily travelling distance of their residence. "Residence" and "reasonable daily travelling distance" are not defined.

In this context (as in section CW 17B, in relation to relocation payments) "residence" refers to the employee's home immediately before the secondment. The distance test is assessed in relation to that residence.

The concept of "reasonable daily travelling distance" also appears in section CW 17B. Following the introduction of that provision, guidance on the meaning of "reasonable daily travelling distance" was published in *Tax Information Bulletin* Vol 21, No 9 (December 2009), page 6. This guidance is also applicable to the accommodation exemptions.

Relationship with the relocation payments rule

If an employee is not eligible for the secondment or capital project exemption, they may still qualify for an accommodation exemption for up to three months under section CW 17B and Determination 09/04 (provided the relevant criteria are met).

Sections CW 16C(1)(c) and CW 16C(2)(c) provide that eligibility for the section CW 16B exemption ends if an employee receives a relocation payment under section CW 17B in relation to the costs associated with settling the purchase of a new home.

Anti-avoidance rules

The rules are subject to certain conditions to protect against abuse:

- The exemption does not apply if accommodation is provided under an explicit salary trade-off arrangement.
- There is an anti-avoidance rule to prevent behaviour intended simply to restart the respective time limit.

New employees

The exemptions described above apply to accommodation provided to existing employees, and to new employees in specific instances.

New employees qualify for the three-year exemption, subject to the same conditions as existing employees, including that the work is on a project of limited duration and their contract is for a period of three years or less. This ensures there is no disparity between the treatment of new and existing employees working on the same project.

New employees only qualify for the two-year exemption when:

- the employee is newly recruited to work at a particular work location but is then sent to work at another work location temporarily, for example, an individual is recruited to work in Auckland but is then sent to work in Dunedin for a month before returning to Auckland; or
- an employee working for one employer is seconded to work for another employer on a temporary basis, with

the expectation that the employee will return to work for the original employer, for example, an individual working for an Australian accountancy firm is sent to work for an affiliated New Zealand firm in Auckland for 18 months.

A more restrictive approach is taken for new employees under the two-year rule compared with the three-year rule because the scope for behavioural changes to the way new employees are remunerated is considered to be greater when fewer limitations are in place. The existing rules applying to tax-exempt relocation payments will continue to be available to these new employees.

Exceptional circumstances

There is restricted ability to extend the thresholds in exceptional circumstances. Exceptional circumstances are confined to those that are outside the control of the employer and employee, such as a natural disaster or medical emergency, that mean the employee has to stay at the work location beyond the maximum tax-free time threshold. The time limit can be extended for as long as the employee is unable to leave the work location because of the exceptional circumstance.

Accommodation linked to Canterbury earthquake reconstruction work

Given the special nature and scale of the Canterbury earthquake reconstruction work, there is a transitional rule (new section CZ 29) for employer-provided or paid accommodation for employees working on Canterbury earthquake reconstruction projects over the period from 4 September 2010 to 31 March 2019.

a) When the employment duties of the employee require them to work in greater Christchurch on a project or projects for rebuilding or recovery work arising out of the Canterbury earthquakes, the time limits in the section CW 16B(5) definition of "project of limited duration" are effectively replaced by the following:
   - five years when the employee's date of arrival is in the period from 4 September 2010 to 31 March 2015;
   - four years when the employee's date of arrival is in the period from 1 April 2015 to 31 March 2016; and
   - three years when the employee's date of arrival is in the period from 1 April 2016 onwards, for arrivals up to 31 March 2019. The normal three-year rule will apply to Canterbury rebuild and recovery work from 1 April 2019.

b) When the date of arrival in "greater Christchurch" (as defined in the Canterbury Earthquake Recovery Act 2011) is in the period from 4 September 2010 (the date of the first earthquake) to 31 March 2015, the time limit will be applied by reference to the time the employee works continuously in greater Christchurch rather than to any expectation. For other periods, the time limits apply based on the employer's expectation.

   This approach also applies more generally for out-of-town secondments and projects (see section CZ 30) so that for the period 1 January 2011 to 31 March 2015, the relevant time limit is applied by reference to the time the employee works continuously at the distant location rather than to any expectation. For other periods, the time limits apply based on the employer's expectation.

2. Employee accommodation – ongoing multiple work places

When an employee has to work at more than one workplace on an ongoing basis the accommodation or accommodation payment is tax-exempt without an upper time limit (section CW 16F).

There are a number of circumstances in which an employee has to work at more than one workplace on an ongoing basis. These may be because of the nature of their duties or because the additional workplaces are beyond reasonable daily travelling distance from their home. This could be the case, for example, for senior managers of large organisations. In these circumstances there is an exemption for employer-provided accommodation and accommodation payments, without an upper time limit, given that there will be genuine ongoing additional costs in such cases. (If the employee has multiple work places for a limited period, the two or three-year time limit-based exemptions may also apply.)

Example 6

Andrew manages two offices, one in Christchurch and one in Dunedin. He works in Christchurch two days a week and in Dunedin for three days a week. His home is in Dunedin. Andrew has more than one ongoing work location. When he works in Christchurch, he is beyond reasonable daily travelling distance from his home in Dunedin. An accommodation payment to cover his hotel costs when staying in Christchurch is not taxable. The Christchurch accommodation is exempt under the multiple workplace rule. The Dunedin accommodation is not tax exempt.

The multiple workplace rule can also apply when an employee is sent on a short-term business trip to another location. In these circumstances the employee will continue to have ongoing duties at their normal place of work while they are working at the other work location during the business trip.

Example 7

Carmen is chief executive of a large group of companies based in Auckland. The company has offices in a number of cities across New Zealand. Each month Carmen visits one of these offices as part of her management duties. Typically these visits can last up to a week and her employer arranges and pays for her accommodation.

When Carmen is visiting the offices away from Auckland she has more than one ongoing workplace for the duration of her visit. The accommodation while working at those offices is exempt under the multiple workplace rule.

3. Employee accommodation – meetings, conferences and training courses

When an employee needs to attend a work-related meeting, conference or training course that requires at least an overnight stay, the accommodation or accommodation payment is tax-exempt without an upper time limit (section CW 16D).

While the need for accommodation would normally arise because the work-related meeting, conference or training course is beyond reasonable daily travelling distance from the employee's home, this need not be the case. Some courses may be held locally but may require employees to stay overnight for reasons such as networking and team-building. Section CW 16D, therefore, covers both local and distant accommodation situations by extending the definition of "period of continuous work" to specifically include a location that is not distant from the employee's regular workplace (see section CW 16D(4)). It is possible, depending on the circumstances, that the multiple workplace exemption or the two or three-year time-based exemption could also apply.

Accommodation for necessary travel in connection with performance of duties

Section CW 16D exempts both accommodation at the location of the conference, training course, or work-related meeting and any accommodation for necessary travel in connection with the performance of the employee's duties in connection with their attendance. This means that if a stopover is required in travelling to or from the location, accommodation at that stopover will also be exempt.

Example 8

Matt is required to travel to London for an international conference. The timing of available flights means it is necessary for Matt to stay in Hong Kong for a night on the way to London between flights. The Hong Kong accommodation will be exempt, along with the accommodation in London for the duration of the conference.

Example 9

Sophie works in Auckland. Her employer requires her to attend a meeting in Canberra that starts early in the morning. No direct flights are available from Auckland to Canberra and the first flight from Auckland on the day of the meeting would not reach Sydney in time to catch the necessary connecting flight to Canberra. Sophie could either:

a) fly to Canberra the day before (in which case the accommodation would be exempt under section CW 16D(1)(c)(i) or (ii)); or

b) fly to Sydney and stay the night then take the first morning flight from Sydney to Canberra (in which case the Sydney accommodation would be exempt under section CW 16D(1)(c)(iii)).

Accommodation for necessary travel in connection with secondments and capital projects

As with meetings, conferences and training courses, accommodation for necessary travel to and from a distant workplace in relation to secondments and capital projects is also exempt (see section CW 16B(1)(c)(iii)).

Taxable employee accommodation – determining its value

When employer-provided accommodation, accommodation allowances and other payments for accommodation are taxable, the amendments to section CE 1, and new sections CE 1B, CE 1C, CE 1D and CE 1E specify how to determine their taxable value.

The taxable value of the accommodation continues to be linked to market rental value but will be subject to certain adjustments and exceptions as follows:

- The taxable value is confirmed as market rental value when accommodation is provided by the employer, less any rent paid by the employee and any adjustment for business/work use of the premises. There is also an adjustment when employees share accommodation, to avoid over-taxation.
- The taxable value of employer-funded accommodation provided to employees as part of an overseas posting

is capped at the average or median rental value for accommodation in the vicinity where the employee would live if in New Zealand (section CE 1C). This cap, which is of significance to employees who remain tax-resident in New Zealand, recognises that the market rental value of accommodation in overseas locations can be disproportionately high compared with that which an employee might occupy if working in New Zealand.

- There is a specific rule to confirm that the market value is discounted in the case of accommodation provided to New Zealand Defence Force (NZDF) personnel to reflect the specific limitations imposed on these properties (section CE 1D).
- There is also a specific valuation rule for accommodation supplied by religious bodies to their ministers (section CE 1E). A long-standing administrative practice has capped the benefit of church supplied accommodation at 10% of ministers' stipends. This longstanding practice has been incorporated into the legislation, subject to the amount to which this treatment applies being capped at a reasonable rental value that is commensurate with the duties of the minister and the location in which the minister performs his or her duties. This rule is intended to apply across a wide variety of churches.

Apportionment of taxable value between employees when accommodation is shared

Generally, when more than one employee shares the accommodation provided by their employer, the taxable amount is either:

- apportioned equally between the employees; or
- if the employer and employees agree, apportioned between the employees on some other reasonable basis such as one employee having a larger room.

Separate rules apply for ministers of religion.

Example 10

Two employees share a house provided by their employer, with a weekly rental value of $300. They are each taxed on $150.

Example 11

Three employees share a house provided by their employer, with a weekly rental of $400. One employee has a much smaller room than the others and they all agree with their employer that the employee with the smaller room will be taxed on $100 and the other two employees will be taxed on $150 each.

Work use of accommodation

The deduction from the taxable amount when part of the accommodation is used for work purposes reflects current practice and the amendment is merely intended to clarify and confirm that approach. To qualify, a clearly identifiable part of the accommodation needs to be used "wholly or mainly" for work purposes related to the employee's employment or service. The accommodation does not need to be used solely for work purposes to meet the "wholly or mainly" test, but it must at least be used predominantly for work purposes, and its primary purpose must be work-related. Any non-work-related use must be temporary or sporadic, or otherwise minor (such as using an office for checking personal emails or a family member occasionally using it for personal projects). The deduction is determined by apportioning between the business and private use.

Example 12

An employer provides an employee with accommodation with a market rental value of $500 a week. The employee has set up one of the bedrooms as an office, and it is usually only used as an office. However, the office has a couch that is also a fold-out bed. On occasion, when the employee has house guests, the office is also temporarily used as a place for the house guest to sleep. As the office is one-tenth of the total floor area of the accommodation, $50 is deducted from the weekly taxable amount.

Accommodation for employees working overseas

The exception to the general valuation rules allowing the use of a New Zealand-based value rather than the market value of the overseas accommodation applies not only to employer-provided accommodation but also when the employer makes an accommodation payment for the employee's accommodation costs at the overseas location.

In establishing the value of the comparable New Zealand property, regard must be had to the location where the employee would be likely to be working for the employer, the equivalent accommodation the person would be likely to occupy if living in New Zealand, and the average or median market rental values at or near that New Zealand work location.

Example 13

Zoe is seconded by her employer to Brussels for three years and is provided with a flat for the duration of her secondment. The rent paid by the employer is equivalent to $50,000 a year. Zoe would normally work in central Wellington if working in New Zealand, and would be likely to be living in a two-bedroom house in Thorndon where an average annual rental value would be $24,000. Zoe is taxed on an accommodation value of $24,000 per year.

When there is more than one location in New Zealand where the employee could work for the employer, a New Zealand-wide valuation can be used. There is a choice of using either the average market rental value or the median market rental value for the whole of New Zealand.

There is a range of sources available to help determine average or median market rental values; for example, the Ministry of Business, Innovation and Employment website **http://www.dbh.govt.nz/market-rent** provides market rental statistics based on bonds lodged with its Building and Housing Group.

Accommodation provided to Defence Force personnel

The valuation rule for accommodation provided to NZDF personnel is that, up to 31 March 2015, the rent currently being paid is treated as the market rental value (section CZ 31) and, after that date, the market rental value is the lesser of (i) the market rental value for the accommodation and (ii) the market rent for the national NZDF benchmark property of that type less a discount (section CE 1D).

Given the requirement for NZDF personnel to accept a posting anywhere in New Zealand, the NZDF has historically considered it appropriate to take a national approach to considering market rental value of NZDF accommodation. The deployment of personnel is concentrated around the central North Island, and therefore national benchmark properties have previously been assessed by reference to accommodation in the area of Linton Camp. Linton also offers a representative range of NZDF housing stock, reasonable access to amenities and a stable basis for rental comparison purposes.

The benchmark properties, their market value and the discount will be determined by the Commissioner of Inland Revenue and the Chief of Defence Force in consultation with a registered valuer. The determination of these matters must be reviewed every three years, at the instigation of either the Commissioner of Inland Revenue or the Chief of the Defence Force.

Accommodation provided by religious bodies to ministers of religion

The specific rule for accommodation provided to ministers of religion is given by the following formula:

remuneration × (1 – adjustment) + excess rental

Where:

remuneration is the amount that equals 10% of the remuneration that the minister receives for the income year for the performance of their duties as a minister;

adjustment is the part of the value of the accommodation that is apportioned to work-related use, expressed as a decimal fraction of the total value of the accommodation. To be eligible for apportionment, the minister needs to use the relevant part of the accommodation wholly or mainly for work purposes. If more than one minister of religion lives in the accommodation, the adjustment is apportioned equally between them;

excess rental is the amount (that is not less than zero) that is the difference between the accommodation's market rental value for the income year and the market rental value for the income year of accommodation that is reasonably commensurate with the duties of the person as a minister and for the location in which they perform their duties.

A "minister of religion" is defined "as a person who is ordained, commissioned, appointed or otherwise holds an office or position, regardless of their title or designation, as a minister of a religious denomination or community that meets the charitable purpose of the advancement or religion and whose duties are related mainly to the practice, study, teaching or advancement of religious beliefs; and whose accommodation is an integral part of performing their duties".

The definition specifically excludes a member of a religious society or order who is covered by the exemption in section CW 25. That exemption relates to board and lodging provided to members of religious societies and orders whose sole occupation is service in a society or order and who are not paid for their service. The specific valuation rule for accommodation provided to ministers of religion therefore supplements, rather than replaces, the existing exemption in section CW 25.

The requirement that a minister's church-provided accommodation is used as an integral part of performing the minister's duties refers to the expectation underlying a minister's pastoral duties that some parishioners might visit their home, irrespective of whether this happens in practice. There is no intention that ministers need to measure such use.

If the accommodation is provided for only part of the year, the calculations of the value are done with reference to that part of the year.

Further guidance on determining taxable value

During submissions to the Finance and Expenditure Committee, some submitters raised questions about how market rental value would be ascertained, particularly in relation to specific situations when accommodation is provided at the place of work, such as accommodation provided to staff at boarding schools. To assist employers, Inland Revenue will be issuing operational guidance on the valuation of employer-provided accommodation.

Payments to cover employee meals

Employers typically meet an employee's meal costs when linked to work-related duties. This recognises that these meals may be more expensive for the employee than normal meal costs at home.

Under previous rules, when an employer reimbursed the cost of a work-related meal, the amount saved by the employee (their normal expenditure on the meal) was arguably taxable.[1] However, it would not be practical to carry out an apportionment each time a meal payment is made, so a more practical approach that better matches business practice was needed, given that these meal payments are generally not provided as a substitute for taxable salary.

Section CW 17CB introduces two specific exemptions:

- An exemption of up to three months for meal payments if the employee is required to work away from their normal work location because they are travelling on business. This may be for a specific short-term, work-related journey or for a longer period such as a secondment to a distant work location.
- Payments to cover working meals and light refreshments when working off the employer's premises are exempt without any upper time limit.

In both circumstances, when the exemption applies, the full amount of any meal payment will be exempt. The exemption includes reimbursement payments and meal allowances.

These rules do not affect the existing exemptions in section CW 17C that apply to overtime meal payments and sustenance allowances. Likewise, the direct provision of a meal by an employer remains subject to the fringe benefit tax rules (including any "on premises" exemption) rather than the new rules. The rules that limit employers' deductions of entertainment expenses also continue to apply.

[1] However, see application dates for new rules set out earlier.

Calculating the three-month time limit

The three-month time limit runs from the date the employee starts working at the workplace and extends for as long as the employee works continuously at that location.

Example 14

Vernon normally works in Christchurch but is sent by his employer to work in the employer's Nelson office for a period of six months. Vernon's employer pays him a meal allowance for the duration of the secondment. The meal allowance is exempt for the first three months and taxable for the remainder of the secondment.

If the employee is sent away from their normal workplace and for the period they are away does not have a fixed work base, but instead works at a variety of locations and works out of an accommodation base (a single accommodation location, away from their normal residence, from which they travel to the various workplaces), then the time limit will apply from the date at which they arrive at the accommodation base.

Example 15

Bruce normally lives in Napier. He is sent by his employer to work on an infrastructure project that requires him to work in a variety of locations around the Waikato. Rather than moving to each location, Bruce rents a house to use as a base from which he can travel to those locations each day as required. The three-month time limit applies from the date Bruce moves to the rented accommodation.

In determining whether the employee is working continuously at a particular location, periods when away from the location for personal reasons such as leave and weekend breaks and short breaks that are required for work purposes will be disregarded.

The payment will not be exempt when it is paid by way of a salary trade-off.

Working meals and light refreshments at or near the employee's normal work location

Payments to cover meal expenses for a working meal near the employee's work location will be exempt in certain circumstances. For example, this will include lunches at conferences or training courses near their normal work location.

The expense will only be exempt if the employee attends the meal because of the nature of the duties of the job. The meal expense will not be exempt if it is provided as a salary trade-off.

The amendments will also introduce an exemption for payments for light refreshments (in the form of snack food such as biscuits and fruit, or liquid refreshments such as tea or coffee), when the following criteria are met:

- the nature of an employee's employment duties mean they have to be away from the employer's premises for most of the day;
- the employer would normally provide the refreshments to the employee on the day; and
- it is not practicable for the employer to provide the refreshments on the day.

Example 16

Jane normally works in an office where her employer provides tea and coffee for employees while working. Jane is required to spend two days out of the office staffing a recruitment stand for her employer at a local employment expo. During her attendance at the expo, it is not practical for Jane's employer to provide her with tea or coffee. A payment made by Jane's employer to cover tea or coffee in these circumstances will be exempt.

Application of new rules to past periods

As noted earlier, employers can apply the new accommodation and meal rules to periods before 1 April 2015 in certain circumstances. In the case of accommodation, the rules can be backdated for accommodation provided or expenditure incurred from 1 January 2011 provided the employer has not taken a tax position before 6 December 2012 that the accommodation or accommodation payment is taxable. Similarly, employers have the option to apply the work-related meal rules from 1 April 2011, provided they have not already taken a tax position that the expenditure was taxable.

This means in some situations amounts that were treated as taxable income will become exempt income, resulting in a refund to the employee.[2]

Example 17

Anna lives and works in Hamilton. In January 2013 she was sent on a 15-month secondment to Blenheim. The secondment was expected to last 15 months, and did, in fact, last 15 months. Her employer paid for her accommodation in Blenheim and treated these payments as taxable. Under the new rules the accommodation would be exempt from tax. Anna's employer may now elect to backdate the application of the new rules to exempt the payments, meaning a refund of the tax paid on the accommodation can be claimed.

Example 18

Grace lives and works in Invercargill. In February 2011 her employer sent her on secondment to New Plymouth to assist with setting up a new site. The secondment was expected to last 18 months, but in fact lasted 20 months as the new site progressed slightly behind schedule. Grace's employer provided her with an accommodation allowance which was treated as taxable, with PAYE deducted. Grace's employer is unable to backdate the new provisions because although the accommodation allowance would be exempt under the new rules and was provided after 1 January 2011, it was treated as taxable before 6 December 2012.

Backdating can be applied on an employee-by-employee basis. Accordingly, when the employer agrees to backdate the new rules, the employer should indicate to Inland Revenue which employees and which tax years they have chosen to apply this option to, and the employees' new gross earnings and the tax-exempt amounts. They should also provide each employee with a letter confirming they have chosen this treatment, setting out the new gross earnings details and the amount that is now tax-exempt for each tax year.

The employee will then need to make a request to Inland Revenue to amend their IR3 return or personal tax summary assessment or, if necessary, request a personal tax summary.

Employees should note that the income adjustments described above will affect their social assistance entitlements and obligations (such as Working for Families, child support and student loan repayments). For example, if as a result of the adjustment it is found that the employee's student loan repayments have been too high, the employee should indicate whether they want the repayments refunded to them or treated as voluntary repayments.

Example 19

Jon was on an out-of-town secondment for two years with accommodation provided Monday to Friday at a cost of $300 per week. Jon's employer had originally treated the accommodation as tax exempt as Jon returned home every weekend to his family. Jon's employer provided a voluntary disclosure and treated the accommodation for the last 12 months as taxable income. Jon's salary was $75,000 on top of which his employer paid the additional PAYE of $150 per week, being the grossed up amount of the accommodation, increasing his earnings by a total of $450 per week.

[2] If the employee owes tax, the amount that would be refunded will first be used to offset the tax owing.

Jon's employer agrees to apply the new rules to his accommodation making the cost of the accommodation—$300 per week—tax exempt.

Jon's employer provides him with a letter confirming the details to amend his return. Jon sends a copy of the letter and requests that the Commissioner amends his return to reduce his taxable income and issue a refund of the overpaid tax.

Any requests for amendments, voluntary disclosures or case-specific queries can be sent to: **accommodation@ird.govt.nz**

Payments to cover "distinctive clothing"

Under the previous general rules used to determine whether a payment or allowance is taxable, expenditure incurred on the purchase and maintenance of clothing is normally a private expense. Case law has confirmed that there is an exception to this general approach when the particular clothing is "necessary and peculiar" to the employee's occupation. This has been taken to include a uniform, or specialist clothing that is not reasonably suitable for private use. Examples include uniforms worn by nursing staff, members of the armed forces and police officers. However, ordinary clothing of a particular style or colour which could reasonably be worn outside the job would not be treated as a uniform. Specialist clothing might include overalls and protective clothing worn for health and safety reasons.

When an employer directly provides and/or maintains work-related clothing instead of paying an allowance, rather than relying on case law, the fringe benefit tax rules specifically include a distinctive work clothing exemption (see section CX 30). Applying this same approach to clothing allowances will provide consistency in this area.

New section CW 17CC makes it clear that an allowance to cover the cost of buying and maintaining distinctive work clothing is not taxable income. "Distinctive work clothing" is defined drawing on the fringe benefit tax definition in section CX 30(2) to mean a single item of clothing, that:

- is worn by an employee as, or as part of, a uniform that can be identified with the employer:
  - through the permanent and prominent display of a name, logo, or other identification that the employer regularly uses in carrying on their activity or undertaking; or
  - because of the colour scheme, pattern, or style is readily associated with the employer; and
- is worn in the course of, or as an incident, of employment; and
- is not clothing that employees would normally wear for private purposes.

The distinctive clothing exemption also covers plain clothes allowances that were in place on 1 July 2013 and paid to uniformed personnel who are required to wear plain clothes in order to carry out their duties. This is in line with a longstanding expectation that a portion of the plain clothes allowance paid to police officers is non-taxable, based on the specific circumstances involved. This exemption applies only when:

- the employer provides a uniform to its employees to wear when performing the duties of their employment;
- despite the fact that the employee has been provided with a uniform, it is a requirement of their current job with the same employer that they do not wear that uniform but instead need to wear plain clothes;
- the plain clothes allowance was in place at 1 July 2013;
- historically, the plain clothes allowance was part of a larger plain clothes amount the employer paid to employees, the balance being a taxable amount that was subsequently included in the taxable salary of employees receiving the plain clothes amount, under the employer's general terms and conditions; and
- the employer's general terms and conditions of employment continue to provide for the payment of a plain clothes allowance.

Payments in relation to the purchase and maintenance of other clothing continue to be subject to the general rules for determining when a payment that does not have its own exemption rules is tax-exempt.

General rule for determining taxable portion of other expenditure payments

For the most part, beyond the specific payments discussed earlier in relation to accommodation and meals and distinctive clothing where the need for particular rules have been identified, the previous general rule for establishing the taxable part of an employee expenditure payment has worked satisfactorily. However, some further clarity around what the rule involves was merited. Furthermore, there is still a possibility that at some time in the future the general rule may not be able to provide an appropriate outcome for another particular type of payment. There are advantages in having a mechanism to handle this other than through specific legislative amendment.

Nexus test – clarification of the approach

Under the general approach set out in section CW 17, the expenditure being paid to or on behalf of the employee is exempt income of the employee provided it is incurred in

NEW LEGISLATION

connection with the employee's employment or service and the employee would be allowed a deduction in respect of that amount if the limitation on employees claiming deductions (the employment limitation) did not exist. This is often referred to as the "nexus test". It effectively means that a payment is exempt provided it is not of a private, domestic or capital nature. This is not confined to actual expenditure. Section CW 17 allows an employer to make a reasonable estimate of the expenditure likely to be incurred.

These rules generally satisfactorily deal with the vast majority of expenses that do not have their own rule. The changes are simply aimed at providing greater clarity about what the nexus test involves by providing further detail of what is considered expenditure incurred, or an amount paid, in connection with an employee's employment or service.

New section CW 17(2B) provides that to qualify as expenditure that is incurred in connection with an employee's employment or service, it has to be incurred because the employee is performing an obligation required by their employment or service, and the employee earns income through the performance of the obligation, and the expenditure is necessary in the performance of the obligation. This does not remove the requirement to consider whether the employee would have received a deduction for the amount but for the employment limitation, which necessarily incorporates consideration of whether the capital or private limitations apply.

Commissioner determination power

A new power enables the Commissioner of Inland Revenue to issue a determination (under section 91AAT of the Tax Administration Act 1994) in respect of a payment made to a wide group or class of employees. This does not dispense with the general requirements of section CW 17 but rather, in situations where it is hard to measure the precise private or capital portion of the expense, the Commissioner may determine the extent to which on average the amount is exempt income by setting a percentage that represents the extent to which the payment for the particular type of expense, based on a reasonable estimate, is taxable.

This determination-making power is discretionary. Before deciding to issue a determination, the Commissioner needs to be satisfied that the payment not only affects a large group or class of employees but also that the average private or capital benefit likely to be received is hard to measure, and that the payment is not paid as a substitute for salary or wages (see section CW 17(2C)). The power is only available in respect of payments made to a wide group of employees to ensure that the cases in which the Commissioner issues a determination are of sufficient importance to the wider business community. This is likely to mean an employee expenditure payment that is commonly provided across a wide spectrum of businesses. It may include an employee expenditure payment provided in a specific industry if it covers many employees.

Any determination issued will be binding on the Commissioner but not the taxpayer, which means that it will act as a safe harbour. If the employer or employee has evidence to demonstrate that in their particular circumstance some other apportionment is appropriate under the section CW 17 general rule, the taxpayer will still be able to apply that apportionment.

Expenditure on account of an employee

When an employer reimburses or otherwise meets a specific employee expense, this is an employee expenditure payment known as "expenditure on account of an employee". The statutory definition is very widely drawn, so there is a comprehensive list of exclusions from the definition. These include two general exclusions that covered employee expenditure payments in general.

The first general exclusion (section CE 5(3)(a), which remains unchanged) excludes payments to third parties or to employees for expenditure incurred by those employees in deriving their employment income. The second general exclusion (section CE 5(3)(c)) excluded payments made by employers to employees for expenses that an employee had incurred and paid for on their employer's behalf, when the expenses were the employer's liability. An example would be when the employee buys a box of photocopying paper on the employer's behalf on the basis that the employer will reimburse them.

There have been a number of significant changes to the definition of "expenditure on account of an employee" since it was first introduced in 1985. As a result, the general exclusions have been amended and expanded and it was no longer clear how the two exclusions should apply in relation to each other. Arguably, there was some overlap, which the amended provision is designed to remove.

The general exclusion in section CE 5(3)(c) has been amended so that it excludes expenditure from being "expenditure on account of an employee" when:

- the particular payment does not already fall within the section CE 5(3)(a) exclusion (this ensures the section CE 5(3)(a) exclusion takes priority);
- the expense covered by the payment is incurred by or on behalf of the employee's employer; and
- the expense has been paid for by the employee on their employer's behalf.

Other matters

A number of minor technical amendments have been made to support the wider changes to the rules governing the tax treatment of employer-provided accommodation, accommodation payments, and other allowances and payments by employers to cover employee expenditure.

The amendments cover changes to definitions, headings and cross-references to ensure compatibility with other taxing rules.

THIN CAPITALISATION RULES

Sections GB 51, FE 1 to 4, 14, 16, 18, 25, 27 and 31 D, and YA 1 of the Income Tax Act 2007

Changes have been made to five aspects of the thin capitalisation rules to help strengthen the rules and better protect New Zealand's tax base. The most significant change is that the rules will now apply when non-residents who appear to be acting together own 50 percent or more of a company. Non-residents will be treated as acting together if they hold debt in a company in proportion to their equity, have entered into an arrangement setting out how to fund the company with related-party debt, or act on the instructions of another person (such as a private equity manager) in funding the company with related-party debt.

The rules will now also apply to all trusts that have been majority settled by non-residents, as well as all companies controlled by the trustees of such trusts.

Amendments have also been made to the "110 percent worldwide debt test". This test, in essence, compares the amount of debt in a company's worldwide operations to the debt in the company's New Zealand operations. Debt that originates from shareholders will be excluded when calculating the debt level of a company's worldwide operations.

Increases in asset values following internal company reorganisations will be ignored, unless the increase in asset value would be allowed under generally accepted accounting principles in the absence of the reorganisation, or if the reorganisation is part of the purchase of the company by a third party.

A technical amendment has also been made to ensure that, in the outbound thin capitalisation rules, individuals and trustees will generally be required to exclude their indirect interests in offshore companies if the interest is held through a company they are associated with.

Background

The thin capitalisation rules form part of New Zealand's international tax rules and are designed to protect our tax base. The rules place limits on how much debt a non-resident can put into their New Zealand investments. This is important as the use of debt is one method that non-residents can use to take profits out of New Zealand, lowering the amount of tax they would otherwise pay.

While the thin capitalisation rules have generally been operating effectively, Inland Revenue became aware of some situations where the rules could usefully be strengthened. The changes made in this Act provide that strengthening.

These changes follow an officials' issues paper, *Review of the thin capitalisation rules*, released in January 2013. At a high level, the changes largely follow what was originally proposed in the issues paper, although it was decided not to proceed with one of the proposed changes (excluding capitalised interest from a company's asset base). Technical and minor policy changes have also been made in response to submitters' concerns raised during three rounds of consultation (the initial issues paper, a subsequent technical paper, *Thin capitalisation review: technical issues*, and Parliament's Select Committee process).

Key features

- The inbound thin capitalisation rules will apply when non-residents (or entities subject to the rules) act together when investing in New Zealand. (The previous rules applied only when a single non-resident controlled the investment.)
- Debt linked to shareholders of group entities or their associates will be excluded from the worldwide group debt test used in the inbound rules.
- The inbound thin capitalisation rules will apply to all resident trustees if 50 percent or more of settlements made on the trust were made by a non-resident, or a group of non-residents and/or other entities subject to the rules who are acting in concert.
- The on-lending concession will be extended to cover financial arrangements held by a trust provided certain criteria are met.
- Increases in asset values will be ignored if they are the result of transactions between associated persons, unless the increase would be allowed by accounting standards in the absence of a transaction.
- In the outbound thin capitalisation rules, individuals or trustees will be required to exclude their indirect interests in offshore companies if their interest is held through a company they are associated with.

Application date

The amendments apply from the 2015–16 income year.

DETAILED ANALYSIS

Companies controlled by shareholders acting together

The thin capitalisation rules apply to companies controlled by shareholders who have the ability to substitute equity with debt. This is clearly evident when a company is controlled by a single non-resident—the controlling non-resident has little constraint on how it can fund the

company, and so is free to invest through debt rather than equity. However, the ability to substitute equity with debt is also available to non-residents who are acting together. They are able to coordinate their activities and act in much the same way as a single non-resident.

The rules have been amended so they also apply to companies controlled by a group of shareholders who appear to be acting together. Section FE 2 provides that the thin capitalisation rules apply if a *non-resident owning body* holds 50 percent or more of a company's ownership interests, or has control of a company by any other means.

As a consequence, section FE 1 has been amended to reflect the broader application of the rules.

Non-resident owning body

In short, a non-resident owning body is a group of non-residents or entities described in sections FE 2(1)(cc) to (db) (such as trusts settled by non-residents) that have one or more characteristics indicating they are acting together to debt-fund a New Zealand company. These characteristics are having:

- proportionate levels of debt and equity among the group;
- an agreement that sets out how the company should be funded with *member-linked funding* if the company is not *widely held* (a term defined in section YA 1);
- *member-linked debt* in the company in a way recommend by a person (such as a private equity manager), or implemented by a person on behalf of the members.

Arrangements on how to fund the company are only counted as a characteristic of acting together if the arrangement applies to the current income year. That is, shareholders who have agreed how to fund an entity in the event of a specified event that is yet to occur (such as insolvency) are not a *non-resident owning body* by virtue of that agreement.

The proportionality rule

Proportionality is a characteristic of acting together as it generally requires a degree of coordination to achieve. More generally, proportionality is also a situation where shareholders are able to substitute debt for equity. This is because, where there is proportionality, the level of debt in a company does not change shareholders' exposure to the risk of holding equity in the company or shareholders' overall return. As debt levels increase, the makeup of the return will change (ie, fewer dividends and higher interest payments) but the sum of interest and dividends will be unchanged.

The new proportionality rule will capture both direct and indirect proportionality, including debt or equity that is routed through a trust (*a linked trustee*, explained below).

Subsection FE 4(a)(i) provides that the rule will apply if the company ultimately owes money to each member of the group and, for each member, the member's debt as a fraction of the total debt the company owes to all members (the *member debt*) is the same as the member's direct or indirect interests in the company as a fraction of direct or indirect ownership interests held by all members in the company.

Subsection FE 4(a)(ii) provides that the rule also applies in relation to a member if the criteria of subsection FE 4(a)(i) would be met if the debt and equity held by the member's *linked trustees*, and the debt held by the member's subsidiaries, were held directly by the member.

A *linked trustee* is a trust that a person has provided money to, whether through settlement or some other arrangement (such as a financial arrangement). This is to ensure a non-resident cannot avoid being included in a *non-resident owning body* by holding shares or debt in a New Zealand company through a trust.

Note that as per subsection (2) of the definition of *non-resident owning body*, each type of ownership interest is to be considered in the proportionality rule.[3]

Anti-avoidance provision

New section GB 51 provides that arrangements are void if they have the effect of defeating the intent of the proportionality rule (to capture groups of non-residents and entities described in section FE 2(1)(cc) to (db) who, in economic substance, have proportionate levels of debt and equity). An example of this type of arrangement would be using a back-to-back loan to make it appear as if there is no proportionality.[3]

Member-linked debt

The other two characteristics of acting together described above only apply to *member-linked debt*. This is debt that where the member:

- is a party to the financial arrangement;
- guarantees or provides security for the arrangement (if the worldwide group is provided by sections FE 3(e) or FE 31D—this is described more in more detail in the section *Worldwide group debt test*); or
- has entered into a back-to-back arrangement with the person who has provided the funds to the company.

[3] These are: shares, decision-making rights, the right to receive income and the right to receive the net value of any assets.

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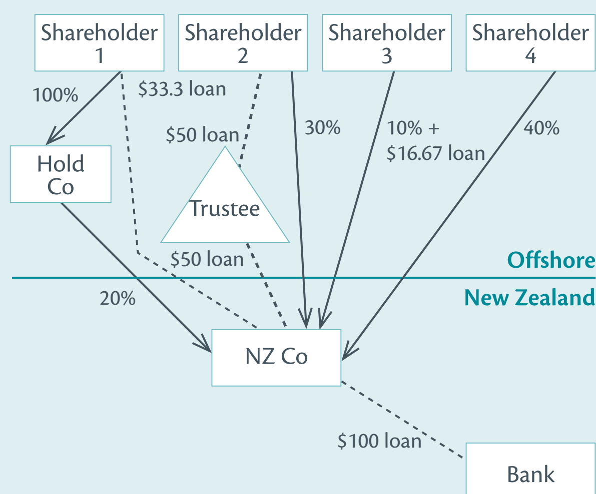
Example

Resident company NZ Co has four non-resident shareholders: Hold Co, 2, 3 and 4. Shareholder 1 owns 100 percent of Hold Co and is therefore an indirect owner of NZ Co.

Shareholders 1 and 3 have lent money to NZ Co ($33.33 and $16.67, respectively). Shareholder 2 has lent $50 to Trustee, who has on-lent that money to NZ Co. As shareholder 2 has provided money to Trustee, it is a *linked trustee.*

NZ Co has also borrowed $100 from a New Zealand bank. The bank is not associated with any of NZ Co's shareholders.



Shareholders 1 (together with its associate Hold Co), 2 and 3 will be members of a non-resident owning body. NZ Co's total member debt is $100 ($33.33 + $50 + $16.67) and the total equity in NZ Co held by the members is 60 percent (20 percent + 30 percent + 10 percent). This means:

- Shareholder 1 holds 33.33 percent of the total member debt and 33.33 percent of the total member equity (through its shareholder in Hold Co);
- Shareholder 2 holds 50 percent of the total member debt (through its linked trustee) and 50 percent of the total member equity; and
- Shareholder 3 holds 16.67 percent of the total member debt and 16.67 percent of the total member equity.

Each shareholder's share of total member debt is equal to their share of total member equity. They therefore have proportionate levels of debt and equity (ratio of 1:0.6 debt to equity).

The thin capitalisation rules will therefore apply to NZ Co as 60 percent of its shares are held by a non-resident owning body.

Aggregation of ownership interests

New section FE 2(1)(cb) provides that the total ownership interests of a non-resident owning body should be determined as if the members were associated persons. The purposes of this is that, as per section FE 41, the ownership interests of the owning body will be calculated by aggregating the ownership interests of the body's members, except to the extent the aggregation would result in double counting.

Example

Resident company A Co has five non-resident shareholders: Mr W (married to Mrs W), Mrs W, Mr X, Mr Y and Mr Z. Each holds 20 percent of the issued shares. They all have agreed to lend some of their own money to the company, and therefore form a non-resident owning body.

Mr W's ownership interest in A Co is 40 percent (as his interests are aggregated with Mrs W under section FE 41). Mrs W's ownership interest is similarly 40 percent. The other shareholders (who are not associated with each other or Mr and Mrs W) have an ownership of 20 percent each.

The ownership interests are added together, but with 40 percent removed to correct for double counting of Mr and Mrs W's interests.

The non-resident owning body made up of Mr W, Mrs W, Mr X, Mr Y and Mr Z therefore has 100 percent of the ownership interests in A Co.

New Zealand groups

Under the new rules, the New Zealand group of a company controlled by a non-resident owning group will be determined much in the same way as a company controlled by a single non-resident.

As with companies controlled by a single non-resident, new section FE 26(2)(bb) will provide the general rule that a New Zealand company is a New Zealand parent company if a non-resident owning body has direct ownership interests of 50 percent or more in the company.

There is an exception to this if one or more of the members operates a branch in New Zealand or has New Zealand-sourced income (other than non-resident passive income). In that case the non-resident owning body itself is the New Zealand parent. This matches the treatment of companies owned by a single non-resident where that non-resident operates a branch or has New Zealand-sourced income (other than non-resident passive income).

A similar amendment has been made to section FE 26(3) (d), which defines the parent of an excess debt entity as the company where the non-resident owning body directly holds 50 percent or more of its ownership interests. Again, there is an exception when one or more members of the non-resident owning body operates a branch in New Zealand or has New Zealand-sourced income (other than non-resident passive income). In this case the parent will be the non-resident owning body.

Example

Non-residents X Co, Y Co and Z Co (who are not associated persons) each own 33 percent of resident company A Co and have proportionate debt and equity. They therefore will form a non-resident owning body.

A Co has three resident subsidiaries.

The New Zealand parent for A Co is determined under section FE 26(2)(bb) (a non-resident owning body has direct ownership interests in A Co of 50 percent or more). A Co is therefore the New Zealand parent. A Co's subsidiaries will determine their New Zealand parent (A Co) under section FE 26(3)(d)(ii).

A Co's New Zealand group will therefore comprise A Co and its three subsidiaries.

Special grouping rule: investments via holding companies

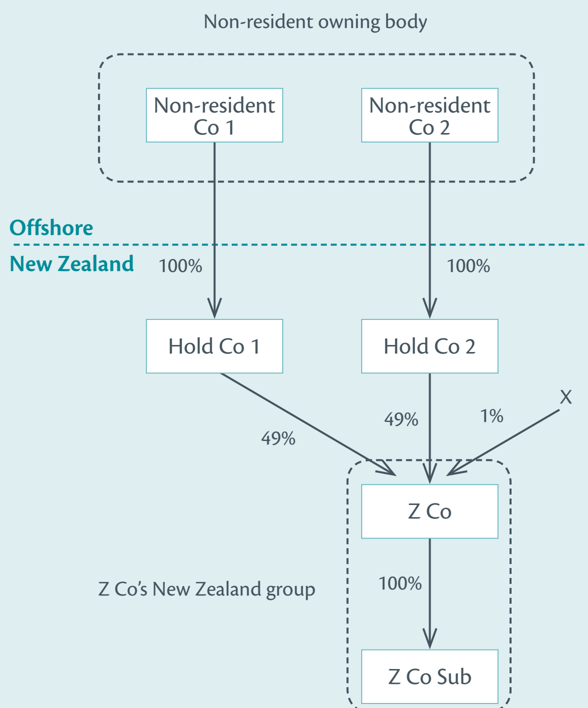
A special rule will apply if some members of a non-resident owning body invest into New Zealand through a holding company. The grouping rules described above will not be able to identify a New Zealand parent for the top-level operating company in New Zealand (Z Co in the example below).[4]

Accordingly, section FE 26(6) will deem the top-level operating company as the New Zealand parent. A company controlled by the top-level operating company will identify the operating company as its parent under section FE 26(3). Each holding company will also have a New Zealand group that is just the company.

Example

Non-resident Co 1 owns 100 percent of Hold Co 1 and Non-resident Co 2 owns 100 percent of Hold Co 2. Hold Co 1 and Hold Co 2 are therefore subject to the thin capitalisation rules under section FE 2(1)(c).

The non-residents meet the criteria for being a non-resident owning body. Z Co is therefore also subject to the thin capitalisation rules under section FE 2(1)(cb).



Hold Co 1's New Zealand group is Hold Co 1 (as Hold Co does not hold 50 percent or more of Z Co's ownership interests it does not include it in its group under section FE 26). Hold Co 2's New Zealand group is similarly just Hold Co 2.

Z Co's New Zealand group cannot be determined under section FE 26 other than under subsection (6). Z Co is therefore deemed to be its New Zealand parent. Z Co Sub will identify Z Co as its parent under FE 26(3)(d)(ii). Z Co's New Zealand group will therefore be Z Co and Z Co Sub.

New grouping rules only apply if existing rules do not

These new grouping rules will only apply if the thin capitalisation rules as they currently stand do not apply—that is, to a company not controlled directly or indirectly by a single non-resident.[5] This means the New Zealand parent of a company controlled by a single non-resident will

[4] There would be no issue if one of the holding companies held ownership interests of 50 percent or more of Z Co. The thin capitalisation rules as they were before these amendments would apply.

[5] For example, section FE 26(2)(bb) applies only if "none of the other paragraphs apply" and subsection (3)(d)(ii) applies only if subsection (3)(d)(i) does not. Subsection (3)(d)(i) is a paraphrase of previous section FE 26(3)(d).

be unaffected by the changes, even if the company is also controlled by a non-resident owning body. Its New Zealand group will, by extension, also be unaffected.

Example

Non-resident companies Z, X and Y own 51, 25 and 24 percent, respectively, of New Zealand-resident company A Co. Companies Z, X and Y have funded A Co with related-party debt as instructed by a private equity manager. Companies Z, X and Y therefore form a non-resident owning body.

A Co has three resident subsidiaries. Company Z also owns 100 percent of an Australian company.

Under the current thin capitalisation rules, the New Zealand group of A Co comprises A Co and its three New Zealand subsidiaries. The worldwide group is the New Zealand group, Company Z and the Australian company.

There will be no change to the New Zealand or worldwide group of A Co as a single non-resident (Company Z) owns 51 percent of its shares—even though a non-resident owning body also holds 50 percent or more of A Co's shares.

Worldwide groups

New section FE 31D provides that the worldwide group of a company controlled by a non-resident owning body is just its New Zealand group, unless a single non-resident also controls the company. This is because it is not possible to construct a meaningful worldwide group when a company is not controlled by a single person.

Rules to ensure matching New Zealand groups

Under the thin capitalisation rules it is important that New Zealand groups of different entities match. That is, if Company A includes Company B in its New Zealand group, then Company B should include Company A in its group. It is also important that an entity cannot be included in multiple groups. This is to prevent the double-counting of the entity's debt and assets.

Section FE 3(d) excludes a company from a trust's group if the company does not include the trust in its own group (that is, the trust is not found to be the company's New Zealand parent under section FE 26(4D)). This ensures the two groups are identical.

A separate rule in section FE 14(3B) ensures that an entity cannot include its debt and assets in more than one New Zealand and worldwide group. This might arise, for example, if it were possible to argue there are multiple different *non-resident owning bodies* that hold 50 percent or more of the ownership interests in a company.

An ordering rule applies in some cases when determining the group an entity's debt and assets should be included in. If the entity is a company that is controlled indirectly or directly by a single non-resident, it must include its debt and assets in the New Zealand group of the single non-resident. Otherwise there is no rule for determining the group the debt and assets should be included in.

Worldwide group debt test

Whether there is any interest denial under the thin capitalisation rules depends on the result of two tests. One of these tests is known as the "worldwide group debt test" and is designed to ensure that the amount of debt in a New Zealand company is proportionate to the amount of genuine external debt of the ultimate non-resident parent of that New Zealand company.

In some circumstances, however, the debt of the ultimate parent company may also include debt from the parent's shareholders or other owners of the group. In such cases the debt level of the worldwide group does not reflect the level of genuine external debt.

To address this, new section FE 18(3B) provides that, when an excess debt entity (other than an outbound excess debt entity)[6] is calculating its worldwide group debt percentage, it must generally exclude debt that is linked to an owner of the worldwide group. There are a few carve-outs to this rule; these are described below.

An "owner" will be a person who has an ownership interest in a member of the group or is a settlor of a trust that is a member of the group.

A financial arrangement will be treated as linked to an owner of the group if the owner, or an associate of the owner (excluding associates who are members of the group):

- is a party to the financial arrangement (for example, by a loan directly from the owner);
- has guaranteed or otherwise provided security for the financial agreement and the entity's worldwide group is deemed to be the same as its New Zealand group under sections FE 3(e) or FE 31D (discussed below); and
- has provided funds or will provide funds, directly or indirectly, to another person who is providing funds under the financial arrangement (such as a back-to-back loan).

[6] This change applies to the "inbound" thin capitalisation rules, which apply to non-resident investments in New Zealand. The "outbound" thin capitalisation rules, which apply to New Zealand investment abroad, are not affected.

Worldwide group is the same as New Zealand group

When a company is owned by a group of non-residents who meet the definition of a "non-resident owning body" (or by trusts subject to the thin capitalisation rules) there is no true worldwide debt test that can be used to ensure the owners have allocated a fair amount of their worldwide debt to New Zealand. It is therefore important that shareholder-guaranteed loans are counted as "owner-linked". The presence of a shareholder guarantee suggests the New Zealand entity would not be able to commercially support the loan in the absence of the guarantee. This provides an indication that debt that should be allocated elsewhere in the world has been put in New Zealand—since the loan is implicitly being supported by assets outside of New Zealand.

The issue of shareholder-guaranteed debt is less significant in the case of a company controlled by a single non-resident. While shareholder guarantees could nonetheless be used to excessively gear the worldwide group, this concern must be tempered with the fact that the worldwide group debt test can act to ensure that only a reasonable amount of the worldwide group's debt is allocated to New Zealand. Moreover, a New Zealand company may struggle to get information about guarantees provided by shareholders of the ultimate parent company.

On this basis, section FE 18(3B)(b)(ii) applies only in relation to entities with a worldwide group deemed to be the same as their New Zealand group under sections FE 3(d) or FE 31D.

Carve-out for public debt and minor shareholders

New section FE 18(3B) also includes a carve-out for minor shareholders and publicly traded debt. An owner's financial arrangement will not be excluded from the worldwide group debt test if:

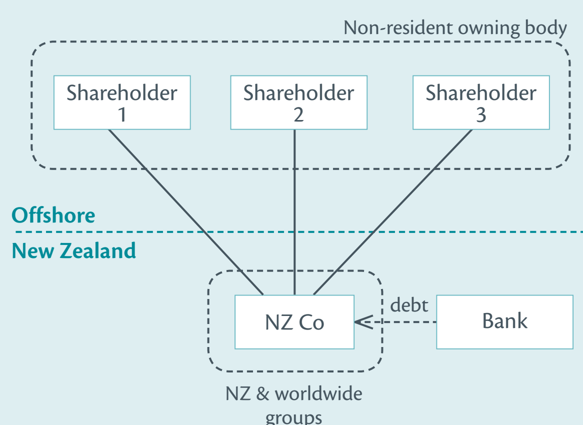
- the owner has a 5 percent or less *direct* ownership interest in the group; or
- the financial arrangement held by the owner is traded on a *recognised exchange* (if the definition of recognised exchange in section YA 1 was read to include a reference to an exchange for trading financial arrangements).

These carve-outs are designed to reduce compliance. It would be difficult to manipulate a company's debt financing through publicly traded debt where the debt is widely traded. Excluding such debt reduces compliance costs. Limiting the rule to shareholders with a direct ownership interest of 5 percent or more limits the number of shareholders that a company needs to investigate to determine if they hold owner-linked debt.

The 5 percent ownership threshold does not refer to indirect interests or interests held by associates. This is intentional. Otherwise the exemption's purpose as a compliance reduction measure would be defeated. However, it is not intended to provide an opportunity for a non-resident with a significant interest in a company to avoid the application of the owner-linked debt rules by spreading their interests across numerous associated entities.

Example

Three shareholders collectively own New Zealand company NZ Co. As NZ Co is controlled by a non-resident owning body, its worldwide group is the same as its New Zealand group.



The three non-resident shareholders will be treated as "owners" of NZ Co as they each have an ownership interest in NZ Co and are outside of its worldwide group. Any debt they extend to NZ Co will not be treated as debt in NZ Co's worldwide group debt test.

"Bank", however, will not be treated as an "owner" of NZ Co as it has no ownership interest in NZ Co and is not associated with any of the shareholders. A loan from Bank will therefore be included as debt in NZ Co's worldwide group debt test.

Effect of shareholders lending to NZ Co

The three shareholders decide to lend a total of $500,000 to NZ Co. NZ Co has $800,000 of assets.

The debt-to-asset ratio of NZ Co's New Zealand group is ($500,000 ÷ $800,000) = 62.5 percent.

The debt-to-asset ratio of NZ Co's worldwide group is ($0 ÷ $800,000) = 0 percent (as the debt from the owners is excluded).

The debt-to-asset ratio of NZ Co's New Zealand group exceeds both the 60 percent safe harbour and worldwide group debt test. NZ Co will therefore have income under section CH 9 to cancel out some of its interest deductions.

Effect of Bank lending to NZ Co

Instead of borrowing from its shareholders, NZ Co borrows the $500,000 from Bank. Again, NZ Co has $800,000 of assets.

The debt-to-asset ratio of NZ Co's New Zealand group is ($500,000 ÷ $800,000) = 62.5 percent.

The debt-to-asset ratio of NZ Co's worldwide group is ($500,000 ÷ $800,000) = 62.5 percent.

While the debt-to-asset ratio of NZ Co's New Zealand group exceeds the 60 percent safe harbour, it does not exceed the worldwide group debt test. The debt percentage of the New Zealand group is less than 110 percent of the debt percentage of the worldwide group. NZ Co will not have any income under section CH 9.

Extending the thin capitalisation rules to more trusts

Amendments to section FE 2(1)(d) extend the thin capitalisation rules to all types of trusts for tax purposes (complying trusts, non-complying trusts and foreign trusts). The new rules mean a trust is subject to the thin capitalisation rules if the majority of settlements on it come from non-residents or from persons who are subject to the thin capitalisation rules.

A trust will be subject to the rules if 50 percent or more of the settlements are made by:

- a non-resident or a person associated with the non-resident;[7]
- an entity subject to the inbound thin capitalisation rules (that is, an entity to which section FE 2(a) to (cc) and (db) applies); or
- a group of non-residents or entities subject to the thin capitalisation rules that act in concert.

As with companies, the thin capitalisation rules apply to trusts settled by entities acting in concert. This is important to ensure the rules cannot be easily circumvented through the use of trusts. However, the rules for determining when a group of entities appear to be acting together used for companies (described in the section *non-resident owning body*) cannot be used for trusts. Instead, the rules apply to a trust settled by a group "acting in concert". This is because, for example, it is not sensible to refer to settlements made in proportion to debt extended to a trust because rights to income from a trust generally do not depend on the amount a person has settled on it.

New section FE 2(1)(db) also provides that a trust is subject to the thin capitalisation rules if a person subject to the thin capitalisation rules has the power to appoint or remove a trustee. This is designed as an anti-circumvention measure. It means trusts are subject to the rules if they have been settled by a New Zealand resident and then effective control of the trust is transferred to a non-resident by giving the non-resident power to appoint or remove the trustee.

There is a carve-out from this rule if a person has the power to add or remove a trustee for the purpose of protecting a security interest. This type of security interest is commonly held by banks that have lent to a trust.

Section FE 2(1)(d) and (db) provides that settlements made by the trustee and powers of removal or appointment of the trustee must be ignored when applying the sections. This is to prevent circularity if two trusts make settlements on each other or each has the ability to appoint the other's trustee.

To illustrate, say settlements on Trust A are made by a non-resident and Trust B. Settlements made on Trust B are made by Trust A. It is only possible to determine whether Trust B is subject to the thin capitalisation rules if the settlement it has made on Trust A is ignored. Ignoring the settlement means the sole settlor of Trust A is a non-resident. Trust B is therefore subject to the thin capitalisation rules as it has been settled by a trust that is itself subject to the rules. Once Trust B's status is determined, it is possible to determine that Trust A should also be subject to the rules as it has also been settled by entities that are subject to the rules (a non-resident and Trust B).

Grouping rules for trusts

Amendments to section FE 3 define the New Zealand group of a trust as the trust and all companies controlled by the trust. Whether a trust controls a company is determined under section FE 27, based on the trust's choice of control threshold under that section.

Similarly, the New Zealand group of a company that is controlled by a trust will be the trust and all other companies controlled by the trust. This is provided by new section FE 26(4D), which defines the New Zealand parent of a company controlled by a trust to be the trust. The other members of the New Zealand group will then be determined under section FE 28.

As with companies controlled by non-resident owning bodies, the worldwide group of a trust will be the same as its New Zealand group. This is provided by section FE 3(1)(d).

[7] Here, an associate will not include a relative that has not made any settlements on the trust. This is to prevent the rules from applying to a trust settled by a New Zealand resident merely because the resident has a non-resident relation.

Extension of on-lending concession for trusts

Currently, section FE 13 provides what is commonly referred to as the "on-lending concession". It removes financial arrangements that provide funds to a person from the ambit of the thin capitalisation rules.

Proposed amendments to section FE 13 mean that, for a trust that holds only financial arrangements and property incidental to those financial arrangements, the on-lending concession will apply regardless of whether the arrangement provides funds.

This amendment is designed for securitisation vehicles that hold only financial arrangements which will become subject to the rules because of the changes relating to trusts described above. This carve-out is on the basis that the on-lending concession would apply to most of the trust's debt in any event.

Exclusion of asset uplift

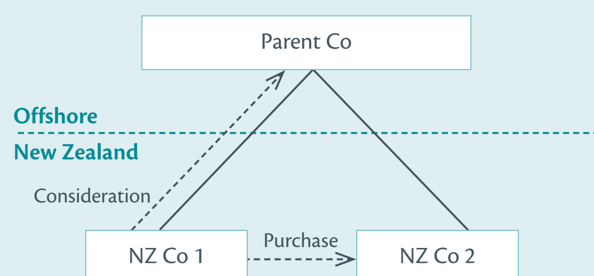
New sections FE 16(1D) and (1E) provide that increases in a company's New Zealand group assets that arise from the sale or other transfer of assets between a member of the group and a person associated with the group must be ignored. This may or may not be another member of the group.

This change applies only in relation to transfers that occur in or after the 2015–16 income year.

The purpose of this change is to ensure that increases in asset values that are not recognised under generally accepted accounting practice in the consolidated worldwide accounts of a company cannot be recognised in the asset values of the company's New Zealand group.

Example

Parent Co owns two New Zealand subsidiaries, NZ Co 1 and NZ Co 2.



NZ Co 1 purchases the shares in NZ Co 2 from Parent Co. NZ Co 1 will not be able to include any increase in asset values resulting from this purchase for thin capitalisation purposes unless that increase would have been allowed under generally accepted accounting practice in the absence of the purchase.

When uplift can be recognised

Section FE 16(1E) will provide two exemptions to the rule above. These are when:

- generally accepted accounting practice would allow the increase in asset values in the absence of the transfer; or
- the transfer is part of a restructure following the purchase of the group by a person not associated with the group and the change in the value of the New Zealand group's assets is a reasonable proportion of the change in the value of the group's total assets.

The intention behind the second exemption is to allow uplifts to be recognised when a third party has, in essence, purchased a group of companies and part of that purchase price relates to the group's intangible property. Following this, the purchaser may restructure the group, in part to spread the value of the intangible property among all its subsidiaries. An increase in the assets of the New Zealand group following such a restructure is allowable, provided the increase is a reasonable considering the increase in the value of the entire group's assets (for example, having regard to the relative size of the New Zealand group).

Excluding individuals' and trustees' interest in a CFC

New section FE 16(1BA) largely rewrites the previous section FE 16(1B) but with a new provision. Individuals or trustees will be required to exclude certain interests in a controlled foreign company (CFC) or foreign investment fund (FIF) they hold indirectly through an associate that is outside their New Zealand group if the associate is outside their group by virtue of being an excess debt outbound company or included in the group of such a company.

This provision is necessary as section FE 3(2)(a) excludes from the New Zealand group of an individual or trustee who is an outbound investor, all companies that are excess debt outbound companies or included in the group of such a company. Despite this provision, the person or trustee's indirect interests in the CFC or FIF should be still be excluded from their group assets.

BLACK HOLE EXPENDITURE

Sections CG 7B, DB 19, DB 37, DB 40BA, DB 63 to DB 63C, EE 25, EE 57 and schedule 14 of the Income Tax Act 2007

Several amendments have been made to the Income Tax Act 2007 relating to business expenditure for which taxpayers were previously allowed neither an immediate tax deduction, nor depreciation over time. Such expenditure is commonly referred to as "black hole" expenditure. The two broad areas of black hole expenditure addressed are: expenditure towards applying for resource consents, patents and plant variety rights, and various company administration costs. The changes were part of changes announced in Budget 2013.

Background

Applications for resource consents, patents and plant variety rights

Sections DB 19 and DB 37 previously required a taxpayer to have lodged an application for the grant of a resource consent or a patent in order to obtain a deduction for capital expenditure that failed to give rise to a depreciable asset. A taxpayer who incurred capital expenditure for the purpose of applying for the grant of a resource consent or a patent but did not lodge the application could not receive a deduction for that expenditure. If expenditure would have been depreciable if the intangible asset had been obtained, making this expenditure deductible when it fails to give rise to a depreciable asset improves the symmetry between the tax treatment of successful and unsuccessful expenditure, and reduces distortions against investment in these assets.

Additionally, a deduction was not allowed for expenditure incurred on an application for a resource consent, if the resource consent was granted but not used before it lapsed or was surrendered. This could happen if its conditions were not met or the resource consent was not exercised. This result was inappropriate, as the situation is economically identical to that when a resource consent is refused, withdrawn or not lodged.

Similarly, a taxpayer who incurred capital expenditure for the purpose of applying for the grant of plant variety rights was unable to deduct that expenditure when the plant variety rights were not granted, as there was no equivalent provision to section DB 19 or DB 37 for plant variety rights. As this expenditure would have been depreciable if the plant variety rights had been obtained, making this expenditure deductible when it fails to give rise to a depreciable asset improves the symmetry between the tax treatment of successful and unsuccessful expenditure.

Claw-back for subsequent applications or disposals

After taking a deduction for expenditure incurred on an aborted or unsuccessful application for the grant of a resource consent, a patent or plant variety rights, a taxpayer may use or sell some or all of that application property at a later date. In the case of selling application property, the taxpayer will have conceptually derived income. A claw-back provision was therefore considered necessary to preserve a neutral tax treatment, otherwise taxpayers could receive a deduction that is larger than the loss they have suffered.

The tax treatment of expenditure on application property from an aborted or unsuccessful application that is later used in a successful application and expenditure on a first-time successful application should be neutral. In other words, expenditure on a depreciable intangible asset should be depreciated over the estimated useful life of the asset; that certain expenditure did not create a depreciable asset in the first instance does not change the fact that the expenditure has ultimately created depreciable intangible property. Continuing to allow an immediate deduction for such expenditure would not be a neutral tax treatment. Including a claw-back provision ensures that taxpayers do not receive a timing advantage from immediately deducting expenditure on initially unsuccessful, but ultimately successful, application property instead of spreading depreciation deductions over its estimated useful life.

Company administration costs

The dividend payment process involves authorising, allocating and paying the dividend, as well as addressing any disputes arising over its allocation. Expenditure incurred during this process is a mixture of capital and revenue. However, requiring taxpayers to separately track or apportion this expenditure into its deductible and non-deductible constituent parts could result in disproportionate compliance costs and uncertainty for taxpayers.

Listed companies incur expenditure on an annual listing fee to maintain registration on a recognised stock exchange. Allowing this expenditure to be deductible recognises that its benefit persists for one year only, and is a necessary expense for a listed company.

Annual general meetings (AGMs) are an annual, recurring cost of doing business as a company, while special shareholder meetings are often held to consider a material change in the business of the company. Allowing a deduction for AGM costs while denying a deduction for special shareholder meeting costs ensures that taxpayers

are not subject to disproportionate compliance costs or uncertainty over the tax treatment of shareholder meeting costs, and reflects the capital-revenue principles.

Fixed-life resource consents

Depreciation is appropriate for resource consents if they have a fixed life after which they have no economic value. Resource consents granted under the Resource Management Act 1991 (RMA) to do something that would otherwise contravene section 15A or 15B of the RMA have a fixed life of between five and 35 years. Adding these resource consents to schedule 14, which lists items of depreciable intangible property, brings their tax treatment into line with other fixed-life resource consents.

Key features

- An amendment to section DB 19 removes the requirement for a taxpayer to have lodged an application for the grant of a resource consent before capital expenditure incurred on an aborted or unsuccessful resource consent application can be deducted. The amendment also extends deductibility to situations where a taxpayer obtains the grant of a resource consent, but does not use the resource consent before it lapses or is surrendered.
- An amendment to section DB 37 removes the requirement for a taxpayer to have lodged an application for the grant of a patent before capital expenditure incurred on an aborted or unsuccessful patent application can be deducted.
- New section DB 40BA allows a taxpayer a deduction for capital expenditure they have incurred for the purpose of applying for the grant of plant variety rights, if they do not obtain the plant variety rights because the application is not lodged or is withdrawn, or because the grant is refused.
- New section CG 7B claws back as income, deductions that have been taken for an aborted or unsuccessful application for the grant of a resource consent, a patent or plant variety rights, if the taxpayer subsequently sells or uses the abandoned application property. In the latter case, amendments to sections EE 25 and EE 57 ensure that these costs are included as part of the cost of the new intangible asset for depreciation purposes.
- New section DB 63 allows companies a deduction for all direct costs associated with the payment of a dividend. This does not include the amount of the dividend itself.
- New section DB 63B allows listed companies a deduction for expenditure incurred on an annual listing fee to maintain registration on a recognised stock exchange.
- New section DB 63C allows companies a deduction for expenditure incurred to hold an annual general meeting (AGM) of the shareholders of the company, but denies a deduction for expenditure incurred to hold a special or extraordinary meeting of the shareholders of the company.
- An amendment to item 10 in schedule 14 ensures that expenditure incurred on resource consents granted under the Resource Management Act 1991 (RMA) to do something that would otherwise contravene section 15A (Restrictions on dumping and incineration of waste or other matter in coastal marine area) or section 15B (Discharge of harmful substances from ships or offshore installations) of the RMA is able to be depreciated over the life of the resource consent.

Application date

The amendments apply from the beginning of the 2014–15 income year.

Detailed analysis

Applications for resource consents, patents and plant variety rights

An amendment to section DB 19 allows a taxpayer who incurs expenditure for the purpose of applying for the grant of a resource consent, but does not obtain the grant because the application is not lodged, a deduction for the expenditure they incurred in relation to the intended application. The deduction is allocated to the income year in which the taxpayer decides not to lodge the application.

The amendment to section DB 19 also allows a taxpayer who incurs expenditure for the purpose of applying for the grant of a resource consent and who obtains the grant, but does not use the resource consent before it lapses or is surrendered, a deduction for the expenditure they incurred in relation to the application. The deduction is allocated to the income year in which the resource consent lapses or is surrendered.

An amendment to section DB 37 allows a taxpayer who incurs expenditure for the purpose of applying for the grant of a patent, but does not obtain the grant because the application is not lodged, a deduction for the expenditure they incurred in relation to the intended application. The deduction is allocated to the income year in which the taxpayer decides not to lodge the application.

New section DB 40BA allows a taxpayer who incurs expenditure for the purpose of applying for the grant of plant variety rights, but does not obtain the grant because the application is not lodged or is withdrawn, or because the grant is refused, a deduction for the expenditure they incurred in relation to the application or intended application. The deduction is allocated to the income year in which the taxpayer decides not to lodge the application, withdraws the application, or is refused the grant of plant variety rights.

Claw-back for subsequent applications or disposals

New section CG 7B is a claw-back provision which applies when a taxpayer:

- has taken a deduction under section DB 19 or DB 37 or new section DB 40BA (for expenditure on an aborted or unsuccessful resource consent, patent or plant variety rights application), and subsequently derives consideration for the disposal of property acquired as a result of the expenditure on the intended, withdrawn or unsuccessful application; or
- has taken a deduction under section DB 19 for expenditure on:
  - an aborted or unsuccessful application for the grant of a resource consent; or
  - a resource consent that is granted but is not used before it lapses or is surrendered,

  and subsequently uses property acquired as a result of the expenditure in obtaining the grant of a resource consent; or
- has taken a deduction under section DB 37 for expenditure on an aborted or unsuccessful application for the grant of a patent, and subsequently uses property acquired as a result of the expenditure in the lodging of a patent application with a complete specification; or
- has taken a deduction under new section DB 40BA for expenditure on an aborted or unsuccessful application for the grant of plant variety rights, and subsequently uses property acquired as a result of the expenditure in obtaining the grant of plant variety rights.

When the taxpayer derives consideration for the disposal, the amount that will be clawed back as income will generally be the lesser of the consideration derived for the disposal and the amount of the deduction that has previously been taken. The exception to this will be when the disposal of the property otherwise gives rise to income under the Income Tax Act 2007, in which case the entire amount of the consideration derived from the disposal will continue to be considered income.

When the taxpayer subsequently uses property in the lodging of a patent application with a complete specification or in obtaining the grant of a resource consent or plant variety rights, the amount that will be clawed back as income will be the total amount of deductions taken for expenditure under section DB 19 or DB 37 or new section DB 40BA (whichever applies) to the extent that the property acquired as a result of the expenditure was subsequently used in the lodging of a patent application or in obtaining the grant of a resource consent or plant variety rights.

An amount clawed back under new section CG 7B is income of the taxpayer in the income year of the disposal (in the case of a disposal for consideration), or in the income year of the lodgement or grant (in the case of subsequent applications).

In the case of subsequent applications, an amount clawed back under new section CG 7B can then be included in the cost base of the resource consent, the patent application (and subsequently the patent if it is granted) or the plant variety rights, and be depreciated over the legal life of the depreciable asset in the usual way.

An amendment to section EE 25 ensures that any expenditure clawed back as income under new section CG 7B is included in the cost of a subsequent plant variety rights application for the purpose of calculating the pro-rated deduction for the cost of a plant variety rights application that a taxpayer is allowed when they are granted plant variety rights.

An amendment to section EE 57 ensures that the "base value" used for the purpose of calculating a depreciable asset's "adjusted tax value" includes any expenditure clawed back as income under new section CG 7B.

Company administration costs

New section DB 63 allows a company a deduction for expenditure incurred in authorising, allocating, or processing, the payment of a dividend, or resolving a dispute concerning one of these matters. The dividend itself remains non-deductible.

New section DB 63B allows a listed company a deduction for expenditure incurred as periodic fees of a recognised exchange for maintaining the company's registration on the exchange.

New section DB 63C allows a company a deduction for expenditure incurred in holding an annual meeting of the shareholders of the company to consider the affairs of the company, but denies a deduction for expenditure incurred in holding a special or extraordinary meeting of the shareholders of the company.

Fixed-life resource consents

An amendment to item 10 in schedule 14 includes as an item of depreciable intangible property a consent granted under the Resource Management Act 1991 (RMA) to do something that would otherwise contravene section 15A (Restrictions on dumping and incineration of waste or other matter in coastal marine area) or section 15B (Discharge of harmful substances from ships or offshore installations) of the RMA, if the consent is granted in or after the 2014–15 income year.

FOREIGN ACCOUNT INFORMATION-SHARING AGREEMENTS

Sections BB 3(2), BH 1(5B), DB 1(1)(bb) and section YA 1 of the Income Tax Act 2007; sections 3, 22(2)(lc), 143(1)(ab), 143(2B), 143A(1)(ab), 173B and 185E–M (Part 11A) of the Tax Administration Act 1994

New Zealand has entered into an intergovernmental agreement (IGA) with the United States to clarify the reporting obligations of New Zealand financial institutions under the United States law commonly known as the Foreign Account Tax Compliance Act (FATCA).

Amendments to New Zealand's tax legislation were required to bring the IGA into domestic law and allow New Zealand financial institutions to comply with its terms.

FATCA requirements took effect from 1 July 2014. Accordingly, this is the effective date for the new provisions.

Background

The United States has enacted a law commonly known as the Foreign Account Tax Compliance Act, or FATCA.

It requires foreign financial institutions (including New Zealand financial institutions) to enter into individual reporting agreements with the United States' Internal Revenue Service (IRS). These agreements require the institution to report to the IRS account information on accounts held (and certain accounts controlled) by United States taxpayers—or otherwise have a 30% withholding penalty imposed on certain United States-sourced income that they derive.

Because of domestic legal constraints, the Government understands that New Zealand financial institutions would be unable to comply with these individual reporting agreements, effectively leaving financial institutions with the choice of:

- not investing either directly or indirectly into the United States (to avoid the withholding penalty); or
- investing in the United States and incurring the withholding penalty.

To alleviate these concerns, and to reduce compliance costs more generally, the Government has entered into an intergovernmental agreement (IGA) with the United States. Many other countries (including Australia, the United Kingdom, Germany and Canada) have signed similar agreements with the United States and many more are still negotiating such agreements.

Under the IGA, instead of sending account information individually to the IRS, New Zealand financial institutions will instead send the information to Inland Revenue, which will exchange it with the IRS. The IGA is reciprocal, meaning that New Zealand will also receive information about certain accounts held by New Zealand residents with United States financial institutions.

It was necessary to amend the Income Tax Act 2007 and the Tax Administration Act 1994 to enable financial institutions to comply with the terms of the IGA.

Key features

The Income Tax Act 2007 and the Tax Administration Act 1994 now contain "foreign account information-sharing agreement" as a defined term. The first such agreement is the IGA with the United States. There may be other similar agreements entered into in the future. For this reason, the legislation is deliberately broad in its nature—so other agreements can, if possible, be accommodated with as few legislative amendments as possible.

Although this broad drafting is deliberate, the IGA is currently the only agreement of this type that New Zealand has entered into. As it uses defined terms in the IGA, it is recognised that the relevant provisions and terms may have limited or no application to other similar agreements that may be entered into in the future.

Status of the agreement

The IGA, and other similar agreements that New Zealand may enter into in the future, are defined as "foreign account information-sharing agreements". The new legislation introduces this concept as a defined term in section YA 1 of the Income Tax Act 2007, and a cross-reference to that definition in section 3 of the Tax Administration Act 1994.

Amendments to sections BB 3(2) and BH 1(4) clarify that foreign account information-sharing agreements will be "double tax agreements for the purposes of the Income Tax Act". This means the agreements, like other double tax agreements and tax information exchange agreements, have effect despite anything in the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993. New section BH 1(5) states that proposed part 11B of the Tax Administration Act 1994 applies to these agreements. This simply clarifies that part 11B sets rules for these agreements despite their generally overriding nature.

Operative provisions

Part 11B of the Tax Administration Act 1994 contains the operative provisions that govern how foreign account information-sharing agreements are brought into New Zealand law. A consequential amendment has moved the definition of "competent authority" from section 173B to section 3 of this Act.

NEW LEGISLATION

Part 11B

Part 11B contains provisions that implement foreign account information-sharing agreements. These provisions are important because, for the New Zealand Government to comply with its obligations under such an agreement, it is required to obtain and exchange certain information with a foreign government. It is necessary to have rules that require the relevant New Zealand taxpayers to acquire this information and provide it to the New Zealand Government, so this exchange can take place.

This part of the Act therefore provides the compulsion for New Zealand taxpayers to obtain this information and pass it on to Inland Revenue. It comprises the following sections:

185E – Purpose

This section sets out the purpose of the Part, which is to give effect to and implement foreign account information-sharing agreements.

Section 185F – Permitted choices

Industry choices

The IGA contemplates that financial institutions may have choices in the way they comply with the agreement. Equally, the agreement allows the New Zealand Government to make choices that could have consequences for the affected financial institution. The choices a person makes will determine the way the agreement applies to them. Section 185F is designed to recognise these choices, and then authorises a person to make them and treat such choices as being binding for the purposes of the agreement and the person's obligations under the agreement.

Section 185F(1) identifies these choices. Section 185F(2) explicitly authorises a person to make such a choice and anything necessarily incidental to give effect to that choice. Section 185F(3) clarifies that a person's obligations are modified to the extent necessary to give effect to that choice.

This is important because financial institutions should not be in a position where they are required to comply with all possible scenarios that an agreement contemplates. An institution that makes a choice should be accountable for the consequences of that choice—but not be punished for failing to take the alternative option. In other words, the provision allows a financial institution to make, and carry into effect, a choice contained in the relevant agreement. It is not intended to compel a financial institution to make all possible choices.

Government choices

Under the IGA, New Zealand has a number of choices it can make at government level. As the IGA is a double tax agreement, these choices will be made by the Commissioner of Inland Revenue. Section 185F caters for these choices and allows the Commissioner to publish a choice made or revoked in a publication of the Commissioner's choosing (see subsection (4)). The method of publication is broad, to allow the Commissioner maximum flexibility in the publication method, which may be important in terms of quickly communicating decisions.

In relation to the IGA, the Commissioner has made three choices in accordance with section 185F—with this *Tax Information Bulletin* (along with the Inland Revenue website) being the Commissioner's publication of choice for these purposes. Reporting New Zealand financial institutions are permitted to:

- rely on due diligence procedures in the United States Treasury Regulations in lieu of procedures in Annex I of the IGA (per Annex I (I)(C) of the IGA);
- use third-party service providers to fulfil the obligations imposed on such institutions as contemplated by the IGA (per Article 5(3) of the IGA); and
- rely on due diligence procedures performed by third parties to the extent provided in relevant United States Treasury Regulations (per Annex I (VI)(F) of the IGA).

It is important to note that these choices are accurate at the time of publication, but may be varied or revoked by future action or regulatory change. Notification of any changes will be made by the Commissioner at that time.

Effect of choices

Section 185F(5) clarifies that choices made by the Government or by an affected person are treated as part of the agreement for all aspects of Part 11B and section BH 1 of the Income Tax Act 2007.

Excluded choices

The general ability to make choices is removed if the choice is an "excluded choice" under sections 185F(6) and (7). Having these particular choices as "excluded" is intended to prevent unnecessary reporting of accounts. The IGA provides for certain reporting thresholds. An example being that a financial institution does not have to report on a "depository account" with an end of reporting period balance of US$50,000 or less.

Without the excluded choices provision, a financial institution could report on these low value accounts if it was administratively more convenient for it to do so. However, given the privacy concerns surrounding the exchange of personal data, it was not considered appropriate for low-value accounts to be reported.

It is important to note that the "excluded choice" wording does not prevent the financial institution from gathering relevant information on account opening (or any other time designated under the agreement); it merely prevents the provision of that information to Inland Revenue.

Section 185G of the Tax Administration Act – Registration

The IGA provides that financial institutions that meet certain requirements must register with the United States IRS. Section 185G brings the aspects of this registration requirement relevant to the financial institution into New Zealand law.

Section 185H of the Tax Administration Act – Due diligence

The IGA also sets out detailed due diligence obligations for affected financial institutions. Section 185H therefore clarifies that a financial institution is required to apply the relevant procedures. The relevant procedures may depend on permitted choices that the Government and/or the financial institution will have made. A financial institution is only required to perform the due diligence procedures that flow from permitted choices they have made.

Section 185I of the Tax Administration Act – Information for New Zealand competent authority

Section 185I is the central provision for ensuring New Zealand's compliance with foreign account information-sharing agreements. In essence, it says that if New Zealand is obliged to obtain and exchange information with a foreign competent authority, the person described or contemplated in the agreement as obtaining and providing the information must obtain and provide it to the New Zealand competent authority. All relevant steps in relation to obtaining and providing that information must be done in accordance with the agreement.

In the IGA context, this means that any information the New Zealand Government is obliged to exchange with the United States must be obtained by New Zealand financial institutions and provided to Inland Revenue.

The section allows the provision of information if it is not required for exchange purposes, as long as obtaining and providing that information is contemplated in the agreement.

As with the other operative provisions, the relevant information may be dependent on choices that the Government and financial institution have made. Section 185I compels the person to provide whatever information is produced from the exercise of their choices. The provision of this information is not optional—however, the composition of this information will depend on choices made.

The section is designed to neither force a financial institution to report on the maximum or minimum number of people. Such an obligation would be impossible to enforce in any event because it may not be known at the time the choice is made what the exact consequences of that choice will be. An institution is simply required to follow the consequences of any choices made. However, to the extent that obtaining and providing the information is not described or contemplated in the agreement, there is no statutory protection for a person that obtains or provides it.

The section also clarifies that the Government may wish to make regulations in this area (under the existing regulation-making power in section 224 of the Tax Administration Act 1994) to spell out any finer details in a person's reporting obligations.

Section 185J of the Tax Administration Act – Information for third parties

The IGA contemplates that a financial institution may have to provide information to third parties. These third parties could be foreign competent authorities or other financial institutions. Section 185J authorises obtaining and proving this information, provided it is described or contemplated in the agreement.

For foreign competent authorities, the request for information must be "validly requested" under the terms of the agreement. In the IGA context, a "valid" request from the United States competent authority is one where the competent authority has reason to believe that a minor or administrative error may have led to incorrect information reporting. It is anticipated that these requests will be made when the Internal Revenue Service is attempting to quickly resolve simple queries. Where it is unclear whether a request is strictly of a "minor or administrative" nature or whether the request is actually more substantial, the competent authority at Inland Revenue will be available to assist financial institutions in making this judgement call, if the need ever arises.

Again, this section clarifies that the Government may wish to make regulations in this area (under the existing regulation-making power in section 224 of the Tax Administration Act 1994).

Section 185K of the Tax Administration Act – Prescribed form

Section 185K allows the Commissioner to prescribe the form in which information is received. This is particularly important for foreign account information-sharing agreements because it may be that the form of the information is set by either a foreign competent authority or other international organisation. Some flexibility

to set these forms is therefore crucial to the smooth administration of these agreements.

Section 185L of the Tax Administration Act – Anti-avoidance

Section 185L is an anti-avoidance provision that allows an arrangement to be treated as having no effect if the main purpose of entering into the arrangement is to avoid a person's obligations under part 11B. This provision recognises that some people may not want to report on their customers for commercial/compliance costs reasons. However, in entering into foreign account information-sharing agreements, the Government is agreeing to obtain and provide certain information. The ability to unwind arrangements that avoid reporting is a requirement of the IGA.

Section 185M of the Tax Administration Act – Timeframes

Foreign account information-sharing agreements may not set a specific reporting period. For example, the IGA states that relevant account balances or values "shall be determined as of the last day of the calendar year **or other appropriate reporting period**" (emphasis added).

In New Zealand most businesses have systems designed to report on a tax-year basis. Section 185M therefore provides that, when an agreement or regulation does not specify or is discretionary as to a reporting period, that period will be a tax year, from 1 April to 31 March. For the IGA, this means that the "appropriate reporting period" will be the year ended 31 March.

When an agreement or regulation does not specify or is discretionary about the time in which a person must provide the information to Inland Revenue, it must be provided within three months of the end of the period. For the IGA, as the reporting period ends on 31 March, the information must be provided to Inland Revenue by 30 June of that year.

Other matters

Tax returns

The definition of "tax return" in section 3 of the Tax Administration Act sets out that information provided in the form set out in section 185K is not a tax return for the purposes of the Act.

Records

Section 22(2)(lc) has been added to the Tax Administration Act to clarify that a taxpayer must keep sufficient records to allow the Commissioner to readily ascertain the person's compliance with part 11B. This makes it a statutory requirement for an affected person to collect and keep the information necessary for compliance with a foreign account information-sharing agreement. It also ensures that the records must be kept for the statutory record-keeping period set out in section 22.

Failure to keep documents required by this provision will result in an absolute liability offence under section 143 or a knowledge offence under section 143A, as applicable.

Penalties

Sections 143(1)(ab) and 143A(1)(ab) introduce an "absolute liability" offence and "knowledge" offence related to a person's failure to register with a foreign competent authority as required by part 11B.

These offences enable New Zealand to comply with obligations under the IGA, and possibly future agreements. New Zealand has an obligation under the IGA to rectify what is known as "significant non-compliance" through its domestic law.

The main form of non-compliance that existing legislation did not appear to address was if a financial institution failed to register. The amendments to sections 143 and 143A provide the legislative sanction to support section 185G, which, as mentioned above, requires a financial institution to comply with any registration requirements in a relevant agreement. However, to recognise the fact that a failure to register may occur for circumstances beyond the control of the person concerned, section 143(2B) provides an exclusion from the absolute liability offence if the relevant failure to register occurred through no fault of the person.

Deductions for withholding

Under section DB 1 of the Income Tax Act 2007, various types of taxes are disallowed as deductions for income tax purposes. Section DB 1(1)(bb) states that any withholding that a person suffers under FATCA law (in particular under section 1471 or 1472 of the United States Internal Revenue Code) is not available as a deduction, even if the general permissions for deductions are satisfied.

Application date

The amendments apply from 1 July 2014.

NEW RULES FOR DEREGISTERED CHARITIES

Sections CV 17, CW 41, CW 42, HC 31(1B), HF 11 (3), HR 11, HR 12 and YA 1 of the Income Tax Act 2007

New tax rules have been introduced to address the tax consequences that arise for entities that are removed (or deregistered) from the charities register administered by the Department of Internal Affairs – Charities Services. This includes entities which voluntarily request to be removed from the charities register.

The new rules clarify when a deregistered entity should start its life as a taxpaying entity, how the entity should treat its assets and liabilities when it becomes a tax-paying entity, and what tax provisions should apply to the entity in the future. The rules also clarify the tax consequences for donors that have made donations to these entities.

Background

An officials' issues paper, *Clarifying the tax consequences for deregistered charities*, was released in July 2013. The paper discussed problems with the current tax treatment of deregistered charities and suggested a possible solution for clarifying the tax consequences for these entities by prescribing in legislation rules to deal with their new tax-paying status. A "deregistered charity" refers to an entity that has been removed from the Charities Register by the Department of Internal Affairs – Charities Services.

In general, an entity must be registered with the Charities Services to qualify for the income tax exemption for charities in sections CW 41 and 42 of the Income Tax Act 2007. Registered charities are also entitled to an exemption from fringe benefit tax, and are treated as "donee organisations", which means that donors are entitled to some form of tax relief on donations made to these entities.

Several high-profile cases involving deregistered charities, particularly when the entity continues in existence, showed that these entities faced a range of complex tax consequences that can be retrospective, transitional and prospective in nature. These consequences gave rise to questions such as when the entity should start its life as a tax-paying entity, how the entity should treat its depreciable property or financial arrangements when it becomes a tax-paying entity, and what tax provisions should apply to the entity in the future.

The way the tax rules were written meant that it was possible for a charity to be deregistered and to face retrospective tax liabilities even if it had been fully compliant with its rules that Charities Services had previously approved. This was possible if the rules were later interpreted to mean the entity's purposes were not in fact charitable, whether this was due to a change in jurisprudence or otherwise.

The nature and extent of the potential tax consequences ultimately depended on the underlying reason why the entity was deregistered. These consequences were more onerous (and involved retrospective tax liabilities) if the deregistered charity was found never to have had a "charitable purpose" or had ceased being charitable in purpose at some time in the past, compared with the situation when a deregistered charity had simply failed to file the required annual return with Charities Services.

Consultation on the officials' issues paper confirmed that the current tax law as it related to deregistered charities was neither comprehensive nor robust, that is, it did not adequately deal with the full range of tax consequences involving deregistered charities and, in some cases, did not achieve the desired policy intentions.

The new rules are aimed at clarifying the tax law so that deregistered charities and their donors have greater certainty about their tax obligations. The changes also protect the integrity of the revenue base by ensuring the tax concessions that apply to charities are well-targeted and policy intentions are met. This includes, for example, ensuring that if an entity has claimed tax exemptions as a charity and has accumulated assets and income, these assets and income should always be destined for a charitable purpose.

For the majority of deregistered charities that have in good faith tried to meet their registration requirements, the new rules should provide them with greater certainty about their tax obligations after deregistration. On the other hand, the very small minority of deregistered charities that have wilfully refused to meet their registration requirements could still face onerous tax consequences (including retrospective tax liabilities) under the new rules.

The issues paper also highlighted an asymmetry in the requirements relating to the assets of deregistered charities. Although there was a requirement for a deregistered charity that "winds up" to distribute its assets and income to charitable purposes, there was no such requirement when a deregistered charity continued its operations. After deregistering, an entity could alter its constitution to allow distribution for non-charitable purposes. The new rules also address this anomaly.

Key features

- New section HR 11 prescribes how a deregistered charity should establish its initial tax base—such as the opening values of its assets and consideration for its financial arrangements.
- Amendments to section CW 41 ensure that entities which are removed from the charities register will continue to be tax-exempt either until the day on which the entity does not comply with its rules (as these appear on the charities register) or the "day of final decision".
- A definition of "day of final decision" is contained in section YA 1. The day of final decision is the later of the day the entity is removed from the charities register or the day on which all reasonably contemplated administrative appeals and Court proceedings, including appeal rights, are finalised or exhausted in relation to the person's charitable status.
- New section HR 12 imposes a tax on net assets of the entity which are held 12 months after the day the entity is no longer exempt from tax under sections CW 41 or CW 42.
- New section CV 17 provides that any amount of income arising under new section HR 12 will be income of the entity for the income year that is 12 months after the day of final decision.
- The definition of "charitable organisation" in section YA 1 has been widened to include an entity which has been removed from the charities register but only for a specified period. This amendment ensures that deregistered charities can in certain circumstances still qualify for an FBT exemption even if that entity is later deregistered.
- An amendment to section LD 3(2) ensures that monetary gifts that meet the requirements of a "charitable or other public benefit gift" in section LD 3(1) made to registered charities can still qualify for donations tax relief even if that entity is later deregistered.

Application dates

The new rules generally apply from 14 April 2014. There is one exception to this, which relates to the new tax on the net assets of deregistered charities, for which there is a split application date. This new tax on net assets applies from:

- 14 April 2014 for entities which choose to voluntarily deregister; or
- 1 April 2015.

Detailed analysis

Clarifying how the general tax rules apply to deregistered charities

All charities which are removed from the Charities Register from 14 April 2014 will have greater certainty about their income tax obligations when they enter the tax system. To acknowledge that some entities which are deregistered continue to operate as charities, albeit no longer as tax exempt charities, the term used in the legislation is a "non-exempt charity".

Section HR 11 sets out how an entity which has ceased to meet the requirements to derive exempt income under section CW 41 or CW 42 should:

- establish the cost base for its property—specifically premises, plant, equipment and trading stock;
- establish the consideration for any financial arrangements; and
- value prepayments it has made.

These tax base calculations are required to be undertaken on and after the date that a deregistered charity ceases to be eligible to derive exempt income under section CW 41 or CW 42. This point in time is referred to as the "date of cessation". The date of cessation is used to trigger the tax base calculations in the year the entity becomes a tax-paying entity but may also apply for each subsequent income year that the deregistered charity ceases to meet the requirements to derive exempt income under section CW 41 or CW 42.

For the purposes of applying section HR 11, a deregistered charity may use information from their annual returns contained on the Charities Register, if they have no other information that is more readily available.

Section HC 31 has been consequentially amended so that it no longer applies to a charitable trust that has lost its charitable status (see section HC 31(1B)). Instead, new section HR 11 will apply to all charities which come into the tax base.

The following examples illustrate how and when the tax base calculations are to be undertaken.

Example 1: Depreciable property

Charity A was registered as a charitable entity in 2008. That same year, Charity A purchased office furniture for $50,000 (GST exclusive) during the first month of the 2008 tax year. In 2013, Charity A was deregistered because it was found by Charities Services to have been non-compliant with its rules. This non-compliance has been occurring since 2008. Charity A still owns the office furniture at the date of deregistration. The depreciation rate for office furniture is 19.2%.

Charity A must file an income tax return for each year starting from the 2008 year.

Under new section HR 11(2), the cost of premises, plant, equipment and trading stock is the value that would be used at the "date of cessation" under the general tax rules if section CW 41 or CW 42 never applied. Under the general tax rules, office furniture must be depreciated each year it is used in the business of Charity A. Therefore, the cost of office furniture for each year from 2008 to the present day is as follows:

Year	2008	2009	2010	2011	2012	2013
Opening value ($)	50,000	40,400	32,643	26,376	21,312	17,220
Depreciation ($)	9,600	7,757	6,267	5,064	4,092	3,306
Year-end balance ($)	40,400	32,643	26,376	21,312	17,220	13,914

Charity A will introduce the asset into the tax base at $50,000 and recognise a depreciation charge of $9,600 in its 2008 income tax return.

Example 2: Financial arrangement rules

Assuming the deregistration facts as above, Charity A had loaned $100,000 to person X in 2008. The loan was repayable on demand and interest was 10% per annum, compounding. No loan repayments were made.

Under new section HR 11(3), Charity A is required to account for this loan under the financial arrangement rules in each of the years that it had ceased to meet the requirements of section CW 41 or CW 42. It must also calculate an opening value using the formula in new section HR 11(4). The calculations are as follows:

Year	2008	2009	2010	2011	2012	2013
Opening value ($)	100,000	110,000	121,000	133,100	146,410	161,051
Interest ($)	10,000	11,000	12,100	13,310	14,641	16,105
Year-end balance ($)	110,000	121,000	133,100	146,410	161,051	177,156

In 2008 the opening value would be $100,000 and the closing value would be $110,000. Charity A would account for $10,000 accrued interest income in its 2008 income tax return.

Point at which a deregistered charity will be subject to taxing provisions

The amendments to section CW 41 provide that income derived by a deregistered charity in a specified period is treated as exempt income. The specified period starts with the day they are registered on the Charities Register and ends with the earlier of the following days:

- the day on which the entity does not comply with the its rules contained in the Charities Register; or
- the day of final decision.

During the specified period the deregistered charity is treated as a "tax charity" under section CW 41(5).

A definition of "day of final decision" is included in section YA 1. It is the later of two dates, namely:

- the day the entity is removed from the Charities Register; or
- the day on which that entity exhausts all disputes and appeals its charitable status.

The amendments to section CW 41 should afford entities a greater level of certainty that, for tax purposes, they should be able to rely on the decision made by Charities Services to recognise that entity as charitable in purpose. This protection, however, only applies when the deregistered charity has acted in accordance with its rules (as these appear on the Charities Register). If an entity has ceased to act in accordance with its rules, then that entity should not be able to take advantage of registration.

Therefore, entities that have continued to be compliant with their rules will not be liable for tax in periods before they were deregistered, and if they dispute their deregistration, not before the date their dispute is finally decided.

Section HF 11(3) has also been amended to clarify that when a deregistered entity makes an election to be a Māori authority for tax purposes, the election takes effect on the day on which the entity does not comply with its rules contained in the Charities Register if the entity nominates that date in the notice.

Tax on net assets of a deregistered entity

The assets and income of a charitable entity should always be destined for a charitable destination, irrespective of whether the entity ceases to exist as a charity. However, if

a deregistered charity continues in existence, the value of the deregistered entity's net assets (assets minus liabilities) should be subject to income tax. The imposition of tax in this instance is consistent with the current policy intentions underlying the charities-related tax concessions. In other words, the tax concessions should only be available to *bona fide* charities, and deregistered charities should be held to account for the assets and income they have built up while they enjoyed the benefit of the tax concessions.

For reasons of fairness, however, deregistered charities will be given time to apply any assets or income to charitable purposes before the imposition of any tax, and an adjustment will be permitted for any donated assets as these assets were not funded by non-taxed income or through a tax-preferred source.

New sections CV 17 and HR 12 provide that an entity has an amount of income equal to the greater of zero or the value of its net assets held on the day one year after the day of final decision.

Adjustments are made to carve out certain assets, which reduce the net assets balance that will be subject to tax. The assets carved out are:

- any assets distributed or applied in the year after the day of final decision, for charitable purposes;
- assets distributed or applied in the year after the day of final decision, in accordance with the entity's rules, (as those rules were contained on the Charities Register);
- assets received from the Crown to settle a Treaty of Waitangi claim or in accordance with the Māori Fisheries Act 2004; and
- any assets (not including money) gifted or left to the entity when it met the requirements to derive exempt income under sections CW 41 and CW 42.

Section HR 12 is intended to encourage deregistered charities to choose to distribute their assets for charitable purposes, rather than to retain them. The assets of an entity that has enjoyed tax-exempt status should always be destined for a charitable purpose, irrespective of whether the entity ceases to exist as a charity.

"Net assets" means the assets of the entity held on the day of final decision, less the liabilities of the entity on the day of final decision. An example of a liability would be the amount of tax which an entity would be liable to pay in relation to past years if it ceased to comply with its rules at some point before deregistration. Similarly, an entity might have incurred legal costs in disputing the decision to deregister it but not yet paid those amounts.

However, section HR 12(2) provides that the tax on net assets does not apply if the deregistered charity:

- meets, on the day before the day of final decision, the requirements to derive exempt income under a provision in subpart CW (excluding section CW 41 or CW 42).
- is re-registered on the Charities Register within one year of the day of final decision.

This provision ensures that the tax on net assets does not apply to entities which are still eligible for an income tax exemption, whether by virtue of another exemption, or because they have been reregistered as a charity.

Section HR 12 has a split application date. It generally applies from 1 April 2015, but applies from 14 April 2014 for charities that choose to voluntarily deregister.

Example: Taxation of tax-exempt accumulation

Charity A's date of deregistration is 1 June 2014. Charity A did not dispute its deregistration, and so this is also its day of final decision. The balance sheet for Charity A at 1 June 2014 is shown below.

Assets	
Cash	$50
Inventory	$300
Land (donated)	$3,000
Liabilities	
Loan	$200
Equity	
Shareholders' equity	$3,150

The net assets calculation will be $3,150 less the value of the donated land and less any relevant adjustments such as assets and income distributed for charitable purposes or in accordance with the entity's rules within 12 months of the date of deregistration. The net assets value will be $150 ($3,150 less $3,000). Assume Charity A has a July balance date for tax purposes. Charity A would include $150 as income in its 2015 income tax return.

Eligibility to be a charitable organisation for FBT purposes

A deregistered charity might continue to qualify for the fringe benefit tax exemption if it met other requirements to be a "charitable organisation".

Previously, if a deregistered charity was no longer eligible for the FBT exemption, the FBT rules applied to that entity in the same way as for income tax purposes. This meant that deregistered entities that were found to have stopped being charitable at some point in the past lost their FBT exemption from the date they ceased being charitable, and entities which were still charitable from the date of deregistration.

The definition of "charitable organisation" in section YA 1 has been amended to ensure that a deregistered entity can still be a charitable organisation for a specified period for FBT exemption purposes. The period in question starts from the date the entity is registered on the charities register, and ends with the earlier of two dates. These dates are:

- the last day of the relevant quarter or income year in which the entity fails to act in accordance with its rules; or
- the last day of the relevant quarter or income year in which the final decision on the entity's charitable status is made.

This means that if an entity has acted in compliance with its rules up until the time of deregistration, it will not face a retrospective FBT liability. If, however, the entity ceased being compliant with its rules, and was not eligible for an FBT exemption under other grounds, it will have an FBT liability from the first day of the quarter after the date of non-compliance.

Eligibility to be a donee organisation for donation tax relief purposes

Previously, a deregistered charity could still qualify for donee organisation status if it met the other donee organisation requirements.[8] If, however, the entity no longer qualified for donee organisation status, donors would no longer have been entitled to tax relief on their donations. This could have occurred at the point at which the entity no longer satisfied any of the requirements to be a donee organisation. This could have been before the entity was removed from the Charities Register, which would have given rise to retrospective consequences for donors.

Section LD 3(2) of the Income Tax Act 2007 has been amended to confer donee status on an entity registered on the Charities Register. The amendment ensures donors have a greater level of certainty that their donations tax relief will not ordinarily be reversed in circumstances when they have made a *bona fide* monetary gift and the entity they have donated to is later deregistered.

The amendment should protect donors who have claimed donations tax relief in good faith, assuming that an organisation was a donee organisation.

[8] A donee organisation is an organisation that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic or cultural purposes within New Zealand. The Income Tax Act 2007 also lists 108 donee organisations whose charitable purposes are largely carried out overseas.

TAX STATUS OF COMMUNITY HOUSING ENTITIES

Sections CW 42B and LD (3)(1)(ab) of the Income Tax Act 2007; section 225D of the Tax Administration Act 1994

Amendments have been made to the Income Tax Act 2007 and the Tax Administration Act 1994 to confer tax-exempt status and donee organisation status on certain community housing providers that meet specified criteria (referred to as "community housing entities"). The amendments clarify the tax status of certain community housing entities that provide pathways to home-ownership for low-income households that cannot afford to buy a home on their own.

Background

Previously, the tax-exempt status and donee organisation status of certain community housing providers who provided financial assistance to low-income households to purchase their own home was not always certain. This was because the charitable status of these entities was not clear. Charities law recognises the relief of poverty as a charitable purpose but entities that offer financial assistance to people to purchase a home tend to fall outside the charities criteria—the ability to purchase a house is an indication that a person is not "in poverty".

The Government believes that community housing providers should be able to offer a range of housing assistance options to their clients, for example, rental and home ownership. If an entity provides affordable home-ownership products aimed at low-income households, but in all other ways would be recognised as charitable in purpose, the Government believes that the provision of home ownership products alone should not disqualify that entity from being entitled to tax-exempt status or donee organisation status.

The Finance and Expenditure Committee recommended a number of clarifications to ensure that the provisions were clear and achieved their purpose. These changes allow:

- community housing entities to provide assistance to people who want to purchase an existing home, not just new homes;
- profits to be distributed to a parent organisation or other entity provided it is also for charitable purposes;
- income earned by a community housing entity from sources other than its housing activities, such as interest or investment income, to also be exempt; and
- the income threshold to apply only at the time a community housing entity starts helping a household, not on an on-going basis.

The amendments should provide greater tax certainty for certain community housing providers, and help to promote home ownership for New Zealanders who would not otherwise be able to afford to buy a house on their own.

Key features

- Section CW 42B of the Income Tax Act 2007 confers an income tax exemption on certain community housing providers which meet specified criteria as listed in the section. This entity is referred to as "community housing entity".
- Section LD (3)(1)(ab) of the Income Tax Act 2007 confers donee organisation status on a community housing entity, and ensures that donors who give monetary gifts of $5 or more to the entity qualify for tax relief on their donations.
- Section 225D of the Tax Administration Act 1994 provides for a regulation to be set describing who can be a client or beneficiary of a community housing entity.

Application date

The amendments apply from 14 April 2014 to coincide with the beginning of the new registration regime for community housing providers under the Housing Restructuring and Tenancy Matters Act 1992.

Detailed analysis

New income tax exemption

Under section CW 42B of the Income Tax Act 2007, the income of a community housing entity will be exempt from income tax.

To be a "community housing entity", an organisation must:

- be either a company or trust;
- be involved predominantly in the provision of housing;
- not be carried on for the private pecuniary profit of any individual;
- retain its profits, or distribute or apply its profits only to the following groups of people:
  - community housing entities; or
  - beneficiaries or clients of the entity; or
  - tax charities; or
  - persons to whom distributions would be in accordance with charitable purposes, and
- ensure that no individual is able to exert control over the activities of the entity to direct or divert amounts from those activities to their own benefit or advantage;

- be a registered community housing provider under the Housing Restructuring and Tenancy Matters Act 1992.

The majority of these criteria are similar to those described in sections CW 42(5), (6), (7) and (8) of the Income Tax Act 2007. They ensure that only community housing entities that operate under a non-profit model are eligible for the proposed income tax exemption.

There are also rules about the beneficiaries or clients of community housing entities. Even if an entity meets all of the requirements set out above, it will not be a "community housing entity", and its income will not be exempt if:

- less than 85 percent of its beneficiaries or clients are, at the time of first becoming beneficiaries or clients, described in regulations made under section 225D of the Tax Administration Act 1994; and
- the quality and standard of the housing provided by the entity is not consistent across all the recipients of the housing assistance.

Classes of recipients described in section 225D of the Tax Administration Act 1994

Section 225D of the Tax Administration Act 1994 permits the Governor-General to make regulations specifying people, or classes of people who are counted as beneficiaries or clients of the entity.

The factors which may be used to specify these beneficiaries or clients are:

- the person's geographic location in New Zealand;
- the composition of the household a person lives in;
- the income of the person or household relative to a maximum set by taking into account the lower quartile of household income based on household economic survey data published by Statistics New Zealand and adjusting the income maximum by an appropriate economic factor; geographic, household composition or otherwise; and
- the person's assets.

The regulation will contain income and asset thresholds. This will help community housing entities to determine what proportion of the recipients of their assistance meet the requirements, and therefore if they have breached the 85 percent rule described above.

The 85 percent rule means that an entity can still be a "community housing entity" if up to 15 percent of its beneficiaries or clients breach the income and asset thresholds set out in the regulation.

The income and asset thresholds are to be applied at the point at which a client or beneficiary first registers for housing assistance with the community housing provider, and are not to be measured on an on-going basis. This means assessments to determine whether an entity breaches the income and asset threshold's 15% limit must also be done at the point of entry.

Although up to 15 percent of the beneficiaries or clients that a community housing entity takes on are allowed to breach the income and asset thresholds, there is a requirement that the provision of housing to these people must not be substantially different to the provision of housing to the rest of the entity's beneficiaries or clients. This rule ensures that the quality and standard of the homes provided by the entity is consistent across all of the recipients of the housing assistance and avoids the entity being used to provide expensive homes to people on moderate to high incomes.

These criteria ensure that the income tax exemption is aimed at community housing entities that are involved in providing housing products to people who are on low incomes and who could not otherwise afford to buy a home without Government assistance.

The Minister for Housing and the Minister of Revenue will be responsible for establishing a framework for determining who can be an eligible recipient of housing assistance for the purposes of the proposed exemption. This framework is currently being developed.

Donations tax relief for donations to tax-exempt housing entities

Under current tax law, donors who make cash donations of $5 or more to donee organisations are entitled to tax relief based on their donation. In the case of individuals, this relief is in the form of a tax credit; in the case of corporate or Māori authority donors, in the form of a tax deduction.

The amendment to section LD 3(2) of the Income Tax Act 2007 confers donee organisation status on community housing entities.

THE TAXATION OF LAND-RELATED LEASE PAYMENTS

Sections CC 1, CC 1B, CC 1C, DB 20B, DB 20C, EE 7, EE 67, EI 4B and YA 1 of the Income Tax Act 2007

Amendments have been made to achieve a more coherent and consistent tax treatment of land-related lease payments. The reforms address specific revenue risks with lease transfer payments (that is, received by an exiting tenant for transferring a lease to an incoming tenant). Certain lease transfer payments, which are substitutable for taxable lease surrender and lease premiums payments, are taxable from 1 April 2015.

These reforms build on amendments made to the Income Tax Act 2007 in 2013 that treat lease inducement and lease surrender payments as deductible to the payer and taxable to the recipient over the lease term.

There are also a number of technical amendments to tax law relating to leases and licences of land to provide consistency and certainty.

LEASE TRANSFER PAYMENTS

Sections CC 1B and EI 4B of the Income Tax Act 2007

Background

Lease transfer payments are generally received by an exiting tenant (assignor) from a new incoming tenant (assignee), for the transfer or assignment of a lease. Prior to this amendment, the payment was typically non-taxable to the exiting tenant for income tax purposes.

The previous non-taxable status of lease transfer payments, in tandem with taxable lease surrender payments,[9] could potentially distort commercial decisions upon termination of a tenant's lease. It could be tax advantageous for a tenant to exit a lease by transferring it to a third party for a then tax-free lease transfer payment, rather than surrendering it to a landlord for a taxable lease surrender payment.

From the exiting tenant's perspective, there is no economic difference between surrendering the lease to the landlord and transferring it to a third party. The effect is the same—the tenant exits the lease and receives consideration for it. Treating similar payments differently for income tax purposes distorts business decisions and results in economic inefficiency and unfairness.

Key features

Section CC 1B has been extended and now includes certain lease transfer payments that are substitutable for taxable lease surrender payments in section CC 1C and taxable lease premiums in section CC 1. This inclusion makes these lease transfer payments taxable to the recipient and tax-deductible to the payer.

In accordance with new section CC 1B, a lease transfer payment is income of the payee, and therefore taxable, in the following situations:

- The person purchasing the lease is associated with the owner of the estate in land from which the land right is granted; such a payment is substitutable for a lease surrender payment.
- The amount is sourced from funds provided by the owner of the estate in land from which the estate is granted for the purpose of obtaining the surrender or termination of the land right; the lease transfer payment is substitutable for a lease surrender payment.
- The vendor of the lease is associated with the owner of the estate in land from which the land right is granted; the lease transfer payment is substitutable for a lease premium.

Detailed analysis

If a person (the payee) derives an amount in relation to a land right as consideration for the transfer of the land right from the holder of the land right to another person, the amount will be taxable to the payee (new section CC 1B(1)(b)(ii) and (2)). The land right must be a right that is a leasehold estate (other than a lease with permanent right of renewal) or a licence to use land.

The term "leasehold estate" is defined broadly in section YA 1 to include any estate, however created, other than a freehold estate.[10] The charging provision, therefore, does not apply to payments for a freehold estate in land, such as the proceeds from the sale of land.

Despite this broad charging provision for lease transfer payments in section CC 1B, most lease transfer payments will not be taxable, if the following conditions are satisfied:

- the payee is the holder of the land right (for example, the exiting tenant);
- the amount is consideration for the transfer of the land right to the person paying the amount (for example, the incoming tenant);
- the amount is not sourced from funds provided by the owner of the estate in land from which the estate

[9] Lease surrender payments are taxable under section CC 1C of the Income Tax Act 2007.

[10] For income tax purposes, an interest in land has the same meaning as an estate in land.

is granted for the purpose of obtaining the surrender or termination of the land right—an arm's length transaction between a landlord and an incoming tenant would therefore satisfy this condition;

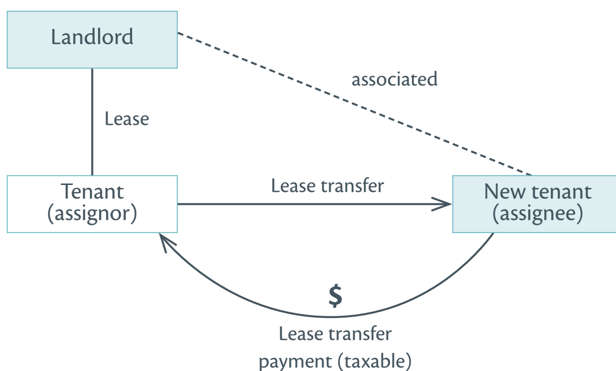
- the payee and the incoming tenant are not associated with the owner of the estate in land from which the land right is granted.

Payments derived in situations when the conditions above are not satisfied, will be taxable to the payee. If a lease is transferred as part of a business transfer, consideration for goodwill attaching to the land will be taxable to the payee; however, consideration for business or personal goodwill will not be subject to the charging provision in section CC 1B.

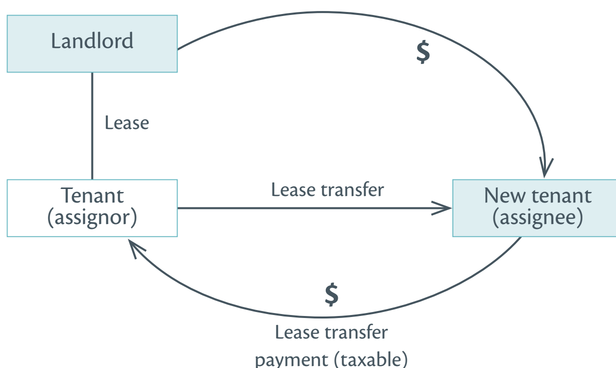
Situations involving lease transfer payments that are covered by new section CC 1B are payments that are substitutable for taxable lease surrender payments in section CC 1C and taxable lease premiums in section CC 1.

There are two situations when lease transfer payments that are substitutable for lease surrender payments will be taxable to the payee. They are:

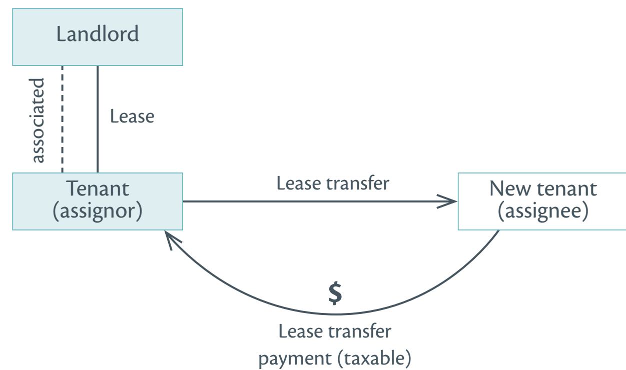
- If the person paying the amount (that is, the incoming tenant) is associated with the owner of the estate in land from which the land right is granted.



- If the amount is sourced from funds provided by the owner of the estate in land from which the land right is granted,[11] for the purpose of obtaining the termination of the lease.



Another situation when lease transfer payments will be taxable is payments that are substitutable for lease premium payments. In particular, a lease transfer payment will be taxable if the payee (that is, the exiting tenant) is associated with the owner of the estate in land from which the land right is granted.



This would prevent a landlord setting up a lease with a low rent with their associate and, as part of this arrangement, the associated tenant transfers the lease to a non-associated tenant and receives a non-taxable lease transfer payment.

Taxing a lease transfer payment in such situation supplements the existing anti-avoidance provision in section GC 5, which allows the Commissioner to set an adequate level of rent for leases between associates.

The definition of "land provisions" in section YA 1 has been amended so the definition of "associated person" applying in new section CC 1B is the one applicable to land provisions.

If a person receives a lease transfer payment on behalf of another person, the nominee rules in section YB 21 apply to treat the amount as derived by that other person.

An amount that is subject to the existing capital contribution rules is not subject to the charging provision (section CC 1B(5)). A capital contribution continues to be income under section CG 8 and needs to be spread evenly over 10 years unless the payee chooses to reduce the cost base of the depreciable property under section DB 64.

Residential exception

A lease transfer payment will not be income of the payee if the payee is a natural person (individual) and derives the amount as a tenant or licensee of residential premises whose expenditure on the residential premises does not meet the requirements of the general permission, and is not associated with the owner (section CC 1B(4)). This exclusion is intended to provide a consistent tax treatment with that for lease surrender payments in section CC 1C.

[11] Note that the payment from the landlord to the new tenant for the lease transfer is deductible to the landlord under section DB 20B and taxable to the new tenant under section CC 1B.

Timing of income

The timing provision in section EI 4B applies to the amount of income under section CC 1B. Under that provision, the allocation of income is affected by when the income is derived in relation to the spreading period.

The exiting tenant (assignor) who receives a lease transfer payment has no remaining period over which to spread the amount of income under section CC 1B. Therefore, the amount of income is allocated to the income year in which the amount is derived.

A remedial amendment has been made to section EI 4B to ensure that if a lease is terminated early, land owners can receive the balance of deductions for a lease inducement payment in the year of termination. For example, if a tax-deductible lease inducement payment of $1,000 was provided by a landlord in relation to a tenancy agreement that was meant to last for 10 years but terminated after two years, the landlord can deduct the remaining $800 in the year of termination. This is consistent with the treatment of a lessee who is taxed on the balance of income from a lease inducement payment if the lease is terminated early.

Application dates

New section CC 1B applies from 1 April 2015.

The amendment to section EI 4B applies from 1 April 2013.

PERPETUALLY RENEWABLE LEASES

Sections CC 1B, CC 1C, DB 20B, DB 20C and EE 7 of the Income Tax Act 2007

Amendments exclude perpetually renewable leases from the charging provisions for land-related lease payments in sections CC 1B and CC 1C, as well as the related deduction provisions. An amendment also excludes perpetually renewable leases from being depreciable property.

Background

Perpetually renewable leases (commonly known as "Glasgow" leases) last for a certain period of time (for example, 7, 10 or 21 years), but are renewable in perpetuity at the option of tenants.

The "right to use land", which includes a lease, is contained in the list of depreciable intangible property in schedule 14 of the Income Tax Act 2007. Usually, a commercial tenant under a lease can claim depreciation deductions for their cost to acquire the lease (that is, a lease premium or lease transfer payment) over its term.

A tenant under a perpetually renewable lease cannot claim depreciation deductions during the term of the lease because these leases have a perpetually renewable lease period. The tenant, however, may have been able to claim a depreciation loss when the perpetually renewable lease was sold for less than its adjusted tax value if the lease met the definition of "depreciable property" in section EE 6, that is, in normal circumstances, the lease might reasonably be expected to decline in value.

Key features

Previously, the charging provisions for land-related lease payments in sections CC 1B and CC 1C included all leasehold estates, including those with a perpetual right of renewal.

Because perpetually renewable leases are more akin to freehold property than ordinary commercial leases with a finite term, amendments have been made to align their treatment with that of freehold estates. Section CC 1B has been amended to exclude payments made for the grant, renewal, extension or transfer of perpetually renewable leases from being income of the person to whom the payment was made. Section CC 1C has also been amended to exclude payments for the surrender of a perpetually renewable lease from being income of the recipient.

Note that a premium paid on the grant of a perpetually renewable lease continues to be taxable to a landowner under section CC 1.

Sections DB 20B and DB 20C have been amended to exclude a payment for a grant, renewal, extension or transfer of a perpetually renewable lease from being deductible to the person who made such a payment.

Section EE 7 has been amended to exclude a lease of land with a perpetual right of renewal from being depreciable property. Accordingly, depreciation deductions are not available for a perpetually renewable lease. The purpose is to treat a perpetually renewable lease similarly to freehold land under the depreciation rules.

Application dates

The amendments to sections CC 1B, DB 20B and EE 7 apply from 1 April 2015.

The amendments to sections CC 1C and DB 20C apply from 1 April 2013.

PERMANENT EASEMENTS

Section CC 1 of the Income Tax Act 2007

This amendment excludes a payment for a permanent easement (for example, a permanent right of way) from being taxable to a landowner under section CC 1.

Background

Section CC 1 applies broadly to tax income from land by providing that amounts derived from land by a landowner

are taxable even if the amounts are traditionally categorised as capital in nature, for example, a lease premium. Before this amendment, a payment for a permanent easement was taxable to a landowner under section CC 1.

A payment for a permanent easement is generally non-deductible to the payer (the grantee) under the depreciation rules. Generally, a permanent easement does not meet the definition of depreciable property under section EE 6; in particular, in normal circumstances, a permanent easement is not reasonably expected to decline in value.

Key features

An amendment to section CC 1 excludes a one-off payment for the grant of a permanent easement from being income of the landowner, by inserting new section CC 1(2C). Accordingly, a payment for a permanent easement is not taxable to the owner of land under section CC 1.[12] The purpose of this amendment is to align the tax treatment of a permanent easement with that for freehold land under section CC 1.

The amendment applies only to one-off payments, but not to periodical payments, which are more in the nature of rental. Periodical payments received for permanent easements continue to be taxable under section CC 1.

Application date

The amendment applies from 1 April 2015.

CONSECUTIVE LEASES

Sections EE 67 and YA 1 of the Income Tax Act 2007

This amendment treats consecutive leases of land as a single lease for depreciation purposes.

Background

Consecutive leases are multiple leases for the same parcel of land that are granted to a person or an associated person at the same time, and are linked to take effect immediately after one terminates. Under the previous rules, depreciation deductions on a lease could be accelerated by entering into consecutive leases, including involving associated persons, rather than a single lease.

Key features

Section EE 67 has been amended to include consecutive leases in the existing definition of "legal life" for a lease and licence to use land. The definition of "legal life" is used to determine the annual depreciation rate for an item of fixed-life intangible property, such as a lease of land, in section EE 33.

If consecutive leases over the same parcel of land are granted to a person or an associated person at the same time, the term of a lease owned by the person also includes the terms of consecutive leases owned by that person or their associate. This has an effect of treating consecutive leases as a single lease.

Example

On 1 April 2015, A Ltd and its associates, B Ltd and C Ltd, enter into three separate leases for the same parcel of land to take effect immediately after one terminates. The first lease commences on 1 April 2015. Each lease lasts for 10 years.

Lease	Commencement date	Lease ownership	Term of the lease
1	1 April 2015	A Ltd	10 years
2	1 April 2025	B Ltd	10 years
3	1 April 2035	C Ltd	10 years

A Ltd, B Ltd and C Ltd are associated and they have entered into consecutive leases for the same parcel of land on the same day. Therefore, under the new rules:

- A Ltd's interest (owner's interest) in the lease is treated as lasting for 30 years, which includes both B Ltd and C Ltd's interests in the lease.
- B Ltd's interest (owner's interest) in the lease is treated as lasting for 20 years, which includes C Ltd's interest in the lease.
- C Ltd's interest (owner's interest) in the lease lasts for 10 years as there is no consecutive lease.

Any genuinely subsequently negotiated leases or licences of land are not counted towards the legal life of a lease. Consecutive leases would need to be acquired by the person or associated person at the same time to be counted towards the legal life of a lease.

This is an anti-avoidance measure preventing the timing of depreciation deductions for the cost of acquiring a lease (a lease premium or lease transfer payment) being accelerated by entering into consecutive leases. If consecutive leases are entered into around the same time (such as one day apart), the general anti-avoidance provision in section BG 1 may apply to counter any transactions that attempt to circumvent this measure contrary to the policy intent.

The definition of "land provisions" in section YA 1 has been amended so that the definition of "associated person" applying in section EE 67 is the one applicable to land provisions.

[12] Note that the land provisions in sections CB 6–CB 23B continue to apply to permanent easements.

Also, paragraph (d)(v) of the definition of "lease" in section YA 1 has been amended to remove the Commissioner's discretion to determine consecutive leases for the purposes of personal property lease payments. A similar definition to the one that has been inserted in section EE 67 for depreciation purposes has been adopted to provide certainty and consistency.

Application date

These amendments apply from 1 April 2015.

RETIREMENT VILLAGE OCCUPATION RIGHTS

Section YA 1 of the Income Tax Act 2007

The amendment ensures that all occupation right agreements under the Retirement Villages Act 2003 are excluded from the financial arrangement rules.

Background

Leases are excluded from the financial arrangement rules because they are excepted financial arrangements under section EW 5(9). However, retirement village occupation rights that are licences to occupy were previously regarded as financial arrangements because they were not a lease for the purposes of the financial arrangement rules as defined in section YA 1.

Treating certain retirement village occupation rights as financial arrangements was undesirable; if certain retirement village occupation rights were subject to the financial arrangement rules, there could have been tax consequences for a retirement village resident.

Key features

Paragraph (f) of the "lease" definition in section YA 1 has been amended to include an occupation right agreement as defined in the Retirement Villages Act 2003. Retirement village occupation rights are therefore treated as an excepted financial arrangement in section EW 5(9), and accordingly excluded from the financial arrangement rules.

This amendment aligns the treatment of retirement village occupation rights, that are licenses to occupy, with leases of land under the financial arrangement rules, and provides certainty that retirement village residents will not be subject to these rules.

Application date

The amendment applies from 1 April 2015.

FINANCIAL ARRANGEMENTS – AGREEMENTS FOR THE SALE AND PURCHASE OF PROPERTY OR SERVICES IN FOREIGN CURRENCY

Sections EW 15D, EW 15F to EW 15I, EW 32, EW 33B, EW 33C, EW 35, EZ 75, EZ 76 and YA 1 of the Income Tax Act 2007

The tax rules for the valuation of property or services included in agreements for the sale and purchase of property or services (ASAPs) in foreign currency (foreign currency ASAPs as defined) have been changed. Consequently, the taxation spreading methods for income and expenditure under foreign currency ASAPs for tax have also been changed. The changes have been made to make compliance easier for all taxpayers and to remove volatility between accounting income and taxable income.

There is an exception to the new rules for foreign currency ASAPs that are life financial reinsurance. There are no changes to the tax rules for agreements for the sale and purchase of property or services which are not foreign currency ASAPs.

Key features

Taxpayers who use International Financial Reporting Standards (IFRS taxpayers) to prepare financial statements will almost always use the accounting valuation of the property or services in foreign currency ASAPs as the tax cost for depreciation purposes. They will also use the accounting results to spread income and expenditure under foreign currency ASAPs. The income or expenditure included in the financial statements for foreign currency ASAPs will generally be any recognised interest.

The valuation and spreading rules for foreign currency ASAPs will incorporate the effect of IFRS designated FX hedging of FX amounts in the financial statements.

There are some legislative modifications to the use of the accounting results. These modifications only apply to hedges of certain transactions.

Non-IFRS taxpayers will generally use spot foreign exchange rates to convert amounts paid to value property or services included in foreign currency ASAPs. Interest income or expenditure will arise in two situations:

- interest may be commercially agreed and expressly included in the terms of the contract; or
- it will be calculated where there are payments 12 months or more before or after the "rights date" (as defined).

In the second situation, interest is calculated on a future or discounted value basis. Progress payments and deposits up to 10 percent of the total price are not payments included in the second situation. The spreading and valuation rules will allow a one-time-only election to include the effects of prescribed hedging rules for foreign exchange amounts included in foreign currency ASAPs. In substance this is designed to replicate the tenor of the equivalent IFRS rules.

It is expected that relatively few foreign currency ASAPs for non-IFRS taxpayers will have interest income or expenditure to spread under the new rules. The reasons for that are the exclusion of 10 percent deposits and progress payments, and other payments that are less than 12 months before or after the rights date.

The changes to the rules mean that Determination G29 will have no relevance for either IFRS or non-IFRS taxpayers for foreign currency ASAPs that are subject to the new rules.

The new rules apply to foreign currency ASAPs entered into from the 2014–15 income year. IFRS taxpayers can make a one-time-only election to apply the new rules to foreign currency ASAPs entered into from the beginning of an income year commencing with the 2011–12 income year so long as they have filed on that basis since that first year.

Further, tax positions taken consistently for existing agreements for the sale and purchase of property or services in foreign currency which are based on the new rules are confirmed.

Foreign currency ASAPs entered into before the 2014–15 income year or an earlier elective year will continue to have the old rules applied to them for their life.

Detailed analysis

Background

Agreements for the sale and purchase of property (or services) in foreign currency have been subject to Determination G29 since the 1996–97 income year. Determination G29 and associated deemed interest rules have caused significant compliance difficulties and volatility of taxable income (compared with accounting income). The volatility of taxable income is especially significant for IFRS taxpayers. The compliance difficulties are relevant to all taxpayers but are especially significant for non-IFRS taxpayers.

Modern IFRS accounting practice has now comprehensively and coherently dealt with this issue, thereby offering an opportunity to change the tax rules for the foreign currency ASAPs.

Foreign currency ASAPs

A foreign currency ASAP is defined in section YA 1. It is a financial arrangement that is an agreement for the sale and purchase of property or services. At the time it is

entered into, 50 percent or more of the consideration in New Zealand dollars is in a foreign currency, measured using spot rates at that time. For example, where a contract includes the sale of aluminium for a total consideration equivalent to New Zealand $5 million it will be a foreign currency ASAP if $2.5 million or more equivalent New Zealand dollars is to be paid in a foreign currency (measured at the spot rate when the contract is entered into).

IFRS taxpayers

Subsection EW 15D(2)(ae) has been inserted. The subsection, along with the amendments to sections EW 15F, EW 15G and EW 15H, means that the IFRS financial spreading method applies to foreign currency ASAPs entered into from the 2014–15 income year (or an earlier income year from the 2011–12 income year if returns were filed under the new rules, see the section "Application dates"). There is an exception to the application of section EW 15D(2)(ae) for foreign currency ASAPs that are life financial reinsurance. Section EW 15I continues to apply to spread income and expenditure for foreign currency ASAPs that are life financial reinsurance.

Some foreign currency ASAPs may include significant payments before or payments after the accounting recognition dates for property or services. In these cases the IFRS financial statements may exclude some of the amounts paid from the value of the property or services and allocate them separately to the income statement. This treatment will generally not apply to deposits and progress payments which are not generally regarded as financial instruments under IFRS.

Any amounts allocated directly to the income statement are in the nature of interest resulting from future value or discounted value calculations for the amounts paid. Using section EW 15D for foreign currency ASAPs means these amounts are income or expenditure in the income years they are allocated to the income statement. The IFRS valuation and spreading of interest treatment described in this paragraph applies to all foreign currency ASAPs.

Subsection EW 15D(2)(ae) refers to sections EW 32 and EW 33B to value property or services in foreign currency ASAPs and any relevant IFRS-designated FX hedges for those foreign currency ASAPs. Those sections are discussed further below.

Subsection EW 15D(2B)(b) has been amended to remove Determination G29 for foreign currency ASAPs entered into from the 2014–15 income year (or an earlier income year from the 2011–12 income year if returns were filed under the new rules).

Subsection EW 15F(1)(bb) has been inserted to remove the expected value method for calculating income and expenditure for foreign currency ASAPs.

Subsection EW 15G(1)(bb) has been inserted to exclude using the modified fair value method for calculating income and expenditure for foreign currency ASAPs.

Subsection EW15H(1)(d) has been repealed to remove Determination G29 from being used to value property or services and spread income and expenditure for foreign currency ASAPs.

Subsection EW 15I(1)(b)(iii) has been replaced. It previously applied to all agreements for the sale and purchase of property or services (including foreign currency ASAPs). It now applies to foreign currency ASAPs that are life financial reinsurance, or agreements for the sale and purchase of property or services that are not foreign currency ASAPs. Income and expenditure on these financial arrangements will continue to be spread under section EW 15I.

New subsection EW 32(2B) applies to foreign currency ASAPs of IFRS taxpayers. It values property and services in foreign currency ASAPs at the values under IFRS accounting rules. These are usually amounts in New Zealand dollars at the time they are recognised in IFRS financial statements, using spot exchange rates to convert foreign currency amounts.

New subsection EW 32(8) provides that section EZ 75 overrides the application of section EW 32 for IFRS taxpayers in certain cases. The effect of section EZ 75 is described in the section "Application dates".

The IFRS values will include amounts allocated to the value of the property or services in the IFRS financial statements for IFRS-designated FX hedges of foreign currency amounts (as provided for in new subsections EW 33B(1) and (3) below).

Section EW 35 (as amended by this Act) applies to use the IFRS values for property or services in foreign currency ASAPs for other provisions of the Act, such as the cost of depreciable assets, the cost of revenue account property, or income from sales of goods or services.

IFRS-designated hedging

Subsections EW 33B(1), (3) and (5) apply to certain foreign currency ASAPs and IFRS-designated FX hedges (defined in section YA 1) of foreign currency amounts in those foreign currency ASAPs. Subsection EW 33B(1) limits the application of the IFRS-designated FX hedges rules to certain property or services. Subsection EW 33B(3) includes in the tax values of property or services described

in subsection EW 33B(1) amounts for IFRS-designated FX hedges attributed to the values of that property or services in the IFRS financial statements.

Subsection EW 33B(1) limits the IFRS-designated FX hedging rules. They are limited to foreign currency ASAPs for depreciable property and revenue account property, or services which result in assessable income or deductible expenditure under provisions under the Act outside the financial arrangements rules. Therefore the rules do not apply to IFRS-designated FX hedges for foreign currency ASAPs for non-revenue account property that is not depreciable property and non-deductible/non-taxable services. Hedges for these matters will continue to be treated as stand-alone financial arrangements. All consideration for, and under those hedges, will continue to be spread under the present rules. None of the consideration for the IFRS-designated FX hedge will be included in the value of the non-revenue account property or services under the new rules for foreign currency ASAPs.

This is the appropriate policy outcome. The objectives of new rules for foreign currency ASAPs are to reduce compliance with, and the volatility of, taxable income compared with accounting income. They are achieved by allowing IFRS taxpayers to use the values and spreading of any income and expenditure used in the financial statements for tax. However, IFRS-designated FX hedges are financial arrangements which, in the absence of the new tax rules, would be fully taxed under the financial arrangements rules. Where the hedges are for non-revenue account property, amounts relating to the hedges should continue to be taxed under the financial arrangements rules because they otherwise would not be in the tax base.

Subsection EW 33B(3) allocates for tax amounts for IFRS-designated FX hedges attributed under IFRS rules to the value of relevant property or services in a foreign currency ASAP described in subsection EW 33B(1). So the tax values for property or services in these cases are those used in the IFRS financial statements, including amounts attributed to them for IFRS-designated FX hedges.

Subsection EW 33B(5) excludes from the spreading methods and base price adjustments for the IFRS-designated FX hedges amounts attributed to the tax values of property or services by subsection EW 33B(3). This prevents double counting of these amounts under the two financial arrangements. Therefore amounts for designated FX hedges attributed to the value of property or services will not be spread for tax under the FX-designated hedge. Those amounts will usually be allocated to reserves in "Other Comprehensive Income" in the IFRS financial statements until the property or services are recognised in the financial statements. The amounts attributed to the value of property or services will also be excluded from the base price adjustment for the IFRS-designated hedges.

New subsection EW 33B(6) provides that section EZ 75 overrides the application of section EW 33B for IFRS taxpayers in certain cases. The effect of section EZ 75 is described in the section "Application dates".

Example: The new tax rules applied to the purchase of a depreciable asset of an IFRS taxpayer

The example is based on the following assumptions:

The purchase of a depreciable asset for US$100,000 in 12 months (being the IFRS GAAP recognition date).

The payments are US$50,000 in 6 months (payment A, a non-monetary item for IFRS GAAP), and US$50,000 at the recognition date in 12 months (payment B).

Both payments are hedged from the beginning with forward exchange contracts (FEC/s) designated as cashflow hedges. However, for comparison the example includes the treatment where both payments are not hedged at all (the "No Hedges" column) and where the hedge is not designated.

The forward (FEC) rate for payment A is 0.72 and the FEC rate for payment B is 0.65.

The spot rate for payment A is 0.65 and the spot rate for payment B is 0.80.

A balance date falls three months prior to the recognition date when the spot rate is 0.75.

The IFRS GAAP results are set out for three situations: the hedges are designated as cashflow hedges; the hedges are not designated as hedges; and there are no hedges at all.

($000)	Designated		Not designated		No hedges	
	P&L	SFP	P&L	SFP	P&L	SFP
Contract date	0	0	0	0	0	0
Payment A date						
Cash (FEC or spot rate)	0	69 CR		69 CR		77 CR
Prepayment (non-monetary)	0	69 DR		77 DR		77 DR
Profit and loss				8 CR		
Balance date						
Payment B FEC:						
Fair Value CFHR/OCI	0	11 DR				
FEC Fair Value	0	11 CR	11 DR	11 CR		
Subtotal for 1st year	**0**	**0**	**3 DR**	**3 CR**	**0**	**0**
Payment B: IFRS Recognition date						
Payment B to Asset	0	77 DR	15 DR	62 DR		62 DR
Cash (FEC or spot rate)	0	77 CR		77 CR		62 CR
Reverse CFHR/OCI	0	11 CR				
Reverse FEC Fair Value	0	11 DR	11 CR	11 DR		
Reverse prepayment		69 CR		77 CR		77 CR
Prepayment to Asset		69 DR		77 DR		77 DR
Subtotal for 2nd year	**0**	**0**	**4 DR**	**4 CR**	**0**	**0**
Summary of IFRS GAAP entries						
SFP – Depreciable Asset	**146 DR**		**139 DR**		**139 DR**	
– Cash	**146 CR**		**146 CR**		**139 CR**	
Profit and loss	**0**		**7 DR**		**0**	

Designated IFRS FX hedges: The asset is capitalised and depreciated for tax at the FEC rates, being $146k. There is no impact on the profit and loss up to the IFRS recognition date and therefore no income or expenditure under the financial arrangements rules for tax up to that point.

Undesignated IFRS FX hedges: The asset is capitalised and depreciated for tax at the spot rates, being $139k. The P&L has been debited with $7k ($3k and $4k for the two years up to the recognition date). These amounts are expenditure under the financial arrangements rules for the undesignated IFRS FX hedges. The spreading of them will depend on which of the available spreading methods is being used for these types of financial arrangements.

No hedges: The asset is capitalised and depreciated for tax at the spot rates being $139k. There is no impact on the profit and loss and therefore no income or expenditure for tax under the financial arrangements rules.

Non-IFRS taxpayers

Rights date

A new definition of "rights date" has been inserted into section YA 1 for agreements for the sale and purchase of property or services. The definition only applies to foreign currency ASAPs of non-IFRS taxpayers because the tax rules for agreements for the sale and purchase of property or services which are not foreign currency ASAPs are not being changed. The definition does not apply to IFRS taxpayers because they will apply the IFRS recognition dates for property or services in foreign currency ASAPs. The definition means the date on which the first right in the property is transferred or the services are provided. The words used in the new definition are similar to those contained in section EW 32(3) for the use of lowest price to establish the point at which the property or services in non-foreign currency ASAPs is valued.

The intended effect of the definition of "rights date" is to identify when property or services in foreign currency ASAPs are valued under the new rules for non-IFRS taxpayers. It is intended that this is the same point at which the property or services would be valued under the old rules for foreign currency ASAPs and the ongoing rules for non-foreign currency ASAPs. For instance, if the first right in the property under the foreign currency ASAP was to possession, that would be the rights date under the new rules and the point at which the value was established under the old rules.

Spreading methods

The spreading methods in sections EW 16 to EW 22 (based on their terms) are available to use to spread income or expenditure for foreign currency ASAPs of non-IFRS taxpayers. Using them has to recognise the consistency and anti-arbitrage rules contained in sections EW 24, EW 25 and EW 26. However, as an integral part of the new tax rules it is intended that under section EW 20, Determination G29 is not used by non-IFRS taxpayers for foreign currency ASAPs entered into from the 2014–15 income year.[13]

Value of property or services

Express "interest" foreign currency ASAPs (section EW 32(2C))

Section EW 32(2C) applies to the foreign currency ASAPs of non-IFRS taxpayers. It values property and services in foreign currency ASAPs at the aggregate of the amounts paid or payable in the foreign currency ASAPs. However, it excludes from the values of property or services amounts expressly provided for in the foreign currency ASAPs as "interest" (amounts paid or payable on account of the future value, or the discounted value, or a combination of both the future

[13] After further analysis, it is considered that as currently drafted, the legislation does not give the intended result for cancelling the use of Determination G29 for new foreign currency ASAPs from the application dates. Legislative amendments are expected to be made in the next tax bill to achieve the intended result, with the application date for the amendments likely to be the same as the application dates for the new rules for foreign currency ASAPs.

and discounted values, on the rights date"). The exclusion is intended to apply to interest which has been agreed on a commercial basis where there are payments before or after the rights date. These amounts will be income or expenditure under foreign currency ASAPs and spread using an applicable spreading method.

Where interest is expressly provided for in a foreign currency ASAP subsection EW 32(2C) applies to exclude it from the value of property or services. Subsections EW 32(2D) and (2E) (see below) are therefore overridden by subsection EW 32(2C) where interest is expressly provided in foreign currency ASAPs. Otherwise the subsequent subsections will apply to value property or services in foreign currency ASAPs of non-IFRS taxpayers.

After the value of the property or services and the express interest in the foreign currency ASAP are identified in foreign currency an appropriate spreading method will be applied to spread the interest income or expenditure.

The conversion of the foreign currency value of the property or services into New Zealand dollars will use spot rates on the payments dates (see below). The value may include amounts for non-IFRS designated FX hedges if the non-IFRS taxpayer elects into that part of the new rules (see below).

12-month ASAPs (section EW 32(2D))

Section EW 32 (2D) applies to foreign currency ASAPs of non-IFRS taxpayers which are "12-month ASAPs". The policy background is that significant pre-payments and delayed payments for property or services are in the nature of loans under the financial arrangements rules. Any interest component of the financial arrangement should be spread as income or expenditure for tax and not be included in the value of the property or services.

Section YA 1 has a new two-part definition of "12-month ASAP". A 12-month ASAP means an agreement for sale and purchase of property or services for which:

a) An amount paid or payable for property or services is pre-paid by reference to the rights date and the pre-payment is 12 months or more before the rights date.

   A pre-payment by the purchaser of property under a foreign currency ASAP is a loan by the purchaser to the supplier and will result in assessable income to the purchaser under the financial arrangements rules. Limiting the definition to payments 12 months or more before the rights date should significantly restrict its application to a small number of foreign currency ASAPs of non-IFRS taxpayers and limit compliance for taxpayers. The limitation also reflects that there would not be a significant overall tax impact of pre-payments within 12 months of the rights date. As well, some pre-payments are excluded from the definition which should also help to restrict its application to relatively few foreign currency ASAPs. They are:

   i) Pre-payments which are made for either making or constructing property, or providing services ("progress payments"). The exclusion of progress payments is to recognise that some commercial contracts provide for payments which are linked to the progress for making or constructing property, or providing services, and they are not in the nature of loans. Therefore they should be excluded from creating income or expenditure under the financial arrangements rules for foreign currency ASAPs.

   ii) Deposits paid within the first three months of the contract which aggregate to 10 percent or less of the amount paid or payable for the property or services. This exclusion is intended to apply to commercially agreed deposits which are often included in agreements for the sale and purchase of property or services. As with progress payments these amounts are not considered to be in the nature of loans; and

b) An amount paid or payable for the property or services is delayed (the deferment) and the deferment is paid 12 months or more after the rights date.

   Some deferments are excluded from the definition. They are amounts or adjustments that are commonly commercially agreed and included in agreements for the sale and purchase of property or services:

   i) Earnout amounts based on business performance after the sale of a business. The deferral of payment in such a case occurs because of uncertainty regarding the value of the business, not because there is some imputed interest component as between the parties that ought to be recognised for tax purposes.

   ii) Adjustments to amounts paid or payable for property services under warranties. These types of adjustments can take more than 12 months to determine.

   iii) Adjustments to amounts paid or payable for property or services on account of working capital. Sales and purchases of businesses often include these adjustments which can sometimes take more than 12 months to determine.

Property or services in a foreign currency ASAP which is a 12-month ASAP is valued at the future value, or the discounted value, or a combination of the two, on the rights date, of the amounts paid under the foreign currency ASAP. The interest component will be income or expenditure under

the foreign currency ASAP and spread appropriately using an applicable spreading method.

Calculating the future and/or discounted values for foreign currency ASAPs applies when the foreign currency ASAP is a 12-month ASAP. It is anticipated this will apply to relatively few foreign currency ASAPs which have qualifying pre-payments or deferred payments, or both. Qualifying pre-payments or deferred payments do not include the exclusions set out in a) and b) above, for example, progress payments and earnout amounts.

It is intended that only pre-payments and deferred payments 12 months or more before or after the rights date will result in interest income or expenditure. So when a foreign currency ASAP also has pre-payments or deferred payments within 12 months of the rights date, they are ignored for calculating the value of the property or services and any interest income and expenditure.

Calculation of the future value or discounted value amounts to be used to value property or services in foreign currency ASAPs which are 12-month ASAPs will be on usual commercial principles. Existing Determination G21A encompasses these principles in paragraphs 1.(2)(a)(ii) (Explanation – discounted value), 4.(4) (Principle – discounted value), 5.(2) (Interpretation – acceptable present value calculation), and 6.(2)–(4) (Method – present value calculations). The calculations are carried out using foreign currency and interest rates relevant for those foreign currencies. Determination G21A also refers to the use of Determinations G10B (Present Value Calculations) and G13A (Prices or Yields) where relevant. These three determinations provide appropriate guidance for calculating discounted/present values and include examples. While they do not expressly address future valuing, the principles to be applied are the same as for discounted/present valuing but in reverse. These principles are applied in the simple example provided below.

Once the value of the property or services and any income or expenditure has been calculated in foreign currency, Determinations G9A or G9C may be applied as applicable to spread the income or expenditure on the deemed loans. Using Determinations G9A and G9B to spread the income or expenditure will need to meet the consistency requirements for the same or similar financial arrangements in section EW 24. Other spreading methods in sections EW 16 to EW 22 may be applied as appropriate.

Converting the foreign currency values of property or services at spot rates and including amounts for non-IFRS designated FX hedges if relevant is on the same basis as set out for section EW 32(2C) (see below).

Express value: Foreign currency ASAPs not subject to 12-month ASAP (section EW 32(2E))

Section EW 32 (2E) applies to foreign currency ASAPs of non-IFRS taxpayers which are not "12-month ASAP(s)". The value of property or services is the value expressly provided in the agreement as paid or payable for the property or services. The value of property or services in commercial contracts is usually clearly stated and easy to obtain. It will usually be the aggregate of the total amounts paid or payable for the property or services under the contract.

Section EW 33B (non-IFRS designated FX hedges) may apply to valuing property or services in 12-month ASAPs. Its application will be the same as set out for "express interest" foreign currency ASAPs above.

Converting the foreign currency values of property or services at spot rates and including amounts for non-IFRS designated FX hedges if relevant is on the same basis as set out for section EW 32(2C) (see below).

Use of spot exchange rates to convert amounts in foreign currency ASAPs

Section EW 33C applies to convert amounts paid or payable in foreign currency to New Zealand dollars. It applies the spot exchange rate for the foreign currency on the payment dates to convert them to New Zealand dollars.

When no spot exchange rate is available because payments are deferred until a subsequent income year, two alternative spot rates can be used for the deferred payments. The spot exchange rate at the end of the current income year can be used in all cases. Alternatively, if amounts are paid or payable within 93 days of the end of the income year, the spot exchange rates on the dates they are paid or payable may be used. Differences between New Zealand dollar amounts converted at these spot exchange rates and the New Zealand dollar amounts converted at spot exchange rates when they are ultimately paid will be income or expenditure under foreign currency ASAPs.

Non-IFRS designated FX hedges

Section EW 33B may apply in relation to FX hedges. Section EW 33B(2) applies to foreign currency ASAPs when section EW 32(2C), (2D), or (2E) applies, and:

a) The foreign currency ASAP relates to:
    i) property that is depreciable property or revenue account property (such as trading stock); or
    ii) services which give rise to assessable income or deductions under the Income Tax Act 2007 outside the financial arrangements rules (which are on revenue account); and

b) The taxpayer has made, at the time of filing a return of income for the income year in which they enter into the foreign currency ASAP or at the time of filing a return of income for an earlier income year, an irrevocable election in writing to apply section EW 33B(2) to all foreign currency ASAPs described in (a)(i) and (ii) above; and

c) The person holds a non-IFRS designated FX hedge in relation to the fore ign currency ASAP.

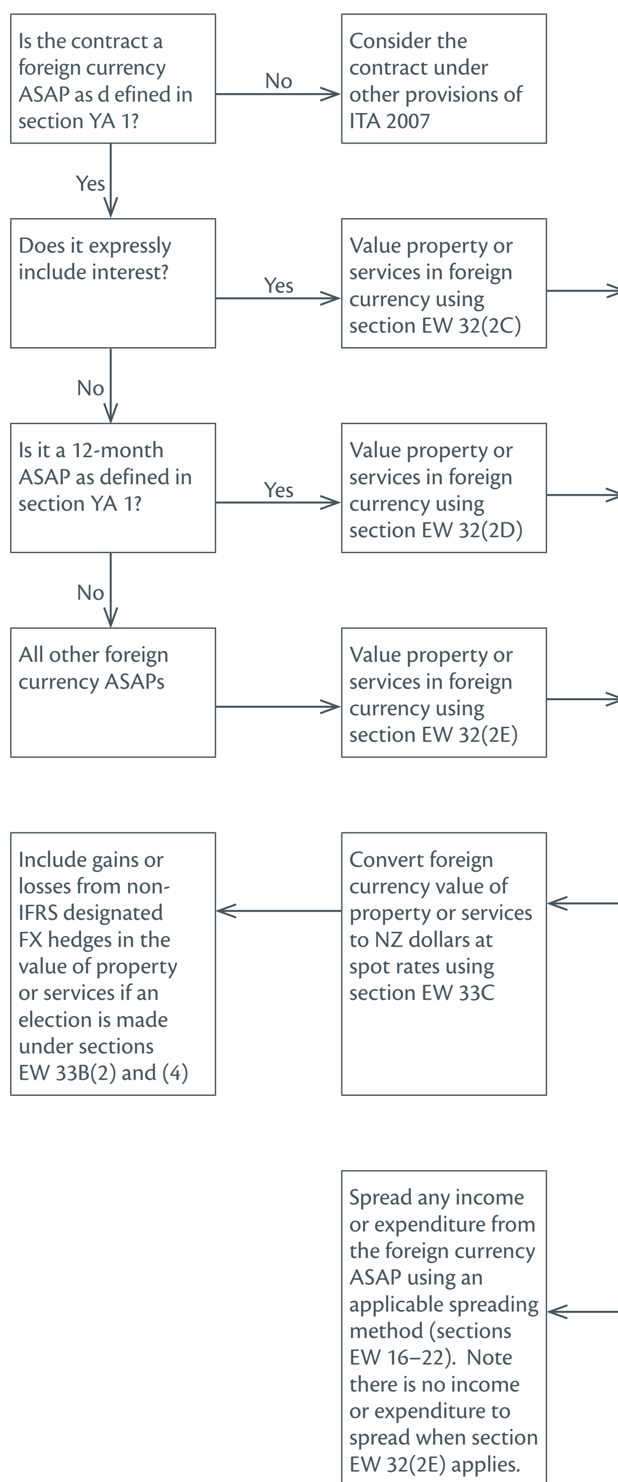
Section EW 33B(4) applies to modify the value of property or services in foreign currency ASAPs which are subject to section EW 33B(2). For non-IFRS taxpayers these are foreign currency ASAPs when section EW 32(2C), (2D), or (2E) applies. The value of the property or services in these foreign currency ASAPs is modified by the amount that would be the base price adjustment for the non-IFRS designated FX hedge in the absence of section EW 33B. Section EW 33B(4) works in tandem with section EW 33B(5) to obtain the value of property or services in foreign currency ASAPs when the elective non-IFRS designated FX hedging rules apply.

Section EW 33B(5) applies to amounts for non-IFRS designated FX hedges which are attributed to the value of property or services in foreign currency ASAPs. It excludes these amounts from being included in the spreading methods or the base price adjustments for the non-IFRS designated FX hedges. This prevents double counting these amounts for tax purposes. They are included in the value of the property or services and are not included in income or expenditure under the financial arrangements rules. The intention is to allow non-IFRS taxpayers to ignore spreading of income and expenditure on non-IFRS designated FX hedges. It also provides that amounts for non-IFRS designated FX hedges included in the value of property or services is not taken into account for the base price adjustment calculations.

The elective hedging rules for non-IFRS taxpayers apply in a different manner to IFRS-designated hedging and all gains or losses on non-IFRS designated hedges are mandatorily included in the value of property or services. So where the overall gain or loss for a non-IFRS designated FX hedge is included in the value of property or services there is no income or expenditure to spread and the base price adjustment will be nil. The application of section EW 33B(4) and (5) is intended to provide those outcomes for non-IFRS taxpayers who elect into the rules for non-IFRS designated FX hedging.

The effects of section EW 33B for non-IFRS designated FX hedges described above apply to all foreign currency ASAPs under section EW 32(2C), (2D) and (2E). It is intended that amounts from non-IFRS designated FX hedges attributed to the value of property or services are attributed after the provisions of other sections are applied to arrive at the relevant values. Therefore sections EW 32(2C) or (2D) (interest) and EW 33C (spot exchange rates) are applied before amounts for non-IFRS designated FX hedges are attributed.

Flowchart of new tax rules for foreign currency ASAPs for non-IFRS taxpayers



Example: Future valuing and discounted valuing of amounts for valuing property in a foreign currency ASAP of a non-IFRS taxpayer

A non-IFRS taxpayer agrees to buy trading stock for US$2 million for possession in 12 months' time (the rights date). Unusual payment terms are agreed (for the purposes of this example) where the taxpayer pays US$1 million when the contract is signed and US$1 million 12 months after the possession date. The US$1 million paid when the contract is signed is not a progress payment as defined.

The foreign currency ASAP is a 12-month ASAP as defined because it has at least one payment 12 months or more before or after the rights date. In this case the foreign currency ASAP has two payments which meet the definition.

Assume that an appropriate discount rate for discounted and future valuing purposes in this case is 4% a year.

To value the trading stock at the rights date, the taxpayer will future-value the first payment to the rights date and discount the last payment back to the rights date. From Investopedia's future value calculator (**www.investopedia.com/calculator/fvcal.aspx**) the future value of US$1 million paid 12 months before the rights date for one 12-month period at 4% per period is US$1,040,000 approximately. This amount will be included in the value of the trading stock for tax. The taxpayer is treated as making a loan to the supplier of US$1 million from the date it is paid to the rights date. The deemed loan will earn US$40,000 interest over the 12-month period to the rights date.

The US$1 million paid 12 months after the rights date is discounted back to the rights date. From Investopedia's discounted value/present value calculator (**www.investopedia.com/calculator/pvcal.aspx**) the discounted/present value of US$1 million paid 12 months after the rights date for one 12-month period at 4% per period is US$962,000 approximately. This amount will be included in the value of the trading stock for tax. The taxpayer is treated as receiving a loan for US$962,000 from the rights date to the final payment date. Interest of US$38,000 is paid on this deemed loan over that period.

As the term of the foreign currency ASAP runs for 24 months it will be relevant to two or three income years. However each deemed loan only affects two income years. Spreading the income and expenditure on the deemed loans for tax may be achieved by various appropriate spreading methods. Determinations G9A or G9B (section EW 20) could be applied to calculate how the income and expenditure is spread for each loan. They are both variants of YTM (yield to maturity) calculations (section EW 16) for financial arrangements in foreign currency. Section EW 17 (Straight-Line) may be applied if the total value of the taxpayer's financial arrangements is less than $1.85 million during the income year (which it would probably not be in this example).

The trading stock is valued at US$2,002,000 approximately (US$1,040,000 + US$962,000) for tax and this will be the tax cost of the stock. It will be converted to New Zealand dollars at the spot exchange rate on the rights date. Say the spot exchange rate at the rights date is 0.8500, the New Zealand dollar value of the stock is $2,355,294.

The taxpayer may hedge the US$1 million payment 12 months after the rights date and make an election under section EW 33B(2) to include hedging amounts in the value of the trading stock. It will include any gain or loss on the hedge in the value of the trading stock which has been converted to New Zealand dollars. Say there is a gain of $15,000 on the hedge; this will be included in the value of the stock to reduce the tax value of the stock to $2,340,294. The amount of the gain or loss on the hedge is not spread or included in the base price adjustment for the hedge.

Value of property or services relevant for non-financial arrangements rule

Section EW 35 has been amended to include services. The omission of services from this section was an oversight when the previous legislation was extended to services. This change is treated as coming into force on 1 April 2008.

Application dates

General application – IFRS and non-IFRS taxpayers

The new rules apply to foreign currency ASAPs entered into in the 2014–15 and later income years. This means that foreign currency ASAPs entered into before the 2014–15 income year remain subject to the old rules until base price adjustments are performed.

Early adoption by IFRS taxpayers from the 2011–12 income year

IFRS taxpayers can apply the new rules for foreign currency ASAPs entered into from the 2011–12 or subsequent income years. They apply the new rules for foreign currency ASAPs by filing the return of income for the relevant income year using the new rules.

The new rules will be applied to all foreign currency ASAPs entered into in that income year and all subsequent income years. The first income year to apply the new rules can be

any of the 2011–12 to 2013–14 income years. They will continue to apply the old rules to foreign currency ASAPs entered into before the relevant income year.

Foreign currency ASAPs entered into before the 2014–15 income year

Sections EZ 75 and EZ 76 apply to foreign currency ASAPs entered into before the 2014–15 income year. They are "savings" positions for taxpayers who have filed returns of income for foreign currency ASAPs essentially based on the new rules for years prior to the 2014–15 year.

Section EZ 75 applies to IFRS taxpayers who have foreign currency ASAPs for which section EW 32 applies to value the property or services, the foreign currency ASAPs have been entered into before the end of the 2013–14 income year, and the taxpayers have filed returns of income for the foreign currency ASAPs in accordance with section EZ 75 for the 2013–14 income year and every earlier income year.

Under section EZ 75(2) the taxpayer, applying sections 66 and 67 of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 as if in force, may:

a) treat sections EW 32 and EW 33B as applying to the foreign currency ASAPs for the 2013–14 income year and every earlier income year; or

b) treat section EW 32 as applying, but excluding section EW 33B. The value of the relevant property or services is modified by excluding amounts attributed under IFRS accounting rules from the value on account of IFRS-designated FX hedges.

Therefore, tax positions taken for foreign currency ASAPs which have followed the new IFRS rules are confirmed. Those positions will have been taken for all income years for the relevant foreign currency ASAPs. Those positions will have followed the IFRS accounting treatment (para (a) above), being based on either spot exchange rates or including designated hedging where relevant. However, where IFRS designated hedge accounting applies to a foreign currency ASAP the position taken may have excluded that effect (para (b) above) and effectively be based on spot exchange rates.

As well, subsection (3) of section EZ 75 modifies the treatment under subsection (2) for payments that have been made prior to the property or services being recognised in IFRS financial statements. These payments will have been recognised at their original New Zealand dollar amounts using the spot exchange rates at that time. This modification allows those payments to be revalued for tax using spot exchange rates at the point they are recognised in IFRS financial statements. Those payments will not have been revalued in the IFRS financial statements from the amounts recognised at the spot exchange rates when they were paid. However for tax the revaluation changes on the amounts paid have been taxed and the value of the property or services adjusted by the same amounts compared with the values recognised in IFRS financial statements.

Section EZ 76 applies to non-IFRS taxpayers who have foreign currency ASAPs for which section EW 32 applies to value the property or services; the foreign currency ASAPs have been entered into before the end of the 2013–14 income year; and the taxpayers have filed returns of income for the foreign currency ASAPs in accordance with section EW 76 for the 2013–14 income year and every earlier income year.

Under section EW 76(2) the taxpayer, applying sections 65 and 66 of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 as if in force, may treat sections EW 32 and EW 33C as applying to the foreign currency ASAPs for the 2013–14 income year and every earlier income year. However, section EW 33B (non-IFRS designated FX hedges) is excluded from this application. This means that returns filed in those years for relevant foreign currency ASAPs based on spot exchange rates are confirmed.

CLARIFYING THE ACQUISITION DATE OF LAND

Section CB 15B of the Income Tax Act 2007

The land provisions contained in subpart CB of the Income Tax Act 2007 have been amended to clarify the time at which land is considered to have been acquired for tax purposes.

Background

New section CB 15B clarifies the acquisition date of land for the purposes of the land disposal provisions in the Income Tax Act 2007, in particular section CB 6, which has caused considerable uncertainty for taxpayers, their agents and Inland Revenue.

Section CB 6 deals with land acquired for the purpose of, or with the intention of, disposal and the taxation of income derived from disposing of the land. If a taxpayer acquires the land with the intention or purpose of disposal and subsequently disposes of the land, any profit made is taxable.

Uncertainty arose around the timing of when the taxpayer's intention or purpose should be determined. The Courts held that "intention" or "purpose" should be tested when a taxpayer has acquired the land in question (known as the date of acquisition). However, because the definition of "land" in the Income Tax Act 2007 includes estates and interests in land, and the taxpayer acquires different interests and estates in "land" at different times under a typical sale and purchase agreement (which are then merged when the title is registered), neither the legislation nor common law provided sufficient clarity over which interest in "land" the date of acquisition should apply to.

To address this uncertainty, as part of Budget 2013, officials released the issues paper *Clarifying the acquisition date of land*. The issues paper discussed two possible interpretations of the provisions. It concluded that the "first interest" interpretation whereby the date of acquisition is the date when the first equitable or legal interest in land arises in a sale and purchase agreement (typically in the early phases of a sale and purchase agreement), would provide greater certainty and be more economically efficient. This interpretation also more closely reflected the policy underlying this provision when it was first introduced in the late 1800s (that is, to target property speculators), as it is the initial decision-making that informs how a person intends to use the property. It would be unusual for a property speculator to enter into a sale and purchase agreement unless they thought at the time of acquisition that it was likely that the purchase and its subsequent disposal would be profitable.

The new legislation is intended to provide taxpayers with greater certainty about the timing of land acquisition for tax purposes.

Key features

New section CB 15B is a general rule for subpart CB (income derived from land) and provides that the date a person acquires land is the date that begins a period in which the person has an estate or interest or option in that land.

There are two exceptions to this general rule.

The first exception, contained in subsection CB 15B(2), provides that if a person on behalf of a company (that is yet to be formed) enters into an agreement whereby the company will eventually have the land, the purpose and intention of the person is imputed on the company as if the company existed at the time of entering into the agreement.

The second exception contained in subsection CB 15B(3) provides that if a person has an estate or interest in land, and subsequently as a consequence of the person exercising an option obtains a new estate or interest in the same land, the person is treated as acquiring this new estate or interest from the time this person exercised the option.

New subsection CB 15B(4) provides that the timing provided for in new section CB 15B is overridden by any timing provided for in subpart FB or FC (which relates to transfers of property).

Detailed analysis

General rule of when land is acquired

New section CB 15B(1) provides that a person acquires land at the beginning of a period in which the person has an estate or interest or option in that land. Practically, this means that the date the taxpayer's purpose or intention is tested for the land sale provisions, will be the date a binding agreement is entered into.

Indicative characteristics of the date a binding agreement is entered into (that is, the agreement has no conditions precedent, but the vendor and the purchaser intend to be bound by the terms of the contract even if there are conditions subsequent that have to be fulfilled) are:

- the date a binding sale and purchase agreement has been signed and executed by both the vendor or purchaser (including nominees or agents); or
- the "Date" indicated on a binding sale and purchase agreement, which is then subsequently signed by the parties to the agreement; or
- the date a binding oral agreement for the disposal of land was agreed to by the parties, which has then been subsequently actioned by part performance of the agreement and if required later, evidenced by a memorandum.

As noted above, the policy underlying the general rule is the "first interest" principle, whereby the date of acquisition is the date when the first equitable or legal interest in land arises in a sale and purchase agreement, as typically it is the initial decision-making that informs how a person intends to use the property.

Exceptions to the general rule of when land is acquired

Acquisition of land by company yet to be formed

One exception to the general rule clarifies when a person, on behalf of a company that is yet to be formed enters into an agreement whereby the company will have the land, the purpose and intention of the person is imputed on the company as if the company existed at the time of entering into the agreement.

The purpose of this exception is to ensure that new section CB 15B is not circumvented on the basis that the company did not have the requisite purpose or intention as they did not exist at the time that the nominator, transferor or assignor entered into an agreement for the land. This is despite the nominator, transferor or the assignor having some form of decision-making authority to form the company or decision-making authority once the company is formed.

Further land from the exercise of an option

Another exception to the general rule provides that where a person has a previous (first) interest in land, and exercises an option that is related to that land, the person has entered into a new acquisition and sections CB 6 and CB 15B should be applied, as if the previous interest did not exist.

This situation is only likely to occur when there is an option to exercise a right to acquire another estate or interest in land.

For example:

- Brian has an unregistered leasehold in land with a "first right" option to acquire the fee simple estate if it is disposed of by the lessor, April.
- April decides to sell the estate in fee simple and offers the land to Brian according to the terms of the lease agreement.
- Brian agrees to exercise the option to acquire the estate in fee simple.

In this example Brian has a number of interests and estates —the leasehold land, the option and once the option is exercised, a contingent equitable interest in the land that eventually merges into an estate in fee simple. Without this subsection, Brian's intention or purpose is only tested when he acquires the unregistered leasehold interest. However because an unregistered leasehold interest does not merge into the legal estate in fee simple, if Brian had the intention to acquire the estate in fee simple to dispose of it, and Brian disposes of the estate in fee simple, any gain Brian makes from this disposal falls outside the ambit of section CB 6. This is because when Brian acquired (the leasehold) he did not have the intention to dispose of the leasehold, despite making another active decision to exercise the option and acquire the estate that is eventually disposed of.

This outcome is not consistent with the underlying policy intent of section CB 6 or the first interest principle, as Brian has made another active decision to enter into an agreement to acquire the estate in fee simple. The new subsection therefore treats the subsequent acquisition as a separate acquisition of land, and Brian's intention or purpose should be tested at this time (when he exercises the option). As stated in the officials' issues paper:[14]

> ... the policy intent of section CB 6 is to capture property speculators, arguably the most appropriate time to assess a taxpayer's intention and purpose should be when a person decides to enter into a sale and purchase agreement. **It is the initial decision-making that informs how a person intends to use the property.** It would be unusual for a property speculator to enter into a sale and purchase agreement unless they thought it very likely that the purchase and its subsequent disposal would be profitable.
>
> [Emphasis added]

The example described above is distinct from the situation when a person just has an option to acquire land but no other previous interest in land. As described in the officials' issues paper, the appropriate time to test their intention or purpose in relation to the option is when the option is granted.

Application date

New section CB 15B applies to disposals of land from 22 November 2013, the date the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill was introduced. Therefore, section CB 15B can be applied retrospectively to land acquired before the 22 November 2013, as long as this land has not yet been disposed of.

For land that has been disposed of, the Commissioner's current interpretation of section CB 6 still applies (that is, the disposal interpretation—where the date of acquisition is determined by the "land" that is disposed of, usually at the later stages of a sale and purchase agreement).

Although the officials' issues paper acknowledged that the "first interest" interpretation is the preferred tax policy interpretation, the current interpretation is not a totally unreasonable interpretation that it is warranted for the Commissioner to "unwind" previous positions taken by both the taxpayer and Inland Revenue when the land has already been disposed.

[14] *Clarifying the acquisition date of land* at para 3.5, http://taxpolicy.ird.govt.nz/publications/2013-ip-acquisition-date-land/overview.

OTHER POLICY MATTERS

ANNUAL INCOME TAX RATES FOR 2014–15 TAX YEAR

The annual income tax rates for the 2014–15 tax year are the rates set out in schedule 1 of the Income Tax Act 2007 and are the same that applied for the 2013–14 tax year.

Application date

The provision applies for the 2014–15 tax year.

REPEAL OF SUBSTITUTING DEBENTURE RULE

Sections DB 10, DB 25, DP 8, EZ 77, FA 2, HD 14 and YA 1 of the Income Tax Act 2007

The substituting debenture rule previously contained in section FA 2(5) of the Income Tax Act 2007 has been repealed as it is now outdated. There are also a number of consequential amendments as a result of the repeal of the rule.

Background

From the 1940s, the substituting debenture rule recharacterised debt issued by a company to its shareholders by reference to their equity (most commonly debt issued in proportion to shares held), as equity for tax purposes. This recharacterisation meant interest paid in respect of substituting debentures was taxed as a dividend—it was non-deductible to the company and (in recent times) subject to imputation.

A number of tax advisers and commentators recently raised concerns about the rule.

It applied too widely in some circumstances. Arguably, any shareholder loan was caught. It was easy for those not taking advice to inadvertently issue substituting debentures. Often the rule applied to fairly common company dealings which are of no policy concern. Taxpayers who inadvertently issued substituting debentures may have had consequential problems with past tax years, for example, the company may have paid too little tax by virtue of treating the interest as deductible, the incorrect amount of resident withholding tax (RWT) may have been deducted by the company from the payments, no imputation credits would have been attached by the company to the "dividend", and there may have been penalties and use-of-money interest payable as a result of taking an incorrect tax position in past years.

Conversely, the rule was too narrow in other circumstances and was easily circumvented. For example, the rule did not apply where the debt was in the form of a convertible note or when the loan was not made by the direct shareholder, but an indirect shareholder higher in the ownership chain. Taxpayers may have also deliberately structured their funding as substituting debentures to take advantage of the equity recharacterisation. The ease with which the substituting debenture rule could be manipulated had the potential to facilitate cross-border tax arbitrage, as taxpayers could effectively choose whether a debenture is treated as debt or equity for New Zealand tax purposes.

The scope and the application of the rule was also uncertain, which led to increased compliance costs as taxpayers were inclined to seek advice (and sometimes binding rulings) on fairly straightforward transactions.

Furthermore, in light of recent tax avoidance cases, taxpayers were becoming increasingly concerned about standard commercial transactions which seemingly circumvented the rule. It was difficult to determine whether Parliament's intention was frustrated by these arrangements when the policy issue Parliament contemplated no longer existed given that the rule was enacted in 1940 as a specific anti-avoidance rule and under very different tax policy settings (in particular, New Zealand did not have an imputation regime).

The rule originally targeted transactions in which companies were swapping their ordinary equity for debt. These transactions were popular at the time because dividends were paid out of post-tax income and were exempt income to the shareholders, whereas interest was deductible to the company and taxable to the recipient, generally at a lower tax rate than the (then) company rate. Ultimately, the tax burden on dividends was often higher than that on interest. It is also possible that the Government was concerned about the collection of tax from ultimate shareholders as the predecessor of resident withholding tax (RWT) was easily circumvented.

In 1958 the dividend exemption was removed. This meant that dividends were subject to double tax, but interest was not (absent the substituting debenture rule). There was a clear tax incentive to structure investments as debt rather than equity, so the substituting debenture rule continued to serve an anti-avoidance purpose at this time.

Since the introduction of imputation in 1988, the original purpose of the substituting debenture rule ceased to be relevant in many cases—as debt and equity returns are generally subject to the same tax treatment in the hands of a New Zealand-resident in a taxpaying position.

For investors such as non-residents, who still prefer to receive interest rather than dividends for tax reasons, there are targeted rules such as the thin capitalisation and transfer pricing rules which limit the ability to take undue advantage of the preference.

Accordingly, the rule is now outdated and has been repealed. To mitigate any risk to the tax base as a result of the repeal, the application date of the repeal broadly coincides with the strengthened thin capitalisation rules.

Key features

Section FA 2(5) of the Income Tax Act 2007, which defines "substituting debenture", and section FA 2(7), which quantifies the amount of the debenture, have been repealed.

As a result of the repeal, there have been a number of consequential amendments to sections DB 10, DB 25, DP 8, HD 14 and YA 1, primarily to remove references to substituting debentures.

Section EZ 77 contains a transitional provision for substituting debentures that are already in existence when the rule is repealed. Its purpose is to ensure that no adverse tax consequences arise on transitioning from treating the debenture as a share for tax purposes, to treating it as a debt for tax purposes.

For both the issuer and the holder, the transitional provision treats the substituting debenture as having been redeemed for its outstanding principal and outstanding accrued interest on 31 March 2015. On 1 April 2015, the outstanding principal and accrued interest is deemed to have been re-advanced by the lender to the borrower under a new loan.

Any income derived or expenditure incurred in respect of the new loan on or after 1 April 2015 must be accounted for under the financial arrangements rules. Any income and expenditure arising under the substituting debenture on or before 31 March 2015 will not be taken into account under the financial arrangements rules because that income and expenditure will have been dealt with under the tax rules applying to shares.

As this measure is not intended to be adverse to taxpayers, there is limited elective grandparenting of existing transactions (so they may continue to be treated as equity transactions for their term by a party) where:

- the debenture is issued under a transaction that was entered into before 22 November 2013 (the date the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill was introduced);
- the transaction was subject to a binding ruling which would continue to apply in the absence of the repeal of the substituting debenture rule (that is, the facts disclosed in the binding ruling continue to be correct and all ruling conditions are met);
- for the whole of the relevant income year, the total amount and the term of all debentures issued under the transaction are not more than those disclosed in the application for the binding ruling; and
- an electing party notifies the Commissioner by 31 July 2014 that it irrevocably elects to continue to treat the debentures as shares.

If any of the grandparenting conditions above cease to apply in future, the previously grandparented debentures will transition to shares in the manner described above with respect to substituting debentures transitioning on 31 March/1 April 2015. The only difference will be that the transition date will be the date that the conditions ceased to be satisfied.

Section EZ 77(5) also ensures that the deemed redemption of the substituting debenture does not result in a shareholder continuity breach for the purposes of the continuity provisions, for example, the loss carry forward or imputation credit continuity provisions.

Application dates

The repeal and consequential amendments apply from 1 April 2015.

The transitional provision—section EZ 77—applies from the date of Royal assent, being 30 June 2014.

WITHHOLDING TAX AND INFLATION-INDEXED BONDS

Sections RE 2(3), RE 18B, RF 2 and YA 1 of the Income Tax Act 2007, and sections 25(6), 33A(2), 33AA(1) and 51(2) of the Tax Administration Act 1994

The resident withholding tax (RWT) and the non-resident withholding tax (NRWT) rules in the Income Tax Act 2007 have been amended to deal with technical problems relating to the application of withholding tax rules to inflation-indexed instruments. The amendments relate to the timing and the amount of withholding tax to be deducted from the inflation-indexed component of such instruments.

To administer the changes, the record-keeping and filing provisions in the Tax Administration Act 1994 have also been amended.

Background

As part of the 2012 Half Yearly Economic Fiscal Update, the Government announced that it intended to target up to 10–20 percent of total bonds outstanding over time in an inflation-indexed bonds format. The Government had previously issued inflation-indexed bonds in 1996 but suspended their issue in 1999.

Inflation-indexed bonds are intended to diversify the Crown's investor base, by providing long-term, cost-effective funding for the Government. They also provide investors with a hedge against inflation, as recommended by the Capital Market Development Taskforce in 2009, and in accordance with the 2010 Government Action Plan.

Two technical tax problems have been identified with the reissue of these bonds which the amendments seek to address.

Key features

The changes are as follows:

- Section RE 2(3) has been amended to exclude the inflation-indexed component, which is income that accrues to the bond holder at the end of the tax year, from being interest for the purposes of the general application of the RWT rules.
- New section RE 18B will:
  - limit the RWT payer's obligation to deduct resident withholding tax on both the interest and inflation-indexed amount to the amount of the interest payment; and
  - require RWT to be deducted from the interest and inflation-indexed amount when the bond coupon is paid.
- Section RF 2(1) has been amended to treat the inflation-indexed component as being non-resident passive income at the time the coupon interest is paid. This is to ensure that NRWT is deducted at the same time.
- Section YA 1 has been amended to insert a definition of an inflation-indexed instrument.
- New paragraphs in sections 25(6) and 51(2) of the Tax Administration Act 1994 require the bond issuer to notify the bond holder of their requirement to file, and the Commissioner of Inland Revenue of any remaining tax liability.
- New paragraphs in sections 33A(2) and 33AA(1)(l) of the Tax Administration Act 1994 that provide an exclusion from non-filing requirements for a bond holder who has an interest payment capped by new section RE 18B.

Application date

The amendments apply from 30 June 2014, being the date of enactment.

Detailed analysis

An inflation-indexed bond is a bond in which the nominal capital value invested increases by a measure of inflation in any year. The measure of inflation is generally a price index published by Statistics New Zealand and is actually credited when the bond matures, but is taken into account in calculating the coupon payments.

The coupon paid in any year is paid quarterly on the capital value of the bond. The capital value of the bond is the face value or nominal amount of the bond adjusted for cumulative changes in the Consumer Price Index.

Section EI 2 treats the inflation-indexed component as income having been credited at the end of the year.

Tax treatment of inflation-indexed instruments

The tax treatment of inflation-indexed bonds falls within the relevant RWT, NRWT and inflation-indexed instruments provisions in the Income Tax Act.

RWT is due on most forms of interest for New Zealand residents who do not hold an RWT exemption certificate.

NRWT is also due on most forms of interest for non-residents, unless a 0% NRWT rate applies. In most cases where a 0% NRWT rate applies, approved issuers (or a person on their behalf) must pay a levy on the securities they register with Inland Revenue, known as the approved issuer levy (AIL).

Approved issuers are able to pay interest to non-residents without deducting NRWT. Instead approved issuers are required to pay a levy at the rate of 2% for every dollar of interest paid on the inflation instrument.

If RWT or NRWT has been deducted at the wrong rate, the taxpayer may be obliged to file a tax return at the end of the year and make up the difference (or receive a refund). NRWT for the majority of non-resident holders is a final withholding tax.

Problems the amendments seek to address

Two technical tax problems have been identified with the reissuance of these bonds which these amendments seek to address.

The primary problem is the potential for a withholding tax obligation to exceed the coupon amount. In this situation, the issuer of an inflation-indexed bond would have a liability to pay withholding tax, but no administratively workable "payment" to deduct it from.

At present this problem is a potential risk rather than an actual problem. The current coupon rate for the new Government issue of inflation-indexed bonds is 2% per annum and this low coupon rate increases this potential

risk. The following table provides an indication of what the rate of inflation needs to be in order for the potential risk to become a problem.

Tax type and rate	Coupon rate	Annual inflation rate for the coupon payment to be insufficient
RWT at 33%	2%	4.1%
RWT at 30%	2%	4.7%
RWT at 17.5%	2%	9.5%
NRWT at 15%	2%	11.3%

While the risk of withholding tax exceeding the coupon payment is currently perceived to be low, the changes go some way towards mitigating the cashflow and potential tax collection consequences if the inflation risk profile were to change significantly.

The amendments that limit the RWT liability to the amount of the coupon are not extended to NRWT because the risk is considered lower.

The second and related problem stems from a timing issue. The legislation intends that RWT should be deducted annually from the inflation-indexed component. However, the coupon is generally paid quarterly and the administrative practice is to withhold the tax on the inflation-indexed component for the previous quarter, and deduct it from the coupon payment. This can result in an unclear situation where an issuer may be withholding tax from a coupon amount in advance of the bond holder's legal obligation because there is some form of cashflow from which to deduct the withholding tax.

So that Inland Revenue can administer these changes, additional record-keeping requirements for the bond issuer and filing requirements for the bond holder have also been included in the new legislation.

DEDUCTIONS FOR UNDERGROUND GAS STORAGE FACILITIES

Sections CT 1, CT 7 and CZ 32 of the Income Tax Act 2007

The Income Tax Act 2007 has been amended to remove from the ambit of the petroleum mining tax rules underground facilities that are used to store processed gas. Transitional provisions have been included to clarify the treatment of any sale proceeds from a sale of an underground gas storage facility that is currently treated as being subject to the petroleum rules and to grandparent an existing permit.

Background

Prior to this amendment, underground facilities for storing processed gas were eligible for concessionary treatment as a petroleum mining asset. This meant that expenditure on an underground gas storage facility was deductible over seven years, instead of over the economic life of the facility (which would be the treatment under the depreciation rules). This was seen as contrary to the policy intent that only expenditure on petroleum exploration and development should be eligible for concessionary treatment. The underground storage of gas that has already been extracted and processed is not considered to be an exploration or development activity.

Key features

Section CT 7 has been amended to prevent underground facilities used to store processed gas being treated as petroleum mining assets. These underground facilities will be subject to the depreciation rules, rather than the petroleum mining rules. The amendment uses the definition of "underground gas storage facility" from section 2 of the Crown Minerals Act 1991.

The proceeds received from the sale of an underground gas storage facility are currently treated as being on revenue account under the petroleum mining rules (section CT 1). Following the removal of underground storage facilities from the petroleum mining rules, the sale of an underground gas storage facility will be treated as being on capital account.

However, section CZ 32 provides a transitional rule for the tax treatment of proceeds from selling an underground gas storage facility constructed before the amendments come into force. This rule overrides section CT 1(2).

Consideration received from a disposal must be apportioned to reflect the amount of expenditure that has been incurred under the existing rules. For example, if an underground gas storage facility is sold for $500 million in 2016, with $300 million of expenditure incurred before the amendments are enacted and $100 million incurred after the amendments are enacted, the amount of income from selling the facility would be:

$300 million ÷ $400 million × $500 million = $375 million.

Section CZ 32(4) provides a grandparenting provision for an existing gas storage facility.

Application date

These changes take effect from the date of Royal assent, being 30 June 2014.

RECIPIENTS OF CHARITABLE OR OTHER PUBLIC BENEFIT GIFTS

Schedule 32 of the Income Tax Act 2007

The following organisations have been granted donee status from the 2015–16 income year:

- Every Home Global Concern Incorporated
- Namibian Educational Trust.

Background

New Zealand-based charities who apply some or all of their funds for overseas purposes and who want donors to receive tax benefits in connection with any donations received, are required to be named as a donee organisation on the list of recipient of charitable or other public benefit gifts in the Income Tax Act 2007.

Donee status entitles individual donors to a tax credit of 33⅓ percent of the monetary amount donated to these organisations, up to the level of their taxable income. Companies and Māori Authorities are eligible for a deduction for monetary donations up to the level of their net income.

Application date

The change applies from the 2015–16 and later income years.

CLASSIFICATION OF MINING PERMITS AS REAL PROPERTY FOR INCOME TAX PURPOSES

Section YA 1 of the Income Tax Act 2007

A definition of "real property" in section YA 1 has been enacted to clarify that mining permits issued under the Crown Minerals Act 1991 are "real property" for the purposes of the Income Tax Act 2007 and New Zealand's double tax agreements (DTAs).

Background

Under the previous rules, there was some uncertainty about the treatment of mining permits for tax purposes because section 91 of the Crown Minerals Act 1991 states that a mining permit is neither real nor personal property.

The new definition of "real property" will ensure that New Zealand has source-taxing rights over income from these permits under Article 6 of its DTAs, which applies to income from real property. This is consistent with the approach taken in New Zealand's newer DTAs (signed since the 1990s) where mining permits fall within the definition of "real property" contained in those treaties.

Key features

Section YA 1 now contains a definition of "real property" which includes a permit as defined in the Crown Minerals Act 1991.

Application date

The new definition of "real property" applies from the date of enactment, being 30 June 2014.

EXTENDING THE TAX EXEMPTION FOR NON-RESIDENT OFFSHORE OIL RIG AND SEISMIC VESSEL OPERATORS

Section CW 57 of the Income Tax Act 2007

Section CW 57 contains a temporary exemption for non-resident offshore oil rig and seismic vessel operators. This exemption was due to expire on 1 January 2015, but has been extended to 31 December 2019. The scope of the exemption has been modified slightly to cater for two particular types of operator. These modifications will apply from 1 January 2015.

Background

Offshore rigs and seismic vessels operated by non-residents are covered by an exemption in section CW 57. These rigs and vessels are used to drill for oil and gas and gather data on potential oil and gas finds. There is a worldwide market in rigs and seismic vessels. No New Zealand company owns offshore rigs or seismic vessels, so any company wishing to explore in New Zealand waters needs to use a rig or seismic vessel provided by a non-resident owner.

Section CW 57 was introduced to deal with a problem created by our double tax agreements (DTAs). New Zealand generally taxes non-residents on income that has a source in New Zealand. However, our DTAs provide that non-residents are only taxable on their New Zealand-sourced business profits if they have a "permanent establishment" in New Zealand. Many of our DTAs (such as the New Zealand-United States DTA) have a specific rule providing that a non-resident enterprise involved in exploring for natural resources only has a permanent establishment in New Zealand if they are present for a particular period of time, often 183 days in a year. Once a non-resident has a permanent establishment in New Zealand, they are taxed on all their New Zealand business profits starting from day one.

The issue caused by this DTA provision was that seismic vessels and rigs used in petroleum exploration were leaving New Zealand waters before the 183-day limit was reached so they would not be subject to New Zealand tax. This meant that, in some cases, a rig would leave before 183 days and a different rig was mobilised to complete the

exploration programme. This "churning" of rigs increased the cost for companies engaged in exploration and had the potential to delay exploration drilling and any subsequent discovery of oil or gas.

A temporary five-year exemption from tax on the income of non-resident offshore oil rig and seismic vessel operators was introduced in 2004. This exemption was rolled over in 2009 for a further five years and expires on 31 December 2014.

Key features

The temporary tax exemption for non-resident offshore oil rig and seismic vessel operators in section CW 57 of the Income Tax Act 2007 has been extended to 31 December 2019, subject to two modifications:

- The exemption now excludes operators of drilling rigs of modular construction that are installed on an existing offshore platform. This is because these modular drilling rigs were never intended to be included within the scope of the exemption, which was designed with larger rigs (specifically semi-submersible and jack-up rigs) in mind. Modular drilling rigs do not have the same high mobilisation and demobilisation costs as larger rigs, which means the rationale for the exemption does not apply in relation to these rigs.
- The exemption now includes operators of electromagnetic surveying vessels. From a policy perspective, it is generally desirable for substitutable products to be given the same or similar tax treatment whenever possible. Because electromagnetic and seismic surveying are two techniques that achieve broadly the same result for the same purpose, the exemption has been expanded to include operators of electromagnetic vessels.

Application date

The exemption takes effect at the expiry of the existing exemption, on 1 January 2015. The modifications to the exemption will also apply from that date.

TAX TREATMENT OF FOREIGN FISHING CREWS

Section YA 1 of the Income Tax Act 2007 and sections 3(1) and 33A(1B) of the Tax Administration Act 1994

As a result of the Government implementing changes to the way foreign charter vessels are regulated in New Zealand waters, foreign charter vessels will be required to reflag to New Zealand by May 2016.

Following the reflagging, New Zealand companies that use foreign charter vessels in New Zealand waters will become the employers of the non-resident fishing crews. The New Zealand-sourced income of the crew members will be taxable and subject to PAYE deductions.

Key features

To collect the correct amount of tax from members of non-resident fishing crews, and to reduce the compliance costs on the crew members, the following changes have been made:

- All non-resident members of the fishing crews are to be taxed on their New Zealand-sourced income at a flat rate of 10.5%.
- The requirement on the crew members to file tax returns on completion of a fishing season, or at year's end, has been removed.

For simplicity and consistency reasons, all non-resident members of fishing crews will be subject to these changes. This applies without regard to the type of vessel on which they are employed (a foreign charter or a domestically owned vessel), and without regard to the position occupied by them (for example, captain or deckhand).

Detailed analysis

The 10.5% flat tax rate

The 10.5% flat tax rate reflects the fact that the annual New Zealand-sourced income of the overwhelming majority of non-resident fishing crew members is less than $14,000. This 10.5% flat rate therefore accurately reflects the annual tax liability that would arise for members of non-resident fishing crews using annual rates, and the tax payable by New Zealand residents on the same amount of income. If the M tax code were to be used for PAYE, the members of fishing crews would be overtaxed, because this tax code assumes that an employee works, and is subject to New Zealand income tax, for a full year.

ACC earner premium

ACC earner premium should be deducted only from the New Zealand-sourced portion of income of non-resident crew members, with the applicable rate being the rate in force at the time of the deduction.

No return filing requirement

The requirement to file tax returns has been removed, to reduce compliance and administrative costs. Although non-resident members of fishing crews are able to file end-of-year tax returns if they wish to do so, it is not expected that they will do so to a significant degree. This is because the withholding rate of 10.5% accurately reflects their annual tax liability.

Non-resident status

To be covered by these changes, fishing crew members must remain non-resident for tax purposes for the whole

duration of their stay in New Zealand. That means that those crew members who are defined as New Zealand tax residents in accordance with section YD 1 of the Income Tax Act 2007, will be subject to standard PAYE rules.

Taxable portion of income

The portion of income that is sourced in New Zealand under section YD 4(4) and is subject to New Zealand tax is based on the actual percentage of time spent by non-resident crew members within New Zealand's territorial limits. "Territorial limits", for the purposes of these changes, include the Territorial Sea, and the land. The Territorial Sea is the belt of coastal waters extending 12 nautical miles (22.2 km) from the New Zealand coast. Employers will need to include only that portion of income earned while within New Zealand's territorial limits on employer monthly schedules.

Example

A foreign charter vessel with a non-resident fishing crew fishes within New Zealand's Exclusive Economic Zone.[15] They come within New Zealand's territorial limits for 11.5 days (rounded to the nearest hour) out of every 31 days.

If the crew members are paid monthly, the proportion of their monthly pay that is sourced in New Zealand and subject to tax is 11.5/31 or 37.1 percent.

The time spent within New Zealand's territorial limits, to determine the portion of income subject to New Zealand tax, includes any time under the employment contract between an employee and their employer, whether or not any physical services have been performed within the territorial limits by the employees.

Amendments to legislation

Income Tax Act 2007

To give effect to the flat tax rate on the income of the members of non-resident fishing crew the following legislative amendments have been made:

- The definition of "non-resident seasonal worker" in section YA 1 has been amended to include those workers employed under the foreign crew of fishing vessels instructions. This change ensures that these workers can use the "NSW" tax code which deducts tax at the rate of 10.5%.
- A new definition, "foreign crew of fishing vessels instructions", is inserted in section YA 1. This definition links back to the immigration instructions certified under section 22 of the Immigration Act 2009.

Tax Administration Act 1994

An amendment has been made to section 33A(1B) to ensure that members of non-resident fishing crews are not required to file tax returns, in the same manner as other non-resident seasonal workers.

Application date

The amendments apply from 1 October 2014.

AMATEUR SPORTS TAX PROMOTERS' EXEMPTION – INCLUSION OF TRUSTS

Section CW 46 of the Income Tax Act 2007

Section CW 46 of the Income Tax Act 2007 has been amended to ensure that trusts can take advantage of the amateur sports promoters exemption.

Background

Previously, section CW 46 of the Income Tax Act provided that the income derived by a "club, society or association" established mainly to promote an amateur game or sport is exempt income. The game or sport must be conducted for the recreation or entertainment of the general public and no part of the funds can be available for the pecuniary profit of a member, proprietor or shareholder.

Inland Revenue's interpretation was that section CW 46 did not apply to trusts that had been established for the purposes of promoting amateur sport. This is on the basis that a trust is not a "club, society, or association". The result of this interpretation was that a trust that had been established to promote an amateur game or sport, and that otherwise met the requirements of section CW 46, was treated differently from other entities established with an identical purpose.

There was no clear policy basis for excluding trusts from the amateur sports promoters' income tax exemption. As a matter of principle, tax exemptions should be applied consistently to organisations with the same objects and purposes, regardless of their legal form.

Key features

Section CW 46 has been amended to include the terms "trustee or trustees of a trust" and "promoter". These amendments confirm that sporting trusts may be eligible for the income tax exemption for amateur sports promoters.

Application date

The amendments are retrospective in nature and will apply for the past four income years, which corresponds to the time in which the Commissioner of Inland Revenue can reassess tax liabilities. This means the amendments will apply from the 2010–11 and later income years.

[15] Exclusive Economic Zone comprises an area which extends from the coast to 200 nautical miles (370 km), and includes the Territorial Sea.

GST

Sections 2 (definition of commercial dwelling, dwelling and resident), 3(2) (definition of life insurance contract), 6(3), 11(1)(p)(ii), 11(8D), 11(A)(1)(maa), 11A(3B), 20(3K), 20(3LB), 20(3LC), 20(4B), 21FB, 21(HB), 25(4), 46(1B), and 54C of the Goods and Services Tax Act 1985; section YA 1 of the Income Tax Act 2007; and section OB 1 of the Income Tax Act 2004

The new Act introduces a number of Goods and Services Tax (GST) amendments to clarify and reinforce existing GST policy, and reduce compliance costs. All section references refer to the Goods and Services Tax Act 1985 unless otherwise stated.

DWELLING DEFINITION – RETIREMENT ACCOMMODATION

Section 2 (definition of dwelling and commercial dwelling) and section 21HB

Two amendments have been made to the dwelling and commercial dwelling definitions to clarify that residential units in retirement villages and rest homes where the occupants are essentially living independently are treated as GST-exempt "dwellings". Transitional rules have also been introduced in section 21HB for retirement villages and rest homes that have treated residential units as taxable commercial dwellings.

Background

GST is imposed on accommodation in "commercial dwellings" such as hotels but not in "dwellings" such as private residences, which are GST-exempt.

The definitions of "dwelling" and "commercial dwelling" were amended on 1 April 2011. The policy intention behind the changes was to clarify the boundary between these definitions, and to narrow the scope of what could be considered a "dwelling" on the basis of economic equivalence with owner-occupied homes.

Following the 2011 amendments, concerns were raised that accommodation in residential units in retirement villages and rest homes may not meet the new dwelling definition requirement of providing "quiet enjoyment". As such, despite the previous treatment of these units as GST-exempt dwellings, they could be treated as taxable commercial dwellings. This did not align with the policy intent, which was to maintain the pre-April 2011 GST treatment of retirement village and rest home accommodation.

Key features

The amendment to the "dwelling" definition creates a new subsection (b)(iii) which states that when the consideration paid or payable for the supply of accommodation in a retirement village or rest home is for the right to occupy a residential unit, the unit will be treated as a dwelling.

The amendment to the "commercial dwelling" definition will replace subsection (b)(ii) with a cross-reference to the new amendment to the "dwelling" definition. This ensures that units in retirement villages where the occupants are living independently are excluded from the "commercial dwelling" definition.

A special transitional rule has been introduced, under section 21HB. It gives taxpayers that have been treating the supply of residential units as taxable for GST purposes from 1 April 2011 the choice of continuing to treat the supply of residential units in retirement villages and rest homes as taxable.

This amendment recognises that affected taxpayers have made commercial decisions on the basis that the supply of these residential units would be taxable. However, the taxable treatment option would only apply to residential units acquired before 1 April 2015. The supply of residential units acquired after that date would be treated as exempt.

Alternatively, taxpayers that have been treating the supply of residential units as taxable for GST purposes from 1 April 2011, can decide to return to exempt treatment before 31 March 2015. For these taxpayers, a "savings" provision applies to turn off the application of the wash-up rule under new section 21FB. Therefore, these taxpayers would not be required to return input tax deductions claimed between 1 April 2011 and 31 March 2015 in one lump-sum payment. Instead, the regular apportionment rules would apply to take into account the change of use brought about by the dwelling amendment, thereby allowing the payments to be spread over time.

Application dates

The amendments apply for the 2011–12 and later income years. A "savings" provision preserves tax positions taken up until 31 March 2015 on the basis that the supply of residential units became taxable as a result of the 1 April 2011 amendments.

CHANGE OF TAX RESIDENCY FOR GST PURPOSES

Section 2 (definition of resident)

The amendment to the GST definition of "resident" turns off the retrospective application of the day test rules for determining the tax residency status of individuals. For GST

purposes, the day test rules now apply on a prospective basis.

Background

The residency status of a person for GST purposes is determined by section YD 1 of the Income Tax Act 2007. The provision contains two rules that determine a person's tax residence—the permanent place-of-abode rule and the day-count rules.

There are two "day count" rules, the 183-day rule for determining whether a person becomes a tax resident, and the 325-day rule for determining when a person ceases to be a tax resident. Previously, once the time period had been exceeded, the person's residence status was backdated to the beginning of the time-period.

A number of provisions in the GST Act refer to the residency status of a person, for example, the provision that allows services supplied to non-residents who are offshore at the time of supply to be zero-rated. The retrospective application of the day-count rules meant that the GST treatment applied at the time of the transaction (based on the facts known at the time) could subsequently become incorrect.

The retrospective application of the rules led to uncertainty. This was because the service provider was unlikely to be aware upfront of whether the non-resident would become a resident (or vice versa) after the services had been provided. The amendment addresses this problem by turning off the retrospective application of the residency rules in relation to both the 183-day residence test, and the 325-day absence test.

Key features

Whether a person is a resident or non-resident for the purposes of the GST Act is dependant, in part, on whether the person is present or absent from New Zealand for a certain period of time as determined by section YD 1 of the Income Tax Act 2007. Previously, once the time-period was exceeded, the person's residence status was backdated to the beginning of the time period (see section YD 1(4) and (6) of the Income Tax Act 2007).

The amendment to the definition of "resident" under section 2 of the GST Act means when applying the resident day-count rules, a person is now treated as a resident or non-resident for the purposes of the GST Act on a prospective basis. Specifically:

- To be considered tax resident, a person must be present in New Zealand for more than 183 days in total, over a 12-month period. The amendment means that a person will be treated as being a tax resident from the first day after the 183-day period has been exceeded.
- To be considered non-resident, a person must be outside New Zealand for more than 325 days in a 12-month period. In this case, the resident will be regarded as a non-resident from the first day after the 325-day period has been exceeded.

It is important to note that the day-count rules are not the only rules for determining an individual's tax residency status, and the amendment does not affect the application of the "permanent place of abode" test.

Application date

The amendment applies from the date of Royal assent, being 30 June 2014.

DIRECTORS' FEES

Section 6(3)

Two amendments have been made to section 6 that relate to the GST treatment of fees paid to directors and board members.

The first amendment provides that when an employee is engaged by a third party to be a director or board member, and the employee is required to remit fees to their employer for any payments received, the employer will be treated as supplying services to the third party. The employer will therefore return GST and the third party will be able to claim input tax on the payment for these services.

The second amendment extends the proviso under section 6(3)(b), that deems services performed by directors to be supplied in the course and furtherance of a taxable activity when that director has a broader taxable activity, to persons listed in section 6(3)(c)(iii) such as members of boards.

Background

The first amendment relates to an issue identified in an Inland Revenue Public Ruling (BR Pub 05/13) regarding the GST treatment of directors. It occurs when an employee who is not GST-registered is engaged by a third party to be a director and is required to remit fees paid by the third party to their GST-registered employer.

In this situation, the directors' fees paid to the employee are not subject to GST because the employee is precluded from having a taxable activity. However, when the employee passes these fees on to their employer, the employer is required to account for output tax on the payment as it is a payment received in the course and furtherance of their taxable activity.

This result means that the third party will not receive an input tax deduction for the fees paid. The director's employer will, however, have to account for output tax on the amount reimbursed by the employee. The same issue

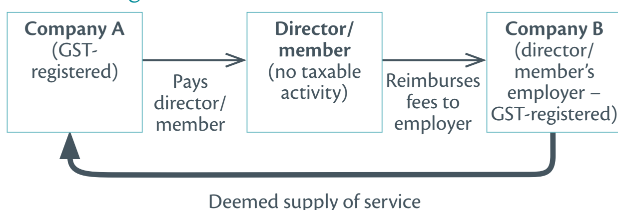
could arise in relation to the persons listed in section 6(3)(c)(iii), such as members of boards.

The second amendment concerns the exception to the rule that precludes a director from carrying on a taxable activity, under section 6(3)(b). The rule applies when directors have a broader taxable activity, in which case their services as a director are deemed to be supplied in the course and furtherance of that taxable activity. However, members of boards and the other persons listed in section 6(3)(c)(iii) can also have broader taxable activities. In this sense the persons listed in section 6(3)(c)(iii) are similar to directors, therefore arguably directors and members of boards should be subject to the same rules.

Key features

The first amendment creates a "flow-through" rule (shown below) that deems services to be supplied by an employer (Company B) to a third party (Company A) when an employee is engaged by the third party to be a director or person listed in section 6(3)(c)(iii) (such as a board member) and when the employee is required to account for any fees or other amounts to their employer (Company B). The rule will in effect require the employer (Company B) to issue a tax invoice for the fees paid and the third party (Company A) will be able to claim the related input tax deduction.

Flow-through rule



The second amendment extends the provision that deems services performed by directors to be supplied in the course and furtherance of a taxable activity when that director has a broader taxable activity, to persons listed in section 6(3)(c)(iii) (such as members of a board).

Application date

The amendments apply from the date of Royal assent, being 30 June 2014.

SURRENDERS AND ASSIGNMENTS OF INTERESTS IN LAND

Section 11(8D)

An amendment to section 11(8D) has been made to clarify that assignments and surrenders of interests in land are subject to the zero-rating of land rules.

Background

The policy intent of section 11(8D)(a) is to treat assignments and surrenders of interests in land as zero-rated when the requirements for the zero-rating of land rules are met.

The previous wording of section 11(8D) arguably treated all "surrenders" or "assignments" of interest in land as zero-rated, even when the other zero-rating land transaction requirements were not met, for instance, when the recipient of the supply is not GST-registered.

Key features

The amendment will replace "chargeable with tax at 0%" with "under subsection (1)(mb) if it meets the requirements set out in that subsection" in section 11(8D)(a) and (b). Therefore, the GST treatment of assignments and surrenders of interests in land will depend upon meeting the zero-rating of land requirements in section 11(1)(mb).

Application date

The amendment applies from 1 April 2011.

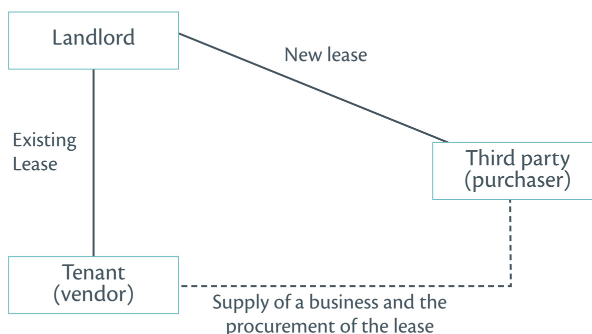
PROCUREMENT OF A LEASE

Section 11(8D)

An addition to section 11(8D) has been made to ensure payments for the procurement of a lease are subject to the zero-rating of land rules.

Background

There were concerns that the procurement of a lease when purchasing a business did not fall under the zero-rating of land rules. For example, as a condition of a business sale, the purchaser requires the vendor to arrange for the landlord to enter into a new lease with the purchaser.



An argument could be made that when a new interest has been created in the procurement transaction, no transfer of an interest in land occurs between the vendor and the purchaser. Therefore, any consideration payable in relation to this supply could not be zero-rated. This was inconsistent with lease assignments which are subject to the zero-rating of land rules.

Key features

An addition to section 11(8D) has been made to ensure new interests in land through a procurement of a lease by a third party of an existing lease will be zero-rated, subject to the zero-rating of land requirements of section 11(1)(mb) being met.

Application date

The amendment applies from the date of Royal assent, being 30 June 2014.

ZERO-RATING TOOLING COSTS

Section 11A(1)(maa)

New subsection 11A(1)(maa) ensures services carried out on tools are zero-rated when the tools are used in New Zealand solely to manufacture goods that will be exported.

Background

The Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 extended the application of the zero-rating rules to tools used in New Zealand solely to manufacture goods for export when they are supplied to a recipient who is a non-resident and not GST-registered (see section 11(1)(p)).

A further amendment was required to ensure that when services are carried out on tools that are to be zero-rated under the new provision, the services can also be zero-rated. This is consistent with the treatment of services in relation to exports more generally and the policy intention of GST neutrality in cross-border trade.

Key features

New subsection 11A(1)(maa) zero-rates services supplied directly in connection with goods, the supply of which is subject to section 11(1)(p) and for a recipient who, when the services are performed, is a non-resident and not a registered person.

Application date

The amendment applies from the date of Royal assent, being 30 June 2014.

ZERO-RATED SERVICES SUPPLIED TO NON-RESIDENTS

Section 11A(3B)

Section 11A(1)(k) allows services supplied to non-residents that are outside New Zealand at the time the services are being performed to be zero-rated. New section 11A(3B) has been introduced to allow "outside New Zealand" to be interpreted, for a natural person (individual), as a presence in New Zealand that is minor and not directly in connection with the supply.

Background

New Zealand's GST system is based on the "destination principle" under which supplies of goods and services are taxed in the jurisdiction where the goods and services are consumed. Since services supplied to offshore non-residents will not typically be consumed in New Zealand, the services are zero-rated (see section 11A(1)(k)). This ensures GST is not a cost to overseas consumers.

The zero-rating rule suggests that the supplier must have knowledge of the whereabouts of the non-resident consumer during the period in which the services are performed. However, this may not always be realistic, for example, in some cases the non-resident may visit New Zealand (during the period the service is supplied) on a matter that is unrelated to the services being supplied. In this situation the supplier may be unaware of the non-resident's presence in New Zealand and may mistakenly zero-rate the service.

The amendment addresses this problem by allowing services to remain zero-rated as long as the non-resident's presence is "not directly in connection" with the services being supplied. However, to ensure services are only zero-rated when they are performed to a non-resident that is predominantly outside New Zealand, the amendment also requires the non-resident's presence in New Zealand to be "minor" in nature.

Key features

A new section 11A(3B) has been introduced and applies for the purposes of section 11A(1)(k) of the GST Act. Section 11A(1)(k) zero-rates services supplied to non-residents who are outside New Zealand at the time the services are performed, unless the services are directly connected with land or personal property situated in New Zealand.

The new section defines "outside New Zealand" for the purposes of section 11A(1)(k), which includes a minor presence in New Zealand that is not directly in connection with the supply.

Detailed analysis

In practice, whether or not a person's presence in New Zealand is "minor" and "not directly in connection" with the supply, will be factual.

The policy rationale behind the new section is to deal with situations when it is unreasonable for the supplier to be aware that the non-resident is in New Zealand during the time the services are performed, and therefore, whether the services should be zero-rated. In practice, if the supplier is unaware of the person's presence in New Zealand, it is

less likely that the presence is directly connected with the services being performed.

The requirement that the presence be "minor" is to ensure the non-resident is predominantly outside New Zealand while the services are being performed. If the non-resident is present in New Zealand for most of the time the services are being performed (despite the fact that the presence may be unrelated to the services being performed) the person's presence will not be considered as minor, and therefore, the services cannot be zero-rated.

Example

Jim, a non-resident, applies for a visa to work and live in New Zealand. The visa application process takes six months to complete. During this period Jim visits New Zealand for two weeks to view some property that he would like to purchase. The immigration consultant is unaware of Jim's visit to New Zealand.

In the above example, while Jim's presence in New Zealand could be regarded as being connected with his move to New Zealand, it is not "directly" connected to the supply of immigration services. Jim's presence is also relatively minor compared with the six month period in which the services are performed. Therefore, the services can still be zero-rated despite Jim being in New Zealand during some of the time the services are performed.

Example continued

One of Jim's visa requirements is that he has a job offer from an accredited employer. Therefore, on a separate occasion Jim visits New Zealand for two weeks to seek employment opportunities. During his visit he meets with the immigration consultant to discuss job opportunities in New Zealand.

In this situation, it is more likely that Jim's presence is directly connected with the supply of immigration services. Therefore, the services cannot be zero-rated and must be standard-rated.

Application date

The amendment applies from the date of Royal assent, being 30 June 2014.

NON-PROFIT BODIES EXEMPTION

Section 20(3K)

An amendment to section 20(3K) clarifies that non-profit bodies can claim all of their GST input tax deductions other than those that relate to the making of exempt supplies.

Background

Non-profit bodies are able to apply a special input tax deduction rule that allows them GST deductions on the acquisition of any goods or services received except to the extent that those goods or services are used for making exempt supplies. However, the introduction of the new GST apportionment rules on 1 April 2011 created some uncertainty around the application of the special rule.

This is because the definitions of "percentage actual use" and "percentage intended use" only enable input deductions to the extent that goods and services are actually used for making "taxable supplies". Hence, it was arguable that non-profit bodies may not be able to claim input tax credits for purchases that relate to non-exempt supplies.

The new apportionment rules were not intended to alter the GST input tax entitlements of non-profit bodies.

Key features

The amendment ensures that non-profit bodies can claim all of their GST input tax deductions except those that relate to exempt supplies. It achieves this by extending the application of section 20(3K) so that it applies for the purposes of section 20(3) and (3C), and the definitions of "percentage actual use" and "percentage intended use" in section 21G(1).

Application date

The amendment applies from 1 April 2011.

NON-RESIDENT REGISTRATION RULES

Sections 20(3LB) and 20(3LC)

New sections 20(3LB) and (3LC) limit the ability of GST-registered non-residents to claim input tax deductions that relate to GST levied by the New Zealand Customs Service.

Background

The Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 introduced rules under which non-resident businesses can register for New Zealand GST and claim input tax deductions for GST incurred. This ensures that GST is neutral for these businesses in the same way as it is for domestic businesses. The new rules took effect from 1 April 2014.

However, a potential fiscal risk with the design of these new non-resident registration rules was identified. The new rules may have enabled registered non-residents to sell high-value goods to New Zealand private consumers without the net imposition of GST.

This could be achieved by the non-resident treating themselves as the "importer" of the goods so that the GST liability falls on the non-resident rather than the recipient of the good. The non-resident would then be able to claim an input tax deduction for the GST incurred on importation. Because the goods were offshore at the time of supply, GST would not be required to be returned on the sale. Therefore, no net GST would be collected despite the final consumer having received the imported good.

Key features

The new sections 20(3LB) and (3LC) limit the ability of GST-registered non-residents to claim input tax deductions in relation to GST levied by the New Zealand Customs Service. Instead, when the non-resident acts as an "importer", the recipient of the good will be treated as if they had paid the GST and will be entitled to an input tax deduction for the GST if they are GST-registered and receiving the goods as part of their taxable activity.

However, the new section does not apply when the non-resident is in fact the recipient of the good, unless the non-resident is merely delivering the good to another person in New Zealand.

Application date

The amendment applies from 1 April 2014, the date the new non-resident registration rules came in to force.

ALLOWING INPUTS TO REGISTERED PERSONS SUBJECT TO THE DOMESTIC REVERSE CHARGE

Section 20(4B)

An amendment has been made to section 20(4B) to ensure that it does not prevent a person from claiming an input tax deduction in cases when they are already registered for GST.

Background

In limited situations, zero-rating can give rise to the revenue risk of purchasers avoiding paying GST by intentionally or unintentionally representing that they are GST-registered and making the relevant taxable supplies. The "domestic reverse charge" mitigates this risk by requiring the purchaser in this situation to account for the output tax on the sale of the land, but preventing the purchaser from claiming an input tax deduction in relation to this sale (unless they subsequently become registered).

What was not catered for is a purchaser who is already GST-registered incorrectly zero-rating a transaction, for example, as a result of a genuine error. Under the previous legislation, output tax would be payable under section 20 with no corresponding input tax credit.

Key features

The amendment extends the scope of the exclusion in section 20(4B) to cover a person that is already registered. This will mean that if a purchaser was already registered for GST when they incorrectly zero-rated a transaction, they will still be able to claim an input tax deduction to offset the GST paid under the domestic reverse charge.

The extended exclusion will only apply to the extent that the person uses the goods for making taxable supplies.

Application date

The amendment applies from 1 April 2011.

WASH-UP RULE FOR TAXABLE OR NON-TAXABLE USE

Section 21FB

New section 21FB requires taxpayers who have applied the apportionment rules to perform a "wash-up" calculation when their use of an asset changes to 100 percent taxable or 100 percent non-taxable use.

Background

A taxpayer who purchases an asset with the purpose of using it for both taxable and non-taxable purposes must apportion their input deductions to account for the non-taxable use. However, if the taxpayer changed the use of the asset to 100 percent taxable, under the previous rules they were still required to perform on-going input tax adjustments. This posed a compliance cost burden on taxpayers, especially in relation to long-lived assets such as land.

New section 21FB allows taxpayers to claim a 100 percent deduction or return input tax already claimed earlier to avoid this compliance burden.

Key features

The amendment applies to assets that have been subject to the apportionment rules and requires taxpayers to perform a compulsory "wash-up" calculation to account for any unclaimed input tax or pay output tax when the use of the asset changes to solely taxable or solely non-taxable.

Under new section 21FB:

- Taxpayers that change from mixed-use to 100 percent taxable use of an asset will be able to claim the "full input tax deduction" (defined under section 21D(2)(a)) less the "actual deduction" (defined under section 21F(3)(c)).
- Taxpayers that change from mixed-use to 100 percent non-taxable use of an asset will be required to pay output tax equal to the "actual deduction" already claimed.

Under the new rules, once the wash-up calculation has been performed, taxpayers will no longer be required to make any on-going adjustments.

To qualify for the "wash-up", the taxpayer will need to sustain the 100 percent taxable or non-taxable use of their asset for the current adjustment period and the next adjustment period (up to two years).

Example

John purchases a building that is used 50 percent for commercial use and 50 percent as residential apartments. On the basis that the apartments will be leased as dwellings, an input tax deduction of 50 percent is taken at the time of purchase. After two years, John gives notice to his tenants and signs an agreement with a management company that will operate the apartments as serviced apartments for business travellers.

As serviced apartments are commercial dwellings, the building is now being used solely for making taxable supplies. If the apartments continue to be used solely for making taxable supplies for the remainder of the adjustment period and for the following adjustment period, the balance of the unclaimed input tax deduction can be claimed taking into account any adjustments made leading up to the second adjustment period after the change in use.

Application date

The amendment applies from the date of Royal assent, being 30 June 2014.

TRANSITIONAL RULE FOR COMMERCIAL DWELLING ACQUISITION COSTS BEFORE 1 OCTOBER 1986

Section 21HB

An amendment to the transitional rule in section 21HB ensures that input tax deductions cannot be claimed in relation to a dwelling reclassified as a commercial dwelling if it was acquired before 1 October 1986.

Background

Section 21HB was originally introduced to address transitional problems associated with the 1 April 2011 changes to the "dwelling" and "commercial dwelling" definitions. The rule gave suppliers of accommodation who were required to start charging GST as a result of the changes to the "dwelling" and "commercial dwelling" definitions the ability to claim input tax deductions for the acquisition costs of their newly defined "commercial dwelling" accommodation.

However, an unintended effect of the transitional rule was that suppliers affected by the definition changes could arguably claim input tax deductions for accommodation acquired before the introduction of GST on 1 October 1986. This is contrary to the policy rationale underlying the rule as this outcome would allow suppliers to claim input tax for property acquired when no GST was incurred.

Key features

The amendment to section 21HB(1) ensures that suppliers who are required to treat their supplies of accommodation as commercial dwellings as a result of the changes to the definitions of "commercial dwelling" and "dwelling" cannot claim input tax deductions for the acquisition costs incurred before 1 October 1986. This is achieved by replacing the requirement for the costs to be incurred before 1 April 2011, with the requirement that they were incurred between 1 October 1986 and 1 April 2011.

Application date

The amendment will apply for tax positions taken after 22 November 2013 (the date the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill was introduced).

TRANSITIONAL RULE FOR NEWLY DEFINED COMMERCIAL DWELLINGS

Section 21HB

The amendment to section 21HB allows suppliers affected by the changes to the definitions of "commercial dwelling" and "dwelling" to have the option of either including or not including a commercial dwelling as part of their broader taxable activity.

Background

The definitions of "dwelling" and "commercial dwelling" were amended on 1 April 2011. In certain situations, the amendments increased compliance costs by forcing taxpayers to register for GST. In particular, the amendments affected non-registered owners who had another activity, but were previously not required to register for GST as supplies from their other activity fell below the $60,000 GST registration threshold. However, the combined supplies from their newly defined commercial dwelling and their other activity pushed their supplies above the registration threshold and therefore required them to be registered.

Another situation where the amendment potentially increased compliance costs is when the owner of a newly defined commercial dwelling is registered for GST as a result of a separate activity. This owner may be forced to return GST on supplies of accommodation in their commercial dwelling even if the total supplies from their commercial

dwelling falls below the $60,000 registration threshold. If this person did not have a broader taxable activity they would not be required to return GST on their supplies of accommodation in their commercial dwelling.

Key features

The amendment to section 21HB gives a person the option not to treat a supply of accommodation in a dwelling affected by the 1 April 2011 amendments as a taxable supply. However, this option is not available if the total supplies of accommodation affected by the amendments exceeds the $60,000 GST registration threshold.

Application date

The amendment applies from 1 April 2011.

SCOPE OF THE "HIRE PURCHASE" DEFINITION

Section YA 1(a)(i) of the Income Tax Act 2007 and section OB 1(a) of the Income Tax Act 2004

The definition of "hire purchase agreement" has been broadened to include any contract where a person has an option to purchase.

Background

The definition of "hire purchase agreement", in section YA 1 of the Income Tax Act 2007 is intended to cover two types of agreement. The first is when the goods are let or hired to a person with an option to purchase (an "option to purchase agreement"). The second is when a person has agreed to purchase the goods with a condition (a "conditional contract of sale"). The main difference between the two is whether the person has agreed to purchase the goods at the time the relevant contract is entered into.

An amendment made to the "hire purchase agreement" definition that took effect from 1 April 2005 contained a drafting error which arguably meant a person's upfront agreement to purchase the goods is required in order for an arrangement to be a hire purchase agreement. This interpretation is inconsistent with the original policy intention, which was to capture both forms of agreement.

The amendment fixes the drafting error by extending the hire purchase agreement definition to include "option to purchase" agreements.

Key features

The definition of "hire purchase agreement" contained in section YA 1(a)(i) of the Income Tax Act 2007 and section OB 1(a) of the Income Tax Act 2004 has been amended to explicitly incorporate contracts under which the person has an option to purchase, but that option is not exercised until a later date.

Application date

The amendment applies from 1 April 2005, with a "savings" provision for taxpayers who filed returns under the contrary position until 30 June 2014, being the date of enactment.

OTHER REMEDIAL AMENDMENTS

A cross-reference to the Accident Insurance Act 1998 has been updated to the Accident Compensation Act 2001 in the definition of "life insurance contract" in section 3. The amendment applies from 1 April 2002.

The wording of section 11(8D)(b)(ii) has been amended to ensure commercial lease arrangements are standard-rated unless an irregular and large payment is made. The amendment applies from 1 April 2011.

Section 25(4) has been amended to ensure that when the supply of land has been incorrectly standard-rated instead of zero-rated, the recipient of the supply must correct any input tax claim in relation to that supply. The amendment applies from 1 April 2011.

Section 46(1B) has been amended to clarify that the extended period to claim refunds only applies to GST-registered non-residents under the non-resident registration rules (section 54B). The amendment applies from 1 April 2014.

Section 54C(3)(a) has been amended to clarify the effective date of non-resident deregistration. The amendment applies from 1 April 2014.

Section 54C(3)(b) has been amended to clarify the scope of the 5-year embargo on non-resident registration. The amendment applies from 1 April 2014.

CFC REMEDIALS

CFC AND FIF EXEMPTIONS FOR AUSTRALIAN UNIT TRUSTS

Sections EX 22 and EX 35 of the Income Tax Act 2007

Under the new rules Australian Unit Trusts that are not taxed as companies under Australian law are excluded from the exemptions for Australian controlled foreign companies (CFCs) (section EX 22) and interests in foreign investment funds (FIFs) resident in Australia (section EX 35). This change removes an inconsistency in the previous rules and ensures that the taxation of Australian Unit Trusts is consistent across both countries.

Background

Before the 2009 international tax reforms, taxpayers did not have to return attributed income in respect of their interest in a CFC if the CFC was resident in a "grey list" country. The grey list comprised eight countries that were thought to have broadly comparable tax systems to our own. Income earned in a grey list country was exempt and income earned in other countries was subject to tax.

When the grey list exemption for CFCs was repealed in 2009 it was replaced by an exemption for active income (the active business test) and an exemption for Australian CFCs. Passive income, which included interest, dividends and some types of rent, would be taxable, while active income, primarily business profits, would be exempt. The active business test granted a full tax exemption to CFCs that had only small amounts of passive income.

While the active business test required CFCs to earn less than 5 percent passive income, the Australian exemption was a broader, simpler test. CFCs had to be resident in Australia (and only resident in Australia) and subject to Australian income tax.

A broader exemption was justified in order to reduce compliance costs for SMEs. Many New Zealand firms looking to expand offshore made their first move across the Tasman and the Australian exemption meant these companies did not need to learn or comply with the attribution rules.

The simpler test is buttressed in two ways. First, Inland Revenue and the Australian Tax Office have a close working relationship which makes it easier to monitor and respond to trends and developments. Secondly, the opportunity for mischief is reduced as companies face similar levels of taxation in Australia to those in New Zealand.

An equivalent exemption for non-portfolio FIFs (that is, when a taxpayer holds more than a 10 percent interest in a FIF) was introduced when the FIF grey list exemption was repealed in 2012.

Australian Unit Trusts (AUTs) are generally seen as trusts under Australian tax law but are considered companies under New Zealand tax law.

Under the Australian trust regime only a low rate of tax is withheld from passive income; under the New Zealand CFC or non-portfolio FIF regime that income is exempt. In addition, no Australian tax is paid on non-Australian sourced income to which a New Zealand-resident beneficiary is presently entitled.

This outcome is concessionary and contrary to the policy objectives of the Australian exemption for CFCs. AUTs are unlikely to be used by New Zealand SMEs looking to expand offshore and the level of taxation on passive income is significantly lower in Australia than it would be in New Zealand.

Key features

Unit trusts cannot claim the Australian exemptions unless they are taxed under Australian law as companies (sections EX 22 and EX 35).

Application date

The changes apply to income years beginning on or after 1 July 2014.

REPEAL OF SECTION DB 55

Sections DB 44 of the Income Tax Act 2004 and DB 55 of the Income Tax Act 2007

Section DB 55 of the Income Tax Act 2007 has been repealed. This section allowed companies to claim deductions for expenses incurred in deriving exempt foreign dividends. This provision was introduced as exempt foreign dividends were subject to the foreign dividend payment (FDP) rules which were seen as being equivalent to a tax.

Background

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 repealed FDP and section DB 55 no longer served a purpose as exempt foreign dividends were no longer subject to the FDP rules.

Key features

Section DB 55 has been repealed from the 2008–2009 income year.

A "savings" provision is included to preserve assessments based on the current rules if the returns were filed before

NEW LEGISLATION

the date of introduction of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill on 22 November 2013, for the 2013 and 2014 income years, if the taxpayer has previously relied on that section.

A retrospective amendment has also been made to resolve a potential conflict between section DB 55 and the general rules governing deductions.

Application dates

The amendment repealing section DB 55 applies from 30 June 2009.

The amendment to section DB 55, and section DB 44 of the Income Tax Act 2004, applies from 1 October 2005.

INDIRECT INTERESTS IN FIFS

Sections EX 50 and EX 58 of the Income Tax Act 2007

The rules that apply to indirectly held interests in FIFs have been clarified. Additional FIF income is calculated only if the CFC or FIF holds an interest in a FIF that would be an attributable interest if the person had directly held their indirect interest.

Background

The previous rules applied a formula to determine the amount of income that should be attributed when a person holds an interest in a CFC or FIF which itself holds an interest in another FIF.

For example, a person may hold a 50 percent interest in a CFC which holds a 15 percent interest in a FIF.

The intended effect of those rules was that the person should have FIF income attributed to them on the basis of a 7.5 percent indirect interest holding. The new rules ensure that a person in this situation cannot access the exemption for interest in a FIF resident in Australia (section EX 35) as they only hold an indirect interest of 7.5 percent.

Key features

Taxpayers who indirectly hold FIF interests are treated as if they directly held an equivalent interest.

Application date

The changes apply to income years beginning on or after 2014–15.

ACTIVE BUSINESS TEST FOR WHOLLY OWNED GROUPS

Sections EX 21B and EX 21D of the Income Tax Act 2007

Under the previous rules, taxpayers determining whether a CFC met the active business test had the option of grouping multiple CFCs together into a test group and working out the ratio of active to passive income based on the consolidated accounts of that group.

Amendments have been made to allow companies that are part of wholly owned groups to form test groups which include any interest in a CFC held by a member of the wholly owned group. The same-jurisdiction rule continues to apply.

Wholly owned groups of companies are not restricted from forming over-lapping test groups by including any one CFC in multiple different test groups.

The changes remove unnecessary restrictions on how these groups can access the active business test.

Background

Taxpayers determining whether their CFCs meet the active business test have the option of grouping multiple CFCs together into a test group and working out the ratio of active to passive income based on the consolidated accounts of the test group. The CFCs must be resident in the same country and the taxpayer must hold an income interest of more than 50 percent in each CFC.

It is not uncommon for CFC interests to be held by different members of a wholly owned group. The current rules place unnecessary restrictions on how those groups can access the active business test given that the group effectively has control over all of the CFC holdings.

Key features

The change extends the test grouping rules to CFCs owned by a group of companies.

Application date

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

NEGATIVE PASSIVE INCOME AND ACCOUNTING STANDARDS TEST FOR CFCS

Section EX 21E of the Income Tax Act 2007

A negative numerator in the formula defined in section EX 21E(5) no longer disqualifies a CFC from passing the active business test. Instead the negative numerator is deemed to be zero. The change removes an unnecessary compliance burden.

Background

The formula for the accounting standards active business test is defined in subsection EX 21E(5) as below:

$$\frac{\textit{reported passive} + \textit{added passive} - \textit{removed passive}}{\textit{reported revenue} + \textit{added revenue} - \textit{removed revenue}}$$

Subsection EX 21E(3) provided that if the numerator (the top line of the formula) is negative, the CFC would fail the accounting standards test and would need to perform the default test (EX 21D).

CFCs that are demonstrably active CFCs, that is they receive very little, if any, passive income, may fail the accounting standards if they hold foreign currency (that is, currency other than the currency in their home jurisdiction) and that currency loses value, resulting in a foreign exchange loss.

Requiring these CFCs to undertake the more demanding default test is considered to be an undue compliance burden.

Key features

Negative numerators no longer exclude a CFC from passing the active business test.

Application date

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

FOREIGN EXCHANGE GAINS AND LOSSES ON LIABILITIES

Section EX 21E of the Income Tax Act 2007

Taxpayers now have the option to include foreign exchange gains and losses on both financial assets and liabilities when applying the accounting standards test (section EX 21E).

Under the accounting standards test, the ratio of passive income to active income takes into account foreign exchange gains and losses from financial assets and not from financial liabilities.

Taxpayers who are unable to readily distinguish the foreign exchange gains and losses on financial assets from those on liabilities can now apply the accounting standards test using a combined amount.

Background

It is not unusual for companies to produce financial accounts that provide a single rolled up figure of foreign exchange gains and losses from both financial assets and liabilities.

The amendment relieves these companies from the additional compliance costs of separating foreign exchange gains from losses.

Key features

Taxpayers who are unable to readily distinguish the foreign exchange gains and losses on financial assets from those on liabilities are able use a combined amount.

Application date

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

Detailed analysis

This change has been made in response to taxpayer submissions which said that foreign exchange amounts are often accounted for together in ledger accounts. Financial arrangements such as intercompany accounts or cash sweep accounts could also change from being financial assets to financial liabilities within a financial year (or vice versa). Depending on the financial reporting system used, the gains and losses on assets may not be readily distinguishable from those on liabilities.

Meaning of "readily distinguishable"

Whether this information is readily distinguishable will depend on the facts and circumstances in each case. Taxpayers should use their own judgement about whether their systems readily distinguish between the gains or losses on assets and liabilities.

Consistency

If information is or is not readily distinguishable in one year then it is reasonable to assume that it will or will not be readily distinguishable in future years unless there has been a change to the taxpayer's financial reporting system.

Similarly it is expected that if a taxpayer's financial reporting systems do or do not readily distinguish between the gains or losses on assets and liabilities for the interests in one CFC, they will or will not do so for all of the CFC interests under those financial reporting systems.

The policy intent behind this change is to provide a compliance concession to taxpayers who would otherwise have to incur undue costs to meet their obligations. It is not intended that taxpayers will be able to switch between the two options on a regular basis, or apply different approaches for different CFC interests, depending on the tax outcome.

APPORTIONED FUNDING INCOME

Sections EX 20B and EX 20C of the Income Tax Act 2007

The provisions relating to apportioned funding income have been moved from section EX 20C (Net attributable CFC income or loss) to section EX 20B (Attributable CFC income).

The specific effects of the provisions are unchanged. Taxpayers can exclude a portion of income from financial liabilities (that is, foreign exchange gains on loans taken out by the company) based on the percentage of the company's assets (the asset fraction) used to generate active income.

Moving the provisions into section EX 20B means taxpayers can take this adjustment into account when applying the active business test under section EX 21D.

The change is intended to provide a CFC with a more accurate calculation of its active-to-passive income ratio.

Background

Section EX 20B contains the rules defining how a CFC calculates its attributable CFC amount. This is broadly equivalent to the CFC's gross attributable income.

Section EX 20C contains the rules which define what deductions can be taken against that gross attributable income to derive the CFC's net attributable income or loss.

The current subsection EX 20C(3) includes an adjustment which excludes some of the income that was previously included in the gross attributable income (apportioned funding income).

As this adjustment is an exclusion of income rather than a deduction against income, it is better situated in section EX 20B.

Moving the provision to section EX 20B also provides more accurate calculations of a CFC's active-to-passive income ratio as the current rules do not take the adjustment for apportioned funding income into account.

Key features

The specific effects of the provisions are unchanged.

Moving the provisions into section EX 20B means taxpayers can take this adjustment into account when applying the active business test under section EX 21D.

Application date

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

TEST GROUPS FOR CFCS WITH OFFSHORE BRANCHES

Sections EX 21D and EX 21E of the Income Tax Act 2007

Taxpayers can now form test groups for the active business test that include CFCs with offshore branches. The CFC must be able to pass the active business test in its own right and any active income attributed to the offshore branch is excluded from the test group active business test calculation.

Background

It is not unusual for an operating company to have an offshore branch in another jurisdiction which may, for example, comprise a small sales team. The rules determining whether a branch exists are not clear cut, and can vary from country to country, so it is possible that a CFC may unintentionally establish an offshore branch and unexpectedly fall outside of the test group rules.

The CFC rules allow taxpayers to group multiple CFCs together for the purposes of calculating the active business test. There are rules which limit the CFCs that can be included in the group, one of which is that each CFC must have a "taxed CFC connection" with the same country or territory.

The "taxed CFC connection" essentially requires that the CFC is taxed and resident in the country it is based in and not taxed or resident in any other country. Under the previous rules, this had the effect of barring any CFC that has an offshore branch from being included in a test group. This had a disproportionate effect on CFCs that have minor business presences in other countries.

Key features

CFCs with permanent establishments are able to join test groups.

However, these CFCs must be able to pass the active business test in their own right.

Active income from the permanent establishment is excluded from the test group calculation.

Application date

The change applies for income years beginning on or after 1 July 2009.

EXTENDING THE ON-LENDING CONCESSIONS AND EXEMPTIONS FOR GROUP FUNDING

Sections EX 20C and EX 20D of the Income Tax Act 2007

The CFC rules have been amended so that the on-lending concession and exemptions that apply to certain interest payments also apply to those dividends that are taxed like interest payments. The measure is intended to align the treatment of dividends from deductible and fixed-rate shares with the treatment of interest.

Background

The CFC rules generally treat dividends from certain types of shares (deductible and fixed-rate shares) in the same way as interest on debt. This is because these shares have debt-like characteristics and are highly substitutable for debt.

Under the CFC rules, a CFC that borrows money and then lends that money on to an associated CFC is able to claim a full deduction of any expenses incurred (the on-lending concession). There is also an exemption for interest income that a CFC receives from lending money to an associated active CFC that is located in the same country.

These rules did not apply to fixed rate foreign equity or shares giving right to a deductible foreign equity distribution. In some instances this led to the same income being taxed twice.

Key features

Dividends that are treated like interest under the normal tax rules are given access to the same exemptions that apply to interest under the CFC rules.

This applies to fixed rate foreign equity or shares giving right to a deductible foreign equity distribution.

Application date

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

REWRITE ADVISORY PANEL REMEDIALS

The following amendments reflect the recommendations of the Rewrite Advisory Panel following its consideration of submissions on the rewritten Income Tax Acts.

The Panel monitors the working of the Income Tax Act 2007 and reviews submissions on what may be unintended changes in the law as a result of its having been rewritten. The Panel recommends legislative action, when necessary, to correct any problems.

REQUIREMENT TO AMEND ASSESSMENTS ON RECOVERY OF DIVIDENDS FROM SHAREHOLDERS

Section CD 40 of the Income Tax Act 2007 and section CD 29 of the Income Tax Act 2004

Section CD 40 of the Income Tax Act 2007 and section CD 29 of the Income Tax Act 2004 provide that, if a company recovers a dividend from its shareholders, section 113B of the Tax Administration Act requires the Commissioner to amend the following:

- any income tax assessment and foreign dividend payment assessment of a shareholder to ensure that the dividend and any imputation or foreign dividend payment cr edit previously attached to the now-recovered dividend are disregarded; and
- any assessment of the company made under the imputation rules, the non-resident withholding tax rules, the resident withholding tax rules or under the supplementary dividend rules in subpart LP. This ensures that the dividend and any imputation or foreign dividend payment credit previously attached to the now-recovered dividend are disregarded.

Application dates

The amendment to section CD 40 of the Income Tax Act 2007 applies from the beginning of the 2008–09 income year.

The amendment to section CD 29 of the Income Tax Act 2004 applies from the beginning of the 2005–06 income year.

Background

A submission made to the Rewrite Advisory Panel (the Panel) that the cross-reference from section CD 29 of the Income Tax Act 2004 to section 113B of the Tax Administration Act 1994 contained an unintended change in outcome. The submission was that after enactment of the Income Tax Act 2004, this cross-reference to section 113B no longer requires the Commissioner to amend an assessment of a company's imputation credit account on the company recovering a dividend from its shareholders.

If a company recovers a dividend from its shareholders and notifies the Commissioner that the dividend has been recovered, the intention is that the Commissioner is obliged to amend any assessment to disregard that recovered dividend.

The Panel considered that the correct outcome could be obtained by relying on the transitional provisions in section YA 3. However, the Panel considered it should be unnecessary to rely on the transitional provisions in section YA 3 and that the legislation should be more clearly drafted.

This issue also arises in the linkage between section CD 40 of the Income Tax Act 2007 and section 113B of the Tax Administration Act 1994, resulting in a similar amendment being made to section CD 40.

OPTION TO USE FOREIGN TAX BALANCE DATE

Sections EG 1 of the Income Tax Act 2007 and Income Tax Act 2004

Section EG 1 provides that New Zealand-resident taxpayers may elect to include foreign-sourced income (apart from interest, dividends and foreign investment fund income) in the tax year in which the taxpayer's balance date in the overseas jurisdiction falls.

Application dates

The amendment to section EG 1 of the Income Tax Act 2007 applies from the beginning of the 2008–09 income year.

The amendment to section EG 1 of the Income Tax Act 2004 applies from the beginning of the 2005–06 income year.

Background

The amendment arises from a submission to the Rewrite Advisory Panel that section EG 1 of the Income Tax Act 2004 does not permit a taxpayer to elect to include foreign-sourced income (apart from interest, dividends and foreign investment fund income) in the tax year in which the taxpayer's balance date in the overseas jurisdiction falls. The submission noted that this election was permitted in the corresponding provision (section EP 1) of the Income Tax Act 1994. The Panel agreed with the submission.

FOREIGN COMPANY – MEANING OF DIRECT CONTROL INTEREST

Sections EX 5(1)(c) and (d), EX 9(1)(c), (d) of the Income Tax Act 2007 and Income Tax Act 2004

Section EX 5(1)(c) and (d) in both the Income Tax Act 2004 and the Income Tax Act 2007 provide that a direct control interest does not include interests of a person in a foreign company if that person is not entitled to the income or assets and is prohibited from applying the same for their own benefit or interest.

Consequentially, section EX 9(1)(c) and (d) of both Acts are also amended.

Application dates

The amendments to sections EX 5(1) and EX 9(1) of the Income Tax Act 2007 apply from the beginning of the 2008–09 income year.

The amendments to sections EX 5(1) and EX 9(1) of the Income Tax Act 2004 apply from the beginning of the 2005–06 income year.

Background

The Panel considered a submission that section EX 5 in both the Income Tax Act 2004 and the Income Tax Act 2007 contained an unintended change concerning the calculation of control interests to determine whether a foreign company is a controlled foreign company under the international tax rules. Control interests include direct control interests and indirect control interests.

Section CG 4(4)(c) and (d) of the Income Tax Act 1994 was clear that a direct control interest did not include interests held by a person in a controlled foreign company unless the person would have been entitled to have the income or any value of the net assets dealt with in their interest or on their behalf.

The Panel concluded that the provisions were unclear and that the correct outcomes could be obtained by applying the transitional provisions in section YA 3 of the Income Tax Act 2004 and section YA 3 of the Income Tax Act 2007. The Panel considered that the legislation should be clearer so that reliance on the transitional provisions would be unnecessary.

The wording in section EX 9(1)(c) and (d) in both the Income Tax Act 2004 and the Income Tax Act 2007 mirror the wording in section EX 5(1)(c) and (d). Section EX 9 in both Acts has been amended in the same manner to ensure the two provisions are consistently worded.

COMPARATIVE VALUE METHOD FOR CALCULATING FIF INCOME

Section EX 51 of the Income Tax Act 2007 and section EX 44 of the Income Tax Act 2004

Section EX 51 of the Income Tax Act 2007 and section EX 44 of the Income Tax Act 2004 provide that expenditure incurred for, or on behalf of the person having the foreign investment fund (FIF) interest is included in the meaning of "cost of a FIF interest" for the purpose of calculating FIF income under the comparative value method.

Application dates

The amendment to section EX 51 of the Income Tax Act 2007 applies from the beginning of the 2008–09 income year.

The amendment to section EX 44 of the Income Tax Act 2004 applies from the beginning of the 2005–06 income year.

Background

A submission made to the Panel identified an unintended change in outcome in the meaning of "cost of a FIF interest" applied for the purpose of calculating FIF income under the comparative value method. The submission was that since the enactment of the Income Tax Act 2004, the term "cost" for the comparative value method of calculating FIF income, does not include expenditure incurred for or on behalf of the person having the FIF interest. The Panel agreed with the submission.

The policy and legislative history of the provisions show that expenditure incurred on behalf of a person holding a FIF interest is included in the meaning of "cost" for the purpose of calculating FIF income under the comparative value method. For example, if the FIF interest is a shareholding in a foreign company, the cost of an increase in the shareholding made on behalf of the owner of the FIF interest should be included in the value of that cost.

LAND TRANSFERRED TO A CLOSE RELATIVE

Section FC 5(3)(b) of the Income Tax Act 2007

Section FC 5(3)(b) of the Income Tax Act 2007 provides for the valuation of the cost of land transmitted into an estate if sections CB 9 to CB 11, and CB 14 of the Income Tax Act 2007 apply to the land.

The amendment ensures that the cost of that land allowed as a deduction from the income under the land sales rule can include costs incurred by the executor or administrator within 10 years following the acquisition of the land by the deceased person.

Application date

The amendment to section FC 5(3)(b) applies from the beginning of the 2008–09 income year.

Background

The Panel considered a submission that section FC 5 of the 2007 Act does not include expenditure incurred by the administrator or executor of the estate as part of the cost of land held in an estate. The submitter states this represents a change from the outcome under the corresponding provisions of the 2004 Act (section FI 7(3) of the 2004 Act). The Panel agreed with the submission.

Section FI 7(3) of the 2004 Act provides that if the transfer of land is subject to the same land sale rules, the cost of land held by an estate is intended to include expenditure incurred on that land by the administrator or executor of that estate if the expenditure is incurred within 10 years following the acquisition of the land by the deceased person.

LIABILITY WHEN COMPANY LEAVES CONSOLIDATED GROUP

Section FM 5 of the Income Tax Act 2007

Section FM 5 of the Income Tax Act 2007 provides that the joint and several liability imposed on all members of a consolidated group to satisfy income tax obligations of the consolidated group does not apply to a company that has left the group, in relation to an increase in an income tax obligation of the group made:

- for a tax year the exiting company was a member of the group; and
- under an amended assessment for that tax year after the exiting company left the group.

Application date

The amendment applies from the beginning of the 2008–09 income year.

Background

The Panel considered a submission that when a company exits from a consolidated group, section FM 5 incorrectly results in the exiting company retaining a joint and several liability for increased income tax obligations of the group assessed after the company has left the group. The Panel agreed with the submission.

In the corresponding provision of the 2004 Act (section HB 1(2)), that joint and several liability was removed for a company that has left a consolidated group for increases in income tax obligations of the consolidated group made:

- for a tax year the exiting company was a member of the group; and
- under an amended assessment for that tax year after the exiting company left the group.

REVOCATION OF DIRECTORS' ELECTIONS

Section HA 31(2)) of the Income Tax Act 2007

Section HA 31(2) provides that a director's notice of revocation should take effect from the later of:

- the year in which the notice is received by the Commissioner; or
- the effective year stated in the notice.

Application date

The amendment applies from the beginning of the 2008–09 income year.

Background

The Panel has agreed with a submission that the 2007 Act rewrite of the notice of revocation of a director's election has inadvertently allowed retrospective revocation of a director's election for a company to attain qualifying company status.

The amendment ensures that the director's notice of revocation should take effect from the later of:

- the year in which the notice is received by the Commissioner; or
- the effective year stated in the notice.

TREATMENT OF FOREIGN TRUSTS WHEN SETTLOR BECOMES RESIDENT

Section HC 30(4)(a) of the Income Tax Act 2007

Section HC 30(4)(a) of the Income Tax Act 2007 provides that if a settlor of a foreign trust becomes resident in New Zealand, and no election is made for the trust to become a complying trust within 12 months of the settlor becoming resident, the trust continues to be treated as a foreign trust until the end of that 12-month period. After the expiry of that 12-month period, the trust becomes a non-complying trust.

Application date

The amendment applies from the beginning of the 2008–09 income year.

Background

The Panel considered a submission that relates to the taxation consequences when a settlor of a foreign trust becomes resident in New Zealand under section HC 30(4) of the Income Tax Act 2007 and no election is made within 12 months of the settlor becoming resident. The Panel agreed with the submission.

For foreign trusts, if the settlor becomes resident in New Zealand, the settlor, trustee or any beneficiary may choose that the trust becomes a complying trust. This election must be made within 12 months of the settlor becoming resident in New Zealand, and the trust is treated as a complying trust for distributions made from the date of the election.

If this election trust is not made within the 12-month period, the trust is treated, in relation to distributions from the trust, as:

- a foreign trust until the end of that 12-month period; and
- as a non-complying trust after the end of that 12-month period.

SHORTFALL PENALTIES AND GROUPS OF COMPANIES

Section IW 1(3) of the Income Tax Act 2007

Section IW 1(3) of the Income Tax Act 2007 provides that a group of companies may elect to use a tax loss of one company in the group of companies to satisfy a shortfall penalty assessed against any company within the same group of companies.

Application date

The amendment applies from the beginning of the 2008–09 income year.

Background

The Panel considered a submission that section IW 1(3) of the 2007 Act does not allow a wholly owned group to use tax losses of one company in the group to pay the shortfall penalties of another company in the group. The submission is that this differs from the outcome given by the corresponding provision; section IG 10(1A), of the Income Tax Act 2004. The Panel agreed with the submission.

Section IG 10(1A) of the Income Tax Act 2004 provided for a group of companies to elect a tax loss to satisfy a shortfall penalty assessed against any company within that group of companies.

MINOR MAINTENANCE ITEMS

The following amendments relate to minor maintenance items referred to the Rewrite Advisory Panel as minor maintenance items and retrospectively correct any of the following:

- ambiguities;
- compilation errors;
- cross-references;
- drafting consistency, including use of terminology, definitions and readers' aids, for example, the defined terms lists;
- grammar;
- punctuation;
- spelling; or
- consequential amendments arising from substantive rewrite amendments.

Application dates

In the table below:

- amendments to the Income Tax Act 2007 apply retrospectively from the beginning of the 2008–09 income year;
- the amendment to the Income Tax Act 2004 applies retrospectively from the beginning of the 2005–06 income year.

Section	Act	Amendment
EE 7 EE 7	2007 Act 2004 Act	Correct cross-referencing Correct cross-referencing
EX 46(11)	2007 Act	Correct terminology
GB 34	2007 Act	Correct cross-referencing
LJ 3	2007 Act	Drafting consistency
LJ 5(3)(c)	2007 Act	Correct cross-referencing
RE 14(2)	2007 Act	Error in formula corrected

OTHER REMEDIAL MATTERS

EXCEPTED FINANCIAL ARRANGEMENTS

Section EW 8 of the Income Tax Act 2007

Technical amendments have been made to section EW 8 of the Income Tax Act 2007 to clarify the application and effect of the financial arrangement rules to short-term agreements following an earlier change made by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013.

Background

Before its amendment by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013, section EW 8 allowed taxpayers to treat certain agreements and arrangements as falling within the scope of the financial arrangement rules. The election had an unintended consequence of allowing taxpayers to obtain a deduction under the financial arrangement rules for the purchase price connected with acquiring a short-term agreement for sale and purchase in situations when the purchase would be ordinarily classified as being on capital account (and therefore non-deductible). The Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 amended section EW 8 so that the scope of the election was narrowed—refer to page 44 *Tax Information Bulletin* Vol 25, No 9 (October 2013).

In response to a submission on the bill from a life insurer, additional changes have been made to section EW 8 of the financial arrangement rules to clarify the treatment of short-term agreements for sale and purchase. The technical amendments made by the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 reverse elements of the earlier amendment made by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013.

Key features

Specifically, the technical amendments:

- repeal, from 27 September 2012,[16] the changes to section EW 8 made by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013; and
- retrospectively restore, from 17 July 2013,[17] the election permitted under section EW 8 of the Income Tax Act 2007, provided that the expenditure to be spread is on revenue account (that is, it does not rely on the election allowed by section EW 8 to deem the expenditure as on revenue account).

Taxpayers who applied the changes made by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 in a return of income or in connection with the determination of a binding ruling made by the Commissioner of Inland Revenue before 14 April 2014, and choose to continue with the tax position, are not affected by retrospective change.

Application date

The amendment has effect from 27 September 2012.

SPREADING OF INCOME FOR INCOME DERIVED FROM LAND

Sections EI 7 and EI 8 of the Income Tax Act 2007

Sections EI 7 and EI 8 provide that certain income derived from land is spread forward evenly over the period of time referred to in those sections.

Transitional provisions apply to income derived before the 2015–16 income year if the taxpayer has previously chosen to apply either section EI 7 or section EI 8. The transitional provisions apply to that unallocated income as follows:

- If the period of time referred to in those sections has not expired before the start of the 2015–16 income year, that unallocated income is spread evenly over the number of years remaining in that period, beginning with the 2015–16 income year.
- If the period of time referred to in those sections has expired before the start of the 2015–16 income year, the unallocated income is allocated to the 2015–16 income year.

Background

Sections EI 7 and EI 8 of the Income Tax Act 2007 apply to taxpayers who derive income from land, either:

- in the nature of fines, premiums or from a payment of goodwill on the grant of a lease (section EI 7); or
- as a result of a compulsory disposal of land to the Crown (section EI 8).

Before self-assessment legislation was enacted in 2001, the corresponding provisions to sections EI 7 and EI 8 in the Income Tax Act 1994 allowed taxpayers to elect to spread the income forward. However, this spreading of income was

[16] Section 50 of the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 amended section EW 8 of the Income Tax Act 2007 from 27 September 2012 unless a taxpayer had taken a tax position.

[17] The date the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 received Royal assent.

required to follow the Commissioner's practice of spreading forward on an even basis over the number of years stated in the provisions. Following the enactment of self-assessment legislation, taxpayers had a choice to spread that income forward, although not necessarily on an even basis.

The amendments to sections EI 7 and EI 8 clarify that taxpayers may choose to spread the income forward, but the spreading must be on an even basis over the years referred to in both of those sections.

Application dates

The amendment applies to income derived in the 2015–16 income year and later income years. However, a transitional provision applies to income derived before the start of the 2015–16 income year if the taxpayer has previously chosen to apply either section EI 7 or section EI 8 for that income.

Detailed analysis

Sections EI 7 and EI 8 provide timing relief for taxpayers who derive income from land in certain circumstances. The provisions permit the taxpayers to spread the income forward evenly across the current and certain future income years instead of returning the income in the year it is derived. This relief applies to income derived either:

- in the nature of fines, premiums or from a payment of goodwill on the grant of a lease (section EI 7, Income Tax Act 2007); or
- from a compulsory disposal of land to the Crown (section EI 8, Income Tax Act 2007).

If the taxpayer chooses to allocate the income under either section EI 7 or section EI 8:

- income derived from land for payments in the nature of fines, premiums or goodwill on the grant of a lease is allocated evenly over the income year the income is derived in and the five immediately succeeding income years; and
- income derived from a compulsory disposal of land to the Crown is allocated evenly over the income year the income is derived in and the three immediately succeeding income years.

Transitional issues

Transitional provisions apply to income from land that has been derived:

- before the 2015–16 income year; and
- has not been fully allocated at the end of the 2014–15 income year.

In this circumstance, the taxpayer may elect to allocate the unallocated portion of the income evenly to income years from 2015–16 onward, ensuring that the income spread does not exceed the time period referred to in sections EI 7 or EI 8.

However if the period of time referred to in the relevant provision has expired before the start of the 2015–16 income year, the taxpayer is required to allocate the unallocated portion of the income to the 2015–16 income year.

Example 1: Transitional effect

The taxpayer has chosen to spread the income derived in the 2011–12 income year from land for payments in the nature of fines, premiums or goodwill on the grant of a lease on an even basis. The policy intention is that this would result in all of that income being allocated evenly over the 2011–12 to 2016–17 income years.

The transitional rule provides that the amount of income derived in the 2011–12 income year that remains unallocated at the start of the 2015–16 income year is spread evenly over the 2015–16 and 2016–17 income years.

Example 2: Transitional effect

A taxpayer has derived income from a premium on the grant of a lease in the 2008–09 income year. Under section EI 7 it was arguable that the taxpayer could choose to allocate all or some of the income to an income year of choice, for example the 2018–19 income year. The policy intention is that the income should have been spread evenly over each of the 2008–09 to 2013–14 income years.

The transitional rule provides that the income derived in the 2008–09 income year that remains unallocated at the start of the 2015–16 income year is allocated fully to the 2015–16 income year. This is because the allocation of the income has already been deferred beyond the intended relief period, and therefore should be allocated to the 2015–16 income year.

REMEDIAL AMENDMENTS TO THE MIXED-USE ASSET RULES

Sections DG 6, DG 9, DG 11, DG 16, DG 17 and DZ 21 of the Income Tax Act 2007

Remedial changes have been made to the mixed-use asset rules in subpart DG and section DZ 21 of the Income Tax Act 2007.

Background

The mixed-use asset rules were introduced as new subpart DG and related provisions by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act

2013. They are designed to prevent excess deductions being claimed where an asset is used partly to earn income and partly for private purposes—an example of which is a bach that is rented out when the owner is not using it.

The rules apply to land and improvements for the 2013–14 and later income years; and to certain boats and aircraft for the 2014–15 and later income years.

Since the rules were introduced, a number of technical issues have been identified. The following remedial amendments address some of those issues:

- the specific associated persons rule for mixed-use assets in section DG 6 has been amended to ensure it applies as intended;
- minor corrections have been made to several examples in the legislation;
- the depreciation rollover relief provision that applies when a company distributes its mixed-use asset to one or more shareholders in the 2013–14 income year has been amended. This ensures that depreciation recovery income is ultimately crystallised if the shareholder sells the asset for more than its adjusted tax value (taking into account depreciation claimed by the company);
- the "asset value" for land used in the apportionment formula and the quarantined expenditure provision has been modified to ensure it accurately reflects the true economic value to the taxpayer;
- the apportionment formula in section DG 9 has been amended to deal with the use of an asset for capital purposes; and
- the "asset income" definition in section DG 17 has been aligned with the definition of the same term in section DG 16.

These amendments are all consistent with the policy intent of the mixed-use asset rules.

Key features

Specific associated person rule for mixed-use assets

The concept of association is key to the mixed-use asset rules. Section DG 6 modifies the general associated persons definition. Specifically, section DG 6(a) deemed a shareholder who holds 5 percent or more of the shares in a company to be associated with that company. It was intended to remove this provision from the bill that introduced the mixed-use asset rules, however it was not removed before enactment. Accordingly, section DG 6(a) has been repealed with application for the 2013–14 and later income years. Section DG 6(b), which deems a shareholder to be associated with a company if the person's share in the company gives them a right to use a mixed-use asset owned by the company, will remain.

Corrections to legislative examples

Several examples in the earlier legislation contained minor errors. These are summarised below with the corrections made under the new legislation marked-up for emphasis.

Section	Example and correction	Why correction is needed
DG 11	**Example** Holiday Home Ltd holds a holiday home with a rateable value of $200,000. The company has debt of $40,000, with associated interest expenditure of $4,000. Since the debt value is less than the asset value, all the interest expenditure must be apportioned (section DG 11(3)). Boat Ltd has a charter boat whose **adjusted tax value** ~~cost~~ is $60,000. The company has debt of $100,000, with associated interest expenditure of $10,000. Since the debt value is more than the asset value, the company must apportion interest expenditure of $6,000 (section DG 11(4)-(6)). The formula is $10,000 × ($60,000/$100,000) = $6,000.	Under section DG 11(8)(b), the appropriate "asset value" for property other than land is its adjusted tax value, not its cost.
DG 16	**Example** David has a city apartment with a rateable value of $300,000. He rents out the apartment and also uses it privately. He receives market rate rental of $4,000 from non-associates, and $6,000 from associates. David's total allowable expenditure, under sections DG 7, DG 8 and DG 11, is $15,000. **The income from associates is exempt under section CW 8B, and is ignored. David therefore has asset income of $4,000 and deductions of $15,000, giving rise to an excess of expenditure over income of $11,000.** Since David's income from non-associates is less than 2% of the apartment's rateable value, the excess expenditure of **$11,000** ~~$5,000~~ is denied as a deduction. The amount denied may be allocated to a later income year under section DG 17.	The excess expenditure in this example is $11,000 not $5,000. The amendment also provides additional explanation of the calculations to assist readers.
DG 17	**Example, continued from section DG 16** In the following income year, David derives $10,000 from renting his city apartment at market rates to a non-associate. David's total allowable expenditure, under sections DG 7, DG 8, and DG 11, is $8,000. He also has expenditure of **$11,000** ~~$5,000~~ quarantined from the previous income year. David is able to deduct $2,000 of that quarantined expenditure. The remaining **$9,000** ~~$3,000~~ continues to be quarantined and may be allowed as a deduction for a later income year.	Carry-through from correction of section DG 16 example.

Section	Example and correction	Why correction is needed
DG 18	**Example** Aircraft Ltd owns an aircraft to which the rules in this subpart apply; the income derived from the asset in the current year is less than 2% of the cost of the aircraft. The company has calculated an outstanding profit balance of $12,000 after the application of section DG 16. Aircraft is 100% owned by Parent Ltd, which has apportioned interest expenditure of $5,000 calculated under section DG 12. Parent Ltd has 2 equal shareholders, Alisa who has apportioned interest expenditure of $8,000, and Hamish who has apportioned interest expenditure of $1,000, both calculated under section DG 14. Parent Ltd must apply section DG 18 first, and is not required to quarantine any of its interest expenditure; the outstanding profit balance is reduced to $7,000 ($12,000 – $5,000). Alisa's and Hamish's share of the outstanding profit balance is $3,500 each (**$7,000** ~~$7,500~~ x 50%). Alisa must quarantine $4,500 of interest expenditure ($8,000 – $3,500); Hamish is not required to quarantine any interest expenditure.	Correction of numeric error.
DG 19	**Example, continued from section DG 18** In the following income year, Aircraft **Ltd** has calculated an outstanding profit balance of $16,000 ~~after the application of section DG 18~~. Section DG 19 does not apply to Parent Ltd or **Hamish** ~~Alisa~~ because they have no previously quarantined interest expenditure. However, the section does apply to **Alisa** ~~Hamish~~ because **she** ~~he~~ has $4,500 of quarantined interest expenditure from the previous year. **Because Parent Ltd does not have any current year expenditure, Alisa's** ~~Hamish's current year apportioned interest expenditure is $7,000, calculated under section DG 14, and his~~ share of the outstanding profit balance **of Parent Ltd** is $8,000 ($16,000 x 50%). **Alisa's current year apportioned interest expenditure is $7,000, calculated under section DG 14.** **Alisa** ~~Hamish~~ is allowed a deduction for **all her current year expenditure and also a deduction for** $1,000 of previously quarantined expenditure ($8,000 – $7,000). ~~His~~ **Her** remaining quarantined expenditure is $3,500 ($4,500 – $1,000).	Correction of names and additional clarification.
DZ 21	**Example** **On 31 March 2013,** Boat Co **has a boat with an acquisition cost of $85,000**. ~~on 31 March 2013 which~~ **The boat** meets the various requirements set out in subpart DG. All the shares in Boat Co are owned by Michelle. The boat has a market value of $75,000, and an adjusted tax value of $55,000. Boat Co transfers the boat to Michelle without payment (which is treated as a dividend of $75,000). For depreciation purposes, Boat Co is treated as disposing of the boat for $55,000, and Michelle is treated as acquiring it for ~~$55,000~~ **$85,000, and having been allowed a deduction of $30,000 for depreciation loss in past income years.**	Amendments to ensure the example is consistent with the change to section DZ 21.

Depreciation recovery income for assets transferred in the 2013–14 income year under section DZ 21

There is a one year transitional period (2013–14 income year) in which companies that own mixed-use assets can transfer those assets to their shareholders without triggering depreciation recovery income (this is referred to as "rollover relief"). The rollover relief provision is contained in section DZ 21.

Section DZ 21(2) previously treated the transfer as if it were a disposal and acquisition for an amount equal to the adjusted tax value of the asset on the date of the transfer. This meant that there was no deprecation recovery income to the company when it transferred the asset to its shareholder(s) because the consideration deemed to have been received was the same as the asset's adjusted tax value.

If the shareholder later sells the asset for more than its adjusted tax value, the policy intention is that depreciation recovery income will be crystallised at this point. To ensure this policy objective is achieved, amendments to section DZ 21 treat the shareholder as stepping into the shoes of the company for depreciation purposes—that is, by having:

- acquired the asset on the date on which the company acquired it for an amount equal to the amount the company paid to acquire it;
- used the asset for the purposes for which the company used it;
- used the depreciation method used by the company in relation to the asset; and
- been allowed a deduction for an amount of depreciation loss that the company has been allowed since the company's acquisition of the asset.

As well as including all depreciation deductions the company has previously been allowed in the depreciation recovery calculation, this amendment also ensures that any change in use or depreciation method by the shareholder is captured and the shareholder has the correct depreciation cost base.

Value for land and improvements

The value of land and improvements is relevant to the close company interest deduction quantification provision (section DG 11) and the expenditure quarantining provision (section DG 16).

As originally introduced, these provisions treated the value of land and improvements as the later of:

- the most recent capital value or annual value (as set by the relevant local authority); or
- its cost on acquisition (or market value, if the transaction involves an associated person).

In the case of leased land and multiple activities carried out on a single land title, using the capital value or annual value (as set by the relevant local authority) could overstate the asset's value for the purposes of subpart DG.

If, for example, a bach is on leased land, the capital value of the land is likely to overstate the value to the lessee as the lessee does not own the land. Therefore, a greater proportion of the interest deductions of a close company may be subject to apportionment under subpart DG than was intended and more apportioned expenditure will be quarantined under section DG 16 than was intended.

A similar valuation issue arises if, for example, two different taxpayers own separate baches situated on a single legal title. The capital value on the legal title will give the value for both buildings and the whole of the land area. Where the mixed-use activity is being carried on by only one of the owners, it would be very difficult for that owner to reach the quarantining threshold because of the presence of the two houses.

Another example is if a farmer sets up a house on a farm as a farmstay. The house is on the farm land, and is used to derive rental income, but is also used by the farmer's children and their friends when they come home. If the land value cannot be apportioned, the farmer will almost certainly have his farmstay expenditure quarantined under section DG 16 because it would be highly unlikely for the annual income from the farmstay to exceed 2 percent of the value of the total farm.

It is arguable that a leasehold estate is an asset separate from the freehold estate and therefore does not have a capital/annual value itself, which means that the relevant "asset value" is the price paid for the leasehold estate or the market value (if acquired from an associate).

Nevertheless, sections DG 11 and DG 16 have been clarified to ensure the "asset value" used for land and improvements is accurate for both leased land and land where two activities are carried out on a single title. This is achieved by defining the value of land and improvements for the purposes of sections DG 11 and DG 16 as:

a) the later of either the land's most recent capital value or annual value as set by the relevant local authority, or its cost on acquisition or, if the transaction involves an associated person, its market value; or

b) if the land or improvement to land is a leasehold estate in land, the market value of the leasehold estate which the person may establish by a valuation that is or has been made by a registered valuer no more than 3 years before the end of the income year; and

c) if different activities are carried out on the land on a single certificate of title within the meaning of the Land Transfer Act 1952, the value applying under paragraph (a) or (b), as applicable, adjusted as follows:

    i) by multiplying the value by the percentage that the area of land that is the portion of the land used in relation to the asset to which this subpart applies bears to the total land area described in the certificate of title:

    ii) by a valuation that is or has been made by a registered valuer no more than 3 years before the end of the income year, of the portion of land used in relation to the asset to which this subpart applies.

Example

Bach Co Ltd owns a bach on leasehold land. The bach is subject to the mixed-use asset rules. The capital value of the land is $400,000, but a registered valuer has provided Bach Co Ltd with a valuation of the leasehold interest in the land of $300,000. The "debt value" for the purposes of section DG 11 is $400,000. Bach Co Ltd has annual interest expense of $20,000 and derives $7,500 of assessable income from the bach annually.

Under the mixed-use asset rules as introduced (and before the recent amendment), all of Bach Co Ltd's interest expenditure would be subject to apportionment under section DG 9. This is because the debt value is less than or equal to the asset value (section DG 11(3)).

In addition, Bach Co Ltd would be subject to the expenditure quarantining provision because the income derived ($7,500) is less than 2 percent of the value of the land.

Both outcomes are unintended, as the true economic value of the asset to Bach Co Ltd is $300,000, not $400,000.

Under the amended valuation rule, Bach Co Ltd can use $300,000 as the asset value. This means that only $15,000 of interest expenditure ($20,000 x $300,000/$400,000) is subject to apportionment under subpart DG and the expenditure quarantining provision does not apply (because the income derived is more than 2 percent of the asset value).

Capital use of an asset

The apportionment formula in section DG 9 has been amended to deal with the situation when there is capital use of an asset, as well as income-earning use and private use.

The issue is explained by the following example.

A privately owned corporate group owns a plane that has the following use (per year):

- private use (for example, the principal individual shareholder of the group flying overseas on holiday)—20 days;
- income-earning use (for example, the shareholder/manager flying overseas for business purposes where there is a direct nexus with income)—20 days; and
- capital use (for example, the shareholder/manager flying overseas to analyse potential capital acquisitions)—20 days.

The plane is therefore used 1/3rd for private use, 1/3rd for income-earning use and 1/3rd for capital use. The plane is unused for the remainder of the year.

The following expenditure is incurred in relation to the plane:

- $100,000 solely relating to private use (for example, fuel and pilot costs directly attributable to private use);
- $100,000 solely relating to income-earning use (for example, fuel and pilot costs directly attributable to income-earning use);
- $100,000 solely relating to capital use (for example, fuel and pilot costs directly attributable to capital use); and
- $100,000 "mixed-use" expenditure that does not solely relate to any specific use (for example, the annual insurance premium for the plane).

In relation to the non-mixed-use expenditure, the $100,000 solely relating to the income-earning use should be fully deductible (as per section DG 7(1)) and the $200,000 that solely relates to private and capital use should be non-deductible (as per the private and capital limitations in section DA 2).

Mixed-use expenditure of $33,000 that is considered to relate to income-earning use should be deductible under subpart DG. To ensure that this is the result under the mixed-use asset rules, the definition of the "expenditure" item in section DG 9(3)(a) has been amended to ensure the full $100,000 of mixed-use expenditure is included in this item. This requires there to be no apportionment under the capital limitation and the private limitation before the application of the apportionment formula in section DG 9(2):

$$\textit{Expenditure (that is, all mixed-use expenditure)} \times \frac{\textit{Income-earning days}}{\textit{(Income-earning days + counted days)}}$$

$$\$100{,}000 \times \frac{20}{60} = \$33{,}000$$

Definitions of "asset income"

If a taxpayer generates assessable income from a mixed-use asset in an income year of less than 2 percent of the asset's value, some of the deductions generated by the asset are quarantined until a future income year. The low relative level of income generated by the use of the asset suggests that the asset is likely to be a predominantly private asset and therefore it is appropriate to suspend tax deductions that could otherwise be used to offset the taxpayer's income from other sources.

If the income does not reach the 2 percent threshold, any deductions above the assessable income from the asset (the "asset income") derived in that income year are quarantined, to be accessed in future income years. The effect is that, in a year when a taxpayer derives a relatively low level of assessable income from the asset, the taxpayer is allowed deductions sufficient to offset that assessable income (so no tax is payable in respect of the income from the asset), but is not able to access other deductions for that asset.

In a future income year, the taxpayer is able to access quarantined deductions if they have income from the use of the asset that exceeds their current year deductions. The amount of quarantined expenditure that can be accessed by the taxpayer is the lesser of the quarantined expenditure and the excess of current year income from the asset (the "asset income") above current year allowable deductions.

An amendment to the definition of "asset income" in the provision that allows taxpayers to access quarantined expenditure (section DG 17) has aligned this definition with the definition of the same term in section DG 16.

In the primary quarantining provision (section DG 16), the "asset income" is the total amount of income, other than an amount of exempt income, derived for the income year from the use of the asset. This is the correct approach as taxpayers should not be able to access excess deductions because they have earned exempt income, as they do not need the deductions to offset against the exempt income.

In contrast, before the amendment to section DG 17, "asset income" was the total amount of income derived for the current year from the use of the asset. There was no exclusion for exempt income. This means that taxpayers could have accessed excess quarantined deductions on the basis of exempt income they derive in relation to the asset (for example, income from associates, which can be easily manipulated). Given the income is exempt, accessing quarantined deductions in this way would also have given rise to a net loss on the asset for that income year which is contrary to the policy intention of the provision.

Accordingly, the definition of "asset income" in section DG 17 has been aligned with the definition of the same term in section DG 16, that is, for both sections "asset income" is the total amount of income, other than an amount of exempt income, derived for the income year from the use of the asset.

Application dates

The amendments to the mixed-use asset associated persons rule and the legislative examples apply for the 2013–14 and later income years (the beginning of the mixed-use asset regime).

The amendment to the depreciation rollover relief provision applies generally for the 2013–14 and later income years. However, the amendment does not apply in relation to an asset when a shareholder who acquires the asset disposes of it before 22 November 2013 (the date of the introduction of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill).

The amendment to address the potential overvaluation of land and improvements for the purposes of the mixed-use asset rules applies for the 2013–14 and later income years.

The amendment to address capital use of an asset applies for the 2013–14 and later income years for land and improvements, and for the 2014–15 and later income years for aircraft and boats.

The amendment to align the "asset income" definition in section DG 17 with that in section DG 16 applies for the 2013–14 and later income years for land and improvements, and for the 2014–15 and later income years for aircraft and boats.

LOSS GROUPING CONTINGENT ON GROUP LOSS COMPANY SATISFYING ITS LIABILITIES FOR DEDUCTIBLE EXPENDITURE

Sections CG 2, CG 2C, CG 2D, CG 2E and FM 5(3), (4) of the Income Tax Act 2007

The loss grouping rules have been amended to correct an unintended consequence arising during the rewrite of the Income Tax Acts. The amendments confirm the benefit of past loss grouping is contingent on the group loss company satisfying its liabilities relating to past deductible expenditure (other than under the financial arrangement rules).

Consequential amendments have also been made to clarify the relationship of new sections CG 2C to CG 2E with the consolidated group rules in subpart FM, the amalgamation rules in subpart FO, and the loss grouping rules in sections IC 11 and IC 12.

Background

Since enactment of section 191(7B) of the Income Tax Act 1976, the grouping of tax losses has been contingent on the group loss company fully satisfying its liabilities for deductible expenditure included in its tax losses made available to another company under the loss grouping rules. Section 191(7B) was re-enacted into the Income Tax Act 1994 as sections CE 4, IE 1(4) and IG 2(9).

These provisions permitted the Commissioner to amend an assessment of a group profit company to reduce the amount of grouped tax losses to the extent the group loss company had not satisfied all liabilities giving rise to deductions included in the grouped tax losses. This amendment could be made for any income year as the time bar did not apply.

The rewrite of these provisions included a policy change (in section CG 2 of the 2004 Act), that changed the timing of the adjustment for remitted or cancelled debts for past deductible expenditure. This policy change was to better align the adjustment (for remitted or cancelled liabilities relating to past deductible expenditure) with self-assessment by eliminating the need to amend past assessments.

Under current section CG 2, a remitted or cancelled debt for past deductible expenditure is treated as income derived in the year the debt is remitted (for example, on the company being struck off or liquidated). However, section CG 2 does not provide that the benefit of loss grouping is contingent upon the group loss company fully satisfying its liabilities for past deductible expenditure incurred in years

in which tax losses were grouped. The amendments correct this anomaly in the law.

Key features

Section CG 2 no longer applies to a group loss company if:

- the group loss company has previously made a tax loss available to another company in the same group of companies under the loss grouping rules; and
- the group loss company in the same group of companies as the group profit company has unsatisfied liabilities for deductible expenditure included in those past tax losses made available under the loss grouping rules; and
- the group loss company in the same group of companies is removed from the register of companies; or
- either the group profit company or the group loss company has left the group and for both cases, the group loss company is insolvent, in receivership or in liquidation at that time.

Instead, new sections CG 2C and CG 2D apply, as appropriate, to these circumstances. These amendments restore to the law, the long-standing policy that the benefit of grouped tax losses is contingent on the group loss company fully satisfying its liabilities relating to past deductible expenditure incurred in the year the losses are grouped.

Under sections CG 2C or CG 2D, the group profit company derives income equal to the amount of certain unsatisfied liabilities of the group loss company.

New section CG 2C will apply if the group loss company has been removed from the register of companies.

New section CG 2D will apply if the profit company and the group loss company break their grouping status.

New section CG 2E permits the company deriving income under either section CG 2C or CG 2D to apportion the income appropriately among certain group companies.

Amendments to section FM 5 clarify how sections CG 2C and CG 2D are to apply to a consolidated group of companies.

An amendment to section FO 5 ensures that neither of sections CG 2C or section CG 2D apply on an amalgamation. However, to ensure an amalgamation cannot be used to avoid the effect of section CG 2C or CG 2D, the amalgamated company is treated as if it were the group loss company after amalgamation in relation to relevant unpaid liabilities of the group loss company.

Sections IC 11 and IC 12 (relating to loss grouping) apply before section CG 2C or section CG 2D apply.

Application date

New sections CG 2C, CG 2D, and CG 2E, and consequential amendments to sections FM 5 and FO 5 apply from 22 November 2013, the date the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill was introduced.

Detailed analysis

Reduction in benefit of group tax losses under the Income Tax Act 1994

The interaction of sections IG 2(9), IE 1(4) and CE 4 of the Income Tax Act 1994 permitted the Commissioner to amend an assessment of a group profit company to reduce the amount of losses made available under the loss grouping rules. This amended assessment of a group profit company could be made for any income year—it was not limited by the four-year time bar that normally applies to income tax assessments. However, the reduction in the benefit of grouped tax losses was limited to the amount of remitted or cancelled debts of the group loss company.

In the decision of *Hotdip Galvanisers (Christchurch) Ltd v CIR* (1999) 19 NZTC 15,337, the Court of Appeal confirmed that, under the 1976 Act's corresponding provision to section IG 2(9) of the 1994 Act:

- the Commissioner was entitled to amend an assessment of a group profit company in a group that received the benefit of tax losses from a group loss company, if the group loss company's deductible expenditure forming part of the loss offsets was remitted or cancelled;
- the provision did not require the Commissioner to first re-assess the group loss company for the remission adjustment; and
- the Commissioner was not limited by the four-year time bar that normally applies to income tax assessments.

Policy change in Income Tax Act 2004

In rewriting sections CE 4 and IE 1(4)(d) of the Income Tax Act 1994 into section CG 2 of the Income Tax 2004, it was considered desirable to place the timing of the effect of the remission on a basis consistent with self-assessment. This policy change resulted in timing the effect of the adjustment for the remitted or cancelled debts to the year of remission or cancellation in contrast to the amendment of previous years' assessments under the former law.

Unintended consequence

Section CG 2 applies only to the taxpayer that had incurred the debt, and does not apply to a group profit company if a group loss company cannot be assessed for section CG 2 income (a company that is removed from the register of companies cannot be assessed for remission income).

Consequently, no legislative provision exists to reduce the benefit of past grouped tax losses from group profit companies if debts of the group loss company are remitted or cancelled, in contrast to the situation under the 1994 Act.

New sections CG 2C and CG 2D correct this anomaly in the law and ensure that the benefit of past loss grouping is contingent on the group loss company:

- fully satisfying its liabilities for deductible expenditure included in a net loss (other than expenditure relating to a financial arrangement rules); and
- that net loss has been included in a tax loss subsequently made available under the loss grouping rules to another company in the same group of companies.

Group loss company removed from the register of companies

Section CG 2C applies to a group profit company in a group of companies if:

- the group profit company has received the benefit of tax losses under the loss grouping rules from a group loss company in the same group of companies;
- the group loss company is removed from the register of companies (and not subsequently restored to the register);
- the group profit company and the group loss company are in the same group of companies immediately prior to the removal of the group loss company from the register of companies;
- at the time the company is removed from the register of companies, the group loss company has unsatisfied liabilities for past deductible expenditure relating to tax losses made available to the group profit company under the loss grouping rules; and
- the removal of the group loss company from the register of companies occurs after the tax loss has been made available to another company under the loss grouping rules.

On removal from the register of companies, there is no longer a company in existence to meet those unpaid unsatisfied debts or be assessed for income under section CG 2. New section CG 2C section treats the group profit company as deriving income equal to the remitted or cancelled liability for deductible expenditure incurred by the group loss company.

New section CG 2C applies if the group loss company and the group profit company are in the same group of companies immediately before the group loss company is removed from the register of companies. If grouping status is broken, section CG 2D applies.

The income is treated as derived on the day the group loss company is removed from the register of companies.

New section CG 2C will not apply to an expenditure relating to the financial arrangement rules.

Group loss company or group profit company leaving the group

A number of commercial considerations mitigate against section CG 2C applying to a group profit company when grouping status is broken with a group loss company.

These considerations include the following:

- At the time the group loss company is removed from the register of companies, the management decisions relating to the group loss company would made by a different management team from that managing the affairs of the group profit company. A decision to remove the group loss company from the register of companies by the new owners need not consider the implications for that group profit company given they are no longer part of the same group of companies.
- A tax obligation for a company arising from the liquidation of a group loss company that is no longer part of the same group as the group profit company (and beyond the management of the group's affairs) can impact adversely on the group profit company's balance sheet.
- The tax obligation can potentially affect existing financing arrangements.

When a company exits the group, it can be assumed that management would be aware of the following facts at that time:

- if an insolvent group loss company has not satisfied its debts giving rise to tax losses transferred under the loss grouping rules;
- if the exiting company has received the benefit of tax losses from that insolvent group loss company;
- if the exiting company is the insolvent group loss company; and
- there is a risk that the insolvent loss group company might not subsequently satisfy its debt obligations for past deductible expenditure incurred in years in which past tax losses were made available under the loss grouping rules.

Under new section CG 2D, the benefit of past grouped tax losses is adjusted to the profit company, to the extent the insolvent loss group company has unsatisfied liabilities for past deductible expenditure in years in which losses were grouped. However, if the group loss company satisfies its unpaid debts for past deductible expenditure before the

exit time, without giving a preference to one creditor over another, section CG 2D would not apply.

New section CG 2D will not apply to an expenditure relating to a financial arrangement.

Voidable transaction

Because solvency is measured at a point in time, an issue arises under the voidable transaction rule in the Companies Act 1993.

It is possible for a payment by the group loss company to satisfy an unpaid liability for past deductible expenditure to be a voidable transaction under the Companies Act 1993. If the payment is a voidable transaction (a creditor is repaid in preference to other creditors), a liquidator could subsequently recover the payment from the creditor, resulting in the relevant liability being reinstated.

The Commissioner has discretion, at the time grouping is broken, to determine whether a transaction to satisfy relevant unpaid liabilities could be a voidable transaction under the Companies Act 1993. If the Commissioner exercises this discretion, for the purpose of section CG 2D only, transactions relating to the funding and payment of such a transaction can be ignored in determining whether the group loss company is solvent.

Section IC 11 and IC 12

Section IC 11 permits the Commissioner to amend an assessment of a group profit company to reduce the tax loss of a group loss company made available to it for a tax year if the Commissioner has reduced the available tax loss of the group loss company for that year. This section applies, for example, when the group loss company has taken a tax position on the deductibility of an expenditure that has not been accepted by the Commissioner.

Section IC 12 ensures that deductions of a group loss company relating to inter-company bad debts or decline in the value of shares in a group company are not available for grouping.

Sections IC 11 and IC 12 are applied before sections CG 2C or CG 2D are applied.

REMITTED AMOUNTS ON DISCHARGE FROM BANKRUPTCY

Sections CG 2 and CG 2B of the Income Tax Act 2007

Section CG will no longer apply to a bankrupt on discharge from bankruptcy, as it conflicts with the “fresh start” principles of insolvency law on discharge from bankruptcy. Section CG 2 applies to treat an amount of income equal to the amount of remitted or cancelled debts that were incurred for past deductible expenditure.

Instead, section CG 2B now applies to a person discharged from bankruptcy. This new section provides that a discharged bankrupt will derive remission income to offset against any tax losses the person has. However the amount of the income is limited to the lesser of the following:

- the total amount of debt remitted on discharge from bankruptcy that relates to past deductible expenditure; and
- the bankrupt’s loss balance at the end of the tax year preceding the discharge from bankruptcy after taking into account any reduction in the loss balance made by the Commissioner under section 177C of the Tax Administration Act 1994.

Background

On 3 October 2011, the Minister of Revenue issued a press release calling for submissions on remedial items, including one relating to the Commissioner’s powers, under section 177C of the Tax Administration Act 1994. Under section 177C, the Commissioner may:

- write off uncollectible amounts of tax owing by the bankrupt; and
- make consequential adjustments to the taxpayer’s tax losses carried forward (the loss balance).

Submissions raised two issues relating to the remission of most debts when a bankrupt is discharged from bankruptcy:

- Insolvency law remits most debts of a bankrupt at the time of discharge. One issue was whether it was appropriate for section CG 2 to recover all of the past deductions (as remission income of the taxpayer) if debts incurred for those past deductions:
  - remained unpaid on the taxpayer being adjudged bankrupt; and
  - were subsequently remitted on discharge from bankruptcy.
- It was unclear whether remission income under section CG 2 was taken into account in the calculation of the bankrupt’s taxable income before or after being discharged from bankruptcy. This uncertainty potentially impacted on the Commissioner’s powers to write off tax and adjust a loss balance of the bankrupt.

Application date

The amendment applies to a discharge from bankruptcy that occurs on or after 1 April 2014.

Detailed analysis

Section CG 2 applies to a person:

- who has been allowed a deduction for an amount the person is liable to pay;

- that liability is later remitted or cancelled (but not if the remission or cancellation is a dividend); and
- the financial arrangement rules do not require a base price adjustment to be made for that remission or cancellation.

Effect of law under the Income Tax Act 1994

Before enactment of the Income Tax Act 2004, a debt remission in the course of bankruptcy would have resulted in the Commissioner amending the income tax assessment for the tax year if the debt was incurred for a deductible expenditure (section CE 4 of the Income Tax Act 1994).

This amended assessment was not limited by the four-year time-bar that normally applies to the amendment of income tax assessments. However, the amount of the amended assessment to reduce past tax losses was limited to the amount of remitted or cancelled debts of the bankrupt. This amended assessment would have resulted in either:

- a reduction in the person's loss balance at the end of that earlier tax year; or
- an increased income tax liability being assessed for that earlier tax year.

Policy change in Income Tax Act 2004

In rewriting section CE 4 of the Income Tax Act 1994 as section CG 2 of the Income Tax 2004, it was considered desirable to place the timing of the effect of the remission on a basis consistent with self-assessment. This change was to the timing of the adjustment for the debt remission, that is, the adjustment would be made in the year of remission rather than amending prior years' assessments to make that adjustment.

However, this change in the timing has left it unclear whether the bankrupt would have income under section CG 2 on discharge from bankruptcy.

Amendment to section CG 2, new section CG 2B

The potential application of section CG 2 to a bankrupt on discharge from bankruptcy conflicts with the "fresh start" policy of insolvency law for a discharged bankrupt. The amendments ensure that section CG 2 does not apply on discharge from bankruptcy. Instead, the new section CG 2B applies to a person discharged from bankruptcy.

If a person discharged from bankruptcy has a loss balance at the end of the tax year preceding the year in which the discharge occurs, the person has income equal to the lesser of:

- the total amount of debts remitted which relate to past deductions; and
- the person's loss balance at the end of the tax year preceding the year of discharge (after taking into account any reduction in that loss balance by the Commissioner under section 177C of the Tax Administration Act 1994).

Income derived under section CG 2B is treated as derived on the first day of the income year in which the person is discharged from bankruptcy. This income is included in the calculation of the person's taxable income for the year of discharge and:

- effectively reduces the benefit of the loss balance of the taxpayer brought forward from the previous year; and
- ensures that a discharged bankrupt does not have an income tax liability for debts discharged in bankruptcy.

If a person discharged from bankruptcy does not have a loss balance at the end of the tax year preceding the year in which the discharge occurs, that person will not have remission income under either of sections CG 2 or CG 2B.

SERIOUS HARDSHIP

Sections 176 to 177C of the Tax Administration Act 1994

Amendments have been made to allow the Commissioner, in appropriate circumstances, to bankrupt taxpayers, who are in serious hardship and to ensure the reasons why the debt arose are not a factor in determining whether the taxpayer is in serious hardship. These amendments ensure that the legislation is consistent with Inland Revenue's operational practice.

Background

In 2003, the debt and hardship rules were introduced. Under the rules the Commissioner must maximise the recovery of outstanding tax from a taxpayer and deal with cases in an efficient manner. However, the Commissioner may not recover to the extent that recovery is an inefficient use of the Commissioner's resources or if it would place a taxpayer, who is a natural person (individual), in serious hardship.

The rules provide incentives for taxpayers who are having problems paying their tax to contact Inland Revenue and discuss the payment options available to them. The best option is always payment of the full amount on or before the due date. If that is not possible, taxpayers can enter an instalment arrangement and pay the debt off over time. If the debt cannot be paid off over time, the Commissioner has a discretion under which she can write off tax. In addition, the Commissioner must write off the tax that is not collected if the taxpayer is bankrupted, liquidated or their estate has been distributed. The Commissioner's practice is to bankrupt taxpayers who cannot pay in appropriate circumstances, for example, when it is

considered the write-off would have an adverse effect on taxpayers' perceptions of the integrity of the tax system.

Following a review of the legislation, an alternative view of the rules was raised which had two related implications.

The first implication was that bankruptcy is a recovery action and at the point that any further recovery action would cause serious hardship, bankruptcy, along with any other recovery action, was prohibited. Therefore, the Commissioner could not bankrupt a taxpayer when the taxpayer was facing serious hardship.

Inland Revenue's view is that bankruptcy does not necessarily place or cause a taxpayer to be in serious hardship. This is consistent with the policy intent; the Official Assignee takes over the bankrupt's affairs and ensures they do not suffer serious hardship.

The second implication arose from the alternative view that in determining whether a taxpayer is in serious hardship, Inland Revenue needed first to consider how the debt arose. For example, if the taxpayer's debt arose from the taxpayer enjoying goods of an expensive nature, the taxpayer would not be in serious hardship and Inland Revenue could recover the debt.

This view was at odds with the way Inland Revenue applies the debt and hardship rules and could result in adverse outcomes for taxpayers. The view was also inconsistent with the policy intention of the rules which is to protect taxpayers from being placed in serious hardship as a result of recovery actions taken by Inland Revenue.

Inland Revenue's approach is that when a taxpayer applies for financial relief, Inland Revenue determines whether the taxpayer can pay the debt, or whether paying part or all of the debt would place the taxpayer in serious hardship. The cause of the outstanding tax is not taken into account in determining serious hardship as the alternative view would have required. If paying the debt would place the taxpayer in serious hardship, Inland Revenue then considers how best to deal with the debt, and in some cases writes off the debt. In some cases the taxpayer would be bankrupted and in other cases the debt would remain. In deciding which action to take, Inland Revenue will, at this stage, consider how the debt arose and the need to maintain the integrity of the tax system.

Key features

The Tax Administration Act 1994 has clarified the meaning of "serious hardship" and it has been made clear that the factors that give rise to the taxpayer not being able to pay the outstanding tax are not taken into account when determining whether or not the taxpayer is in serious hardship.

It has also been clarified that the Commissioner of Inland Revenue can, in appropriate circumstances, bankrupt taxpayers, when they are in serious hardship.

Application date

The amendments apply from 30 June 2014, being the date of enactment.

UNACCEPTABLE TAX POSITION

Section 141B of the Tax Administration Act 1994

An amendment to the unacceptable tax position penalty clarifies that the penalty does not apply to shortfalls that arise in respect of GST and withholding-type taxes. That is, the unacceptable tax position penalty only applies to income tax shortfalls. The amendment clarifies an amendment made in 2007.

Background

A tax shortfall is the difference between a taxpayer's correct tax liability calculated under the legislation and the position a taxpayer took in their tax return. There are five categories of shortfall penalty—ranging from not taking reasonable care (when the penalty is 20 percent of the tax shortfall) to evasion or a similar act (when the penalty is 150 percent of the tax shortfall). The appropriate penalty is assessed when a required standard is breached, for example, if the taxpayer does not take reasonable care, the penalty for not taking reasonable care is assessed.

One of the shortfall penalties is the unacceptable tax position penalty. An "unacceptable tax position" is a tax position that, if viewed objectively, fails to meet the standard of being "about as likely as not to be correct". This does not mean that the taxpayer's tax position must be the better view or be more than likely the correct view, but rather that the position is "about as likely as not to be correct".

The aim of the shortfall penalty is to encourage taxpayers to take tax positions that are correct in terms of the law. A taxpayer is liable to pay a shortfall penalty of 20 percent if the taxpayer takes an unacceptable tax position in relation to income tax, and the tax shortfall arising from the taxpayer's tax position is more than both:

- $50,000; and
- 1 percent of the taxpayer's total tax figure for the relevant return period.

A change to the legislation in 2003 meant the unacceptable tax position penalty potentially applied to all tax shortfalls over the thresholds, including cases when the tax shortfall arose from a mistake in the facts or when an unacceptable

tax position was taken and immediately corrected. Taxpayers and tax agents noted that the penalty was having an adverse effect on taxpayer behaviour, resulting in taxpayers being less inclined to make voluntary disclosures. In 2006 a short-term solution was put in place which gave Inland Revenue a discretion not to impose the penalty in specific circumstances.

In 2007 the discretion was repealed, the threshold for imposition of the penalty was increased and the scope of the penalty was limited to income tax, that is, the penalty was no longer to be imposed on GST or withholding tax shortfalls. At the same time, the reduction given for voluntary disclosures made before a taxpayer is notified of a pending audit or investigation when the shortfall arose from the taxpayer not taking reasonable care, or from an unacceptable tax position, increased from 75 percent to 100 percent.

Following a review of the legislation, it was determined that the 2007 amendment did not achieve the desired policy outcome. The 2007 amendment inserted the words "in relation to income tax" in section 141B of the Tax Administration Act 1994. However, section RA 2 of the Income Tax Act 2007 deems the tax types listed in section RA 1 to be "income tax" and therefore were subject to the unacceptable tax position penalty. These taxes include PAYE, fringe benefit tax and non-resident withholding tax.

The intention of the 2007 amendment was clear and taxpayers expected that following the amendment the unacceptable tax position penalty would only apply to tax shortfalls that arose in annual income tax returns. Inland Revenue's practice was to apply the penalty only to tax shortfalls that arise in annual income tax returns.

Key features

The amendment clarifies that the tax types listed in section RA 1 of the Income Tax 2007 have been removed from the scope of the unacceptable tax position shortfall penalty so that the penalty applies only to tax positions relating to income tax.

Application date

The amendment applies retrospectively to tax positions taken on or after 1 April 2008 (the application date of the 2007 amendment).

CLARIFICATION OF NEW DUE DATE FOR PAYMENT OF TAX

Section 142A of the Tax Administration Act 1994

Amendments clarify that a new due date is not set when the Commissioner makes a systems-generated default assessment, and that when a taxpayer files a return following a systems-generated default assessment, a new due date is set for the resulting tax liability.

Background

If the Commissioner makes an assessment or amends and increases an assessment, a new due date is set for the tax assessed. Before an amendment in 2007, a new due date was only required when the Commissioner increased an assessment. This had the effect of creating an incentive for taxpayers who considered they did not have a tax liability to file a "nil return". This meant that if the Commissioner determined at a later date that the taxpayer did have a tax liability, a new due date would be set for the tax assessed by the Commissioner. In the absence of the "nil return", the taxpayer would be liable for use-of-money interest and late payment penalties from the original due date and, when the taxpayer had breached a required standard of behaviour, shortfall penalties.

There was a concern that the penalty rules were discouraging taxpayers from complying voluntarily with their tax obligations, as the imposition of both use-of-money interest and late payment penalties overly penalised taxpayers. Also, the application of late payment penalties when the taxpayer considered they did not have a tax liability could be seen as inappropriate. In some cases the late payment penalty was effectively being used as a penalty for the taxpayer not filing their return on time.

In 2007 an amendment was made under which Inland Revenue is required to set a new due date when it makes an assessment or increases an assessment. In 2009 the provision was again amended. The aim of this amendment was to remove the requirement to set a new due date when Inland Revenue makes a systems-generated default assessment.

More recently, concerns were raised that the 2009 amendment did not achieve the desired policy outcome. In particular, it was found that when a taxpayer files a return following a default assessment, a new due date would only be set when the tax assessed by the taxpayer is more than the default assessment and the new due date only applied to the difference.

This was contrary to the policy intent which is that the late payment penalty is a penalty imposed when the taxpayer knows they have a tax liability and they do not pay on time. Default assessments are made by the Commissioner under section 106 of the Tax Administration Act 1994. There are a number of different circumstances when the Commissioner can issue a default assessment, for example, when a return has not been made or following an audit or investigation when the Commissioner is not satisfied with the return filed by the taxpayer.

The 2009 amendment which removed the requirement to set a new due date when Inland Revenue makes a default assessment was aimed at systems-generated default assessments, assessments generated by Inland Revenue's FIRST system to encourage the taxpayer to file an outstanding return. It was not aimed at assessments made by the Commissioner following an audit. It was considered appropriate to impose late payment penalties from the original due date because, in the case of systems-generated default assessments, the assessment is issued because there is a concern about the taxpayer's non-compliance.

Key features

Section 142A of the Tax Administration Act 1994 has been clarified to ensure that a new due date is not set when the Commissioner makes a systems-generated default assessment. It has also be clarified that when a taxpayer files a return following a systems-generated default assessment, a new due date is set for the resulting tax liability.

Application date

The amendment will apply retrospectively from 6 October 2009 (which was the application date of the 2009 amendment).

REFERENCES TO LOSS ATTRIBUTING QUALIFYING COMPANIES

Sections 141EB and 141FD of the Tax Administration Act 1994

In 2010 the loss attributing qualifying company rules were repealed and the look-through company rules introduced. The promoter penalty legislation still referred to "loss attributing qualifying companies" when it should have referred to "look-through companies".

The amendment updates references in the promoter (section 141EB) penalty legislation that referred to loss attributing qualifying companies so they now refer to look-through companies. The penalty relief provision for loss attributing qualifying companies has also been repealed.

Application date

The amendments apply from 1 April 2011 (the date from which the look-through company rules apply).

WORKING FOR FAMILIES TAX CREDITS

Sections MB 1(5C), 7B(2) and 13(2) of the Income Tax Act 2007

Amendments have been made to clarify that various payments that are of a capital nature, or are windfall gains, are excluded from the definition of "family scheme income" in section MB 13 of the Income Tax Act 2007. These include repayments of mistaken or misdirected payments, refunds, a capital payment from a person's ownership in a business, inheritances and lottery winnings.

Background

Working for Families tax credits are provided to the principal caregiver of dependent children based, among other things, on their level of family scheme income for a tax year. The tax credits are abated when family scheme income exceeds $36,350 at a rate of 21.25 cents per dollar. Families that choose instalment payments of tax credits throughout the year are required to estimate their family scheme income and are subject to an end-of-year reconciliation. Alternatively, families can apply for an end-of-year lump sum payment.

The family scheme income provisions have been amended several times over the last decade, including as part of the rewrite of the Income Tax Act. The definition of "family scheme income" was broadened as part of Budget 2010, with effect from 1 April 2011. This included a new provision for other payments a family may receive to replace lost income or to meet their usual living expenses. The broader definition is intended to improve the fairness and integrity of Working for Families tax credits by, for example, countering arrangements that have the effect of inflating entitlements beyond what people's true economic circumstances justify.

In 2012 the Government agreed that employer-provided vouchers and other short-term charge facilities should also be included in family scheme income. This change came into effect from 1 April 2014.

The definition of "family scheme income" is also used, with some adjustments, for determining eligibility for some people applying for student allowances and the community services card. A similar definition is used for student loan repayments.

Key features

Changes to the rules in subpart MB of the Income Tax Act 2007 describing the definition of "family scheme income" have been made. The main change adds the following items to the list of payments that are excluded from the "other payments" rule in section MB 13:

- repayment of a loan;
- repayment of a mistaken or misdirected payment;
- refund of a payment (including tax, student loan and child support refunds resulting from an overpayment);
- payment from the person's ownership of an investment activity or business, where it is received on capital

account, and the payment is not a loan and is not a payment by a trustee;

- payment of an inheritance from a deceased person's estate;
- money won from gambling or a New Zealand lottery.

The other changes in subpart MB:

- correct a cross-reference error in section MB 1(5C);
- amend section MB 1(5C) to cover depreciation loss for a building in an investment activity, to mirror earlier changes made to section MB 3 to ignore net losses from investment activities; and
- correct a drafting error in section MB 7B(2)(b) to refer to a "benefit" instead of a "fringe benefit".

Application dates

The amendments to section MB 13(2) apply for the 2015–16 and later income years.

The amendments to section MB 1(5C) apply from 1 April 2011.

The amendments to section MB 7B(2) apply from 1 April 2014.

Detailed analysis

Current sections MB 1 to MB 12 list specific amounts that are included in family scheme income. Section MB 13(1) includes other payments in the definition of family scheme income when the payment is paid or provided to the person from any source and used by the person to:

- replace lost or diminished income of the person or the person's family; or
- meet usual living expenses of the person or the person's family.

Section MB 13(2) excludes payments from section MB 13(1) when the payment is not intended to form part of family scheme income. An example is when a payment is already included in family scheme income under sections MB 1 to MB 12, or when it is paid or provided by the government and treated as exempt income for tax and welfare purposes.

The Working for Families tax credits are income-tested on family income. While it has a broad definition of income, it is not the policy intent for the tax credits to be asset-tested. For example, using money or cash assets from a person's bank account for usual living expenses is not intended to be included in family scheme income, whereas interest earned on savings is included. Similarly, the family scheme income definition is not intended to capture the realisation of assets into cash, other than the extent to which it is assessable income under the Income Tax Act 2007.

Section MB 13(2)(b) excludes a payment if it is the proceeds of the disposal of property and not assessable income of the person disposing of the property. This is intended to prevent, for example, the proceeds from the sale of a family car, when the proceeds are used to meet usual living expenses, from being included in family scheme income. The exception is when sales proceeds are assessable income for that person.

There are payments not covered by section MB 13(2)(b) but which are similar, or they relate to a change in how assets are held or realised, which should be excluded. It is also not the policy intention to include windfall gains in family scheme income, to the extent that they are not assessable income. For families who estimate their family scheme income upfront, it would not be possible to accurately estimate windfall gains, and could lead to end-of-year debts. It is also unlikely that the family would rely on windfall gains to meet the family's usual living expenses.

Section MB 13(2) has been amended to exclude items that can be technically caught by the wording of section MB 13(1) but do not come within the policy intent of that provision. They are:

- repayment of a loan—this covers the repayment of the principal of the loan. Interest payable on the loan is assessable income and is already included in family scheme income under another provision;
- repayment of a mistaken or misdirected payment—this is not additional money for the person or their family;
- refund of a payment (including tax, student loan and child support refunds resulting from an overpayment);
- payment of an inheritance from a deceased person's estate; and
- money won from gambling or a New Zealand lottery–these windfall gains are not intended to be caught by the "other payments" rule.

The amendments also include in the list of excluded items:

- a payment from the person's ownership of an investment activity or business, when it is received on capital account, and the payment is not a loan and is not a payment by a trustee.

Dividends, shareholder salary, interest, or rent from a business or investment activity are not received on capital account and are already included under other provisions in subpart MB. A payment from a person's investment or business received on capital account is equivalent to the withdrawal of funds from a savings account and should likewise not be included in family scheme income. The person and their family are not "better off" from receiving

the payment; rather they are converting their assets into cash. Often the payment on capital account will be referred to as "drawings", although some drawings may be a loan or income that has been incorrectly labelled.

A loan from a business or investment to the person will be excluded under section MB 13(2)(a) if it is on the basis of ordinary commercial terms and conditions.

The following examples illustrate situations when drawings are not included in the definition of family scheme income under section MB 13(2).

Example 1

In 2012 John invests $20,000 into his partnership to boost working capital. The partnership grows. In 2016, John withdraws $20,000 from the partnership into his family's joint bank account. He and the family use the money for normal day-to-day items. The $20,000 would not be included as family scheme income under section MB 13 as, while it was paid to John and used to meet the family's usual living expenses, it falls under the exemption for withdrawal of capital funds invested in a business—section MB 13(2)(bd).

Example 2

Hayley owns a company and draws out an amount of money on capital account for living costs. The company derives a profit and income tax is paid. An imputed dividend is declared, from which Hayley repays/offsets the drawings. The taxable dividend is treated as family scheme income so the drawings are not included in the family scheme income because section MB 13(2)(p) would apply. (Note also that under section MB 4 any company income that would be attributed as family scheme income is reduced by the dividend.)

CHILD SUPPORT

Sections 2, 9, 40, 44, 65, 81, 92, 98, 142, 179A of the Child Support Act 1991

Various remedial changes are made to the Child Support Act 1991 to clarify wording, correct errors, make further consequential changes and make small changes to simplify the child support scheme.

Background

Under the Child Support Amendment Act 2013 a number of changes were made concerning child support terms, for example, the "custodial parent" of the qualifying child is now referred to as the "receiving carer". The Child Support Amendment Act 2013 will also amend, from 1 April 2015, the way a formula assessment of child support is determined and make improvements to the operation of the child support scheme.

Key features

The Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 makes the following remedial changes to the Child Support Act 1991 (as amended by the Child Support Amendment Act 2013):

- the definition of "election period" in the interpretation section has been repealed as there is a new definition of "election period" in new section 40AA;
- new section 9(1)(c) clarifies that a beneficiary is not required to apply for child support if they are **already** a receiving carer;
- it is clarified that notices of election in new section 40(1) cannot be given after the end of the child support year to which the election relates;
- the ordering of provisions in new section 44 relating to the end-of-year reconciliation of an estimate of income have been corrected to ensure the intended policy outcome is achieved;
- consequential changes to section 65 have been made in light of the new rules for determining liable parents and receiving carers, and to prevent a voluntary agreement and a formula assessment for a child being in force simultaneously;
- new section 92(3A) has been repealed as the provision is no longer required;
- section 98 has been amended to align with new section 32 on the method for distributing the minimum annual amount of child support when there is more than one receiving carer;
- a change ensures that a non-parent receiving carer who has been granted a social security benefit under the Social Security Act 1964 cannot waiver the right to collect child support from a liable parent; and
- further consequential amendments have been made to reflect the changes in child support terminology.

Application date

The amendments will apply from 1 April 2015.

ASSOCIATED PERSONS AND PERSON WITH A POWER OF APPOINTMENT OR REMOVAL

Section YB 11(2) of the Income Tax Act 2007

An amendment to the associated persons rules ensures that a person with a power of appointment or removal of a trustee will not be associated with the trustee under section YB 11 (Trustee and person with power of appointment or removal) if they are subject to the professional code of conduct and disciplinary processes of an approved organisation. This is a remedial amendment to ensure the provision operates as intended. Before the amendment, members of approved organisations could avail themselves of the exclusion, but non-members, who were still subject to the approved organisation's professional code of conduct and disciplinary processes, could not.

Background

Section YB 11(1) of the Income Tax Act 2007 prescribes that a trustee of a trust and a person with the power of appointment or removal of trustees in relation to the same trust are associated for tax purposes.

An exclusion to this associated persons test was enacted by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013. This exclusion was intended to ensure that those who receive a power of appointment or removal of a trustee in their professional capacity are not associated with the trustee of the trust.

Among other requirements, the exemption applies to a person who is a "member of an approved organisation". To be an approved organisation, the organisation's natural person members must be subject to a professional code of conduct and to disciplinary processes in accordance with that code (among other requirements).

There were circumstances in which this exemption did not operate as intended.

Using New Zealand Institute of Chartered Accountants (NZICA) as an example of an approved organisation, chartered accountancy (CA) practices can have partners who are members of NZICA and partners who are not members. A partner in a CA practice who is not a member of NZICA is still subject to NZICA's code of ethics and disciplinary process because they are part of a member firm. However, because they are not a member of NZICA themselves, they were previously not covered by the exclusion in section YB 11(2).

This was contrary to the policy of the exclusion—to exclude from the association test those trustees acting in a professional capacity. The membership of a professional body is generally an appropriate test to achieve this policy intention as it ensures that the class of persons able to avail themselves of the exclusion is limited and a high standard has to be met before the exclusion is available. The members of professional bodies (such as the New Zealand Law Society and NZICA) are also the most likely trustees to be acting in a professional capacity. However, a non-member of NZICA working in a CA firm is just as likely as an NZICA member to be a trustee in their professional capacity and should not be treated any differently for the purpose of the associated persons test.

Key features

The exclusion in section YB 11(2) has been extended to include not only members of an approved organisation, but also persons who are subject to the approved organisation's code of ethics and disciplinary process (provided the other requirements of the exclusion in section YB 11(2) are also met).

Application dates

The remedial amendment has the same application date as the original exclusion in section YB 11(2), that is, it applies for the purposes of:

a) provisions other than the land provisions, for the 2010–11 and later income years;

b) the land provisions other than section CB 11, for land acquired on or after 6 October 2009; and

c) section CB 11, for land on which improvements are begun on or after 6 October 2009.

TAX ADMINISTRATION ACT 1994: CROSS-REFERENCES TO SECTIONS 108 AND 109

Sections 93(2)(b), 94(2)(b), (c), 95(2)(b), 97(3)(a), 97B(3)(a), 98(2)(a), 98B(3)(a), 99(2)(a), (b), 100(3)(b), 101(2)(a) and 101B(2)(a) of the Tax Administration Act 1994

Sections 93(2)(b), 94(2)(b), (c), 95(2)(b), 97(3)(a), 97B(3)(a), 98(2)(a), 98B(3)(a), 99(2)(a), (b), 100(3)(b), 101(2)(a) and 101B(2)(a) are being amended to correct a cross-referencing error within section 94(2)(b) noted in a recent court decision. The other provisions listed are consequentially amended for consistency.

Background

In a recent court decision,[18] it was identified that section 99(2)(a), in seeking to cross-refer to section 108, used language that did not appear in section 108. The same cross-referencing problem arises in a number of provisions

[18] *Vinelight Nominees Limited v CIR* [2012] NZHC 3306 (HC); (2013) 26 NZTC 21-055, [2013] NZCA 655.

from section 93 to section 101B of the Tax Administration Act 1994.

Similar drafting issues arise from the use of the term "taxpayer" in a number of provisions from section 93 to section 101B of the Tax Administration Act 1994 that refer to section 109 of the Tax Administration Act 1994. This is because the term "taxpayer" no longer appears in section 109.

Application date

The amendments apply from 1 October 1996.

Detailed analysis

Section 99 of the Tax Administration Act 1994 enables the Commissioner to assess a person for RWT if the Commissioner considers that person has not paid the correct amount of RWT. Under the RWT rules, a person paying resident withholding income is required to withhold RWT and pay to the Commissioner the amount of RWT withheld on a periodic basis.

The reference in section 99(2) of the Tax Administration Act 1994 to section 108(1) of the Tax Administration Act 1994 is to ensure that the Commissioner cannot amend an earlier RWT assessment outside the time-bar period. Peters J's comments in the Vinelight decision highlight a technical problem that the time bar may not apply to RWT assessments. Peters J identified a remedial issue within section 99 of the Tax Administration Act 1994, concerning the relationship of section 99 to section 108 of the Tax Administration Act 1994. This finding was endorsed in the later Court of Appeal decision in the same case. In the High Court, Peters J stated:

> There is an obvious difficulty with s 99(2)(a), because s 108(1) does not include the words "income tax for any year". [100]

The judge's comments in the Vinelight decision highlight a technical problem that the time bar may not apply to resident withholding tax (RWT) assessments. The words identified by Peters J, "income tax for any income year", were repealed in 1996 as part of the reforms of the disputes resolution legislation. Section 99 of the Tax Administration Act 1994 was not updated at that time to reflect the new wording in section 108(1).

Section 108(1) imposes a time limit (time bar) on the Commissioner's power to amend an earlier assessment of income tax. That time-bar period is four years after the end of the tax year in which the earlier assessment was made.

Section 109 of the Tax Administration Act 1994 provides that disputable decisions are treated as correct unless a challenge is lodged against that decision, but the provision no longer uses the word "taxpayer". Disputable decisions include assessments by the Commissioner and most decisions of the Commissioner in relation to the application of a tax law to a taxpayer's circumstances.

This drafting issue also arises from these provisions not being updated correctly in 1996 to reflect the amended wording in sections 109.

These amendments are solely to correct the cross-reference wording into either section 108 or section 109 and do not change the effect of the current law.

DISPOSAL OF CERTAIN SHARES BY A PIE

Section CB 26 of the Income Tax Act 2007

Section CB 26 has been amended so that it does not apply in relation to dividends from a listed PIE.

By way of background, section CX 55 provides that gains arising from the sale of most Australian and New Zealand-listed shares are excluded income for PIEs and similar entities. However, section CB 26 deems a taxable dividend to arise when a share that satisfies the criteria of section CX 55 is sold after a dividend is declared but before the dividend is paid. This is to prevent a PIE turning a taxable dividend receipt into a non-taxable gain on sale.

These concerns do not arise for dividends received from listed PIEs as those dividends are not taxable in any event. There is no tax advantage in selling a share in a listed PIE after a dividend is declared but before it is paid. There is therefore no need for section CB 26 to apply to dividends from a listed PIE as the unimputed portion of such dividends are not taxable under section CX 56C.

Application date

The amendment applies from the beginning of the 2013–14 income year.

TRUSTS THAT ARE LOCAL AND PUBLIC AUTHORITIES

Sections CW 38 and CW 39 of the Income Tax Act 2007

Amendments to sections CW 38 and CW 39 clarify that an amount derived by a trustee for a local authority or a public authority constituted as a trust:

- does not enjoy the exempt income status under sections CW 38 or CW 39 if that amount is retained and included in trustee income of the trustee; and
- is exempt income if that amount is distributed to a beneficiary that itself is exempt from income tax in relation to that distribution.

Background

The Income Tax Act 2007 currently exempts from tax any amount derived by a local authority and a public authority other than "an amount received in trust". The exact meaning of these words is unclear and their interpretation has caused difficulty for taxpayers and Inland Revenue.

The policy is that this exemption should not extend to amounts that a local authority receives as a trustee. However, if the trustee receives an amount as trustee for a beneficiary which itself enjoys exempt income status, the trustee may take that exemption into account in meeting the trustee's income tax obligations for the beneficiary.

Application date

The amendment applies from 30 June 2014, being the date of enactment.

Detailed analysis

The amendments to sections CW 38 and CW 39 address questions raised with the Commissioner relating to the trustee's tax obligations for the beneficiary of a trust for which a local or public authority is the trustee.

The amendment clarifies, for the avoidance of doubt, that income derived by a local or public authority as trustee on the terms of a trust is to be treated as follows:

- the exemption for income derived by a public authority or a public authority does not extend to income derived in the capacity as trustee that has not been distributed; and
- the trustee may take into account an exemption from income of the beneficiary for determining the trustee's income tax obligations on that beneficiary income under other provisions of the 2007 Act.

ORDERS IN COUNCIL

FORESTS (PAYMENT OF MONEY) ORDER 2014

A payment to landowners for permanently protecting native forest with high conservation values on their land can be exempted from income tax if the appropriate Order in Council is made.

An Order in Council, made under the Forests Amendment Act 2004 (see *Tax Information Bulletin* Vol 16, No 8, p19) grants an income tax exemption in relation to a payment made by the Nature Heritage Fund to the owners of a block of land in the West Rowallan Survey District. The payment made in January 2014 was in exchange for the owners entering into conservation covenants over the land.

The Order in Council, which came into effect on 24 July 2014, is part of the Government's SILNA (South Island Landless Natives Act 1906) Policy Package announced in 2002.

Forests (Payment of Money) Order 2014 (LI 2014/193)

FIF DEEMED RATE OF RETURN SET FOR 2013–14 INCOME YEAR

The deemed rate of return for taxing foreign investment fund (FIF) interests is 7.99% for the 2013–14 income year, up from 6.91% for the previous income year.

The deemed rate is set annually and is one of the methods that can be used to calculate income from FIF interests.

The rate is based on an average of the five-year Government bond interest rate at the end of each quarter, plus a 4% margin.

The new rate was set by Order in Council on 23 June 2014.

Income Tax (Deemed Rate of Return on Attributing Interests in Foreign Investment Funds, 2013–14 Income Year) Order 2014 (LI 2014/210)

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 14/06: GST – HIRE FIRM SECURITY BONDS

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

This Question We've Been Asked (QWBA) is about ss 2, 8 and 10.

During a review of the *Public Information Bulletin* and *Tax Information Bulletin* series published before 1996, the answer to Question 11 in a series of GST questions and answers in *Public Information Bulletin* No 148, p 4 (May 1986) was identified as no longer reflecting the Commissioner's interpretation of the law as it relates to GST and hire firm security bonds. The Public Information Bulletin review has now been completed, see "Update on *Public Information Bulletin* review" *Tax Information Bulletin* Vol 25, No 10 (November 2013): 37.

This QWBA updates and replaces the *Public Information Bulletin* item.

Question

1. What are the GST implications of a customer paying a bond to a GST registered hirer of goods as security when the goods are hired?

Answer

2. The paying of the bond has no GST effect because there are no services supplied in return for the bond. If the bond is repaid in full on the return of the goods, that remains the case. If, or to the extent, the bond is forfeited because it is applied in accordance with the agreement between the parties:
    - as payment of an extra hire charge, because the goods are returned late, then it is consideration for a supply and is subject to GST;
    - as compensation for damage to, or loss of, the goods, then it is not consideration for a supply and is not subject to GST;
    - for the purchase of goods or services, then it is consideration for a supply and is subject to GST; or
    - for a breach of a condition (eg, operating the goods in a way not permitted under the hire agreement), it is not consideration for a supply and it is not subject to GST.

Explanation

Background

3. In *Public Information Bulletin* No 148, p4 (May 1986) there was a series of GST questions and answers. Question 11 asked: "What is the treatment of deposits by way of security (bonds) taken by hire firms, which are refunded when the goods are returned in good condition at the end of the hire period?". The answer provided was: "Such deposits are not consideration for a taxable supply and are not therefore subject to GST when paid. If, however, these deposits are appropriated as a result of a contingency such as non-compliance with the bond conditions, the amount so appropriated is consideration for a taxable supply and subject to GST."
4. Where a customer pays an amount as security for the return of goods (a bond) and the hire firm appropriates that amount as a result of a contingency, such as non-compliance with bond conditions, and does not supply anything in return to the customer, the Commissioner now considers there is no GST payable by the hire firm. In some scenarios this will result in a different answer to that provided in Question 11. This is because where there is no supply (as is the case in the second and last bullet points in [2] above) there is no GST.

Taxable supply

5. For GST to apply to a transaction, a registered person must make a supply for consideration in the course or furtherance of a taxable activity they carry on. This is the combined effect of s 8(1), which imposes GST with reference to the "value of a supply", and s 10, which determines the value of a supply by reference to the "consideration" for the supply. "Consideration" is defined in s 2 to include:

> any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person; but does not include any payment made by any person as an unconditional gift to any non-profit body …

QUESTIONS WE'VE BEEN ASKED

6. For GST to apply to a payment, it must be more than just a payment to a registered person in the course or furtherance of their taxable activity. For GST to apply, the payment must also be a payment for a supply. To determine whether a payment satisfies this test, a relevant supply must be identified. Then it must be determined whether, or at what point, a payment is made for that identified supply (see *CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093 (CA)).

A bond

7. When a customer hires goods from a hire firm, the customer may be asked to pay a bond. If the goods are returned on time and undamaged, the bond will be refunded. If the goods are returned late, the hire firm, in accordance with the agreement between the parties, may retain some, or all, of the bond to pay additional hire charges. A hire agreement may also provide that a bond will be forfeited, in whole or in part, for a breach of another term of the hire agreement. An example of such a term is a restriction on using the hired goods in a particular way or in a particular place or damaging or losing the goods. Other agreements may simply provide that customers must forfeit their bond if there is any damage to the hired goods. In these types of situations, working out whether GST applies to the bond payment requires identifying whether there is a relevant supply and then determining whether, or at what point, a payment is made for that identified supply. Each transaction must be carefully analysed to determine whether there has been a supply. This is demonstrated in the following scenarios, which identify some types of transactions that might arise in the hire industry.

Initial payment of bond

8. A hire firm may require a customer to pay a bond as security when the goods are hired. The initial payment of a bond is not for any supply. The payment arises in the context of a supply of hired goods but it is not for that supply. The bond is paid to give the hire firm an amount to resort to in case an event provided for in the agreement occurs. If the agreement is complied with, then the bond will be returned to the customer.

Late return of goods

9. Where, in accordance with the agreement between the parties, the hire firm retains some, or all, of a bond to pay additional hire charges because hired goods are returned late, that is consideration for a supply. For example, if goods are hired for two days but returned after three, the amount of the bond forfeited is consideration for the extra day's hire of the goods.

10. In cases where previously agreed consideration is increased and a tax invoice has already been issued (and the supply is not a successive supply under s 9(3)), the supplier must provide the recipient with a debit note that meets the requirements of s 25(3)(b). If the supplier did not account for the increased amount of GST in the GST return in which the original supply was returned (as they were not then aware of that increase in consideration), the supplier must make the relevant adjustment in the GST return for the period in which it became apparent that the output tax they returned was incorrect.

Damage to, or non-return of, hire goods

11. Where, in accordance with the agreement between the parties, the hire firm retains some, or all, of a bond to compensate for damage to the hired goods, that is not consideration for a supply. The amount retained is a payment of damages. The Commissioner's view on the application of GST to damages is set out in "GST Treatment of Court Awards and Out of Court Settlements", *Tax Information Bulletin* Vol 14, No 10 (October 2002): 21. GST will not apply where the payment is compensation or damages and not consideration for a supply.

12. The same reasoning applies where a bond is forfeited because the hired goods are not returned at all. The amount the hire firm retains is damages for the loss of the goods and is not consideration for any supply made by the hire firm to the customer.

13. However, if the hire firm and the customer agree that the customer will buy the goods, then GST will apply to that sale in the ordinary way with the hire firm issuing a tax invoice to the customer and returning the GST on that sale in the return for the appropriate GST period.

Breach of another term

14. A hire agreement may contain a term that restricts the use of the goods in a particular way or in a particular place and provides for the deposit to be forfeited if the term is not complied with. If the bond is forfeited for such a breach, GST will not apply. The hire firm does not supply anything for the amount forfeited. Generally, the amount will be an estimate of damage suffered because of the breach of the term. In some cases, forfeiture of the bond may be viewed as a penalty. That is relevant to the enforceability of the term but will not alter the GST treatment.

15. By contrast, the hire agreement may contain a term that does not restrict the use of the hired goods but instead provides that if the goods are used in a particular way extra charges will be incurred that will

be forfeited from the bond. In this case, the hire firm is supplying something extra (ie, the use of the goods in a particular way) for the amount of the bond forfeited and, therefore, GST applies.

16. As stated above, for GST to apply, the payment must be a payment for a supply. Whether a payment is for a supply will ordinarily be determined by the terms agreed to by the parties. However, as is the case under any contract, where the true legal position does not accurately reflect the terms of the agreement (regardless of whether it is written or oral), it is the true legal position that determines whether there is a payment for a supply. In that regard nomenclature, by itself, does not determine the true legal position. Similarly, where the parties have not acted in accordance with the written terms of the hire agreement but have made an alternative agreement, it is that alternative agreement that is determinative (see *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA)).

Different treatment for late payment charges and penalty and default interest payments

17. It is important to note that late payment charges and payments of penalty and default interest are not the same as compensation or damages payments. There are specific sections that apply to late payment charges and payments of penalty and default interest. Under ss 5(25) and (26), a late payment charge on the payment of an account (not including a payment of penalty or default interest) will be liable for GST if the underlying supply to which that payment relates is subject to GST. Penalty or default interest imposed under a contract for the supply of goods or services is exempt from GST under s 14(3).

Examples

18. The GST consequences of each of the examples below are a result of those particular facts. This means that any additions, or variations, to the facts in the Examples may give rise to different GST consequences.

19. The hire firm in each example is GST registered and all hire fees paid are GST inclusive.

Example 1: Goods returned late

20. Robert rented a concrete mixer from ABC Hire for two days for $50. Robert paid a bond of $200. The hire agreement provided that the bond would be repaid to Robert if he returned the mixer on time and undamaged with the hire agreement providing that ABC Hire could charge an extra amount for any additional day(s) the mixer was retained beyond the agreed hire period.

21. Robert returned the mixer one day late. ABC Hire deducted $25, for an extra day's hire, from the bond and returned the balance of $175 to Robert.

22. The initial payment of the bond by Robert was not consideration for a supply, so ABC Hire does not have to account for GST on that payment. The $25 deducted from the bond was consideration for the supply of the mixer for an extra day, so ABC Hire must account for GST on that $25.

Example 2: Goods returned damaged

23. Ann rented tables and chairs from ABC Hire for a party she was holding in her backyard. The total rent was $300 and Ann also paid a bond of $200 against the return of the furniture on time and undamaged. The hire agreement stated that the chairs must be returned in the same condition (fair wear and tear excepted).

24. Ann returned the furniture on time but two chairs were damaged. ABC Hire estimated that the cost of repairing the chairs would be $60 and deducted that from the bond before returning the balance to Ann.

25. The initial payment of the bond by Ann was not consideration for a supply, so ABC Hire does not have to account for GST on that payment. The $60 deducted from the bond was also not consideration for a supply. That deduction was to compensate ABC Hire for damage suffered, so it is not subject to GST.

Example 3: Goods not returned

26. Helen rented a tent for a week from ABC Hire. Under the hire agreement, the rental charge for the tent was $200, with Helen also paying a bond of $300 to ensure the safe return of the tent.

27. When Helen did not return the tent, the manager at ABC Hire called the phone number Helen gave on the hire form. The person who answered the phone said Helen used to live there but had left owing rent and without leaving a forwarding address. ABC Hire kept the bond as compensation for the loss of the tent.

28. The initial payment of the bond by Helen was not consideration for a supply, so ABC Hire does not have to account for GST on that payment. The forfeiting of the bond was also not consideration for a supply. The bond amount was taken by ABC Hire to compensate it for the loss it suffered (ie, the loss of the tent), so it is not subject to GST.

Example 4: Goods kept

29. Brian rented a vintage suit from Suit Hire Co for his school ball. Under the hire agreement, Brian paid a bond of $200 for the return of the suit on time and in the same condition (fair wear and tear excepted). Unfortunately, at the ball Brian ripped one arm of the suit.

30. When Brian returned the suit, he was told that he would forfeit the bond because of the damage. Brian asked Suit Hire Co what it would cost to buy the suit instead. Suit Hire Co told Brian if he paid an extra $100 and forfeited the bond, the suit was his. Brian agreed.

31. In this case, Suit Hire Co relinquished its damages claim against Brian. Instead, Suit Hire Co sold the suit to Brian and applied the $200 bond towards the $300 purchase price of the suit. The initial payment of the bond by Brian was not consideration for a supply, so Suit Hire Co does not have to account for GST on that payment. However, Suit Hire Co must account for GST on the $300 sale price of the suit, which includes the $200 bond amount that was paid as part of the purchase price.

Example 5: Breach of a condition of hire

32. Jane rented a car from Holiday Rentals for a day. Under the hire agreement, the rental charge was $80 and Jane also paid a bond of $200. The hire agreement also provided that the car was not to be driven on a local beach and that the bond would be forfeited if this condition was broken. Holiday Rentals included that term because cars driven on that beach regularly fell into holes. Sometimes the car suspension was damaged as a result and often cars had to be towed out. This condition was pointed out to Jane by the Holiday Rentals' manager when Jane signed the hire form.

33. The manager saw Jane driving the car on the beach later that day. When Jane returned the car, she was told that she had breached the hire agreement and Holiday Rentals would not be refunding the bond.

34. The initial payment of the bond by Jane was not consideration for a supply, so Holiday Rentals does not have to account for GST on that payment. The forfeiting of the bond is also not subject to GST. Under the hire agreement, Holiday Rentals did not supply anything to Jane in return for the forfeited bond, so it is not consideration for a supply.

References

Related rulings/statements
"GST Treatment of Court Awards and Out of Court Settlements" *Tax Information Bulletin* Vol 14, No 10 (October 2002): 21
Subject references
Consideration; GST; Hire bond; Taxable supply
Legislative references
Goods and Services Tax Act 1985 – ss 2, 8 and 10
Case references
Buckley & Young Ltd v CIR (1978) 3 NZTC 61,271 (CA)
CIR v Databank Systems Ltd (1989) 11 NZTC 6,093 (CA)

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 *Binding rulings: How to get certainty on the tax position of your transaction (IR 715)*. You can download this publication free from our website at **www.ird.govt.nz**

PRODUCT RULING BR PRD 14/05: PROCARE HEALTH LIMITED

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

Name of the Person who applied for the Ruling

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

Taxation Laws

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

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

The Arrangement to which this Ruling applies

The Arrangement is the issue by ProCare Health Limited (PHL) PHL of two tranches of new shares to its existing shareholders on 15 October 2012, and the redemption of one of the tranches issued to existing shareholders. A further two tranches of shares may also be issued by PHL, to the ProCare Charitable Foundation (the Trust).

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

The parties to the Arrangement

1. PHL was incorporated in New Zealand in 1995 and provides management and clinical services to its subsidiaries. One of PHL's subsidiaries is a Primary Health Organisation, which is contracted by the Auckland regional Health Boards to provide primary healthcare services to patients in the Auckland, Counties Manukau and Waitemata District Health Board domiciles. PHL also has two commercial subsidiaries that provide medical services.
2. PHL had 389 shareholders as of 15 October 2012 (as at 15 November 2013, it had 379 shareholders), each being a general practitioner (GP) contracted to PHL. It is currently not mandatory for contracted GPs to hold a share in PHL, and as at the date of this ruling there are approximately 400 GPs currently contracted to PHL who are not shareholders.
3. The Trust was established on 17 July 2012 with PHL as the Settlor. Under the Procare Charitable Foundation Trust Deed, the Trust has the purpose of promoting the health and wellbeing of disadvantaged communities across the Greater Auckland Region and, to that end, the Trust is authorised to provide grants and funding and develop programmes. The Trust is registered as a charitable entity under the Charities Act 2005.

Background to the Arrangement

4. It is currently proposed that PHL will introduce a mandatory shareholding requirement for contracted GPs. It is hoped that the introduction of mandatory shareholding will increase the engagement of contracted GPs with the organisation, and that it will provide all contracted GPs with the ability to participate in PHL's governance. Other means by which PHL might increase the participation of contracted GPs and operate more effectively to promote the health and wellbeing of people within the Greater Auckland Region are also being considered.
5. In the event that mandatory shareholding is introduced, PHL will need to issue new ordinary shares to contracted GPs who are not currently shareholders. In anticipation of the introduction of mandatory shareholding, PHL has undergone a capital restructure to return value to its existing shareholders, and has established the Trust. PHL has obtained over 90% shareholder approval for the proposed restructure.

Steps involved in the Arrangement

6. The steps involved in the Arrangement are:
   a) The issue by PHL to all existing shareholders on 15 October 2012 of two tranches of non-voting redeemable preference shares (RPS), being:
      i) a fully imputed taxable bonus issue, as defined in s YA 1, subparagraph (b) (Tranche 1); and
      ii) a non-taxable bonus issue as defined in s YA 1 (Tranche 2).

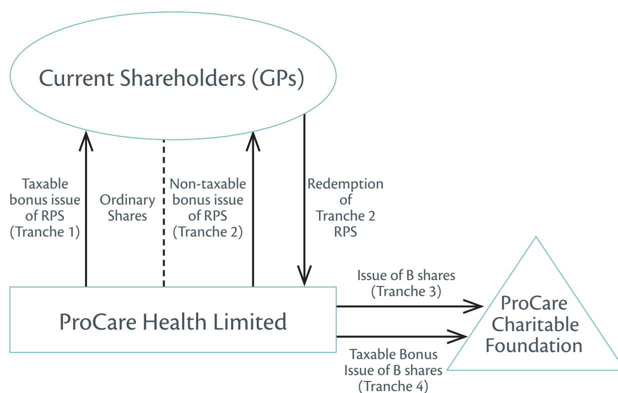
b) The redemption and cancellation off-market by PHL of the Tranche 2 shares at face value (in aggregate, approximately $2.5 million).

7. It is anticipated that the Arrangement will incorporate the following additional steps:

   a) The issue by PHL of a small number of non-voting B shares to the Trust (Tranche 3).

   b) The fully imputed taxable bonus issue, as defined in s YA 1, subparagraph (b), by PHL of non-voting B shares to the Trust (Tranche 4).

8. The steps involved in the overall Arrangement (including the issue of the Tranche 3 and Tranche 4 shares) are summarised in the following diagram:



Further details of the Arrangement

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

   Shares on adoption: Upon or following adoption of this constitution, the Company will have the following classes of share on issue:

   a. Ordinary Shares;

   b. Redeemable preference Shares; and

   c. B Shares.

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

    a. Are redeemable within the meaning of section 68 of the Act;

    b. Confer preferential rights to receive distributions of capital or income;

    c. Confer special, limited or condition voting rights; or

    d. Do not confer voting rights.

11. Clause 2.5 of the Constitution provides:

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

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

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

14. PHL has redeemed and cancelled the Tranche 2 shares. The amount paid by PHL for the redemption and cancellation exceeded the available subscribed capital of the class under the ordering rule.

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

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

17. Following the steps outlined in paragraphs 6 and (if implemented) 7 above, it is anticipated that PHL will undertake further changes to its operating and business ownership structure and PHL currently proposes that contracted GPs who are not existing shareholders of PHL will be required to subscribe for an ordinary share (with the subscription amount expected to be approximately $500 per share). These further changes are not part of the Arrangement (and this ruling does not apply to these further changes).

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

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

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

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

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

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

The period or income year for which this Ruling applies

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

This Ruling is signed by me on 20th day of June 2014.

Dinesh Gupta

Manager (Taxpayer Rulings)

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, Privy Council and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

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

COMMISSIONER AWARDED DISCOVERY ORDERS

Case	TRA 022/12 [2014] NZTRA 06
Decision date	4 June 2014
Act(s)	Tax Administration Act 1994, High Court Rules, Taxation Review Authorities Regulations 1998
Keywords	Discovery orders, particular discovery, evidence exclusion rule

Summary

This case concerned an application by the Commissioner of Inland Revenue ("the Commissioner") for discovery of documents supporting the disputant's statement in her Statement of Position ("SOP") explaining how she funded her losses.

Impact of decision

The evidence exclusion rule will not preclude a discovery order over documents supporting a statement in a SOP even when that statement is not identified as a separate legal issue or proposition of law. The statement forms part of the disputant's case and therefore the Commissioner is entitled to reply to it.

Facts

This was an interlocutory application by the Commissioner for discovery orders.

The substantive dispute involves a claim for deductions. The disputant failed to file income tax returns for the 2006, 2007 and 2008 income tax years (inclusive). In June 2009, the Commissioner issued default assessments based on annualised sales from GST returns filed for the periods in dispute.

The disputant subsequently filed income tax returns for the 2006, 2007 and 2008 income tax years and issued a Notice of Proposed Adjustment. The disputant claimed expenses exceeding income derived in two of the three years in dispute. The expenses claimed represented 139%, 99% and 113% of income for those years respectively.

The disputant's SOP stated that she was handling work for which she would not be paid until the end of the matter. Therefore, her taxable income was not greater than her expenses resulting in taxable losses. She claimed she funded the losses by loans from a family trust.

The Commissioner sought discovery of the following documents:

1. a copy of the disputant's diary for the 2006 to 2008 income years;
2. all documents/material that evidence or explain what funds the disputant or her family used to fund her losses and to support her and her family's lifestyles during the 2006 to 2008 income years; and
3. all documents relevant to the deductions claimed by the disputant in each income year.

Subsequent to the hearing, the parties reached agreement for informal discovery of the documents referred to in 1 and 2 above.

The remaining issue for determination related to discovery of documents identified in 2 above.

Decision

An order was made for discovery of the documents identified in 2 above.

Relevance of documents

The Commissioner argued that whether the disputant has satisfied her onus of proof will in part turn on her credibility, assessed in the context of the background facts. A key background fact is whether it is credible that the disputant had virtually no net income in the years in dispute given that she claims to be successful in her chosen career.

The Commissioner further argued that the documents sought are relevant, as such evidence has a tendency to disprove that all the deductions claimed are genuine business expenses (section 7(3) of the Evidence Act 2006);

that the Commissioner is entitled to respond to the disputant's statement that her net income is temporarily low and that she has lived off loans from her family trust; and that the disputant cannot justify her returns and then not discover the documents relevant to that justification.

The disputant argued that neither party in her SOP identifies the disputant's source of funds as a legal issue in dispute and, therefore, the discovery sought is not relevant.

The Taxation Review Authority ("TRA") agreed with the Commissioner and found that the discovery sought is relevant to the legal issue for the following reasons:

1. for the purpose of assessing the credibility of the taxpayer;
2. the documents sought have a tendency to disprove that all the deductions claimed are genuine business expenses; and
3. it is necessary for the Commissioner to be able to respond to the disputant's statement that her net income is temporarily low and that she has lived of loans from her family trust.

Applicability of evidence exclusion rule

While the disputant accepts that the operation of section 138G(1) of the Tax Administration Act 1994 ("TAA") (the "evidence exclusion rule") does not preclude an order for discovery of relevant material, she argued that the Commissioner has failed to establish that discovery of the documents is either relevant or necessary to resolve the present challenge.

The disputant argued that the scope of the evidence exclusion rule refers back to the requirements to be included in the parties' respective SOPs. Sections 89M(4) and 89M(6) of the TAA provide that SOPs must, with sufficient detail to fairly inform the other party, give an outline of the facts and the evidence on which the party intends to rely; an outline of the issues that the party considers will arise; and specify the propositions of law on which the party intends to rely.

The disputant argued that neither party identified any legal issues or propositions of law relating to the question of how the disputant funded her expenditure or supported her family.

The disputant argued that no reasonable person reading the parties' SOPs would think either party had made an issue of her source of funds.

The Commissioner argued that it is necessary under sections 89M(4)(b) and 89M(6)(b) that SOPs only contain an outline of evidence. The discovery sought is within the outline of evidence in the disputant's SOP and therefore cannot be excluded under the evidence exclusion rule.

The Commissioner argued that when the disputant explained her ability to fund her losses from her family trust, she put in issue how she funded her losses and it now forms part of the outline of the case.

The TRA found that it is not necessary for the matter to be identified as a separate legal issue or proposition of law. The disputant clearly raised the issue of the source of her funds in the context of her claim for deductibility of expenditure when she sought to explain how she funded her losses. That explanation now forms part of the disputant's case and the Commissioner is entitled to rely on it.

EMPLOYEE ENTITLEMENT FUND AND TAX AVOIDANCE

Case	HC Services Ltd v Commissioner of Inland Revenue [2014] NZHC 1169
Decision date	29 May 2014
Act(s)	Tax Administration Act 1994, Income Tax Acts 1994 and 2004
Keywords	Employee entitlement fund, tax avoidance, fraud, shortfall penalties

Summary

The High Court confirmed the decision of the Taxation Review Authority ("TRA") and dismissed the appeal of HC Services Ltd.

Facts

This was an appeal against the decision of the TRA, delivered on 6 November 2013 (TRA 11/10 [2013] NZTRA 09); and the earlier Threshold Ruling of the TRA, delivered on 11 September 2012 (TRA11/10 [2012] NZTRA 08).

The appellant made payments to a purported employee entitlement fund ("the EEF") for the benefit of the appellant's employees and claimed income tax deductions for the various payments made in relation to the EEF in the income tax years ended 31 March 2004 to 31 March 2006 (inclusive). The Commissioner assessed the appellant on the basis the appellant was not entitled to deductions under the following black letter provisions: sections DC 5, DA 1, DA 2, DB 6 and/or DB 7 of the Income Tax Act 2004 ("ITA 2004"); and/or alternatively, the EEF it invested in and promoted, was a tax avoidance arrangement. The Commissioner also imposed shortfall penalties for taking an unacceptable tax position pursuant to section 141B of the Tax Administration Act 1994 ("TAA") and for taking an

abusive tax position pursuant to section 141D of the TAA (reduced by 50%) in each of the tax years.

In the TRA, the appellant challenged the Commissioner's assessments and asserted it was entitled to deductions under section DB 33 of the ITA 2004 for misappropriation. However, before the substantive issues were considered by the TRA, the parties requested the TRA determine whether fraud on the appellant in relation to any arrangement precludes sections OB 1, BG 1 and GB 1 of the ITA 2004 from applying.

The TRA found that, even if there had been a fraud on the appellant, the fraud did not prevent the general anti-avoidance and reconstruction provisions applying (TRA11/10 [2012] NZTRA 08 at [149]).

At a separate hearing, the TRA considered the substantive issues and confirmed the Commissioner's assessments including shortfall penalties for having taken an abusive tax position (TRA 11/10 [2013] NZTRA 09 at [127]).

Decision

Fogarty J agreed with the TRA that the EEF did not meet the requirements of section DC 5 of the ITA 2004 as there was no evidence that there was any intention to "fully secure" employees' rights to receive benefits from the fund.

His Honour agreed with the TRA's findings at [133]–[136] that any fraud on the appellant by a third party is not relevant to the application of the anti-avoidance provisions (*HC Services Ltd v Commissioner of Inland Revenue* [2014] NZHC 1169 at [25]–[29]).

Further, Fogarty J dismissed the submission that fraud in an arrangement has the same vitiating effect as a sham. At [37] he found:

> The fact that one of the principals behind this tax arrangement may have intended at some point, either from the outset or during the transactions, to defraud the taxpayer, does not mean that there were no rights and obligations created by the transactions, that they were not real.

His Honour concluded at [62]:

> An argument that elements of fraud – either in the construction, promotion or operation of the tax avoidance arrangement – vitiated the arrangement so that the tax avoidance provisions could not apply – would render tax avoidance provisions of the Act significantly ineffectual. On such a construction, the best way to sell a tax avoidance package would be to sell an ineffective one! That has to be nonsense.

Finally, in relation to penalties, and having found that the appellant was a party to a tax avoidance arrangement, Fogarty J upheld the Commissioner's abusive tax position shortfall penalty assessments pursuant to section 141D(7)(b)(i) of the TAA, commenting that the High Court has no power to apply subsection (7)(b)(ii) of the TAA.

STATEMENT OF POSITION DECLARED INVALID

Case	TRA 007/13 [2014] NZTRA 05
Decision date	4 June 2014
Act(s)	Tax Administration Act 1994
Keywords	Statement of Position, section 89(M) of the Tax Administration Act 1994, prescribed form

Summary

The respondent's Statement of Position ("SOP") was considered invalid and the respondent was therefore unable to challenge the assessments under Part 8A of the Tax Administration Act 1994 ("TAA").

Impact of decision

It is not enough for a SOP to be filed in the prescribed form (IR 773). It must also meet the requirements of section 89M(6) of the TAA.

Facts

The Commissioner of Inland Revenue ("the Commissioner") applied to strike out the respondent's Notice of Claim on the ground that the Notice of Claim discloses no right of challenge under Part 8A of the TAA and therefore should be struck out pursuant to section 138H of the TAA.

The respondent is a taxi driver and disputes the Commissioner's GST and income tax assessments for various income years. On 24 September 2012, the Commissioner issued the respondent a disclosure notice which provided that the respondent had two months from the date of the disclosure notice to issue a SOP.

On 11 October 2012, the respondent issued a document in the prescribed form (IR 773) for a SOP. The document contained very little information.

On 16 October 2012, the Commissioner advised the respondent by letter that she was of the view that the document purporting to be a SOP did not meet the legislative requirements in section 89M(6) of the TAA. The Commissioner requested that the respondent supply additional information or a new SOP by 23 November 2012. The respondent did not do so.

Decision

The Taxation Review Authority ("TRA") agreed with the Commissioner's submission that the respondent's SOP did not contain sufficient detail to fairly inform the Commissioner of the facts, evidence and propositions of law on which the respondent relied. The TRA found that the SOP was therefore in breach of section 89M(6) of the TAA. The TRA considered that at best it was "a bare outline of matters".

Consequently, the TRA found that the respondent had not issued a valid SOP in the prescribed form within the requisite response period. Accordingly, the respondent was deemed not to have issued a Notice of Proposed Adjustment pursuant to section 89M(7)(b).

The TRA also agreed with the Commissioner's submission that a taxpayer cannot rely solely on filing the IR 773 for the purposes of section 89M(7) of the TAA without complying with the requirements of section 89M(6), as this would have the effect of making section 89M(6) redundant. The TRA stated further that section 89M(6) is mandatory.

Accordingly, the TRA decided that, as the respondent had failed to follow the disputes procedure, the Commissioner's assessments are deemed correct under section 109 of the TAA and section 138B of the TAA provides that the respondent is unable to challenge the Commissioner's assessments under Part 8A.

LEAVE TO CONTINUE CHALLENGE

Case	TRA 025/11, [2014] NZTRA 07
Decision date	5 June 2014
Act(s)	Taxation Review Authorities Regulations 1998
Keywords	Challenge deemed withdrawn, good reason, exceptional circumstances

Summary

The disputant showed a genuine wish to continue the litigation and the right to a hearing and determination should not be lightly denied. The disputant was granted leave to proceed with the challenge proceeding.

Impact of decision

The Taxation Review Authority ("TRA") will not be quick to deem a challenge withdrawn if the application to continue under regulation 32(2)(a) is within the time limits and the disputant can provide a plausible explanation. This was distinguished from regulation 32(2)(b) which has a higher threshold as exceptional circumstances need to be satisfied.

Facts

This proceeding was set down for a directions hearing on 20 February 2014. The disputant failed to attend the hearing and the challenge was deemed to be withdrawn. The disputant made an application for leave to continue on 27 February 2014.

An affidavit in support was filed by Mr AB who lives in Australia and is the sole director of the disputant. He stated that Mr XY had been the principal person involved in handling this dispute and that on 19 February 2014 Mr XY advised him by email that he was no longer acting on behalf of him in this matter. Mr AB stated he was unaware of the directions hearing, and in any case believed Mr XY was acting on his behalf.

The Inland Revenue investigator stated in an affidavit that during a conversation held on 5 July 2013, Mr XY advised her that he was no longer acting for the disputant and that she should contact Mr AB to obtain new contact details. On 20 August 2013, the investigator stated she met with Mr AB and discussed the status of his challenge proceeding.

Mr XY also filed an affidavit. Mr XY stated that in the middle of 2013, he stopped acting for the disputant in relation to the settlement discussions with the Commissioner of Inland Revenue ("the Commissioner"). After that he was only engaged on a limited basis regarding small residual matters.

In an email to the TRA on 19 February 2014, Mr XY disclosed he no longer acted for Mr AB. However, in his affidavit, Mr XY stated that this was not strictly true. He believed, because of his diminished role in the matters, attending the hearing was no longer his responsibility. He also stated that Mr AB could have thought the hearing was a procedural matter of which he was still responsible.

The disputant submitted that the evidence of Mr AB and Mr XY are consistent and both state that due to the lack of communication between them, Mr AB thought erroneously that Mr XY was handling the directions hearing.

The Commissioner submitted that the circumstances show there was no room for confusion. Mr AB knew that Mr XY was not acting for him and would not attend the directions hearing.

Decision

The disputant was granted leave to proceed with this challenge proceeding.

The disputant filed its application within 20 working days of the directions hearing so regulation 32(2)(a) of the Taxation Review Authorities Regulations 1998 applies. The disputant then needed to satisfy the TRA that it had a good reason for failing to attend the directions hearing.

The TRA stated that because the matter was heard on the papers, there was no opportunity to examine the credibility of the witnesses. The TRA was satisfied, based on the investigator's evidence, that there could have been confusion between Mr AB and Mr XY as to Mr XY's involvement in the proceeding.

The TRA recognised that there was no case law on what constitutes a "good reason" for failing to attend a directions hearing and agreed with the disputant's submission that the test for obtaining leave under 32(2)(a) was less demanding than an application under 32(2)(b). The TRA further added that it was mindful that the right to a hearing and determination should not be lightly denied and took into account that having a case withdrawn is a severe consequence for any disputant.

The TRA determined that, while greater care should have been taken, the failure to attend arose from a misunderstanding and was not deliberate and that in the context of the regulation, the explanation provided amounted to a "good reason" for failing to attend.

SOVEREIGN ASSURANCE REFUSED LEAVE TO APPEAL TO THE SUPREME COURT

Case	Sovereign Assurance Company and Others v Commissioner of Inland Revenue [2014] NZSC 68
Decision date	10 June 2014
Act(s)	Income Tax Act 1994
Keywords	Accrual rules, capital/revenue, insurance and reinsurance contracts

Summary

The Supreme Court refused Sovereign Assurance's application for leave to appeal the Court of Appeal decision in *Sovereign Assurance Company Limited v Commissioner of Inland Revenue* [2013] NZCA 652.

Impact of decision

An appeal to the Supreme Court is not as of right. Applicants have to request leave from the Supreme Court in accordance with the criteria set out in section 13 of the Supreme Court Act 2003. Those criteria include whether a substantial miscarriage of justice has occurred, whether the case involves a matter of general or public importance or has general commercial significance. Each application made to the Supreme Court will turn on its own facts.

Facts

Sovereign Assurance Co Ltd sought leave to appeal the decision of the Court of Appeal in *Sovereign Assurance Company and Ors v Commissioner of Inland Revenue* [2013] NZCA 652.

The Court of Appeal upheld the Commissioner of Inland Revenue's assessments for the 2000 to 2006 years that applied the accruals regime to the refundable commission transactions resulting from reinsurance treaties entered into by Sovereign.

Decision

The Supreme Court dismissed Sovereign's application for leave stating:

> Both Dobson J and the Court of Appeal rejected Sovereign's contention as to the limited application of the accruals regime. As well, Dobson J held that in accordance with ordinary principles, the refundable commissions were not income and that accordingly the repayments were not deductible. Two members of the Court of Appeal panel reached the same conclusion. In part, this was because they treated them as loans (see [122]–[124] of the Court of Appeal decision) but their conclusion was also based on the premise that the refundable commissions could not be "counted as gains completely made" (an expression which comes from an Australian case). In this latter respect, their conclusions were to the same effect as those of Dobson J. [9]
>
> It follows that if the legal arguments which Sovereign wishes to advance as to the displacement of the accruals regimes and the categorisation of the arrangements as loans were to succeed, Sovereign still faces the hurdle of findings on the capital/revenue issue. These findings could be categorised as being factual but even if they are not, we see no good reason for allowing a second appeal. The relevant principles are well established, if not always easy to apply. The question raised by the case is thus one of application rather than principle and there is no appearance of a miscarriage of justice. [10]

SUMMARY JUDGMENT FOR $367 MILLION

Case	Commissioner of Inland Revenue v Russell [2014] NZHC 1296
Decision date	10 June 2014
Act(s)	Insolvency Act 1996
Keywords	Summary judgment, arguable defence, interim relief

Summary

A summary judgment was entered by the Court as there was no arguable defence, and no grounds upon which the Court ought to exercise its residual discretion to decline summary judgment.

Impact of decision

A judicial review proceeding will not of itself amount to an arguable defence in a summary judgment application. The discretion of the Court in rule 12.2 is a discretion of the most residual kind.

Facts

The Commissioner of Inland Revenue ("the Commissioner") applied for summary judgment against John George Russell ("Mr Russell") in the amount of $367,204,207.41, plus costs and disbursements.

In January 2004, the Commissioner assessed Mr Russell for profits of $15,757,556.18 in relation to the 1985 to 2000 income tax years. Mr Russell challenged those assessments in the Taxation Review Authority ("TRA"). On 17 September 2009, the tax challenge was dismissed by the TRA.

On 3 September 2010, Mr Russell's appeal of the TRA decision to the High Court was dismissed. On 3 April 2012, the Court of Appeal dismissed Mr Russell's appeal of the High Court decision. On 13 August 2012, Mr Russell's application for leave to appeal to the Supreme Court was dismissed.

It was common ground between the parties that Mr Russell had exhausted his ability under the statutory disputes and challenge process provided for by the Tax Administration Act 1994 ("TAA").

In addition to the original assessments made, over the intervening years, additional tax penalties and interest increased the amount owed to the sum claimed by the Commissioner.

It is relevant to note that Mr Russell commenced judicial review proceedings against the Commissioner just prior to the summary judgment hearing. The judicial review seeks to challenge the Commissioner's decisions reached in 2006 and 2013, not to enter into an instalment payment arrangement with Mr Russell under section 177 of the TAA.

Decision

The High Court entered summary judgment for the Commissioner in the sum of $367,204,207.41. His Honour directed the parties to confer on the matter of costs and if unable to agree, to file memoranda not exceeding five pages on each side within 10 working days from the date of the judgment.

No arguable defence/effect of the judicial review proceedings on the ability of the Court to enter summary judgment

The Court dealt with the issues of whether the Commissioner could prove Mr Russell had no arguable defence to her claim and the effect that the filing of the statement of claim commencing judicial review proceedings had on the ability of the Court to enter summary judgment together.

In doing so, the Court considered the causes of action set out in the statement of claim filed in the judicial review and in particular Mr Russell's arguments that the Commissioner's decision to decline to accept Mr Russell's instalment arrangement proposals were "decisions that were not made fairly, reasonably or in accordance with the law".

In particular, the Court referred to the causes of actions whereby Mr Russell asserted that the decisions made by the Commissioner were not consistent with collecting the highest net revenue that is practicable within the law because continuing litigation against him will not lead to any recovery of revenue given he owns no assets.

The Court noted that the Commissioner did not accept that Mr Russell enjoyed any realistic expectation of success in the judicial review proceedings and went on to discuss the central authority relied upon by the Commissioner in support of her submissions, namely *Raynel v Commissioner of Inland Revenue* (2004) 21 NZTC 18,583 (HC) ("*Raynel*"). After discussing *Raynel* in detail, the Court accepted the Commissioner's submission that *Raynel* has been applied in later cases where similar arguments on the Commissioner's duty to maximise recovery of outstanding tax and collect over time the highest net revenue have been raised.

The Court considered that the prospects of Mr Russell successfully obtaining judicial review of the determination on the part of the Commissioner not to accept the proposed instalment plan were not great. Further, the Court considered that the proposal for payment put

forward by Mr Russell was not advantageous to the Commissioner.

In coming to a conclusion on the prospect of success in the judicial review proceedings, the Court stated that it has to bring common sense to bear. Accordingly, the Court considered that the argument that Mr Russell had put forward did not constitute a compelling case. However, the Court accepted that having heard arguments and evidence in proceedings which are specifically designed for the purpose of testing the legality of the Commissioner's decisions, the Court might come to a different view to him.

However, his Honour found that on the basis of the material available, the enquiry in the summary judgment proceeding is whether the plaintiff has been able to satisfy the Court that the defendant has "no defence" to the particular cause of action, which has been interpreted as meaning "no bona fide defence, no reasonable ground of defence, no fairly arguable defence", ie, the absence of any real question to be tried. Viewed from that perspective, and adopting as the principal question whether Mr Russell has a prospect of success in the judicial review proceedings, the Court held that the Commissioner had succeeded in showing that Mr Russell had no arguable defence.

Procedural issues raised by the intended application for interim relief

Before departing from the subject of judicial review and the application for interim relief, the Court commented on the process the Court should take in cases where an issue arises about the possibility that a defendant to proceedings in which judgment is being sought, might be able to seek judicial review which would reverse the basis upon which the judgment is sought.

The Court considered that obiter comments made in *Air New Zealand v Wellington International Airport Ltd* [2009] NZCA 259, [2009] 3 NZLR 713 (CA) and *Tannadyce Investments Limited v Commissioner of Inland Revenue* [2010] NZCA 253, (2010) 24 NZTC 24,341, are authority for the proper process, which is to seek interim relief under section 8 of the Judicature Amendment Act 1972 prior to the hearing of applications, such as the present proceeding. This is instead of arguing before the Court that its intended judicial review proceeding would arguably provide a defence to a plaintiff's claim.

While the Court noted the comments in the above authorities were obiter and therefore not directly binding, his Honour agreed with the views expressed by the Court in both cases. The Court did not consider that the Commissioner should be delayed in obtaining judgment because of the last minute judicial review proceedings when there had been adequate opportunity for Mr Russell to seek substantive relief by way of judicial review at any time during recent years. Further, having been served with the summary judgment proceedings on 13 December 2013, the Court considered that Mr Russell had adequate time to bring an application for relief.

Exercise of the Court's residual discretion

The Court accepted the Commissioner's submissions concerning the scope of the discretion under rule 12.2 of the High Court Rules and in particular that the discretion could be exercised where the use of summary judgment would be oppressive or unjust.

In considering whether to exercise the discretion not to enter summary judgment, the Court considered Mr Russell's argument that the Commissioner ought to have agreed to a payment instalment arrangement. The Court noted in regard to this argument that Mr Russell seems to have assumed that attempts to enter summary judgment are so inconsistent with what he sees as his entitlement to a payment instalment plan that the Court ought to exercise its discretion to decline summary judgment.

Accordingly, the Court considered the effect on the underlying debt that would have resulted, if the Commissioner had agreed to enter an instalment arrangement with Mr Russell. In the absence of any statutory indication, the Court commented that it would seem unlikely that the legislative intention was that one effect of entering into an instalment arrangement would be that the underlying debt would be abrogated entirely and replaced by a statutory obligation to make instalment payments. This view was implicitly supported by the fact that there is power in the legislation (section 177B(6) of the TAA) for the Commissioner to cancel an arrangement in certain circumstances.

The Court considered this issue relevant because it was implicit in the fact that Mr Russell invoked the discretion to decline to enter summary judgment that the step would be necessary to permit Mr Russell to take advantage of any instalment arrangement that the Commissioner might eventually be required to enter into as a result of a direction following the judicial review hearing. His Honour concluded in this regard that the entry of judgment would not have the effect of pre-empting interim relief in the judicial review proceedings. In other words, he considered it was not correct to characterise the availability of summary judgment and the instalment type proposal as being mutually exclusive alternatives.

The Court later considered the argument that Mr Russell did not obtain financial advantages equivalent to the amount of the tax imputed to him following the Commissioner's reconstruction of his income under section

99(3) of the Income Tax Act 1976. Counsel for Mr Russell put forward this argument in support of the Court exercising its discretion not to enter summary judgment. In response, the Court noted that the reconstruction which the Commissioner carried out was approved by the Court of Appeal in its judgment and it was this judgment that finally fixed the tax liability Mr Russell owes.

The Court noted that the Court of Appeal expressed the conclusion that there had been large-scale tax avoidance by a group of companies under the control of Mr Russell. The Court then found that it was not an answer to say that Mr Russell should be able to avoid liability because he did not receive the fruits of the tax avoidance scheme. That is because the legislature when conferring the power of reconstructing tax avoidance arrangements so as to move the burden of those arrangements to the author of the arrangements, did not make it a precondition of the assessment of reconstructed tax that the person assessed should actually have received pecuniary advantages from the arrangement.

The Court held that not only was the analysis of the policy put forward by counsel for Mr Russell flawed, but the entire argument about whether the reconstruction had been carried out on a legally justified basis or otherwise was irrelevant to the question of whether summary judgment ought to be entered.

Further, the Court commented on counsel for Mr Russell's criticism of the Commissioner for allegedly not taking steps to recover the tax from the parties who were the direct beneficiaries of the tax avoidance scheme. The Court found there was no basis upon which it could reasonably decline to enter summary judgment against Mr Russell, noting there were no express terms in the legislation giving rise to a defence of this kind and nor could it be said that such a defence is one that was arguably intended by implication from the legislation.

In conclusion, the Court found there were no grounds upon which the Court ought to exercise the residual discretion to decline summary judgment.

REGISTRATION APPEAL AND TAX CHALLENGE PROCEEDINGS CONSOLIDATED

Case(s)	The National Council of Women of New Zealand Incorporated v The Charities Registration Board (CIV-2014-485-1017) [2014] NZHC 1297 The National Council of Women of New Zealand Incorporated v CIR (CIV-2013-485-10805)
Decision date	10 June 2014
Act(s)	High Court Rules
Keywords	Consolidation

Summary

The National Council of Women of New Zealand Incorporated (NCWNZ) applied, among other things, for an order that its appeal against a decision of the Charities Registration Board ("the Charities Board") not to backdate its registration be consolidated with its tax challenge of income tax assessments made by the Commissioner of Inland Revenue ("the Commissioner") for the period that NCWNZ was deregistered as a charity. Clifford J granted the order on the basis that both the appeal and the tax challenge arose out of the same facts and circumstances, and both involved related interpretational issues.

Facts

The NCWNZ is a charitable organisation established in 1896.

On 4 June 2009, following the enactment of the Charities Act 2005, NCWNZ was registered as a charitable entity by the Charities Commission as of 30 June 2008 ("the registration decision").

On 22 July 2010, the Charities Commission revoked the registration decision with effect from 19 August 2010.

On 10 September 2012, NCWNZ applied to the Charities Board, the successor to the Charities Commission, for reregistration as a charitable entity. NCWNZ asked that its reregistration be backdated to the date of deregistration, namely 19 August 2010.

On 15 April 2013, NCWNZ was reregistered with effect from 10 September 2012, not 19 August 2010 as requested. The Charities Board refused to backdate NCWNZ's registration.

The Commissioner assessed NCWNZ for income tax for the period that it was not registered as a charitable entity, namely 19 August 2010 to 10 September 2012. NCWNZ has challenged the assessments ("the tax challenge").

NCWNZ has also appealed the Charities Board's decision not to backdate its registration ("the appeal").

Decision

The only issue in this proceeding that concerns the Commissioner is the issue of consolidation. The other issues relate only to the appeal.

Consolidation

Clifford J referred to rule 10.12 of the High Court Rules regarding consolidation of proceedings. The factors he considered relevant included the savings in time, cost and judicial resources, the need to remove the risk of inconsistent decisions, the potential shortcut of consolidation at trial, and the care required to avoid confusion through multiplicity of parties and issues.

His Honour stated that the appeal and the tax challenge arose essentially out of the same facts and circumstances. He accepted that, on the one hand, because NCWNZ was a charity, there was a real public interest in limiting NCWNZ's exposure to the costs of two separate proceedings. However, he also accepted, on the other hand, that if NCWNZ was successful in the appeal, the tax challenge would be rendered moot and the Commissioner would not be required to participate at all.

On balance, his Honour found that it was appropriate that the appeal and the tax challenge (to the extent that it involves the question of interpretation of section CW 41(5)(b) of the Income Tax Act 2007, the provision in issue in the tax challenge) be heard together. However, he did not consider that formal consolidation was necessary because hearing the appeal and the tax challenge at the same time would promote the efficient use of everyone's resources.

APPLICATION FOR LEAVE TO APPEAL DECISION TO THE SUPREME COURT DISMISSED

Case	Vinelight Nominees Limited & Anor v Commissioner of Inland Revenue [2014] NZSC 74
Decision date	17 June 2014
Act(s)	Income Tax Act 1994, Tax Administration Act 1994
Keywords	Leave to appeal, interests of justice

Summary

The appellant's application for leave to appeal was dismissed.

Facts

An application for leave to appeal the decision of the Court of Appeal (*Vinelight Nominees Ltd v Commissioner of Inland Revenue* [2013] NZCA 655) was made by the applicants.

Decision

The Supreme Court dismissed the application for leave to appeal the Court of Appeal's decision.

The Court considered it was not necessary in the interests of justice that the appeal be heard. The Court stated further that given the findings of fact in the lower Courts, there was no matter of general or public importance raised by the applicants. In addition, the Court could see no risk that a substantial miscarriage of justice had occurred.

GST IMPLICATIONS ON THE SUPPLY OF EQUIPMENT

Case	TRA 007/12 [2014] NZTRA 08
Decision date	12 June 2014
Act(s)	Goods and Services Tax Act 1985
Keywords	Supply, supplier, assignment

Summary

The Taxation Review Authority ("TRA") confirmed the Commissioner of Inland Revenue's ("the Commissioner") assessments for goods and services tax ("GST") and shortfall penalties. The TRA found the disputant remained the lessor of the equipment and the supplier for the purposes of the Goods and Services Tax Act 1985 ("GST Act"). Therefore the disputant was liable for the GST on the leased equipment it provided its customers and shortfall penalties for not taking reasonable care.

Facts

The disputant purchased equipment from equipment vendors using funds borrowed from a finance company ("Finance Limited"). The disputant leased this equipment to its customers under lease agreements which were assigned to Finance Limited. The rental payments paid under the lease agreements were made to Finance Limited. The disputant claimed input tax credits on the purchase price of the equipment but did not return the output tax on the lease rental payments. The Commissioner says that the disputant is liable to return GST on these payments.

To finance the purchase of the equipment, the disputant entered into a Vendor Assignment Facility Agreement ("the Master Agreement") with Finance Limited. Under the Master Agreement, Finance Limited paid the purchase price (including the GST) to the equipment vendor. The disputant (the Vendor under the Master Agreement) assigned its rights under the agreements with its customers ("Customer Agreements") to Finance Limited.

The Master Agreement set out the terms on which the assignments were made. The assignments could be either

Mortgage Assignments or Absolute Assignments. An Absolute Assignment represented a sale by the vendor to Finance Limited of the equipment and rights under the Customer Agreement. A Mortgage Assignment represented a security interest over the equipment to Finance Limited.

All but one of the assignments entered into by the disputant with Finance Limited were in the form of Mortgage Assignments not Absolute Assignments.

The Mortgage Assignment provided that in consideration of the amount advanced (the Assignment Amount), the vendor (disputant) assigned all title and property in the equipment, all rights, title and interest in the Customer Agreement and all amounts payable.

Pursuant to the Mortgage Assignment, the disputant agreed (inter alia) to pay to Finance Limited, monies received from the customer under the Customer Agreement. The Customer Agreement was subject to GST and provided that all rental payments are GST exclusive and GST must be paid to the vendor.

The customer would then make the rental payments into a "lock box" bank account in the name of "[Finance Limited] t/a. [disputant]". Finance Limited had unrestricted access to this bank account and the rental payments, while the disputant's access to the account was limited solely to viewing transactions and balances.

The disputant contended that he understood the assignments between Finance Limited and the disputant were not Mortgage Assignments but a hybrid under which the disputant retained ownership of the equipment and the disputant's right, title and interest in the rental payments were assigned absolutely to Finance Limited. The disputant says that Finance Limited was therefore the supplier and responsible for payment of the GST.

Decision

The TRA found the Commissioner's witness, Mr B, to be a reliable witness who had a clear knowledge of Finance Limited's contractual documents and the company's practices and procedures. The TRA accepted Mr B's evidence that at the time that the Mortgage Assignments were entered into Finance Limited's computer, they were incorrectly coded as Absolute Assignments resulting in automatically generated letters and documents (including those described above).

The TRA was not satisfied that there was any hybrid arrangement in place. Instead, the TRA found that there was no variation of any sort to the Mortgage Assignment and that the assignments of the Customer Agreements were assignments by way of mortgage to Finance Limited.

The TRA went on to find under the Mortgage Assignment, that the disputant in consideration of the sum advanced by Finance Limited, assigned by way of mortgage to Finance Limited, the equipment and the disputant's rights under the Customer Agreement. The disputant therefore remained the lessor of the equipment and the supplier for the purposes of the GST Act.

In relation to the tax invoices issued by Finance Limited, the TRA confirmed that a supplier will be liable for GST on a taxable supply whether or not they have issued a tax invoice. The fact that Finance Limited may have issued tax invoices or that the disputant may not have done so, does not displace the disputant's liability to pay GST.

Finally, in relation to the shortfall penalty, the TRA agreed with the Commissioner's submission that a taxpayer of ordinary skill and prudence would have recognised the obligation to account for the GST on a careful reading of the documents, as these were not complex documents. The TRA was satisfied that the disputant had not acted as a reasonable person would have done in the same circumstances.

THE CROWN'S LEGAL PROFESSIONAL PRIVILEGE

Case	Martinovich v Commissioner of Inland Revenue [2014] NZHC 1357
Decision date	17 June 2014
Act(s)	Judicature Amendment Act 1972, High Court Rules, Tax Administration Act 1994
Keywords	Attorney-General, solicitor/client privilege

Summary

A judicial review application was brought by the taxpayer, seeking a report (with relevance to the taxpayer) in relation to which the Commissioner of Inland Revenue ("the Commissioner") claimed solicitor/client privilege.

Impact of decision

The law of solicitor/client privilege applicable to the Commissioner is the common law. This privilege can only be waived by the Attorney-General.

The Commissioner obtains all legal advice on behalf of the tax system as a whole, pursuant to her duties and responsibilities under sections 6 and 6A of the Tax Administration Act 1994 ("TAA").

Facts

A judicial review application was brought by Leanne Martinovich ("the applicant") seeking an order requiring the Commissioner to provide the applicant with a copy of an independent report ("the report") resulting from a review of the applicant's file.

On 14 August 2009, the Commissioner issued a default assessment for $867,758.73 against the applicant for unexplained deposits into her bank account totalling $2,252,360.

On 10 December 2009, the applicant filed a Notice of Proposed Adjustment ("NOPA"). The applicant advised that the deposits in her bank account were not returnable as income as they were capital amounts raised from the sale of company stock.

In her Notice of Response ("NOR") of 9 February 2010, the Commissioner rejected the applicant's NOPA contending that her assessment was correct. The Commissioner's reasoning was that the applicant had not provided evidence that established on the balance of probabilities that the default assessment was incorrect, the reason why it was incorrect; and by how much it was incorrect.

The applicant's solicitors made requests for documentation under the Official Information Act 1992 and Privacy Act 1993. On 8 February 2011, Mr Jeram, the Inland Revenue investigator of this matter, responded to this request. Some of the documents Mr Jeram provided in response to the request had been redacted due to Inland Revenue's procedures and information containing details of another taxpayer.

The applicant's solicitors wrote to the Commissioner on 25 February 2011. This letter included concerns around the Commissioner's decision to withhold certain information. The letter also requested that a senior officer within Inland Revenue review the way in which the investigation had been conducted.

On 2 March 2011, the investigator responded by letter stating that a review would be conducted and the outcome of the review would be produced in due course.

The Investigations Manager formed the view that a legal review was required by a senior lawyer who could provide legal advice on the Commissioner's next steps, taking into account the relevant law, facts and Inland Revenue's procedures. Accordingly, a senior solicitor within Inland Revenue was approached to complete the review.

Upon completion of the review, senior management offered to meet with the applicant's solicitors to discuss the outcome. The applicant's solicitors were available to meet, but in the interim they requested a copy of the report under the Official Information Act and the Privacy Act. The Commissioner refused to provide the report on the basis of legal privilege.

A complaint was then made to the Ombudsman, without any success. On 3 November 2011, the investigator's team leader wrote to the applicant's solicitor advising that the 2009 default assessment would be withdrawn as a result of information obtained by the Commissioner from third parties.

Issues and decision

The relevant factors are set out below.

Whether the Commissioner undertook an independent review on behalf of the taxpayer

The Court found that based on the evidence before it, the independent review was not undertaken on behalf of the taxpayer: there had been an overlap between the applicant's request for a review of her file and the investigator's manager's request for a review from a case management perspective.

The Court also found that the Commissioner acts not on behalf of a taxpayer but on behalf of the tax system as a whole. The Commissioner obtains all legal advice, including the report in this instance, for the purpose of, and in the course of, carrying out her duties and responsibilities under sections 6 and 6A of the TAA.

Whether the report produced as a result of the independent review is subject to solicitor/client privilege in favour of the Commissioner

The law of solicitor/client privilege applicable to the Commissioner is the common law, being the same law that applies in commerce and to disputes between private persons. The Court found that the common law on solicitor/client privilege should be applied in respect of the Commissioner and that privilege could only be waived by the Attorney-General, to comply with the Cabinet Manual.

The Court found that the report was legally privileged and that the Commissioner was entitled to the benefit of solicitor/client privilege, and had not done anything to waive that privilege.

Whether the applicant had a legitimate expectation to receive a copy of the report produced as a result of the independent review

The Court noted that the Commissioner had promised the applicant, in her letter of 25 February 2011, "the outcome" of the review. This was not a promise to disclose the content of the review.

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