

# Tax tips

30 October 2009

Issue Number: 14/2009

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## Options for corporate tax reform

The Government-appointed Tax Working Group addressed concerns about the lack of coherence in New Zealand's tax system at its fourth meeting in early October.

The misalignment of tax rates and the differing tax rates applicable to savings held through different entities are currently influencing investment decisions and encouraging the sheltering of income in corporate or trust structures.

The Working Group questioned the viability of the current tax system given the inherent problems and considered different options for reforming the current company tax system in particular. These ranged from minor changes to the current rules to a wholesale overhaul of New Zealand's company tax system.

The Working Group acknowledged that any reform of New Zealand's company tax system would need to respond to changes made in the tax systems of our major trading partners, particularly any changes made in Australia in response to the recommendations of the Henry Review that is currently considering the Australian tax system in its entirety (excluding GST).

### Alternative company tax systems

The Working Group considered different approaches to taxing corporate income including rate alignment, the Nordic system, the Irish system, and the Sorenson-Johnson 'ACE-DIT' model.

#### *Tax rate alignment*

Consistent with the Government's medium-term objective of aligning the corporate, trustee and top personal marginal tax rates at 30%, the Working Group considers that tax rate alignment, combined with an imputation system, is an attractive option. However, it recognises that the rate at which alignment should occur could come under pressure from global trends toward lower corporate tax rates, especially if Australia reduces its company tax rate.

If alignment is not possible, the Working Group considers that non-alignment may be sustainable, provided there is less

than 3 to 6% between the top personal rate and the corporate and trust tax rates.

#### *Classical (Irish) system*

If tax rate alignment is not possible or is undesirable, the Irish approach is a feasible option. The Irish system applies a low rate of tax (e.g. 20%) to non-residents to attract foreign investment and a higher rate of tax (e.g. 30%) to passive income. The Group believes the Irish system is worth considering particularly if a significant company tax rate cut is needed to improve productivity and competitiveness.

While the Irish model encourages inbound foreign investment, thereby boosting capital and productivity, because dividends do not carry imputation credits it also increases the tax paid by local shareholders and encourages companies to retain earnings.

#### *The dual income tax (Nordic) system*

Under the Nordic system, capital is taxed at a lower rate than labour, in order to promote capital imports and reduce the dead weight loss associated with taxing capital income. This is not seen as an attractive model for New Zealand primarily because design features in the system can cause bias against risky investments and entrepreneurship and because New Zealand has a highly mobile labour market.

#### *The Sorenson-Johnson model*

The Sorenson-Johnson 'allowance for corporate equity and dual income tax' (ACE-DIT) model was considered as part of the Australian Tax Review. The model allows companies a deduction for the normal return on their equity and taxes income in excess of the normal return. Shareholders are taxed on dividends and on capital gains on shares in listed companies.

The Working Group sees some merit in the approach as it reduces tax on investment but maintains tax on economic rents. It will therefore keep the model under consideration, particularly if other countries adopt it. However, given that it has never been implemented before, there are obvious concerns about implementation and compliance issues.

## Interim options for reform

In the event that the above options are impossible in the short term, the Working Group also considered possible interim reform options. The Working Group's preferred interim option is for the Government to formalise dual tax rates for capital and labour by extending the 30% PIE tax rate to other forms of investment income. However, it acknowledges that there would continue to be fairness issues as between the taxation of labour and capital income.

The Group's final session in November will be a 'wrap-up' of the previous four sessions and will enable the Group to collate all the reform options it has considered prior to the public conference on 1 December 2009.

## Westpac Banking Corporation v CIR

The High Court recently held in favour of the Commissioner in its second substantive decision on structured financing transactions undertaken by a bank. The Court agreed with the Commissioner's decision to disallow Westpac's deductions for certain guarantee procurement fees (GPFs) paid as part of the arrangements and found that the arrangements entered into by the bank constituted tax avoidance.

### The facts

In the late 1990s and early 2000s Westpac subsidiaries entered into a number of structured financing transactions with overseas counter parties. The transactions resulted in Westpac receiving returns that were either exempt from tax under the conduit tax relief rules or relieved of tax under the foreign tax credit rules. The bank claimed a deduction for the expenditure (principally borrowing costs and the GPFs) incurred in relation to the transactions.

The Commissioner gave Westpac a favourable ruling in respect of one of the transactions but later challenged the other transactions. He issued amended tax assessments (totalling \$961 million including use of money interest of \$375 million) for the relevant income years on the grounds that the arrangements had a purpose or effect of tax avoidance. The Commissioner argued that the commercial viability of the transactions depended wholly on the achievability of the deductions and that the bank's deductions under the specific provisions were unlawful.

Westpac argued that it advanced real money to real parties and assumed a real and substantial credit risk, that the transactions made use of specific tax provisions in a manner consistent with Parliament's purpose, and that the bank acted entirely within its legal rights in choosing a structure that used permissible tax advantages.

### The High Court decision

The High Court followed the approach taken by the Supreme Court in 2008 in its first decisions on tax avoidance, *Ben Nevis Forestry Ventures Ltd v CIR* and *Glenharrow Holdings Ltd v CIR*. The judge, Harrison J., interpreted the *Ben Nevis* decision to mean that proof of a taxpayer's compliance with a specific provision does not exclude the scope for a wider inquiry (on the tax avoidance question) into the arrangement as a whole.

Harrison J did not think that the ruling issued by the Commissioner on a similar arrangement was relevant and considered that the inquiry the Court must take is much more extensive than that which the Commissioner was able to

undertake when considering the ruling application in the late 1990s.

Harrison J. also noted that the decision in the *BNZ* case (decided by the High Court in Wellington in July) was relevant but not binding and could not be substituted for his own independent evaluation of the particular facts. He said that, while there were material similarities between the transactions concluded by both banks, there were also material differences in the way the cases were presented and argued.

The judge ruled that the Commissioner correctly disallowed Westpac's deductions for the GPFs. He found that the fees were not paid under a "financial arrangement" or in deriving gross income and were therefore not deductible. The judge held that Westpac's use of the deductibility provisions was not within the ordinary meaning and scope of those provisions in the light of their specific purposes.

On the question of whether the arrangements constituted tax avoidance, Harrison J. found that each transaction had a commercial purpose but also a separate purpose of tax avoidance, which was not merely incidental or subsidiary to the commercial purpose. He considered that Westpac's primary purpose in proceeding with one of the main transactions was "the prospect of generating substantial deductible expenses and altering the incidence of its income tax".

Although the final outcomes reached in both the *BNZ* and *Westpac* cases were the same (i.e. that the arrangements in question constituted tax avoidance), the approach taken by Harrison J. in the *Westpac* case is different to that taken by Wild J. in the *BNZ* case in several key respects. In the *BNZ* case Wild J. concluded that the guarantee fees were paid under a financial arrangement and were therefore deductible. In considering whether the arrangements entered into by the *BNZ* were tax avoidance arrangements Wild J. focused more heavily on Parliamentary contemplation – i.e. on whether, if Parliament had foreseen transactions of this type when enacting the specific provisions used in the transaction, would it have contemplated and intended that the rules be applied by taxpayers in such a way?

The High Court in the *Westpac* case concluded that the four transactions in dispute were tax avoidance arrangements and that their primary or substantial purpose was to reduce the bank's liability to tax. *Westpac* is likely to appeal the decision.

## Guides to new tax rules

Inland Revenue has released its preliminary guides to several of the reforms in the Taxation (International Taxation, Life Insurance and Remedial Matters) Act 2009, including:

- CFCs and foreign dividends;
- New definitions of 'associated persons';
- GST and emissions trading;
- Payroll giving; and
- R&D tax credit changes

The special reports are available on the IRD's website. They are intended to provide early information to taxpayers on the

new rules. Inland Revenue will publish more detailed analysis of the associated persons, payroll giving, GST/emissions trading and R&D changes in a *Tax Information Bulletin* later this year.

## SME tax compliance

Small businesses should not be required to spend more than one hour on tax compliance, file more than one tax return or make more than one tax payment each month according to proposals developed by the New Zealand Institute of Chartered Accountants (NZICA) and Tax Management New Zealand (TMNZ).

In a discussion paper released in October, NZICA and TMNZ set out proposals to simplify the taxation of small businesses. The aim of the Discussion Paper is to determine whether there is a mood amongst both policy makers and small business owners to tackle tax compliance costs. The Discussion Paper received support from the Minister of Finance, Bill English, at the recent NZICA Tax Conference.

NZICA and TMNZ believe that their proposals could help reduce tax compliance costs for small businesses by up to a third.

The first proposal targets businesses that have very small turnovers ('micro businesses'). The second proposal targets small businesses whose annual turnover is less than \$1.2m. Both proposals are aimed at taxpayers earning active income. Passive income (e.g. rental, interest and dividend income) would continue to be taxed under the current rules.

### Micro business taxation

A 'micro business' is defined in the Discussion Paper as a business that has no employees, has an annual turnover under \$60,000 and is not registered for GST. This definition is intended to capture businesses in start up mode and businesses earning 'under the table' income.

NZICA and TMNZ propose that micro businesses pay a final tax of 15% on business turnover (which would include a component for ACC levies). Payment would be made monthly or at any other time (e.g. upon receipt of the income). Tax returns would not be required. The income would be included in the taxpayer's summary of earnings and no further income tax would be payable.

The businesses would not be able to claim tax deductions. Assessable income for social policy purposes (e.g. Working for families and Child Support) would be 50% of gross income.

### Small businesses

A 'small business' is defined in the Discussion Paper as a business with annual turnover of less than \$1.2 million.

The Discussion Paper proposes a cash basis of accounting for income tax that would merge the income tax and GST calculations and returns. Like GST, income tax would be returned every two months, with no year-end adjustments or provisional tax requirements.

As income would be based on cash inflows taxpayers would be able to meet their obligations as they arise.

Tax would be imposed on companies at the shareholders' marginal tax rates. The tax rate thresholds would be adjusted

where there is more than one shareholder engaged in the business on a full time basis.

Transactions such as dividends and shareholder salaries would be disregarded, eliminating the need for small companies to maintain imputation credit accounts. Fringe benefit tax would also be eliminated.

Safe harbour thresholds would exist for both proposals to allow taxpayers exceeding the specified limits during the year to remain in the relevant regime.

The Discussion Paper is available at: [www.smetax.co.nz](http://www.smetax.co.nz). NZICA and TMNZ are seeking feedback on the proposals, particularly as to the materiality of the changes, the definitions proposed and how businesses would find the transition to such measures.

## Employee share schemes - Australia

Australia is introducing significant changes to the taxation of employee share plans. Draft legislation proposes:

- more stringent conditions for deferral, with an additional requirement that shares or rights/options be subject to a genuine risk of forfeiture. Generally this will mean that, for share options and restricted stock units, taxation arises on vesting (where there is a real risk of forfeiture and there are no genuine disposal restrictions on the underlying shares);
- loss of the ability for participants to elect to be taxed at grant on their employee share awards; and
- a new approach to the taxation of employee share awards for internationally mobile employees.

Once enacted, the new rules will apply to shares and rights acquired on or after 1 July 2009.

These changes should not affect New Zealand employees unless they were granted share awards in Australia before they came to New Zealand.

The New Zealand tax treatment of employee share schemes may be subject to change in the future as Inland Revenue is currently undertaking a review of employee share schemes.