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## New tax bill

Changes to New Zealand's international tax rules, the "associated persons" definitions, the treatment of relocation and overtime meal allowances, compliance cost thresholds and the taxation of life insurance business are the key measures included in the latest tax bill. The Bill also introduces a new payroll giving system.

The Bill does not include amendments to the treatment of stapled stock instruments. We expect the Government will introduce a Supplementary Order Paper to the Bill to include these amendments. Once enacted, the new rules will apply to debt stapled on or after the date of the Government's announcement on stapled stock on 25 February 2008.

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill was introduced into Parliament on 2 July 2008. After its first reading the Bill will be referred to the Finance and Expenditure Select Committee (FEC). Confirmation of the closing date for submissions to the FEC is expected shortly. We do not expect the Bill to be passed before February or March 2009, given that there will be a general election later this year.

## NZ's international tax rules

The Bill includes new rules which will change fundamentally the way in which income derived from investments in foreign subsidiaries is taxed. Proposals to overhaul the international tax rules were announced in a Government discussion document issued in December 2006 and a series of Officials' issues papers released last year. The final proposals were confirmed in the Budget in May.

The new rules are intended to apply from the start of the 2009-2010 income year. As it is unlikely that the Bill will be passed before Parliament is dissolved for the upcoming election, the rules, once enacted, may apply retrospectively for taxpayers with early balance dates.

### Active income exemption

A key feature of the reform is the exemption from New Zealand income tax for active income derived by New Zealand residents from interests in controlled foreign companies (CFCs). Passive income (such as dividends, interest, royalties and rents) will be taxed on an attribution basis. "Attributable income" is specifically defined in the draft legislation. It is pleasing to see the scope of income that is subject to attribution is considerably narrower than under the original proposals.

For CFCs that pass an "active business" test, no income from the CFC will be attributable to the New Zealand shareholders. A CFC will pass the active business test if its passive income is less than 5% of gross income. The test may be

applied using either tax rules or financial accounting information.

The active business test will replace the current grey list exemption. However, we are pleased to see that an exemption from attribution of income will be retained for CFCs in Australia. Given the country's close economic ties to Australia and Australia's comprehensive tax base it makes sense to exempt all income derived from CFCs in Australia from New Zealand income tax. Australia is generally the first country of choice for small and medium sized businesses looking to invest offshore, and the retention of a "grey list of one" will represent a significant compliance saving measure for these businesses.

During the consultation process, Officials acknowledged that the active business test could result in CFCs that are actively in the business of deriving passive income (eg financial institutions) being subject to tax on attribution. In this regard it is pleasing to see that the draft legislation provides that CFCs that are insurance companies can apply to the Commissioner for a determination qualifying them for the active income exemption. However, it is disappointing that this exemption has not been extended to other financial institutions that may also actively derive "passive income".

### Interest allocation rules

The Bill also extends the current thin capitalisation rules to New Zealand companies that are controlled by New Zealand residents and have interests in CFCs. However, the new rules will not apply where the New Zealand resident has:

- 90% or more of their assets in New Zealand; or
- less than \$250,000 of interest deductions.

The new outbound thin capitalisation rules are intended as a base protection measure to prevent New Zealand residents with international businesses from allocating an excessive amount of their global interest costs against the New Zealand tax base.

It is important to note that the outbound thin capitalisation rules will also apply to New Zealand companies with Australian subsidiaries, even though the Australian subsidiary will be exempt from attribution under the CFC rules.

In addition, the Bill amends the definitions of “debt” and “assets” for the purposes of calculating the New Zealand group debt percentage and worldwide debt percentage. Under the amended rules:

- fixed rate shares issued by a New Zealand company to New Zealand taxpayers are treated as debt for the purpose of calculating the New Zealand group debt percentage;
- equity investments in CFCs are excluded from the definition of assets for the purpose of calculating the New Zealand debt percentage; and
- the definition of debt for the worldwide group has been aligned with the definition of debt for the New Zealand group.

We are pleased that the earlier proposals to include fixed rate shares issued by New Zealand companies as debt for the thin capitalisation rules have not been included in the draft legislation.

### Conduit tax relief

The Bill removes the ability to obtain conduit tax relief in the future. In relation to existing conduit tax relief account (CTRA) balances, the proposed rules provide that CTRA accounts are to be maintained for a period of two years following the introduction of the new rules. This is to allow taxpayers to use up their existing credit balances and to prevent additional tax liabilities arising for non-resident shareholders who receive dividends paid out of conduit relieved income.

We are pleased that conduit companies will have the option to elect to cease being a conduit company at any time after the beginning of the 2009-2010 income year. Any conduit credits existing in the CTRA will be cancelled from the end of the income year in which the election is made.

### Foreign dividends received by companies

Under the proposed rules, most dividends received by New Zealand companies will be exempt from domestic tax. Exceptions to this general rule include:

- dividends on fixed rate shares and dividends for which the CFC has received a tax deduction in its home jurisdiction will continue to be taxable in New Zealand;
- dividends from portfolio FIFs (ie interests under 10%) that are exempt from the FIF rules (eg interests in Australian listed companies) will continue to be taxable in New Zealand.

The exemption from New Zealand tax for most dividends from CFCs and non-portfolio FIFs will make the current underlying foreign tax credit (UFTC) and foreign dividend payment (FDP) rules largely redundant. As such the FDP and UFTC rules will be repealed from the start of the 2009-2010 income year.

Debits existing in branch equivalent tax accounts will be able to be carried forward and used for a period of two years. However, BETA credit balances will be cancelled immediately. Similarly FDP credit balances will be able to be utilised for five years. At the end of this five year period, any remaining credits will be converted to imputation credits.

## Associated persons

The Bill introduces significant changes to the definitions of “associated persons” in the Income Tax Act. The changes will have adverse implications for some taxpayers, particularly land dealers, developers and builders, who hold investment properties as well as the properties they are dealing in, developing or building. Existing property portfolios will not be affected by the new rules as they do not come into effect until next year.

The Bill replaces the four current definitions of “associated persons” and other provisions employing a similar concept with one standardised definition that will be subject to several modifications for the purposes of the land taxing provisions.

The new definition will include:

- tests associating a trustee and a beneficiary, a trustee and a settlor, a settlor and a beneficiary, and the trustees of two trusts that have the same settlor;
- tighter rules for aggregating the interests of associates – the Government is concerned that the current tests associating two companies and a company and an individual are being “circumvented by the fragmentation of interests among close associates”; and
- a tripartite (daisy-chaining) test associating two persons if they are each associated with the same third person.

We are relieved to see that the new standardised definition will be modified in some respects in the land sales context. For example, the beneficiary-based associated persons tests (ie the trustee-beneficiary and settlor-beneficiary tests) will not apply to the land taxing provisions. Under the reform proposals originally floated (in the Officials’ Issues Paper released in March 2007), these tests would have applied in the land context, which would have resulted in many people becoming associated with land dealers, developers and builders despite their having no knowledge or control of the activities of those persons.

The application of the tripartite test will be limited in certain circumstances. For example, partners in a partnership will not be associated with each other by virtue of their association with the same partnership unless they are separately associated with each other under another of the tests. This is a sensible outcome, although we remain concerned about the risk that the tripartite test is too broad in its scope. We believe that it should be applied only in those circumstances where tax base maintenance is a real concern.

Currently the general associated persons definition associates people who are related as far as the fourth degree of blood relationship (ie as far as cousins). Sensibly the new definition will limit the test to people within two degrees of relationship only ie a person will be associated with their parents, children, grandchildren, siblings and grandparents only.

A new definition of "settlor" that will apply for the purposes of the associated persons test will not include a person who provides services to a trust for less than market value. This should provide some protection for professional advisors and independent trustees from inadvertently being associated with client trusts.

In the context of dividends and fringe benefits, the Government has made a sensible decision to replace the current associated persons tests that apply in the dividend and FBT contexts with rules providing that:

- if a company transfers value to a person and the transfer is caused by a shareholding in the company, the company will have paid a dividend regardless of whether the recipient of the benefit is a shareholder; and
- if an employer provides a benefit because of an employment relationship, the employer will have provided a fringe benefit subject to FBT regardless of whether the recipient of the benefit is an employee.

Most of the proposed reforms will apply from the 2009-2010 income year (1 April 2009 for taxpayers with standard balance dates). In the land context, the new rules will apply to land acquired on or after 1 April 2009 (and in the case of builders to improvements begun on or after that date) regardless of the taxpayer's balance date.

## Relocation payments and overtime meal allowances

The Bill provides that relocation costs and overtime meal allowances paid by employers to employees are exempt from income tax and fringe benefit tax in most circumstances.

For relocation payments to be tax-free, the following criteria must be met:

- the employee's relocation must result from them:
  - taking up employment with a new employer;
  - taking up new duties at a new location with their existing employer; or
  - continuing in their current position but at a new location.
- the employee's existing home must not be within reasonable travelling distance of the new workplace (unless accommodation is provided as an integral part of the new job);
- the expense must be on a list of eligible relocation expenses to be set by the Commissioner in a Determination;
- the payment must reflect the expenditure incurred; and

- the expenditure must be incurred within certain time limits.

For overtime meal payments and allowances to be tax-free, the following criteria must be met:

- the employee's employment contract must specify that the employee is eligible for a payment in relation to overtime hours worked; or
- an employer must have a policy or practice of paying overtime meal allowances; and
- the allowance must reflect the actual expenditure incurred by the employee; or
- be a reasonable estimate of the expected costs likely to be incurred by the employee.

The amendments are retrospective and apply from the 2002-2003 income year. Employers who have paid tax on qualifying payments in the past will be entitled to seek reassessments. We support the Government's decision to clarify the law in this area and to make the amendments retrospective. We look forward to the Commissioner issuing the Determination specifying the list of eligible expenditure as soon as he is able to do so.

## Payroll giving

The Bill introduces a voluntary payroll giving system that will enable employees to make regular donations from their salary or wages to charities of their choice. The system will enable employees to receive the tax benefit of their donations each payday without the need to retain receipts for donations.

The key features of the proposed system are:

- participation in the payroll giving scheme will be voluntary for employers and employees;
- payroll giving will be available only to employees whose employers file their monthly schedules electronically;
- employees who choose to make payroll donations will receive a tax credit on the amount of those donations each payday. The tax credit will be calculated at a set rate of 33 1/3% of the donation;
- the tax credit will be offset against the PAYE calculated on the employee's gross pay, reducing the amount of PAYE payable for that period; and
- employers will be responsible for ensuring that payroll donations are transferred to the selected charities within three months.

People who make donations other than through the payroll giving system will continue to claim the charitable donation tax credit at the end of the tax year.

The changes will apply from 1 April 2009.

## Threshold changes for SMEs

The Bill raises certain thresholds to reduce tax compliance costs particularly for small and medium-sized enterprises (SMEs).

The key changes are:

- the threshold for filing and paying PAYE once a month increases from \$100,000 to \$250,000;
- the threshold for filing FBT on an annual basis is raised from \$100,000 to \$250,000;
- closely held businesses will be allowed to file FBT returns annually, regardless of their annual PAYE and SSCWT deductions, when their FBT liability arises solely from the provision of up to two vehicles for shareholder employees;
- the safe harbour threshold for provisional tax use-of-money interest is increased from \$35,000 to \$50,000;
- the threshold for valuing closing trading stock at opening value increases from \$5,000 to \$10,000;
- non-individuals (such as trusts and companies) who meet certain criteria will be allowed to return income or expenditure for financial arrangements on a cash accounting basis;
- the threshold for allowing financial arrangements to be accounted for on a straight line basis increases from \$1.5 million to \$1.85 million;
- the threshold above which GST registration becomes obligatory increases from \$40,000 to \$50,000; and
- the threshold for filing GST on a six monthly basis moves from \$250,000 to \$500,000.

Businesses incur significant tax compliance costs. We support the Government's decision to amend the thresholds as this should assist SMEs to reduce their tax compliance costs.

The changes will apply from 1 April 2009.

## Life insurance tax reform

The Bill introduces comprehensive changes to the taxation of life insurance businesses. Under the proposals, income from a life insurer's business will be separated into shareholder income (income earned by the equity owners of the company) and policyholder income (income earned for policyholders from life insurance savings products).

Under the new rules, shareholder base income will be taxed at the corporate tax rate in a similar manner to other businesses. The current portfolio investment entity (PIE) rules will apply to policyholder income. Essentially this will mean that savers in life products will be taxed on their investment income at a maximum rate of 30%. This will mean that savers in life insurance products will now be taxed on their investment income in the same way as they are taxed on other investment products.

The new rules will apply for income years starting on or after 1 April 2009. However, a number of transitional rules will apply for life insurance products entered into prior to the new rules taking effect.

## Emissions trading scheme

The Bill amends:

- the Income Tax Act 2007 to include provisions governing the tax treatment of emissions units under the Government's Emissions Trading Scheme; and
- the Goods and Services Tax Act 1985 to ensure both the supply of emissions units and the actual, or deemed, supply of any services in exchange for emissions units are zero-rated for GST purposes.

Taxpayers will generally be able to claim a deduction for expenditure associated with meeting Emissions Trading Scheme obligations. Where taxpayers are allocated free emissions trading units, generally the Government subsidy of emissions costs will be assessable.

The specific tax treatment of emissions units varies depending on the emissions type as follows:

- non-forestry – generally dealt with on an accruals basis;
- post-1989 forestry – dealt with on a cash basis;
- pre-1990 forestry, where the land is held on capital account – outside the tax system; and
- pre-1990 forestry, where the land is held on revenue account – special rules will apply.

The Bill introduces special rules for the surrender of emissions units to the Government and for the timing of the recognition of income arising from the Government subsidy.

Emissions units will be treated as excepted financial arrangements that are revenue account property. Consequently emissions units will generally be deductible upon acquisition but added back at cost at year end to the extent they are still on hand.

The changes included in the Bill are linked to the tax amendments in the Climate Change (Emissions Trading and Renewable Preference) Bill that was introduced in December 2007 and is currently before Parliament.

## Other matters

The Bill includes amendments in a range of other areas including:

### Payments to volunteers

New rules clarifying the tax treatment of reimbursement and honoraria payments made to volunteers will apply from 1 April 2009.

The proposed rules provide that reimbursement payments to volunteers will be exempt income (and therefore not taxable) where:

- the payment is based on actual expenditure incurred by the volunteer; or
- the paying organisation puts in place a process for making a reasonable estimate of the amount of expenditure likely

to be incurred by a volunteer and the payment is based on that estimate.

Payments that are characterised as honoraria will be taxed under the PAYE rules. This also applies to payments that are partly honoraria and partly reimbursements.

## **GST**

The Bill includes changes to the GST Act to allow:

- certain loyalty programme operators to defer imposing GST until loyalty points have been redeemed; and
- exported second-hand goods to be zero-rated in certain circumstances when the exporter has claimed a second-hand goods input tax deduction.

The amendments will apply from the date of the Bill's enactment.

## **Right of non-disclosure**

The Bill amends a taxpayer's right not to disclose tax advice documents so that it applies to discovery and similar processes that occur during litigation with the IRD. The new rules will allow the Courts to have access to the facts (the tax contextual information) but not to the tax advisor's view of the facts.

The amendment applies to challenge proceedings filed on or after the date of the Bill's enactment.

## **Tax pooling**

The tax pooling rules are being amended to ensure the legislation reflects the original policy intent. Generally the amendments will apply from 1 April 2009. We will provide further detail in the next edition of Tax Tips.

## **Petroleum mining**

The Bill includes several changes to the petroleum mining tax rules. The key changes:

- ring fence the deductibility of foreign petroleum mining expenditure to foreign petroleum mining income applying retrospectively from 4 March 2008; and
- allow petroleum miners to amortise petroleum development and expenditure on a units of production basis or a straight line basis over seven years.

## **Remedial and technical amendments**

The Bill includes several remedial amendments to the portfolio investment entity (PIE) rules relating to the:

- eligibility criteria for becoming a PIE to ensure income under a lease of land derived by a PIE from an associated company does not count as qualifying income;
- allocation of tax credits received by PIEs;
- filing and information requirements; and
- investors' tax rates that are used by PIEs.

The Bill also contains several remedial amendments to the offshore portfolio share investment rules addressing the:

- venture capital exemption;
- Australian-resident listed company exemption;
- exclusion of managed funds from the grey list exception in the fair dividend rate (FDR) method; and
- comparative value method and currency conversion rules.

Other remedial amendments contained in the Bill relate to the research and development tax credit rules and KiwiSaver aimed at ensuring the legislation gives full effect to the policy intent of the regimes.