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Tax Bill reported back

The Finance and Expenditure Committee (FEC) has reported back to Parliament on the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill introduced in May 2007. The FEC has recommended a limited number of changes to the Bill following consultation with interested parties including PricewaterhouseCoopers.

The key reform measures included in the Bill are the introduction of compulsory employer contributions to KiwiSaver and a tax credit for employers that will reimburse them partially for their contributions to KiwiSaver; tax credits for research and development (R&D) expenditure; more tax incentives for charitable giving; and amendments to a range of tax penalties that are generally taxpayer favourable.

The Bill also amends the Income Tax Act to reflect changes following the adoption of International Financial Reporting Standards (IFRS) particularly in relation to the financial arrangements rules. In addition, it includes a number of transitional and consequential amendments relating to the new 30% company tax rate, remedial changes to the new offshore portfolio investment rules and portfolio investment entity (PIE) rules, and a range of other minor and technical amendments.

The Government's objective is for Parliament to pass the Bill before the end of December. Given that the R&D tax credit rules and many of the company tax rate transitional and consequential amendments apply from the beginning of taxpayers' 2008-2009 income years, it is essential that the Government achieves this objective.

KiwiSaver

The Bill includes a number of the enhancements to KiwiSaver announced in the Budget – principally compulsory employer contributions (phased in from 1 April 2008) and an employer tax credit of up to \$20 per week for each employee who joins KiwiSaver.

The FEC received many submissions calling for changes to the enhancements, a number of which were rejected, including;

- allowing people aged 65 or over to join KiwiSaver;
- extending eligibility for KiwiSaver member tax credits to people below the age of 18;
- allowing shareholder-employees in close companies (most companies with five or fewer shareholders) who have opted to be self-employed (i.e. not to have PAYE deducted from their salaries) to be eligible for the employer tax credit and the employer compulsory contribution;
- removing compulsory employer contributions; and

- capping the amount of an employee's gross salary or wages that is used to calculate the compulsory employer contribution.

Employee contributions

Some organisations submitted that the minimum employee contribution rate should be reduced from 4% to 2%. The FEC has not supported a reduction in the contribution rate.

For people who join KiwiSaver before 1 April 2008 the Bill proposes a transition period during which the minimum 4% employee contribution may be shared between the employer and the employee.

The FEC has recommended that the sharing of the minimum employee contribution rate (between employee and employer) be phased in as follows:

- 2% (of gross salary or wages) from the employee and 2% from the employer until 31 March 2010;
- 3% from the employee and 3% from the employer from 1 April 2010 until 31 March 2011; and
- 4% from each from 1 April 2011 onwards.

Employer contributions

The FEC has recommended that employer contributions for employees enrolled in a registered superannuation scheme under the terms of a collective agreement settled before 17 May 2007 (the date of the Budget announcements regarding KiwiSaver) should count toward compulsory employer contributions to KiwiSaver. This is intended to ensure that employees cannot 'double dip' – ie that they cannot receive employer contributions to both KiwiSaver and an existing superannuation scheme.

For similar reasons the FEC has recommended that employers be exempt from compulsory employer contributions to KiwiSaver if they are making contributions to a defined benefit scheme that meets certain criteria. The exemption should not affect the ability of anyone employed after 1 April 2008 (or on a collective agreement formed after 17 May 2007) to contribute to a KiwiSaver scheme or a complying fund for which employers will be required to make employer contributions.

Contributions to existing schemes have to vest immediately to the employee to count towards an employer's compulsory contribution.

Funding employer contributions

In response to many submissions questioning whether KiwiSaver should form part of an employee's total employment package, the FEC has recommended that the Bill be amended to provide that:

- any employment agreement provisions entered into before the enactment of the Bill, which in effect bind employees to fund the compulsory employer contributions through reductions in their gross salary or wages, will have no effect;
- initially, compulsory employer contributions will be in addition to current remuneration;
- after the date of assent of the Bill (likely to be in December), compulsory employer contributions may be offset in part against pay movements, subject to agreement between the employer and the employee concerned, as part of 'good faith bargaining'.

"Salary or wages" for KiwiSaver purposes

KiwiSaver contributions are based on an employee's gross "salary or wages". The FEC has recommended that the term "salary or wages" for KiwiSaver purposes should:

- exclude redundancy payments and accommodation benefits and allowances;
- include ACC weekly compensation and paid parental leave; and
- continue to be defined by reference to "gross base" salary and wages for the purpose of calculating employee deductions and matching employer contributions.

Member tax credits

Disappointingly Officials did not recommend to the FEC that it accept our submission that the member tax credit (of \$1042 per year) be available in full in the first year of membership regardless of when the member joins KiwiSaver, provided the member contribution is at least \$1042.

Home ownership

Subject to certain conditions a first home buyer is able to make withdrawals from their KiwiSaver scheme to fund their first home purchase. The FEC has recommended that 'second-chance' home buyers who have a determination from Housing New Zealand that they are in the same financial situation as a first home buyer be eligible for the first home ownership withdrawal.

R&D tax credits

The Bill introduces a 15% refundable tax credit for businesses in New Zealand that have incurred eligible expenditure on R&D activities. The Bill includes a number of significant changes to the R&D tax credit rules. These changes further narrow the scope of the initial proposals. The intention is to ensure that the R&D concession is sustainable and to avoid having to reduce its scope later. The Government's objective is to achieve stability and ensure the effectiveness of the R&D credit.

The FEC did not support submissions that called for:

- R&D tax credits to apply to R&D carried out on behalf of overseas affiliates. The Committee felt that the potential costs would outweigh the potential benefits (such as job opportunities) and did not want New Zealand taxpayers subsidising the R&D activities of foreign companies; and
- the removal of the general cap on internal software development. The majority considered that removing the cap would expose the Government to significant fiscal risk and pointed to the Ministerial discretion to raise the cap in certain circumstances. The Government will monitor the implementation of the rules on internal software development.

Definition of R&D

The FEC has recommended that the definition of 'R&D activities' be amended to refer to activities that "seek to achieve an advance in science or technology by resolving scientific or technological uncertainty". The Committee did not consider that this amendment would reduce the scope of the definition.

The IRD will provide guidance on the meaning of an 'appreciable element of novelty' in the draft guidelines which are due to be released in December 2007.

Support activities

In a bid to tighten the eligibility test for support activities, the FEC has recommended that these activities will only qualify as R&D activities if they are wholly or mainly for the purpose of the core R&D. The aim is to ensure routine business activities are not eligible for the R&D tax credit.

CRIs, tertiary institutions, DHBs

In line with our submission the FEC has recommended that the tripartite test of association (which means that if A is associated with B, and C is associated with B, then A and C are associated with each other) not apply in the R&D tax credit context. The Committee agreed that the test was too wide. This change will lessen but not remove the chance that inadvertently some businesses will be disqualified from eligibility to claim the tax credit by dealing with CRIs, tertiary institutions and DHBs on R&D matters.

Eligibility requirements – control, risk and ownership

In relation to the three eligibility tests:

- **Control:** Further guidance on the meaning of control will be provided in the guidelines.
- **Risk:** Claimants are no longer required to bear both the financial and technical risk. For clarity the Government has removed the reference to ‘technical risk’ on the basis that it is effectively a component of financial risk.
- **Ownership:** The previous requirement that a claimant “owns the results” has been amended to “effectively owns the results”.

Cap on internal software development

The cap which limits R&D tax credit claims for internal software development has been increased to \$3 million per income year. However, the limit will now apply to internal software development as both a core and a supporting activity. This was amended to prevent claimants reclassifying core software development activities as supporting activities.

The FEC has recommended that the definition of ‘internal software development’ be expanded to include software that is used for the internal administrative functions of the claimant or for providing the claimant’s customers with a service other than a computer service.

A welcome clarification is that the internal software cap does not apply to firmware such as software included in goods developed by the claimant mainly for sale. The emphasis here is on the software being intended for sale rather than for internal use.

Other amendments mean claimants will be able to seek a Ministerial waiver of the cap before the R&D expenditure is incurred and the Minister will be given the power to impose conditions on the waiver.

Joint/collaborative R&D

To allay concerns about the eligibility of R&D performed collaboratively, the FEC has recommended that the rules be amended to make it clear that the criteria (ie control of the R&D, bearing the risk and owning the results) will be applied to the collaboration. This means that, if the R&D is carried out by an unincorporated joint venture (UJV), the criteria will be applied to the UJV rather than the individual parties to the venture. If the joint venture meets the criteria, the parties to it will also be treated as having met the criteria.

A further change is that the R&D must be carried out on behalf of the claimant and not on behalf of someone else.

Capital expenditure on prototypes

The FEC has recommended that special rules will apply to restrict eligibility for certain types of capital expenditure on creating assets. The type of capital expenditure that will be eligible is expenditure incurred in seeking to create:

- a depreciable intangible asset that is the object of the R&D activities; or
- a depreciable tangible asset that is the object of the R&D activities (such as prototype or innovative plant) to be used

solely for R&D that is not subsequently used in the ordinary business or by an associate.

The Government will review how the rules for capital expenditure on prototypes are working in practice within the next three years.

R&D conducted overseas

For a project conducted predominantly in New Zealand the original proposals limited the amount of overseas R&D expenditure that could be claimed to 10% of the eligible expenditure incurred on R&D activities conducted in New Zealand.

The FEC has recommended that expenditure incurred overseas does not have to be incurred in the same tax year as that incurred locally on the same project. This means that, if there is an excess of overseas R&D expenditure in any given year, the claimant will be permitted to carry it forward so that it can be linked to any new local expenditure on the same R&D project. Where this happens, the carried forward expenditure will be eligible for the R&D tax credit in subsequent years.

Other changes include:

- eligible employee costs have been extended to include fringe benefits, fringe benefit tax, superannuation contributions, specified superannuation contribution withholding tax and insurances;
- expenditure deferred in accordance with the deferred deduction rules will be eligible for the R&D tax credit in the year it is incurred, even though the deduction for it will be taken at a later date;
- prepaid expenditure will be eligible in the year that it is deductible;
- the requirement to have a fixed establishment in New Zealand to be eligible will apply only to non-resident claimants and not to New Zealand resident claimants; and
- capital expenditure incurred in seeking to create a depreciable intangible or tangible asset will be eligible. This reduces the amount of black-hole expenditure that will not be eligible for the credit. The Government has placed black-hole expenditure on the tax policy work programme for further consideration.

Charitable giving

The Bill substantially removes the limitations which currently apply to rebates and deductions for charitable donations. From 1 April 2008:

- individual donors will be able to claim a 33 1/3% tax rebate on all charitable donations up to their taxable income; and
- companies (including unlisted close companies) will be able to claim a tax deduction for charitable donations up to their net income.

The amendments have been welcomed by the charitable sector and should assist in encouraging philanthropy.

The Government is currently undertaking further policy work on a range of other tax incentives for charitable giving, including a gift aid scheme (where the tax benefit of a donation goes directly to the charitable organisation rather than the donor) and tax relief for non-monetary donations. It is also considering the tax treatment of reimbursement payments to volunteers and honoraria recipients.

The FEC has not recommended bringing forward the amendments to the current income year to ensure donors do not “store up” donations until 1 April 2008 as this would have a fiscal cost which has not been taken into account in Budget 2007 and would require IRD systems to be amended earlier than currently planned.

Officials have noted certain issues raised in submissions for consideration in their ongoing review of tax incentives for charitable giving. These include:

- extending the entitlement to a deduction for charitable donations to sole traders;
- allowing individuals to claim tax relief for donations in excess of their net income; and
- enabling charities to use the imputation credits attached to dividends they receive.

Penalties

The Bill gives effect to the proposals set out in the Government's 2006 Discussion Document, 'Tax penalties, tax agents and disclosures'. Most of the proposals are intended to be taxpayer-friendly, to encourage voluntary disclosure and compliance, and to ensure the penalties rules are applied more consistently and fairly.

Shortfall penalties

Voluntary disclosure

The Bill provides that shortfall penalties for lack of reasonable care and for the taking of an unacceptable position will be reduced by 100% when a taxpayer discloses the tax shortfall voluntarily before notification of a tax audit or investigation.

Lack of reasonable care

Shortfall penalties will be imposed where taxpayers:

- fail to provide adequate information when seeking advice;
- fail to provide adequate instructions to tax agents;
- unreasonably rely on tax advisers or on advice that they have reason to believe is not correct; or
- have had a previous tax shortfall penalty imposed for the same error or action.

Officials consider that “adequate” should not be defined in the legislation, as “adequate” information or instruction will depend on the taxpayer's circumstances. However, they accept operational guidelines are needed in this area.

Unacceptable tax position

The Bill limits the scope of the unacceptable tax position penalty by removing GST and withholding taxes from it and by

increasing the thresholds for its application so that the penalty applies only if the tax shortfall exceeds both:

- \$50,000; and
- 1% of the taxpayer's total tax figure for the relevant return period.

It is disappointing that Officials recommended that the FEC decline submissions calling for the repeal of the controversial unacceptable tax position penalty and for the penalty not to apply when a taxpayer has exercised reasonable care.

The FEC acknowledges that there have been concerns about the penalty since it was introduced in 2003 but believes that the proposals in the Bill will deal with the majority of concerns about its application.

Abusive tax position

The Bill repeals the threshold for imposing an abusive tax position shortfall penalty. This means that, where a taxpayer's behaviour has the dominant purpose of reducing or removing a tax liability or providing tax benefits, a 100% shortfall penalty can be imposed for an ‘abusive tax position’, irrespective of the tax shortfall amount.

Late filing penalties

The Bill introduces a late filing penalty for GST returns that are not filed by the due date. A \$250 penalty will be imposed where a taxpayer accounts for GST on an invoice or hybrid basis and a \$50 penalty will apply to taxpayers using a GST payments basis.

Late payment penalties

The new rules require the IRD to notify a taxpayer the first time their payment is late instead of imposing an immediate late payment penalty. Taxpayers will be entitled to one such notification every two years. Disappointingly the FEC has not recommended reducing the period to one year. The Bill clarifies that the late payment notification will not apply to provisional tax payments.

Corporate tax rate change

The Bill includes a number of consequential and transitional amendments relating to the reduction in the corporate tax rate to 30%. Many of the amendments apply from the beginning of taxpayers' 2008-2009 income year.

The key amendments include:

- a change in the imputation ratio to 30/70 from the start of the 2008/2009 tax year. The current ratio of 33/67 will still be available until 31 March 2010 (the transitional period) for the distribution of profits taxed at 33%;
- from the beginning of the 2008/2009 income year corporate shareholders will receive only a 30% tax credit for imputation credits attached to dividends received when the dividends are imputed at 33/67. However, they will still receive a full 33/67 credit to their imputation credit account;
- the resident withholding tax (RWT) rate will remain at 33%, so imputing at 30/70 will result in 3% having to be deducted as RWT. The Government has announced that the RWT rates are under review;

- branch equivalent tax account and conduit tax relief credits and debits will receive a 3% 'haircut' from the beginning of the 2009 income year. This reflects the fact that, when the credits are used, the applicable tax rate will be 30%; and
- a new foreign investor tax credit (FITC) formula will apply when dividends are imputed at 30/70. This will still result in a FITC equal to the supplementary dividend. The 33/67 FITC formula continues for dividends imputed at 33/67.

The FEC has not supported submissions to extend the transitional period beyond 31 March 2010. It considers that any extension would require a dual imputation system which would have higher compliance and administration costs.

The FEC has recommended that widely held unit trusts and group investment funds that have not previously accounted for RWT on dividends be allowed to use the 30% rate.

IFRS

The Bill contains a number of changes to ensure that taxpayers who adopt International Financial Reporting Standards (IFRS) can continue to use tax rules that rely on accounting practice. The most significant change allows IFRS accounting methods to be used as a basis to spread income and expenditure under the financial arrangements rules.

Under the original proposals, taxpayers who prepared IFRS financial statements were required to use the IFRS accounting method to spread taxable income and expenditure under the financial arrangements rules. This rule was subject to a limited range of exceptions, principally where the taxpayer qualified to use certain Determinations issued by the Commissioner.

Despite pressure to defer the introduction of the new rules, the general application date for most taxpayers remains the current 2008 income year. In a positive move, Officials have recognised the adverse impact of volatility under the IFRS method, which can produce an unfair result for tax purposes particularly where taxpayers are not actively dealing in financial arrangements, and there are a number of favourable changes to the Bill.

These include a wider range of exceptions for taxpayers qualifying to use certain Determinations issued by the Commissioner and ordering rules that require some of those Determinations (eg for hybrids) to be applied instead of the IFRS method.

In a welcome development the FEC has recommended that the Commissioner should be able to accept late elections for using Determination G14B and G9C.

Two new methods

The FEC has recommended the introduction of the following two alternative methods of spreading income and expenditure under the financial arrangements rules, specifically as a carve-out from the volatility issue under the IFRS method:

- the expected value method; and
- the equity-free fair value method.

Taxpayers who satisfy certain conditions will be able to apply these methods to derivative financial instruments that are fair valued under IFRS and to foreign-currency denominated

financial arrangements. The methods will not be available to taxpayers who are in the business of dealing in the financial arrangement or, for consistency, if the arrangement hedges another financial arrangement for which the IFRS method has been applied.

Expected value method

This method requires taxpayers to spread a reasonable amount of income and expenditure based on expected payments. This means that any in-built gains and losses on these instruments would have to be spread in accordance with the objective of the financial arrangements rules.

Equity-free method

This method allows taxpayers to defer any gains or losses that have been reported in equity reserves under IFRS. This would apply to financial arrangements that qualify and are effective cash flow hedges or hedges of net foreign investments under IFRS.

PIE amendments

The Bill includes a number of amendments rectifying technical issues in relation to the portfolio investment (PIE) rules, including:

- any investors that are not unit valuers can now calculate FDR income arising from their investments daily, thereby eliminating the requirement to calculate 'quick sale' gains upon disposal of investments during the year.;
- the exclusion from the 'investor membership' requirement in the PIE eligibility rules has been broadened to include existing superannuation funds;
- the PIE eligibility rules have been amended to require those entities using the qualifying unit trust tests to do so on a class by class as opposed to entity basis; and
- start up and wind down concessions for PIEs in relation to 'investor in' eligibility criteria can now be determined on a class by class as opposed to an entity basis.

GST amendments

The Bill makes several amendments to the Goods and Services Tax Act, including in relation to:

- GST and consumable stores. The Bill clarifies that the zero-rating rules apply to consumable stores (such as fuel) supplied to aircraft and commercial ships that depart New Zealand or are present in New Zealand as part of a wider international journey;
- GST and shared tax invoices. This amendment simplifies the disclosures required on a tax invoice when two or more suppliers use one tax invoice to charge customers for supplies of goods and services. The change applies to suppliers that are in the same GST group or those suppliers who have a statutory obligation which makes it practical to use a single invoice. The FEC declined to recommend widening the amendment so that any two registered persons can issue a shared invoice but recommended that Officials look into the possibility of widening the scope; and

- GST and exported goods. The FEC has recommended that goods being exported should be zero-rated in the narrow class of cases where the purchaser arranges for the goods to be exported.

Other amendments

The Bill makes many other amendments including:

- several changes to improve consistency between the taxation of life insurance savings products and other forms of savings products arising from the introduction of the PIE and FDR rules. The changes in the Bill will require life insurers to adjust the way in which they currently calculate policyholder income. The FEC has declined requests to extend the capital gains exemption for Australasian shares to conventional life savings products. This is on the basis that it will be considered as part of the wider life insurance tax review. In the interim this will disadvantage policyholders holding conventional life insurance policies via other unit linked savings products;
- amendments addressing remedial issues in relation to the alignment of provisional tax with GST payments and the GST ratio method; and
- clarifying when the Commissioner can begin a new tax dispute and introducing three exceptions to the time limit. The FEC recommended that the proposed exception for failing to supply relevant information could create uncertainty and should be removed.

Finance leases

Following a request from the Minister of Revenue, the amendments relating to the finance lease rules in Supplementary Order Paper 119 have not been included in the Bill. The amendments proposed in SOP 119 sought to change the finance lease rules to require a certain type of cross-border lease to be classified for tax purposes as a finance lease rather than an operating lease from the beginning of an affected taxpayer's income year after 20 June 2007 (the date the Minister announced the proposed amendment). Following submissions expressing serious concerns about the retrospective effect of the proposed amendments, the amendments have been put on hold to allow further work to be done.